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The combination of the empirical evidence and the analysis of contemporaneous documents leads us to conclude that more aggressive monetary policy was certainly possible in the early 1930s. The Federal Reserve could have done much more to counter the spiraling decline without running into limitations imposed by the gold standard. This suggests that much of the blame for the Great Depression rests where Friedman and Schwartz placed it 40 years ago — at the doorstep of the Federal Reserve.

¹ C. D. Romer and D. H. Romer, "Federal Reserve Information and the Behavior of Interest Rates," NBER Working Paper No. 5692, July 1996, and in *American Economic Review*, 90 (2000), pp. 429-57.

² C. D. Romer and D. H. Romer, "A New

Measure of Monetary Policy Shocks: Derivation and Implications," unpublished manuscript, July 2002.

³ C. D. Romer, "Spurious Volatility in Historical Unemployment Data," *Journal of Political Economy*, 94 (1986), pp. 1-37; C. D. Romer, "Is the Stabilization of the Postwar Economy a Figment of the Data?" *American Economic Review*, 76 (1986), pp. 314-34; and C. D. Romer, "The Prewar Business Cycle Reconsidered: New Estimates of Gross National Product, 1869-1908," NBER Working Paper No. 1969, July 1986, and in *Journal of Political Economy*, 97 (1989), pp. 1-37.

⁴ C. D. Romer, "Changes in Business Cycles: Evidence and Explanations," NBER Working Paper No. 6498, February 1999, and in *Journal of Economic Perspectives*, 13 (1999), pp. 23-44.

⁵ C. D. Romer and D. H. Romer, "A

Rehabilitation of Monetary Policy in the 1950s," NBER Working Paper No. 8800, February 2002, and in *American Economic Review*, 92 (2002), pp. 121-7.

⁶ C-T Hsieh and C. D. Romer, "Was the Federal Reserve Fettered: Devaluation Expectations in the 1932 Monetary Expansion," NBER Working Paper No. 8113, February 2001.

⁷ M. Friedman and A. J. Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton University Press for NBER, 1963.

⁸ B. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939*, Oxford University Press and NBER, 1995; and P. Temin, *Lessons from the Great Depression*, Cambridge, MA: MIT Press, 1989.

The New Comparative Economics

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The traditional field of "Comparative Economics," which deals with comparisons of socialism and capitalism, died with the collapse of socialism in Eastern Europe and the Soviet Union a decade ago. But from its ashes, and from the challenging experiences of transition and the Asian financial crisis, emerged a new field. This field, the "New Comparative Economics," shares with its predecessor the notion that by comparing alternative economic systems, we can better understand what makes each of them work. But this new field sees the key comparisons as being of alternative capitalist models prevailing in different countries.

Every capitalist economy has many public and private institutions.

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These institutions' function is to choose political leaders, to maintain law and order, to secure property rights, to redistribute wealth, to resolve disputes, to govern firms, to allocate credit, and so on. Political economy over the last two centuries, as well as recent empirical research, demonstrate that these institutions differ tremendously and systematically among countries, and that these differences have significant consequences for economic and political performance. The comparison of these institutions and of their effectiveness, with a focus on understanding which ones are appropriate in what circumstances, is the subject of the New Comparative Economics.

The New Comparative Economics shares with institutional economics the recognition that the pure competitive model is not a useful way to think about capitalist economies, and that political and economic institutions crucially shape performance. Unlike

institutional economics, however, which stresses the common achievements of capitalist economies, such as protection of private property, the New Comparative Economics focuses on institutional diversity. The New Comparative Economics also shares with the field of public choice its emphasis on politics. Most crucial institutional differences among countries — whether regulating markets or regulating politics — are governmental. It is impossible to understand the formation of institutions, their consequences for performance, or their appropriateness for the circumstances without understanding the political forces that drive institutional evolution.

In thinking about institutional diversity and its consequences, it is best to start from first principles. Since the days of the Enlightenment, economists agreed that good economic institutions must secure property rights, enabling people to keep the returns on

their investment, enter into contracts, and resolve disputes. Such security encourages people to invest in themselves and in physical capital, and thus fosters economic growth. But there are two sides to the security of property rights. On the one hand, investment must be secured from expropriation by one's neighbors, be they thieves, competitors, or other violators. For this, effective *public* enforcement of property rights is required, sometimes termed law and order. On the other hand, a strong government — one capable of protecting property against private infringement — can itself become the thief. To contain such a government, institutions restricting its power are necessary, sometimes referred to as the rule of law.

Accordingly, it is useful to distinguish two aspects of institutional design. The first concerns restrictions on private expropriation: law and order. The second concerns restrictions of public expropriation: the rule of law. In both of these areas, recent research has greatly expanded our understanding. I cannot survey this research, but can illustrate some of the recent findings largely using the papers I wrote with several colleagues, including Simeon Djankov, Edward L. Glaeser, Simon Johnson, Rafael La Porta, Christian Pop-Eleches, and Robert W. Vishny.

Law and Order

The tremendous diversity of the security of property rights among *capitalist* economies, with its profound consequences for economic growth, raises two related questions. First, are the existing institutions efficient, and if not, why not? Second, are the factors that shape institutions endogenous to the geographic, ethnic, or political conditions of a country, or are they alternatively exogenously determined by a country's history of institutional adoption? From the efficiency perspective, a crucial determinant of law and order is the effectiveness of enforcement of rules by the government. Such enforcement cannot be taken for granted — it is an economic activity generally performed by the agents of the state, and

as such is limited in its effectiveness by incentives and resources. A country's circumstances might determine the government's capacity to enforce different rules, and thus indicate which rules are appropriate.

In a series of papers, Glaeser and I argue that an important property of a successful institution is its invulnerability to subversion by powerful citizens. People will attempt to influence any system to their own advantage, thereby benefiting themselves at the expense of others, making property rights insecure in the process. Controlling such subversion is necessarily costly, and may require different approaches in different circumstances. Peaceful, relatively equal societies can adopt decentralized, community rules in areas such as dispute resolution, because local justice is more efficient and there is relatively little risk of it being subverted. Less orderly, more unequal societies, in contrast, could not rely on enforcing community rules, because local justice is likely to be subverted by powerful interests. Instead, they must rely on the more centralized rules promulgated by the sovereign, which can withstand attempts at subversion, even when such rules contradict the community's ideas of justice and fairness.

Glaeser and I¹ use this theory to explain why, starting in the 12th and 13th centuries, the jury-based common law system developed in relatively peaceful England, while the state-employed-judge civil law system developed in the warring France. Glaeser and I² present a related theory to explain why, during the Progressive era at the beginning of the 20th century, the United States replaced litigation with government regulation in many areas of social control of business. The reason was the vulnerability of courts to subversion by the newly powerful economic interests — the robber barons. The perception that regulatory bodies — like the royal courts in 13th century France — would be less vulnerable to subversion was a key argument for regulation.

The efficiency perspective has much to recommend it, especially in the long run. But we cannot discuss the variety of capitalist institutions

without recognizing that many of them are inefficient and detrimental to growth. There are two prominent sources of inefficiency. First, because most governments in the world are far from perfect, so are the institutions they design and perpetrate. Second, many institutions in developing countries are not indigenous, but rather have been transplanted during colonization. Although many transplanted institutions improve the security of property rights, there is no reason to think that colonial transplantation is automatically efficient.

Much of the evidence on institutions — both within and across countries — suggests that politics and not just efficiency shapes them. Besley and Burgess³, for example, examine the differences in the legislation concerning workers' rights among the Indian states. They find that pro-worker amendments to the Industrial Disputes Act are associated with lowered investment, employment, productivity, and output in registered manufacturing. The evidence suggests that attempts to redress the balances of power between capital and labor can end up hurting the poor.

Djankov, La Porta, Lopez-de-Silanes and I⁴ collect data on the regulations faced by entrepreneurs trying to officially open a business in 85 countries. We find that entry regulation is extremely heavy in most countries in terms of both the time and the number of procedures that an entrepreneur must complete. Moreover, heavier entry regulation is not associated with superior quality of products, but rather with greater corruption and larger unofficial economies. Last but not least, heavier regulation of entry is pursued by the less democratic and less limited governments. All of these results support the public choice view that regulation of entry benefits bureaucrats and politicians rather than consumers.

A second cause of institutional inefficiency is colonial transplantation. As European powers conquered most of the world in the 19th century, they brought with them their institutions, including their laws. England brought the common law tradition to its colonies in South Asia, East Africa, Australia, and the New World, includ-

ing the United States and Canada. France brought its civil law through Napoleonic conquest to much of continental Europe, including Spain and Portugal, and from Europe it was transplanted to Latin America, North and West Africa, and many other places around the world. The spread of German civil law is more limited, with East Asian countries being the most important adopters. It appears that a significant portion of institutional variation among countries is explained by transplantation.

Legal origin determines a broad range of institutions. For example, La Porta, Lopez-de-Silanes, Vishny, and I⁵ identify legal origin as a crucial determinant of the laws governing the protection of outside investors from expropriation by corporate insiders, with common law providing better protection than civil law. We measure the laws protecting outside shareholders and creditors from expropriation in 49 countries. We find that better investor protection is strongly associated with broader and more valuable capital markets, higher pace of public offerings, more dispersed ownership structure, and other indicators of financial development. Subsequent research shows that civil law countries exhibit heavier government intervention in economic activity, including more burdensome regulation and red tape⁶, higher government ownership of banks⁷, and more burdensome regulation of new business entry⁸. The evidence identifies no benefits of the more interventionist institutions for economic or social outcomes. To the contrary, French legal origin typically is associated with worse public sector outcomes, as well as greater corruption.

Recent research points to another important aspect of transplantation. Acemoglu and his co-authors⁹ show that settlers suffered very different rates of mortality in different colonies, and accordingly were more likely to stay and develop their institutions where survival rates were higher. The transplantation of Western institutions, with its benefits for the security of property rights and economic development, consequently was more effective in the places where the set-

tlers survived than where they did not. This theory, like legal origin, accounts for some exogenous variation in institutions among countries. It also suggests that, at least where the colonists settled themselves, institutional transplantation has been highly beneficial. The United States, Canada, and Australia did not have to invent their laws from scratch; they inherited them from England. On the other hand, when the colonists did not settle, transplantation may account for institutional inefficiency.

The fact that many institutions in developing countries have taken their shape through transplantation rather than an organic (and perhaps efficient) response to local conditions raises a concern. Institutions that are appropriate for democratic countries, with their limited and constrained governments, might not work well when transplanted to a different political environment. Indeed, as Glaeser and I¹⁰ show, centralized regulation and law enforcement are least efficient when the interests of the sovereign diverge the most from those of the public, and when the rules are most subject to subversion. Our theory might explain why the centralized institutions of civil law, while working reasonably well in democratic France and Germany, can become a tool of oppression in the hands of a “bad” government.

Rule of Law

Governments successful in delivering law and order may be so powerful as to escape the rule of law. This is not to say that such powerful governments are never sought after. History is replete with episodes of public demand for dictatorship in the periods of massive deterioration of law and order. Nevertheless, on average, unlimited government is associated with less security of property rights. Long-term historical evidence shows that, over the last millenium, countries have grown faster under limited government than under autocracy.¹¹

Weak rule of law comes in part from politicians pursuing policies and designing institutions that serve primarily to keep them in power. Glaeser and

I¹² argue, for example, that some of the worst policies pursued by politicians ranging from American mayors to African dictators aim to encourage the emigration of voters who oppose them, and thus to improve the re-election chances of the incumbents.

But the differences among countries in the regulation of politics are highly systematic as well, and transplantation is again crucial to understanding the existing variation. One important area deals with constitutional design, particularly with respect to the judiciary. According to Hayek,¹³ there are two very distinct ways in which the judiciary secures freedom. The first is the English common law idea of judicial independence: once laws are passed by Parliament, they are enforced by courts without political interference. According to this idea, the courts cannot interfere with Parliament, and the Parliament cannot intervene in courts except by passing laws. The second is the American constitutional idea of checks-and-balances: the courts themselves have the power to check the decisions and laws passed by the legislature against the constitution. Unlike in the English conception, here the courts can very much interfere with legislative choices.

Both the English and the American constitutional ideas were transplanted throughout the world in the last 200 years, as most countries wrote their own constitutions. But these ideas spread differently. The institution of judicial independence spread to Britain's colonies along with other elements of common law; it generally did not get adopted in the civil law countries. The American idea of constitutional review spread to countries influenced by the U.S. Constitution — especially those in Latin America — but after World War II to many other parts of the world, including Continental Europe, as constitutional courts became common.

La Porta, Lopez-de-Silanes, Pop-Eleches, and I¹⁴ examine the recent constitutions of 71 countries, and measure whether these constitutions adopted either (or both) of the two ideas about the judiciary. We find significant but highly systematic variation among countries, generally following the patterns of transplantation described

above. Specifically, judicial independence is prevalent in common law, but not in civil law countries. Constitutional review, on the other hand, is more typical of countries influenced by the United States. La Porta and his co-authors¹⁵ also consider the relationship between these constitutional rules and measures of political and economic freedom around the world. In the data, an independent judiciary is associated with greater economic and political freedom, whereas constitutional review is associated with greater political, but not economic freedom. This evidence identifies significant benefits of transplantation of judicial institutions for both “law and order” and “rule of law.”

Djankov, La Porta, Lopez-de-Silanes, and I¹⁶ examine a related dimension of regulation of politics: the operation of courts in 109 countries. We focus on the formalism of judicial procedure: the extent to which the law regulates dispute resolution. To this end, we examine in detail the procedures that need to be followed to take each of two cases — the eviction of a non-paying tenant and the collection of a bounced check — through a nation’s court. From this examination, we construct indexes of procedural formalism — or regulation of dispute resolution — for each country. We find that French civil law countries exhibit much greater levels of procedural formalism than do common law countries, just as appears to be the case with other kinds of regulation. We also find that greater procedural formalism is associated with significantly longer delays in bringing cases through courts, but *not* with greater measures of efficiency, consistency, fairness, or accessibility of the legal system. The evidence on the regulation of dispute resolution mimics that on other kinds of state intervention: legal origin is a strong predictor of greater interventionism, and there is no evidence that such interventionism improves social outcomes.

The papers I summarized point to some patterns in the nature of institutions regulating both markets and politics. Specifically, in many instances, legal origin appears to shape both. Civil law countries are more centralized

and interventionist than common law countries across a range of institutions; they exercise tighter central control of new entrepreneurs and banks, but also courts. In the mother countries — England and France — this difference in institutional design may have been a response to the different law-and-order conditions. But in colonies, these institutional features often were transplanted, and thus do not have such apparent efficiency justifications. This does not mean that the consequences of transplantation are necessarily adverse — there are significant benefits of common law in both rich and poor countries. A central conclusion for the New Comparative Economics is that legal origin is an important factor pervasively shaping the institutions of capitalist economies.

Appropriate Institutions

The New Comparative Economics has made great strides in the last decade. I have focused on three forces (and there may be others) shaping institutional diversity: efficiency, politics, and transplantation. This research teaches that there is nothing inevitable about the existing institutions. Although some are efficient and appropriate, many are not. The fact that many institutions are designed to serve the interests of the incumbent rulers and the political interests that support them, combined with the crucial role of colonial transplantation, are the two key sources of inefficiency. In the years ahead, institutional reform may become one of the key strategies for improving human welfare.

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² E. L. Glaeser and A. Shleifer, “The Rise of the Regulatory State,” NBER Working Paper No. 8650, December 2001.

³ T. Besley and R. Burgess, “Can Labor Regulation Hinder Economic Performance? Evidence from India,” (mimeo), London School of Economics (2002).

⁴ S. Djankov, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, “The Regulation of Entry,” NBER Working Paper No. 7892,

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⁷ R. La Porta, F. Lopez-de-Silanes, C. Pop-Eleches, and A. Shleifer, “The Guarantees of Freedom,” NBER Working Paper No. 8759, January 2002.

⁸ S. Djankov, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, “The Regulation of Entry.”

⁹ D. Acemoglu, S. Johnson, and J. Robinson, “The Colonial Origins of Comparative Development: An Empirical Investigation,” NBER Working Paper No. 7771, June 2000, and in *American Economic Review*, 91 (5) (2001), pp. 1369-401.

¹⁰ See E. Glaeser and A. Shleifer, “Legal Origins”; and E. Glaeser and A. Shleifer, “The Rise of the Regulatory State.”

¹¹ J. B. De Long and A. Shleifer, “Princes and Merchants: European City Growth Before the Industrial Revolution,” NBER Working Paper No. 4274, February 1993, and in *Journal of Law and Economics*, 36 (2) (1993), pp. 671-702.

¹² E. L. Glaeser and A. Shleifer, “The Curley Effect,” NBER Working Paper No. 8942, May 2002.

¹³ F. A. Hayek, *The Constitution of Liberty*, South Bend, In: Gateway Editions Ltd, 1960.

¹⁴ See R. La Porta, F. Lopez-de-Silanes, C. Pop-Eleches, and A. Shleifer, “The Guarantees of Freedom.”

¹⁵ See R. La Porta, F. Lopez-de-Silanes, C. Pop-Eleches, and A. Shleifer, “The Guarantees of Freedom.”

¹⁶ S. Djankov, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, “Courts: The Lex Mundi Project,” NBER Working Paper No. 8890, April 2002.