

# **International Political Economy: Some African Applications**

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## 1. Introduction

Political economy is about the sources of political power and its uses for economic ends. The sources of political power are coercion and legitimacy in varying combinations. Power can reasonably be seen as an objective in itself, so that both force and claims of legitimacy will be used so as to gain, retain and expand power. The study of this struggle for power is part of the subject of political economy. However, power is not just an end in itself: it can also be used to increase and to redistribute incomes. To further these objectives political power has two instruments: the provision of public and private goods financed by taxation, and the regulation of private economic activity. Political economy investigates how interests and institutions shape these choices.

*International* political economy, which is the subject of this paper, only arises because the struggle for power has produced an equilibrium in which there is a multiplicity of nations. This outcome is something to be explained as part of the subject. Not only is this the logical issue with which to begin international political economy, understanding the opposing forces that induce consolidation and fragmentation of nation states is particularly pertinent for Africa. The region is distinctive in having very many young and small nations. This aspect of political economy, which is concerned with the optimal size of nations, is the subject of Section 2.

While the basic questions concerning power and its uses remain the same whether the focus of political economy is national or international, there is a striking difference between them: there is no equivalent at the international level to the power concentrated in the typical national government. Governments at the national level are sovereign whether viewed from below, within the nation, or above, beyond the nation. The absence of a world government hugely constrains the scope for using the normal instruments of political power: public goods provision, taxation and regulation. In effect, at the global level governance is weak. This creates an unexpected parallel between international political economy and the political economy of the typical African state. Compared to the state in the typical developed country, the state in Africa is weak and ineffective. Both at the global level and in Africa the rule of law is fragile. Both international political economy and the political economy of Africa can therefore draw upon the new institutional economics of ‘lawlessness’.

The economics of ‘lawlessness’ is about what happens when agents lack reliable recourse to the public good of enforced justice for the purposes of economic transactions. When it is provided, enforced justice serves three important functions. First, justice protects the weak from the strong: all are equal before the law and this is often of most value to those who are not sufficiently strong to have other means of enforcement. When violence is unrestrained by law economic actors have an incentive to use it. The political economy of unrestrained violence was pioneered by Hirshleifer (2001), who called it the ‘dark side’ of the force of economic incentives. Second, justice protects all agents from opportunism. Because agents can subject themselves to the public good of enforcement mechanisms all are empowered to bind themselves to a commitment. This overcomes the

myriad difficulties that time-inconsistency would otherwise present to inter-temporal economic transactions. Such transactions predominate in all but the most primitive economic relationships. Where such transactions are prohibitively expensive, development is likely to be severely retarded. The political economy of opportunism has recently been expounded by Dixit (2004). Third, enforced justice is the meta-public good that enables other aspects of collective action to be enforced, most notably taxation and regulation. This in turn permits the provision of public goods and the curtailment of public bads. When enforced justice is absent this is not possible. The political economy of global public goods and bads is well expounded by Sandler (2005) and Barrett (forthcoming).

Enforced justice is a public good that can only be supplied by an effective government: it cannot be well-provided by the private sector. As Dixit shows, a purely private enforcer would have both the ability and the incentive to extort: clients would become victims. Effective laws thus need effective governments to enforce them. In conditions of 'lawlessness', or more generally where law enforcement is fragile, agents will need to develop substitutes. The weak will need to protect themselves against the strong as best they can, all agents will need strategies for countering opportunism, and *ad hoc* arrangements will sometimes be able to overcome the collective action problem for public goods and bads. Hence, the study of international political economy involves both the problems that international 'lawlessness' creates and the potential solutions to these problems. This is the subject of Section 3.

Where enforced justice is lacking some problems are more amenable than others to alternative solutions. Hence, both at the international level and among African states, there is a patchwork. The coexistence of patchy governance globally and in Africa creates a potential opportunity. In some areas where African societies have been unable to find substitutes for missing justice, substitutes are available at the international level. In such areas there may be some scope to draw on these international substitutes to alleviate the costs of missing governance to Africa. This is the subject of Section 4.

## **2. How Many States?**

Why is there no 'world government'? During the eighteenth and nineteenth centuries states rapidly consolidated: for example, Germany shrank from having over 300 states to having one. Even the USA consolidated: before 1860 the term 'United States' was a plural noun: *they were* alliance. Only after the shift of power to the centre due to the civil war did the term change to the singular: *it was* a single country. Similarly, during the nineteenth century four massive empires developed: the British, French, Russian and Austrian. Evidently, there were powerful economies of scale that drove these consolidations. Why did they not drive the process all the way to a single government for the world, and indeed, in the case of the empires actually get reversed?

Three distinct theories suggest that there is some optimal size to government that is likely to stop short of being global. The first reflects the balance between military economies of scale versus the mounting costs of maintaining a monopoly of force as the size of nation

or empire gets bigger. The bigger the army the better its chances of winning and this obvious scale economy favours large nations. However, as nations and empires expand both the distance that the army has to travel, and the length of the frontier, increase. Further, they take in increasingly culturally diverse people, and this is likely to reduce their sense of legitimacy and so increase the costs of enforcement. Hence, there is a margin at which these factors offset the military scale economies and the expansion comes to an end. The world has seen some vast military empires, but all have encountered limits well short of global dominance. The theory of these offsetting military forces is set out in Findlay and Wilson (1987). The advantages that accrue to component societies as a result of belonging to an empire are set out in Lal (2004). These advantages are basically the avoidance of the problems of international 'lawlessness' that are set out in Section 3.

The second approach reflects a broader view of the state than mere military dominance: it supplies a range of public goods to people with different preferences. As the state gets larger it includes a more diverse range of preferences and so while the scale economies of production for any one type of good are greater, the state gets less and less able to satisfy these diverse demands. Beyond some point, the people of the periphery are better served setting up their own state and supplying public goods for themselves, which although more expensive are more in accordance with their wants. This is set out in Alesina and Spolaore (1997).

A third possible theory of the size of the state concerns scale economies in the production of *private* goods: states need to be sufficiently large to exhaust these economies. For any good which is internationally tradable, such scale economies have no implications for the size of the state: a small state such as Switzerland can specialise in pharmaceuticals, an industry with massive knowledge economies of scale, because its market is global not national. Scale economies therefore only matter for non-tradable goods. The general view is that such scale economies cannot be important otherwise there would be a relationship between the size of nations and their overall economic performance, and there is no evidence for such a relationship. However, the lack of a significant relationship at the global level may well disguise a significant relationship that only sets in at the very end of the size range – the tiny economies that characterize much of Africa. One potentially important type of non-tradable good subject to strong scale economies is media which are specialized on financial, economic and political discussion of government policies and performance. As with other knowledge-based activities such as pharmaceuticals, there are strong economies of scale in production, but unlike pharmaceuticals, the market for a discussion of national policy issues is very largely non-tradable: few people outside Switzerland wish to purchase a discussion of Swiss policy. Where such media exist they enable an informed consensus to develop that can then be communicated to a larger group of the population through other media channels. India is sufficiently large to support such specialized media, but Burkina Faso is not. Hence, the level of understanding of policy and governance is liable to be lower in small societies. One way in which they can avoid the problem is if they are closely integrated into the policy debates of larger countries. Switzerland probably avoids any of these knowledge costs of being small because it is not isolated from larger societies: it can learn from the

specialized media of Germany, France and Italy. But a society such as Burkina Faso lacks a large society which is sufficiently proximate and similar for its policy discussions to be pertinent. This theory would predict that very small economies will be less likely to have good policies and governance because of the lower quality of public debate. Recall enforced justice is the meta-public good from which all else follows. On this thesis, the small size of the typical African nation may make the supply of enforced justice more difficult. If this is correct, it has considerable repercussions: without enforced justice citizens face the three problems of abuse of power asymmetries, unchecked opportunism, and the undersupply of public goods.

A satisfactory theory of the optimal size of the state might include all of these considerations: scale economies in military force, public goods, and private non-tradable goods, versus the mounting costs of size and diversity. However, even as sketched above, it has implications both globally and for Africa.

The global implication is that the world is divided into many nations because a world government would very likely be hugely inefficient. People are better governed by having many nations. 'Lawlessness' at the international level, which is a consequence of the absence of a global authority, creates problems which will be discussed below. However, they are not as serious as the problems that would be generated by enforced global justice. The lack of a world government is not something to lament.

How about the implications for Africa? Sub-Saharan Africa fragmented from three empires into 44 sovereign nations because the costs of empire rose and the benefits declined. The costs rose because of the radical decline in the sense of legitimacy of empire, so that opposition to membership mounted. The benefits to the imperial nations declined as the empires became unnecessary for the maintenance of trading relationships. As discussed below however, it is notable that at the same time as the old European-led empires were dissolving, European states themselves invented the new technology of a 'consociation empire' for themselves. Consociation provided the legitimacy with which to override national sovereignty. Thus, just as African societies were gaining national sovereignty, European societies were dissolving theirs into the European Union.

Does an Africa of 44 nations have too many nations or too few? A common critique of colonialism is that it amalgamated social groups arbitrarily creating a difficult legacy of multi-ethnicity. This particular criticism of colonialism seems to me to be radically misplaced. Africa has around two thousand ethno-linguistic groups. It would clearly be absurd for Africa to be divided into two thousand countries: the nations would be far too small. Looked at from the perspective of other regions, Africa already looks to have far too many countries, not too few. All nations are consolidations among distinct ethnic groups: that is an unavoidable feature of nation-building. A more pertinent critique of colonialism is that it probably prevented this process of consolidation in Africa.

Consider in turn how the three criteria for optimal size relate to Africa: military force, public goods, private non-tradable goods. Is there any evidence that the typical African state is too small or too large?

In terms of military force there is some evidence that the typical state is too small to maintain order, rather than too large. Evidently, as the size of states is increased, the scope for international war is reduced and the scope for civil war is increased. Africa has had very little international war, so the gains from reducing it had there been fewer countries would have been modest but unambiguously either positive or zero. The key issue is therefore whether there would have been more or less *civil* war. The evidence on this comes from two quantitative studies of how population size affects the risk of civil war (Fearon and Laitin, 2003; Collier and Hoeffler, 2004). Both studies find that a doubling of population size, such as would occur were two typical African societies one nation instead of two, would result in the new nation having a higher risk than each of its component societies individually, but a lower risk than that faced by both the societies viewed together as separate nations. Restated, the risk of civil war in a nation formed of Kenya-Tanzania-Uganda-Rwanda, would have had a higher risk of civil war than that faced by each country separately, but East Africa would overall have been less likely to have civil war on its territory.

In terms of public goods provision there is no corresponding evidence. All that can be said is that the much greater ethnic diversity of the typical African society than societies in other regions would, on the criteria of Alesina and Spolaore suggest that their optimal size would indeed be smaller.

Finally, in terms of private non-tradable goods, notably knowledge about government performance, there is again evidence that the typical African country may be too small. Chauvet and Collier (2005, 2006) study globally the process of how low-income countries break out of initially poor policies and governance through decisive reform. They find a strong global relationship that larger population size makes such reform much easier.

Despite these suspicions that the typical African nation may be too small, since the dissolution of empires the dominant force in Africa has been to split nations further rather than to merge them. As discussed below, the extent of the regional integration of political power has been very limited both absolutely and relative to that in other regions. One secession has been admitted legally, that between Ethiopia and Eritrea. Currently there are three further *de facto* secessions: in Cote d'Ivoire, DRC, and Somalia, and a prospective legal secession in Sudan should the population of the south vote for it in the forthcoming referendum. Indeed, Somalia points to a lack of momentum towards state expansion of an extraordinary degree. Despite the absence of a functioning state for fourteen years, no neighbouring state has intervened to incorporate all or even part of the territory.

### **3. Consequences for Africa of International 'Lawlessness'**

The weakness of political authority at the international level has a consequence: the lack of an enforceable international legal system. In turn this creates three problems. First, international power asymmetries will not be restrained, so that the powerful can abuse the

weak. Second, unchecked opportunism will raise the cost of transactions that are transnational. Third, there is no power to tax or regulate, and so global public goods will be radically undersupplied and global public bads will be unrestrained. Each of these has consequences for Africa and I group the discussion around them. Sometimes there is scope for *ad hoc* solutions that do not require the existence of a global government.

### ***The abuse of international power asymmetries***

Historically the most obvious abuse of international power relations for Africa was colonialism: this is where I start the discussion. Colonialism is over but power asymmetries persist and I consider how this affects inter-government bargaining on the rules of international trade, and bargaining between African governments and international firms on the returns on investment.

### ***Colonialism, extraction and institutional transfer***

Colonialism was universally an affront to freedom and dignity, but its economic consequences varied greatly depending upon its rationale. Acemoglu *et al.* (2000) distinguish between those colonies whose rationale was resource extraction, and those where there was sufficient settlement that the colonizers had an incentive to promote development. In the former case colonization was ruinous: the Belgian Congo provides one of the most grotesque illustrations in history. However, in the latter case, where colonizers had an incentive to promote development, colonies gained a double economic benefit. One was the transfer of growth-enhancing institutions, as emphasized by Acemoglu *et al.* The transfer of economic institutions can be so beneficial that sometimes sovereignty has been voluntarily relinquished in order to gain the benefits of reduced transaction costs. For example, in medieval Europe hundreds of sovereign towns chose to turn themselves into the quasi-colonies of other towns by asking to adopt their legal charters as models (Bartlett, 1993). Disputes about transactions in the ‘colonial’ town would then be settled by adjudication in the ‘imperial town’. The ‘imperial’ or ‘charter towns’ as they were known, exported enforced justice. The other benefit of being a colony was membership of an international trading system. Whereas the transfer of institutions lowered the cost on internal transactions, membership of an international trading system reduced the costs of international transactions. This benefit is the one emphasized by Lal (2004).

While colonialism is long over, its effects remain pertinent. Acemoglu *et al* (2000) argue that globally the two distinct institutional legacies of colonialism, extractive versus institutional transfer, have proved highly persistent beyond the dissolution of the empires that generated them. Their celebrated result is that where settler mortality rates were too high to sustain any economic activity other than resource extraction, the institutions have remained dysfunctional for development. However, although globally their analysis has good predictive power, it does not explain intra-African variation. Either all African colonies were predominantly extractive, or where beneficial institutions were transferred they were insufficiently rooted and so did not long survive independence. This yields two rival international political economy accounts of post-independence African economic

performance. The former, based on the view that all colonies were extractive, would see post-independence economic stagnation as being due to the persistence of anti-developmental colonial institutions: *independence failed to uproot dysfunctional institutions*. The other would accept this for a group of extractive colonies, such as the Belgian Congo, but would argue that elsewhere decolonization arrested fragile institutional development and so adversely affected economic performance: *independence uprooted functional institutions*. Distinguishing between these hypotheses would be an interesting research question.

The other reason why colonialism remains pertinent is that because Africa is richly endowed with natural resources under the sovereignty of small and weak countries, even post-independence it faces a potential problem of extractive quasi-colonialism. A famous post-colonial description of the relations between France and Africa proposed that 'France without Africa is like a car without petrol'. This strategy has continued to have practical consequences. For example, the successful rebellion that enabled President Sessou to seize power in Congo Brazzaville was helped by substantial finance from ELF, which was followed by a generous concession awarded by President Sessou to ELF. Similarly, by the time Laurent Kabila became president of DRC he had reputedly already signed up \$500m of resource extraction contracts. Even within Africa there are extreme asymmetries of power. President Kabila granted valuable concessions to President Mugabe and the army of Zimbabwe in order to buy what were in effect mercenary defence services.

What can be done to defend resource-rich African countries against the adverse consequences of international power asymmetries? One promising approach is the Extractive Industries Transparency Initiative (EITI). This is a voluntary international standard relating to transparency in resource extraction to which several African governments have now committed themselves. If ELF and President Mugabe had known that their resource extraction deals would be subject to the EITI they would have had less incentive to invest in violence.

#### *Power asymmetries in setting the rules of international trade*

A less extreme, but still substantial area of power asymmetries concerns international trade. Probably the issue on which power asymmetries have been most important for Africa is intellectual property rights.

Knowledge is a public good unless artificially restricted and public goods have the wonderful advantage of non-rival consumption: everyone can eat the same apple. There are, however, good reasons for restricting it: property rights create the incentive for investment in knowledge. There is thus a trade-off between the static benefits of non-rival consumption and the dynamic benefits of knowledge generation. The correct point on this trade-off is a social choice. Now comes the key point: *the optimal trade-off differs radically and systematically between societies*. The further is a society from the global knowledge frontier the more it can benefit from catching up. Africa, which is farthest from the frontier, thus has an overwhelming interest in global knowledge being a public

good. By contrast, a society such as the USA which is at the frontier, has a strong interest in global knowledge being a private good.

The WTO regime on intellectual property rights is characterized by three major errors. The first is that has adopted a *common* regime for all countries. Any common regime is bound to be grossly inefficient: rights need to be differentiated according to the distance of the country from the knowledge frontier, which would be well-measured by its per capita GDP. Secondly, because of international power asymmetries, the WTO has adopted the US standard of property rights as the global standard. By setting the standard adopted by the country closest to the frontier, this destroys far too much of the public good properties of knowledge for the typical global citizen, and radically too much from the African perspective. Third, the WTO has made these property rights retrospective. Since the investment for existing knowledge has obviously already been made, based on calculations that did not include this global extension of rights, the granting of retrospective rights has no incentive effect whatsoever and creates a pure windfall for the owners of existing knowledge financed by a highly regressive transfer from low-income countries.

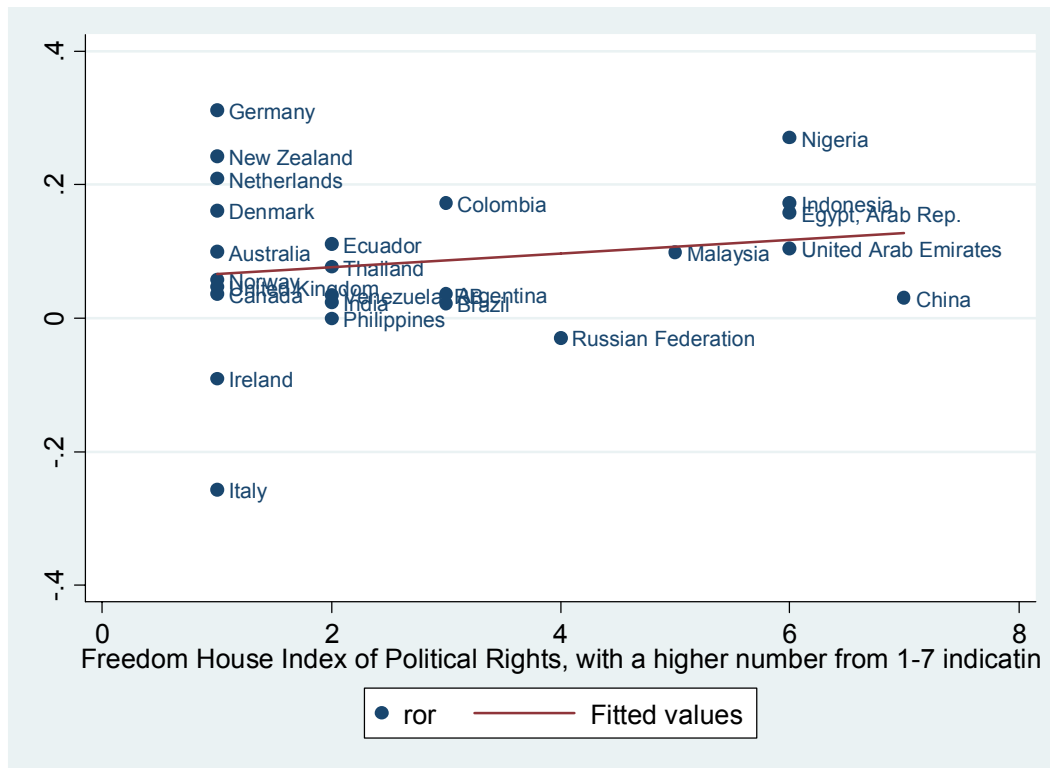
The current intellectual property rights regime of the WTO is thus a grotesque example of the abuse of global power asymmetries. Research could usefully quantify the resulting income transfers.

#### *Big firms, small countries*

Now consider the relationships between African governments and international firms. The obvious popular image is of a small and ill-informed government having to negotiate with a large and sophisticated international firm. The implied radical power asymmetry is often used to justify corruption: better to force the firm to pay something over-the-odds, even if it the proceeds do not accrue equitably.

There is indeed some recent evidence that large foreign firms have profited excessively from their relations with African governments. An unpublished analysis of the rate of return on investments by American oil companies overseas, analysed by Margaret Macmillan of Tufts University, finds that the return on their investments in Africa has been high. While some of this will reflect a reasonable competitive return for taking higher risks, a component seems likely to be rents: African countries have been getting a bad deal from foreign oil investment. As shown in the graph, the rate of return is systematically increasing in the lack of political rights as measured by the Freedom House Index, and Nigeria at the end of the Abacha era was the setting for one of the highest rates of return in the world.

**Figure 1: The Rate of Return on US Oil Company Investments, (1999 only), Related to the Freedom House Index of Political Rights**



Source: Margaret Macmillan

Thus, far from this justifying corruption, the prevalence of corruption in such contracts provides the most likely explanation for the high returns. Opportunities for corruption depend upon non-transparent systems of awarding contracts such as oil concessions. In turn, systematically high returns on investments depend upon non-competitive access to contracts: corruption purchases monopoly. Hence, the defence against the excessive power of large foreign firms is to require them to compete openly against each other. Even in the oil industry no international firm is sufficiently large to have market power against even the smallest African government: with open competitive tendering, African governments can use the power of one large oil company against another. The tendency of African governments to seek to redress the power imbalance by establishing national oil companies that then do business in a secretive manner has likely radically weakened the true bargaining power of African governments relative to what could have been achieved through a transparent system of international competition.

*The 'paradox of power'*

Despite the above examples, Africa's extreme weakness is not as damaging as it might seem. Hirshleifer (2001) demonstrates that there is a simple 'paradox of power' which tends to shield the poor from the rich even if they are much weaker. This is that although

the rich have the power to exploit the poor, the returns to doing so are modest precisely because the poor do not have much to exploit. The rich are generally better served by using their resources for productive rather than redistributive objectives which is why redistribution tends to take place from the rich to the poor rather than in the direction which would be predicted based only on the power imbalance. Being weak and poor, Africa is not so much exploited by the strong and rich as patronized and ignored.

### ***Unchecked Opportunism and the Cost of International Transactions***

The weakness of enforced justice at the global level potentially exposes international transactions to the risk of opportunism. Exposure depends, however, upon whether the countries involved in the transaction themselves have reliable enforced justice at the national level. Suppose that the transaction is between firm 1 in country A and firm 2 in country B. Then if both A and B have enforced justice at the national level both firms are safe from opportunism. If firm 1 defaults on a commitment, firm 2 can appeal to the courts in country A and the impartial justice system in A implies that firm 1 is not at an advantage. Conversely, if firm 2 defaults on a commitment, firm 1 can appeal to the courts in country B. Hence, the deficiencies of enforced justice at the international level only matter where the international transaction involves at least one country which itself does not have reliable enforced justice. What happens then? I first consider inter-firm relationships and then revisit the issue of transactions between African governments and foreign firms.

### ***Transactions between African firms and foreign firms***

Much of the work on the economics of lawlessness has focused on contract enforcement between firms, and especially upon how firms can guard against opportunism in the absence of enforced justice. Firms can substitute for the lack of justice by relying upon long term relationships, with the implicit threat that opportunism will be punished by ending the relationship. The dilemma is that the transactions that have the potential to be most mutually profitable are those between firms which are very different, and such pairs of firms are less likely to know each other in the first place. These problems are particularly pertinent for those African firms which are newly entering international trade.

The problem is made more acute by the coexistence of two different enforcement systems. The typical African firm has learnt to operate in an environment of fragile law: the formal legal system is slow and unreliable because of corruption. The firm therefore tends to depend upon extra-legal enforcement, notably the information flows and opportunities for sanction generated by repeat transactions with firms owned by people within the same tightly knit social network. Dixit (2004) shows that if the network grows beyond a certain point it becomes less effective: enforcement requires that the group stays relatively small and tight. The ethnic minority communities within Africa have an evident advantage in such an environment. The typical firm in a developed economy such as the USA operates with much greater reliance upon legal enforcement of contracts. As a result it does not need to restrict transactions in this way: it can safely enter into one-off

transactions with firms it knows little about because they can be enforced by the law. Now consider a possible new international transaction between an African firm and an American firm in which both firms are exposed to the possibility of opportunism by the other. There is now an asymmetry: if the American firm defaults the African firm can seek justice in the American legal system where it will not be disadvantaged by being an outsider. By contrast, if the African firm defaults the American firm has recourse only to the African legal system where justice is unreliable and it is likely that the local firm is at an advantage. Knowing this, the American firm will decline the transaction. More generally, given its knowledge, the American firm will not seek out opportunities for such transactions. To do business internationally, the African firm will need to find partner firms abroad within its own social network. This again advantages Africa's ethnic minorities: a Patel in Kenya can trade more readily with a Patel in California than a Kikuyu-owned firm in Kenya can trade with General Motors.

The problem is somewhat analogous for FDI. An American firm, other than one from an appropriate ethnic minority, which is thinking of investing in Africa will know that it is entering an environment in which it lacks the social network for the enforcement of local contracts. Thus, the coexistence of an international economic system largely reliant upon legal enforcement, and an African system largely reliant upon extra-legal enforcement, has two important consequences. First, many opportunities for profitable transactions are likely to be wasted. Second, African business is likely to be dominated by ethnic minority networks, which while they are efficient responses to the problem of enforcement, are also inherently uncompetitive, being highly susceptible to cartels.

What are the solutions to this problem? Obviously, in the long term the solution is to reform the African legal environment. However, this may be difficult. Further, as Dixit shows, along the way an improving legal environment may actually make informal enforcement more difficult before it delivers a very efficient substitute. An alternative to reforming the legal system is to reduce the costs of its malfunction. One of these costs is the lack of competition among domestic firms. However, at least for internationally tradable goods this cost can be substantially reduced by trade liberalization: even if local firms will not compete with each other, they can be exposed to competition from imports. Another major cost is that export opportunities for African economies might be missed. One solution to this problem is to permit exporting firms to enter into agreements with foreign firms for binding international arbitration. In effect, legal services become a tradable good and are imported, breaking the monopoly of the local judiciary. Such competition may also make judicial reform easier: faced with the loss of cases, African courts might have an incentive to improve. Another solution, which is complementary, is to improve publicly available information about local firms through encouraging, and possibly temporarily subsidizing, credit rating systems (Fafchamps, 2004). The case for a temporary subsidy is that in a system in which contract enforcement is by means of ethnic social networks, the existing firms do not need to use the credit rating agency, whereas the firms that would use it do not yet exist. The economics of a credit rating agency in such circumstances are somewhat analogous to the establishment of other network goods such as a telephone system: initial users generate large externalities and so warrant subsidy.

*'Big firms, small countries' revisited*

The commitment problems faced by African firms are greatly exceeded by those faced by African governments. Like other governments, African governments are sovereign and so are not subject to any higher legal system to which firms can appeal in the event of a dispute. All sovereign governments have potential problems arising from their inability to commit themselves: they face a time consistency problem.

I start with a practical African example: the relations between the small country of Guinea, and the huge American aluminium company ALCOA. For many years the company mined bauxite in Guinea but decided not to process the bauxite before export. This was despite very large economic gains from processing within the country: transport costs would have been radically reduced. Because of these potential gains the company repeatedly reconsidered its decision but always arrived at the same conclusion. The reason was that to process bauxite in the country would have involved an irreversible investment of around \$1 billion, and the company feared the resulting time-consistency problem. Once the investment was installed, the company would only be able to get a return on it if the government refrained from capturing the returns itself through confiscatory taxation. The government had no way of committing itself not to pursue this course of action which would be rational once the investment had been made. Hence, despite the massive scope for mutual gains the investment was not made.<sup>1</sup> The government of Guinea, and the country, both lost because of the inability of the government to commit itself. Paradoxically, the government of Guinea was too powerful relative to ALCOA for its own good!

The severity of the problem of excessive sovereignty evidently depends upon the reputation of the government. The reputation of a government depends partly upon the conduct of previous governments of the same country, and partly upon the conduct of other governments regarded as similar. The speed with which reputations are revised to reflect current behaviour of the government concerned depends upon the amount that foreign firms are willing to invest in information. African governments are at an acute disadvantage in all three respects. First, most African countries have been through a phase of poor governance so that the legacy is a poor reputation even if currently unwarranted. Second, because most African countries are small, more weight is likely to be placed on the reputation of the neighbourhood than, say if firms are making an assessment of China or India. Pakistan can fall apart without firms down-rating either China or India, but when Cote d'Ivoire falls apart that may lead to a down-rating across West Africa. Third, because Africa is economically small, less money will be invested in current information, so that reputation is likely to be react more slowly to improvements in the African environment.

A reforming African government thus needs instruments which accelerate the improvement in its international reputation. One approach pioneered by the government of Senegal is to invite and pay for a rating by the international commercial rating

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<sup>1</sup> Source: personal communication with the ex-chief executive officer of ALCOA, Paul O'Neal.

agencies such as Standard and Poor's. Many international investment funds are subject to rules that prevent them from investing in countries that lack an 'investment' grade rating. Thus, purchasing such a rating is analogous to pump-priming a domestic credit-rating agency. It provides verifiable information for investors. Until the rating is in place the investors who would use such a rating are not interested in Africa.

### ***International Public Goods and Bads***

The absence of international enforcement of justice makes it much more difficult to supply international public goods and to regulate international public bads. Some of these are global and so need action at the global level, others are regional and so require only international action among African governments.

#### *Global public goods and bads*

Other things equal, the poor have more to gain from public goods than the rich, for the simple reason that they are less able to benefit from the consumption of private goods. Hence, there is some presumption that the failure of provision of global public goods hits Africans harder than others. This is compounded by the fact that on any reasonable system of payment, were global public goods provided, Africans would not need to contribute much. However, although global public goods by definition benefit all countries, Africa has a stronger interest in some than in others. For example, it would gain disproportionately from global disease control, but would probably gain relatively little from the control of international terrorism. Global power imbalances help to shape which global public goods are best supplied and this is obviously to Africa's disadvantage. There is also potentially some conflict between the money needed for global public goods and the money needed for aid to Africa. Both come from the very limited funds that the governments of rich countries find politically able to devote to international well-being.

While Africa has a strong interest in general in improving the provision of global public goods, for some of them it is an important obstacle to better supply. This is because some public goods are subject to the 'weakest link' problem: the amount of the public good available globally depends disproportionately upon the country that does the least to contribute. For example, in the global eradication of smallpox the last country in the world to eliminate the disease was Somalia in 1974. Had eradication been delayed by two decades it would have become infeasible because of the collapse of the Somali state. Sometimes the weakest link problem is more severe: the country actually profits from being the weakest link. An important example is the regulation of international shipping. The high seas are relatively lawless: as long as a ship is registered by one internationally recognized government it can operate virtually anywhere. This has produced a 'race to the bottom' in terms of regulatory standards through 'flags of convenience'. Around one third of the world's shipping is registered in Liberia, one of the weakest governance environments in Africa. It is ironic that a country with such extremely weak governance should be exporting global governance services for shipping on such a major scale. The

problem arises because Liberia makes a profit out of registrations and so has an interest in setting standards that are sufficiently low to attract them.

### *Africa's regional public goods and bads*

Potentially, intra-African arrangements would be more suitable than global arrangements for the supply of regional public goods and the regulation of regional public bads. Because Africa is so fragmented into countries, many public goods which are national in large countries such as China, India and the USA, are regional in Africa and so the need is markedly greater.

The most obvious need for a regional public good in Africa is probably inter-state transport routes. However, such transport corridors encounter the problem of extreme power imbalances: in conditions of 'lawlessness' the weak have little defence against the strong. In particular, landlocked African countries are dependent upon their coastal neighbours in a way that is not reciprocal: Niger is acutely dependent upon Nigeria, but Nigeria is not dependent upon Niger; Uganda upon Kenya, but not Kenya upon Uganda; Ethiopia upon Eritrea, but not Eritrea upon Ethiopia.

A second regional public good is a trans-national electricity grid. The problem here is to police free-riding. Once in the grid, no country has an incentive to provide capacity for peak loads, and so the grid can only work either if one country is so dominant that the free-riding of others does not matter, as in the southern Africa grid, or if there is an effective system of incentives for sharing the burden of investment in capacity.

The regulation of regional public bads potentially includes such diverse issues as disease control, military insecurity, and trade restrictions. The rapid spread of polio across Africa once one Nigerian state had decided to cease vaccination illustrates the need for regulation: local politicians had chosen policies with massively adverse externalities for other African countries without, as far as can be seen, any significant peer pressure to desist.

The need for cooperation on security comes partly from neighbourhood arms races. African governments set their military spending with reference to each other and so, in the absence of coordination, it is significantly higher than it would be if all agreed to limits (Collier and Hoeffler, 2006a). This feature makes it a regional public bad. Because the chain of neighbours spreads across the continent and includes so many countries, local deals to limit spending are generally not feasible: only a pan-regional arrangement could be effective. Clearly, the key problem is one of enforcement: governments would need to be assured that their neighbours were in compliance through verifiable information. Thus, an effective agreement requires an effective monitoring mechanism. The main security threat facing African governments is not from their neighbours but from their own armies: coups continue to be frequent: Cote d'Ivoire, the Central African Republic, and Mauritania are all recent examples of successful coups. At present, African governments defend themselves against the coup threat by raising military spending, presumably to buy off the military lobby (Collier and Hoeffler, 2006b). Thus, an effective

neighbourhood defence against coups would both prevent the current phenomenon of illegitimate changes of regime and reduce the need for military spending. In Latin America the Mercosur pact included an anti-coup safeguard.

The best-studied attempts to regulate regional public goods have concerned trade restrictions. Africa has had an enormous number of attempts to build regional trade groups. Although there are a plethora of regional agreements, the only fully functioning customs union is SACU. The other agreements have left each country free to set its trade barriers against non-members. Where governments felt like doing so, they have ignored regional agreements without penalty. The agreements are expressions of aspiration, rather than institutions: that is, they do not include incentives that induce changes in government behaviour.

All the above regional public goods and bads would be suitable subjects for research within the framework of international political economy with a focus on how credible incentives for compliance could be constructed.

#### **4. Using the International System to Counter African ‘Lawlessness’**

‘Lawlessness’, or less dramatically, a system of enforced justice which is unreliable, characterizes both the international system and much of Africa. So far, I have considered how weaknesses at the international level affect Africa. Now I change the question: given weaknesses at the national level in Africa, to what extent can international arrangements, deficient as they are, provide a remedy or a substitute? As at the international level, the three practical problems consequent upon weak governance are the abuse of power asymmetries, the failure to check opportunism, and the failure to supply public goods. But now these problems arise at the level of the nation.

What is the scope for Africa to internationalize those aspects of governance that work least well at the level of the typical African nation? Potentially, it can internationalize by using any or all of the models adopted by developed countries. These include ‘consociation empires’ that pool sovereignty among countries in the region such as done by the EU; voluntary systems of peer pressure such as the OECD; and *ad hoc* global institutions such as the WTO and the IMF.

##### ***The abuse of intra-national power asymmetries***

In many African countries there has been a long history of power imbalance: some groups are excluded, and groups that are in power abuse it to redistribute to themselves. The attempt to rectify this entirely through internal struggle can take a long time and can be extremely costly. Historically, in Europe external pressure was important for broadening effective representation. The threat of external conflict created the need for high military spending which in turn forced governments to seek compliance to high taxation. The price of compliance in taxation was political representation and scrutiny of government (North and Thomas, 1973). In Africa these pressures are radically weaker: states are generally not threatened externally, and large aid inflows and natural resource

rents further reduce the need for domestic taxation. Can Africa use other forms of regional or global international pressure to offset internal power asymmetries within its states?

### *Pan-African defence of the weak*

Both NEPAD and the AU are important recent attempts by Africans to address the problem of internal power asymmetries through international action.

NEPAD has explicitly committed itself to improving African governance. Its instrument is the African Peer Review Mechanism. The mechanism is loosely modelled on the OECD which for many years has used peer review as a means of bringing pressure to bear upon the national governments of developed countries. There are potentially two pressure points. Governments face some pressure to participate in a review because otherwise non-participants are revealed as fearful of criticism. Once a review has been completed, governments face some pressure to comply with proposals both through peer pressure and because domestic civil society can use the findings as evidence of the need for change. The APRM is only just getting started and so it is rather early to evaluate it. Peer pressure to participate is proving modestly effective: a majority of countries have now committed to being reviewed. The first completed review, of Ghana in 2005, looks to be an impressive effort to suggest weaknesses in Ghanaian governance and how they could be remedied. Evidently, the test will be whether this facilitates pressure within Ghana to effect change.

The AU has attempted to set standards in various areas of governance. It sends observers to elections, it condemns coups d'états and tries to put them down, and it organizes military peacekeeping. All this is a major advance on the stance of its predecessor the Organization for African Unity, which upheld an extreme version of national sovereignty through the doctrine of 'non-interference'. In effect, the OAU was a club to protect excess sovereignty rather than to curtail it. However, to date the AU has relatively little to show for the new stance. Its observers of elections have worked to more lenient standards than other observers. Of the several coups that have occurred in Africa since the AU came into existence, only one has been reversed by AU pressure, namely Sao Tome, Principe, which is the smallest country in Africa. The AU has failed to reverse more recent coups in the Central African Republic and Mauritania. Similarly, the AU military intervention in Darfur, though a major step forward, has clearly not yet ended the killing.

### *Donor conditionality in defence of the weak*

The standard game-theoretic analysis of conditionality presupposes that African governments and donor governments had divergent interests (Adam and O'Connell, 1999). The African government wishes to favour the elite, whereas the donor wishes to favour a disempowered majority. They investigate under what circumstances the preferences of each party prevail. The donor as the 'principal' faces a time consistency problem: once the government, the 'agent', has the money the donor has lost the power to enforce the agreement. Adam and O'Connor suggest that the way around this problem for

the donor is if it is able to permanently change the interest of the recipient by conditioning not on policies but on governance: the condition for aid is that the elite should be broadened. By widening the effective franchise, policy choices are shifted irreversibly. Evidently, the elite will only do this if it receives a sufficiently large incentive, and so there is a case for an aid 'big push' which compensates the elite for its anticipated future losses.

Given the way the problem is structured the answer to the normative question of whose preferences should prevail is built in to the problem. Clearly, from the point of view of the African government there is only one answer: its own. However, the criterion of social welfare allows the possibility that government preferences are not coincident with those of society and as designed this is the case in the present problem. However, this is to put far too rosy an interpretation upon donor conditionality. Can political economy provide any guidance?

An important result of political economy, which is indeed a feature of the Adam-O'Connell model, is that the more narrowly power is held the greater is the incentive for those with power to use the instruments of power to redistribute to themselves at the expense of overall economic performance. This suggests that where donors successfully condition their aid on requiring broad participation in power they are likely indirectly to benefit the ordinary people whom they thereby empower. New Institutional Economics teaches us to think about information as costly, and institutions as being more or less efficient in economizing on information. Because donors are far more remote from ordinary people than are their own governments, it is likely that broad-based governments are better judges of the priorities of ordinary people than are donors. This suggests that beyond the meta-issue of how power is distributed, donors should not try to overrule government policy choices. Between these two principles of conditionality-for-governance, but non-interference on policies, there is a grey area that arises if conditionality-for-governance has failed. What should donors do in situations where the government is manifestly undemocratic and so its choices are unlikely to reflect the preferences of ordinary people? In principle, it can try to guess what ordinary people want and try to condition its aid on these policies; or it can give the aid to the undemocratic government and hope that ordinary people derive some benefit, or it can transfer the aid to societies with democratic governments. There is currently no consensus view on this issue and it is an interesting area of international political economy on which to work.

### ***Unchecked Opportunism and the Cost of Domestic Transactions***

A paradox of Africa's states is that although in many respects they are radically weaker than the states of developed countries, in one respect they are markedly stronger: African states have not relinquished any significant sovereignty to other entities. The trend in developed societies has been quite the contrary. Most European states have now relinquished their own currency and thereby relinquished monetary policy. Even in those developed countries that have kept their own currency, in most the power of decision over monetary policy has been transferred from governments to genuinely independent

central banks. In respect of fiscal policy most European countries have relinquished to a supra-national authority the freedom to set their own fiscal deficits, except within a narrow range. In respect of trade policy most European states have relinquished independent control to a supra-national authority, and all developed countries have bound themselves to international commitments through the WTO. In respect of foreign investment, European governments have virtually no powers to exclude the firms of other European governments, including hostile take-overs of domestic firms. Most have ceded power of government procurement and subsidy practices to supra-national regulators. Even the rights of citizenship have been radically redefined: all citizens of any EU country have the right to live, work and own property in any other EU country and to vote in EU elections. In respect of many aspects of law, most states have now elevated large areas of supra-national law above the status of national law, and citizens have the right of appeal to supra-national courts. Beyond the sphere of economics, a large majority of developed countries have bound themselves together in a military alliance that commits them to mutual support and to integrated military operations. Virtually all are committed to the mutual maintenance of democracy. Dictatorships disappeared from Western Europe during the 1970s – Spain, Greece and Portugal – as part of their entry process to the EU. Such governance conditionality has had equally dramatic effects in Eastern Europe during the 1990s, and is now starting to pressure Turkey.

African states have generally not followed this trend towards sharing sovereignty with supranational entities as a means of reducing the scope for government opportunism. Monetary policy is the area in which most has been done to share sovereignty, through the Franc Zone and the Rand Zone. Even these cover only a minority of African economies. In respect of fiscal policy only the Franc Zone imposes long term rules. The most common restraint is through IMF programs, whose legitimacy as a commitment mechanism has been under constant challenge. Since IMF programmes are by the nature short term, they are inherently ill-suited for the task of long term commitment: they are more like a rape than a marriage. Perhaps as a result, adherence has been spasmodic. In respect of trade policy governments have largely chosen not to bind themselves through the WTO, preferring to be non-playing members without requirements for reciprocity of market access.

This extreme preservation of sovereignty is particularly paradoxical since both the weakness in African governance and the fragmentation of Africa into so many countries suggest that Africa has more to gain from internationalization than developed countries. The typical African government is running an economy the size of an average European town, with legal powers of sovereignty that exceed the combined authority of the executive and legislature of the USA, and the national and Community-level governments of Europe. The lack of the normal international restraints on the power of government is compounded by the weakness of domestic restraints, both formal, such as legislatures, and informal, such as the media. Again, the weakness of internal restraints would suggest a greater need for the use of international restraints.

A consequence of the extreme lack of restraints is that African governments face acute commitment problems. How can they use the international system to enhance their ability to make credible commitments?

#### *African initiatives at reducing opportunism*

At the level of fiscal policy, I have suggested that IMF programmes are inherently ill-suited for long-term commitments. An alternative would be to form a fiscal club among those African countries that already had good fiscal policies and wished to lock in to this policy. The analogy would be with the European Stability Pact. The value of such a pact depends initially upon creating incentives for governments to adhere: this essentially requires the design of some credible penalties for breaches. Over time, as the pact acquires credibility so that membership becomes valuable due to its reputation effect, it can potentially be enforced by the threat of expulsion.

The East African Community is a model of a club with the potential for multiple commitment mechanisms. In respect of trade policy there is a common external tariff, so that member countries have relinquished independent control of trade policy. There is a parliament and so there is the potential to generate laws that surmount national laws. There is also the potential to revive the East African Shilling and hence transfer monetary policy outside the control of national governments. The EAC also has few members and this massively reduces the coordination problem. Further, its members are of similar size so cooperation is easier because there is no dominant member. By contrast, within NEPAD and the AU the imbalance due to South Africa and Nigeria is evident: for example, some 95% of the funding for NEPAD comes from South Africa. Small groupings such as the EAC may have more scope to be effective than pan-African groupings.

#### *Global opportunities to reduce opportunism*

The EITI, discussed above, is a pioneering example of how a voluntary international code can be used to reduce opportunism in environments with unreliable justice. There may be considerable scope to extend this approach. For example, African states need an international code on the rights of investors to which they could choose to commit. At present, those governments with low investor credibility have no instrument beyond the promulgation of national investment codes which, however generous, suffer from the basic time consistency problem that reflects a lack of commitment mechanism. Many African governments are currently wary of such an international code, seeing it as a restraint upon their actions. But a reasonable code would only restrain those governments that wanted to lure investment in and then expropriate it. It is the very fear of this behaviour that keeps investment in Africa so low, so even the would-be expropriators have nothing to expropriate, while those governments that genuinely want to develop their economies cannot differentiate their type from the would-be expropriators. Hence, a code would cost the would-be expropriators nothing, while enabling non-expropriators to reveal their type by committing to it and in consequence increasing investment.

One stage up from an investment code, which should apply to all investment not just foreign investment, is to extend current investor insurance arrangements from foreign to domestic investors. The global public insurance facility for investors, the Multilateral Investment Guarantee Agency (MIGA) is currently restricted to providing insurance only for foreign investors. This produces the absurd situation that foreign capital is safer than domestic capital, something which may have contributed to African capital flight. It also implies that global public money committed to helping developing countries, which is what underwrites MIGA, can benefit the companies of developed countries but not African companies. To date, the main obstacle to broadening the remit of MIGA has been that the governments of some developing countries do not want to provide international protection to domestic firms. This is a further example of ‘excess sovereignty’.

### ***Public Goods and Bads***

The international community has sometimes tried to get involved in increasing the incentives for African governments to supply national public goods. A high-profile recent example is the conditionality surrounding the Chad-Cameroon pipeline. International oil companies refused to invest in Chad unless some credible agency took the burden of the risk to reputation should the oil revenues be badly used. The World Bank designed a governance system in which the government of Chad agreed to use 80% of the revenues for national public goods such as health and education, and to allow civil society organization within Chad to scrutinize and authorize this spending. These commitments were enshrined into Chad law. So reassured, the oil companies invested over \$4bn. No sooner had the oil revenues started to flow than the government repealed the law and declared that military spending would be its priority, this being the fear that had motivated the initial international concern. The example demonstrates both the need for international incentives to increase the concern of African governments for public goods provision and the extreme difficulty in making this effective.

### **5. Conclusion**

The new international political economy raises issues that are highly pertinent for Africa. Why does the region have so many states? Is Africa a victim of its weakness in the international economic system? It also opens bring into prominence contract enforcement and credibility that are seen as increasingly critical for economic development. These are matters on which African governments and firms face acute challenges in living down the past.

Although these issues have been debated for a long time, the application of rigorous economic analysis to them is recent. They therefore offer enormous scope for African economists to contribute to topics which are both of central importance for their region, and which are gravely under-researched.

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