STATE-BUILDING, LEADERSHIP, AND LOCAL DEMOCRACY[1]

by Roger Myerson, University of Chicago

Introduction

Jean-Jacques Laffont used sophisticated advances in mathematical economic theory as tools for analyzing important questions of social policy. To honor him today, I will try to follow him in considering some practical policy questions about international state-building operations. Jean-Jacques would forgive me, I think, for treating these questions non-technically here, but only because this talk is intended for a general audience in the City Hall of Toulouse.

The policy problems that I will consider are those which arise in international operations to stabilize a nation and rebuild its state. I am thinking particularly about 2002 and 2003, when the United States led invasions to reconstruct the governments of Afghanistan and Iraq. Serious mistakes were made, and we need better theories and analysis to guide our thinking about what should have been done. Please, let us set aside questions about whether these interventions were well justified, and instead let us focus here on questions about what policies in such an intervention could best help to rebuild the nation.

The mission of state-building or stabilization is to help a nation to heal from the chaos of war and a breakdown of the state, by establishing a new political regime that can provide effective government for the nation. A political system must be established which puts some people in positions of power and induces the rest of the nation to accept their authority. The practical problems of such political reconstruction raise questions that are fundamental to social theory, as they force us to order the essential priorities in building a strong democratic system.

Xenophon's fable about Cyrus the Great

As Jean-Jacques Laffont sometimes took insights from writings of Adam Smith, the founder of modern economics, today I may start with some insights from Xenophon, the ancient Greek writer who gave economics its name.

Xenophon addressed questions about the theoretical foundations of the state in his classic *Education of Cyrus*, which considers how Cyrus the Great established the Persian Empire. According to Xenophon, the key to Cyrus's state-building success was his apparent love of

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justice, which enabled him to earn the trust and loyalty of a great army. But Cyrus was not much concerned about for justice for poor peasants, whose crops were gathered to support his conquering forces. What Cyrus loved was justice for the soldiers who served his cause. Apparently Cyrus's greatest pleasure in life was to judge the valor of troops in battle and to reward them richly for their accomplishments, asking nothing for himself. Once Cyrus had established a reputation as the most reliable leader for justly distributing booty after a battle, soldiers from all nations readily accepted his command, and his power steadily spread over Asia.

Thus, Xenophon portrays Cyrus as establishing the Persian Empire on one essential quality of leadership: a reputation for generously rewarding good service. Once this reputation was established, Cyrus could enjoy privileges of power as long as he acted accordingly, and so his followers could depend on his justice, even if he actually loved wealth and power more. In our modern terms, we can say that Cyrus and his captains were in a good reputational equilibrium where they could trust his promises of rewards for good service, and he gained great power and wealth by maintaining that trust.

So the story of Cyrus illustrates the general observation that political organizations are established by recognized leaders who maintain reputations for reliably rewarding their supporters. To compete for power in any political system, a leader needs to build a base of active supporters, and the essential key to motivating this base is the leader's reputation for distributing patronage benefits to his supporters. Thus, Xenophon gives us a theory of the state based on leadership and patronage.

Failure of the state as a crisis of moral hazard

Such historical narratives and dialogues were the media of theoretical analysis for ancient social philosophers, but now we seek new insights by analyzing models of modern economic theory. In particular, I want to argue that moral-hazard agency theory offers the key to understanding these vital questions of state-building. *Moral hazard* is the problem of creating incentives for agents to behave in some prescribed manner when their behavior cannot be directly observed by others.

A well-functioning state normally helps to reduce moral hazard problems in social and economic transactions, when people can rely on the state's system of justice to help enforce contracts and laws that stipulate appropriate behavior in social and economic relationships. The

disaster that afflicts a nation after a breakdown of the state can be described as a vast national escalation of moral hazard problems in all relationships. When the state has failed, systems of control are scarce and urgently needed throughout the nation. Military intervention can have a value in such situations, when all other controls have failed, because military units are designed to obey orders in the most challenging circumstances. To get beyond military occupation, however, the state must be restored, and so we must face the question of how a state solves its own internal moral-hazard problems.

Back-loaded moral-hazard rents and leadership

Legal and constitutional rules of government are effective only when they are enforced by the actions of individuals who have positions of responsibility in the government. But powerful government agents have many opportunities to profit from abusing their power, and they must expect greater long-term rewards from serving the state appropriately. So in addition to basic compensation for the disutility of effort, responsible agents must expect greater rewards, called *moral-hazard rents*, as incentives for not abusing their power. Gary Becker and George Stigler (1974) showed that, in an efficient solution to dynamic moral-hazard problems, the responsible agents should be motivated by promises of large late-career rewards that will be paid if they maintain a good performance record. The prospect of large moral-hazard rents could make candidates willing to pay for appointment to such responsible offices. Becker and Stigler suggested that such payments for office could be interpreted economically as posting a bond for good performance.

The evaluation of agents' performance and their consequent rewards (or return of their performance bonds) must depend on judgments by their superiors in the administrative hierarchy, and so the system of incentives ultimately depends on top leadership. Promises of great rewards for past service become debts of the state, however, and ex post the leaders of the state would have a direct interest in repudiating such debts. Falsely finding evidence of corruption in an official's record would relieve the state of a large expense and would open the possibility of re-selling the office to a new candidate. Thus, we find a crucial moral-hazard problem at the very top of the state apparatus. Agents of the government must trust that their top leaders will judge their performance appropriately and will reward good service generously.

Such a central moral hazard problem exists not only in the state's administrative

apparatus but also in the political foundations of the state. As we saw in the story of Cyrus, to compete for power under any political system, a leader needs active voluntary support of many people. These supporters must be motivated by some expectation of future rewards if they win. But after being installed securely in power, a ruler might be tempted to ignore the claims of past supporters. A leader's promises would be doubted if nothing could constrain him to fulfill past promises when his rivals have been defeated. Thus, to mobilize support, a strong competitive leader needs some institutional court where his promises to supporters can be credibly enforced.

Who can bind a leader who wields the sovereign power of the state? The other high officials who sustain the state together have such power, if they share a sense of identity that would cause them all to lose trust in their leader if he cheated any one of them. As a minimal constitutional structure, a strong leader needs to organize a court or council where his active supporters can collectively judge his treatment of them. In negotiation-proof equilibria of a simple model of sequential contests for political power, I showed (Myerson, 2008) that a contender for power would be unable to credibly recruit any supporters without organizing such a court where his supporters could depose him if he lost their trust.

Thus, in a leader's court, his reputation for reliably judging and rewarding his supporters and agents can be collectively guarded by his senior supporters and agents, even as they serve him. The norms which these courtiers expect of their leader become a kind of "personal constitution" for him, which he must uphold or forfeit their trust.

This point brings us back to the basic lessons of Xenophon's *Education of Cyrus*: The political and administrative machinery of the state depend on its leaders' reputations for reliably rewarding their loyal supporters. This distribution of rewards requires a long-term relationships of trust between leaders and supporters in a network of patronage and power. A state-builder like Cyrus must begin by building such a network of trusting supporters.

Building stability by national political networks

If a state-building intervention is to establish a political regime that can stand on its own, it will happen because the leaders who hold power under the regime have developed networks of trusting supporters that are wide and strong enough to defend the regime against those who would take power from it. Disciplined security forces can be formed only under such political leadership. The real political strength of the regime must be found in the leaders who have

political stakes in the regime and in their ability to mobilize active support. When they are too few or too weak, the regime can be sustained only with the help of foreign intervention.

At any point in time, in any society, there are recognized structures of local social leadership in all communities. These local leaders help solve coordination problems and adjudicate disputes within their respective communities. Although an established national regime may gradually redistribute positions of local authority, the successful establishment of a political regime depends first on its general recognition and acceptance by the existing local leaders. This is the meaning of political legitimacy. If a new regime is endorsed by an overwhelming majority of local leaders throughout the nation, then the others will feel compelled to acquiesce, and so legitimacy will be achieved as a stable equilibrium of a coordination game among local leaders. But if there are communities where the regime lacks any local supporters, then these communities can become a fertile ground for insurgents to begin building a rival system of power with encouragement from disaffected local leaders. So the success of a state-building mission will depend on key decisions about the distribution of power in the new regime, which will determine how many local leaders can find a comfortable place for themselves in the regime, and how many local leaders feel excluded from power in it.

When national leaders can rely on foreign military support, however, their incentive to negotiate a broadly inclusive distribution of power is reduced. The most prominent leaders who cooperate with a stabilization intervention can expect to get positions of national power at the center of the new regime, and so they can benefit more from a constitutional structure that concentrates power in the center. Furthermore, foreign interveners often find it convenient to have one strong national leader who is empowered to work with them in all the myriad complications of their occupation. So the leading collaborators of a stabilization operation may endorse a system of narrow political centralization, and such centralization may initially seem convenient for the intervening forces. But the result of this centralization may be to alienate other local leaders who are not aligned with the faction that holds power in the capital, and their alienation may compel the regime to depend more on foreign support.

For example, under Hamid Karzai's leadership, a centralized presidential regime was installed in Afghanistan in 2004. Only one elected leader can get a direct political stake in the presidency, and President Karzai's refusal to create a political party meant that he did not build a national network of local political supporters who could expect to share sustained benefits from

his presidential power. In the National Assembly, the formation of parties was also discouraged by the use of single non-transferable voting in the 2005 legislative elections, and the predictably incoherent results of this voting system elected representatives who had support from only a small fraction of the voters. Under the unitary constitution, provincial councils were not given any autonomous powers. A change in any of these aspects of the political system could have yielded a broader distribution of political power in which more local leaders would have a direct stake in the regime, and their ability to mobilize local political supporters could have reduced the regime's chronic dependence on foreign forces.

Karzai's plan to build a centralized presidential democracy without any political parties was an impossible ideal for Afghanistan or anywhere else. Parties are social networks that distribute power and privilege to their active members, but such networks are needed to mobilize agents who have stakes in sustaining democracy.

In a decentralized regime that devolves substantial power to locally elected councils of provincial and municipal governments, local leaders throughout the nation can compete for a share of local power even if they are not affiliated with the faction that controls national power at the center. Thus, decentralized democracy can create a broad class of local leaders in all communities who have a positive expected stake in defending the new political system.

Local democracy can strengthen national democratic competition

The essential requirement for a stable regime is active support from a broad political network that reaches into every community in the nation, but if the goal were only political stability then this network might not be democratic. In the past, foreign interventions could create stable colonial regimes by devolving a share of power to feudal networks of local leaders, who provided a decentralized base of political support in exchange for confirmation of their local privileges. International stabilization operations today need to assure the world that their goal is different: not colonial exploitation, but to establish a stable regime that will protect and serve its citizens.

As market competition can limit profits and yield better values for consumers, so democratic competition should yield better government for the public and should limit elite privileges to the smallest possible moral-hazard rents. This is the basic argument for democracy. Even a benevolent autocrat may find it difficult to resist his courtiers' urge for greater privileges

if further exploitation of the public would entail no more risk of losing power.

Even with free elections, however, a corrupt political faction could maintain a grip on power if the voters believed that other candidates would not be any better. Successful democracy requires more than just elections; it requires alternative candidates who have good democratic reputations for using power responsibly to benefit the public at large, and not merely to reward a small circle of supporters. In a nation with a long tradition of democracy, there are typically many politicians who have such good democratic reputations. (Indeed, when democracy is well established, a senior politician who violated democratic norms or constitutional limits could lose his supporters' trust as if he had cheated one of them.) But in a nation that is emerging from generations of authoritarian rule, like Iraq in 2003, good democratic reputations are typically lacking. While waiting in exile, expatriate leaders could talk about democracy, but they could not demonstrate any ability to allocate public funds and patronage in a way that provides public goods and services for the population. Voters may be reasonably skeptical of candidates' promises when they have no evidence of good public service in the past.

In a simple game-theoretic model, I have shown (Myerson 2006) that such failure of democracy can be an equilibrium for a centralized unitary state, but this bad equilibrium can be eliminated by decentralizing a share of power to independently elected local and provincial governments. The key is that local governments create independent opportunities for local leaders to begin cultivating good democratic reputations. Then, if political leaders at all levels of government were expected to be uniformly corrupt, a local leader who offered better public service could establish a good reputation with the voters that could make him a serious contender for power at higher levels of government.

Thus, decentralization of political power can make national democratic competition more effective for the voters, by reducing barriers against the entry of new political competitors. That is, the value of local democracy for enhancing national democratic competition can be derived from a basic result in the economic theory of industrial organization: that equilibrium levels of profit-taking can be decreased when barriers to entry are reduced. A successful competitive system needs an ample supply of qualified competitors. So the essential key to successful democratic development is to increase the national supply of leaders who have good reputations for using public funds responsibly to serve the public at large, and not just to provide salaries for their active supporters.

Thus, the vital first step in a project of democratic state-building should be to encourage more individual politicians to begin building independent reputations, by giving them administrative power and budgetary authority in different domains. In occupied Iraq, the Coalition Provisional Authority could have begun in 2003 to cultivate local democratic leadership by holding local elections throughout Iraq and then giving the elected leaders responsibility for spending local reconstruction budgets. Much of this money might have been wasted (as it was even under the CPA's control), but local leaders who spent it well would have gained good reputations that could have made them serious contenders for higher office after national sovereignty was restored. Instead, however, the CPA put priority on drafting a national constitution before any introduction of local democracy in occupied Iraq. While local leadership was not cultivated, insurgencies took root.

Resistance to decentralization

The competition-enhancing effects of decentralization can stimulate powerful opposition to it, however. National leaders may not want local leaders to develop independent reputations that could make them future challengers for power. Prospects for such competition can be reduced when by making local authorities dependent on the central national leadership for their positions or budgets. In the long run, the scope of administrative and budgetary authority for autonomous local and provincial governments must be defined and protected by recognized constitutional rules.

Even within a democratic political party, top leaders may sometimes prefer to control advancement for party activists on the basis of their loyalty to the top leadership, rather than on the basis of their independent reputations for public service, as such reputations can become the basis for contesting leadership of the party. This centralizing tendency has been called the "iron law of oligarchy" by Robert Michels (1915). In a democracy, however, a party's competitive strength depends on its local agents' efforts to win popular support. Incentives for such local political work are strengthened when local agents' political advancement depends on their success in gaining local voters' trust and approval. Thus, when such approval is measured in local elections, local democracy can help a political party to decentralize in a way that makes the whole party stronger and more competitive, even if this decentralization sometimes seems against the interests of top leadership.

In Pakistan, the neglect of local democracy under constitutional governments left a political gap that military rulers could fill to legitimize themselves. Institutions of local democracy have been repeatedly created by military rulers and then dissolved when national power was transferred to civilians. Under both military and civilian rule, the long tradition of denying legal and democratic rights to people in Pakistan's Tribal Areas fostered a narrow feudal leadership which made these areas particularly vulnerable to the Taliban insurgency.

National parties can strengthen local democracy

Just as local democracy can help make national politics more competitive, so national democracy can also help make local politics more competitive, when national parties have the right to sponsor alternative candidates in local elections. Local bosses should know that, if they fail to provide good public service, they could face serious challengers supported by a rival national party. Allowing the major national parties to nominate candidates in local elections can also give these parties a vital interest in supporting the institutions of local democracy and in making sure that local elections are fair. Any democratic national party must maintain a reputation for defending its candidates' rights to compete in elections, and electoral abuse by its own people could tarnish a party's reputation.

Democratic norms can develop naturally in an elected assembly. When political parties are based in an elected national assembly, the national party leaders owe their positions to success in popular elections, and so they have a direct personal stake in maintaining the system of electoral competition. Members of a legislative assembly regularly develop working relationships that cross party lines, and such connections further encourage members of the assembly to identify their shared interest in maintaining a system of elections in which they all can compete fairly.

Against violent insurgents, some restrictions on nomination to local elections may be necessary, to prevent elections from being stolen by candidates who use force to threaten voters. Such restrictions should not be used to exclude candidates of national democratic parties, however. A good rule is that any party which is endorsed by at least some minimal fraction of the national assembly should be able to nominate candidates in all elections throughout the nation, but elected members of the assembly should be free to endorse new parties.

Distributing responsible control over public funds even before a constitution

When Paul Bremer headed the Coalition Provisional Authority in Iraq, he insisted that the formulation of a general constitutional document must be the first step in democratic state-building. In the absence of a constitution, he prohibited any local elections and retained central budgetary authority (Bremer, 2006). Under his theory, after popular ratification of a constitution, elections could fill its constitutional offices with appropriate leadership, and thereafter the new democracy would hopefully function as well as any other. A constitution can be important, but the rules of a new regime are not written on a blank slate. The first officials under a new constitution need support to win their high offices, and they cannot be expected to abandon their past supporters at the start of the new constitutional system. Provisions of the new constitution would be unenforceable if they asked these leaders to violate the terms of longstanding relationships with supporters. Thus, the fate of a new constitution may depend critically on the pre-existing personal constitutions that bind its first political leaders with their primary supporters. To build a new democratic regime may require the development of new political leadership.

So in contrast to Bremer's ideal constitutionalism, we have developed here a leadership-patronage theory of state-building, based on two propositions: First, political institutions are established by leaders who have reputations for distributing patronage benefits to active supporters. Second, competitive democracy requires an ample supply of leaders who also have good democratic reputations for responsibly providing public goods and services, even as they distribute patronage. Just as Cyrus's reputation was developed by distributing booty, so politicians today must develop their political reputations by spending public funds. To develop the supply of new democratic leadership, elected officials at different levels of government need opportunities to show what they can accomplish with public funds.

Thus, the distribution of public budgetary control can be vital to democratic state-building, and this point needs to be recognized by foreign donors who may provide much of the national budget during a state-building operation. When the goal is political reconstruction, the essential measure of success for a development project may be, not in how many bridges or schools it builds, but in how it enhances the reputations of the political leaders who spend the project's funds. To create a federal system that distributes power across national, provincial, and municipal governments, the distribution of aid funds directly to elected leaders at all these levels

may be more important than the promulgation of provisional constitutional documents.

To best support the development of public reputations for responsible governance, the distribution of public funds must be matched by systems of transparent accounting for the public funds that are spent by political leaders at all levels. The essential accounting here must be to the local population, however, not to foreign donors who may have provided the funds; but donors should insist on such accountability. Local people must be able to learn what funds were spent by their leaders and must be able to monitor what public services were provided by these funds. For these purposes, reconstruction of the public finance ministry may be a vital priority even when other agencies of the government are still badly underdeveloped. (See Ghani and Lockhart, 2008.) Basic press freedoms are also essential for such accountability.

The ability to get funding from foreign donors can, however, reduce politicians' incentive to develop the capacity for domestic taxation, which is essential for true national independence. Thus, Dobbins *et al.* (2007) urge foreign supporters to establish a plan for gradually reducing their budgetary assistance to the new state over a period of 5 to 10 years.

An example worth remembering

To conclude, it might be helpful to offer one example of a good transitional regime for a state-building operation: the American Articles of Confederation (1776-1788) which distributed power widely among thirteen locally-elected provincial assemblies. This decentralization of power might have sometimes seemed inconvenient to the regime's foreign supporters, but it guaranteed that every community had at least one local leader, its representative in the provincial assembly, who had a substantial vested interest in defending the new regime. This broadly distributed political strength was what made the American Revolution unbeatable. And with its founding leaders owing their positions to popular elections, the new nation's commitment to representative democracy was never seriously challenged.

The contrast is stark between this broadly inclusive political structure and the ultra-centralized regime that was installed in Afghanistan in 2004. Narrow centralization might seem more convenient for those at the pinnacle of power, but it increases demands on foreign supporters of the regime. Those who would support state-building should be aware of how the broad strength of the regime can depend on the way that its constitutional structure distributes power and on the way that donors distribute funding to groups and leaders throughout the nation.

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AUTHOR'S ADDRESS:
Roger Myerson, Economics Department, University of Chicago, 1126 East 59th Street, Chicago, IL 60637, USA.
Phone: 773-834-9071. Fax: 773-702-8490. Email: myerson@uchicago.edu
Web site: http://home.uchicago.edu/~rmyerson/
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