

# State-Building, Leadership, and Local Democracy

Jean-Jacques Laffont Prize

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# Applying economic theory, in the tradition of Laffont

We should follow Jean-Jacques Laffont in using sophisticated advances in mathematical economic theory to analyze practical questions of social policy.

Our question: What policies in a state-building intervention can best help to rebuild the nation?

(taking international intervention as a given)

State-building: establishing a new political system, which gives power to some individuals, induces others to accept their authority.

# Xenophon's ancient model of state-building

*The Education of Cyrus* by Xenophon:

Cyrus apparently\* loved "justice" and was the best leader to distribute booty from battles generously and in proportion to valor.

So Cyrus the Great founded the Persian Empire with one essential quality of leadership: a reputation for generously rewarding service.

(\*Or maybe he loved the wealth and power from his good reputation?)

A theory of the state based on leadership and patronage:

Political organizations are established by recognized leaders who maintain reputations for reliably rewarding their supporters.

State-builders must develop relationships of trust with supporters, in a network of patronage and power.

## **Failure of the state as a crisis of moral hazard**

Moral hazard agency theory offers the key to understanding vital questions of state-building.

*Moral hazard* is the problem of creating incentives for agents to behave in a prescribed manner, when behavior is not observed.

People regularly rely on the state to reduce moral hazard by enforcing laws and contracts.

A breakdown of the state creates a vast disastrous escalation of moral-hazard problems throughout the nation.

Restoring the state: How does the state solve its own internal moral hazard problems in motivation officials to enforce the rules?

## **Distribution of moral-hazard rents in high offices**

Legal and constitutional rules of government are effective only when enforced by actions of individual agents of government.

Powerful government agents could profit from abusing power, and so they must expect greater long-run rewards from good service.

Candidates would be willing to pay for such highly rewarded offices.  
(Becker-Stigler, *J Legal Studies*, 1974.)

Agents' rewards must depend on judgments of their superiors in the network, and so incentives ultimately depend on top leaders.

Promises of back-loaded rewards become a debt owed by the state, which leaders could be tempted to repudiate. (by false accusations)

To build a state, a leader (Cyrus) must solve this central moral hazard problem of binding himself credibly to reward past service.

Solution: organize top supporters in a court or council where they monitor his distribution of rewards and offices, as they serve him.

The leader's personal constitution: keep the courtiers' collective trust.

## **Building stability by national political networks**

The political strength of a regime is in the leaders who have stakes in the regime and in the networks of supporters they can mobilize.

In every community, local leaders coordinate and adjudicate disputes.

Legitimacy: If most local leaders throughout the nation accept the regime, the rest will feel compelled to acquiesce. (coord'n game)

But if there are communities where the regime lacks any supporters then they can become fertile ground for insurgency.

Distributing power broadly, giving more local leaders a stake in the regime, strengthens it and reduces need for foreign military support.

But foreign support reduces national leaders' incentive to negotiate a broad inclusive distribution of power. (*moral hazard in client state*)

Karzai's centralized nonparty presidential democracy in Afghanistan.

(vital mobilizing role of party privileges) (reform of governors)

Decentralized local democracy creates a broad class of local leaders in all communities who have a positive stake in defending the regime.

## **Local democracy can strengthen national competition**

Democratic competition should limit political profits (corruption), but it can fail if nobody has a reputation for good governance.

My *QJPS* ('06): In a centralized democracy, a corrupt leader may be re-elected when voters expect that challengers would be no better. Successful democracy requires many alternative leaders with good reputations for serving the public (not just rewarding supporters).

Political decentralization creates opportunities to build such reputations, eliminating the bad equilibrium of my *QJPS* '06.

If voters expected corrupt government at all levels, a local leader who serves better could become a serious candidate for higher office.

Provincial and local democracy *reduce barriers to political entry*, by increasing opportunities for politicians to prove governing ability.

Decentralization can *increase the national supply of individuals who have good reputations for using public resources responsibly*.

Iraq 2003: What if Bremer gave power to elected local councils?

## Resistance to political decentralization

To reduce competition, national leaders have incentive to centralize, to raise barriers against political entry of new independent leaders.

Suppressing entry by control from top, with advancement based on loyalty to top leader. (*Iron law of oligarchy* of Michels, 1915)

A party's competitive strength depends on its local agents' efforts to win popular support. (moral hazard of local political agents)

Agents' incentives are stronger if promotion depends on their success in winning popular approval, as measured in local democracy.

Party leaders who promote the party's successful local candidates should be rewarded by a stronger and more competitive party.

National leaders could try to tame local governments by threatening budget reductions or administrative actions against potential rivals.

Scope of authority for local governments should be constitutionally protected, with clear fiscal rules determining local budgets.

Pakistan: local democracy intermittently; but not in Tribal Areas...

## **National parties can strengthen local democracy**

Successful democracies have a balance of local and national politics.

The rights of national parties to sponsor alternative candidates in local elections can be vital to sustaining local democracy.

Local bosses should know that, if they fail to give good public service, they could face challengers supported by a rival national party.

Democratic norms develop naturally in an elected assembly, where members share interests in protecting their rights to compete.

Any party must defend its candidates' rights to compete in elections, and electoral abuse by its own people can tarnish its reputation.

Against violent insurgents, some restrictions on nomination to local elections may be necessary.

But any party with some minimal fraction of the National Assembly should be able to nominate candidates in all elections in all areas.

## **Distributing control of public funds even before a constitution**

Bremer's theory: A constitution must come first, before any elections;  
central budgetary control of CPA.

But the fate of any new constitution must depend on leaders' prior  
relationships with their active supporters.

Our leadership-patronage theory:

1. Political institutions are established by leaders with reputations for reliably distributing patronage to their supporters.
2. Democracy requires an ample supply of leaders with reputations for providing good public service, while distributing patronage jobs.

As Cyrus distributed booty to build his reputation, politicians today build reputations by spending public funds.

To build a federal system, distributing funds separately to national and local governments can be as important as constitution-writing.

Transparent public accounting to voters is vital.

## **An example worth remembering**

America Articles of Confederation (1776-1788) distributed power broadly to 13 locally-elected provincial assemblies.

Such decentralization may have often seemed inconvenient to foreign supporters of the regime.

Every community had at least one elected local leader with a substantial stake in the new regime, which made it unbeatable.

The contrast is stark with the centralized regime of Afghanistan 2004. Narrow centralization might seem convenient for those at the pinnacle of power, but it increases demands on foreign supporters.

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