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LA DYNAMIQUE DE L'INFORMALITÉ ET SES IMPLICATIONS POUR UN NOUVEL ORDRE POLITICO-ÉCONOMIQUE

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À mes parents, Minh et Rémy

THE DYNAMICS OF INFORMALITY AND ITS IMPLICATIONS FOR A NEW ECONOMIC POLITICAL ORDER

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Résumé de la thèse en français

La présente thèse explore la dynamique des institutions informelles dans la gouvernance nationale et mondiale et l'ajustement de l'ordre politico-économique, dans un pays en transition et à l'échelle mondiale dans un contexte de crise financière internationale en utilisant l'approche institutionnelle comparative.

De l'ajustement de l'ordre politico-économique…

En 2008, nous avons assisté à une évolution dramatique de la situation économique mondiale. À partir de la crise des subprimes aux Etats-Unis et la crise financière qui la suit dans tout le secteur bancaire, l'économie mondiale entière est entrée dans une récession générale. Bien qu'il n'y ait pas une seule explication à la situation actuelle, la plupart des observateurs s'accordent à dire que la crise a révélé un déficit de gouvernance mondiale à tous les deux niveaux micro et macro. Au niveau de l'entreprise, un manque de confiance se fait jour à propos de l'intérêt des actionnaires et des parties prenantes. En particulier, les systèmes d'incitation pour la gestion font l'objet de critiques importantes dans la mesure où ils conduiraient à suivre les objectifs à court terme qui ne sont pas conformes au profit global et/ou à la maximisation du bien-être. Par ailleurs, au niveau macro, il y a une perception que l'environnement institutionnel ne serait pas approprié dans le contexte de la mondialisation croissante et que le cadre institutionnel actuel n'est pas adéquat pour la tâche d'ajuster la gouvernance dans le contexte international des activités commerciales. Toutefois, cette thèse, se concentre uniquement sur les questions de gouvernance au niveau macro.

Les lacunes de la gouvernance nationale et mondiale et l'exigence de l'ajustement de l'ordre politico-économique font l'objet de débats anciens. La crise financière en Asie en 1997 a mis fin à la période de forte croissance de cette région en moins de dix ans et a eu un effet épidémique sur la dépression économique mondiale. Avant le déclenchement de cette crise, la croissance faible en Amérique Latine et en Afrique dans les années 1990 a été critiquée pour leur confiance naïve dans les descriptions formelles des stratégies "Consensus de Washington" (ou les politiques recommandées par les institutions financières internationales et le Trésor Public des Etats-Unis et considérées comme les recettes du succès économique, telles que la libéralisation de l'économie de marché, du commerce et du marché des capitaux, la stabilisation macro-économique, ou la privatisation (Williamson 1990, 1999)). Dans le même temps, le succès économique des pays d'Asie orientale a été attribué à des politiques

industrielles et à des institutions adaptatives (ou informelles)[1] créées par le gouvernement pour soutenir le bon fonctionnement du marché (Rodrik 2008). Toutefois, les pays touchés par la crise en Asie de l'Est comme la Thaïlande ou la Corée sont ceux qui ont échoué dans l'ouverture des marchés de capitaux, tandis que ceux qui ont été à peine affectés par la crise ont visé à faire des innovations institutionnelles favorisant des marchés et la croissance. La sous-estimation des institutions informelles et de la relation mutuelle entre les institutions formelles et informelles dans la conception des réformes est le défaut majeur des modèles économiques néoclassiques dans les pays en développement.

Concernant l'ajustement de l'ordre politico-économique au niveau macro-économique, celui qui pourrait être appelé "le paradoxe de notre époque" se réfère au fait que les défis collectifs qu'il convient de relever ont une ampleur et une intensité croissantes, mais les moyens pour faire face ceux-ci sont faibles et incomplets. Il existe une variété de raisons pour la persistance de ces problèmes, mais au niveau le plus de base, la persistance de ce paradoxe demeure un problème de gouvernance telle qu'elle est observée par les récents prix Nobel Joseph Stiglitz et Paul Krugman. Un problème important à cet égard est qu'un nombre croissant de questions couvre à la fois les domaines intérieurs et internationaux. La fragmentation institutionnelle et la concurrence entre les gouvernements aux niveaux local et mondial semblent conduire à une course vers le bas où ces questions sont abordées dans une manière ad hoc et dissonant. En outre, même si les dimensions nationales ou mondiales d'une problématique sont reconnues, il n'y a pas de division claire du travail entre la myriade d'institutions sous-nationales ou internationales qui cherchent à y remédier: leurs fonctions se chevauchent souvent, leurs mandats entrent en conflit, et leurs objectifs deviennent souvent flous. Enfin, le système actuel de gouvernance nationale et mondiale souffre de graves déficits de responsabilité et d'inclusion.

L'enjeu est crucial aussi bien dans les perspectives juridiques que dans les perspectives économiques. En effet, la recherche des régulations optimales et des mécanismes de gouvernance optimale, en théorie et en pratique, conduisait à accentuer les lacunes et les

[1] Les institutions formelles sont créées par le gouvernement pour guider les activités économiques à prendre place dans l'ordre juridique (ou public) et imposées par son instrument judiciaire; tandis que les institutions informelles sont créées par les sociétés civiles ou par les organisations non gouvernementales pour orienter les activités économiques à prendre place dans un ordre privé et imposées par les normes de comportement partagées par ceux qui sont identifiés eux-mêmes comme membres de ces organisations privées et sociales. Voir de plus amples explications dans le Chapitre 1.

pièges dans la mise à disposition exclusive des régulations soit par l'État ou par le secteur privé (auto-régulation). L'argument d'aujourd'hui est de "revenir aux bases". Il semble intéressant, mais quelles sont les bases à considérer? Certes, la solution n'est pas simplement de revenir au passé. Le monde a changé, et il a besoin d'un nouvel ordre politico-économique avec une meilleure interaction entre les mécanismes de gouvernance et le cadre institutionnel.

La crise a remis en cause plusieurs hypothèses qui étayent le système de régulation. Les conséquences de la crise financière vont de plus en plus affecter les travailleurs ordinaires au cours des années à venir. Cela, à son tour, va focaliser l'attention politique, et peut-être la colère populaire, sur les actions des entreprises et des organismes de régulation qui sont considérés comme responsables. Donc, la tâche de « réingénierie » du système pour l'avenir est particulièrement urgente.

… à la dynamique de l'informalité

La transplantation sélective et adaptative des institutions modernes (telles que la démocratie de proximité, la responsabilité individuelle des présidents de collectivités locales, la transparence, les droits de propriété, la décentralisation administrative, l'économie de marché, ou l'e-gouvernement) de différents pays conduit à une institutionnalisation partielle mais légitime qui est unique au Vietnam. Malgré deux crises financières mondiales récentes, le taux de croissance moyen du Vietnam au cours de la période 2000-2010 est de 7,2 pour cent (Indicateurs du développement mondial, la Banque mondiale), et le pays devient de plus en plus une destination attrayante pour les investisseurs étrangers. Une des caractéristiques intéressantes des réformes institutionnelles au Vietnam est leur dépendance à l'égard des institutions informelles et des processus d'institutionnalisation. Chaque réforme a été un cas de *fence-breaking* - la création de règles innovantes par des collectivités locales ou par des entreprises appartenant à l'Etat se soustrayant aux règles juridiques. Une série de réformes institutionnelles importantes a été réalisée au cours de la "Doi Moi" (ou rénovation) dans ce pays autoritaire : la légalisation des incidents de *fence-breaking* dans certains districts ou provinces, y compris la libéralisation du commerce et des investissements, l'ouverture des marchés de capitaux, la privatisation, le système de contrat dans tous les secteurs économiques, l'abolition du système de subvention, les réformes des prix et des salaires basées sur le marché, la réforme agraire, l'autonomie des ressources humaines et financières dans le secteur public, la décentralisation administrative et du marché, et la démocratie de

proximité. Par conséquent, les réformes et le *fence-breaking* ne sont pas mutuellement exclusifs au Vietnam (Dang 2004).

La prédominance de l'informalité dans la création d'institutions de gouvernance modernes a accru la capacité de l'État à gérer avec souplesse « l'incongruité institutionnelle » et le changement institutionnel, ceci évitant la tension entre les institutions formelles et informelles quand elles étaient traitées comme paradoxes plutôt que comme un système d'institutions intégrées. L'économie dominante concerne principalement la stabilité macroéconomique ou la croissance du revenu national, et prend le bon fonctionnement du système des institutions formelles pour acquis. Par conséquent, pour évaluer les résultats des réformes institutionnelles dans un pays, les modèles économiques modernes ont besoin de tenir compte de la variation dans le cadre institutionnel, y compris la dynamique et l'endogénéité des institutions informelles.

Le rôle des institutions informelles pour la gouvernance et le développement économique varie selon les juridictions. Cette variation provient du fait que l'origine de l'évolution de chaque institution informelle et les modèles la permettant d'interagir avec les cadres institutionnels formels diffèrent d'une localité à une autre et d'un pays à un autre. La raison pour laquelle les pays d'Europe centrale sont plus efficaces dans la transition vers l'économie de marché que dans les pays asiatiques est que les institutions informelles évoluées en Europe centrale sont intégrées dans sa culture sociale et politique de l'individualisme, dans les droits de propriété et dans la règle de droit alors que les institutions de gouvernance économique en Asie sont construites en se basant sur leur adaptation à la culture régionale du collectivisme, à l'égalitarisme, et aux normes. Le gouvernement des États-Unis reconnaît les avantages comparatifs des institutions informelles (par exemple, les jugements des associations de l'industrie) comme compléments ou substituts pour les institutions formelles manquantes ou inefficaces et adopte une attitude de tolérance (Dixit 2009). Dans d'autres pays, les institutions de gouvernance similaires ne sont ni effectivement créées par le gouvernement, ni encouragées à fonctionner. De nombreuses institutions privées sont par la suite conduites à l'accommodation du système formel ou à la concurrence avec celui-ci.

Les pays choisissent leurs propres niveaux et modèles d'institutionnalisation avec une tentative de diriger le changement structurel et institutionnel vers une gouvernance légitime et efficace. Cependant, la légitimité et l'efficacité des institutions de gouvernance, en particulier dans les organisations gouvernementales, ne peuvent pas être précisément mesurées (Baker et

al., 1994). L'absence d'études empiriques sur l'évaluation des résultats des diverses institutions informelles en relation avec les cadres institutionnels peut nuire à la rapidité du changement institutionnel dans de nombreux pays. La majorité des études empiriques concernent principalement la fonctionnalité des institutions et organisations formelles et assument leur indépendance des institutions informelles. Bien que certaines études aient pour objet d'étudier de façon empirique la relation mutuelle entre les institutions formelles et informelles, elles se concentrent notamment sur les aspects complémentaires ou substitutifs et rendent l'accommodation et la concurrence entre institutions ambigües. D'une part, il est important pour le Vietnam et pour d'autres pays d'évaluer la relation et la performance des institutions formelles et informelles dans les différentes étapes des réformes pour fonder la base pour l'ajustement des politiques de réforme. D'autre part, l'ajustement de l'ordre politico-économique doit tenir compte des institutions informelles complémentaires car elles travaillent effectivement dans certains pays en développement.

Méthodologie

Des travaux de recherche antérieurs sur l'impact des institutions informelles sur la gouvernance et la performance microéconomique /macroéconomique ont principalement utilisé la modélisation théorique ou l'étude de cas. Bien que la modélisation théorique permette de prédire de divers résultats compte tenu de la diversité des scénarios hypothétiques incluses dans le modèle, et que l'étude de cas fournisse des informations riches sur les faits autour d'une histoire de gouvernance ou de développement dans un pays, dans une région ou une localité, toutes les deux laissent encore la question de la relation de cause à effet dans l'implicite (Dixit 2003). Des enquêtes récentes sur l'environnement institutionnel à l'échelle nationale et internationale menées par la Banque mondiale, par le Fonds monétaire international, par l'Union européenne, par le Programme des Nations unies pour le développement, et par de nombreux autres bureaux nationaux de statistiques ont fourni des données pour l'analyse économétrique de la relation de cause à effet entre les institutions et les résultats en matière de gouvernance.

La Nouvelle économie institutionnelle, la sociologie et la science politique ont récemment accordé plus d'attention à l'endogénéité des institutions informelles par rapport aux institutions formelles (North, 1990, Voigt et Kiwit 1998, Helmke et Levitsky 2004, Dixit 2007). Plus spécifiquement, les institutions informelles peuvent renforcer ou affaiblir l'efficacité des règles et des organisations formelles, et vice versa, un changement dans ces

dernières déterminera la trajectoire des premières. Comme la présente thèse vise à analyser les divers aspects des institutions de gouvernance informelles tels que leur impact sur la performance de gouvernance, l'endogénéité des institutions informelles par rapport aux cadres institutionnels, et le changement organisationnel et institutionnel provoqué par l'interaction entre les institutions formelles et informelles, j'envisage d'utiliser deux méthodes principales: l'étude de cas et l'analyse empirique statistique. Chaque méthode a ses avantages et ses inconvénients en répondant à des questions de recherche.

L'état de l'art de la recherche empirique sur les institutions informelles semble ignorer l'origine des institutions informelles émergentes (Helmke et Levitsky 2004). Cela est la raison pour laquelle les institutions informelles sont souvent considérées comme des produits ou émergentes de l'adaptation à la culture et à l'histoire. Ces institutions informelles qui sont endogènes par rapport aux cadres institutionnels formels ont des intérêts indus. L'étude de cas est la méthode préliminaire qui permet à l'auteur d'aborder l'histoire de l'émergence et du développement de diverses institutions informelles (comme le *fence-breaking*, la responsabilité individuelle des présidents des gouvernements provinciaux, ou l'économie informelle) en réponse à l'environnement institutionnel contraignant. Cependant, l'étude de cas est limitée dans l'analyse de la cause et de l'effet, particulièrement dans une approche institutionnelle comparative. Par conséquent, l'étude de cas n'est que la première étape pour aborder des questions de recherche.

L'instrument principal de la présente thèse est des enquêtes, sur la base desquelles de différentes méthodes d'analyse économétrique sont utilisées pour étudier la dynamique des institutions de gouvernance économique informelles dans soixante-quatre provinces vietnamiennes et dans quarante-cinq pays développés et en développement. Les études sur le Vietnam sont basées sur deux séries d'enquêtes: les unes sur l'indice de compétitivité provinciale (*Provincial Competitiveness Index* - PCI) et les autres sur les journaux officiels provinciaux pour la période 2006-2009.

Le PCI du Vietnam est un projet conjoint entre la Chambre de commerce et d'industrie du Vietnam (*Vietnam Chamber of Commerce and Industry* - VCCI) et l'Initiative sur la compétitivité du Vietnam (*Vietnam Competitiveness Initiative* - VNCI) parrainé par l'Agence américaine pour le développement international (USAID). Les enquêtes PCI sont menées chaque année pour les entreprises privées à propos de leurs perceptions de la qualité des administrations locales et des environnements d'affaires. En se basant sur les résultats des

enquêtes et la performance économique réelle de chaque province, un indice de compétitivité provinciale (PCI) a été construit. En 2006, les enquêtes PCI ont attiré les réponses d'environ sept milles entreprises privées dans toutes les provinces, et le PCI est composé de onze sous-indices mesurant les coûts d'entrée, les coûts horaires de la conformité réglementaire, l'accès aux terrains et la sécurité foncière, la transparence, la corruption, la qualité institutionnelle, l'environnement compétitif, la pro-activité des dirigeants provinciaux, la politique du travail, la qualité des services publics fournis au secteur privé, et l'infrastructure. En plus des indicateurs de performance de gouvernance des administrations locales, les enquêtes PCI posent aussi des questions concernant les points forts de certaines institutions informelles telles que celles considérées comme *fence-breaking*.

La deuxième série d'enquêtes est effectuée sur toutes les décisions sous la forme de documents juridiques émis par trente-cinq gouvernements provinciaux et publiés dans les journaux officiels des Comités populaires provinciaux de 2006 à 2009. L'examen des documents juridiques délivrés par les autorités provinciales permet de comparer la répartition des droits de décision aux différentes politiques de développement socio-économique local. L'étude de cas dans le Chapitre 3 montre que pour les décisions ayant la même teneur, la responsabilité des résultats diffère selon les provinces. Il y a aussi une division dans le cadre de dirigeants provinciaux. Certains sont conformes à la règle du consensus (ou à la responsabilité collective) du gouvernement central tandis que les autres sont prêts à être individuellement responsables devant la communauté sous leur autorité et font pleinement usage de leur autonomie dans la prise de décisions pour les intérêts de la communauté, même si leurs décisions se soustraient aux règles centrales. Le premier groupe fait moins de décisions et leurs documents juridiques reformalisent purement les mandats et les programmes centraux. Le deuxième fait plus de décisions, en particulier celles qui ont une faisabilité élevé ou une bonne réactivité au développement local-spécifique. En conséquence, les journaux officiels provinciaux sont une bonne source de données sur l'interaction entre les mécanismes de responsabilisation formels et informels au sein des gouvernements provinciaux.

Pour une analyse portant sur plusieurs pays, la présente thèse bénéficie de l'enquête mondiale sur les valeurs (*World Values Survey* - WVS) pour mesurer l'incongruité institutionnelle - ou la différence dans la perception de comment des activités / comportements économiques sont considérés comme légaux et / ou légitimes entre le gouvernement et les acteurs économiques. La WVS a débuté pour la période 1981-1984 en

collectant des données comparatives sur les valeurs et les systèmes de confiance à l'échelle mondiale. Jusqu'à présent, il y a eu déjà six vagues d'enquêtes. Dans cette thèse, je n'utilise que les statistiques fournies par la dernière vague (2005-2008) qui permettent de comparer l'incongruité institutionnelle en ce qui concerne les activités économiques informelles dans quarante-cinq pays, représentant environ soixante-dix pour cent de la population mondiale. La WVS a été utilisée par plusieurs chercheurs économiques et politiques, notamment Knack et Keefer (1997), Slemrod (2002), Torgler (2003), et Torgler et al. (2007).

Afin de déterminer la relation entre les institutions formelles et informelles et leur effet mutuel sur la gouvernance, une méthode d'analyse courante consiste à inclure un paramètre d'interaction à deux variables institutionnelles dans un modèle de régression par la méthode des moindres carrés ordinaires (*Ordinary Least Squares* - OLS), étant la variable dépendante (voir le Chapitre 4). Toutefois, l'inclusion du paramètre d'interaction à deux variables continues dans le modèle OLS va produire des estimations biaisées en raison de sa forte corrélation avec les paramètres individuels et de son incapacité à prendre en compte l'endogénéité. Alternativement, nous utilisons l'approche de Zellner et Theil (1962), Greene (2002), et Poppo et Zenger (2004) en employant un modèle de régression par la méthode des triples moindres carrés (*Three-Stage Least Squares* - 3SLS) dans le Chapitre 2. L'utilisation du modèle 3SLS permet de produire des estimations cohérentes tout en prenant en compte la corrélation dans les paramètres de perturbation de toutes les équations (Stata 1999). Comme cette thèse utilise de différents jeux de données, les données de panel sur la responsabilité informelle et sur la performance de gouvernance au cours des années de 2006 à 2009 présentées dans le Chapitre 3 permettent à l'auteur d'évaluer la dynamique des mécanismes de responsabilisation informels au fil du temps. En outre, pour chaque question de recherche, la vérification de robustesse utilisant de différentes méthodologies est réalisée afin d'assurer la crédibilité des estimations de référence.

De méthodes empiriques statistiques traitent l'endogénéité en utilisant des variables instrumentales qui ne sont pas affectées par d'autres dimensions institutionnelles ainsi que par la performance économique actuelle. Quelques exemples de ces variables instrumentales sont l'origine coloniale ou légale (Glaeser et al. 2004), les conditions météorologiques et climatiques (Eagles 1994, Tietjan et Kripke 1994, Torgler et al. 2007, Torgler et Schneider 2007), la culture politique, l'histoire et la géographie (Torgler et Schaltegger 2006, Tsai 2007). Cependant, de nombreux chercheurs doivent admettre qu'ils ne peuvent pas résoudre le problème d'endogénéité dans leur modèle à cause de l'indisponibilité des variables

instrumentales valides. Cela est aussi une des raisons pour lesquelles la relation endogène entre les institutions formelles et informelles reste encore inadéquatement traitée dans l'état de l'art institutionnel comparatif empirique. Ainsi, la présente thèse tente de contribuer aux travaux de recherche visant à aborder cette problématique.

Présentation de la thèse

La thèse se compose de quatre grands chapitres, en plus de l'introduction générale (en français et en anglais) et une conclusion.

Le Chapitre 1 donne un aperçu de l'état de l'art de la recherche sur la gouvernance informelle en soulignant les lacunes et les questions ouvertes à aborder dans les chapitres suivants. Cette thèse est motivée par les arguments principaux de la nouvelle économie institutionnelle qui expriment que les institutions formelles et informelles sont des entrées alternatives du processus de gouvernance, et que la production d'une bonne sortie de gouvernance[2] requiert une attention appropriée à leurs avantages comparatifs et à la façon dont elles interagissent les unes avec les autres (North 1990, Williamson 1996, Klein 2000, Tsai 2001, Brinks 2003, Helmke et Levitsky 2004, Farrell et Héritier 2003, Dixit 2009). Chaque combinaison d'institutions formelles et informelles va insérer de différentes incitations et contraintes par rapport au comportement des acteurs. Le bon choix de leur combinaison va inciter les acteurs à agir efficacement.

Ce chapitre commence par la réussite du *fence-breaking* - l'émission de décisions provinciales sur l'expérimentation des politiques de réforme économique violant les lois et les règlements centrales – en tant que manière informelle mais légitime de créer des innovations dans les politiques au Vietnam. En analysant les avantages comparatifs des institutions de gouvernance formelles et informelles et des tendances hétérogènes d'institutionnalisation (informelle / partielle / formelle) dans le monde entier, ce chapitre met en évidence les ignorances suivantes dans l'état de l'art de la recherche sur les institutions de gouvernance.

1) Il y a un manque d'études empiriques sur les institutions de gouvernance économique informelles.

[2] La sortie de la gouvernance peut être mesurée par la qualité et quantité des biens et services publics (Kaufmann et al. 2004), par le nombre et distribution de documents juridiques réceptifs et responsables (Vu et Deffains 2013), ou par le nombre de licences et taxes requis pour démarrer une entreprise (World Bank 2009), par exemple.

2) L'hypothèse de l'indépendance des institutions informelles dans les cadres institutionnels formels dans les paradigmes économiques « néoclassiques » devrait être assouplie.
3) Le succès de la gouvernance informelle dans certains pays émergents et les échecs des modèles économiques appliqués dans de nombreux autres pays en développement impliquent la nécessité d'ajuster l'ordre politico-économique.

Le Chapitre 2, intitulé "L'informalité, la décentralisation et la gouvernance sous-centrale", vise à aborder les trois lacunes ci-dessus mentionnées, en mettant l'accent sur l'interaction entre les dimensions formelles et informelles de la décentralisation de la gouvernance publique dans une économie de transition. La décentralisation formelle est définie comme l'affectation des droits de décision sur certaines politiques publiques à partir du niveau supérieur de gouvernement à un niveau inférieur. En raison de défaillances de coordination entre les niveaux de gouvernement (par exemple l'asymétrie d'information, l'incomplétude des contrats, des conflits d'intérêt, ou la capacité et les contraintes de ressources), la décentralisation n'est que partielle dans la réalité. Les bureaucrates ont toujours des incitations à la création ou au moins à la favorisation de l'établissement d'un ordre privé qui pourrait compléter, substituer, accommoder, ou faire concurrence avec le système d'ordre public faible ou inefficace, que ce soit pour le bien de leur communauté locale ou tout simplement dans le but de maximiser leurs profits privés. Cet ordre privé permet aux gouvernements de niveau inférieur de manipuler les règles et réglementations de niveau supérieur dans leur discrétion et même de mettre en place leurs propres règles qui sont respectés et reconnus par les citoyens locaux comme à faibles coûts fixes.

Les institutions formelles et informelles sont souvent considérées comme des compléments ou des substituts dans les études empiriques et théoriques. Dans ce chapitre, je ne trouve aucune preuve de relation complémentaire ou substitutive dans notre analyse empirique de la relation entre les décentralisations formelle et informelle dans soixante-quatre provinces vietnamiennes. En se basant sur la typologie des institutions informelles endogènes dans les cadres institutionnels formels[3] proposée par Helmke et Levitsky (2004), le chapitre démontre

[3] Quatre modes d'interaction entre les institutions formelles et informelles (complémentaire, substitutive, accommodante et concurrente) sont introduits par Voigt et Kiwit (1998) et Helmke et Levitsky (2004). La distinction entre eux réside dans la force de l'institution formelle existante, dans l'objectif fonctionnel de l'institution informelle évoluée, et dans leurs incitations à l'efficacité. Les complémentarités existent lorsque les institutions informelles sont créées pour faciliter le fonctionnement de quelques institutions formelles et pour

que durant la période 2006-2008, le système de biens publics et de fourniture de services formellement décentralisé accueille l'informel, et la décentralisation informelle dans la disposition d'ordre public tend à faire concurrence avec le système formel inefficace existant. Cela donne à penser que le système formellement décentralisé pour la fourniture de biens et de services publics donne suffisamment d'incitations aux gouvernements de niveau inférieur pour qu'ils puissent performer efficacement, mais il reste encore un manque d'efficacité dans la disposition d'ordre public, en particulier la protection des droits de propriété, l'exécution des contrats, la transparence et la réduction de la corruption. Les résultats présentés dans ce chapitre impliquent que le gouvernement central a besoin de réorganiser la disposition d'ordre public décentralisée et la fourniture de biens et de services publics pour rendre les institutions informelles des compléments plutôt que des concurrents ou des resquilleurs vis-à-vis des institutions formelles.

Le chapitre 3, intitulé "Les mécanismes de responsabilisation formels et informels dans la gouvernance locale: le cas d'un état autoritaire", propose une étude empirique des origines et des effets de la gouvernance informelle, notamment en mettant l'accent sur l'émergence endogène des mécanismes de responsabilité informels dans la transition du Vietnam. Ce chapitre cherche à répondre à la question suivante: quels types d'institution sont efficaces pour maintenir les agents locaux responsables et réceptifs à ses citoyens dans des pays autoritaires où la démocratie est limitée et les institutions formelles sont faibles?

La responsabilisation est réalisé par deux mécanismes principaux: la fourniture d'informations et les sanctions (Dubnick 1998 Schedler 1999 Bovens 2007). Le premier de ces deux est un ensemble d'arrangements institutionnels de communiquer les attentes vis-à-vis de la qualité de gouvernance, d'assimiler les normes de bonne gouvernance, de justifier et de juger le comportement des agents. Ces procédures fondent la base pour une certaine forme de sanctions au cas où toute faute est trouvée et jugée. La menace de sanctions, que ce soit

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aider à la mise en œuvre effective de ces dernières. Les institutions informelles substitutives sont créées pour aider une certaine institution formelle inefficace à atteindre son objectif. Quand une certaine institution formelle n'est pas fonctionnellement souhaitable pour un groupe d'acteurs, ils cherchent à créer un ensemble d'équivalents informels pour résoudre plus efficacement leurs propres problèmes sans violer les règles formelles. Dans ce scénario, les institutions sont accommodantes. Toutefois, les institutions informelles pourraient dominer les institutions formelles faibles et conduire les acteurs à ignorer et à violer les règles formelles. Dans ce cas, les institutions deviennent désormais en concurrence et dysfonctionnelle.

formelle ou informelle, agit comme des mécanismes d'incitation qui rendent le comportement et les actions des agents corrects dans le but de répondre aux attentes du président.

Ce chapitre établit une distinction entre les mécanismes de responsabilisation formels et informels. La responsabilisation formelle est un processus de "donation de responsabilité" et de "maintien de responsabilité" au moyen de la communication et de la réceptivité, un ensemble de mécanismes juridiques et bureaucratiques sous le contrôle direct de l'Etat (ou le système basé sur le contrôle et l'équilibre directs), et un ensemble de mécanismes d'incitation formels (y compris la possibilité de sanctions et de récompenses qui est bien communiquée dans les documents juridiques). La responsabilisation informelle est un ensemble d'arrangements institutionnels qui sont formulés, communiquées et appliquées par un président "non étatique" ou par un tiers qui n'est pas l'Etat, en vue de faciliter, de contrôler et de motiver l'accomplissement des fonctions par l'agent à la hauteur des attentes du président via les sources d'incitations intrinsèques et indirects. La responsabilité tenue grâce à la réponse de l'agent aux médias, à la société civile, aux organisations non gouvernementales, aux normes de gouvernance, à l'éthique, à la confiance, à l'identité, à l'avancement professionnel, ou à la réputation est considérée comme informelle.

La gouvernance responsable est progressivement devenue un sujet à débattre dans l'économie et dans la politique, surtout quand elle est blâmée pour la dépression actuelle du monde, qui a commencé par la crise des subprimes aux Etats-Unis en 2008. Les analyses empiriques dans ce chapitre comme dans le Chapitre 2 ont montré que les mécanismes formels (similaire aux institutions démocratiques) ne suffisent pas à créer des incitations pour que les acteurs publics fassent des efforts particuliers afin d'achever la pleine responsabilité. Ils doivent être accompagnés de ceux informels pour combler les déficits de responsabilité du système formel. Dans ce chapitre, nous soulignons quelques solutions alternatives, y compris les mécanismes basés sur l'identité et sur la performance qui sont discrètement introduits dans le kit de stratégies de gouvernance dans l'objectif d'atteindre une responsabilité plus élevée, même de la façon informelle.

Notre étude de cas et analyse empirique de tous les documents juridiques présentés par trente-cinq gouvernements provinciaux du Vietnam publiés dans leurs journaux officiels de 2006 à 2009 montrent que la responsabilité et culture individuelle informelle ont un impact positif sur la production d'une sortie de gouvernance réceptive alors que l'influence des institutions formelles est insignifiante. Compte tenu de cette allocation de politiques, les provinces qui

rendent publics plus de documents juridiques de réforme administrative établissent la confiance plus élevée chez le public dans leur réactivité. Ce chapitre fournit également des preuves de comment l'élaboration des politiques au niveau provincial et l'identification sont influencées par un classement PCI externe et non contraignant mené par une organisation non gouvernementale à capitaux étrangers (NGO). Les résultats obtenus impliquent que la légitimité des régimes à parti unique devrait être mieux garantie par les instruments de gestion modernes plutôt que par la refuse de tels instruments et que par la centralisation de leurs pouvoirs.

Le chapitre 4, intitulé "La non-congruence institutionnelle et l'économie informelle: une analyse empirique", étudie l'impact de la non-congruence institutionnelle - la différence dans la façon dont les institutions formelles et informelles perçoivent si un comportement économique est légal et / ou légitime - sur les limites de l'économie informelle dans quarante-cinq pays développés et en développement. Le chapitre fournit une analyse empirique et des preuves à cinq hypothèses: (1) la participation dans l'économie informelle n'est qu'une expression de la non-congruence institutionnelle, (2) l'impact de la non-congruence institutionnelle sur les limites de l'économie informelle varie en fonction du niveau de non-congruence , (3) et (4) la non-congruence institutionnelle a un impact globalement positif sur la taille de l'économie informelle, mais exerce un impact négatif dans les pays avec un contrôle plus efficace de la corruption ou avec des initiatives gouvernementales plus ciblées, et (5) la limite de l'économie informelle peut se déplacer, ce qui est l'objet d'un changement dans la non-congruence institutionnelle de la part du gouvernement et des acteurs économiques informels.

La relation avec l'Etat est la dimension la plus populaire pour distinguer l'économie informelle à l'économie formelle depuis que le terme "économie informelle" a été lancé dans Hart (1971, 1973). Elle se réfère aux travailleurs et aux entreprises qui ne sont pas protégés et réglementés par l'État (ILO 1972). Cette définition ne parvient pas à distinguer les activités économiques illégales de celles restant dans les limites de l'économie informelle. D'un point de vue plus restreint, Webb et al. (2009) définit l'économie informelle comme comprenant des activités produisant de revenus qui sont menées en dehors du cadre réglementaire, mais acceptées par un grand groupe de personnes comme "légitime". Avec cette définition, les contraintes institutionnelles formelles ne sont pas la seule incitation pour les acteurs économiques (les travailleurs et les entreprises) pour qu'ils soient engagés dans l'économie informelle. Leur décision est également guidée par la façon dont ils perçoivent la légitimité de leurs activités

économiques et par comment ils jugent si les institutions gouvernementales (la constitution, les lois, les tribunaux, la police et les organismes de réglementation) perçoivent leurs activités comme légitimes ou non.

Pour tester les cinq hypothèses ci-dessus présentées, une mesure de la non-congruence institutionnelle est réalisée sur les enquêtes *World Value Surveys* (WVS) 2005-2008. La non-congruence institutionnelle est le pourcentage de la population, qui a choisi "jamais justifiable" à la question V200 dans les WVS 2005-2008, avec le pourcentage élevé représentant une attitude explicitement biaisée contre la fraude fiscale et les perceptions les moins non-congrues de l'illégitimité de l'économie informelle par le gouvernement et les acteurs économiques. Les pays à faible non-congruence institutionnelle sont ceux qui ont plus de soixante pour cent des personnes interrogées choisissant "jamais justifiable" et les pays à forte non-congruence institutionnelle sont ceux qui ont moins de soixante pour cent. L'économie informelle est mesurée par le pourcentage du produit intérieur brut (*Gross Domestic Product* - GDP) en 2007, en utilisant la méthode d'estimation à indicateurs multiples et à causes multiples (Multiple Indicators Multiple Causes - MIMIC) (Schneider et al. 2010).

Les études empiriques antérieures considèrent les valeurs / attitudes sociales et l'environnement institutionnel formel comme les facteurs qui ont un impact indépendant sur la croissance de l'économie informelle (Torgler et Schaltegger 2006, Torgler et al. 2007, Torgler et Schneider 2007). Dans le cadre des travaux de cette thèse, on suppose que la relation entre la non-congruence institutionnelle et l'économie informelle dépend de la performance de gouvernance du gouvernement. Les variables factices pour les q-quantiles de la performance du gouvernement sont générées et interagissaient avec les mesures de la non-congruence institutionnelle dans un modèle d'équations structurelles. Dans ce chapitre, deux variables de la performance du gouvernement incluses dans le modèle sont la qualité de la lutte contre la corruption et l'intensité des politiques gouvernementales ciblées vers l'économie informelle.

GENERAL INTRODUCTION

This dissertation explores the dynamics of informal institutions in national and global governance and the adjustment of the economic political order in a transition country and on the global scale after two recent global financial crises, using the comparative institutional approach.

From adjusting the economic political order

In 2008, we have witnessed a dramatic evolution of the worldwide economic situation. Starting with the subprime crisis in the United States and the subsequent financial crisis in the overall banking sector, the entire world economy has moved into a global recession. While there is not one single explanation for the current situation, most observers agree that the crisis uncovered a global governance deficit both at the micro and at the macro levels. At the firm level, there is a lack of confidence that management follows the interest of shareholders and stakeholders alike. In particular, incentive schemes for management have been the target of significant criticisms, supposedly misleading the latter to follow short-term objectives that are incongruent with overall profit and/or welfare maximization. Moreover, at the macro level, there is a sense that the institutional environment is not appropriate in the light of growing globalization and that the current institutional framework is not adequate for the task of adjusting governance in the international context of business activities. However, this dissertation only focuses on economic governance issues at the macro level.

It was not until 2008 did national and global governance deficits and the demand for adjusting the economic political order become a serious debate. The financial crisis in Asia in 1997 ended the high growth period of this region over less than a decade and had an epidemic effect on global economic depression. Before the outbreak of this crisis, the low growth in Latin America and Africa in the 1990s was criticized for their naive trust in formal descriptions of the “Washington Consensus” strategies (or those policies recommended by international financial institutions and the United State Treasury and considered as the recipes for economic success such as market economy, trade and capital market liberalization, macroeconomic stabilization, or privatization (Williamson 1990, 1999)). At the same time, economic success of East Asian countries was attributed to industrial policies and adaptive (or

informal) institutions[4] designed by the government to support the well-functioning of the market (Rodrik 2008). However, those crisis-hit countries in East Asia such as Thailand or Korea are those who failed in opening capital markets while those who were hardly affected by the crisis focused on making the institutional innovations conducive to markets and growth. The understatement of informal institutions and the mutual relationship between formal and informal institutions in designing reforms is the shortcomings of the neoclassical economics models in developing countries.

With respect to the adjustment of the economic political order at the macroeconomic level, what could be called "the paradox of our times" refers to the fact that the collective issues we must grapple with are of growing extensity and intensity, yet the means for addressing these are weak and incomplete. There are a variety of reasons for the persistence of these problems, but at the most basic level, the persistence of this paradox remains a problem of governance as it is observed by recent Nobel prizes Joseph Stiglitz and Paul Krugman (Stiglitz 2002, Krugman 2008). One significant problem in this regard is that a growing number of issues span both the domestic and the international domains. The institutional fragmentation and competition between governments at both local and global levels seems to lead to race to the bottom where these national and global issues are addressed in an ad hoc and dissonant manner. In addition, even where the national or global dimensions of a problem are acknowledged, there is no clear division of labour among the myriad of sub-national or international institutions that seek to address them: their functions often overlap, their mandates conflict, and their objectives often become blurred. Finally, the existing system of national and global governance suffers from severe deficits of accountability and inclusion.

The challenge is crucial in both legal and economic perspectives. Indeed, the seek for optimal regulations and optimal governance mechanisms, in theory and in practice, has been leading to point out the shortcomings and pitfalls of exclusive provision of regulation either the state or by the private sector (self-regulation). The argument today is to "go back to the basics". It seems interesting, but what are the basics to consider? Certainly, the solution is not simply to

[4] Formal institutions are provided by the government to guide economic activities to take place in the legal (or public) order and enforced by its legal apparatus while informal institutions are provided by civil societies or non-government organizations to guide economic activities to take place in a private order and enforced by the norms of behavior shared by those who are identified themselves as members in these private and social organizations. See further explanations in chapter 1.

go back to the past. The world has changed, and it appeals for a new economic political order with a better interaction between governance mechanisms and the institutional framework.

The crisis has challenged many of the assumptions which have underpinned the regulatory system. The consequences of the financial meltdown will increasingly affect ordinary working people over the coming years. That, in turn, will focus political attention, and perhaps popular anger, on actions of the firms and regulators who are seen to be responsible. So the task of re-engineering the system for the future is urgent.

...to the dynamics of informality

Selective and adaptive transplantation of modern institutions (such as grassroots democracy, individual accountability of the chairmen of local government, transparency, property rights, administrative decentralization, market economy, or e-government) from various countries leads to partial but legitimate institutionalization that is unique in Vietnam. Despite two recent global financial crises, the average growth rate of Vietnam over the 2000-2010 period is 7.2 percent (World Development Indicators, the World Bank), and the country is increasingly becoming an attractive destination for foreign investors. One of interesting features of institutional reforms in Vietnam is their dependence on informal institutions and institutionalizing processes. Each reform was a case of fence-breaking - the creation of innovative rules by local governments or state-owned enterprises to evade legal rules. A series of important institutional reforms during the '*Doi Moi'* (or Renovation) in this authoritarian country were the legalization of fence-breaking incidents in certain districts or provinces, including trade and investment liberalization, the openness of capital markets, privatization, the contract system in all economic sectors, the abolition of the subsidy system, market-based price and wage reforms, land reform, financial and human resource autonomy in the state sector, administrative and market decentralization, and grassroots democracy. Therefore, reforms and fence-breaking are not mutually excluded in Vietnam (Dang 2004).

The dominance of informality in building modern institutions of governance has increased the state capacity to manage institutional incongruence and institutional change flexibly, avoiding the tension between formal and informal institutions when they are treated as paradoxes rather than a system of embedded institutions. Mainstream economics mainly concerns macroeconomic stability or the growth of national income, and takes the well-functioning system of formal institutions for granted. Therefore, to evaluate the outcome of institutional

reforms in a country, modern economic models need considering the variation in the institutional framework, including the dynamics and endogeneity of informal institutions.

The role of informal institutions for governance and economic development varies across jurisdictions. This variation arises because the origin of the evolution of each informal institution and the patterns that it interacts with formal institutional frameworks differ from locality to locality and from country to country. The reason why Central European countries are more successful in transition to the market economy than Asian countries is that informal institutions evolved in Central Europe are embedded in its social and political culture of individualism, property rights, and the rule of law while informal institutions of economic governance in Asia are built through their adaptation to the regional culture of collectivism, egalitarianism, and norms. The United States government acknowledges the comparative advantages of informal institutions (for example, the judgements of industry associations) as complements or substitutes for missing or ineffective formal institutions and adopt the attitude of tolerance (Dixit 2009). In other countries, similar institutions of governance are not effectively provided by the government, but they are not encouraged to function. Many private institutions are subsequently driven to accommodating or competing with the formal system.

Different countries choose their own degrees and patterns of institutionalization with an attempt to lead structural and institutional change towards legitimate and efficient governance. However, legitimacy and efficiency of governance institutions, especially in governmental organizations, cannot be measured precisely (Baker et al. 1994). The lack of empirical studies on the assessment of the outcomes of various informal institutions in relation with institutional frameworks can adversely affect the speed of institutional change in many countries. The majority of empirical studies mainly concern the functionality of formal institutions and organizations and assume their independence out of informal institutions. Some studies empirically investigate the mutual relationship between formal and informal institutions, but they mostly focus on the complementary or substitutive aspects and leave accommodating and competing institutions ambiguous. On the one hand, it is important for Vietnam and other countries to evaluate the relationship and performance of formal and informal institutions in different stages of reforms to set the basis for the adjustment of reform policies. On the other hand, the adjustment of the economic political order needs to take into account complementary informal institutions as they work effectively in certain developing countries.

Methodology

Previous research on the impact of informal institutions on governance and microeconomic/macroeconomic performance mainly used theoretical modeling or case studies. Although theoretical modeling allows predicting various outcomes given the diversity of hypothetical scenarios included in the model, and case studies provide rich information about the facts around a governance or development story in a country, a region, or a locality, both leave the question of cause and effect implicit (Dixit 2003). Recent surveys of institutional environment on the national and international scale conducted by the World Bank, the International Monetary Fund, the European Union, the United Nations Development Programs, and many other national offices of statistics have supplied data for econometrical analysis of the cause and effect relationship between institutions and governance outcomes.

The New Institutional Economics, sociology, and political science have recently paid more attention to the endogeneity of informal institutions with formal institutions (North 1990, Voigt and Kiwit 1998, Helmke and Levitsky 2004, Dixit 2007). More specifically, informal institutions may enhance or undermine the effectiveness of formal rules and organizations, and vice versa, a change in the latter will determine the trajectory of the former. As this dissertation analyses various aspects of informal governance institutions such as their impact on governance performance, the endogeneity of informal institutions with institutional frameworks, and organizational and institutional change caused by the interaction between formal and informal institutions, I consider using two main methods: case studies and statistical empirical analysis. Each method has its own advantages and disadvantages in answering research questions.

Empirical literature on informal institutions seems to ignore the origin of emerging informal institutions (Helmke and Levitsky 2004). This is the reason why informal institutions are often considered to be the products of or emerge from the adaptation with culture and history. Those informal institutions that are endogenous with formal institutional frameworks have undue interests of scholars. Case studies are the preliminary method that enables the author to investigate the history of emergence and development of various informal institutions (such as fence-breaking, individual accountability of the chairmen of provincial governments, or informal economy) in response to the constraining institutional environment. However, case

studies are limited in analyzing the cause and effect, especially in comparative institutional literature. Therefore, case studies are only the first step to investigate research questions.

The main instrument in this dissertation is surveys, based on which different methods of econometric analysis are used to study the dynamics of informal institutions of economic governance in 64 provinces in Vietnam and a sample of 45 developed and developing countries. Research on Vietnam is based on two surveys: the Provincial Competitiveness Index (PCI) surveys and provincial Official Gazettes for the period 2006-2009.

The PCI Vietnam is a joint project between the Vietnam Chamber of Commerce and Industry (VCCI) and the Vietnam Competitiveness Initiative (VNCI) sponsored by the United States Agency for International Development (USAID). The PCI surveys are annually conducted for private enterprises regarding their perceptions of the quality of local governments and business environments. Based on the survey results and actual economic performance of each province, a Provincial Competitiveness Index (PCI) was constructed. In 2006, PCI surveys have attracted responses from approximately 7000 private enterprises in all provinces, and the PCI index is comprised of 11 sub-indices, measuring entry costs, time costs of regulatory compliance, land access and tenure security, transparency, corruption, institutional quality, competitive environment, proactivity of provincial leadership, labor policy, quality of public services for the private sector, and infrastructure. In addition to indicators of governance performance of local governments, the PCI surveys also ask some questions concerning the strengths of certain informal institutions such as fence-breaking.

The second survey is done for all decisions in the form of legal documents issued by 35 provincial governments and published in the official public press (Official Gazettes) of Provincial People's Committees from 2006 to 2009. Surveying legal documents issued by provincial authorities allows comparing the distribution of decision rights to different local socio-economic development policies. The case study in chapter 3 shows that for the decisions of the same content, the accountor differs across provinces. There is also a division in the cadre of provincial leaders. Some are compliant to the consensus rule (or collective accountability) of the central government while the others are willing to be individually accountable to the community under their authority and make full use of their autonomy in making policies for the community's interests even if they have to evade central rules. The former group makes fewer decisions, and their issued legal documents only formalize the central mandates and programs. The later makes more decisions, especially those with high feasibility and responsiveness to local-specific development. Accordingly, provincial official

gazettes are a good source of data about the interaction between formal and informal mechanisms of accountability in provincial government.

For cross-country analysis, this dissertation benefits from the World Values Surveys (WVS) to measure the institutional incongruence - or the discrepancy in the perception of what economic activities/behaviours are legal and/or legitimate between the government and economic actors. WVS was first conducted in 1981-1984, collecting comparative data on values and belief systems among people around the world. Until now, there have been six waves of surveys. In this dissertation, I only use the statistics of the latest wave 2005-2008 which allows comparing institutional incongruence regarding informal economic activities in 45 countries, representing about 70 percent of the world population. The WVS has been used by several economic and political scholars, including Knack and Keefer (1997), Slemrod (2002), Torgler (2003), and Torgler et al. (2007).

To determine the relationship between formal and informal institutions and their mutual effect on governance, a common analytical method is to include an interaction term of two institutional variables in an Ordinary Least Squares (OLS) model of government performance being the dependent variable (see chapter 4). However, the inclusion of the interaction term of two continuous variables in the OLS model will produce biased estimations due to its significant correlation with the individual terms and its failure to account for endogeneity. Alternatively, I follow the approach of Zellner and Theil (1962), Greene (2002) and Poppo and Zenger (2004), and employ a three-stage least squares (3SLS) model in chapter 2. The use of the 3SLS model allows producing consistent estimates while taking the correlation in the disturbance terms across equations into account (Stata 1999). As this dissertation uses different data sets, the panel data of informal accountability and governance performance during 2006-2009 in chapter 3 permits the author to evaluate the dynamics of informal mechanisms of accountability over time. In addition, for each research question, robustness check using different methodologies is carried out to ensure the credibility of the benchmark estimations.

Statistical empirical methods deal with endogeneity by using instrumental variables that are not affected by other institutional dimensions as well as current economic performance. Some examples of these instrumental variables are colonial or legal origin (Glaeser et al. 2004), weather and climate (Eagles 1994, Tietjan and Kripke 1994, Torgler et al. 2007, Torgler and Schneider 2007), political culture, history, and geography (Torgler and Schaltegger 2006, Tsai

2007). However, many scholars have to admit that they cannot solve the endogeneity problem in their model because of the unavailability of valid instrumental variables. That is also one of the reasons why the endogenous relationship between formal and informal institutions remains underinvestigated in empirical comparative institutional literature. This dissertation attempts to contribute to this literature gap.

Overview of the dissertation

The dissertation is composed of four main chapters in addition to the general introduction (in French and English) and conclusion.

Chapter 1 gives an overview of the actual research status in the informal governance literature, point out the shortcomings and open questions for research in the following chapters. This dissertation is motivated by the main arguments of new institutional economics that formal and informal institutions are alternative inputs in the governance process, and the production of good governance output[5] requires the proper attention to their comparative advantages and how well they interact with each other (North 1990, Williamson 1996, Klein 2000, Tsai 2001, Brinks 2003, Helmke and Levitsky 2004, Farrell and Héritier 2003, Dixit 2009). Each combination of formal and informal institutions will insert different incentives and constraints over the actors' behavior. The right choice of their combination will induce the actors to act efficiently.

This chapter begins with the success of fence-breaking – the issuance of provincial decisions on experimenting economic reform policies violating central laws and regulations – as an informal but legitimate way of making policy innovations in Vietnam. Through analysing the comparative advantages of formal and informal governance institutions and heterogeneous trends of (informal/partial/formal) institutionalization around the world, this chapter highlights the following gaps in the literature of governance institutions.

1) There is a lack of empirical studies of informal institutions of economic governance.
2) The assumption of the independence of informal institutions in formal institutional frameworks in neoclassic economics paradigms should be relaxed.

[5] Governance output can be measured by the quality and quantity of public goods and services (Kaufmann et al. 2004), the number and distribution of responsive and accountable legal documents (Vu and Deffains 2013), or the number of licences and taxes required to start up a firm (World Bank 2009), for example.

3) The success of informal governance in some emerging countries and the failures of neoclassical economics models in many other developing countries imply the need to adjust the economic political order.

Chapter 2, titled "Informality, Decentralization, and Sub-central Governance", aims to contribute to three literature gap issues above, focusing on the interaction between formal and informal dimensions of decentralization in public governance in a transition economy. Formal decentralization is defined as the assignment of decision rights over certain public policies from the upper tier of government to a lower one. Due to coordination failures among the tiers of government (e.g., information asymmetry, contract incompleteness, interest conflicts, or capability and resource constraints), decentralization is only partial in reality. Bureaucrats always have incentives to create or at least facilitate the establishment of a private order to complement, substitute, accommodate, or compete with the weak or inefficient system of public order, either for the sake of their local community or simply in an effort to maximize their private benefits. This private order allows lower-tier governments to manipulate higher-tier rules and regulations at their discretion and even to introduce their own rules that are acknowledged and respected by local citizens at low fixed costs.

Formal and informal institutions are often viewed as complements or substitutes in empirical and theoretical studies. In this chapter, I find no evidence of complementary or substitutive relationships in the empirical analysis of the relationship between formal and informal decentralization across 64 provinces in Vietnam. Based on Helmke and Levitsky (2004)'s typology of endogenous informal institutions in formal institutional frameworks[6], I find that during 2006-2008, the formally decentralized system of public goods and service provision accommodates the informal one, and informal decentralization in public order provision tends to compete with the existing and ineffective formal system. This suggests that the formally

[6] Four patterns of interaction between formal and informal institutions (complementary, substitutive, accommodating, and competing) are introduced by Voigt and Kiwit (1998) and Helmke and Levitsky (2004). The distinction among them lies in the strength of the existing formal institution, the functional goal of the evolved informal institution, and their incentives for efficiency. Complementarities exist when informal institutions are created to facilitate the functioning of some formal institutions and aid in the effective enforcement of the latter. Substitutive informal institutions are created to help a certain ineffective formal institution achieve its goal. When a certain formal institution is not functionally desirable to a group of actors, they seek to create a set of informal counterparts to solve their own problems more effectively without violating formal rules. In this scenario, institutions are accommodating. However, informal institutions can dominate weak formal institutions and drive actors to ignore and violate the latter. In this instance, the institutions now become competing and dysfunctional.

decentralized system for supplying public goods and services provides sufficient incentives to lower-layer governments to perform efficiently, but there remains a lack of effectiveness in the provision of strong public order, particularly the protection of property rights, enforcement of contracts, transparency and reduction of corruption. The findings implies that the central government needs to reorganize the decentralized provision of public order and public goods and services to make informal institutions complements to rather than competitors of or free-riders on formal institutions.

Chapter 3, titled "Formal and Informal Mechanisms of Accountability in Local Governance: The Case of an Authoritarian State", continues to empirically study the cause and effect of informal governance, particularly focusing on the endogenous emergence of informal accountability mechanisms in the transition of Vietnam. This chapter aims to find the answer to the question: what kinds of institutions are efficient to hold local agents accountable and responsive to its citizens in authoritarian countries where democracy is limited and formal institutions are weak?

Accountability is achieved through two main mechanisms: information provision and sanctions (Dubnick 1998, Schedler 1999, Bovens 2007). The former is a set of institutional arrangements of communicating expectations of governance quality, internalizing standards of good governance, justifying and judging the agent's conduct. These procedures are the basis for a certain form of sanctions in case any misconduct is found and judged. The threat of sanctions, either formal or informal, acts as incentive mechanisms that hold the agent's behavior and actions proper and meet the expectations of the principal.

This chapter distinguishes between formal and informal mechanisms of accountability. Formal accountability is a process of account-giving and account-holding through communication and responsiveness, a set of legal and bureaucratic procedures under direct state control (or the direct system of checks and balances), and a set of formal incentive mechanisms (including the possibility of both sanctions and rewards that is well communicated in legal documents). Informal accountability is a set of institutional arrangements that are formulated, communicated, and enforced by the non-state principal or a third party which is not the state in order to facilitate, control and motivate the agent's fulfillment of his tasks up to the principal's expectations through intrinsic and indirect sources of incentives. Accountability held through the agent's response to mass media, civil society, non-government organizations, norms of governance, ethics, trust, identity, professional advancement, or reputation is regarded informal.

Accountable governance has increasingly become a debating topic in economics and politics, especially when it is blamed for the current world depression, starting with the subprime crisis in the U.S. in 2008. The empirical analysis both in this chapter and chapter 2 has shown that formal mechanisms (similar to democratic institutions) alone are not sufficient to create incentives for public actors to make private efforts to full accountability. It should be accompanied with other informal ones to fill in accountability deficits of the formal system. In this chapter, I point out some alternatives, including identity-based and performance-based mechanisms which are tactfully introduced into the kit of governance strategies to achieve higher accountability, albeit in the informal manner.

The case study and empirical analysis of all legal documents made by 35 provincial governments of Vietnam published in their Official Gazettes from 2006 to 2009 in this chapter shows that informal individual accountability and culture have a positive impact on responsive policy output while the influence of formal institutions is insignificant. Given this policy allocation, those provinces making more public administrative reforming legal documents have higher public trust in their responsiveness. This chapter also gives evidence of how policy making at the provincial level and identification are influenced by an external and non-binding PCI ranking conducted by a foreign-funded non-governmental organization (NGO). The findings imply that the legitimacy of the single-party regimes should be better guaranteed by modern management instruments rather than avoiding them by centralizing its power.

Chapter 4, titled “Institutional Incongruence and the Informal Economy: An Empirical Analysis”, studies the impact of institutional incongruence - the discrepancy in how formal and informal institutions perceive what economic behaviour is legal and/or legitimate - on the boundaries of the informal economy in 45 developed and developing countries. The chapter provides empirical analysis and evidence to five hypotheses: (1) participation into the informal economy is only an expression to institutional incongruence; (2) the impact of institutional incongruence on the boundaries of the informal economy varies in respect to the level of incongruence; (3) and (4) institutional incongruence has an overall positive impact on the size of the informal economy, but exerts a negative impact in those countries with more effective control of corruption or with more targeted government initiatives; and (5) the boundary of the informal economy can shift, which is subject to a change in institutional incongruence from both government and informal economic actors.

The relation with the state is the most popular dimension to distinguish the informal economy from the formal economy since the term 'informal economy' was first launched in Hart (1971, 1973). It refers to those workers and enterprises that are not protected and regulated by the state (ILO 1972). This definition fails to distinguish illegal economic activities out of the boundaries of the informal economy. From a narrower perspective, Webb et al. (2009) defined the informal economy as comprising income generating activities that are conducted outside the regulatory framework, but accepted by a large group of people as 'legitimate'. With this definition, formal institutional constraints are not the only incentive for economic actors (workers and enterprises) to be engaged in the informal economy. Their decision is also guided by what they perceive the legitimacy of their economic activities and by what they deem whether governmental institutions (the constitution, legislation, courts, the police, and regulatory agencies) perceive their activities legitimate or not.

To test the five hypotheses above, a measure of institutional incongruence is built on the World Value Surveys (WVS) 2005-2008. Institutional incongruence is the percentage of the population who selected 'never justifiable' for question V200 in the WVS 2005-2008, with the high percentage representing an explicitly biased attitude against tax cheating and the less incongruent perceptions of the illegitimacy of the informal economy by the government and economic actors. Low institutional incongruence countries are those with more than 60% of the respondents choosing 'never justifiable' and high institutional incongruence countries are those with less than 60%. The informal economy is measured by the percentage of the GDP in 2007, using the Multiple Indicators Multiple Causes (MIMIC) estimation method (Schneider et al. 2010).

Earlier empirical studies treat social values/attitudes and formal institutional environment as those factors that have an independent impact on the growth of the informal economy (Torgler and Schaltegger 2006, Torgler et al. 2007, Torgler and Schneider 2007). In this chapter, I assume that the relationship between institutional incongruence and the informal economy depends on the governance performance of the government. Dummy variables for q-quantiles of government performance are generated and interacted with institutional incongruence measures in a structural equation model. In this chapter, two variables of government performance included in the model are the quality of controlling corruption and the intensity of targeted government policies towards the informal economy.

Chapter 1

The dynamics of informality and its implications for a new economic political order

"…Research on governance institutions is very much a work in progress…" (Avinash Dixit 2009)

1.1. INTRODUCTION

The topic of this dissertation is ignited by the story of "fence-breaking" and "moral governance" – the 'informal' catalysts for institutional reforms in Vietnam over the past three decades. Before these reforms took place, the country was loyal to the traditional socialist economic model widely used in the Soviet Union, Hungary, Cuba and China. The rationale of this model is based on fences such as central planning and collective decision-making principles, protectionism and public ownership to achieve macroeconomic stability and growth of national income. The pre-eminence of the Soviet-type model was blamed for hunger and poverty, low labour productivity and economic recession in all socialist economies during the 1950s-1970s.

'*Khoan* ' or the contract system formally regularized in agriculture in Vietnam in 1981was a result of 'fence-breaking' in some districts and provinces during two decades. Dang Phong, Vietnam's leading economic historian, interviewed many fence-breakers, who were the authors of many innovative policies before the '*Doi Moi'* or renovation officially began in 1986, including the '*khoan'* initiative.

> " [The contract system in agriculture]... appeared in 1962 in the Kien Thuy district of Kien An province (in 1963 this province was incorporated into Hai Phong), even before the oft-quoted Vinh Phuc contract system in 1966-68. It was a system of contracting to households, that is, to farming families, and different from the two-way contracts applied in the co-operatives. This measure was taken secretly, but with the consent of the leaders of the district. When it came to the notice of the leadership of the province, the secretary, Hoang Huu Nhan, organized a full on-the-spot inquiry, listening to the opinions of each farmer. He found that the programme was appropriate and after discussion among the leaders of the

> provincial party, decided to allow the experiment to continue. The provincial decree was issued on 19 Feb 1963. ...The contract system was applied across the whole province of Vinh Phuc from September 1966. Its real author was Kim Ngoc, the provincial Party secretary. The programme was only stopped by an order from the Party secretariat at the end of 1968." (Dang 2004).

Fence-breaking is an expression to the incongruence between the state and the economic actors about the perceived legality and legitimacy of economic activities. The '*khoan'* policy in the agricultural sector was such a case. It was a response of local government to the farmers' opposition against the low-incentive labour management mechanism of the collective system in which households were paid a share of output by labour units working on communal land and had to sell all of their production to the state at below market prices. Initially, '*khoan*' was a 'hidden policy experiment' of contracting a quota of output to a household in a fence-breaking district or province who was entitled to retain the total surplus of their production over the contracted output. Despite a ban and sanctions from the central government, several local government leaders/fence-breakers sought to implement it in the shadow of 'village' rules until its efficacy was seen and acknowledged by central leaders. It was only until 1988 that the '*khoan 10'* policy of liberalizing agricultural production and leasing farming land in a five- to-thirty-year tenure to farmers[7] was officially introduced and has made the country from the position of an importer of a ton of rice every year before 1975 to become the world leading producer and exporter of rice in 2010.

Fence-breaking is an informal but legitimate way of making policy innovation in Vietnam. A series of important institutional reforms during the '*Doi Moi'* were the legalization of fence-breaking incidents in certain districts or provinces, including trade and investment liberalization, privatization, the contract system in all economic sectors, the abolition of the subsidy system, market-based price and wage reforms, setting three production 'priorities' for export goods, consumer goods and foodstuffs, land reform, the application of financial and human resource autonomy in the state sector, administrative and market decentralization, and grassroots democracy[8].

One of interesting features of institutional reforms in Vietnam is their dependence on informal institutions and institutionalizing processes. Each reform was a case of fence-breaking, a

[7] Resolution No. 10 of the Politburo in April 1988.

[8] Resolution of the Sixth Party Congress in December 1986, the Foreign Investment Law in 1987, Decision No. 27-ND on private business and Decision No. 29-ND on family business in 1988.

government action towards bridging the formal and informal institutional incongruence. Therefore, reforms and fence-breaking are not mutually excluded (Dang 2004). In most cases of successful fence-breaking, the fence breakers – local authorities and state-owned enterprises (SOEs) –have the backup from reformist leaders at the central government level, many of whom were the builders of the broken fences. The contract system in agriculture was an example. Although Kim Ngoc's *'khoan'* policy in 1966 was criticized and banned by the central government, it was a success in Hai Phong province in 1977 thanks to a more subtle approach of Doan Duy Thanh, the chairman of the province. Doan Duy Thanh decided to experiment the household contract system in Do Son, a seaside district, where the Politburo[9] members often came at the weekends and might observe its benefits. As a result, he was appointed to a central subcommittee to work out a plan to regularize the contract system in agricultural sector across all provinces which was subsequently institutionalized in the Order No. 100 of the Party Secretariat in January 1981 (Dang 2004).

The success of fence-breaking as an informal mechanism of policy making was attributed to the symbiotic nature of the relationship between the state and economic actors (Beresford and Fforde 1997) – or the moral governance mechanism. On the one hand, fence-breaking acts as a channel of communicating the demand for institutional change from the bottom (push factor). On the other hand, it also enables these policy initiatives to test their long-term social welfare impact and the state capacity to mobilize sufficient resources to implement them successfully (pull factor). The (pull-push) dualism of fence-breaking allows institutional change to occur gradually and avoid those conflicts that may lead to political and social instability as in the case of China and the Soviet Union. In other words, Vietnam's government chose to push the institutional reforms forward through getting them embedded in informal institutions (i.e., social networks or moral values). Governance based on moral values is one of the factors that make fence-breaking an effective (albeit informal) driver of institutional change in the Vietnamese way. The dominance of informality in building modern institutions of markets as well as governance has increased the state capacity to manage institutional incongruence and change flexibly, avoiding the tension between formal and informal institutions when they are treated as paradoxes rather than a system of embedded institutions.

From a positive standpoint, the economic analysis of informal institutions of governance needs taking into account many issues such as the incongruence between formal and informal

[9] Politburo refers to the Political Bureau of the Central Committee Communist Party of Vietnam.

institutions that fail to be considered in the mainstream economic theory. This dissertation adopts the perspective of New Institutional Economics (NIE) to study how alternative forms of governance, particularly, informal mechanisms of governance, emerge and work in various circumstances. Parties to institutional transactions seek to enhance efficiency through drawing up their coordination rules that 'align transactions, which differ in their attributes, with governance structures, which differ in their costs and competencies, in a discriminating (mainly, transaction cost economizing) way' (Williamson 1991, p.79). Due to the incongruence among large social groups about the legitimacy of the formal and informal rules governing transactions and their associated interests, the actors tend to compare the costs of alternative rules, including both fixed and variable costs of creating and enforcing these rules, and choose the one that saves the most. The creation of an intermediary level of coordination in the form of "private institutions" or "informal institutions" (such as inter-professional organizations, "clubs", or a de facto property rights system created and enforced by the network-based community) that voluntarily organize collective coordination is an example of reducing potential costs of maladaptation in a multi-national governance structure (Brousseau 2004, Brousseau and Raynaud 2006). Informal institutions are not static, and some may become increasingly accepted as efficient coordination rules and are likely to be formalized.

In order to evaluate the outcome of institutional reforms in a country, modern economic models need considering the variation in the institutional framework, including the dynamics of informal institutions. For example, the varying degree of informality in the process of decision-making, policy making, organizing the production and distribution of goods and services, or allocating resources will influence transaction costs of alternative organizational forms and provide different incentives for the government to shift its organizational structure to achieve its long-term objective of welfare maximization. As reforms trigger institution choices, an economic governance model considering the variation in the degree of informality and the diversity of informal institutions is to be expected. Such a model allows assessing the legitimacy and efficacy of certain informal institutions, the relationship between formal and informal institutions, and their joint impact on governance performance and economic growth in a given stage of reforms. Subsequently, the findings from 'informality' analysis will contribute to the choice of a set of formal and informal institutions of economic governance for the next stages of reforms whose interaction is expected to create incentives for better governance and sustainable economic growth.

From a normative perspective, as exemplified in the policy 'fence-breaking' in Vietnam's provincial government and SOEs in its transition to the market economy and its integration into the global economy, the insight provided by the 'informality' analysis can only improve the outcome of institutional reforms. More precisely, any institution of economic governance affects the structure of organizations at both macro- and micro-economic levels and the boundaries of the (formal and informal) economy. In addition, the (complementary/substitutive/accommodating/competing) relationship between formal and informal institutions impinges on the organization of tasks and the effectiveness of the given organizational structure.

However, research on institutions and organizations remain controversial in many aspects. First, the relationship between good institutions of governance and economic development is sensitive to the definition and measurement of the given institution or governance dimension. Dixit (2007) found that "for every paper that endorses one kind of institution or policy, one finds another that makes precisely the opposite claim." Administrative decentralization is such an institution. Torgler et al. (2008) found from their empirical studies on a sample of cantons in Switzerland that empowering local politicians in a federal system makes preferences of tax payers identified and closely considered in tax policies, enhancing tax compliance morale of the citizens and discouraging hidden economic activities. Using the percentage of government tax revenue in the GDP as a measure of decentralization, Johnson et al. (1999) found no evidence for the above argument in their cross-country studies. They argue that giving more control rights to local bureaucrats just create more room for corruption and more incentives for the underground economy. This variation in institutional outcomes explains why current studies on institutions tend to focus on specific institutional dimensions or settings of a country[10].

The difference in the perceived outcomes of an institutional reform or a policy is also expected when a model is in a paradigm shift. Only until a new paradigm emerges, the recipes for economic success are exposed to controversies from various disciplines, theories, and schools of thought (North 1989, Dixit 2007, Rodrik 2008). For example, development

[10] This fact also supports Pande and Udry (2005) who argued that within-country analysis is better than cross-country studies in identifying which specific institutions are necessary for the development of a nation. Under a homogeneous institutional setting, it is more likely to isolate the effects of institutions from unobserved heterogeneity across units of analysis.

economics has undergone a paradigm shift from theories that consider resource and technology constraints as the main obstacles to growth, to those that emphasizes information asymmetry as a source of market failures, and now to those that rely on institutions as determinants of development success/failure (Matthews 1986, Williamson 1996).

Second, the role of informal institutions for governance and economic development varies across jurisdictions. This is where lies the varying degree of institutional incongruence – or the difference in the perceptions of formal and informal institutions about the legitimacy and legality of certain behaviour across jurisdictions (Webb et al. 2009). In some countries, informal institutions (provided by social groups and industry associations) are distinguished with formal institutions of the government to provide private order or similar goods and services in niches where the government cannot or does not operate. In these countries, the government acknowledges the comparative advantages of informal institutions as complements or substitutes for missing or ineffective formal institutions and adopt the attitude of tolerance (Dixit 2009). In other countries, similar institutions of governance are not effectively provided by the government, but they are deterred to work or not formally recognized. Private institutions are subsequently driven to accommodating or competing with the formal system. An account of these institutions in the forms of case studies can be found in Helmke and Levitsky (2004).

Third, determinants, patterns and speed of institutional change vary across regions and countries. Institutions constitute an equilibrium, and institutional change means a shift to a new equilibrium (Dixit 2009). Dixit argued that one of the conditions for shifting an institutional equilibrium is that emerging institutions should interact well with existing institutions. The pace of institutional change is strongly influenced by the level of inertia[11] which varies substantially in different institutional settings and under distinctive socio-economic development conditions. However, current institutional literature confines itself to the studies of the complementary or substitutive relationships between formal and informal institutions[12] while their accommodating or competing relationships, particularly from the

[11] The concept of inertia refers to forces, including webs of interdependent relationships, political coalitions, patterns of communication, or routines that resist institutional and organizational change (March and Simon 1958, Nelson and Winter 1982, Hannan and Freeman 1984, Tushman and Romanelli 1985, Zenger et al. 2002).

[12] Zenger et al. (2002) argues that formal institutions are often treated independent of informal institutions in organization theory. Acquiring more insight into the dynamic interaction between formal and informal governance mechanisms, that is, whether they are complementary or substitutive, is fundamental to understanding the boundaries of the firm. On the one hand, informal institutions have a strong influence on

comparative institutional perspective, are still underinvestigated. The lack of comprehensive analysis of the interaction between formal and informal institutions may partly explain why the same (formal or informal) institution has contrasting effects on governance performance and economic development.

Fourth, the lack of empirical studies on the assessment of the outcomes of various informal institutions limit the learning process of the best governance practices on a global scale and adversely affect the speed of institutional change in many countries. The majority of empirical studies mainly concern the functionality of formal institutions and organizations and assume their independence out of informal institutions. However, many theoretical studies emphasize the importance of the interaction between formal and informal institutions, especially when the latter possess inertial forces that might impede institutional and organizational change and when a global market for (governmental and private) institutions allows the actors to have multiple choices for their governance. Therefore, the issue in the study of different governance institutions is no longer "market versus government" (Dixit 2009). What economists and policy makers worry is the choice of formal institutions that interact well with existing informal institutions and induce institutional change toward efficiency. The recipe for institutional reforms adopted by Vietnam's government is based on this principle: "…a quintessentially Vietnamese trait: casting around for role models, then trying to meld the best aspects of several of them into something uniquely suited to Vietnam" (The Economist 2008). However, what is important for all countries, including Vietnam, is to assess for each stage of reforms whether the selected combination of formal and informal institutions is the "right" choice.

Finally, there is a renewed interest in the assessment of the economic political order at both microeconomic and macroeconomic levels when the recent global crisis has challenged many of the assumptions which have underpinned the regulatory system. That is what Joseph Stiglitz and Paul Krugman called 'the paradoxes of our times" to refer to national and global governance deficiencies. It appeals for a new economic political order with a better interaction between governance mechanisms and the institutional framework that effectively coordinates national and global governance efforts. What is the role of informal institutions in

organizational functioning of a firm. On the other hand, formal institutions determine the trajectory of informal institutions within the firm. I extend Zenger et al. (2002)'s conceptualization and consider the dynamics of the relationship between formal and informal institutions (beyond their complements or substitutes) in public organizations as well as in particular organizational forms of markets.

the re-engineering of a new economic political order that induce more efficient coordination, reliability and accountability in national and global governance?

The following part of this chapter will provide theoretical explanations for five above-mentioned controversial issues in the study of governance institutions and organizations, emphasizing the dynamics of informality and laying the ground for sketching an agenda for empirical analysis in the next chapters of the dissertation. Section 1.2 starts with the discussion of the distinction and the dynamic relationship between formal and informal institutions in shaping governance mechanisms and outcomes. Section 1.3 makes certain implications for a new political economic order that enables to create incentives of sub-national governments to jointly act for national governance, and those of nations for global governance.

1.2. THE DYNAMICS OF INFORMALITY

1.2.1. Formal versus informal governance institutions

Given the increasing importance of institutions as an emerging paradigm of economic development, the distinction between formal and informal institutions has attracted scholarly interest in various sciences (including economics, political science, law, sociology, and anthropology) (North, 1990, Taylor 1992, Dia 1996, Aghion and Tirole 1997, Voigt and Kiwit 1998, Stigliz 2000, Zenger et al. 2002, Tsai 2002, Helmke and Levitsky 2004, Dixit 2007, 2009). Formal and informal governance institutions are distinguished in terms of the mechanism that they evolve and are enforced and the order that they create to support economic activities. Formal institutions are provided by the government to guide economic activities to take place in the legal (or public) order and enforced by its legal apparatus while informal institutions are provided by civil societies or non-government organizations to guide economic activities to take place in a private order and enforced by the norms of behavior shared by those who are identified themselves as members in these private and social organizations[13]. According to Dixit (2009), formal institutions of governance include "the constitution …that lays down the rules of the political game, the legislature that makes more detailed rules within this context, and the courts, the police, and licensing and regulatory agencies that interpret and enforce these rules." Informal institutions are "networks that

[13] My definition is also consistent with Brinks (2003) and Helmke and Levitsky (2004), who define "informal institutions as socially shared rules, usually unwritten, that are created, communicated, and enforced outside officially sanctioned channels."

facilitate search and information, the norms of behavior, and sanctions for enforcement against violations of norms."

Governance is an organizing concept for many fields in all social sciences (Dixit 2009). According to Dixit, "good economic governance underpins the whole Smithian process whereby individuals specialize in different tasks and then transact with one another to achieve the full economic potential of the society." A good equilibrium implies the choice of a combination of formal and informal institutions whose interaction enables a transaction to take place at the lowest costs. Each set of institutions that are selected to support a certain economic activity shapes an economic governance mechanism. They can be either formal institutions (provided by the government) or informal institutions (provided by non-government organizations) or a mixture of both. From new institutional economics perspective, "governance is an effort to craft order, thereby to mitigate conflict and realize mutual gains" (Williamson 2000). Good order is created by aligning institutions with the needs of governance to minimize transaction costs. This is the main content of Williamson's "discriminating alignment hypothesis" (1996, 12).

My motivation in this dissertation is obvious: formal and informal institutions are alternative inputs in the governance process, and the production of good governance output[14] requires the proper attention to their comparative advantages and how well they interact with each other. Each combination of formal and informal institutions will insert different incentives and constraints over the actors' behavior. Although the dissertation mainly investigates the state actors' behavior, the logic of arguments also applies to other social and economic actors. The similar argument can be found in earlier theoretical or case studies such as North (1990), Williamson (1996), Tsai (2001), Brinks (2003), Helmke and Levitsky (2004), Farrell and Héritier (2003), and Dixit (2009). In this dissertation, I make an attempt to prove the above argument empirically, using the comparative institutional approach in both within- and cross-country analysis.

Informal governance institutions have some comparative advantages over formal institutions. First, informal institutions are created at low fixed costs because they do not require a framework of laws, regulations, courts, polices, and a multi-level system of government agencies to be enforced. Trust that is shaped and reinforced through communication and reciprocal relationship among the actors in a small community becomes an efficient

[14] See footnote 5.

mechanism of enforcement. However, the marginal cost of enforcement increases significantly when the boundaries of informal institutions, the social networks, for example, expand, and transactions are made with more distant strangers who are less likely to be trustworthy (Li 2003, Dixit 2007). Vice versa, formal institutions require a substantial public order to function, so they are created with high fixed costs. However, once the formal system is established, the marginal cost of enforcing large-scale transactions is low. The difference in the cost of creation and enforcement of formal and informal institutional systems shows that either of them has its own advantages and disadvantages under specific political, social, economic and technological conditions.

Second, certain informal (or private) governance institutions have advantages of information and expertise over state agencies. Therefore, the parties to a dispute may suffer higher costs (both monetary and time costs) or worse outcomes by adopting public ordering rather than private ordering under certain circumstances. This explains why even in developed countries, governments do not provide all governance. Many informal institutions exist to serve similar purposes of formal institutions. "Sometimes they work in niches where the government cannot or does not operate". One example is private adjudication made by industry associations. In those disputes that the courts find too complex to interpret and adjudicate, they simply enforce the judgements of industry associations (Williamson 2000, Dixit 2009). Keefer and Shirley (2000) and Williamson (2009) argue that formal institutions are not sufficient to achieve economic growth, but they should be embedded into existing informal institutions in order to be successfully enforced.

Finally, informal institutions act as complements or substitutions in weak or bad governments. Weak governments are producers of no effective or ineffective formal governance institutions. Bad governments deviate from the legal order that they establish to guide the proper conduct and behavior of their citizens or sanction citizens' misconducts and misbehavior. Bad governments and their agents may violate private property rights, breach contracts, and renege on promises. For example, they expropriate assets without compensation; make unpredictable changes to laws and regulations, request bribes in exchange for their services or privileges (Dixit 2009).

Informal governance institutions have some disadvantages. First, current politics literature simply assumes that the actors' incentives and behavior are determined primarily, if not exclusively, by formal rules (Helmke and Levitsky 2004). The interplay between formal and informal institutions is mostly disregarded in much political and economic institutional

empirical analysis. Second, given the comparative advantages of informal institutions under certain conditions, attitudes towards informality vary across countries, ranging from acknowledgement, ignorance, tolerance, forbearance, sanction, or deterrence. The government's attitudes significantly influence the selection of governance mechanisms. Third, each private (or informal) institution is a network of individuals who share a norm of behavior, so the identity of the network membership may act as an entry barrier that hinders its members from seeking and exploiting business opportunities at the arm's length or contributing to the development of labor and capital markets (Fafchamps 2004). For this reason, many theoretical and empirical studies have shown that pure informal governance will eventually constrain growth and expansion of trade (Dixit 2009). Forth, private order needs relying on a good quality of information and communication to function well. This ability becomes limited when the informal institutions expand their boundaries. Finally, informal institutional change is expected to be a lengthy process because informal institutions "do not possess a center which directs and co-ordinates their actions" (Lauth 2000) while inertial forces inherent to different degrees in informal institutions make them resist a change (March and Simon 1958, Nelson and Winter 1982, Hannan and Freeman 1984, Tushman and Romanelli 1985). Any successful institutional reforms need taking this feature of informal institutions into account.

1.2.2. Endogeneity

One of the latest advances in institutional theory is the recognition of the endogenous relationship between formal and informal institutions (North 1990, Voigt and Kiwit 1998, Helmke and Levitsky 2004, Dixit 2007). The New Institutional Economics, sociology, and political science have recently acknowledged that informal institutions may enhance or undermine the effectiveness of formal rules and organizations, and vice versa, a change in the latter will determine the trajectory of the former. Therefore, any assessment of government quality or economic development needs considering the endogenous relationship between formal and informal institutions.

Informal institutions shape formal institutional outcomes in many areas such as legislative politics, judicial politics, government organization, campaign sponsorship, regime change, federalism, public administration, the provision of public goods and services, or state building (a summary of literature review is given in Helme and Levitsky 2004). According to Helme and Levitsky, informal institutions can be functional or dysfunctional, and formal institutions can be weak or strong. Informal institutions are functional when they serve similar purposes

of formal alternatives in the provision of solutions to problems of social interactions and coordination (Ullman-Margalit 1978, Axelrod 1988). Informal institutions are dysfunctional when they exist as constraints to social interactions and coordination. The distinct functionality of informal institutions, especially when they are dysfunctional, does not imply clearly the outcomes of their interaction with formal alternatives.

The outcomes of the interaction between formal and informal governance institutions also depend on the strengths of formal institutions at times. Formal institutions are strong when they are trusted and obeyed by all concerned actors (including political, economic, and social actors) who believe that their noncompliance will strictly be sanctioned by legal rules. Vice versa, formal institutions are weak when the actors' trust in the enforceability of formal rules is low, and they seek to alternative (private) ordering to enforce their transactions.

Based on two dimensions of institutions, functionality and enforceability, Lauth (2000) and Helmke and Levitsky (2004) distinguish four types of outcomes when formal and informal institutions interact. One of the applauding points in the typology of Helmke and Levitsky is their emphasis on the origin of informal institutional emergence. First, informal institutions are complementary with strong formal institutions when the former serve the similar function of the latter, but in a niche where the latter cannot or does not operate. Arbitration by industry associations is an example (Dixit 2004, 2007). Complementary relationship is also acknowledged when informal institutions evolve to facilitate the pursuit of individual goals within the formal institutional framework. There are many norms, routines, and procedures that ease decision making and coordination in bureaucracies. The "Rule of Four" employed in the U.S. Supreme Court is an example (Epstein and Knight 1997). The outcomes tend to be the enhanced enforceability of formal institutions and the improved governance performance.

Another commonly investigated case is the substitutive relationship between informal and formal institutions. Extensive theoretical and empirical literature argues that informal institutions evolve as functional substitutes for formal institutions where the latter are weakly enforced or inefficient. Tsai (2007) has surveyed 316 villages in China and found that social networks, particularly the presence of embedding solidarity groups, make some villages outperform the others in mobilizing financial and human resources and substituting the ineffective formal channels of public goods provision. Another example is the collective decision-making principle in legislative and executive process in Vietnam, which is criticized for constraining the responsiveness of lower-layer government to local needs. The

ineffectiveness of this rule has resulted in fence-breaking – or individual decision-making by the chairmen of sub-central governments - in many policy areas that should be under the authority of the whole people's committees and people's councils over the past four decades. The outcomes of emerging substitutive informal institutions are to support the enforcement of formal alternatives.

The third category is the accommodating relationship between formal and informal institutions. According to Helmke and Levitsky (2004), accommodating informal institutions do not emerge to support the functioning of formal institutions in the same manner with the first two categories. When the actors do not like the outcomes of the formal alternatives, but are not in a position to change or openly violate them, informal institutions are created to align the actors' interests with the existing formal institutional framework. Subsequently, the outcomes of this accommodation may not be efficiency enhancing, but contribute to the stability of the formal system. Accommodation is one of informal governance mechanisms in Vietnam that has contributed to the country's political stability and the legitimacy of the single ruling party. Although institutional reforms are slow, and modern governance institutions (such as separation of legislative, executive, and judicial powers, democracy, market economy, privatization, property rights protection, accountability, transparency, media freedom, e-governments, decentralization, or performance-based management) are absent or partially established, there are no obvious signs of collective actions to put pressures on the government to push the reforms forward. Beresford and Dang (2000) argued that the war victory under the leadership of those who then became the leaders of the country in the modern times of state building and development have created a moral reward that dampens any demands for big-bang changes and also become an incentive for those leaders to be reformists to maintain the legitimacy of moral governance. That explains why fence-breaking, albeit illegal, dominates the way that policies are made and formal institutions are built and change in Vietnam. This informal institution still persists.

The final category is the competition between formal and informal institutions of governance. In this case, informal institutions coexist with ineffective formal institutions and create incentives for the actors to ignore or violate the latter. Private sanctions are applied if the actors select the competing institutions. Corruption, clientelism, patrimonialism, or clan politics are examples of competing informal institutions. The outcomes of a competing relationship between formal and informal institutions are not efficiency enhancing.

All four types of informal institutions exist to various degrees in all governance systems. Developmental states consider accommodating and competing institutions as transitional governance mechanisms and need to take initiatives to enhance the strengths of the formal institutional system and limit the emergence of these kinds of informal institutions. This also implies the necessity of developing a competitive market for private institutions of governance and strong formal institutions of governance. However, the interaction between formal and informal institutions and how it may affect political behaviors and outcomes remain understudied in empirical comparative institutional literature and hence call for further scholarly attention. It is also important to selectively analyze those institutions that emerge as alternatives of modern governance mechanisms and have a high likelihood of transplanting in other economies.

1.2.3. Towards good governance reforms

From the discussion of comparative advantages of informal institutions and their endogenous relationship with formal institutions, it is important to sketch out a framework for institutional change that is conducive to good public governance (legislative outcomes or the quality of public order and public goods and service provision) and economic development (economic growth and the size of the informal economy, for example), considering the characteristics of the existing equilibrium in a particular institutional structure. Before setting out an agenda for governance reforms that are tailored to different institutional structures, it is necessary to distinguish several existing patterns of institutional change in the world.

1.2.3.1. Formal institutionalization versus informal institutionalization

Although the difference between formal and informal institutionalization is not new, the perspective of institutionalization following different patterns in response to their comparative advantages over their alternatives and the endogenous relationship between formal and informal institutions in shaping organizational and institutional outcomes remain understudied. Conventional politics literature tends to equate institutional change with changes in formal institutional structure of the state (Gilley 2008). I focus on institutionalization, highlighting the origins and patterns of change, rather than the outcomes of institutional change only.

From this perspective, institutionalization is defined as a step-by-step internalization of frictions in expectations of those actors who always stand at the choice of competing formal and informal institutions to guide their behaviour and conduct. This conceptualization is also

consistent with the notion of 'value infusion' of Selznick (1957) when the actors choose to forgo individual goals and act for their organization. Another definition given by O'Donnell (1994) emphasizes institutionalization as a process by which actors' expectations are stabilized around "regularized patterns of interaction" between formal and informal institutions (rules and norms). Both Selznick and O'Donnell highlight the dynamics of formal and informal institutional interaction in shaping organizational outcomes. Many case studies show that democratization in developing countries has not been guided by formal rules and procedures as expected, but informal alternatives (O'Donnell 1996).

Institutionalization from new pubic governance literature involves a process of building modern institutions. Any newly emerging institution, regardless of being a product of transplantation or innovation, should be accompanied by supporting norms and complementary institutions to perform efficiently (Mukand and Rodrik 2002). Endogenous informal institutions may be culturally rooted or instrumentally created to complement, compete, accommodate, or substitute formal institutions. For those informal institutions that are regarded as a product of culture have strong resistance to change and only change along with the erosion of societal values. From this perspective, institutionalization is associated with increased frictions between the old and new values. For those informal institutions that emerge as an instrument of governance, institutional change may be faster and induced by internalization and creation of informal institutions that support the reduction of frictions as well as the functionality of formal institutional frameworks.

Effective government does not attempt to provide all public governance, and chooses to decentralize certain tasks and functions to the private sector if they are more efficient to do so. This explains why the degree of institutionalization associated with an organizational and institutional change varies across countries and regions in a continuum of formalization or informalization. An example is the property rights to land which have been well protected in many developed countries, but fail to be built or enforced in many less developed countries. Kenya is such a case (Ensminger 1997). When the Kenyan government sought to impose a system of formal land titles, it clashed with the traditional system of land titles granted by the clan chiefs and that of the usufruct rights to other stakeholders who are not title holders. The capital market could not develop because land could not be used as collateral given the opposition from family and community. Subsequently, laws have been changed to resemble traditional land rights and transactions (Dixit 2007). Another example of informal institutionalization can be found in China, where a formal property rights system is not built,

but the country is still a relatively safe destination of foreign investment thanks to private protection from local authorities through the evolution of township and village enterprises (TVEs) – a form of partnership between private entrepreneurs and local state authorities.

The patterns of institutionalization shape institutional outcomes. Formal institutionalization of property rights protection failed in Kenya because it did not create accompanying institutions to support the functionality of the new formal system and minimize frictions with existing informal alternatives. Kenyan government paid a price when it was forced to modify the legal frameworks to internalize values of the clan-based land rights system. Institutionalization of property rights in Kenya is the informalization process when formal rules and procedures fail to provide political and economic legitimacy for their imposition. By contrast, informal institutionalization in China is the strategic creation of legitimacy-based informal institutions to support the good functioning of formal institutional frameworks where the latter are not in a position to serve certain functions efficiently. As informal institutionalization is a policy option of the central government that is carefully designed to facilitate the complementary impact of formal and informal institutions on government performance and economic growth, it gains sufficient political and economic legitimacy for its existence. Specifically, modern institutions of governance (for example, property rights protection, corruption control, press freedom, and democracy) are almost simultaneously institutionalized with a certain degree of formality and enforceability, but only at the sub-central level of government. At the central level, the Communist Party's rules are rigid and unchallengeable (Dixit 2007).

Above examples show that institutionalization is a strategic process of creating legitimacy-based institutional innovations. Political and economic legitimacy facilitates the infusion of order through creating incentives for the actors to use these rules and procedures repetitively in their transactions. Some countries choose to create formal and innovative governance institutions. Some create intermediate informal institutions to serve the similar functions of missing institutions (or partial institutionalization). Others attempt to transplant successful institutions into their countries. The actors' choice of the degree of institutionalization is endogenous to the comparative advantages of the given formal and informal governance institutions and the history of the mutual relationship between them. The empirical analysis in the following chapters of this dissertation shows that the success of institutionalization, albeit formal or informal, depends on the availability of endogenous supporting institutions and the degree of political and economic legitimacy of institutionalized institutions.

1.2.3.2. The political economy of partial institutionalization

Different countries choose their own degrees and patterns of institutionalization with an attempt to lead structural and institutional change towards legitimate and efficient governance. This argument is based on David Easton's (1965) legitimacy-based approach and new institutional economics (North 1990, Williamsons 1985) in modelling institutions endogenously, where institutions are both the cause and consequence of legitimacy and efficiency. However, legitimacy and efficiency of governance institutions, especially in governmental organizations, cannot be measured precisely (Sinkula et al. 1997), and either formal or informal institutionalization may not bring about the intended outcomes when the boundary of collective action is imprecisely defined. In particular, a growing number of issues span both the domestic and the international domains, but they are still treated as functional tasks at local or national government levels. Even where the scale of a problem (local, national, regional, or global) is acknowledged, there is lack of complementary vertical interaction across layers of government or simply there is no clear division of labour among the myriad of national or international institutions that seek to address them. Finally, the existing system of national and global governance suffers from severe deficits of accountability and inclusion.

Recent economic and political theories highlight the partial nature of institutionalization in designing governance structures within public and private organizations. Several dimensions of partial institutionalization that attract scholarly interests include decentralization, democracy, accountability, and legal reforms of economic governance institutions such as market economy in transition countries. Due to coordination failures among the tiers of government (e.g., information asymmetry, contract incompleteness, interest conflicts, or capability and resource constraints), decentralization – the assignment of decision rights in the public management domain from the central government to lower-level government - is only partial in practice. Bureaucrats always have incentives to create or at least facilitate the establishment of private order to complement, substitute, accommodate, or compete with malfunctioning systems of public order, either for the sake of their own community or simply in an effort to maximize their own rents. This private order allows lower-level government to manipulate upper-level rules and regulations at their discretion and even to introduce their own rules that are acknowledged and respected by local citizens at low fixed costs. For fear of losing power, formal decision rights are allocated to a limited degree to lower levels within an organization.

The complex multi-level nature of governance is not the only motivation of partial institutionalization. Partial reform is the choice of many transition countries (Hellman 1998) where habits and norms are strong, and its success depends on the capability of the government to create and sustain strategic institutions to legitimize the existence and support the effectiveness of the new rules. For example, both China and Russia started to legally acknowledge political legitimacy of the private sector and protected the property rights in the 1980s and both used 'insider privatization' strategy to distort the intended outcome of the economic reform. China's government encourages the development of township and village enterprises (TVEs) – private enterprises in the name of local state enterprises – to create incentives for local government to be responsive and accountable to local economic growth. At the same time, China's government commits private investment security through allowing democracy at the sub-central levels such as contested elections, press freedom, or combat against corruption. As a result, by 2005, the country had 29.3 million private enterprises, employing over 200 million people and contributing to 49.7 percent of the GDP (Tsai 2007). However, "insider privatization" was not a success in Russia. The government also legalized private cooperatives but retained ownership of almost all enterprises and continued to give orders over their outputs and regulate prices (Murphy et al. 1992). These quasi-private enterprises could not function in absence of free market-supporting institutions, and such partial reform quickly led to economic collapse in the early 1990.

Taking into account the origins and inertial forces of informal institutions, theoretical models using a repeated game framework argue that a partial improvement of an ineffective formal system through "providing a better outside alternative and thereby making the consequences of breaking a relational contract less bad, can worsen the outcomes from the existing informal system" (Dixit 2004, 2007). This is because a change in formal institutions results in a loss of values of the set of informal institutions that evolve endogenously in the old institutional framework. The diminishing values of the existing informal system imply the increased effort cost of adhering or adjusting to the new formal system (Tsai 2007). Given the change in the formal institutional framework, although the adjustment of informal institutions is uncertain, government always has an incentive to facilitate the creation of informal institutions complementary to the functioning of the new formal institutions to enhance economic

efficiency[15]. This fact underpins the network effects on creating endogenous informal institutions in the formal institutionalization process.

Partial institutionalization may enhance or diminish welfare. Joanis (2008) analysed the institutionalization of a decentralized system of public goods provision and argued that partial decentralization can increase welfare when there are complementarities among different levels of governments. Partial decentralization can harm welfare when the existing political structure distorts this task to the level of government that is the least competent in providing the public good.

To design good governance institutions that are conducive to economic growth and political stability, a policy maker and practitioner must identify which policies or institutions are complements, which ones are substitutes, which ones are accommodators, and which ones are competitors. In case institutions are complementary or accommodating, they should be implemented in a package. The difference between complementary informal institutions and accommodating informal institutions is that the latter is often considered to violate the formal rules. Accommodating informal institutions are created by those actors who do not like the outcomes of the existing formal institutions, but are unable to change or openly violate them. In this sense, accommodating informal institutions, albeit not efficiency enhancing, are useful to align the actors' interests with the formal institutional framework (Helmke and Levitsky

[15] Endogenous informal institutions evolve or exist to accompany a set of formal institutions. They are distinguished with exogenous informal institutions that do not evolve or exist to support or constrain the functionality of the given formal institutions in the first place. Therefore, informal institutions are context specific. This dissertation emphasizes the dynamics of endogenous informal institutions rather than North's (1990) conceptualization of informal institutions as inertial constraints to institutional change. Douglass North (1990, 91) mainly refers to culturally-rooted institutions when he argued that "the formal rules change, but the informal constraints do not. In consequence, there develops an ongoing tension between informal constraints and the new formal rules." However, informal institutions that are endogenous to a set of formal institutions may change, possibly in their design or effectiveness, to interact well with the new rules (Helmke and Levitsky 2004). Adaptive informal institutions in China and Vietnam are one kind of endogenous ones (Beresford and Dang 2000, Tsai 2007). They evolve in response to the existing constraining institutional environment. Tsai called them "coping strategies" or "informal practices" or "local innovations" devised by local public and private actors to evade the restrictions of the new rules in his case studies of how China formally acknowledged and developed the private sector in the absence of similar supporting institutions that prevail in advanced democracies. This dissertation will go beyond the accommodating institutional relationship analysed by Tsai and empirically investigate different kinds of endogenous interaction between formal and informal institutions, using comparative institutional approach.

2004). If they are substitutive or competing, partial improvement of ineffective formal institutions will gradually lead to the loss of comparative advantages of informal alternatives. However, identifying the mutual relationship of institutions is not so easy, which leaves much space for further empirical studies to bridge the literature gap between theory and practice.

1.2.3.3. Institutional incongruence : Paradox lens versus systems lens

Why are certain norms, values, and beliefs institutionalized to become laws while the remaining norms, values, and beliefs in society are considered informal institutions? Rokeach (1973) argued that societies are composed of groups of people that have different opinions about what is socially acceptable. Large groups will struggle to reach agreements about socially acceptable positions concerning a series of social issues (Webb et al. 2009). Where there are disagreements among large groups, the norms, values, and beliefs of one group will make laws and those of other groups will make informal rules. The difference between laws and informal rules, or formal and informal institutions, represents a distance between what is perceived legal by law makers and practitioners and what is perceived legitimate by other social groups[16]. The distance in defining the legitimacy of social issues among large social groups may be narrow or wide, so their interaction may be complementary or detrimental to the efficiency and stability of the formal institutional system. The variation in the perception distance between large social groups is the main source of institutional incongruence.

Institutional incongruence is one of the main causes for the evolution and persistence of informal institutions. It depends on the degree of incongruence that certain informal institutions emerge to complement, substitute, accommodate, or compete against formal institutions. The emergence of industry associations, insider privatization, fence-breaking, mafia, or underground economy is several examples of the consequences of institutional incongruence between the public and private actors. Emerged informal institutions that are not complementary to the enhancement of the efficiency and stability of formal institutional framework tend to increase the tensions between public and private actors.

[16] *Legitimate* is understood as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions" (Suchman 1995, 574). There are issues that are perceived legitimate by certain social groups may be deemed illegal and sanctioned by law, and there are also issues that are perceived illegitimate by certain social groups may be deemed legal and unsanctioned by law. The degree of institutional incongruence regarding an issue may also vary from country to country. The results of the World Values Indicator surveys are a good illustration for this argument.

Recent literature focuses on two approaches that government often adopts to cope with the tensions between formal and informal institutions: paradox lens and systems lens. Governance based on paradox lens means that it is necessary to find out all possible tensions between paradoxical elements and come up with strategies to respond to these tensions (Smith and Lewis 2011). As a product of social construction, paradoxical tensions are defined within a particular time and space (Poole and Van de Ven 1989). Countries may not face a similar set of paradoxes. Paradox thinking, therefore, may restrict the ability of applying the best practices across countries and driving governments in the latter group into a trap of tolerating or accommodating informal activities. Systems thinking is known as an approach to solving problems by viewing the problems as parts of a whole complex system rather than reacting to specific parts or outcomes (Forrester 1961, Simon 1979, 1982, Checkland 1981, Perrow 1984, Senge 1990). Systems thinking has been studied in many sciences, including management and organization sciences. From systems lens, poor governance, organizational failure, and mal-adaptation to change are caused by the discrepancy between limited cognitive skills of individuals and the complexity of the systems they are supposed to manage. In this sense, using systems lens helps find out the bottlenecks that hinder systemic coordination and set the ground for making institutional innovations that lead organizational and structural change towards efficiency.

Using a paradox lens can also increase institutional incongruence and hence may inhibit institutional change. A paradox perspective emphasizes the juxtaposition of contradictory systems in one place and the role of leaders for managing these tensions successfully (Smith and Lewis 2011). Obviously, not all paradoxical tensions of complex and dynamic systems can be managed, at least in the short run, which delays any reform efforts. The paradox perspective's focus on the coexistence of distinctive systems within a unified institutional boundary may simplify the synergies created by certain similarities between them. Biased acknowledgement of exclusive differences or similarities of the two coexisting systems will lead to social divide and avoidance. Thus a paradox perspective may fail to explain why "private privatization" was a success in China, but a failure in Russia. The paradox lens also does not help why Vietnam's economic reforms do not fully transplant China's path, but selectively learn from different models in many countries to make its unique way of institutionalization. In this regards, a systems lens is more helpful to explain how Williamson's "discriminating alignment hypothesis" (1996, 12) has adaptively been applied

in Vietnam's institutional reforms. Adaptive institutionalization in Vietnam will be analyzed in more details in the next chapters of the dissertation.

1.3. TOWARDS A NEW ECONOMIC POLITICAL ORDER

The two above sections, to a certain extent, have discussed several new trends in the study of governance and institutional change. First, the role of state institutions for growth has been increasing against market institutions. Second, institutional innovations that complement modern institutions of governance are critical to economic success in a particular country. Third, governance deficiencies at both micro- and macro-economic and the change in the position of large and emerging countries in the world politics and economy have underpinned the demand for adjusting the economic political order that enables to solve those national and global governance problems systematically and efficiently.

Over the past three decades, economic policy reforms, particularly in the developing world, have more or less been influenced by the neoclassical economics paradigm whose central contents are what Williamson (1990, 1999) called the "Washington Consensus" or those policies recommended by international financial institutions and the United State Treasury and considered as the recipes for economic success such as market economy, trade and capital market liberalization, macroeconomic stabilization, or privatization. However, two recent global financial crises in 1997 and 2008 called attention to the importance of national institutions of economic governance. The policies designed by "Washington Consensus" overemphasized market failures (such as rent-seeking, property rights, multitasking under moral hazard and adaptation problems (Gibbons 2005)) in the explanation of the failures of internal organization while the role of government is minimized.

History shows little support to the market-biased "Washington Consensus" recipes, particularly in Latin American and African countries, and they are also not the way that economic success is realized in East Asia (Stiglitz 2002). Those countries that followed "Washington Consensus" policies did not see growth as expected. Recent debt crises in developing countries which turned into global financial distress in 1997 were resulted from the pure transplantation of such policies as liberalization of agricultural prices, import substitution, capital market openness, or privatization without building supporting institutions and infrastructure. In fact, the economic success of East Asian countries such as China, Korea, and Taiwan in the 1980s and early 1990s was achieved in the absence of these policies (Stiglitz 2008). However, government plays a key role for creating adaptive institutions that

serve similar functions with "Washington Consensus" policies. An example of these adaptive institutions is township and village enterprises (TVAs) in China where formal property rights are not legalized but informally protected through the local government's role of a "stationary bandit" leasing TVAs to entrepreneurs (Dixit 2005).

In order to avoid a complete meltdown of the economy in 2008, governments intervened in an unprecedented magnitude, just as before, without any cooperative approach at the global level. Worldwide government interventions to support the banking sector alone were summing up to more than one trillion Euros. At the same time, many governments announced additional financial supports of up to one trillion Euros for a number of failing industries and, also, in order to enhance the respective aggregate demand. In the light of these gigantic numbers, many voices are joining in a chorus demanding a more fundamental intervention by governments to adjust the underlying economic political order, more specifically, regulating firms.

The renewed demand for the adjustment of economic political order at the macroeconomic level has been raised in the scenario political and economic positions have been changed in the aftermath of the crisis. Before the global crisis in 2008, the United State (US) and other richest G7 countries[17] influenced the design of development policies in the world economy and the operational rules of international institutions such as the International Monetary Fund (IMF). The US was also the biggest creditor in the IMF. After the crisis, the US became the biggest debtor in the IMF, and the IMF had to call for the financial contributions from emerging countries. As a result, this international institution announced its record lending commitments of over 158 billion USD by June 2009 and increased the voting power to large and emerging countries such as Korea, Singapore, Turkey, China, India, Brazil, and Mexico (IMF 2009, Woods 2010). The crisis has led to a multilateral economic political order and a series of reforms in international institutions towards better representing emerging economies.

The crisis also shows other aspects of national governance in those countries that did not suffer heavily from the global crisis. Recipes for economic success prescribed by international institutions and developed countries mostly focus on formal rules and formal institutionalization. Stiglitz (2002, 2008) argued that those developing countries in Africa and Latin America naively following the formal prescriptions of the "Washington Consensus" did not see gains in transition while those countries in Central Europe or East Asia adaptively built similar institutions in informal forms succeed. Transition in Central Europe is more

[17]Large and emerging countries, including China, India, and Brazil, are not in this group.

successful than that in East Asia because informal institutions of market economy evolved in Central Europe are embedded in its social and political culture of individualism, property rights, and the rule of law while the East Asian informal institutions of economic governance are built through their adaptation to the regional culture of collectivism, egalitarianism, and norms. The understatement of informal institutions and the mutual relationship between formal and informal institutions in designing reforms is the shortcomings of the neoclassical economics models in African and Latin American countries.

Given the institutional fragmentation and competition between local governments and states, the role of central government and international institutions in creating innovative governance institutions or legitimizing those created by lower-level government that support systemic coordination of governance is essential. China develops market-oriented economy in absence of formal property rights protection, market liberalization, or democratic institutions, but the country creates informal alternatives to secure investments such as "stationary bandit" of local governments through TVEs, liberalization of agricultural market at the margin (farmers have the freedom to sell their output at the free market price after meeting the state quota), or sub-central democracy[18] (Dixit 2007). Vietnam's economic reforms are based on many informal rules and procedures (for example, moral governance, fence-breaking, individual accountability of the chairmen of sub-central governments, or grassroots democracy); however, economic growth and development of Vietnam is slower than that of China. On the one hand, China's government organization is more disciplined at the central level. On the other hand, China's government is more proactive to create innovative informal institutions that serve the similar functions of the market economy. The system of national governance should be based on both political and economic legitimacy. Both government and market institutions are critical to growth.

The above analysis shows that the economic political order is shifting towards a new order. Domestic institutional fragmentation can be diminished with highly disciplined government organization while creating formal and informal institutions of economic governance that complement or substitute market institutions is a pre-condition for growth. As each country is a particular case of development, transplanting the whole model of other countries without considering its specific institutional environment and the strength and origins of informal

[18] China maintains its authoritarian governance at the central level, but allows several democratic institutions (for example, elections, press freedom, or fight against corruption) to function at the middle and low level of government. The use of partial institutionalization of market institutions

institutions cannot succeed. The global financial crisis in 2008 also shows the need to adjust the economic political order at the global level when many emerging countries have stronger influence in making global rules and policies. However, the existing system of global governance suffers from severe deficits of accountability and accommodation. Many countries only focus on building and legitimizing their national power and contribute little to global governance. Therefore, institutional reforms need to incorporate internal and external mechanisms of accountability to minimize the likelihood that institutional competition between localities and states leads too race to the bottom where national or global issues are addressed in an ad hoc and dissonant manner. In chapter 2 and 3 of this dissertation, I describe how external accountability in coordinating growth policies is achieved through building the annual provincial governance performance index in Vietnam.

1.4. CONCLUSION

This chapter is a conceptual analysis of the link between institutions and growth. It points out the shortcomings of neoclassical economics paradigms that overstate market institutions while understating the role of government. Even when government institutions are acknowledged in modern development economics and become the subject of institutional economics, policy recipes for economic success designed and recommended by developed countries and international institutions only focus on formal institutions. Many examples in developing countries show that the informal institutions and the pattern they interact with formal institutions matter. Many countries in Africa and Latin America fail in transition because the dynamics of informal institutions is not taken into account. Many East Asian countries achieve fast growth because they understand the strengths of informal institutions in their country and the endogeneity of informal institutions with formal institutions, and create those that support the partial improvement of the formal system and economic growth. Accordingly, informal institutions should be regarded as a part of the institutional system in designing reforms in developing countries.

At the same time, the two global financial crises in 1997 and 2008 have shown the shift in economic and political positions of emerging economies and the governance deficits at both micro-and macroeconomic levels. These events imply that the adjustment of the economic political order be imperative. In the following chapters, I am going to analyse how it takes place in Vietnam and 44 other countries, using comparative institutional approach.

Chapter 2

Informality, Decentralization, and Sub-central Governance

"Some formal institutions can meld well with the existing informal ones …In other instances, the two institutions clash with each other and the formal one may lose."

(Avinash Dixit 2005, p.18)

2.1. INTRODUCTION

Institutions are at the core of governance from both macro and microanalytic perspectives (North, 1995). Although institutions of governance are applied on the same principle in different organizations, their trajectories have been shown to vary widely (Helme and Levitsky 2004, Tsai 2010, Grzymala-Busse 2010). For example, contracts, the protection of property rights, privatization, decentralization, courts, democracy, or accountability are formal institutions of governance in both developed and developing economies, but the enforcement of these institutions may be very costly and uncertain in the latter group. Alternatively, economic actors who operate in this constraining formal institutional environment seek to use self-enforced alternatives such as clientelism, corruption, political connections, lobbying, relational contracts, unofficial economies, civil society, norms, culture, and mafias[19].

One of the latest advances in institutional economics literature is the recognition of the endogenous relationship between formal and informal institutions (North 1990, Voigt and Kiwit 1998, Helmke and Levitsky 2004, Dixit 2007). The New Institutional Economics and Social and Political Sciences have recently argued that informal institutions evolve as functional substitutes for formal institutions where the latter are weakly enforced or

[19] Examples of the role of informal institutions that structure political life and shape institutional outcomes in Latin America, Europe and Asia are given in Helme and Levisky (2004).

inefficient. Informal institutions may enhance or undermine the effectiveness of formal rules and organizations, and vice versa, a change in the latter will determine the trajectory of the former. The reciprocal relationship between the two types of institutions is the main source of institutional reform, especially in transitional countries, and the determinant of the pace and direction of change. However, the interaction between formal and informal institutions and how it may affect political behaviors and outcomes remain understudied and hence call for further scholarly attention.

Four institutional issues remain ambiguous. First, institutional reform is the result of a multi-dimensional, interactive process, and not all of the dimensions have the same impact on the outcome. Distinguishing the individual dimensions' contributions to the overall change in a certain period will be helpful in making timely decisions and promoting policy initiatives. Second, the majority of theoretical and empirical studies focus on the complementary or substitutive relationship between formal and informal institutions. Other forms of their relationship such as accommodating or competing remain underinvestigated[20]. Third, understanding the mechanisms through which an informal institution is created and developed helps to predict how a certain set of institutions are chosen in a certain point of time. This also facilitates efforts to evaluate government performance in the process of creating and enforcing institutions. Finally, due to the variation in the origins and trajectories of institutions to be enforced in each political regime, empirical studies in the area of formal and informal institutional interaction in the setting of a particular country will be of importance for local governance.

This chapter attempts to clarify the controversial issues above by empirically investigating how different formal and informal dimensions of decentralization interact to influence the governance performance of sub-central governments in a transitional economy. As defined in many other studies, decentralization is a multi-dimensional institutional reform. Treisman (2002a), for example, supposes that decentralization in the public sector differs in the number of tiers of government, the degree of decision-making autonomy, resources (revenue power and manpower), democracy, and constitutional participation. His study of 154 countries shows that those with a higher degree of decentralization, especially those with more layers of government, have poorer performance in the delivery of basic public services and worse corruption. However, he fails to check the robustness of his findings, and other dimensions of

[20] See footnote 6.

political decentralization have an inconclusive effect on the quality of government. In this chapter, I distinguish formal decentralization – or the legitimate level of autonomy in human resource management assigned by the central government to sub-central governments - from informal decentralization, which is the de facto discretion in sub-central government decision making as shaped by 'village' culture that has been persistent for centuries and lies beyond the control of the central government.

The distinction between formal and informal decentralization has been discussed by several authors (Montinola, Qian and Weingast 1995, Jones-Luong 2003, Malesky 2004, Shah and Thomson 2004), and it can also be abstracted from a number of theoretical and case studies on formal and informal institutions (North, 1990, Stigliz 2000, Taylor 1992, Dia 1996, Aghion and Tirole 1997, Voigt and Kiwit 1998, Zenger et al. 2001, Dixit 2003, Helmke and Levitsky 2004, Tsai 2002). Most of these studies argue that the mechanisms for the creation of power through formal and informal decentralization are not identical and are endogenously determined. Formal decentralization refers to the assignment of decision rights over certain public policies from the upper tier of government to a lower one. Due to coordination failures among the tiers of government (e.g., information asymmetry, contract incompleteness, interest conflicts, or capability and resource constraints), decentralization is, by nature, partial in reality. Bureaucrats always have incentives to create or at least facilitate the establishment of a private order to complement, substitute, accommodate, or compete with malfunctioning systems of public order, either for the sake of their community or simply in an effort to maximize their private benefits. This private order allows lower-tier governments to manipulate higher-tier rules and regulations at their discretion and even to introduce their own rules that are acknowledged and respected by local citizens at low fixed costs (Li 2003). When the private order is rooted in culture and history, it may gain more rapid and stronger consensus within the community and act as an umbrella over a substantial degree of 'informal' local autonomy. The upper tier recognizes this type of inflated behavior by the lower tiers and seeks to restrain it by vertically allocating a limited number of decision rights in certain public areas.

There are three main mechanisms through which decentralization impacts government performance. First, decentralization affects the behaviors and efforts of local government officials through local democracy. Under decentralization, local voters, given their perceptions of the quality of government in the first term, have a deterministic say for the chance that sub-central government officials remain in office in the re-election. So, local

government officials face a trade-off between diverting rents from tax revenue and winning re-election (Seabright 1996, Persson and Tabellini 2000, and Hindriks and Lockwood 2005). Second, decentralization also influences government performance through interjurisdictional competition among sub-central governments. Tiebout (1956) claims that under decentralization, the voters can vote for the bundle of public goods and taxes they prefer, so given the low cost of mobility, they will relocate to the local government that matches their preferences. Brenan and Buchanan (1980) extend Tiebout's theory and argue that under factor mobility, governments have to compete for high-quality labor, which hinders them from making anticompetitive regulations and opportunistic decisions. From a different perspective, Salmon (1987) and Besley and Smart (2007) emphasize the advantage of decentralization as a mechanism of yardstick competition; voters can make inferences of their own local government performance by comparing with their neighboring jurisdictions with similar conditions. Third, under decentralization, local governments are supposedly more likely to be captured by 'elites,' and this can lead to more distortions of policy choice and give rise to overspending incentives. Due to the distance from the central government, the head of local government always has the desire to be honored as the 'king' in the community under their authority. This is really an important aspect in those countries where the 'village' culture, or the kind of common wisdom of 'the King's laws are held back at the gate of the village', prevails and dominates how rules are made and implemented, as in Vietnam's case.

What does the interplay between formal and informal institutions mean for economic growth? Both theoretical and empirical studies have been exhaustive in finding the answer, and it turns out to depend on their relative strength, local preferences for each type of rules, and the extent to which their goals converge during their evolution and development (North 1990, Voigt 1993, Pejovich 1999, Keefer and Shirley 2000, de Soto 2000, Acemoglu, et al. 2001). These studies agree that the same rule may not have the same impacts on all economies because of heterogeneous enforcement mechanisms and preferences. For example, Knack (1995) and Acemoglu and Johnson (2005) found that property rights institutions, defined as 'formal rules constraining government behavior', have a positive long-run effect on economic growth and economic development. However, Keefer and Shirley (2000) and Williamson (2009) argue that formal institutions are not sufficient to maintain economic growth, but they should be embedded into local culture and existing informal institutions in order to be successfully enforced. The identification of the nature of the relationship between formal and informal institutions will certainly be helpful in the next stage of institutional reform.

So far, empirical research on the interaction between formal and informal decentralization has been restricted, partly due to difficulties in quantifying informal aspects. The outcomes of their relationship are sensitive to particular dimensions of decentralization and the mechanisms through which they evolve. If formal decentralization is used as an instrument for the upper level of government to provide incentives for lower-level policy innovation, this may lead to an increase in the level of local autonomy. This occurs when local government officials attach a high value to their identity as a 'president' in their locality, greater than their private rents. As the value of identity is partially linked to the official degree of autonomy, the organizational design of the formal system affects the effort they devoted to alternative tasks (for example, between the provision of public order and the delivery of public goods and services) given the self-assessed value of their identity.

If informal decentralization institutions are created ad hoc to accommodate undesirable formal institutions, compete with or substitute for weak formal institutions, the outcome may or may not be efficiency enhancing. For example, local 'jockeying' over forest resources in Indonesia has resulted in the loss of state control and power over these resources and the unorganized exploitation of timber lands under the implicit consensus of local governments (Ravenel 2004). In China, the Organic Law of Village Committees assigned village committees the responsibility to provide certain infrastructural services to their villagers, but Tsai (2002) found that those villages (among four studied cases) use local social networks such as temples to raise resources and self-finance local spending on certain public services provide more of them compared to those relying on village officials. However, this type of informal system of providing public goods and services is not sustainable and is only applicable to small-scale transactions and in small communities. Informally decentralized institutions and procedures can be quickly destabilized by the introduction of and changes in of more effective formal ones (Stigliz 2000, Dixit 2004). In this case, informal decentralization may have to adhere to formal rules if it does not wish to be suppressed.

Comparing the two systems, Gambetta (1993), Li (2003), and Dixit (2004) found that the informal system is less successful in protecting property rights than in enforcing contracts because the latter requires minimal public order. Montinola et al. (1995) argues that when the sub-central governments act as 'small' national governments, the autonomy they obtain under decentralization may make them unable to credibly commit to actions. This is due to the higher possibility of 'elite' capture at the lower layers of government (Shleifer and Vishny 1993, Bardhan and Mookherjee 2006). Therefore, a multi-tier government structure may not

enhance governance performance at the local level. Formal and informal decentralization institutions may also have divergent outcomes if the former face constraints (i.e., in financial or human resources, or technological change) while informal institutions have channels to ease these constraints, through FDI inflows, for instance, or simply thanks to their fixed cost advantage. It is obvious that studies on the interplay between formal and informal decentralization also support the general view of most scholars on the interaction of formal and informal institutions: whether they are complementary, substitutive, accommodating, or competing and how their relationship impacts governance and economic performance depends on the strength of the existing formal system, the local preference for each institutional system, and the degree to which their goals are shared.

This chapter has three novel aspects that distinguish it from others. First, it contributes to the empirical literature of institutional economics, especially when the relationship between formal and informal institutions remains understudied. This chapter finds that what is important in explaining the variation in the government performance in cross-country studies, such as legal origins and religion, seems unimportant in within-country analysis and in countries with small religious populations such as Vietnam. I claim that the dynamic incentive structure created by the relationship between formal and informal institutions before and after the '*Doi Moi'* or Renovation is critical to the quality of lower-level governments. In this chapter, the findings are based on the empirical study of the relationship between formal and informal decentralization across 64 provinces in Vietnam over the period 2006-2008 (20 years since the beginning of the '*Doi Moi*').

Second, Vietnam is selected because it is typical of a country where the formally decentralized system remains immature. Decentralization was incorporated into the country's institutional reform in the late 1980s, marking the lift of central planning for public policies. It is noted that 'the King's laws are held back at the gate of the village' was a common saying about the lack of public trust in formal rules both in the central planning and post-reform eras. Instead, economic activities during this time have been based on a local order – or a system of fence-breaking rules created by local communities[21]. For this reason, many scholars have argued that Vietnam's transition is not a top-down, policy-driven process, but a bottom-up,

[21] The term 'fence-breaking' was originally used to describe the violation of central rules and regulations by state-owned enterprises in the central planning era (Fforde and de Vylder 1996, Fforde 1989). Fence-breaking has then extended to include the violation of central rules and regulations by local government during the post-reform period, and policy experimentation of local government where rules do not exist (Malesky 2004).

fence-breaking process. Much of major institutional change during the postplanning period results from the formalization of policy initiatives and experimentation at the sub-central level where central rules were not appropriate or missing.

Finally, the majority of the empirical analysis is based on the results of Provincial Competitiveness Index (PCI) surveys conducted from 2006 to 2008. 2006 is the first year that the PCI, measuring the performance of all 64 provincial governments, was launched. The methodology of the survey was stable during this period, allowing us to obtain relatively consistent measurements. This is also the year that the Central Committee of the Communist Party of Vietnam (CCCP) was elected for the 2006-2010 terms, with representatives of provincial government leadership. The ratio of provincial representation in the CCCP is controlled for in my study of the impact of decentralization on government performance. The period 2006-2008 allows sufficient lagged time to evaluate institutional quality after almost provinces were involved in gerrymandering from 1990 to 2004. This is also the period in which provincial governments were given substantial discretion in making public policies (for example, regarding public spending, land management, human resource management, and law-making), and provincial governments are very proactive and innovative in discovering ways to improve their performance and ease their hard budget constraints under the increasing pressure of local democracy and interjurisdictional competition for resources, especially private capital and high-quality laborers.

Empirically investigating the interaction between formal and informal decentralization – one of the most important economic and institutional reform in Vietnam, this chapter finds that formal decentralization accommodates informal decentralization in the delivery of public goods and services and competes with formal decentralization in the provision of public order. This suggests that the formally decentralized system for supplying public goods and services provides sufficient incentives to lower-layer governments to perform efficiently, but there remains a lack of effectiveness in the provision of strong public order, particularly the protection of property rights, enforcement of contracts, transparency and reduction of corruption. Therefore, the emergence of and dependence on an informal decentralized system that co-exists with the formal system is necessary to obtain public satisfaction, at least until the latter is sufficiently effective to compete successfully with the former in the provision of public order and other goods and services. In the next stage of reform, the central government needs to consider the application of modern institutions of governance and establish a more appropriate degree of formal decentralization that provides sufficient incentives for local

governments to maintain and enhance the public satisfaction with their performance. These findings are obtained through three-stage least squares (3SLS) regressions and are then checked for robustness using an OLS model.

The following section provides a review of the literature on the interaction between formal and informal systems of decentralization and its effect on local government performance. Section 2.3 describes how formal and informal decentralization operates in Vietnam. A description of the data and models and a discussion of the results will be provided in section 2.4. Finally, the chapter concludes.

2.2. FORMAL AND INFORMAL DECENTRALIZATION – THE CASE OF VIETNAM

The assessment of the relationship between formal and informal decentralization and government efficiency should be a country-specific issue, taking into account the heterogeneity of political, historical, cultural, and economic conditions of each geographical unit of analysis. There is no "one size fits all" institution for all regions and countries, and hence institutions will produce different constraints and incentives for government performance and imply dissimilar outcomes across jurisdictions. This section will study the case of how decentralization operates in Vietnam and how formal and informal decentralization interact to impact the quality of sub-central (provincial) governments.

2.2.1. Formal decentralization

By law, Vietnam is a politically centralized polity with four levels of government. Until May 2008, the country had 64 provinces, 690 districts, and 11055 communes[22]. Since the economic reform, or the '*Doi Moi'*, was initiated in the late 1980s, decentralization has been conducted in the increasingly broader scope of the public sector, including fiscal, personnel, legislative, planning, investment, land, and public service areas. In this process, the central government has assigned a certain degree of decision-making authority to sub-central governments. The power, roles, and responsibilities of central and sub-central governments are set out in legislation, including the Law on Local Governments enacted in 1958, the Law on the Organization of the People's Council and the Administrative Committees at All Levels of Government in 1994, the Ordinance on Concrete Tasks in 1996, the Law on the State Budget in 1998, the Revised Law on the State Budget in 2003, and the Law on the Issuance of Legal Documents by the People's Council and People's Committee in 2004. In Vietnam, the key

[22] The data are available on the website of the General Statistics Office of Vietnam at www.gso.gov.vn.

sub-central government is the province with major responsibilities being devolved to this intermediate level rather than local units (communes/villages). Therefore, provincial governments are the focus of this chapter.

Although governance responsibilities have been decentralized in a wider range of public policy areas to local governments, formal decentralization is only partial. Consider the example of fiscal decentralization. The Law on the State Budget of 1996 and the Revised Law on the State Budget of 2003 make a list of expenditure responsibilities assigned to the central government and sub-central governments. In 2002, the share of sub-central government expenditures in total government expenditures is 48% (World Bank 2005). This figure suggests that Vietnam is a relatively highly decentralized country in terms of public spending. The central government also stipulates in the Budget Law what types of taxes and fees (i.e., VAT on import goods, export tax, import tax, special consumption tax on import goods) are fully assigned to the central budget, what types (i.e., land and housing taxes, license tax, fee on land use, and others) are fully assigned to and collected by the sub-central governments, and what types (VAT except that on import goods, corporate income tax, tax on remittance, excise tax on domestic goods and services, gasoline and oil fees and personal income tax) are shared between the central budget and the local budget. In reality, local autonomy in revenue generation is limited to some types of fees and land taxes.

The degree of revenue decentralization varies across provinces and is subject to the amount of transfers from the central government to sub-central governments, the revenue from taxes and fees collected in their locality, and the tax sharing rate. In Vietnam, the tax sharing rate[23] is the same for all shared taxes, but it differs by province (Martinez-Vazquez 2005). In 2004, the sharing rate was 100% for the 47 poorest provinces and the other 17 provinces shared a part of their revenue with the central government[24]. The sharing rates are subject to change on the annual basis, and non-uniform sharing rates across provinces are used for equalization purposes. This makes Vietnam different from many other countries which maintain a uniform system of sharing rates and rely on transfer systems to achieve equalization targets. The non-

[23] The tax sharing rate is determined by a formula developed by the Ministry of Finance considering the difference between spending needs and revenue capacity. The former is estimated on the basis of norms and can be negotiated ex ante, while the latter is estimated on the basis of past revenue.

[24] Extracted from the balance sheets of the state government budget and local government budget for the year 2004 disclosed by the Ministry of Finance of Vietnam.

uniform system of tax sharing rates across provinces also leaves a room for local officials to make efforts to enhance the revenue capacity of their local governments.

Since 1998, provincial governments have been empowered to manage their own state officials, including recruitment, appointment, training, and firing[25]. The percentage of government officials under provincial management in total government employees is approximately 54% on average over the period 2000-2008 (General Statistics Office of Vietnam). This figure also shows that Vietnam has decentralized relatively substantially in state human resource management, and the degree of decentralization in this area is equivalent to that in public spending. Similar to other research, decentralization in human resource management and in fiscal areas is highly correlated (0.82 between the former and revenue decentralization and 0.91 in the case of expenditure decentralization). However, state employment decentralization has insignificant correlation with transfer (0.07)[26].

2.2.2. Informal decentralization

Different from other transitional countries, the economic reform of Vietnam was not driven by policy reform from above, but by institutional change from below (Fforde 1993). During the central planning and post-planning period, many policy experiments and initiatives where regulations are not appropriate or do not exist were conducted by provincial governments and state-owned enterprises (SOEs) (Fforde and de Vylder 1996). From the perspective of the central government, all of these initiatives are illegal or 'fence-breaking'. Malesky (2004) called these actions 'de facto decentralization'. I use another term 'informal decentralization' in order to emphasize the mechanism and process of its evolution and distinguish it from that of formal decentralization. A list of 34 'fence-breaking' provinces and responsible officials were named in Decision No. 1387 on 29 December 2005 by the Prime Minister and then punished, despite the fact that many of these policy experiments and innovations at the provincial level were subsequently legalized and became highly successful. The true number of fence-breakers may be higher due to informational constraints. Obviously, along with formal decentralization, fence-breaking is critical to alter government performance. The high

[25] Decree number 71/2003/ND-CP issued on 19 June 2003 by the Government on the decentralisation of human resource management in the state sector allowed sub-central governments a certain degree of discretion in the recruitment, dismissal, and transfer of their employees, but the annual number of employees in the state sector must meet the quotas and norms of the central government agencies. Therefore, the measure of formal decentralisation, the percentage of provincial employment in the state sector in the total central and sub-central government employment, is a formal rule in its true sense.

[26] Authors' calculations based on the balance sheets of state budget and provincial budget from 2000 to 2008 issued by the Ministry of Finance of Vietnam.

degree of actual autonomy at the sub-central levels has intensified the conflicts between the central government and sub-central governments and created intergovernmental competition for resources, especially private and foreign invested capital, a means to build greater autonomy for the sub-central governments. Positively, both formal decentralization and informal decentralization contribute to policy innovation and subsequently to enhancing the quality of governance in many aspects. However, at the initial stage of decentralization, some formal procedures are not effective and strong enough and rely on a certain private order to maintain public order.

Since 2005, the Vietnam Chamber of Commerce and Industry (VCCI) and the Vietnam Competitiveness Initiative (VNCI) project sponsored by the United States Agency for International Development (USAID) conducted a survey of businesses regarding their perceptions of the quality of local governments and business environments. In 2005, 2020 firms in 42 provinces responded to the survey. Based on the survey results and actual economic performance of each province, a Provincial Competitiveness Index (PCI)[27] was constructed. Initially, PCI2005 had nine sub-indices. Since 2006, PCI surveys have attracted responses from approximately 7000 firms, and the PCI index is comprised of 11 sub-indices, measuring entry costs, time costs of regulatory compliance, land access and tenure security, transparency, corruption, institutional quality, competitive environment, proactivity of provincial leadership, labor policy, quality of public services for the private sector, and infrastructure. The PCI also reflects firms' perceptions of the degree of decentralization in Vietnam. In particular, the PCI2007 reported that an average of only 8.4% of the surveyed firms believe that central laws are consistently enforced at the sub-central levels. Approximately 39% of private firms agree or strongly agree that local governments use their own rules and regulations to extract rents.

The broad discretion of local officials is confirmed in many empirical studies (Litvack and Rondinelli 1999, Tenev 2003, Fforde and de Vylder 1996, Malesky 2004 and 2008). Tenev et al. asked CEOs of a sample of SOEs and private firms how they reacted to ambiguous regulations and determined that local officials have various ways to interpret such regulations at their discretions. Litvack and Rondinelli found that local governments have different views on enforcing central laws and regulations: some provinces are more flexible than others in implementing central regulatory policies and experimenting with provincial strategies.

[27] The full survey is available on the website www.pcivietnam.org.

There are attempts to explain why local leaders have greater influence over central laws and regulations and how they build their local autonomy. The most popular contemporary explanation is historical and cultural relics. Local governments in Vietnam evolve out of traditions of community or village self-governance. 'village culture', which prioritizes local rules over national laws and regulations, has a substantial influence on economic activity and causes the conflict between the central and local governments to be intense. Although villages are not administrative units of central or local governments, the rules set by the head of each village have powerful effects, and those national laws and regulations conflicting with village rules are suppressed. This is illustrated in the well-known saying '*Phep vua thua le lang*' (translated as 'The King's laws are held back at the gate of the village').

In addition to historical and cultural determinants, the government organizational structure is also relevant. The highly hierarchical structure of the government also creates opportunities for sub-central leaders to exercise their own local rules. First, the four-level vertical organization of the government from the central to three sub-central layers (including the provincial, district, and communal levels) and the fiscal autonomy of provincial governments allow a great deal of flexibility and asymmetry in implementing and enforcing central laws and regulations. Due to the distance between the central and local governments, there is less likelihood that central legal documents are implemented as directed, and the outcomes of central policies are frequently subject to the discretion of sub-central governments. Second, different from higher level administrative agencies, sub-central administrative units are organized on the subordination principle. They are governed and supervised by an elected body, the People's Council at each level. The Councils represent state power at each of the sub-central levels. The People's Council elects the People's Committee as an executive organ of the Council. Some functional committees (Special Economics Committee, Finance Committee, and others) accountable to the People's Committee are established to address particular demands of businesses and citizens. The responsibilities and powers of these organizations are stipulated by laws and sub-laws, but ambiguous enough to give them substantial latitude in governance, and even the freedom to overturn each other's decisions.

Another explanation is the inconsistency, complexity and ambiguity of the legal system. Tenev (2003) argues that the broad discretion of local officials stems from inconsistent legislation. When a new law is introduced, it simply provides a general framework and leaves sub-central officials with substantial freedom to work out the details and presents them with difficulties in enforcing a mountain of legal documents issued by ministries and upper level

agencies. Nguyen (2004) classified the legal system of Vietnam into three groups. The first group includes very transparent documents (including laws, sub-laws, and regulations). The Enterprise Law of 1999 is in this category. Business registration procedures under this law are not significantly different across provinces. However, the number of legal documents in this group is limited. The second group is a set of outdated documents that fail to govern new economic activities. For example, there are no official central government regulations governing private sector involvement in infrastructure. This creates room for local governments to use their discretion to make their own laws in this domain. The third group covers an extensive range of ambiguous and complex documents that are difficult to implement or highly costly if implemented properly. The majority of legal documents in Vietnam belong to this category. Land regulations are an example. Businesses that face laws and regulations in the last two categories tend to rely on local officials' interpretations, which incidentally increase the power of local governments.

A different line of arguments says that the principle of 'top-down' decentralization is misconceived, and this is one of the causes of inflated informal decentralization. In reality, decentralization is employed in Vietnam in the sense that those functions and responsibilities that the higher-level government should not do will be assigned to lower-level governments (Vu et al. 2007). This principle is contrary to bottom-up decentralization process, in which the higher-level government will be responsible for those tasks or functions the lower layers are unable to perform. Decentralization from the top aims to constrain local autonomy by increasing local leaders' accountability, yet it makes local officials feel unnecessarily constrained in some instances. The top-down principle also places the higher-level government in the position of being the primary accountable actor and creates opportunities for lower-level governments – who implement assigned responsibilities – to relinquish their accountability. Ultimately, the upper governments experience substantial pressures related to workload while facilitating the lower units to depend on them. This moral hazard problem paves the way to uncontrollable local autonomy.

A recent study on informal decentralization in Vietnam by Malesky (2008) uses the content analysis approach to identify which factors, including geographical locations, political connection, natural endowments, and the dominant source of economic activity in terms of ownership are the main contributors to local leaders' policy autonomy. They find that none of the listed factors have a significant impact on the actual level of local autonomy independently, but FDI inflows into provinces do. These authors' findings may prompt

suspicions regarding the ability of a newspaper content analysis to collect reliable data; for example, as the provinces are embedded in close relationships with the central government. Political sensitiveness and media bias may lead to missing data[28]. Furthermore, endogeneity may be at play.

2.2.3. The relationship between formal and informal decentralization

Contemporary research on the relationship between formal and informal institutions tends to focus on the functional effect of the former on the performance of the latter, and neglect the mechanisms by which they are created. From the institutional economics perspective, formal institutions emerge endogenously from pre-existing informal institutions, and vice versa (North 1990, Helmke and Levitsky 2004). On the one hand, formal institutions are not created in a vacuum, but are conditioned on the environment in which they operate. Government considers formalizing pre-existing informal rules or chooses to build formal rules without taking pre-existing informal structures into account. On the other hand, not all informal rules are culturally and historically rooted. Many informal institutions emerge to enhance, substitute for, mitigate, or to subvert the efficiency of formal institutions (Helmke and Levitsky 2004). The choice of mechanisms of building formal and informal institutions shapes the relationship between the two types of institutions, and subsequently their functional outcomes.

Sections 2.1 and 2.2 demonstrate the mutual interdependence of formal and informal decentralization as institutions of public governance in their evolution. The case study of Vietnam's decentralization above supports the view that informal decentralization is the product of the interaction between culture[29] and an ineffective system of formal laws and regulations. That explains the prevalence of local government's autonomy in taking policy initiatives and policy experiments in their communities and highlights the importance of the bottom-up mechanism of institutional change in Vietnam. The relationship between formal and informal institutions change over time, which is subject to a change in the mechanisms by which these institutions are created, the relative efficiency of formal institutions, and public

[28] This measure can be criticized because the press is not significantly free in Vietnam and information is not always accessible in the poorest regions.

[29] Culture explains how formal and informal decentralization differ across regions. Cultural difference between the North and the South has been discussed by Rambo (1973), Taylor (1983), and Jamieson (1993), who identify the North as being more dependent on the central government and more closed than the open and relatively autonomous South. This distinction is the product of the less rigid pattern of village organization, more market-friendly mindset and longer Western dominance in the South than in the North.

preferences for either of them. Therefore, the evaluation of the relationship between a particular type of formal and informal institutions in a certain period of time is critical for making policy recommendations and planning the next stage of reform.

A weak system of formal institutions predicts the absence of a complementary relationship with some informal institutions, and the bottom-up mechanism of institutional change before and after the economic reform forecasts a competitive relationship between formal and informal institutions. In the following section, using Helmke and Levitsky (2004)'s typology of informal institutions in relation to formal institutions, I empirically investigate whether informal decentralization has a complementary, substitutive, accommodating, or competitive relationship with personnel decentralization in provincial governments during the period of 2006-2008 and whether their relationship has a positive effect on government quality[30].

2.3. DATA AND METHODOLOGY

2.3.1. Data

The definitions and sources of all of the variables used in this chapter are summarized in table 2.1. The following describes the construction of measures of formal and informal decentralization, sub-central governance performance and other control variables.

2.3.1.1. Measuring formal and informal decentralization

There has been a major effort to measure the degree of decentralization in public administration, fiscal federalism, and political authority in comparative political economy literature. The most popular measures include revenue generation and expenditure decentralization (Fisman and Gatti 2000, Glaister et al. 2008), policy making and personnel decentralization (Schneider 2003), federal dummy and the number of vertical government tiers (Treisman 2002, Huther and Shah 1998, Fisman and Gatti 2002, Alexeev and Habodaszova 2007), and employment decentralization (Lessmann and Markwardt 2010). In this chapter, I use data from the General Statistics Office of Vietnam to calculate the logarithmized proportion of total government employment under the management of provincial governments as the proxy for the formal decentralization variable[31]. Formal

[30] Helmke and Levitsky (2004)'s typology of the relationships between the two types of institutions has been described in footnote 6.

[31] We do not report the results of empirical analysis of the relationship between formal and informal decentralization, using other measures of formal decentralization, because I do not find their significant relationships in the 3SLS model. One of the explanations is the partial nature of fiscal decentralization in Vietnam – the assignment of expenditure responsibilities from the central government to local governments without corresponding revenue generation autonomy (see Section 2.1 for more

decentralization measures the extent of provincial autonomy in recruiting, using, training, promoting, and firing officials and has been utilized by Hughes (1991), Fisman and Gatti (2002), Treisman (2002a), and Jin, Qian, and Iingast (2005). Although these studies treat state employment decentralization as a *de facto* measure, the quota imposed by the central government in Vietnam's case makes employment decentralization similar to a *de jure* rule and is a good fit for the concept of formal decentralization in terms of its legitimacy.

A measure of formal decentralization has several critics. Oates (1972) argues that it does not always reflect the actual policy autonomy of sub-central governments, as this also depends on the behaviors and actions of local officials in practice. Malesky (2004 and 2008) emphasizes the importance of actual autonomy as a primary source of incentives for sub-central government officials to be creative and accountable. In this chapter, I do not follow the newspaper-content analysis approach proposed by Malesky (2004, 2008), but I instead use a different measure of informal decentralization, constructed from the results of the Provincial Competitiveness Index 2006-2008 surveys with the participation of over 7000 firms across 64 provinces. It should be noted that the model in this chapter is tested, using the provincial data. Informal decentralization is built on three PCI questions surveying firms' perception of how autonomous their provinces are in the development and implementation of public policies. Private firms (accounting for 95.66% of total active firms, excluding foreign invested firms, as of December 2008[32]) generally have few political connections compared to state-owned enterprises and hence are expected to give less biased evaluations of government quality. Question H7.3 asks firms whether the local government where they are located is flexible and innovative in implementing central policies to solve local firm-related problems. Question H7.8 asks firms whether any policy initiatives are made at the sub-central level. Question H7.5 samples the opinions of firms regarding whether good policies initiated by provincial governments are overridden by the central government. Informal decentralization is calculated, aggregating three indicators above based on the methodology suggested by PCI 2006[33]. Each indicator is standardized on a ten-point scale, and the final index is the average

details). Federal dummy and the number of tiers of government are more helpful to explain the variation of decentralization across countries.

[32] GSO (2009), "*Statistical Yearbook of Vietnam 2009"*, Statistical Publishing House, Hanoi.

[33] Each indicator is rescaled, using the formula $9\times\left[\frac{Province_i - Minimum}{Maximum - Minimum}\right]+1$ for those indicators that have positive interpretations and subtracting the above formula from 11 for those with negative interpretations, where $Province_i$ is the

value of equally weighted indicators[34]. Cronbach's alpha is 0.71. Table 2.2 presents summary statistics for all variables, and table 2.3 presents the matrix of correlations. Table 2.3 shows that human resource decentralization has a positive correlation with the measure of informal decentralization, yet the level of significance is not very high (0.22).

2.3.1.2. Measuring sub-central government performance

Provincial government performance is evaluated on the basis of the PCI Vietnam surveys from 2006 to 2008. There are six indicators classified into two categories, measuring the quality of public goods and service provision and public order provision. As the PCI indices reflect the perceptions of private enterprises, concerning local government performance, excluding state-owned enterprises (SOEs), the findings may be biased. However, the SOEs accounted for only 1.6% of the total number of enterprises in 2008[35]; hence, the PCI index represents the voice of the masses and is a relatively impartial measure of the government quality. The following is a detailed description of how governance performance variables are constructed.

To evaluate the quality of public goods and service delivery, we use two PCI Vietnam indices, including the "Private Sector Development Policy" index and "Infrastructure" index. The former aggregates firms' evaluations of the different services provided by provincial government agencies, including the supply of market information, export promotion and trade fairs, industrial zones, and technology-related services. The latter is developed with hard data of the number of industrial zones and their coverage and soft data on firms' perceptions of the quality of industrial zones. Similar to The informal decentralization variable, the two government performance variables in this section use ten-point scale indices, with the higher values representing better quality.

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indicator value of each province, *Minimum* is the smallest value of all provinces, and *Maximum* is the largest value of all provinces. Source: PCI Vietnam Report 2006, available at www.pcivietnam.org.

[34] In order to develop the informal decentralization index, I use exploratory principal component analysis (PCA) to determine which indicators are associated with each factor. I retain those factors that have eigenvalues greater than unity. The PCA leads to only one factor which explains 64.34 percent of the total variance in the original data. This factor (or index) is associated with those variables (or indicators) that have a high and comparable loading - the weights or the correlation between the factor and an indicator. The rotated loadings for three indicators (Questions H7.3, H7.5, and H7.8) that define the factor are 0.84, 0.67, and -0.88 respectively.

[35] GSO (2009)

Table 2.1: Description of the variables

Variables	Description	Source
formal decentralization	The proportion of government employment under provincial management in total government employment averages over the period 2006-2008.	MOF[i]
informal decentralization	A measure of local government officials' flexibility and innovation in developing and implementing public policies (scaled from 1 to 10), using Questions H7.3, H7.5, and H7.8 in the PCI Vietnam 2006-2008 surveys.	PCI[iii]
private sector development policy	A measure of the quality of public services regarding the provision of information about market, technology, export promotion and trade fairs, and industrial zones by local governments, using the "Private Sector Development Policies" index of the PCI 2006-2008.	PCI[iii]
infrastructure	A measure of the quality and coverage of industrial zones in the province, using the "Industrial Zone Quality and Coverage" sub-index of the "Infrastructure" index of the PCI Vietnam survey 2008 (scaled from 1 to 10).	PCI[iii]
legal institutions	A measure of trust in provincial legal institutions, using the "Legal Institutions" index of the PCI Vietnam surveys 2006-2008 (scaled from 1 to 10).	PCI[iii]
transparency	A measure of the predictability of the implementation of central laws and regulations by provincial governments, using the average of two sub-indices ("Predictability" and "Accessibility") of the "Transparency" index of the PCI Vietnam surveys 2006-2008 (scaled from 1 to 10).	PCI[iii]
property rights security	The "Land Access and Tenure" index of the PCI Vietnam 2006-2008 is used to measure the tenure security across 64 provinces of Vietnam (scaled from 1 to 10).	PCI[iii]
corruption	The "Informal Charges" index in the PCI Vietnam 2006-2008 surveys is used as the proxy for corruption (scaled from 1 to 10).	PCI[iii]
North	A dummy with 1 = North and 0 = South.	GSO[ii]
fence-break	A dummy with 1 representing those provinces reported in the Decision No. 1387 on 29th December 2005 by the Prime Minister to have issued local rules and regulations regarding illegal investment incentive policies.	
tax revenue/GDP	The share of provincial tax revenue in total provincial GDP in real terms in 2005.	MOF[i]
population	The proportion of provincial population in total national population in 2005.	GSO[ii]
area	The share of provincial area in total national area.	GSO[ii]
tiers	The number of tiers under provincial governments.	GSO[ii]
political connection	The percentage of provincial representatives in the tenth Central Committee was elected for the term 2006-2010.	
hospital	The number of state hospitals in the province in the total number of hospitals in 2005.	GSO[ii]
competence	The percentage of firms in PCI Vietnam surveys that agree and strongly agree that provincial officials are knowledgeable enough about central laws to solve emerging problems for firms.	Question H7.2 PCI 2006

i) MOF: Ministry of Finance of Vietnam; ii) GSO: General Statistics Office of Vietnam; iii) PCI: www.pcivietnam.org

To assess the quality of public order provision, I follow Shleifer and Vishny (1993), Huther and Shah (1998), McMillan and Woodruff (2000), and Dixit (2004) and employ four indicators, namely trust in provincial legal institutions, transparency, the security of property rights, and corruption. The first variable is the "Legal Institutions" sub-index of the PCI Vietnam 2006-2008, capturing firms' perceptions of legal enforceability and hard data on the number of non-state sector filings to provincial economic courts per 100 firms. The second variable is another measure of trust in the stability and clarity of laws and regulations. It is the average of two sub-indices ("Predictability" and "Accessibility") of the "Transparency" index of the PCI Vietnam surveys 2006-2008. The third variable in this category, *property rights security*, is the 'Land Access and Tenure' sub-index in the PCI Vietnam 2006-2008, which measures the security of land titles. The first three variables are ten-point scale indices with higher values representing better governance. The final variable, *corruption*, captures the results of Question G9.2 of the PCI Vietnam 2006-2008 surveys, measuring the percentage of firms that strongly agree and agree that provincial government officials use local regulations to extract rents. Different from the first three variables, the coefficients of the *corruption* variable have the opposite interpretation in terms of sign. Higher values of *corruption* represent more serious corruption, and accordingly worse provincial government performance. In other words, I expect the signs of the coefficients of the (*in*)*formal decentralization* variables in the governance equations for three first three variables to be in contrast to those for the corruption equation, although this contradiction still implies the same direction (good/bad) of the influence of decentralization on government quality.

2.3.1.3. Control variables

I also control for other province-specific factors that may impact decentralization institutions and provincial government performance. The analysis in section 2 demonstrates that the cultural differences between the North and the South are important, so I use a *North* dummy to control for the impact of culture on the dependent and independent variables. Another cultural consideration is an aspect of the policy-making culture in Vietnam, fence-breaking[36]. However, not all provinces adopt it. This feature of de facto local autonomy may affect the incentives of local government officials to be autonomous and subsequently their governance. Therefore, I also include the dummy *fence-break*, with 1 representing those provinces reported in Decision No. 1387 on 29th December 2005 by the Prime Minister to have issued

[36] The description of fence-breaking is made in footnote 21 and in the section 2.2.

local regulations regarding illegal investment incentive policies to diagnose the sign and significance of both formal and informal decentralization in relation to the quality of sub-central governments. Table 2.3 shows that *fence-break* dummy has very low correlations with the measure of informal decentralization and the other variables. It is possible that not all fence-breakers are identified and punished by the central government, especially in the setting of limited media freedom before 2005.

The market size and economic conditions of each province are also controlled for. The *population* variable (the proportion of provincial population in the total national population in 2005) and *area* variable (the share of provincial area in the total national area in 2005) are included in the models to control for the market size of each province. To control for the economic conditions in each province, I use the share of provincial tax revenue in provincial real GDP in 2005. The main argument is that government officials are motivated by extrinsic incentives, including their provincial tax revenue. Taxes will be the channel to sponsor their autonomous activities and help them depend less on transfers (Qian and Roland 1998, La Porta et al. 1999, Fisman and Gatti 2002). Another indicator that determines the difference in decentralization and government performance is the number of tiers of government. In most empirical studies on decentralization and government performance, tiers are treated as a measure of formal decentralization (Treisman 2002a, 2002b; Lessmann and Markwardt 2010). I include the *tiers* variable to test the potential influence of the number of layers of government on the explained and explanatory variables.

I follow the current literature on political agency theory and agree that politicians and bureaucrats pursue different goals. In addition to intrinsic incentives of having a 'provincial president' identity as discussed above, provincial politicians and bureaucrats are also motivated by the possibility of being appointed members of the Central Committee of the Vietnamese Communist Party, where the most important national laws and policies are determined. The number and structure of the Central Committee varies over a five-year term and depends on the bargaining power of each provincial government, likely through connections with existing members of the government and the politburo. Therefore, to control for the probability that Central Committee membership is an important determinant of both formal and informal autonomy and an incentive for the performance of provincial government officials, I construct the *political connection* variable, which measures the percentage of provincial representatives in the tenth Central Committee established for the term 2006-2010. The tenth Central Committee, elected in 2006, had 161 official members with 64 seats being

the presidents of People's Councils or the general secretaries of 63 provinces (excluding Dak Nong), and the remainder being top members of the Government, the politburo, the military, ministries, and other government agencies. To identify which provinces have stronger connections with the Central Committee, I rely on information about their (most longstanding) positions in a provincial people's council or secretariat; otherwise, I rely on their place of birth.

Table 2.2: Summary statistics

Variables	Obs.	Mean	Std. Dev.	Min	Max
formal decentralization	64	0.0076	0.0059	0.0027	0.0388
informal decentralization	64	5.15	1.42	2.51	9.39
North	64	0.45	0.50	0	1
fence-break	64	0.53	0.50	0	1
tax revenue/GDP	64	0.18	0.10	0.07	0.46
population	64	7.00	0.56	5.70	8.68
area	64	520.32	371.05	82.3	1649.9
tiers	64	5.25	0.47	4	6
political connection	64	0.02	0.01	0.0055	0.0552
hospital	64	0.02	0.01	0.0049	0.0438
competence	64	74.35	9.72	51.61	93.48
private sector development policy	64	4.54	1.32	2.3	8.1
infrastructure	64	3.44	1.69	1.00	8.07
legal institutions	64	4.23	0.74	2.52	6.14
transparency	64	4.19	0.79	2.36	6.22
property rights security	64	6.31	0.68	4.61	7.68
corruption	64	0.39	0.09	0.23	0.73

2.3.2. Methodology

As implied by the case study in section 2.2, formal and informal decentralization are endogenously determined, and there may not exist a complementary or substitutive relationship between some formal and informal dimensions of decentralization in the

provision of public goods and public order[37]. To determine the relationship between institutions and their mutual effect on governance, a common analytical method is to include an interaction term of two decentralization variables in an Ordinary Least Squares (OLS) model of government performance as the dependent variable. However, as decentralization variables are continuous, the inclusion of the interaction term in the OLS model will produce biased estimations due to its significant correlation with the individual terms and its failure to account for endogeneity.

To confirm my hypothesis, I have to test a system of equations where both formal and informal decentralization are simultaneously determined. First, I test whether the degree of formal decentralization is determined by the extent of informal decentralization. Second, I must test whether the degree of informal decentralization is determined by the extent of formal decentralization. Finally, I test the influence of both formal and informal decentralization variables on indicators of government quality. I follow the approach of Zellner and Theil (1962), Greene (2002) and Poppo and Zenger (2004), and employ a three-stage least squares (3SLS) model. "It can be shown that among all instrumental variable (IV) estimators that use only the sample information embodied in the system, 3SLS is asymptotically efficient" (Green 2002, p407). The use of the 3SLS model allows us to produce consistent estimates while taking the correlation in the disturbance terms across equations into account (Stata 1999). The empirical model testing the three above simultaneous equations is given by:

$$FD_i = \alpha_F + \beta_{F1} ID_i + \beta_{F2} North_i + \beta_{F3} fence\text{-}break_i + \beta_{F4} tiers_i + \beta_{F5} ltaxrevenue/GDP_i + \beta_{F6} lpopulation_i + \beta_{F7} larea_i + \beta_{F8} lpoliticalconnection_i + \beta_{F9} lhospital_i + \varepsilon_{Fi} \quad (1)$$

$$ID_i = \alpha_I + \beta_{I1} FD_i + \beta_{I2} North_i + \beta_{I3} fence\text{-}break_i + \beta_{I4} tiers_i + \beta_{I5} ltaxrevenue/GDP_i + \beta_{I6} lpopulation_i + \beta_{I7} larea_i + \beta_{I8} lpoliticalconnection_i + \beta_{I9} competence_i + \varepsilon_{Ii} \quad (2)$$

$$governance_{ij} = \alpha_{Gj} + \beta_{G1j} FD_i + \beta_{G2j} ID_i + \beta_{G3j} North_i + \beta_{G4j} fence\text{-}break_i + \beta_{G5j} tiers_i + \beta_{G6j} ltaxrevenue/GDP_i + \beta_{G7j} lpopulation_i + \beta_{G8j} larea_i + \beta_{G9j} lpoliticalconnection_i + \beta_{G10j} competence_i + \varepsilon_{Gij} \quad (3)$$

[37] Formal and informal decentralization as complements or substitutes have been empirically investigated by Mahmood and Rufin (2005) and Treisman (2006).

where FD_i and ID_i are the degrees of formal and informal decentralization in province *i*, and $governance_{ij}$ represents the indicator *j* of government performance in province *i*, with *j* = {*private sector development policy*; *infrastructure*; *legal institutions*; *transparency*; *property rights security*; *corruption*}. $North_i$, $fence\text{-}break_i$, $tiers_i$, $ltaxrevenue/GDP_i$ (the log of provincial tax revenue/GDP), $lpopulation_i$ (the log of provincial population), $larea_i$ (the log of provincial area), and $lpoliticalconnection_i$ (the log of *political connection*) are control variables in province *i*. ε_{Fi} , u_{Ii}, ε_{Ii} and ε_{Gij} are error terms in equations (1), (2) and (3), respectively.

The 3SLS model simultaneously estimates the three above equations in three stages following the procedure of STATA (Stata 1999). The first stage is to produce the instrumented values of all endogenous variables (formal and informal decentralization), which are their predicted values generated from ordinary least squares (OLS) regressions of each endogenous variable on all other exogenous variables. To minimize causality problems, the timing of exogenous variables is selected to be at least one year before the period 2006-2008 used for the endogenous variables. The second stage produces a consistent estimate of the covariance matrix of the equation disturbances. These are the residuals produced from the two-stage least squares (2SLS) estimation of each structural equation. In this stage, the choice of instrumental variables for each equation is critical. First, I use the logarithmized percentage of state hospitals in the province in the total national number of state hospitals as an identifying instrument in the equation predicting the degree of state employment decentralization (or formal decentralization). The distribution of public hospitals in each province is one of the determinants of the quota for state officials working in these facilities, and hence of the degree of decentralization in state employment management. Table 2.3 shows the high correlation between state employment decentralization and its identifying instrument (0.78), although it is insignificantly correlated with informal decentralization and other controls. For the informal decentralization equations, I use the responses to PCI question H7.2 in 2006, which is the percentage of firms in the PCI Vietnam surveys that agree and strongly agree that provincial officials are knowledgeable enough about central laws to solve emerging problems for firms (The *competence* variable). The link between the capabilities of government officials and their autonomous behavior has also been demonstrated by Malesky (2008). Table 2.3 shows that *competence* is highly correlated with informal decentralization (0.74) while having low correlations with all other variables. The validity of instruments is also carefully checked

Table 2.3: Correlation matrix

	informal decentralization	*formal decentralization (log)*	*North*	*revenue/GDP (log)*	*population (log)*	*area (log)*	*political connection (log)*	*fence-break*	*tiers*	*hospital (log)*
formal decentralization (log)	0.2249* (0.0740)									
North	-0.3360*** (0.0066)	0.0756 (0.5526)								
revenue/GDP (log)	0.2240* (0.0751)	0.1920 (0.1286)	-0.0683 (0.5916)							
population (log)	0.1826 (0.1486)	0.3118** (0.0121)	-0.0077 (0.9520)	-0.0457 (0.7199)						
area (log)	-0.3308*** (0.0076)	-0.0155 (0.9030)	-0.0810 (0.5248)	-0.1294 (0.3080)	-0.2303* (0.0671)					
political connection (log)	0.1366 (0.2819)	0.4611*** (0.0001)	0.2558** (0.0414)	-0.1015 (0.4249)	0.1577 (0.2133)	-0.2801** (0.0250)				
fence-break	0.0676 (0.5955)	-0.0043 (0.9734)	-0.1514 (0.2325)	-0.1097 (0.3883)	-0.0757 (0.5521)	0.0340 (0.7894)	0.0859 (0.4997)			
tiers	-0.0537 (0.6736)	0.2360* (0.0604)	0.0503 (0.6929)	-0.0420 (0.7419)	0.0140 (0.9128)	0.3058** (0.0140)	-0.1793 (0.1564)	-0.1674 (0.1862)		
hospital (log)	0.1578 (0.2131)	0.7761*** (0.0000)	0.2545** (0.0424)	0.0237 (0.8524)	0.2049 (0.1043)	0.1001 (0.4315)	0.4512*** (0.0002)	0.0755 (0.5531)	0.2571** (0.0403)	
competence	0.7095*** (0.0000)	-0.2264* (0.0720)	-0.1858 (0.1416)	-0.1061 (0.4040)	0.0552 (0.6650)	-0.1238 (0.3299)	-0.0976 (0.4428)	0.1496 (0.2380)	-0.0556 (0.6628)	-0.1017 (0.4240)

* significant at 10%; ** significant at 5%; *** significant at 1%; N=64;
P-values denoting the significant level of each correlation coefficient are in parentheses.

in the first stage of the regressions. The final stage runs GLS-type estimation, including all of the instrumented values of the endogenous variables and the covariance matrix of equation disturbances in the third equation regressed on government performance (the *governance* variable). This regression allows us to obtain the coefficients of both the formal and informal decentralization variables and governance in the single regression.

The simultaneous equation model enables us to test the pattern of interactions between two endogenous variables and their impact on the third variable consistently. Based on the signs and significances of the coefficients of the endogenous variables in the three equations and the typology of informal institutions mapped out by Helmke and Levitsky (2004), it is possible to determine whether formal decentralization and informal decentralization are complementary, substitutive, accommodating, or competing. Although Helmke and Levitsky's typology was also reviewed in the introduction, I wish to clarify the interpretation of signs of the coefficients. The tests would support the existence of a complementary (or substitutive) relationship if both formal decentralization and informal decentralization have similar positive (or negative) impacts on each other (equations 1 and 2). The tests would support accommodating (or competing) relationship if the outcomes were opposite and significant. However, to isolate their actual relation, it is necessary to interpret the signs and significances of the coefficients of formal and informal decentralization in equation 3. The estimation would support the existence of an accommodating relationship if the coefficient of formal decentralization were positive, which suggests that this institution is actually effective. The estimation would support the existence of a competitive relationship if the coefficient of formal decentralization were negative, which implies the existence of an ineffective formal institution. It is possible to test whether the accommodating (or competing) effect of formal and informal decentralization is efficiency-enhancing. If both coefficients in equation 3 are positive and significant, it can be concluded that there is an accommodating relationship and its effect on governance performance is efficiency-enhancing. If the coefficients are significant but opposite in signs, conclusions can be drawn on the direction of the effect of each decentralization measure on governance, based on their negative or positive signs.

2.3.3 Results

Table 2.4 presents the results of the 3SLS estimation. Equation 1 tests whether an increase in the level of informal decentralization is associated with a higher or lower degree of formal decentralization. The main coefficients of equation 1 support the notion that the informal

dimension has a substitutive relationship with its formal counterpart. Those provinces identified as having higher levels of policy autonomy are those with less empowerment in management of state human resources. This implies that formal decentralization serves as an instrument for the central government to restrain undesirable autonomy or encourage sub-central proactivity in the desired policy areas. The coefficients of the control variables are also consistent with my hypothesis of the impact of cultural, political, demographic, and economic factors specific to each province on the degree of formal decentralization. The southern provinces have significantly higher levels of formal decentralization than those in the North. Those provinces that have larger shares of tax revenue contributions to provincial GDP are also accorded greater authority over their employment management. This is also true for more populous provinces and those with more representatives in the central committee of the Communist Party. The market size in terms of area and the number of sub-central tiers of government have insignificant influences on formal decentralization. Those provinces reported to have broken fences do not exhibit any greater or lesser likelihood of having formal employment decentralization. As noted above, political collusion or the lack of press freedom may result in some fence-breakers being left off this list. The measure of policy autonomy in the model more accurately reflects the true level of informal decentralization than the *fence-break* dummy. The validity check for the instrument based on the correlation matrix and the first-stage regressions is further supported by the significance of the instrument coefficient in the regression with the formal decentralization measure in equation 1.

Equation 2 tests whether informal decentralization depends on the formal assignment of autonomy in human resource management at the provincial level. The results show that those provinces with a higher degree of formal decentralization have higher levels of actual autonomy. This implies that formal decentralization is a determinant of the increase in informal behavior at the sub-national government level. Similar to formal decentralization, tax revenue is a significant incentive for local autonomy, and southern provinces have higher levels of informal decentralization than northern ones. The degree of informality is also significantly higher in smaller provinces, which supports earlier studies. However, the market size in terms of population and influence from political connections has an insignificant effect on the extent of informal decentralization. Those provinces listed in the Prime Minister's Decision No. 1387 do not have higher levels of local autonomy. This may be explained by the fact that low press freedom and poor information access in the country hindered the central government from identifying many other cases of fence-breaking, and this distorts the

estimation results. This is also observed for the effect of the number of sub-central tiers on the two dimensions of decentralization and government performance. The results are further supported by the significance and validity check of the instrument.

The first two equations demonstrate that the mutual impacts of formal and informal decentralization on each other are significant, but divergent. An increase in the level of formal decentralization is associated with a greater degree of actual local autonomy. However, more autonomous provinces are awarded less formal empowerment in provincial human resource management. These results, therefore, do not support the existence of complementary or substitutive relationships. The typology of Helmke and Levitsky suggests that they are likely to be accommodating or competing, depending on whether formal decentralization is effective. This chapter argues that the quality of formal procedures differs across the functions and tasks of local governments. It attempts to test the effect of the formal and informal systems in two areas: public goods and service supply and public order provision. The estimation results are presented in equation 3 for two indicators of public goods and service quality (the quality of private sector development policy and infrastructure) and four other indicators of public order provision (trust in legal institutions, transparency, property rights security, and corruption).

Equation 3 reveals a common trend in the effects within each group of indicators, but a difference is observed between the two groups. Both the formal and informal systems have significant and positive impacts on the quality of private sector development policy and infrastructure. This implies that the formally decentralized system has been designed in a manner that prioritizes the effective provision of public goods and services. The policy autonomy of provincial governments also contributes to the improvement of the public sphere in this area. The effectiveness of formal decentralization in the provision of public goods and services and the simultaneous existence of the divergence between formal and informal decentralization suggest that they have an accommodating relationship in this public sector, following Helmke and Levitsky's classifications of institutions. However, in the case of public order provision, a positive and significant impact is only observed for informal decentralization. Governance equations with trust in legal institutions, transparency, property rights security, and corruption as dependent variables, respectively, demonstrate the negative and significant effect of formal decentralization on the quality of public order provision. This system of providing public order is not sufficiently effective to increase public trust in the

Table 2.4: Relationship between formal and informal decentralization and their impact on local government performance: the 3SLS model

Robust standard errors in parentheses; * p <0.10, ** p <0.005, *** p < 0.01;

	Determinants of Formal Decentralization	Determinants of Informal Decentralization	Determinants of Governance Performance					
	Equation 1	*Equation 2*	*Equation 3*					
			private sector development policy	*infrastructure*	*legal institutions*	*transparency*	*property rights security*	*corruption*[≠]
formal decentralization (log)		1.140***	0.890***	1.759***	-0.997***	-0.866***	-0.515**	0.111***
		(0.313)	(0.308)	(0.594)	(0.236)	(0.286)	(0.220)	(0.021)
informal decentralization	-0.078**		0.567***	0.284*	0.354***	0.518***	0.216***	-0.042***
	(0.037)		(0.080)	(0.155)	(0.0613)	(0.075)	(0.057)	(0.005)
North	-0.239***	-0.720***	-0.402**	-0.148	-0.328**	0.472***	-0.284**	0.025*
	(0.087)	(0.166)	(0.189)	(0.365)	(0.145)	(0.176)	(0.135)	(0.013)
fence-break	-0.039	-0.192	0.093	0.284	-0.112	0.226	0.208*	-0.017
	(0.073)	(0.163)	(0.165)	(0.318)	(0.126)	(0.153)	(0.118)	(0.011)
tiers	0.128	-0.060	-0.195	-0.220	0.378**	-0.118	0.220	-0.016
	(0.085)	(0.204)	(0.209)	(0.402)	(0.159)	(0.194)	(0.149)	(0.014)
population (log)	0.135**	-0.101	0.182	0.280	0.006	0.068	-0.008	-0.006
	(0.066)	(0.162)	(0.165)	(0.318)	(0.126)	(0.153)	(0.118)	(0.011)
revenue/GDP (log)	0.247***	0.559***	0.358*	0.387	0.375**	-0.048	-0.655***	0.079***
	(0.081)	(0.198)	(0.208)	(0.401)	(0.159)	(0.193)	(0.148)	(0.014)
area (log)	-0.055	-0.386***	-0.257**	-0.778***	0.203**	0.585***	-0.061	-0.020**
	(0.057)	(0.116)	(0.126)	(0.243)	(0.096)	(0.117)	(0.090)	(0.009)
political connection (log)	0.165***	0.124	-0.237	-0.574*	0.457***	0.042	0.017	0.002
	(0.064)	(0.170)	(0.176)	(0.338)	(0.134)	(0.163)	(0.125)	(0.012)
hospital (log)	0.910***							
	(0.123)							
competence		0.111***						
		(0.009)						
constants	-0.760	7.915***	7.107***	12.750**	-2.945	-6.430***	0.777	1.565***
	(1.088)	(2.507)	(2.658)	(5.122)	(2.031)	(2.467)	(1.899)	(0.182)
N	64	64	64	64	64	64	64	64
χ^2	148.58	269.16	188.66	57.81	86.34	70.19	77.51	199.7
R^2 pseudo	0.69	0.81	0.77	0.48	0.57	0.45	0.56	0.77
P_value	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

[≠]: Higher values of *corruption* imply worse provincial government performance while the higher values of all remaining variables mean better government performance.

Table 2.5: Relationship between formal and informal decentralization and their impact on local government performance: the OLS estimations

	private sector development policy	*infrastructure*	*legal institutions*	*transparency*	*property rights security*	*corruption*[≠]
	(1)	(2)	(3)	(4)	(5)	(6)
formal decentralization (log)	1.028***	1.120**	-0.764***	-0.391**	-0.454***	0.113***
	(0.186)	(0.468)	(0.212)	(0.175)	(0.143)	(0.015)
informal decentralization	0.494***	0.345**	0.314***	0.425***	0.209***	-0.034***
	(0.069)	(0.167)	(0.051)	(0.0674)	(0.046)	(0.005)
North	-0.477**	-0.107	-0.362**	0.389**	-0.289**	0.034***
	(0.200)	(0.352)	(0.139)	(0.177)	(0.143)	(0.012)
fence-break	0.097	0.301	-0.116	0.220	0.207	-0.018
	(0.166)	(0.332)	(0.128)	(0.171)	(0.143)	(0.012)
tiers	-0.217	-0.032	0.315*	-0.243	0.202	-0.019
	(0.222)	(0.421)	(0.168)	(0.178)	(0.157)	(0.013)
population (log)	0.167	0.417	-0.040	-0.0217	-0.020	-0.009
	(0.153)	(0.356)	(0.141)	(0.141)	(0.130)	(0.013)
revenue/GDP (log)	0.357	0.553	0.325	-0.144	-0.670***	0.074***
	(0.226)	(0.392)	(0.210)	(0.163)	(0.135)	(0.016)
area (log)	-0.310**	-0.688***	0.161	0.491***	-0.070	-0.016*
	(0.146)	(0.224)	(0.096)	(0.108)	(0.089)	(0.009)
political connection (log)	-0.265*	-0.346	0.380***	-0.111	-0.005	-0.001
	(0.132)	(0.354)	(0.126)	(0.122)	(0.107)	(0.011)
constants	8.622***	8.021*	-1.078	-2.522	1.239	1.519***
	(2.583)	(4.761)	(2.286)	(1.752)	(1.466)	(0.176)
N	64	64	64	64	64	64
R^2	0.775	0.500	0.584	0.511	0.563	0.777
P	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Robust standard errors in parentheses with * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

≠: Higher values of *corruption* imply worse provincial government performance while the higher values of all remaining variables mean better government performance.

system's legal enforceability, predictability and accessibility, the protection of property rights and ability to reduce corruption. The ineffectiveness of the formal system in public order provision and the simultaneous divergent impact of informal decentralization on formal decentralization suggest the existence of a competitive relationship. In other words, at present, the informal system functions as a competing institution to the formal one. Therefore, the 3SLS estimation supports the view that in the first 15 years of decentralization, the formal decentralization system is accommodating the informal one in the supply of public services, but the two systems are competing in the provision of public order, as long as the formal system fails to increase public trust in their role of providing public order.

The signs and significances of the coefficients of the control variables in the governance equations exhibit certain similarities. The South is significantly better than the North in almost all indicators of government quality, except legal predictability and accessibility. The variation in the quality of infrastructure is not significant in either part of the country. Those provinces with larger shares of tax contributions in provincial GDP tend to provide better public goods and services and exhibit higher public trust in provincial legal institutions for enforcing contracts. However, corruption and insecure property rights are higher in these provinces. These results are generally consistent with the findings in La Porta et al. (1999), except for those regarding the protection of property rights. Infrastructure and transparency are not significantly affected by tax revenues. Another influential factor is the province's geographic size. Smaller provinces have better infrastructure and lower corruption. Legal institutions are, in contrast, more efficient in larger provinces. Political representation in the Central Committee of the Communist Party negatively impacts infrastructure quality, but positively affects trust in legal institutions. These are the two governance indicators on which political connections have a significant effect. The other controls seem to have weak explanatory power for the difference in government performance across provinces.

To check the robustness of the 3SLS model, I run the OLS estimation and include both formal and informal decentralization variables. Although interaction terms are often used to test the complementarity or substitutability in performance equations, the high correlation between the interaction term and its component variables and the hypothesis of endogeneity will bias the OLS results. Moreover, the use of the interaction terms does not help us identify the accommodating and competing relationships. The correlation matrix in table 2.3 demonstrates that formal decentralization and informal decentralization variables are not strongly correlated (0.22). Thus, I present OLS estimation results without the interaction terms and are confident

that their results are unbiased. Table 2.5 shows that the signs and significances of coefficients are generally consistent with the findings of the 3SLS. The correlation coefficients and significances (p-values) of formal decentralization and informal decentralization variables and their interaction terms are reported in the appendix. The appendix table A2.1 shows that the two dimensions of decentralization are significantly correlated with governance efficiency; however, the negative and significant correlation coefficients of all interaction terms predict the lack of complementary and substitutive effects on the quality of government. I have also checked for the presence of multicollinearity in all of the regressions. The mean VIFs are more or less than 1.2, which also supports the validity of the results. In addition to the separation of the models with and without the interaction terms, the general low correlation between the exogenous variables and controls shown in table 2.3 and the significance of the chi-squared values ($p<0.00001$), and R^2 values ranging from 0.45 to 0.82 for all specifications increase the credibility of the estimations.

2.4. CONCLUSION

Most empirical and theoretical studies on the relationship between formal and informal institutions focus on their complementarities or substitutability between them, for example, between formal contracts and other self-enforcing mechanisms such as relational contracts or networks. I found that accommodating and competing informal institutions co-exist in the initial period of decentralization rather than complementing or substituting for each other, especially in those countries where an informally decentralized system is rooted in its history and culture. There are priorities in the design of a formal governance system. In the case of Vietnam, the formal decentralization system is effective in addressing tasks little related to culture such as the provision of public goods and services, but finds itself reliant on well-established informal institutions and private order to maintain public order.

The findings of this chapter imply that reforms designed to improve the effectiveness of the procedures and institutions used to provide public order are essential to make informal institutions complementary rather than rivalrous with or free riding on weak formal institutions. It should be noted that the findings are based on surveys of private firms' perceptions of government performance; hence, the results may or may not be consistent with the perspective of state-owned enterprises or household businesses. I have also considered the implications of the hypothesis of an accommodating and competitive relationship between formal and informal systems of decentralization for economic growth, although the results of

these regressions are not reported in this chapter. Applying the same simultaneous equation estimations, using the 3SLS method, it turns out that formal decentralization in state human resource management has a significant but negative impact on the growth rate of real provincial GDP per capita, while provincial policy autonomy has positive but insignificant effects on growth. This result might imply that the accommodation and competition between the two systems of decentralization, especially the ineffectiveness of the formal one in the area of public order provision, are not beneficial for economic growth. The findings of this chapter generally support the popular view of focusing reform efforts on increasing the ability of the formal system to provide public order and creating incentives for provincial governments to be complementary with central goals. In other words, efforts by the central government in making the formal system of decentralization more effective and embedded in the existing informal system are essential.

This study has several limitations. First, the findings of accommodating and competing relationships between the formal and informal dimensions of decentralization in Vietnam are found in the first two decades of economic reform and may not apply to a similar time scales of reforms in other institutional environments (for example, that of developed and developing countries). The generalization of these results should consider institutional differences across countries. Second, the study may be expanded to the analysis of other forms and measures of formal and informal decentralized institutions, controlling for their endogeneity and using other econometric methods.

Appendix

Table A2.1: Correlation matrix: decentralization and government performance

	private sector development policy	*infrastructure*	*legal institutions*	*transparency*	*property rights security*	*corruption*[≠]
formal decentralization	0.4570 (0.0001)	0.3985 (0.0011)	-0.1545 (0.2228)	-0.1618 (0.2015)	-0.3071 (0.0136)	0.5475 (0.0000)
informal decentralization	0.7684 (0.0000)	0.5242 (0.0000)	0.5903 (0.0000)	0.4464 (0.0002)	0.3575 (0.0037)	-0.3460 (0.0051)
*formal decentralization * informal decentralization*	-0.5976 (0.0000)	-0.3813 (0.0019)	-0.6509 (0.0000)	-0.5198 (0.0000)	-0.4953 (0.0000)	0.5594 (0.0000)

[≠]: Higher values of *corruption* imply worse provincial government performance while the higher values of all remaining variables mean better government performance.

P-values denoting the significant level of each correlation coefficient are in parentheses.

Chapter 3

Formal and Informal Mechanisms of Accountability in Local Governance: The Case of an Authoritarian State

"The successful reformer will combine respect for the past and thoughtful innovation."

(Avinash Dixit 2005)

3.1. INTRODUCTION

Accountability is increasingly becoming a buzz word in both governance literature and political forum. It is often argued that accountability is the backbone of democratic governance and a virtue of democracies. Scholars have recently paid their attention to authoritarian states and tried to find out whether similar accountability mechanisms function in these countries. Successive economic crises over the past decades on the global scale have uncovered governance deficits in both types of regimes. However, some authoritarian countries such as China and Vietnam still show their benign economic growth, even during this global hard-hit time and prove their mode of governance is worth further research. What kinds of accountability and governance mechanisms are employed in these authoritarian regimes to ensure their legitimacy and durability?

Globalization has put a lot of pressure on all governments to adopt international best practices and innovations in their governance. A lot of authoritarian regimes are in democratic transition, creating a network of traditional formal and informal accountability mechanisms and innovations at work and inducing institutional change in public organizations. We find that successful authoritarian regimes are those that make use of informal accountability mechanisms in complementary with formal ones. Many authors have pointed out that dependence on either of them might lead to severe deficits of accountability and inclusion

(O'Donnell 1998, Tsai 2007). Different institutional settings also require initiatives to endure their own regime legitimacy. Among a myriad of both formal and informal mechanisms, what will serve best the harmonization of the authoritarian legitimacy and the public interests in lights of the growing globalization and democratization? And how will the choice impact institutional change in public organizations?

Vietnam is a vivid case of the dynamic change in its institutional environment over the past two decades of reform. The formal contribution to the today's Vietnam position is often attributed to the decentralization process in which the tasks of providing public services and public order have been devolved substantially to sub-central governments and private agents. However, the weaknesses of this process arisen in a multi-level system of checks and balances can also be the reasons for undermining the reform achievement. The empirical analysis both in this chapter and chapter 1 shows that formal mechanisms (similar to democratic institutions) alone are not sufficient to create incentives and private efforts to full accountability. It should be accompanied with other informal ones to fill in accountability deficits of the formal system. In this chapter, I point out some alternatives, including identity-based and performance-based mechanisms which are tactfully introduced into the kit of governance strategies to achieve higher accountability, albeit in the informal manner. The main differences between the two types of accountability lie in four main dimensions: legal binding, control (direct versus indirect), mechanisms of account-giving, and incentives (formal versus informal). Formal mechanisms are well communicated in legislature and binding to all involved actors, based on formal incentives to accountability, and incorporated with direct vertical and horizontal control. Informal mechanisms are not institutionalized and binding, based on intrinsic and informal incentives to accountability. Further details of this typology in the case of Vietnam will be provided in the next section.

This chapter also contributes to the burgeoning comparative politics literature, providing empirical support for theoretical link between accountability and governance, especially in an authoritarian regime. In this chapter, I compare the variation in accountability, local government responsiveness and performance across provincial jurisdictions through surveying all decisions in the form of legal documents issued by 35 provincial governments and published in the official public press (Official Gazettes) of Provincial People's Committees from 2006 to 2009 and use the *Proactivity* sub-index in the annual Vietnam Provincial Competitiveness Index (PCI) survey as an indicator of governance quality of provincial-level government. I find that although the single-party government has employed

various mechanisms to make their sub-central arms identify with their exclusive leadership and accountable to the central government, many provinces are inclined to identify themselves as representatives of community and even deviate from central will and rules. Some other provinces, however, show their strong attachment to the central state and act little in response to local development demand. I also give evidence of how policy making at the provincial level and identification are influenced by an external and non-binding PCI ranking conducted by a foreign-funded non-governmental organization (NGO).

The case study and quantitative analysis in section 3.4 prove that although central rules and policy guidelines are uniform for all provinces, there is substantial variation in the number and distribution of provincial legal documents to two main goals: administrative goal (sense of responsibility) and responsive goal (sense of accountability). I argue that the number of responsive decisions and their distribution are signals of provincial identification. Some provinces issue few responsive legal documents, and most of them focus on administrative tasks or implement closely the central guidelines and laws. Some provinces made a large number of legal documents and show their proactivity in making those decisions or initiatives to enhance their provincial competitiveness and brand, particularly those concerning the development of high-quality human resources, science and technology, entrepreneurial activity, and administrative reforms. This chapter also found that for the same policy and decision, accountors are different across provinces. For example, initiatives and decisions on the development of science and technology are the accountability of the collective people's committee in Thua Thien –Hue province, but that of individual chairman in Thanh Hoa province. Obviously, there is an autonomous organization of accountability within each provincial authority despite the fact that there have been central laws and guidelines of the authority and task division for sub-central level government, the extent of how local authorities interpret them as closely as possible with central willingness is beyond the state control. Provinces identify themselves autonomously through policy allocation and decide the internal organization of accountability (individual versus collective).

In this chapter, I attempt to give evidence of how responsive policy making at the provincial level is formulated and driven by formal and informal accountability mechanisms, how internal accountability is organized, and how provinces benefit from their responsiveness in the case of an authoritarian country. The following section begins with giving an overview of current and new conceptualizations of formal and informal accountability mechanisms. Section 3.3 develops some hypotheses linking informal accountability and responsive policy-

making output. Section 3.4 provides some empirical proofs to my hypothesis in the comparative analysis of accountability and governance in 35 provinces in Vietnam. The chapter will end with discussions and conclusions.

3.2. FORMAL AND INFORMAL MECHANISMS OF ACCOUNTABILITY

Accountability has recently become a fashionable concept in governance literature. From the broad sense, the public agency theorists define it as an account-giving relationship between a public agent – the accountor - and a forum of stakeholders – the principal, or the accountee (Bovens 2007). Depending on the organizational feature of the principal and the agent, equivalent institutions of accountability are established to hold the former answerable for their actions and decisions during the processes of public administration[38], including the possibility of imposing sanctions if misconducts are found.

From a narrower sense, it is seen as a standard of performance, an incentive mechanism, or a control means. O'Connell (2005) and Dubnick (2005) consider accountability as the goal or a standard that the account-holder sets for the accountor, or a promise of performance from the later such as the delivery of public services in a high quality, at a low cost, and in a courteous manner. This view highlights public accountability for outcomes and regards agent performance as a measure of his accountability. This explains why accountability carries many virtues such as 'democratic', 'ethical', 'moral', 'trustworthy', 'answerable', 'responsible', 'responsive', 'impartial', 'private efforts', 'transparency', 'openness', 'liable', and 'controllable' in recent research on governance (Dubnick 2003, Mulgan 2000, Koppell 2005, O'Connell 2005). Accountability has become the key to good governance in worldwide institutional reforms.

Accountable governance cannot be achieved if there are no effective mechanisms in place to hold public actors on the virtuous path and to prevent them from misconduct (Bovens 2007, 2010). Bovens (2010) defines accountability as both a virtue and a mechanism. As a virtue, it is a set of standards of good governance performance. As a mechanism, it is a set of institutional arrangements designed to communicate the principal's norms of being

[38] Bovens (2007) has differentiated 15 types of accountability subject to the distinction in the nature of the forum (political, legal, administrative, professional, or social), the nature of the actor (corporate, hierarchical, collective or individual), the nature of the conduct (financial, procedural, or product), and finally the nature of the account-giving obligation (vertical, diagonal, or horizontal). This preliminary classification can produce hundreds of sub-types of accountability by making a subset of two or more basic types.

accountable and give incentives for all parties to perform up to standard. Some other scholars (Burke 1986, Gruber 1987, Caiden 1988, and Dwivedi and Jabbra 1988) consider it as an instrument or a strategy to hold the agent answerable, responsible, and responsive to the principal when he takes actions or makes decisions under the pressure of sanctions.

Each political regime and culture has its own connotation of 'being accountable' and it, therefore, sets their own standards of accountability and establishes their own mechanisms to ensure their achievement and durability. Research on the governmental performance in developing countries has analyzed the prevalence of informal accountability mechanisms given the weak formal accountability system (Bardhan 2002, Tsai 2007). This phenomenological argument has inclined to claim that the emergence of institutions of informal accountability is objective and external. Media, NGOs, independent institutions, civil society, or social networks are in this category. Another strand of governance literature takes a view of sociologists that informal accountability for others is subjective and internal (Tetlock 1992; Akerlof and Kranton 2000, 2005; Royle, et al. 2008). These authors attributed the proactive behavior of employees and public agents in firms and public organizations to intrinsic motivations such as identity, embeddedness, or empowerment. Shearer (2002) and Tsai (2007) argue that formal accountability mechanisms are not sufficient to achieve public accountability. Shearer (2002) proposes to put ethics into mechanism designs.

So far, formal and informal accountability has been assimilated to formal and informal institutions. In the following section, I attempt to distinguish formal mechanisms of accountability from the informal ones based on four main dimensions: legal binding, control, account-giving mechanisms, and incentive structure. The description is summarized in table 3.1.

3.2.1. Formal mechanisms of accountability

As a governance institution, formal accountability has some aspects of a formal institution. It is a set of institutional arrangements (rules and procedures) that are created, communicated and enforced by the state or state bodies such as constitutions, statues, laws, regulations, courts, legislatures, and bureaucracies (Helmke and Levitsky 2004). This way of understanding highlights the legal ground for the creation of formal institutions, not excluding formal accountability. What matters is how to differentiate formal accountability from other types of similar institutions such as control or to get insights into the functional difference

between formal accountability and informal accountability as a mechanism. The above definition is just the first important dimension of formal accountability.

Table 3.1: Formal and Informal Mechanisms of Governmental Accountability

	Formal Accountability	Informal Accountability
Legal Binding	Yes Well-written in Legislature	No Unwritten in Legislature
Control	Direct (legislative, executive, judiciary, and hierarchical)	Indirect (the third party, not the state)
Mechanisms of account-giving	Bureaucratic	Responsive and proactive
Incentives	Formal channels of rewards and sanctions	Informal channels of rewards and sanctions
Institutions of accountability	Bureaucracies, Fiscal Target, Target Investment Programs, Oversights, Election	Identity, Media, Independent Institutions, NGOs, Civil Society, Norms, Social Networks

Existing studies emphasizes two important mechanisms of accountability: information provision and sanctions (Dubnick 1998, Schedler 1999, Bovens 2007). Both of them act as incentives to the accountable performance of public agents. The former is a set of institutional arrangements of communicating expectations of governance quality, internalizing standards of good governance, justifying and judging the agent's conduct. These procedures are the basis for a certain form of sanctions in case any misconduct is found and judged. The threat of sanctions, either formal or informal, acts as incentive mechanisms that hold the agent's behavior and actions proper and meet the expectations of the accountee in a passive manner. This way of understanding has not differentiated the possibility of punishments from that of rewards in case the agent is proactive enough to outperform the forum's expectations. It has also not mentioned the possibility of accountability to provide the accountor with intrinsic incentives rather than just extrinsic values in exchange for his private efforts to do his best. Those active mechanisms can help the actors avoid costly sanctions and deal with accountability crisis, especially in low-trust institutional contexts.

In this chapter, formal (public) accountability refers to a set of institutional arrangements between the principal (or the account-holder) and the agent (or the account-giver) that are formulated, communicated, and enforced by the state in order to facilitate, control, and motivate the agent's fulfillment of his tasks up to the principal's expectations in a direct and justifiable manner. This definition emphasizes the importance of accountability as a process of account-giving and account-holding through communication and responsiveness, a set of legal and bureaucratic procedures under direct state control (or the direct system of balances and checks), and a set of formal incentive mechanisms (including the possibility of both sanctions and rewards that is well communicated in legal documents). Bureaucracies, fiscal and administrative decentralization, courts, state investigations, target programs, and legal sanctions and rewards are examples of formal accountability.

3.2.2. Informal mechanisms of accountability

Any arrangements that violate one of the above dimensions of formal accountability are categorized as informal accountability. In other words, informal accountability is a set of institutional arrangements that are formulated, communicated, and enforced by the non-state principal or a third party which is not the state in order to facilitate, control and motivate the agent's fulfillment of his tasks up to the principal's expectations through intrinsic and indirect sources of incentives. Accountability enhanced through the agent's response to mass media, civil society, NGOs, norms of governance, ethics, trust, identity, professional advancement, or reputation is regarded informal. The accountable agent goes beyond bureaucratic or top-level expectations and acts for grassroots-level expectations for his beliefs of himself as a constructive source of change or as a part of a community (Morrison and Phelps 1999; Akerlof and Kranton 2000, 2005). He may face informal consequences (rewards or sanctions) subject to his success or failure in satisfying the public expectations.

One of the main difficulties in studying accountability empirically is the lack of consensus on the conceptualizations. In other words, accountability means different things in various institutional environments (Bovens 2010). Therefore, the studies of accountability make more sense of policy recommendations if it is analyzed in a particular institutional setting. In the following section, I discuss some literature gaps in the link between local government accountability and performance when getting more insights into different formal and informal institutions of accountability in effect in transitional countries.

3.3. LOCAL GOVERNMENT ACCOUNTABILITY AND PERFORMANCE: WHAT REMAINS INCONCLUSIVE

Public administration literature has been exhausted with seeking new models of accountability that enable to hold public agents accountable to their accountees. Accountable governance has been ever debating in most kinds of institutions and organizations, especially when it is blamed for the current world depression, starting with the subprime crisis in the U.S. in 2008. At the firm level, there is a lack of confidence that management follows the interest of shareholders and stake holders alike. In particular, incentive schemes for management have been the target of significant criticisms, supposedly misleading the latter to follow short term objectives that are incongruent with welfare maximization. At the macro level, the institutional fragmentation and competition accompanied with partial decentralization among states, regions, or localities seems to lead to race to the bottom when many global, national, or regional issues are addressed in an ad hoc and dissonant manner. In many cases, accountability is misplaced along the tiers of a hierarchical organization, which leads to overinvestment or free-riding. For example, public investment in constructing an airport, a road, or a hospital should be a regional and national issue to obtain the economies of scale and to minimize negative externalities rather than decentralizing it to lower levels of government. In addition, even when a global, national, or local dimension is acknowledged, there is still no clear division of labor among the myriad of related institutions that seek to address them: the functions often overlap, their mandates conflict, and their objectives often become blurred. In the end, the system of governance suffers from severe deficits of accountability and inclusion.

The accountability crisis has uncovered some governance issues that need new accountability mechanisms and models to solve. First, the system of incentive mechanisms should be redesigned to reward the making and pursuit of developmental or long-term policies and discourage the making of short-term oriented policies and decisions. Second, accountability mechanisms are considered as skeletons of organizational structure, so the internal structure of the organization is determinant of the efficiency of accountability institutions and vice versa, change in accountability conceptualizations also results in the adjustment within the organizational structure. Third, new accountability mechanisms should be based on the clear division of labour and the allocation of tasks to achieve the economies of scale and avoid negative externalities. Individual and collective accountability need clarification in order to mobilize the coordinated resources and knowledge when necessary. Finally, periodical

assessment of current accountability mechanisms will be essential to proceed with further innovations in governance.

In the light of growing lack of trust in formal institutions, recent empirical studies have applauded the role of informal mechanisms as an incentive to local government being accountable. Tsai (2007) has surveyed 316 villages in China and found that even when formal accountability is weak, social networks or particularly the presence of embedding solidarity groups, make some villages outperform the others in the provision of public goods. Her findings imply that each institution of accountability is built on an equivalent organizational structure, so the structural design of an organization will act as a moderator or a constraint to the process of communicating expectations and commitments of its performance and enforcing them in the account-giving and –holding process. Informal accountability induced by moral reward, a kind of respect, rendered when both the accountor and the accountee are members of a social network are substitute to ineffective formal counterpart.

However, theoretical and empirical studies agree that informal institutions are not durable and limited in the scale of applicability due to their financial and structural constraints or their different norms of governance. Li (2003) argued that informal institutions had low fixed costs of creation, but their marginal costs of enforcement were increasing as the scope of their applicability, for example, the size of social networks expanded. Vice versa, formal institutions need substantial public order to get them enforced, so they are created with high fixed costs but the high-quality formal ones are long-lived thanks to their diminishing marginal cost advantage as the scale of their use is enlarged. Furthermore, the success and durability of informal institutions also depend on other factors such as the types of accountability mechanisms, ownership, performance norms, and the possibility of embedding informal mechanisms into the formal system. For example, civil societies are strong forms of informal accountability in transitional countries; yet, their scope of use is subject to the extent of financial and expertise independence of the state and of dependence on foreign financial and expert resources.

The influence of being accountable on how public agents are responsive to local demand for development has been controversial in public administration literature. The majority of scholars argue for the positive effect of increased accountability on transparency and openness (O'Donnell 1998; Schedler, Diamond, and Plattner 1999), democracy (Bovens 2005), ethical behavior of the agent (Gray and Jenkins 1993; Anechiarico and Jacobs 1994;

Morgan and Reynolds 1997; Dubnick 2003, Bovens 2005), responsiveness (West 2004), and the quality of public goods and services (Dubnick 2003). Dubnick considers it as a *sine qua non* institution of a modern state. Bovens (2005) emphasizes the importance of accountability as a modern institution that guarantees the legitimacy of public governance. There is a group of scholars who analyze the side effect of excess accountability on governance (Behn 2001, Halachmi 2002, Dubnick 2003, Bovens 2005). For example, too much control of corruption and integrity can lead to a proceduralism that negatively affects the efficiency and effectiveness of public organizations (Anechiarico and Jacobs 1996).

In such an exhausting debate, Dubnick (2003) called for new forms of accountability that aim to enhance government responsiveness to the direct consumers of public goods and services, which is not the focus of the old models of modern governance. Initiatives to enhance accountability to local people/voters are objectives of "new public management" (NPM) reforms. It should be noted that accountability is an instrument of public governance and its scope of use is subject to both objective and subjective conditions. It may, therefore, not be conceptualized in the same way in different political systems. The relationship between accountability and responsiveness and governance performance depends mostly on the particular forms of accountability used in the given political environment.

Public administration models emphasize both collective and individual accountability. The review of related literature shows there is little research on the link of these two forms of accountability with responsiveness and other government performance dimensions, especially at the sub-national level. The informality of accountability has also been less documented than formal institutions in public administration, especially in those political systems that have collective decision-making tradition. I agree with several scholars that formal or collective mechanisms of accountability are not sufficient in a complex construct such as multi-sectoral networks (Benner, Reinicke and Witte 2004), or a multi-level government. There should be informal and individual mechanisms in complement with the former in order to enhance government responsiveness to the public they are intended to serve.

A question remains open to scholars. What kinds of institutions are efficient to hold local agents accountable and responsive to its citizens in authoritarian countries where democracy is limited and formal institutions are weak? To answer to this question, scholars need to take several external and objective conditions to its emergence into account. First, accountability is a transitional and deliberate process in authoritarian states. Accountability is an institutional

innovation of democracies and a democratic legacy, but it is incorporated into economic and public administrative reforms of authoritarian regimes under the pressure of globalization. As a virtue, accountability is seen as an added value to governance quality in addition to the norms of authoritarian legacy. Second, it is an inconsistent concept in authoritarian governance. Account-giving mechanisms are allowed to an extent that authoritarian legitimacy is not endangered. For example, accountability is more of a discourse at the upper level of a multi-tier government, but a formal action plan at lower levels in Vietnam. Third, culture matters governance performance. Where informality becomes a social norm, informal mechanisms of accountability are preferred to formal ones. Informality refers to a wide range of issues such as informal economy, corruption, self-regulation, fence-breaking, local autonomy, 'village' culture, the norm of consensus-based decision-making, or the like. Comparative politics literature has also observed the prevalence of social networks in Asian countries, especially in those with Confucian heritage while strong social groups make up powerful accountability institutions in democracies (Gibson 2001).

In the following part of the chapter, I present how the system of formal and informal accountability is established and functioned in an authoritarian country through the case study of Vietnam. I focus on accountability of provincial governments, the middle level in the government hierarchy. The reason for this choice is that they are the kind of public agencies that are faced with the relatively full set of accountability mechanisms (upward vs. downward, vertical vs. horizontal, collective vs. individual, and informal vs. informal). The main claim is that many historical informal institutions such as the norm of authoritarian accountability (the communist-single party legacy), the consensus decision-making culture, and 'village' culture (grassroots self-help) are embedded well into the formal system of accountability and influence the behavior of public agents. The empirical studies of all decisions made by 35 provincial governments from 2006 to 2009 show how de facto individual accountability, culture, and village identity influence government responsiveness to local development and other governance indicators.

3.4. THE EMPIRICAL ANALYSIS OF VIETNAM'S ACCOUNTABILITY SYSTEM

3.4.1. Case study

The organization of local government in Vietnam has experienced significant changes in tandem with several revisions of the constitution over the past 75 years. The most visible change occurs in institutional designs of the accountability system. Despite this structural

change, there are those factors that seem persistent and explain the variation in the local agent's behavior and performance; they are norms of accountability. The following part will analyze this reality.

Local government in Vietnam was first institutionalized in two decrees number 63 and 77 issued in 1945 and then formalized in the 1946 Constitution. Under these laws, local government was organized into four levels: *ky* (departments), *tinh* (cities or provinces), *huyen* (districts), and *xa* (communes), of which cities/provincies and communes were complete governmental levels while departments and districts were middle levels. A complete governmental level consists of both the People's Council and the Administrative Committee. At the middle governmental level, only the later is established as the executive agency for the central government and a supervisor over the performance of the lower-level governmental agencies. A noted point is that Administrative Committees played a more important role and were awarded with more discretions than the People's Council at the same level although the former was the executive agency of the later. The organization and operation of the later was closely supervised by the central government and the upper-level local governmental agencies. The role of the people's representatives of the People's Council seemed ambiguous and weak.

The strength of local governmental structure during that time was its compact, flexible organization and relative clear accountability. The size of People's Councils and Administrative Committees was small, 15-30 agents for the former and about 5 for the later. Not all levels were organized as a complete model. For example, at the departmental level, only an administrative agency was set up with transparent tasks and responsibilities: implementing mandates of the central governments, supervising lower-level People's Councils and Administrative Committees to guarantee the macroeconomic coordination and political cohesion, and other national defense tasks. Similarly, only administrative committees were established at the district level, and they function as a middle agency, coordinating the upper governmental agencies with the lowest ones, or communal People's Councils and Administrative Committees. Provincial Administrative Committees are responsible for implementing upper-level mandates and resolutions issued by the same-line People's Council, and controlling lower-level governmental agencies. Communal agencies mostly act as the implementers of higher-level decisions. Rules of coordination between People's Councils and Administrative Committees at each level were clearly stipulated in legal documents. For example, when the Administrative Committee at the lower level

presented the resolutions issued by the People's Councils at the respective level to the upper level's administrative committee for approval, the response should be returned in writing within 5 days upon their receipt. If there was no formal response from the upper level, these legal documents are automatically enforced.

There were some changes in local governmental organization following the revision of the 1959 Constitution and the introduction of Law on the Organization of the People's Councils and Administrative Committees in 1962. Under these laws, local government in Vietnam had only 3 levels. The departmental level was not recognized any more. Different from earlier years, all three sub-central governmental levels are complete, with the presence of both People's Councils and Administrative Committees. Accountability started to be formally stated in legal documents and political forum or informally incorporated in governmental organizational design. The size of these agencies increased significantly, from 20 to 40 for communal People's Councils, from 30 to 50 for the district level, and from 50 to 120 for the provincial level; or from 5 to 15 agents for administrative committees. This change was based on the norm of large-number democracy. Vertical and horizontal accountability in the central-local relations was made clearer along with administrative decentralization initiated in this period. The relative power of the People's Council was enhanced significantly over the respective administrative committee. The later was also required to directly give account to the former at the same level. The upper-level administrative agency did not have the authority to cancel the resolutions of the lower-level People's Council, but only withhold them temporarily. This is the right of the direct upper People's Council. This is the difference compared to the era of the Constitution 1946. Accountability was also shown in the way local governmental agencies were defined in the Constitution 1959 and other legal documents: "The People's Council is the state power agency in local government", and the Administrative Committee takes dual roles of 'an executive agency' of the responding People's Council and the state administrative agency in local government. Obviously, formal accountability was purely up-ward and highly centralized. Down-ward accountability and democracy were not virtues of the political system at the time being in both discourse and reality.

Some of accountability ambiguity was clarified in the 1980 Constitution and the Law on the Organization of the People's Councils and Administrative Committees in 1983 and the revised in 1989. The People's Council was added one more role – the people's representative as its name reflects. Down-ward accountability started to be institutionalized. At the same time, both local government agencies were assigned many more tasks and responsibilities in

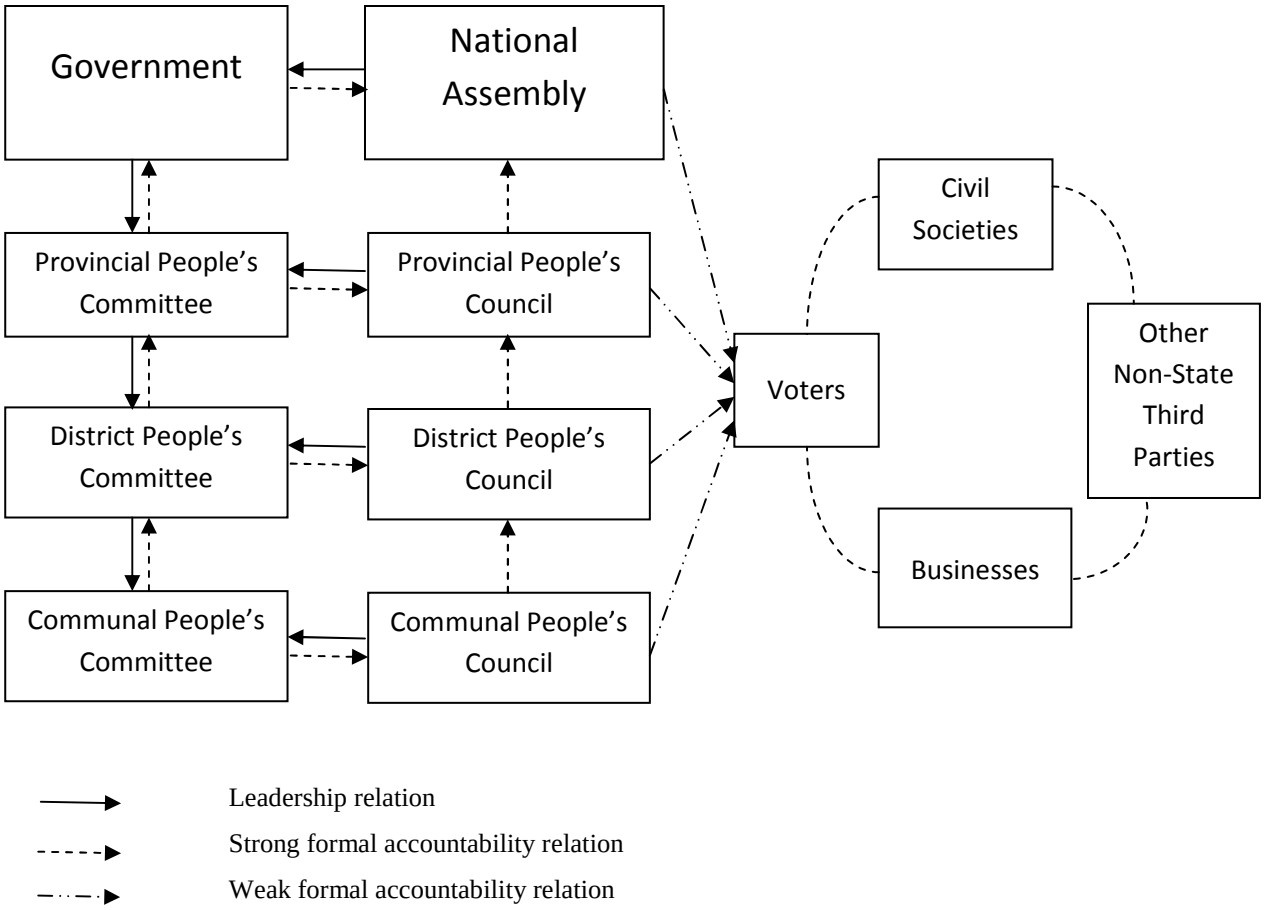
both public goods provision and economic administration. Although accountability was stated as a demand in laws, there remains short of mechanisms to facilitate the account-giving and account-holding processes in this period. Even recent revisions of the constitution have lifted some of them. First, the Law has also revised the internal structure of the People's Council and Administrative Committee toward blurring accountability. Under these laws, the permanent section of the Administrative Committees at all levels was dismantled. This agency has been called a new name, the People's Committee, and makes their decisions on the 'consensus' principle. Almost local issues should be discussed in a monthly meeting and solved to the majority's view. The idea for this change in local governmental organization follows the norm of collective ownership. However, this new design of local government is not suitable for the nature of an executive agency where many local issues need rapid actions and decisions. The consensus principle also blurs the individual accountability of the head of the People's Committee and other Committee's members as well as their creativity and flexibility in governance. The same decision-making principle has also applied to all types of governmental institutions, not excluding the People's Council.

Second, if the decrees number 63 and 77 in 1945 and the Law 1962 included some stipulations on the internal organization of the People's Council and the Administrative Committee and the division of tasks and authorities for these agencies at different levels, they were not incorporated in the revised laws thereafter. This is the main difficulty in determining the account-giver when a local issue arises. This became worse when a permanent section, including the chairman, deputies and a secretary of the Council, was set up to solve daily work. Ridiculously, such a permanent team was not organized at the lowest governmental level which has the direct contact with local people. It is also fruitless when the executive agencies of these Councils do not have respective permanent sections.

Third, ambiguous laws have created a dangerous norm of loose internalized sanctions in local performance. Previous constitutions and laws aimed to design the accountability system on the basis of "dual subordination". For example, the People's Committee was held accountable to both the People's Council at the same level and the next upper executive agency (either the people's committee or the central government). However, the 1980 Constitution and its follow-up laws in 1983 and 1989 seemed to get the councils and committees involved in a horizontal accountability relation. That means the upper executive agency was not directly held accountable to the next upper executive agency or the government even when the committee or its chairman and deputies breached the central rules and regulations. Only the

council at the same level had the right to dismantle its respective committee. However, this exclusive right was rarely realized for many reasons, some of which have mentioned above such as blurring accountability or ambiguous allocation of tasks and responsibilities. In fact, the council performs as a nominal unit. People's Committees have substantial autonomy in making decisions, even fence-breaking central laws in the shadow of a kind of norms of loose internalized consequences. The behavior of these local agents is guided to their belief that in the end they may suffer soft and informal sanctions such as notice, criticism, or job transfer (Beresford and Dang 2000). Hard and formal sanctions such as dismissal or court attendance are generally rare. That is why fence-breaking was popular since the 1980 constitution came into effect. The period 1980-1992 also witnessed an economic crisis in the country with the inflation rate reaching its record in 1986 at 435.5 percent[39].

Figure 3.1: Leadership and accountability relations in the authoritarian state of Vietnam



Source: Author's illustration based on the Constitution 1992 and its revisions in 2001, Law on Governmental Organization in 2001, and Law on Organization of People's Councils and People's Committees in 2003.

[39] The IMF

Local government has been restructured once more in the latest revised Constitution in 1992 with several additions in 2001 and the Law on the Organization of People's Councils and People's Committees in 1994 and 2003. Under this law, local government continues to be organized into three complete layers of the People's Council and the People's Committee. Until May 2008, the country has 64 provinces, 690 districts, and 11055 communes[40]. Figure 3.1 gives an overview of the central-local relations under the current constitution and laws. It exhibits two kinds of relationship: leadership and accountability. Figure 3.1 shows that accountability is a network of vertical and horizontal relations. The centralism of power is still a milestone in the political structure whatever models it is built on. Although the People's Council at all levels is elected by local people and has a permanent leadership, the constitution states clearly that it is a state organ of power in local government in addition to the role of a representative for its voters. The dual role, blurring identity, and overlapping accountability and interests are immense obstacles in local governance. The same problem also occurs to the functioning of the People's Committee.

Despite a lot of criticisms about the organizational constraints for the People's Committee in the 1980 constitution, the 1992 and 2001 constitutions keep blind eyes to all of those. First, although the committee is an executive arm of the local council, the constitution also defines it as an executive arm of the central government in the local government. At the same time, the committee implements the task assignment from and is held accountable to two levels of government. However, accountability to the local community is only an indirect or discretional factor that influences the committee's performance. Centralism principle in the organization of local government also makes the council-committee accountability relationship seemingly nominal. Although the committee is the elected executive arm of the council and directly accountable to the council, the later does not have the genuine right to decide sanctions levied on the former in case of misconducts being found. This right belongs to the Prime Minister or the chairman of the next higher level Committee.

Second, although the party leadership is not institutionalized in the organization and functioning of any organs of the central and local government, it is a powerful informal institution that directs their account-holding behavior. The Communist Party becomes an informal accountee in the central-local relationship. If ones look at the profiles of chairmen of the provincial People's Committees, most of them take a dual role of the deputy of the

[40] The data is available on the website of the General Statistics Office of Vietnam at www.gso.gov.vn.

provincial organ of the Vietnam's Communist Party, and some of them even have their multi roles in the People's Council, the National Assembly, the Central Committee, and many other civil societies[41]. Account-giving turns out to be a costly process when the degree of overlapping identity and interests among various account-holders in the central-local relations is high. In other words, coordination, supervision, and account-giving become too costly when the People's Committee has to deal with the increase in the interest and identity divergence. It makes sense of more cost-effective coordination, given information asymmetry, if the difference in roles by layers reduces. A network-type of account-holders will increase the extent that identity and interests overlap and hence facilitate the accountability process.

Third, local governance performance depends mainly on the accountability of the chairman of the People's Committee in the lack of formal mechanisms of individual accountability even after various revisions of the Constitutions. In reality, the chairman of the Committee has a lot of power in local political and socio-economic life. He has the final say in most of administrative decisions and plans of specialist units of ministries in his localities. Of 168 domains under local administration, the provincial People's Committee has the authority to issue legal documents in 153[42] administrative areas concerning fiscal, investment, trading, enterprise, human resource, public services, natural resource policies, and many other issues. Although People's Committees have a lot of responsibilities and many of them require rapid responses from the executive agencies, this ability faces objective constraints such as monthly meetings, collective decision-making, or double subordination. In many provinces, these meetings only formalize legal documents or decisions prepared by individual chairmen of the Committee. The nominal representation of state power and the lack of flexible accountability mechanisms in local government over the past decades have created good conditions for the 'village' culture dominating the fashion policies are made and implemented in localities. Many fence-breaking decisions have been made by the chairmen of people's committees and legalized in the name of collective knowledge.

[41] The official website of the National Assembly of Vietnam: www.na.gov.vn.

[42] Steering Committee of the National Assembly (2012) 'Report on the Supervision of the Implementation of the Issuance of Legal Documents by People's Councils and People's Committees', No. 94/BC-ĐGS issued on 09 January, 2012. According to this report, the provincial People's Council is entitled to issue legal documents in only 55 out of 168 domains. The numbers are much lower at the district and communal levels. The authority of lower-level governments is generally restricted in implementing the decisions issued by the higher-level People's Committees.

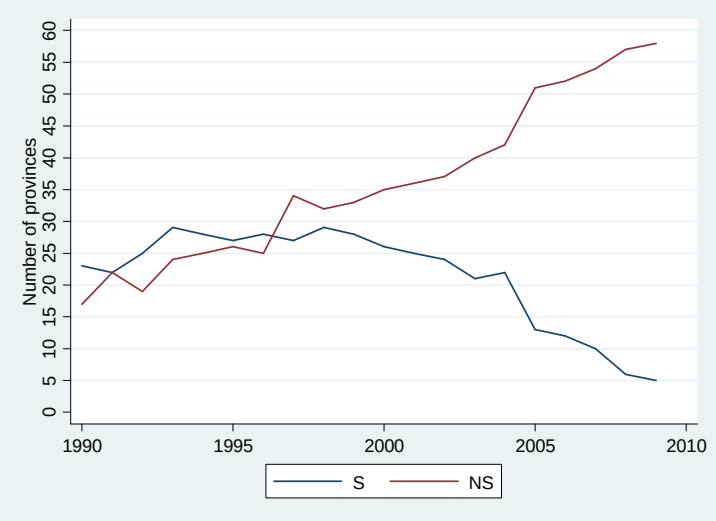
The above case study reveals some controversial points in the way the accountability system of Vietnam has been built. After several revisions of the Constitution, the organization of local government has not changed significantly. First, local government has been stated to be organized on the democratic centralism principle; yet, democratic institutions are rare, and centralism becomes the irreversible basis in designing the political system. Second, building accountability mechanisms on the basis of norms is the typical feature of the country, and in the end, accountability turns out to be partial, half-way, or simply a show. Decentralization of administrative tasks and responsibilities to three lower governmental tiers on the basis of informal 'loose' internalized sanctions is such an example. In other words, centralism of state power acts as a guarantee that the possibility of sanctions is not institutionalized, but subject to the sentiment of the central government. Another example is the use of 'Vietnam's Communist Party' (VCP) identity, or showing a sentiment for the VCP and participating the VCP's network, as an informal norm of accountability. It carries some values of accountability such as loyalty and responsibility. Third, the norm of large number democracy, or the increasing democracy to the expansion of the local government size, has resulted in overlapping functions and responsibilities and blurring accountability. Finally, 'village' culture affects the way down-ward accountability is held and committed by local leaders. A lot of local developmental policy innovations have been made in this way when central policies were perceived unbeneficial to localities. The excessive offer of investment incentives beyond the central framework is such a case. To some extent, this culture remains persistent because it has resulted in local-specific developmental policies, both in the short term and in the long term.

Obviously, the prevalence of informal accountability mechanisms reflects two issues: weak formal accountability and emerging informal mechanisms out of reach of the central government such as ODA providers, NGOs, and foreign-related and non-state professional reports. What political agency literature concerns is to investigate the agent's behavior change in response to the emergence of a certain accountability mechanism and how their behavior influence the organizational adjustment of the accounter-accountee relationships. The following section is an empirical analysis of the impact of some formal and informal accountability mechanisms on the policy allocation of 35 provincial governments between two types of goals: responsibility and responsiveness, and the follow-up institutional change in governmental organization.

3.4.2. Accountability, Policy Allocation, and Local Government Performance: Empirical Analysis of Provincial Governments in Vietnam

The impact of formal and informal accountability institutions varies across provinces. The first possible one is on the choice of identity of local authorities, and hence their policy allocation. Tenev et al. (2003) observed that some provinces were identified themselves as arms of the central government, others as representatives of the localities under their governance. Accordingly, some provinces accepted central mandates; some made their decisions on the basis of their generous interpretation of a central mandate, especially fiscal and development policies; and the others deviated from central will and made their own development policies. An example of the variation in the behavior of local authorities in the selection of identities is the case of pro-market policies.

Figure 3.2: The change in the number of STATE provinces (S) and NONSTATE provinces (NS) from 1990 to 2009



Source: Calculated with the data provided by The General Statistics Office of Vietnam.

S: The provinces with over 50% of their industrial output made by state-owned enterprises.

NS: The provinces with over 50% of their industrial output made by the non-state sector (including household businesses, private firms, and foreign-invested companies.

Figure 3.2 shows in the 1990 when Vietnam initiated its administrative and fiscal decentralization to lower tiers of government, the number of provinces with over 50 percent of their industrial output produced by State-owned enterprises (STATE provinces) was higher than that by the non-state sector (NS provinces). The loyalty to STATE identity lasted until 1999 along with the introduction of the Enterprise Law and the increasing empowerment to

provincial governments over a wider range of policies. The 1999 Enterprise Law works out an institutional framework for state accountability toward the private sector. Market decentralization in public services such as education, training, healthcare, legal consultation, and others has been launched since 2003 (VDR 2010). Provinces are given significant autonomy in planning local socio-economic development, fiscal policy, public investment, human resources, land, public goods and service provision, and legislature. Along with state commitment to pro-market accountability, the entrepreneurial role and function of provincial governments were separated from their bureaucratic role and function. Provincial authorities are no longer leaders of SOEs; they are state ownership representatives in these firms only. The overlapping identity of provincial authorities as SOE 'owners' and local leaders used to be a political constraint in their allocation of local and private resources. What matters is that the allocation of merits or private resources of provincial leaders to NS identity is not the same across provinces despite the uniform formal accountability mechanism of identity overlapping. What are they if not formal institutions at work?

The SOEs and their strength have always been a guarantee for the legitimacy of the single-party (VCP) regime in Vietnam. Even though the private sector has been acknowledged as an economic actor in a level-playing field with SOEs and provincial governments are no longer entrepreneurial bureaucrats in SOEs or the leadership of VCP has never been institutionalized in legislature, the loyalty to STATE identity or VCP is a norm among politicians and bureaucrats. In reality, most leading positions in both central and local governments are VCP members. With the use of this informal accountability mechanism, the VCP expects to maintain the loyalty of the country's politicians and bureaucrats at all levels at a very low cost. However, the decision of loyalty to or deviation from STATE identity or the one of adopting 'local representative' identity versus 'state arm' is the individual choice. Their option will be the determinant of policy allocation to pure implementation of central mandates or responsiveness to local development needs.

The link between identity and accountability has been an issue of interest in political and governance literature (Akerlof and Kranton 2000; 2005). The authors argue that when employees identify with the organization, they have a loss in utility if they do not follow the rules of their superiors and act in the interest of the organization. Identity is shaped through their internalization of organizational formalities, goals and ideals through education and training, and a firm (internal) position in the organization. Identification is problematic when they work for a multi-level organization and identities and interests of each level are

overlapping or even conflicting. Akerlof and Kranton suggested a model of loose supervision with emphasis on work group identity, autonomy and trust be more productivity-enhancing than a tight supervisory model with emphasis on the organization's identity.

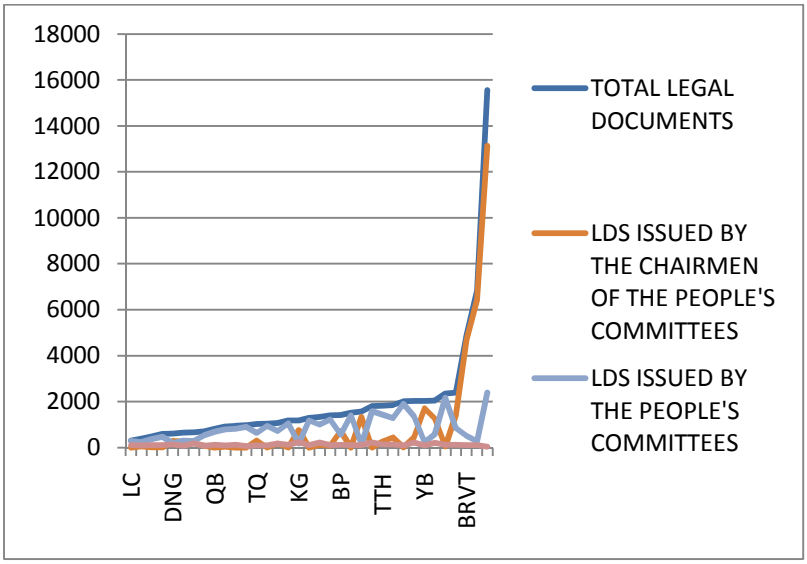
Current literature argues that organizations shape identities and the choice of certain identity (identification or the choice of self-image) is determinant of an accountability relationship. However, whether actors in such a relation benefit from their identification has not much quantitative explanation. Section 3.4.1 has presented various formal accountability mechanisms that the central government uses to shape STATE identity for lower-tier governments and agencies, figure 3.2 shows that it is the desirable option of a certain number of provinces. Other provinces identify themselves as 'local representatives' and choose to enhance their NS identity thanks to their autonomy. Although the goals of the two identities are not always seriously conflicting, their choice acts as an accountability commitment and as an incentive to make administrative and responsive decisions and policies towards those they are identified with.

Another vivid example of identity choice is through the study of decision-making practice by the chairman of the Provincial People's Committee. Figure 3.3 illustrates the variation in the number and distribution of legal documents of 35 provincial authorities in Vietnam[43]. Law on Issuance of Legal Documents of the People's Councils and People's Committees enacted in 2004 has formally institutionalized the authority of local governments to promulgate binding rules of conduct applicable in their localities over a wide range of socio-economic and defense areas in the form of resolutions (for the former) and decisions or decrees (for the later). The supervision report 2012 by the Steering Committee of the National Assembly shows provincial governments are entitled to promulgate and implement legal documents in almost areas (55 for the provincial people's councils and 153 for the provincial people's committees). The authority of district and communal governments is restricted in certain areas and in fact their issued documents simply copy those of the upper-level agencies (SCNA

[43] Although Vietnam has 64 provinces, only 35 provinces are the most accountable in announcing their legal documents on the provincial public press in both printed and electronic forms from 2006 to 2009. Law on the Organization of the People's Councils and the People's Committees states that all legal documents and other decisions and decrees made by the local government should be publicized on the provincial public press, the official state press agency in local government. The number of provinces obeying this accountability mechanism has been increasing over the past years.

2011). Under this law, provinces are of the highest power in the system of local government, and they are also the key subject of research.

Figure 3.3: The number of legal documents issued by 35 provincial governments in Vietnam from 2006 to 2009, classified by the accountor

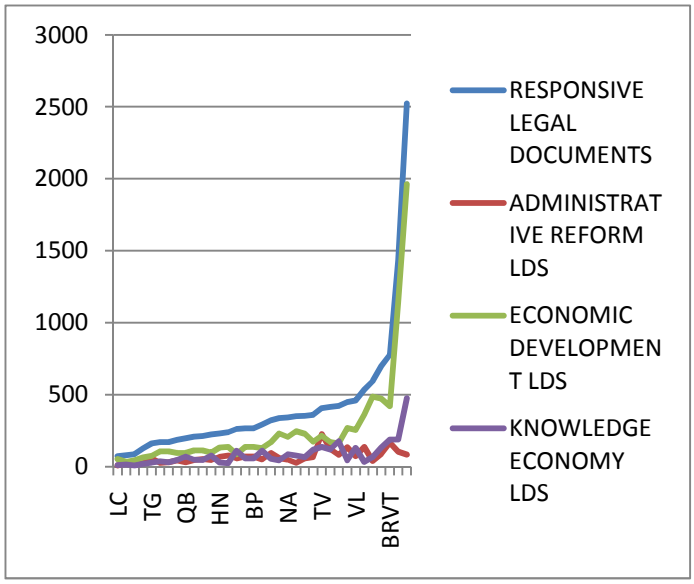


Source: Official Gazettes of 35 provinces from 2006 to 2009 in both printed and electronic forms.

Figure 3.3 shows the number of legal documents, including resolutions, decisions and decrees varies a great deal across provinces despite the uniform law-making policy and accountability system. The variation is mainly for those issued by the provincial people's committees and particularly those by their individual chairmen. Figure 3.3 also shows that for decisions of the same content, the accountor differs across provinces. They may be either the decision or decree of the collective people's committee who meets once a month for approval or that of the individual chairman of a province. The norms of consensus and democratic centralization of decision making have no longer been appreciated in some provinces and accountability has encouraged the proactivity of some chairmen of the provincial people's committees in making local development decisions and policies with personal accountability and autonomy. Obviously, there is a division in the cadre of provincial leaders: some are identified with the consensus rule of the central government while the others have decided to be identified with the community under their governance and make full use of their autonomy in making policies for the community's interests. The former group makes fewer decisions and their issued legal documents only formalize the central mandates and programs. The later makes

more decisions, especially those with high feasibility and responsiveness to local-specific development.

Figure 3.4: The number of legal documents issued by 35 provincial governments by content in Vietnam from 2006 to 2009

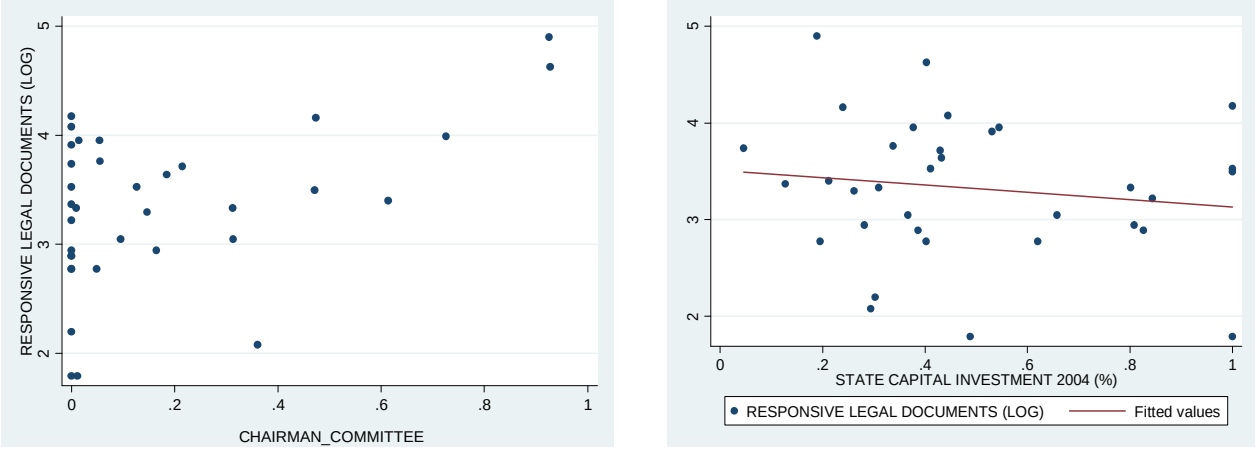


Source: Official Gazettes of 35 provinces from 2006 to 2009 in both printed and electronic forms.

Figure 3.4 shows that the number of legal documents issued by provincial governments also differs by types. The process of promulgating legal documents at the provincial level is nationally uniform and subject to the Law on the Issuance of Legal Documents of the People's Councils and the People's Committees in 2004. Accordingly, the People's Council is entitled to issue resolutions on making local socio-economic development plans, land use, education and training, culture, population, and defense. A standing section of the Council will divide the drafting tasks of these resolutions in certain domains and assign them to the People's Committee and other professional agencies. Resolution drafts are then submitted to the Council for approval at their meetings organized twice a year, normally in July and December. As the Council's executive arm, the provincial people's committee is responsible for formulating policy details based on the former's plans and policy lines and organize the their implementation. Under this law, the committee is entitled to issue decisions and decrees, but they cover a wider range of legal issues than the council (153 versus 55 out of 168). Although the tasks and authority of provincial government are common for all provinces, the number and especially the allocation of their decisions and policies show a significant

variation. Some provinces issues a few hundreds or even thousands of documents covering almost authorized policies; some others only issues tens of documents and fail to make use of their authority.

Figure 3.5: The distribution of responsive policies by individual accountability and by the state capital investment share in 35 provinces in 2006



Source: Author's calculation based on analysis of the list of legal documents issued on the provincial Official Gazettes in 2006.

Figure 3.5 illustrates the relation between the number of responsive legal decisions issued by each province and the ratio of the decisions made by the chairman of the respective province. Responsive policies are those that respond to local competitiveness and development rather than bureaucratic decisions. They consist of knowledge economy and entrepreneurial development policies and administrative innovative decisions. Knowledge economy development includes all legal documents issued by provincial authorities regarding initiatives to improve education, training, information technology, and scientific research. Entrepreneurial development covers all decisions and decrees on promoting all types of local economic sectors such as investment and production incentives, business associations, industrial zones (especially for small and medium sized firms, regardless of foreign or domestic investors), trade village, provincial brand development, local-specific economic advantage exploitation, and the like. The last type of legal documents includes all decisions of implementing or initiating plans and programs to simplify administrative tasks or to increase transparency.

All above evidence leads to the following characteristics of accountability system at the local level in Vietnam:

(i): Formal and internal accountability mechanisms are not effective enough to motivate all local government to be responsive to local demand for development.

(ii): Under decentralization, local authorities have certain autonomy in making their identity choice and identify themselves through the allocation of policies and decisions. Those who identify themselves as a state arm in their localities tend to be fully responsible for central mandates, plans, and policy lines. Those identify themselves with their own communities tend to be more proactive and innovative in making local development policies.

(iii) Individual accountability is an informal mechanism of accountability that may affect the policy output and allocation.

These findings imply that local authorities are more responsive to informal accountability mechanisms than internal and formal ones. This is also the main hypothesis that I attempt to test in the next section.

3.4.3. Data

The main purpose of empirical analysis in this section is to test what factors determine the allocation of legal documents for administrative and responsive goals and whether provincial authorities are really responsive to external and informal accountability mechanisms given the current formal system, and whether they benefit from their choice.

Governance literature has discussed the use of some informal accountability mechanisms such as administrative culture, values, ethics (Sinclair 1995, Beck and Larsen 1987, Denhart 1994, Tsai 2007) where formal ones are weak or inefficient. However, along with the increase in the fragmentation of the political system, the central and local values and cultures tend to diverge. This has made it difficult for local public servants to make a choice of what to follow and favor. In case of prevailing a set of contradicting values and cultures, the effect on accountability may be undesirable to one or the other party (Erkkilä 2007).

Another channel of accountability is dependent on civil societies (Nørlund 2006). Nørlund (2007) identified four types of civil societies in Vietnam: mass organizations, professional organizations, Vietnamese non-government organizations, and community-based organizations. By nature, civil society should be a forum or *an arena outside the state, the family, and the market where people associate to advance common interests* (CIVICUS 2005). Many studies have attempted to assess the influence of over 6000 civil societies across

all provinces, but the general conclusion is that the most influential ones depend on state funding, or are those whose leadership is a state bureaucrat. Therefore, the increasing number of these organizations is a democratic show and state discourse. Genuine civil societies are restricted in formation and operation for some reasons.

In the light of growing globalization and dependence on official development aids (ODA), external means of accountability have been introduced with tight supervision of the state. When internal mechanisms, either formal or informal, show their ineffectiveness in creating a democratic arena between the government and the forum independent of state power, accountability initiatives of foreign organizations related to donors seem more powerful channels for policy advocacy, at least in the short term, and stimulates a competition among provinces for foreign finances to ease local hardening budget constraints, especially in those provinces that tend to identify themselves as the non-state. One of such accountability mechanism is Vietnam Competitiveness Initiative (VNCI) – a project funded by the U.S. Agency for International Development and one part of this project is the Provincial Competitiveness Index developed in 2005 in collaboration with Vietnam Chamber of Commerce and Industry (VCCI) – a Vietnamese financially independent NGO. For the first time, the provincial performance of economic governance has been annually measured for all provinces since 2006 from the perspective of private enterprises and quickly become a channel of dialogue between businesses and local governments.

In its first launch in 2005, the PCI survey was conducted in only 42 provinces with 2,020 firms' responses. However, since 2006, the PCI has been conducted in all 64 provinces, attracting the response of about 7,000 firms. The general PCI index is aggregated from 11 sub-indices covering entry costs, time costs of regulatory compliance, land access and tenure security, transparency, corruption, institutional quality, competition environment, proactivity of provincial leadership, labor policy, quality of public services to the private sector, and infrastructure. As an informal means of accountability, the results of the PCI do not lead to any direct rewards or sanctions. They simply provide provincial authorities with robust information regarding their making and implementation of policies as well as their attitude toward private enterprises (accounting for 97.18 percent of total enterprises in all economic sectors in 2006 (GS0 2009). The annual report of the PCI also analyzes and recommends the type and domain of policies that each provincial government can make reforms to enhance their efficiency. What should be noted about the influence of the PCI are the follow-up consultation requests from over 40 provinces in the form of workshops where provincial

leaders work with the PCI team to find out solutions to better their governance and to improve their rankings.

As 2006 was the first year that all provinces were involved in the PCI survey, I start with testing the hypothesis for the 4-year panel from 2006 to 2009. However, only 35 provinces have published relatively fully their legal documents since 2006, so the panel analysis includes only these localities. In order to test for the responsiveness of provincial government to the PCI 2006 report and whether provinces benefit from their efforts, this chapter tests whether those provinces allocating more decisions to local development goal out of their total number of legal documents have an improvement in the PCI rankings, controlling for the provincial identity and other economic and social characteristics of the province.

The empirical analysis is divided in two parts. The first part aims to test the hypothesis of the effect of individual accountability on the responsive policy output and allocation. The second part continues with testing whether such a choice of policy allocation benefits provincial performance. The definitions and sources for all variables are summarized in the tables 3.2 and 3.3. The correlation matrix of the variables is presented in table 3.4. Below is the description of the econometrics model and how dependent and independent variables and other controls are formulated in this chapter.

3.4.3.1. The first model: methodology and results

Panel data analysis is the modeling approach adopted in this chapter in order to assess the impact of informal individual accountability on the production and allocation of responsive policies. By choosing a fixed effect panel model, we can account for the both observed and unobserved heterogeneity in a sample.

I propose the following baseline equation:

$$RESPONSIVE_{it} = \alpha_0 + \beta_1 CTRL_{it} + \beta_2 INDIV_ACCOUNT_{it} + TD_t + REGION_i + \varepsilon_{it} \quad (1)$$

where i indexes the province in the sample, $RESPONSIVE_{it}$ denotes the number of responsive legal documents made by provincial government i over the period 2006-2009. $INDIV_ACCOUNT_{it}$ is the de facto individual accountability of the chairman of province i. The model also includes several control variables, $CTRL_{it}$, including the average wage in the state sector, the size of local government employment, education, the contribution of tax revenue to GDP, and dependence on state capital. To control for time and regional invariant

factors, I include time fixed effects, TD_t, and fixed regional effects, $REGION_i$[44], in the regressions. ε_{it} is the error term.

Details of the variables in the model are discussed in turn.

Dependent variables:

The main dependent variable, RESPONSIVE is the number of provincial legal documents that respond to the local development rather than those that simply implement administrative functions assigned by the central government. As discussed above, they consist of decisions and initiatives to develop high-quality human resources and economic competitiveness and to restructure public administration process in their own provinces. They are distinguished with routine administrative decisions regarding the management of public servants, organization of meetings, provision of basic public goods and services, or implementation of central laws. Given the joint formal institutional framework and expectation, initial findings from the case study predicted that the sense of personal accountability of local leaders and village culture may act as strong incentives for certain provincial authorities to make more responsive decisions than the others.

The data of decision-making distribution is obtained from surveying the Provincial Official Gazettes (POG) for the periods 2006-2009. The publication of legal documents on the POG is obligatory, so they are considered as a channel of official accountability. The variation in the number of legal documents in each policy domain shows the priority and responsiveness of provincial authorities for their local development needs. Some other authors have attempted to measure policy responsiveness through public goods production (Besley and Burgess 2002), speeches and public expenditure (Hobolt and Klemmensen 2008), or ballot initiatives (Bowler and Donovan 2002). A closer measure of responsiveness to my work is the one by Schattschneider (1942) and Coleman (1999), who studied the relationship between the forms of party control (divided versus unified) and policymaking output (or the number of public and private acts). They argue that a unified government is more productive in making policy

[44] I differentiate those provinces in the North and those in the South in order to control for the heterogeneity in public administration culture across the two regions. The North is more reserved and dependent on the central government than the open and relatively autonomous South. This distinction was sourced from the less rigid pattern of village organization, more market-friendly mindset and the longer Western dominance in the South than in the North (Rambo 1973, Taylor 1983, and Jamieson 1993).

Table 3.2: Description of the variables

Variable Name	Description	Source
Responsive Legal Documents	The number of responsive legal documents made by provincial People's Councils and People's Committees. They consist of knowledge economy and entrepreneurial development policies and administrative innovative decisions.	Provincial Official Gazette
Public administrative reforming LDs (PARLDs)	The number of provincial responsive legal documents that introduce public administrative reforming initiatives.	Provincial Official Gazette
PARLDs/Responsive LDs	The ratio of administrative reforming initiatives in the total number of provincial responsive legal documents.	Provincial Official Gazette
Individual Accountability	The percentage of legal documents made by the chairman of People's Committees in the total number of provincial legal documents.	Provincial Official Gazette
Proactivity	A measure of the provincial autonomy in interpreting central laws and regulations in response to the private sector, using the *Proactivity* sub-index of the PCI Vietnam 2006-2009.	PCI[i]
Government Size	The share of provincial government employment in the total provincial population.	GSO[ii]
Government Wage	The average wage in the state sector of a province.	GSO[ii]
Industrial Output/GDP	The state sector industrial output as a share of the gross domestic product in a province.	GSO[ii]
Tax Revenue/GDP	The provincial tax revenue as a share of the gross domestic product.	MOF[iii]
North	The dummy variable with 1= North and 0 = South.	GSO[ii]
Education	The ratio of high school graduates per 10,000 populations.	GSO[ii]
GDP per capita	The gross domestic product per capita of each province at the constant price of 1994 (million VND).	GSO[ii]
Population density	The provincial population per square kilometer of area.	GSO[ii]
Expenditure decentralization	The provincial public expenditure as a share of the total central and local government expenditure.	MOF[iii]
Distance	The distance of the province to the two major economic centres (Ha Noi and Ho Chi Minh City) with distance dummy=1 if it will fall over one-half of one standard deviation below the national mean; =2 if within one-half of one standard deviation of the national mean; =3 if over one-half of one standard deviation above the national mean.	GSO[ii]
Buddhism	The percentage of the provincial population is Buddhist.	GSO[ii]

i) PCI: www.pcivietnam.org; ii) GSO: General Statistics Office of Vietnam; iii) MOF: Ministry of Finance of Vietnam.

initiatives thanks to cost and institutional advantages of coordination and reaching an agreement. Taking this comparative analysis approach in the within-institutional setting of a unified government, I attempt to gauge the relationship between internal account-giving organization and policymaking productivity.

In this part, compositions of responsive legal documents are also included in the model as dependent variables. The results of these regressions allow predicting those factors that affect the distribution of decisions to administrative reform initiatives, economic growth policies, and knowledge economy development policies. This allows identifying the policy priority given the current structure of accountability. The statistical details and description of these variables are shown in the tables 3.2 and 3.3.

Independent variables:

Given the norm of collective decision-making in the country, many provincial chairmen of the People's Committee have decided to be individually accountable to those legal documents that are issued on behalf of the Committee in other provinces. The identification of a collective versus individual accountor to a legal document is based on the signature. Individual accountability is at the discretion of each provincial government. It is expected that those provinces that are more autonomous in organizing their internal individual account-giving and make more individually accountable legal documents are also more responsive to local development needs. This hypothesis can be explained by an intensive literature on the effect of public management practices on performance (priorities, outputs and outcomes) (Graham and Hays 1993, Cohen 1993, Moore 1997). Although the link between informal individual accountability and public administration performance such as the quality of public service and goods delivery has been investigated and proved (Tsai 2007), the relation between the former and policymaking productivity is not fully understood.

To fill more in this literature gap, the degree of individual accountability (INDIV_ACCOUNT variable) is considered as an independent variable of the model. It is the percentage of legal documents made by the chairman of People's Committees in the total number of provincial legal documents published on the Official Provincial Gazettes from 2006 to 2009. Table 3.3 shows individual accountability varies significantly from 0 to 96 percent.

Table 3.3: Summary statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Responsive legal documents	140	82.54	92.61	8	647
PARLDs	140	14.17	13.40	1	88
PARLDs/Responsive LDs	140	0.22	0.13	0.01	0.75
Individual accountability	140	0.26	0.32	0	0.96
Government wage	140	2015.22	461.58	1135	3340.90
Government size	140	0.03	0.01	0.02	0.06
Industrial output/GDP	140	0.16	0.17	0.01	0.81
Revenue/GDP	140	0.22	0.19	0.06	1.59
North	140	0.43	0.50	0	1
Education	140	2864.37	882.12	912.82	4841.27
Proactivity	140	5.59	1.36	2.32	9.20
GDP per capita	140	17.55	22.85	3 .76	169.66
Population density	140	5.42	8.73	0.40	69.29
Expenditure decentralization	140	0.0077	0.0089	0.0028	0.0555

Control variables

I also control for other provincial formal accountability and political and socio-economic differences to fulfill the ceteris paribus conditions. Public management literature has also claimed for the link between interest group pressure, political ideology, and identity with the proactivity and responsiveness of public agencies (Berry et al. 1998, 2001; Coggburn and Schneider 2003; Akerlof and Kranton 2005). I follow Coggburn and Schneider (2003) and use the number of government employment per 1,000 populations as a proxy for interest group pressure or the perceived role of state government for making commitments to collectively benefited programs. Empirical studies support the significantly positive relationship between the size of government employment and political accountability in democracies (Dodlova 2010). However, this relation is uncertain in authoritarian countries.

To capture the government ideology and identification, I use the approach of Malesky (2005). The author was based on whether the majority of provincial industrial output is created by the state sector or the private sector in order to differentiate State provinces from the Nonstate. This identification of provinces has theoretical links to the incentive that the government softens budget constraints in transition countries (Qian and Roland 1996). This also influences policy priorities and proactivity of local government to enhance their own competitiveness. The log of the share of state-owned enterprise industrial output in the provincial GDP may predict the likelihood of soft/hard budget constraints and the behavior of local government toward responsiveness and accountability. Those provinces with the stronger state economic sector have lower incentives to be proactive.

I also control for provincial differences in socio-economic conditions. Qian and Roland (1996) explain how subnational jurisdictions actively compete for investment and transfers to soften their budget constraints. Those provinces that contribute more tax revenue to the GDP tend to depend less on central government transfers and become more autonomous and proactive in making locally responsive decisions, especially those that benefit all economic sectors. To capture this argument, I also control for the provincial tax revenue as a share of the Gross Domestic Product (GDP). An intensive research has also provided the theoretical and empirical links of capability of public administrators and governance performance. In this chapter, I do not have data about the capabilities of all administrative employees. I use the ratio of high school graduates per 10,000 populations to compare the educational level across provinces. It is expected that those provinces with higher educational level put more pressure on local government to be accountable.

A conventional incentive to the proper behavior and conduct of public agents is wage. To fulfill the ceteris paribus conditions, I also control for the variation in the average wage in the state sector across provinces. Public agents are expected to be more proactive and accountable where their wage is higher on average.

Results and Discussions

Governance literature has discussed the possibility of using informal mechanisms to provide intrinsic incentives for public agents to be accountable when formal ones are weak. In democracies, norms of transparency and individual accountability in decision and policy making along with democratic elections and deliberation are the basis for responsiveness to the citizens. However, many studies have also emphasized the lack of accountability in

authoritarian states due to the absence of these democratic institutions. The case study of Vietnam in section 3.4.1 has provided evidence to this argument and found that some informal institutions such as de facto personal accountability and 'village' culture have strong forces in explaining the variation in the extent of government responsiveness to local development demand across provinces. Table 3.5 presents the results for different estimation methods for the baseline model using the number of responsive legal documents and the number of administrative restructuring legal documents as dependent variables.

For the model of responsive legal document output as the dependent variable, the specifications (1)-(3) of table 3.5 present the results of three estimation methods, fixed effects, ordinary least squares (OLS), and two-stage least squares (2SLS), respectively. A random effects estimator is not reported in the model because the Hausman test (see Hausman 1978 and Greene 2008) P-value (0.0042) suggests that the fixed effects estimator be used. This is the reason why the first column is chosen to present the fixed effects regression results. As the multivariate analysis in specification (1) shows, once other determinants are controlled for, informal individual accountability of the chairmen of provincial people's committees has a statistically significant positive impact on the responsive policy output. The coefficients and their signs show several interesting findings. Consistent with The prediction from the case study, those provinces with higher educational level on average tend to put a higher pressure on local government to make more responsive decisions, and those which have bigger state sector industrial production seem to be less responsive in terms of developmental policy outputs. These three first coefficients are all significant at less than 1%. Two other controls, the average wage of government employees and the contribution of tax revenue to the local GDP, have a negative impact on the responsive policy output at less than 5% of significance level. The results can be explained by the limited role of financial incentives in the performance of government agencies (Dewatripont, Jewitt, and Tirole 1999). However, they are not significant in the specifications using other estimators. Different from some earlier studies, I do not find the influence of the government size on responsiveness. This may be linked to Lassen (2000)'s argument that a larger government will be more difficult to control and their responsiveness is subject to their own discretions.

When the Hausman test supports the selection of fixed effects estimators in the model of responsive legal documents as the dependent variable, the 2SLS using instrumental variables to the independent variable is often used to check the result robustness of the FE model. In accountability comparative analysis, the authors tend to use a lagged variable or political

culture, education, ethnographic features or climate conditions as instrumental variables (Torgler and Schaltegger 2006, Tsai 2007), arguing that they are not correlated with the error terms. I do not have information of informal individual accountability before 2006, so the lagged variable is not the choice in the 2SLS model. One of the other difficulties in within-country comparative studies, using the instruments, is the relative stability of cultural and ethnographical conditions across regions in the short term. Surveys of these characteristics are not conducted annually and the selection of instruments for the 2SLS regressions for a 4-year panel data is not easy in a developing economy like Vietnam, at least at the time being. However, this is absolutely feasible in the near future.

In order to check the robustness of the positive impact of informal individual accountability on legislative responsiveness, I run the same model, using different estimators such as OLS and 2SLS for this OLS model. One of limitations of the OLS estimation method in panel data models is the endogeneity problem. In other words, the OLS may produce inconsistent estimates when there is a causal relation between informal individual accountability of the executive leader and responsive policy output. It is possible that the more productive government in making accountable policies suffer higher agency costs on average, and the use of informal account-giving process induces lower marginal costs of issuing one more legal document than collective formal decision-making. As a result, informal accountability tends to increase in use. To take into account this feed-back effect from policy-making productivity to informal individual accountability, I also present the model estimations, using the 2SLS approach. The two instrumental variables for informal accountability are distance of the province to the two major economic centres in the North and in the South (Ha Noi capital city and Ho Chi Minh city) and the ratio of the provincial Buddhist population. Distance and ethnics are also two popular instruments for accountability in their cross-country or cross-sub-national political studies (Torgler and Schaltegger 2006, Tsai 2007).

Specifications (2) and (3) present the regression results for OLS and 2SLS models. The coefficients and signs still support the impact of informal accountability on responsive legal document output, even at a higher level of significance than in the FE regressions. Education remains an influential determinant of responsive policy-making. However, average government wage, size, and tax revenue no longer take a significant role for responsiveness. Contrary to the fixed effects model, those provinces with higher contribution of state industrial output to the local GDP witness their government making more responsive legal documents. In the OLS and 2SLS regressions, I also control for the North-South variation in

Table 3.4: Correlation matrix

	1	2	3	4	5	6	7	8	9	10	11	12	13
1. Responsive LDs (Log)													
2. PARLDs (Log)	0.67*												
3. PARLDs/Responsive LDs (Log)	-0.48*	0.34*											
4. Individual accountability	0.54*	0.29*	-0.35*										
5. Education	0.26*	0.15	-0.15	0.07									
6. Government size (Log)	-0.24*	-0.20*	0.07	-0.19*	-0.06								
7. Government wage	0.15	0.33*	0.20*	0.00	-0.16	-0.05							
8. Tax revenue/GDP (Log)	-0.14*	-0.04	0.13	-0.26*	0.15	0.39*	0.33*						
9. State industrial output/GDP (Log)	0.28*	0.16	-0.17*	0.06	0.26*	0.11	-0.11	0.05					
10. GDP per capita (Log)	0.37*	0.46*	0.08	0.17*	0.10	-0.07	0.50*	0.15	0.19*				
11. North dummy	-0.02	-0.30*	-0.33*	0.15	0.19*	0.35*	-0.22*	0.11	0.20*	-0.44*			
12. Expenditure decentralization (Log)	0.28*	0.19*	-0.13	-0.15	0.27*	-0.02	0.17*	0.22*	0.46*	0.48*	-0.11		
13. Population density (Log)	0.40*	0.36*	-0.09	0.13	0.14	-0.51*	0.16	-0.05	0.33*	0.57*	-0.39*	0.60*	
14. Proactivity	0.21*	0.36*	0.16	0.10	-0.08	-0.27*	0.39*	0.25*	-0.00	0.32*	-0.25*	0.16	0.34*

***** Indicates 95% confidence interval, N=140

Table 3.5: Regression results: The impact of informal individual accountability on responsiveness

Dependent variables	Responsive LDs (Log)			PARLDs (Log)			
	FE	OLS	2SLS	RE	2SLS	OLS	2SLS
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Individual Accountability	0.600*	1.253***	1.245**	0.585**	1.156*	0.642*	1.264***
	(0.35)	(0.168)	(0.411)	(0.233)	(0.606)	(0.168)	(0.428)
Government Size (Log)	-0.426	-0.294	-0.267	-0.056	0.093	0.088	0.233
	(0.748)	(0.247)	(0.27)	(0.361)	(0.404)	(0.262)	(0.27)
Government Wage	-0.0005**	0.0002	0.0000	0.0000	-0.0001	0.0001	-0.0001
	(0.0002)	(0.0002)	(0.0002)	(0.0002)	(0.0003)	(0.0002)	(0.0002)
State Industrial Output/GDP (Log)	-0.473*	0.193***	0.166***	0.129*	0.095	0.158***	0.125**
	(0.016)	(0.043)	(0.049)	(0.078)	(0.076)	(0.051)	(0.052)
Revenue/GDP (Log)	-0.253**	-0.152	-0.130	-0.196*	-0.156	-0.197*	-0.075
	(0.105)	(0.127)	(0.127)	(0.115)	(0.119)	(0.111)	(0.128)
Education	0.0003*	0.0002**	0.0002***	0.0002**	0.0002*	0.0001**	0.0001*
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
North		-0.187	-0.265*	-0.604***	-0.727***	-0.624***	-0.770***
		(0.135)	(0.137)	(0.189)	(0.212)	(0.126)	(0.144)
Time Fixed Effects	YES	YES	YES	YES	YES	YES	YES
Regional Fixed Effects	YES	NO	NO	NO	NO	NO	NO
_cons	0.604	1.754*	2.730*	1.278	2.878*	1.853**	2.780***
	(2.791)	(0.993)	(1.110)	(1.222)	(1.574)	(0.916)	(0.950)
Hausman P-value	0.0042			0.8648			
F-statistics of excluded instruments			14.45				19.96
P-value of overidentification test			0.4839				0.7135
N	140	140	140	140	140	140	140
R^2	0.3309	0.4702	0.4781	0.3202	0.2913	0.4157	0.3739
p	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Robust standard errors are in parentheses; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$; FE: Fixed effects; RE: Random effects; OLS: Ordinary Least Squares; 2SLS: Two-stage Least Squares. Two instrumental variables (distance dummy and the ratio of Buddhist population) are used in the 2SLS regressions.

responsiveness directly and it turns out that Southern provinces are more productive in terms of signs, but the coefficient is only significant in the 2SLS model.

The users of the 2SLS method concern the validity of the instrument variables. I report two tests to prove it in table 3.5. First, F-test statistics of excluded instruments in the first stage regression is 14.45[45] and is considered sufficiently reliable. Second, I run the overidentification test when the number of instruments is higher than that of endogenous variables. The P-value of Sargan statistics, 0.4839, shows that the null hypothesis of no overidentification cannot be rejected.

Table 3.5 also presents the same logic of empirical analysis and methodology in case the dependent variable is a sub-category of responsive legal documents. Although responsive legal documents are categorized in three groups, economic development policies, knowledge economy development policies, and public administrative reforming initiatives, the regression results of the last category is reported in specifications (4)-(7). I do not find the strong impact of individual accountability on the policy output in the first two groups. This also shows the private effort priority of local government to a narrow goal in this period.

I also stand at the choice of random effects or fixed effects estimators for the model with the number of public administrative reforming legal documents (PARLD) as the dependent variable. The Hausman test reported in specification (4) suggests the selection of the random effects, with p-value of 0.8648 (Hausman 1978, Greene 2008). I, hence, do not report the FE results. I continue to run Breusch and Pagan Lagrangian multiplier test to decide whether random effects or OLS regressions produce more reliable estimations. With the p-value is 0.0001, there is evidence to reject the null hypothesis and conclude that the difference across provinces is significant. Therefore, the random effects estimator is more appropriate.

Specification (4) presents the results of random effects regression. Informal individual accountability has a positive impact on PARLDs at 1.2% of significance level, controlling for other determining factors. Education is still a significant factor that influences PARLD output. As North dummy is time-invariant, I include it directly into the model regressions. As predicted about the difference in policymaking culture between the Northern and Southern provinces, I also find that the number of PARLDs is higher in the autonomous South than reserved and passive North with less than 1% of significance. Similar to the total responsive

[45] F-statistics of excluded instruments are considered “weak” if they are lower than 10.

policy output model, those provinces with larger state sector contribution of industrial output and less tax revenue contribution to the local GDP tend to have more PARLDs at less than 10% of significance. However, they are not significant in the robustness check. Government size and wage do not have a significant effect on PARLDs.

Specifications (5)-(7) report the results of the model, using 2SLS and OLS estimators as a way to check the random effects regression robustness. For the 2SLS regressions, I use distance dummy and Buddhist population percentage as instruments and their validity in the regressions is also tested, acknowledged and reported in table 3.5 with the same arguments in the first model. All three specifications show consistent estimations with the random effects. The results support informal individual accountability, education, and the North-South cultural difference as strong determinants of PARLD outputs. Other controls such as government employment size, wage, tax revenue, and state sector strength are not significantly influential for the production of PARLDs.

3.4.3.2. The second model: methodology and results

As stated above, I also test whether more responsive provincial government benefits from their private effort. As the results of the first model regressions support the role of individual accountability of the chairmen of provincial people's committees for the production of administrative restructuring initiatives only, I would like to test whether this effort of provincial government increases public trust in their governance. Similar to the first model, the fixed effects is chosen to account for the both observed and unobserved heterogeneity in a sample. In order to test how policy output influences public trust in local governance, I continue to appraise the fixed effects model below.

$$PROACTIVITY_{it} = \alpha_0 + \beta_1 CTRL_{it} + \beta_2 PARLD_{it} + TD_t + REGION_i + \varepsilon_{it} \quad (2)$$

where i indexes the province in the sample, $PROACTIVITY_{it}$ is a sub-index in the Provincial Competitiveness Index (PCI) survey from 2006 to 2009; $PARLD_{it}$ denotes the number of legal documents on public administrative reform made by provincial government i over the period 2006-2009. The model also includes several control variables, $CTRL_{it}$, including GDP per capita, education, population density, and expenditure decentralization. To control for

time and regional invariant factors, I include time fixed effects, TD_t, and fixed regional effects, $REGION_i$[46], in the regressions. ε_{it} is the error term.

Changes in government due to the increasing fragmentation of power and successive accountability crises on both national and international scale have challenged traditional formal mechanisms of accountability. The New Public Management doctrine is grounded on alternatives, resembling the market-based or client-oriented mechanisms and self-regulation (Behn 2001, Mulgan 2003). This new governance perspective regards performance as a mechanism of accountability and a standard of government efficiency. The PCI Vietnam survey, albeit an independent ranking of government performance, has quickly become an informal dialogue channel between the private sector and local authorities since 2006 (see the introduction of section 3.4 for an overview). It has even motivated formal communication and policy responses at all levels of government, particularly provincial authorities.

Of sub-indices of the PCI, *Proactivity* is built on annual questionnaire surveys of over 7000 private enterprises in all provinces about the degree of flexibility and responsiveness of local government in policy-making. Private firms normally have low political connection, and hence are expected to give less biased evaluation of government quality. The *Proactivity* index is aggregated on three questions. Question H7.8 asks firms whether policy initiatives are taken at the sub-central level. The question H7.3 asks firms whether local government where they are domiciled is flexible and innovative in implementing central policies to solve firm-related problems. Question H7.5 takes the opinion of firms about whether good policies initiated by sub-central governments are then overridden by the central government. *Proactivity* index is calculated, aggregating three indicators above based on the methodology suggested by PCI 2006[47]. Each indicator is standardized on a ten-point scale and the final index is the average value of equal weight indicators. Table 3.6 shows *Proactivity* varies significantly across provinces in the range of 2.32-9.20. It is expected that those provinces making more PARLDs have a higher degree of public trust in their responsiveness and

[46] See footnote 44.

[47] Each indicator is rescaled, using the formula $9\times\left[\frac{Province_i - Minimum}{Maximum - Minimum}\right]+1$ for those indicators that have positive interpretation and subtracting the above formula from 11 for those negative, where *Province i* is the indicator value of each province, *Minimum* is the smallest value of all provinces, and *Maximum* is the largest value of all provinces. Source: PCI Vietnam Report 2006, available at www.pcivietnam.org.

proactivity. For this argument, *Proactivity* index is selected as the dependent variable, and PARLDs (in both absolute number and percentage) are independent variables.

In order to fulfill the ceteris paribus conditions, I also control for other socio-economic factors that may impact the public perception of local government proactivity. I follow earlier empirical works about the determinants of the government performance (La Porta et al. 1999; Knack 2002; Treisman 2002; Bardhan 2002), controlling for the per capita income, educational level, population density, and expenditure decentralization of each province. Higher-income citizens with higher education are more likely to put pressure on local government to be efficient. In those provinces, local government has a larger tax base to pay higher salaries to their employees and a better pool to recruit more capable and talented officials. Those provinces with larger population density also pose more challenges to government to cope with a wider range of interests and needs. The relation between decentralization and quality of government remain controversial. Bardhan (2002) has made several arguments to explain why decentralization does not encourage downward accountability and responsiveness, especially to the mass, in developing countries. Elite capture, corruption, initial endowment condition heterogeneity, and partial decentralization (e.g., expenditure assignments unaccompanied by revenue-making devolution) all may undermine the advantages of decentralization as an effective mechanism of political accountability in the democratic world.

Table 3.6 presents the fixed effects regression of the second model. Specifications (1)-(3) report the estimation result of the model with the number of PARLDs as the independent variable. I follow the same methodology presented in the first model, running the Hausman test to decide whether a fixed effects or random effects estimator is relevant. P-value of this test (see table 3.6) supports the selection of the fixed effects estimator. Therefore I do not report the random effects regressions in this section.

Specification (1) shows those provinces making more PARLDs, controlling for other relevant influences, have a higher level of acknowledgement of the private sector about local government efforts to make responsive and innovative policies. This impact is significant at less than 1% for the panel data during 2006-2009, excluding the effect of expenditure decentralization. Consistent with earlier empirical studies, those provinces with more educated citizens and smaller population density are more proactive and responsive to local needs, from the perspective of private enterprises. However, richer provinces are not those

that have higher rank of trust in local government responsiveness and proactivity. The problem of elite capture, corruption, or missing local revenue-making power may misallocate the tax base to meet the needs of the mass, especially more disadvantaged stakeholders and account-holders. Even when expenditure decentralization is controlled for, the coefficients and significance of all independent and control variables just vary slightly (see Specification (2)). This also means the insignificant impact of fiscal decentralization on public trust in local government proactivity in terms of policy making.

Table 3.6: Policy allocation and proactivity of local government

Dependent variables: Proactivity	FE	FE	2SLS
	(1)	(2)	(3)
PARLDs (Log)	0.454***	0.456***	0.626**
	(0.163)	(0.165)	(0.262)
GDP per capita (Log)	0.324	0.242	0.281
	(0.816)	(0.857)	(1.015)
Education	0.0005*	0.0005*	0.0005
	(0.0003)	(0.0003)	(0.0003)
Population density (Log)	-1.845**	-1.880**	-1.835*
	(0.704)	(0.799)	(0.967)
Expenditure Decentralization		-0.295	-0.316
		(0.912)	(0.872)
Time Fixed Effects	YES	YES	YES
_cons	3.986*	2.650	2.237
	(2.074)	(4.622)	(4.919)
Hausman P-value		0.0336	
F-statistics of excluded instruments			72.52
N	140	140	140
R^2	0.3723	0.3730	0.3670
p	0.0000	0.0000	0.0000

Robust standard errors are in parentheses; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

To ensure the robustness of the baseline regressions, I follow the same approach of the first model and use an instrumental variable for the endogenous variable. To instrument for PARLDs, I use the percentage of PARLDs in the total number of responsive legal documents. The change in the percentage of PARLDs in the total number of responsive legal documents may be associated with a variation in the absolute number, but there is no evidence of a correlation between the percentage of PARLDs and the governance variables and other observed and unobserved ones. It is the size of the pie, not the percentage, will decide the

significance of the relationship. The validity of the instrumental variable is presented in specification (3). With the F-test statistics of excluded variables from the first stage regression being 72.52, the instrument is sufficiently strong for the 2SLS to be reliable. The positive relationship between PARLD output and trust in local responsiveness is still significant with even higher coefficient. Other controlled influences are the same, except education which is not significant in the 2SLS model.

The empirical analysis supports the role of some informal accountability mechanisms for the production of responsive legal documents in local government in an authoritarian system. Some formal institutions such as decentralization and taxation have an insignificant impact on responsive decision-making of provincial government. The first model also implies an important aspect in the current local organization in Vietnam: informal individual accountability of the chairman of the province is associated with the higher responsiveness. This challenges the collective decision-making and accountability norms persistent in the authoritarian regime of Vietnam. This also implies the need to change the internal organization of government in the way that institutionalizes the role of individual accountability in all functions and tasks of government bodies at all levels. Another noted point is the weakness of formal accountability means. It is possible that governance based on democratic centralization and dual subordination may be the ground for low trust in local governance, and this is also the basis for partial decentralization scheme of the central government in relation to sub-central governments. The inefficiency is the inevitable consequence of low trust being accompanied with loose formal sanction norms as discussed in section 3.4.1. The results of the second model also imply the need for internalizing or institutionalizing effective informal means of accountability. For example, the PCI or similar performance-based mechanisms should be considered as a formal measure of accountability of local government and all other public organizations. This is a step forward a high-trust formal accountability mechanisms and tight sanctioning in authoritarian regimes.

3.5. CONCLUSION

The transition in Vietnam has shown a vivid interaction between formal and informal institutions in government organization at both central and local level. The evolution and experimentation of formal mechanisms based on embedded norms rather than on rules have undermined their effectiveness and made way to the prevalence of ‘village’ norms and other self-regulation mechanisms in governance. In this transitional period, external and informal

institutions have shown their positive effect on local government performance and serve as complements to the current weak formal system. However, in the long term, the internalization of this externality will be a step to enhance the efficiency of formal institutions.

The variation in the number of responsive legal documents in general and the public administrative reforming decisions across provinces shows that some provincial governments are more proactive and responsive to local needs than the others. The empirical analysis has proved that this variation is explained more of the difference in informal institutions such as individual accountability of the chairman of the people's committee, policy-making culture, or the PCI surveys than formal ones. At the moment, individual accountability is only a de facto decision of local government chairmen, and local responsiveness is still based on 'village' culture. Furthermore, performance as a measure of accountability is an optional and informal choice among alternative mechanisms of local governance. The dominance of norms in governance has signaled the deviation of certain provinces from state identity (identified with the exclusive leadership of the Communist Party) and caused the increasing fragmentation of state power and the undermining trust in the single-party regime. The empirical study also illustrates the dynamism of local government organization in response to their people's needs. The authoritarian regime in Vietnam is suggested to head for a new management approach, assessing governmental accountability on the performance basis, organizing local government that honors the leadership and accountability of individual chairmen and the clear division of responsibilities and authorities between legislative and executive bodies and among different layers of government. The legitimacy of the single-party regime is better guaranteed by modern management instruments rather than avoiding them by centralizing its power.

APPENDIX: Sample

An Giang (AG) , Bac Giang (BG), Bac Kan (BK), Bac Ninh (BN), Binh Duong (BD), Binh Phuoc (BP), Binh Thuan (BT), Ba Ria Vung Tau (BRVT), Can Tho (CT), Dak Nong (DNG), Dong Nai (DNA), Dong Thap (DT), Ha Noi (HN), Hai Duong (HD), Ho Chi Minh City (HCMC), Khanh Hoa (KH), Kien Giang (KG), Kon Tum (KT), Lai Chau (LC), Lam Dong (LD), Nghe An (NA), Phu Tho (PT), Quang Binh (QB), Quang Nam (QNM), Quang Ninh (QNH), Son La (SL), Tay Ninh (TN), Thanh Hoa (TH), Tien Giang (TG), Tra Vinh (TV), Thua Thien Hue (TTH), Tuyen Quang (TQ), Vinh Long (VL), Vinh Phuc (VP), Yen Bai (YB)

Chapter 4

Institutional Incongruence and the Informal Economy: An Empirical Analysis

"Although the rules are the same, the enforcement mechanism, the way enforcement occurs, the norms of behaviour, and the subjective models of the actors are not."

(Douglas North 1990, p. 101)

4.1. INTRODUCTION

Recent global economic crisis which started from developed countries in 2008 has unveiled governance deficits at the macro-level and attracted governments' attention to an ignored policy-making principle – "*thinking small first*". This is also an initiative to enhance the competitiveness of the informal economy through minimizing formal and informal institutional incongruence in Europe. While many developed countries have initiated a systems lens of the informal economy and proactively implemented a combination of targeted measures to deter the participation in informal income-making activities, facilitate the transition of informal workers and enterprises into the formal economy, and support them in the post-transition period, many developing countries remain persistent to conventional thinking of the informal economy as a nexus of paradoxes and seek to solve the tension with increased deterrence or prevention, ignorance, or even encouraging its growth.

Governance based on paradox thinking has made the informal economy disconnected to various extents with the whole economy. The nature of paradox thinking is to find out all possible tensions between paradoxical elements and come up with strategies to respond to these tensions (Smith and Lewis 2011). As a product of social construction, paradoxical tensions are defined within a particular time and space (Poole and Van de Ven 1989). Portes and Haller (2005) found four paradoxes of the size of the informal economy in relation to the scope and enforceability of regulations, trust, and accountability. However, the identification of these paradoxes does not contribute much to the development of a unified theory of the informal economy. The boundaries of an informal economy vary from one country to another,

and countries may not face a similar set of paradoxes. For example, Kus (2010) found a negative and significant relation between the degree of regulation and the size of the informal economy in countries with more effective law enforcement, yet a deregulatory reform may not have a desirable effect on pro-formalization in a weak institutional environment. Therefore, paradox thinking may restrict the ability of applying the best practices across countries and driving governments in the latter group into a trap of tolerating or accommodating informal economic activities.

Using a paradox lens can also increase institutional incongruence and can be unbeneficial to growth. A paradox perspective emphasizes the juxtaposition of contradictory systems in one place and the role of leaders for managing these tensions successfully (Smith and Lewis 2011). Obviously, not all paradoxical tensions of complex and dynamic systems can be managed, at least in the short run, which delays any reform efforts. The paradox perspective's focus on the coexistence of distinctive systems within a unified institutional boundary may simplify the synergies created by certain similarities between them. Biased acknowledgement of exclusive differences or similarities of the two coexisting systems will lead to social divide and avoidance. Thus a paradox perspective may fail to explain why the informal economy is more integrated into the national economy in some countries, but it is treated as a 'black sheep' living with its own order and becoming separated from the rest of the whole economy in other countries.

Based on North (1990)'s connotation of formal and informal institutions and Webb et al. (2009)'s conceptualization of institutional incongruence - the difference in how formal and informal institutions perceive whether certain behaviour (particularly, informal economic activities) is legal and/or legitimate, this chapter provides empirical analysis and evidence to the five main hypotheses of the relation between institutional incongruence and the boundaries of the informal economy in 45 developed and developing countries: (1) participation into the informal economy is only an expression to institutional incongruence, or the discrepancy in how government and economic actors perceive what economic activities are legal and/or legitimate and what are not; (2) the impact of institutional incongruence on the boundaries of the informal economy varies in respect to the level of incongruence, and particularly the impact may be positive in high institutional incongruence jurisdictions, but may be negative in low institutional incongruence jurisdictions; (3) and (4) institutional incongruence has an overall positive impact on the size of the informal economy, but exerts a negative impact in those countries with more effective control of corruption or with more

targeted government initiatives; and (5) the boundary of the informal economy can shift, which is subject to a change in institutional incongruence from both government and informal economic actors.

In this chapter, I adopt a systems approach to managing tensions between the formal and informal economies and a Schumpeterian view to define informal enterprises as those with potential entrepreneurial mindset and a willingness to formalize if they are socially and legally treated as a potentially constructive agent of change and an integrated part of an economy as a whole, taking into account their specific characteristics. To test the five hypotheses above, I build measures of institutional incongruence from the World Value Surveys 2005-2008. The informal economy is measured by the percentage of the GDP in 2007, using the Multiple Indicators Multiple Causes (MIMIC) estimation method (Schneider et al. 2010).

The chapter is organized as follows. Section 4.2 briefly reviews theoretical and empirical literature on the dynamics of the boundaries of the informal economy, the relation between institutional incongruence and the informal economy, and develop some testable hypotheses on their relationship. Section 4.3 describes the data. Section 4.4 presents methodology, analyses estimation results, checks their robustness, and discusses the future of the informal economy, emphasizing the shift from the paradox approach to systems thinking to solve the tension between the state and the informal economy. The chapter ends with conclusion.

4.2. THEORETICAL CONSIDERATIONS

Since the social anthropologist, Keith Hart, introduced the term 'informal economy' in 1971, it has become a controversial research subject in various sciences. The boundaries of the informal economies have expanded from a social urban phenomenon in less developed countries to a form of informal institutions of governance in rural areas and developed economies, from social and household economy to modern economy (Alter Chen 2005), from unregulated economic activities to pre-regulated[48] entrepreneurship (Cheng and Gereffi 1994), from marginal operation to enterprise networks and clusters, from low productivity to innovation (Altenburg and Meyer-Staner 1999, Alter Chen 2005), from trust-based transactions to the rule-oriented, and from a symbol of poverty to a force for economic

[48] I use the term *pre-regulated* to highlight the informal economy as a transitional form of formal institutions and the role of institutional change for the speed of formalization.

development and institutional reforms. In the following section, I will analyse advances in the literature on the institutional boundaries of the informal economy and the role of informal institutions, especially institutional incongruence, for the dynamism of the informal economy.

4.2.1. The dynamics of the informal economy boundaries

The relation with the state is the most popular dimension to distinguish the informal economy from the formal economy since the term 'informal economy' was first launched in Hart (1971, 1973). It referred to the part of urban working population earning a living outside the formal wage economy, or self-employment in his terms. In response to its emergence, governments and international organizations began to set a legal boundary for the informal economy and separate it from the formal economy. From the perspective of International Labour Organization (ILO, 1972), the informal economy has been extended to include those workers and enterprises that are not protected and regulated by the state. Workers in the informal economy do not sign labour contracts or are excluded from social protection. Informal enterprises do not register or pay taxes, and are excluded from public goods and services reserved for formal enterprises. The ILO supports the dual existence of the formal and informal economies as legitimate sources of job opportunities and emphasizes the role of the state for creating a level-playing field for both.

A less positive attitude towards the informal economy is found among accounting scholars who define the informal economy as comprising all invisible productive activities which should be recorded in the Gross National Product (GNP). These scholars also seek to find causes of invisibility among workers and enterprises. Tax rates, overregulation/under-regulation, and high costs of entry are among the most cited motivations. The relation between the state and informal economic actors is tense. One the one hand, those enterprises that are not satisfied with state order of rules, regulations, and sanctions find it cheaper to have access to production factors and make sales in the informal market. Informal enterprises do not depend on a public order to facilitate their operation. Instead, a private order emerges and enables economic actors to make arrangements. They even lobby for overregulation to maintain their perceived legitimacy of the informal economy. On the other hand, government recognizes that the private order guiding the functioning of the informal economy is rivalrous to the state (public) order, so government tends to increase deterrence towards the informal economy. This argument supports Beresford and Dang (2000) or Schneider and Enste (2002),

who found that deterrence is a dominant policy against 'carrots' policy for informal economic activities that are conducted in a tense regulatory environment.

Following this conceptualization of the informal economy, institutional theorists elaborate specific legal institutions that define the organization and production of informal enterprises. One of the differences in the boundaries of informal enterprises across jurisdictions is their sizes in terms of assets and employees (Kaufman and Kaliberda 1996). These authors found that informal enterprises are almost small in most parts of the world, which facilitates their invisibility. However, informal enterprises can be medium or large with sophisticated activities and skilled workers in Europe and Central Asia, where a part of production in these enterprises is reported (Alter Chen 2005). This heterogeneity may partly be explained by discriminatory laws regulating the size of start-ups. For example, those household businesses or partnerships with less than 10 employees are not registered as enterprises under Vietnam's Enterprise Law 1999. This might lead to the case in which two firms in the same sector with comparable technology and labour productivity are distinctively treated by the state. In reality, informal enterprises are considered as social businesses in the country and acknowledged by a government decree[49]. Until 2000, no regulations on registration and taxation were imposed on household businesses and small partnerships. So far, no government supporting policies have been targeted to them. An absence of government bias towards different modes of production organization can make informal enterprises more institutionally congruent with formal enterprises.

Adopting comparative institutional approach, many scholars attempt to explain why the informal economy is smaller in certain countries and larger in other countries. Institutional economists argue that the variation of informality across countries and regions is due to the difference in public perception about the benefits of avoiding regulations and taxes and the costs of foregoing public services (Djankov et al. 2003). This argument has attracted a flux of theoretical models and empirical studies in an attempt to find out the link between the quality and intensity of formal institutions and the size of the informal economy (De Soto 1989, Friedman et al. 2000, Enste 2006, 2009). Those scholars argue that the informal economy emerges in response to high taxes, license requirements, labour market regulations, trade barriers, and immigration restrictions. Empirical studies in both developed and developing

[49] Decree No. 27 by the Ministerial Council on 9 Mar. 1988.

countries provided evidence of the larger informal economy in those countries with higher intensity of regulations or lower degree of legal enforcement and property rights security.

Few scholars show their interests in the link between the informal economy and informal institutions. Two most frequently investigated dimensions of the latter are trust in government institutions and tax morale (Körner and Strotmann 2006, Torgler and Schneider 2007, Enste 2009). These authors found that the size of the informal economy is smaller in those countries with higher tax morale, using the tax cheating indicator of the World Values Survey. A common argument among these scholars is the effect of trust in public institutions on informal economic opportunities through tax morale and corruption. Corruption is the main cause of the lack of trust in government institutions and the subsequent dilution of tax compliance and high entry into the informal economy. However, it is not clear about the relation between trust in public institutions and the difference in the boundaries of the formal and informal economies in developed and developing countries, or within an institutional environment.

When informal institutions are considered in the studies of the boundaries of the informal economy, the latter is broadly defined as "a specific form of income generating production...unregulated by the institutions of society in a legal and social environment in which similar activities are regulated" (Castells and Portes 1989: 15). This conceptualization uses both legal order and moral order as the basis to set the boundaries of the informal economies. Accordingly, informal economic activities are both illegal and illegitimate. This definition fails to distinguish the informal economy from the illegal economy, and undermines the role of informal institutions for development. This view also intensifies the unfriendly perceptions of the government about informal economic actors and vice versa, which may be one of the causes of high involvement into the informal economy in certain countries.

A recent study on the institutional boundary of the informal economy has expanded to the incongruent norms of the legitimacy of different forms of informal economic activities between two major social groups – government and entrepreneurs. Based on North (1990)’s typology of formal and informal institutions and the different mechanisms with which state order (shaped by laws, regulations, and the functioning of a multi-level system of governance institutions) and private order (based on norms, values, and beliefs) evolved, Webb et al. (2009) distinguished the boundaries of the formal, informal, and illegal economies. The dual existence of both state order (reinforced by formal institutions) and private order (reinforced

by informal institutions) is due to the difference in the perception of socially accepted norms among large groups in the society. Webb et al. (2009) defined the formal economy as comprising legal and legitimate activities. Those economic activities that are both illegal and illegitimate are categorized as the renegade economy. Those income generating activities that are conducted outside the regulatory framework, but accepted by a large group of people as 'legitimate' are called informal economic activities.

Surveys of informal economic activities in many countries show that formal institutional constraints are not single determinants of increasing informal opportunities (Torgler and Schneider 2007). A recent survey of unregistered household businesses in two largest cities in Vietnam revealed that many of them did not know that they had to register or the others did not see registration necessary, or they did not have a need for public goods and service access. Vietnam seems to be an exception when no single conventional incentives (such as tax evasion, burden regulations, corruption, or subsistence) are the main drivers of participating in the informal economy. A large group of informal businesses do not consider themselves as illegal and refuse exclusive benefits reserved for registered firms (Cling et al. 2009). The results of the PCI's survey for over 7,000 private firms are consistent with the common perception of household businesses. A majority of the respondents do not think that local government have positive attitudes towards the non-state sector (PCI 2006). Furthermore, enterprise laws also exclude household businesses or partnerships from enterprise status and most legal documents classified them into social organizations. In reality, many household businesses do not have production organization that differs from that of private enterprises. This explains why the legitimacy of informal economic activities is relatively incongruent from the perspectives of the laws and regulations and entrepreneurs in Vietnam.

The growing research interest in this field has shown the shift in the boundaries of the informal economy over time. On the one hand, the informal economy evolves and persists because certain forms of production and income generation are socially accepted in a wider scope than what is defined in laws and regulations (Webb et al. 2009). On the other hand, the persistence of the informal economy in developing countries and its emergence in developed countries show a dynamic replacement of old values (marginality, poverty, or illegality) with new values (entrepreneurship, innovation, or legitimacy) associated with it. Formal institutional constraints are not the only incentive for economic actors (workers and enterprises) to be engaged in the informal economy. Their decision is also guided by what they perceive the legitimacy of their economic activities and by what they deem whether

governmental institutions (the constitution, legislation, courts, the police, and regulatory agencies) perceive their activities legitimate or not. The development of new concepts of the informal economy is a process to bridge the existing incongruence among various social groups about the legitimacy of the informal economy and enhance the linkage between the formal and informal economies. From comparative institutional perspective, the variation in incongruence across jurisdictions explains the difference in boundaries of informal economies around the world. However, empirical analysis of this question remains modest.

4.2.2. Institutional incongruence and the informal economy

This section analyzes the relation between institutional incongruence and the size of the informal economy from comparative institutional perspective. The analysis is the theoretical basis for developing some hypotheses that will be empirically tested in the next section.

In this chapter, I am based on North (1990)'s definition of formal and informal institutions and Webb et al. (2009)'s conceptualization of institutional incongruence. The term 'institutional incongruence' refers to the difference in how formal and informal institutions perceive whether certain behaviour is legal and/or legitimate. For example, land transactions (sale, transfer, or lease) are made through the third parties (e.g. a notary) in France, and each parcel of land has been recorded with an index since 1955 (Springer 1998). However, direct land transactions without registration at the administration office or tax payment were a norm in rural Vietnam although Land Law was made in effect in 1993. The use rights of a land parcel are handed from one user to another with a hand-written contract, possibly with or without the witness of a relative or a neighbour. Until 2006, the ratio of land with Land Use Rights Certificates ranged from 11.25% to 96.54% in 64 provinces in Vietnam (PCI 2006). A different example is the case of undeclared work which is considered as a lawful activity in Estonia, an unlawful but legitimate activity in Austria, and a criminal offence in many other European countries (Heyes 2007). Obviously, the degree of institutional incongruence varies across countries and regions under different institutional settings, with varying strengths of formal institutions against the local preference for informal institutions, and unshared attitudes towards economic activities (state/non-state or formal/informal).

The effect of institutional incongruence on the size of the informal economy has also been investigated by several authors. In Webb et al. (2009)'s conceptual paper, the authors argued that different attitudes of large social groups about the legitimacy of informal economic activities might increase the chance that entrepreneurs would find informal economy

opportunities. This argument is also consistent with several earlier empirical studies. Körner and Strotmann (2006), Torgler and Schneider (2007), and Enste (2009) found that those countries with the higher percentage of population showing negative attitudes towards tax cheating have smaller informal economies[50]. A high proportion of population opposing tax fraud is also an indicator of low incongruence between state (formal) institutions and economic actors for the legitimacy of the informal economy. In this setting, social norms act as a moral tax which imposes (sanction) costs of participating in the informal economy to the violators in the same way with formal taxes. One of limitations in these studies is that the authors have not controlled for other economic and social factors that explain the variation in the institutional incongruence across countries. The impact of institutional incongruence on the size of the informal economy may differ in countries with distinctive economic development, regulatory quality, and it also depends on the average level of incongruence in each country or region.

Körner and Strotmann (2006), Torgler (2007), Torgler and Schneider (2007), Bird et al. (2008) and Enste (2009) used the tax cheating indicator in the World Values Surveys (WVS), European Values Surveys (EVS), and other regional or national level surveys as a measure of general attitudes towards the legitimacy of the informal economy and found that the explicit bias of the public against tax cheating has a negative effect on the size of the informal economy. The question on social attitudes towards tax cheating in WVS and EVS is below:

> *"Please tell me for each of the following statements 'cheating on taxes if you have a chance' whether you think it can always be justified, never be justified, or something in between* (on a ten-point scale from 1=never justifiable to 10=always justifiable)."

Using the data from the WVS surveys in the years 1990-2001, theses authors showed the proof of significant effect of tax morale on the size of informal economies in % of the GDP in OECD, developing countries, and transitional countries[51]. Development and institutional

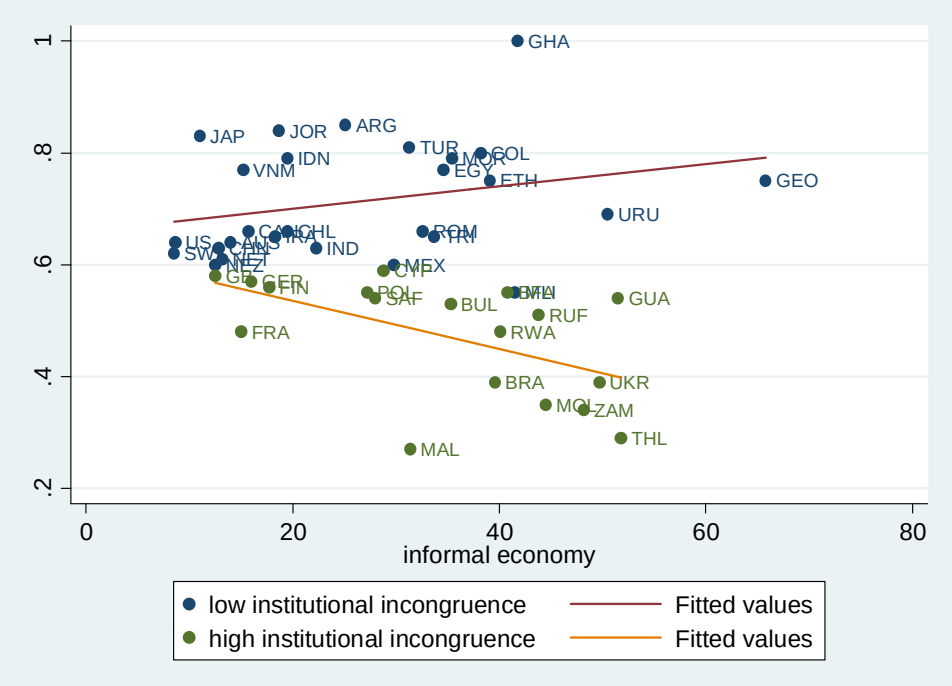
[50] Körner and Strotmann (2006), Torgler and Schneider (2007), and Enste (2009) use the term 'tax morale' to indicate the social attitude to tax cheating –one of the factors that is associated with informal economic activities. In this paper, we emphasize 'institutional incongruence' to generalize multiple institutional dimensions of the informal economy, including norms of high formalization costs and excluded benefits, other than tax evasion.

[51] In their analysis, the WVS's ten-point scale tax cheating values are rescaled into a four-point scale index because they found minor variation in the values for the 4-10 point range.

economists might feel short of satisfaction with these simple findings and attempt to further investigate the heterogeneity in the relation between social norms and the informal economy.

Figure 4.1 illustrates the relation between the perceived incongruence between the citizens and laws for how justifiable the cheating on taxes is and the size of the informal economy in 45 countries in the period 2005-2008. The new wave of WVS, 2005-2008, covered 55 developed and developing countries, 45 of which were involved in the estimation of the size of the informal economy in Schneider et al. (2010). Up to 61.30% of the surveyed respondents on average selected a deterministic answer 'never justifiable'. This figure is slightly lower than the level of the 1999-2000 wave, 64.40%, on average of 67 countries. I argue that the higher percentage of the population shows an explicitly biased attitude against tax cheating, the less incongruent the perceptions of the illegitimacy of informal economic activities by the government and economic actors.

Figure 4.1: Institutional incongruence and the informal economy in 45 countries



Source: The informal economy in % of the GDP, using the MIMIC model (Schneider et al. 2010). Institutional incongruence is the percentage of the population who selected 'never justifiable' for question V200 in the WVS 2005-2008, with the high percentage representing an explicitly biased attitude against tax cheating and the less incongruent perceptions of the illegitimacy of the informal economy by the government and economic actors. Low institutional incongruence countries are those with more than 60% of the respondents choosing 'never justifiable' and high institutional incongruence countries are those with less than 60%.

Figure 4.1 exhibits that the overall decreasing trend of the informal economy (in % of the GDP) in relation with institutional incongruence supports earlier studies although the pattern of the effect is relatively distinctive in the two groups of high and low institutional incongruence[52]. In the high congruence group (including those countries with 60% or more of the surveyed population showing 'never justifiable' attitudes towards tax cheating), up to 61.3% of the respondents showed a deterministic attitude towards the illegitimacy of the informal economy. In those countries with high institutional incongruence, the higher the incongruence becomes, the smaller the size of the informal economy is. The scatter plot below can be a preliminary explanation to the untested argument by Webb et al. (2009) who predicted the more opportunities to be found in the informal economy in those jurisdictions with higher incongruence among large social groups towards the legitimacy of the informal economy.

Tax avoidance is not the only incongruent behaviour in the informal economy. Institutional economists emphasize the difference in the perceived costs and benefits of informality in distinctive regions in order to explain the variation in the size of the informal economy around the world. Actors decide to be engaged in the informal economy if they perceive that the costs of entry into the formal economy are higher than the benefits of foregoing public services reserved for registered and taxed employees and enterprises. One of the factors that determine how economic actors assess the costs and benefits of their decision is whether local governments in which they operate have positive or negative attitudes towards their activities.

Preliminary scatter plot analysis shows the diverse relationship between institutional incongruence and the size of the informal economy in 45 countries. The trend of effect depends on the level of institutional incongruence between the government and economic actors in respect to their mutual perceived attitudes and behaviours towards the legitimacy of the informal economy.

4.2.3. Developing hypotheses

I proceed with developing testable hypotheses of the link of institutional incongruence, government, and the informal economy. The legitimate incongruence may lead to the absence of laws and policies in response to the needs of those economic actors who stand at a choice of staying informal or formalizing. Incongruence in the values of the informal economy

[52] The list of developed and developing countries is available on the World Bank's website.

associated with its legitimacy can be an incentive for entrepreneurs to be engaged in the informal economy to protect it. From comparative institutional perspective, those countries or regions that have a high level of incongruence generally observe a larger size of the informal economy than the others.

Hypothesis 1: Entry into the informal economy is only an expression to institutional incongruence, or the distinction in the perceived values associated with the legitimacy of the informal economic sector between the government and economic actors.

As the informal economy is more legitimate in some countries and regions than the others, the behaviour of informal economic actors in response to the incongruent attitudes of the government varies from one jurisdiction to another. In a highly institutionally congruent environment, the widening gap of perceptions about the legitimacy of the informal economy does not have significant effect on the participation of informal economic actors. In these jurisdictions, the government has a positive attitude towards legitimate economic activities, which generally turns into more supportive policies and reduced restrictions. When informal but legitimate economic actors recognize positive signals from the government, the size of the informal economy can slightly increase. In the inverse case, the government expresses high incongruence towards the legitimacy of informal economic activities. Their negative attitudes tend to turn into strict deterrence against informal economic actors and few incentive schemes (Beresford and Dang 2000, Schneider and Enste 2002). In these jurisdictions, the more the institutional incongruence, the larger the informal economy becomes.

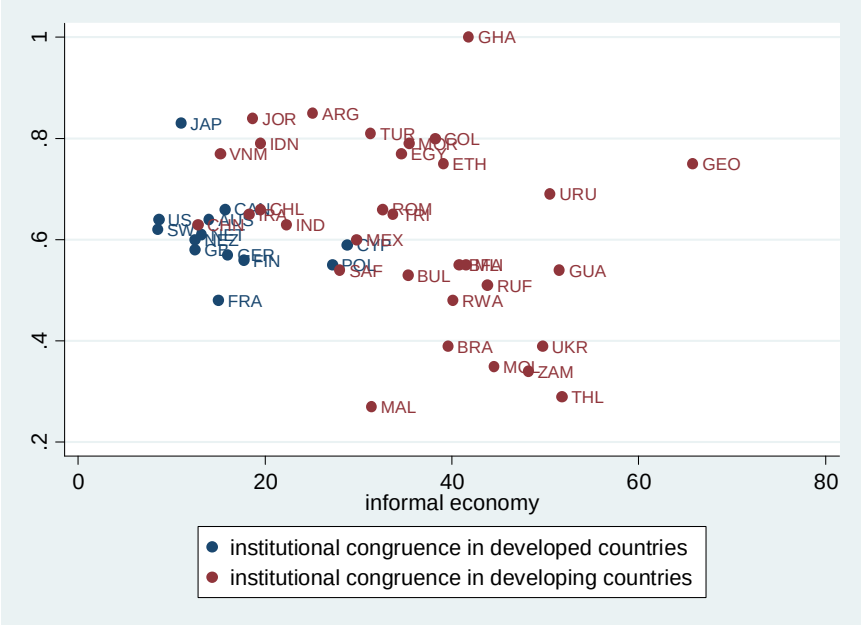
Hypothesis 2: The impact of institutional incongruence on the scale of the informal economy varies in respect to the level of incongruence. More specifically, institutional incongruence may have a positive impact on the size of the informal economy in high institutional incongruence jurisdictions, but the impact may be negative in low institutional incongruence jurisdictions.

This hypothesis is also linked to another hypothesis which emphasizes the causal relation between institutional incongruence and institutional quality. A lot of theoretical and empirical studies argue that the size of the informal economy is larger in those countries with more severe corruption, lower institutional quality (i.e., legal enforcement) and worse government effectiveness (Torgler and Schneider 2007, Torgler and Schneider 2009). Although the first hypothesis predicts the larger informal economy observed in those countries with a wider gap in the perception of the legitimacy of informality between the government and economic

actors, institutional incongruence has a negative impact on the size of the informal economy in those countries with good governance of corruption.

Hypothesis 3: Institutional incongruence has an overall positive impact on the size of the informal economy, but exerts a negative impact in those countries with better control of corruption.

Figure 4.2: Institutional incongruence and the informal economy in developed and developing countries



Source: The informal economy in % of the GDP, using the MIMIC model (Schneider et al. 2010). Institutional incongruence is the percentage of the population who selected 'never justifiable' for question V200 in the WVS 2005-2008, with the high percentage representing an explicitly biased attitude against tax cheating and the less incongruent perceptions of the illegitimacy of the informal economy by the government and economic actors.

Several authors argue that the incongruence between government and informal economic actors stem from various social and political factors such as the cultural difference between the Northern and Southern Europe, trust in legal institutions, tax morale, identity, over- or under-regulation (Torgler 2003, Alter Chen 2005). Thus, informal economic activities are not considered immoral or illegitimate, especially in countries whose legal systems impose too high costs of entry or too low benefits against incurred costs (Torgler 2003). World Bank's Enterprise Surveys 2005-2011show that the percentage of surveyed enterprises competing against the informal economy varies markedly across countries in the range of 10-90%. However, the percentage of those enterprises that perceives the competition from the informal economy as a major constraint for their business accounts for 0-76%. The significant

difference in the perceived values of the informal economy around the world requires adaptive initiatives to bridge the perception gap between government and economic actors.

The boundaries of the informal economy may change to the shift in norms from both government and economic actors (Webb 2009, Fafchamps et al. 2011). One of The criticisms for Fafchamps et al. (2011) is their argument for the ambiguous role of government in the dynamics of the informal economy. Figure 4.2 shows that both developed and developing countries have downward-sloping trend lines, exhibiting the larger size of the informal economy (in % of GDP) in those countries with higher levels of institutional incongruence. However, most developed countries focus in one cluster with a medium incongruent attitude towards informal economic activities and an obviously smaller informal economy than that in developing countries. This difference may have a link to the variation in legislative efforts to legalize certain legitimate informal institutions as well as the power of collective actions to gain legal recognition across countries.

There are several scholar suggestions that can make formal and informal institutions more congruent. First, the boundaries of the informal economy can contract due to legislative efforts to lift restrictions on certain economic activities that are wildly socially acceptable, albeit illegal, or to accept new technologies and services (Webb et al. 2009). For example, micro enterprises with less than ten employees have been recognized as a form of small and medium -sized enterprises (SMEs) and benefited from all rights as other SMEs in European Union law since 2003. However, in many other developing countries, Vietnam, for example, micro enterprises were recognized in 2009, and registered household businesses with the same size of micro enterprises or even in the same sector and using the comparable technology are not regulated as other enterprises and excluded from public services reserved for an enterprise. This regulatory discrimination also means 82% of active workers or two thirds of non-farm workers who earn income in the informal economy and whose production contributes to approximately 20% of the GDP (Cling et al. 2010) are not legally protected and equally treated as the other official workers.

Second, attitudes are seen as a function of values (Rokeach 1973), so the addition and absorption of new values can change attitudes towards bridging the perception gap between the government and economic actors. For example, ‘decent work’ or ‘environment-friendliness’ are the focus of collective actions on both national and international scale to win legal recognition for informal workers –both wage earners and own-account workers – doing

these types of jobs. Mobilizing activities through networking, conferences, and associations have made street vendors, waste collectors, domestic work, and similar decent jobs legally accepted and enjoy the rights as other jobs since the 1990s, at least in Latin America and the EU. The narrowing gap between formal and informal institutions also demands a change in attitudes and norms of informal actors. Informal workers and entrepreneurs do not identify themselves as workers or enterprises. In many developing countries, informal actors identify themselves with a village, and they are supposedly born to work for their village-based industrial clusters (Alter Chen 2005). The initiatives of township-run enterprises in China or certified trade villages in Vietnam or the joint ventures between these village-based industrial and service clusters and other types of enterprises are expected to change the norms and values associated with informal work identity.

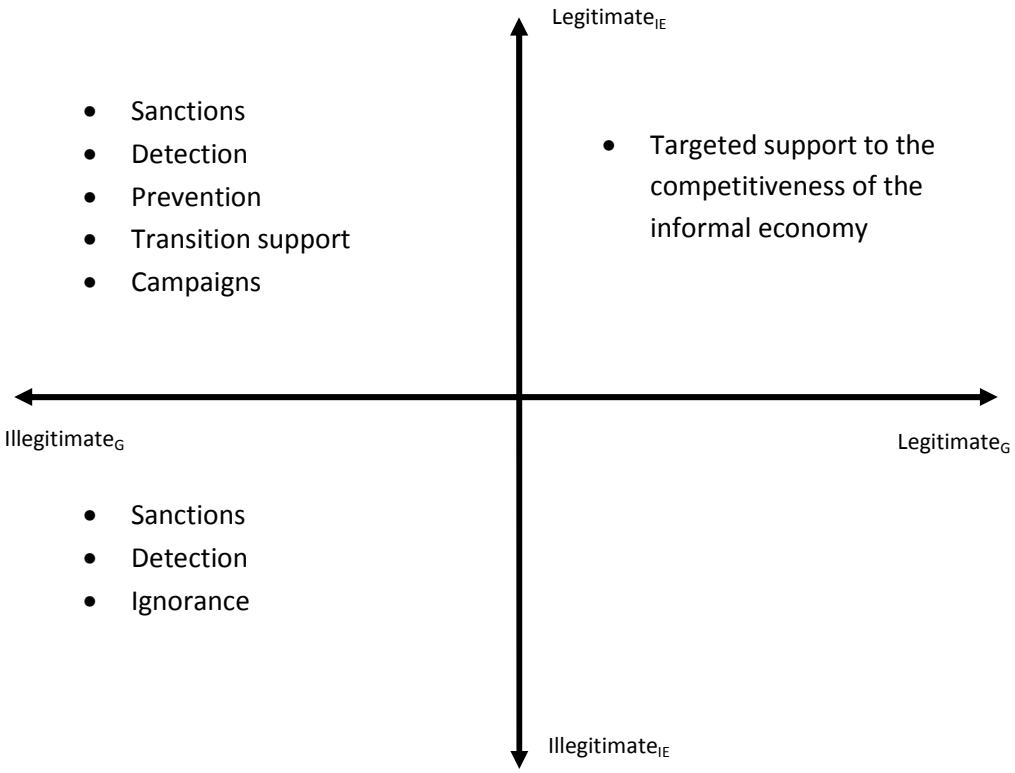
Third, deterrence may be counter-effective when it is overused as a measure to enforce tax compliance or governance of informal economic activities, especially in a high institutional incongruence environment. Punishment, harassment, detection, or auditing have been optimal tax enforcement mechanisms in most public choice and economics models which overestimate extrinsic incentives intended to affect tax payers (Frey 2003). Enforcement by deterrence is costly, and recent empirical studies show that the informal economy is sizable even in those countries with high institutional quality (Schneider et al. 2010). Interdisciplinary research, for example, between sociology and economics, has sought to explain the dynamics of the informal economy through implicit incentives (trust, pride, identity, culture, or morale, for instance) (Frey 2003, Alm and Torgler 2006). Accordingly, the world economy has witnessed the change in values, attitudes, and policies associated with the informal economy towards more Schumpeterian view[53], legitimization, and targeted incentives (see Gurtoo (2009) and Dekker et al. (2010) for a list of supportive programs and initiatives tailored to informal enterprises and workers in Europe).

The boundaries of the informal economy do not only depend on the degree of institutional incongruence, but also the type and intensity of government policies towards the informal economy. Figure 4.3 and table 4.1 exhibit the relationship between the degree of congruence in the perception of government and economic actors regarding the legitimacy of the informal economy and government policies targeting this part of the economy. Based on the

[53] The Schumpeterian school sees informal microenterprises as those with potential entrepreneurial mindset and a willingness to formalize if they are socially and legally treated as a potentially constructive agent of change and an integrated part of an economy as a whole.

methodology and conceptual framework of EIRO surveys[54] and Williams and Renooy (2008) for European and OECD countries, I use content analysis of publications (including reports, journal articles, working papers, and case studies published by international organizations (i.e., International Labour Organization (ILO), the World Bank, the International Monetary Fund (IMF), the Organization of Economic Cooperation and Development (OECD), European Commission, the United Nation (UN), European Employment Observatory (EEO), or Eurofound), national labour and regulatory administrative agencies and scholars with their articles identified with ABI Inform and Emerald search engines in their databases (i.e., Proquest, EBSCO, Elsevier Science, Emerald, and Science Direct)) to obtain the information about government initiatives to control or support the growth of the informal economy. The key words used to search government policies towards the informal economy are abstracted from Williams (2006, p.6) and extended to include informal, undeclared, government initiatives, programs, policies, laws, regulations, measures, and solutions.

Figure 4.3: Legitimacy of the informal economy and government policies



[54] See http://www.eurofound.europa.eu/eiro/2004/06/tfeature/bg0406202t.htm

Table 4.1: Change in government policies towards the informal economy before 2007

	Deterrence		Prevention	Support initiatives			Total policies
	+Sanctions	+Detection		Transition	Social attitudes	Supporting dualism	
ARG		●	●				2
AUS	●	●	●	●	●		3
BRA			●				1
BUL			●				1
BFA				●		●	1
CAN	●	●		●	●		2
CHL	●		●				2
CHN				●			1
COL				●			1
CYP		●					1
EGY			●			●	2
ETH						●	1
FIN	●	●	●	●			3
FRA	●	●	●	●	●		3
GEO							0
GER	●	●	●	●	●		3
GHA			●				1
GB	●	●	●	●	●		3
GUA							0
IND			●	●		●	2
IDN			●	●			1
IRA		●	●				2
JPA			●				1
JOR			●				1
MAL							0
MLI							0
MEX			●				1
MOL							0
MOR							0
NET	●	●	●	●			3
NEZ	●		●		●		3
POL		●	●	●			3
ROM		●	●		●		3
RUF			●				1
RWA				●			1
SAF						●	1
SWI	●		●			●	3
THL							0
TRI			●				1
TUR		●	●				2
UKR	●						1
US	●	●	●	●			3
URU							0
VNM							0
ZAM							0

Source: Williams and Renooy (2008) for several European countries and the author's content analysis of publications (including reports, journal articles, working papers, and case studies published by international organizations (i.e., International Labour Organization (ILO), the World Bank, the International Monetary Fund (IMF), the Organization of Economic Cooperation and Development (OECD), European Commission, the United Nation (UN), European Employment Observatory (EEO), or Eurofound), national labbour and regulatory administrative agencies and scholars with their articles identified with ABI Inform and Emerald search engines in their databases (i.e., Proquest, EBSCO, Elsevier Science, Emerald, and Science Direct)) . See details of these government policies in the case studies in the appendix.

Figure 4.3 shows that government and economics actors around the world may have different perceptions about the legitimacy of informal economic activities, which turns into different types of government policies, either restraining or supporting, or mixed attitudes towards the informal economy. Where government and economic actors share the view of the informal economy as an integrated legitimate driver of national economic growth and development, for example in the case of Ethiopia and Burkina Faso[55], targeted support initiatives are taken to enhance the competitiveness of the informal economy instead of deterrence or preventive measures. Where both government and economic actors have negative attitudes towards informality (such as 'undeclared', 'unreported', 'unregistered', or 'hidden'), the former either casts their ignorance towards the informal economy or rely on few measures to restrain its growth, mainly deterrence or prevention. Examples of these cases are Vietnam, Japan, Ghana, Argentina, or Turkey[56]. In the group of countries where government shows negative attitudes towards the informal economy, and economic actors are incongruent to the former's perception, the government tends to use a combination of measures to deter, prevent, and encourage informal actors to transit to the formal economy at the same time. The use of various measures such as sanctions, detection, prevention, transition support, campaigns, and growth support in 45 countries are presented in table 4.1, elaborated from content analysis and summarized in the case studies in the appendix.

Hypothesis 4: Institutional incongruence has an overall positive impact on the size of the informal economy, but exerts a negative impact in those countries with more targeted government initiatives.

Hypothesis 5: The boundary of the informal economy can expand or contract, which is subject to a change in institutional incongruence from both government and informal economic actors.

[55] See case studies of Burkina Faso and Ethiopia in the appendix for detailed sources.

[56] See table 2 and case studies of these countries in the appendix for details of government measures and sources.

4.3. DATA

This section describes the construction of all variables used in the empirical analysis. A summary of the variables is provided in table 4.2.

Informal economy measure

Although there have been different methods to estimate the size of the informal economy around the world, each measure is based on its own conceptualization of the informal economy boundaries[57]. In this chapter, the informal economy refers to "...those economic activities and the income derived from them that circumvent or otherwise avoid government regulation, taxation or observation..." (Del'Anno 2003). The data for the size of the informal economy is measured by the percentage of the GDP in 2007, using the Multiple Indicators Multiple Causes (MIMIC) estimation method (Schneider et al. 2010). Schneider et al. (2010) treats the size of the informal economy as an unobserved variable in a structural equations model in which the informal economy is estimated in relation with a series of observed variables identified as main causes of the participation into it. Four groups of causes are specified to include tax and social security contribution burdens, regulatory intensity, the quality of public sector services, and the situation of the formal economy. Statistics of the size of the informal economy is summarized in table 4.3.

Institutional incongruence measures

Institutional incongruence, INCONGRUENCE variable, is the percentage of the population who selected 'never justifiable' for question V200 [58] in the WVS 2005-2008 with the high percentage representing an explicitly biased attitude against tax cheating among people in the country and the less incongruent perceptions of the illegitimacy of the informal economy by

[57] Some popular methods to estimate the size of the informal economy are direct surveys (Frey et al. 1982, Loayza 1996), the discrepancy between national expenditures and income statistics (Park 1979, Petersen 1982), the discrepancy between official and actual labour force (see Thomas 1992 for a review), the transactions approach (Feige 1996), the currency demand approach (Tanzi 1980, 1983), the electricity consumption approach (Kaufmann and Kaliberda 1996, Lackó 1996), the dynamic multiple-indicators multiple-causes model (DYMIMIC) (Del'Anno 2003, Giles and Tedds 2002, Schneider and Savasan 2007).

[58] "Please tell me for each of the following statements 'cheating on taxes if you have a chance' whether you think it can always be justified, never be justified, or something in between (on a ten-point scale from 1=never justifiable to 10=always justifiable)."

Table 4.2: Description of the variables

Variables	Description	Source
Informal economy (IE)	*IE* is measured by the percentage of the GDP in 2007, using the Multiple Indicators Multiple Causes (MIMIC) estimation method.	Schneider et al. (2010)
Institutional incongruence (INCONGRUENCE)	INCONGRUENCE is the percentage of the population who selected 'never justifiable' for question V200 in the WVS 2005-2008, with the higher percentage representing an explicitly biased attitude against tax cheating and the less incongruent perceptions of the illegitimacy of the informal economy by the government and economic actors.	WVS
INCONGRUENCE3	INCONGRUENCE3 is measured by the percentage of the population selected up to point 3 on a 10-point scale from 'never justifiable' to 'always justifiable' for question V200 in the WVS 2005-2008, with the high percentage representing a general trend of bias against tax cheating and the less incongruent perceptions of the illegitimacy of the informal economy by the government and actors.	WVS
Control of corruption	CONTROL_OF_CORRUPTION reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. The estimate of governance performance ranges from 1 (weak) to 5 (strong).	Kaufmann et al. (2009)
Targeted government initiatives (INITIATIVES)	The number of government policies that have recently been introduced and are directly targeted at managing the informal economy among four categories: deterrence (including sanctions and detection), prevention, transition and growth support, and ignorance.	Author's calculation from the content analysis approach (see table 4.1)
Urban	The density of population in urban areas.	World Bank (2009)
Labor participation	The labor participation rate among those in the age 18-65.	World Bank (2009)
GDP per capita	The gross domestic product per capita at the constant price of 2000 (in USD).	World Bank (2009)
DEVELOPED dummy	A dummy = 1if it is a developed country; =0 if a developing country.	World Bank (2009)

Table 4.3: Summary statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
INCONGRUENCE	45	0.62	0.16	0.27	1
INCONGRUENCE3	45	0.80	0.11	0.53	1
IE	45	29.58	14.22	8.5	65.8
CONTROL_OF_CORRUPTION	45	2.83	1.03	1.65	5.06
GDPPC	45	9293.13	11874.24	161.59	39965.86
URBAN	45	60.72	22.90	12.12	91.93
LABOR_PARTICIPATION	45	62.54	10.17	40.6	84.8
DEVELOPED dummy	45	1.71	0.46	1	2
INITIATIVES	45	1.42	1.10	0	3

the government and the actors. Table 4.3 shows that 62% of the sample in 45 countries has a firm (negative) attitude towards the informal economy; however, the figure varies significantly across countries in the sample in a range of 27-100%. This variation explains the difference in the degree of citizens' perceived legitimacy of informal economic activities around the world.

Control variables

I also control for institutional and socio-economic heterogeneity across countries to fulfill the ceteris paribus conditions.

Formal institutional environment

Governance literature has attempted to provide evidence to the negative impact of effective control of corruption on the growth of the informal economy (Torgler and Schneider 2007, Torgler and Schneider 2009). I follow earlier studies and control for this governance performance indicator in the regressions. I use the "CONTROL_OF_CORRUPTION" index developed by Kaufmann et al. (2009) for the year 2006 and rescale it on a 5-point continuum from 1(weak) to 5 (strong governance performance) for easier interpretation of the results. Statistical details of this variable are provided in table 4.3.

Targeted support initiatives

Recent research on the informal economy in European countries has shown a change in European government's perception about the legitimacy of informal enterprises and employees (Williams 2004, 2009). A conventional view treats the informal economy as a nexus of paradoxes in the relation with the state (Portes 1994, Portes and Haller 2005). To restrain the growth of the informal economy, the former attempted to increase sanctions or improve detection techniques as though the actors in the informal economy are "criminals". This might be an explanation for a large size of the informal economy in those countries that mainly rely on deterrence or ignorance to tackle informal enterprises and workers. A change in the government's attitudes towards the informal economy has been going on in many OECD countries. From a paradox in the national economy, informal enterprises are considered as microenterprises and entitled to equal public services and benefits with other types of enterprises, and informal workers are seen as a segment of the labour market. This shift in social attitudes towards the role and identity of the informal economy has been accompanied by initiatives to prevent or facilitate the transition of informal enterprises and workers to the formal economy, or improve their competitiveness, or implement campaigns to change social attitudes towards the informal economy (see table A4.1 in the appendix).

Table 4.1 shows the variation in government policies and initiatives across 45 countries to tackle informal enterprises and workers. There are four main categories of policies and initiatives: deterrence (including sanctions and detection), prevention, transition and growth support, and ignorance. To control for the proactivity of the government in easing the tension with the informal economy, I build INITIATIVES variable measuring the total government policies and initiatives introduced before 2007. The data of INITIATIVES is presented in table 4.1, and its statistics summary is provided in table 4.3.

Socio-economic environment

I also control for cross-country differences in socio-economic conditions.

The size of the informal economy is expected to be smaller in richer countries where people and enterprises have a higher capacity to pay taxes and cover their social security, and a higher relative demand for income elastic public goods and services (Bahl 1971, Torgler and Schneider 2007). I use the GDP per capita (GDPPC variable) and a dummy for a developed

country by the World Bank (2009)'s classification (DEVELOPED dummy variable) as proxies for economic development of the countries in the sample.

The variation in demographic and labor characteristics is supposed to affect the size of the informal economy (Bahl 2001, Torgler and Schneider 2007). Active labor force is one of the indicators of the attractiveness of the formal labor market. The high labor participation rate may predict the less attractiveness of the informal economy. Similar to earlier studies, I also control for the labor participation rate among those in the age 18-65 (LABOR_PARTICIPATION) and the density of population in urban areas (URBAN) (World Bank 2009) in the regressions.

4.4. EMPIRICAL ANALYSIS

4.4.1. Methodology

This section will provide empirical proofs to the five above hypotheses of the relation between institutional incongruence and the size of the informal economy, using the statistics of 45 developed and developing countries in the period 2005-2008. The main hypothesis is that the entry into the informal economy is an expression to institutional incongruence, or the gap in the perception of what economic activities/behaviours are legal and/or legitimate between the government and economic actors, and regulatory compliance (tax payment and registration) costs are the price to pay for government's positive attitudes and efforts to minimize the incongruence. This assumption is based on institutional economics literature which models the relationship between the government and economic actors as an implicit contract (Wallerstein and Smith 1992). Accordingly, commitment to regulatory compliance from the actors is a response to private efforts and positive attitudes of the government towards the importance and legitimacy of the informal economy.

In order to test the first two hypotheses, the following benchmark estimation equation is postulated:

$$IE_i = \alpha + \beta \cdot CONTROL_i + \gamma \cdot INCONGRUENCE_i + \varepsilon_i \qquad (1)$$

where IE_i is the size of the informal economy measured by the percentage of the GDP in country i or province i, and $INCONGRUENCE_i$ denotes institutional incongruence in country i or province i, with a higher value of $INCONGRUENCE_i$ representing a higher degree of institutional congruence or a lower degree of institutional incongruence.

$CONTROL_OF_CORRUPTION_i$ (an indicator of government effectiveness in controlling corruption), $URBAN_i$ (the density of population in urban areas), and $LABOR_PARTICIPATION_i$ (the labor participation rate among those in the age 18-65) are control variables in country i or province i. ε_i is the error term. To avoid causality problems, independent variables are chosen to date from one to three years before the timing of the dependent variable. I are mainly interested in the sign and significance of γ, which might be negative, supporting the argument of Webb et al. (2009).

Earlier empirical studies treat social values/attitudes and formal institutional environment as those factors that have an independent impact on the growth of the informal economy (Torgler and Schaltegger 2006, Torgler et al. 2007, Torgler and Schneider 2007). In this chapter, I assume that the relationship between institutional incongruence and the informal economy depends on the governance performance of the government. To test hypotheses (3), I generate dummy variables for q-quantiles of the quality of controlling corruption ($CONTROL_OF_CORRUPTION_{1q}$,…, $CONTROL_OF_CORRUPTION_{qq}$) and interact them with institutional incongruence measures in a structural equation model. For q = 3, it is possible to estimate the trend lines of how institutional incongruence influences the informal economy in two groups of countries or provinces with the lowest, medium and highest level of governance performance.

The estimation equation now takes the form:

$$IE_i = \alpha + \beta \cdot CONTROL_i + \gamma \cdot INCONGRUENCE_i$$

$$+ \sum_{k=1}^{q-1} \delta_k \left(INCONGRUENCE_i \cdot CONTROL_OF_CORRUPTION_{kq_i} \right)$$

$$+ \sum_{k}^{q-1} \theta_k \cdot CONTROL_OF_CORRUPTION_{kq_i} + \varepsilon_i \qquad (2)$$

The interaction terms of institutional incongruence measure and the q-quantile dummies show us whether the relationship between institutional incongruence and the size of the informal economy depends on governance performance. It was my hypothesis that the informal economy is larger in those countries with a wider gap between the perceptions of the government and the actors about the legitimacy of informal economic activities (hypotheses (1) – (4)); however, the impact might be negative in those countries of good governance

performance. Therefore, it is expected that the sign of the interaction term will be positive[59] at less than 10% of significance in the countries with effective control of corruption. The $CONTROL_OF_CORRUPTION_{kq}$ dummy for the countries with the lowest q-quantile of controlling corruption is not considered in the estimations, and is treated as a reference group. γ captures the overall impact of institutional incongruence on the size of the informal economy while δ_k captures the partial effect of the k interaction terms. We obtain the total effect of institutional incongruence on the size of the informal economy by adding the coefficient of an interaction term to the coefficient of the general effect.

4.4.2. Results

Table 4.5 presents the cross-sectional results of two estimation methods, the Ordinary Least Squares (OLS) and the Two Stage Least Squares (2SLS), respectively. White's test for heteroskedasticity in the residuals rejects the null of no heteroskedasticity, so all standard errors of coefficients are calculated using White (1980) correction. The coefficients of institutional incongruence measure are negative and significant in most specifications (3)-(10), supporting the first hypothesis. Only in specification (9), the coefficient of institutional incongruence is not significant in the OLS regression when it controls for government initiatives targeting the informal economy, but it is significant at less than 1% in the 2SLS estimation. It should be noted that the higher value of INCONGRUENCE represents the lower degree of institutional incongruence. Therefore, the benchmark regressions find that those countries with higher incongruence have larger informal economy in the percentage of the GDP. I also estimate the impact of institutional incongruence on the size of the informal economy in two groups of countries: low incongruence (those with INCONGRUENCE >=60%) and high incongruence (those with INCONGRUENCE <60%). Specifications (1) and (2) provide evidence to the second hypothesis about the heterogeneity of the relation between institutional incongruence and the size of the informal economy. Although the overall trend of the relationship is positive, the relationship is significant and negative in low incongruence group (or in high congruence group).

The signs and significance of the coefficients of the independent variable in specifications (5)-(10) show that the overall impact does not change even if I control for the quality of formal

[59] It should be noted that the higher value of INCONGRUENCE means the lower degree of institutional incongruence, and, thus, the negative sign of the coefficient should be interpreted as a positive impact of institutional incongruence on the size of the informal economy.

Table 4.4: Regression results: The impact of institutional incongruence on the size of the informal economy in 45 countries

Dependent variable: Informal economy (IE) (log)	OLS Low incongruence	OLS High incongruence	OLS	2SLS	OLS	2SLS	OLS	2SLS	OLS	2SLS
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
INCONGRUENCE	1.552*	-1.823**	-0.800**	-1.360***	-0.769**	-1.710***	-0.703*	-1.482***	-0.601	-1.451***
	(0.786)	(0.705)	(0.335)	(0.442)	(0.321)	(0.493)	(0.375)	(0.488)	(0.370)	(0.528)
INITIATIVES									-0.203***	-0.163**
									(0.072)	(0.056)
CONTROL_OF_CORRUPTION							-0.346***	-0.317***		
							(0.059)	(0.075)		
GDPPC (log)					-0.244***	-0.232***			-0.149**	-0.158***
					(0.067)	(0.052)			(0.062)	(0.056)
DEVELOPED dummy			-0.800***	-0.759***						
			(0.146)	(0.144)						
URBAN (log)	-0.442***	-0.492**	-0.064	-0.100	0.077	0.028	-0.009	-0.068	0.043	0.009
	(0.155)	(0.213)	(0.107)	(0.144)	(0.270)	(0.180)	(0.110)	(0.169)	(0.188)	(0.163)
LABOR_PARTICIPATION (log)	-0.893	-0.247	0.008	-0.163	-0.316	-0.546	-0.036	-0.257	-0.372	-0.556
	(0.547)	(0.461)	(0.398)	(0.401)	(0.428)	(0.422)	(0.409)	(0.438)	(0.420)	(0.384)
_cons	7.461***	7.310**	4.205**	5.370***	6.708***	8.314***	4.854**	6.378***	6496***	7.911***
	(2.553)	(2.58)	(1.940)	(2.049)	(2.251)	(2.103)	(1.983)	(2.213)	(2.066)	(1.938)
F-statistics of excluded instruments				35.23		31.12		32.38		15.37
P-value of overidentification test				0.2451		0.7281		0.6510		0.8934
N	27	18	45	43	45	43	45	43	45	43
R^2	0.2739	0.4497	0.5543	0.5298	0.4895	0.4398	0.4955	0.4441	0.5897	0.5400
p	0.0189	0.0081	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Robust standard errors are in parentheses; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Higher values of INCONGRUENCE represent lower degrees of institutional incongruence, or higher degrees of institutional congruence.

Low incongruence countries are those with INCONGRUENCE > =60% and high incongruence countries are those with INCONGRUENCE <60%.

Two instrument variables used in the Two Stage Least Squares (2SLS) estimation are moral value and work value built on the results of the World Values Survey 2005-2008. Work value is the mean of the answers for question V120, asking the respondents to show their attitudes for the statement "Hard work brings success" on a ten-point scale from 1= completely agree to 10=completely disagree. Moral value is the mean of the answers for question V199, asking the respondents to show their attitudes for the statement "Avoiding a fare on public transports" on a ten-point scale from 1= never justifiable to 10=always justifiable.

institutional environment, government initiatives and other socio-economic conditions of each country. Control variables also show the expected signs and support the findings of earlier studies. Urbanization and the rate of labor participation among those in the age 15-65 do not have significant impact on the size of the informal economy. However, richer and developed countries have the smaller informal economy. Similarly, government performance also influences significantly the size of the informal economy: the smaller one is observed in those countries with better governance of corruption and with more targeted government policies and initiatives. The coefficients of two latter control variables are almost statistically significant at less than 5% of significance.

To check the robustness of the benchmark regressions, I run the same model, employing the Two Stage Least Squares (2SLS) method. In comparative institutional analysis, scholars tend to use political culture, ethnographic features or climate conditions as instrumental variables (Torgler and Schaltegger 2006, Torgler et al. 2007, Torgler and Schneider 2007), arguing that they are not correlated with the error terms. Climate is a valid instrument in several studies on social attitudes (Eagles 1994, Tietjan and Kripke 1994, Torgler et al. 2007, Torgler and Schneider 2007). I tried using cloud coverage, temperature, and precipitation (Mitchell et al. 2004) as instrumental variables for institutional incongruence in the 2SLS estimations, but they all fail the F-test of excluded instruments in the first-stage regression.

Adopting the same approach in the benchmark analysis, I run both the OLS and 2SLS regression to deal with possible endogeneity bias. The two moral value and work value are used as instrument variables for institutional incongruence. In general, the regression results are consistent in both OLS and 2SLS models, in terms of the sign and significance of coefficients. Specifications (1) and (2) of table 4.5 show that institutional incongruence has a significant and positive overall impact on the size of the informal economy[60] at less than 1% of significance, but exerts a negative impact in those countries with a high performance in controlling corruption at less than 5% of significance. The significance and positive sign of the interaction term show the substitution effect of institutional incongruence and governance performance on the informal economy. Based on the coefficient of INCONGRUENCE (-1.341) and the coefficient of the interaction term INCONGRUENCE*CONTROL_OF_CORRUPTION22 (1.173), the aggregate effect of institutional incongruence on the size of the informal economy in those countries with the

[60] See footnote 59 for explanation.

Table 4.5: Regression results: The impact of institutional incongruence on the size of the informal economy in 45 countries, considering government performance

Dependent variable: Informal economy (IE) (log)	OLS	2SLS	OLS	2SLS	OLS	2SLS
	q=2	q=2	q=3	q=3		
	(1)	(2)	(3)	(4)	(5)	(6)
INCONGRUENCE	-1.341***	-2.022***	-1.534***	-2.326***	-2.073	-7.687**
	(0.357)	(0.572)	(0.376)	(0.726)	(1.268)	(3.402)
INCONGRUENCE*					0.549	2.764**
CONTROL_OF_CORRUPTION					(0.520)	(1.363)
CONTROL_OF_CORRUPTION					-0.447	-1.761**
					(0.307)	(0.832)
INCONGRUENCE*	1.173**	1.849**				
CONTROL_OF_CORRUPTION22	(0.529)	(0.767)				
CONTROL_OF_CORRUPTION22	-0.626*	-0.964*				
	(0.310)	(0.509)				
INCONGRUENCE*			1.485***	2.230**		
CONTROL_OF_CORRUPTION23			(0.511)	(0.893)		
INCONGRUENCE*			0.673	1.494		
CONTROL_OF_CORRUPTION33			(0.761)	(1.379)		
CONTROL_OF_CORRUPTION23			-0.793***	-1.220**		
			(0.265)	(0.559)		
CONTROL_OF_CORRUPTION33			-0.559	-1.021		
			(0.365)	(0.874)		
DEVELOPED dummy	-0.830***	-0.797***	-0.650**	-0.645***	-0.598**	-0.568**
	(0.181)	(0.161)	(0.246)	(0.191)	(0.288)	(0.260)
URBAN (log)	-0.098	-0.184	-0.005	-0.021	-0.026	-0.151
	(0.112)	(0.144)	(0.101)	(0.147)	(0.094)	(0.179)
LABOR_PARTICIPATION (log)	0.013	-0.172	0.171	0.111	0.031	-0.199
	(0.425)	(0.377)	(0.416)	(0.395)	(0.408)	(0.451)
_cons	4.604**	6.050***	3.703*	4.464**	4.990**	9.718***
	(2.055)	(1.958)	(1.909)	(2.045)	(2.189)	(3.378)
F-statistics of excluded instruments		29.73		13.31		5.76
P-value of overidentification test		0.2352		0.0832		0.5078
N	45	43	45	43	45	43
R^2	0.5892	0.5930	0.6176	0.5813	0.5735	0.4234
p	0.0000	0.0000	0.0000	0.0001	0.0000	0.0001

Robust standard errors are in parentheses; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$; higher values of INCONGRUENCE represents lower degrees of institutional incongruence, or higher degrees of institutional congruence; low incongruence countries are those with INCONGRUENCE > 60% and high incongruence countries are those with INCONGRUENCE <=60%; two instrument variables used in the Two Stage Least Squares (2SLS) estimation are moral value and work value built on the results of the World Values Survey 2005-2008. Work value is the mean of the answers for question V120, asking the respondents to show their attitudes for the statement "Hard work brings success" on a ten-point scale from 1= completely agree to 10=completely disagree. Moral value is the mean of the answers for question V199, asking the respondents to show their attitudes for the statement "Avoiding a fare on public transports" on a ten-point scale from 1= never justifiable to 10=always justifiable.

50% highest governance performance of controlling corruption is -1.341+1.173=-0.168. Although the aggregated coefficient is negative, it is much smaller than the coefficient in the model without considering the substitution effect of institutional incongruence and control of corruption on the size of the informal economy, -0.703 (see specification (8)). These results emphasize the importance of government efforts to enhance its effectiveness and efficiency as a channel to mitigate the unexpected impact of the discrepancy in social attitudes on the boundaries of the informal economy. Specifications (3) and (4) of table 4.5 show that institutional incongruence has an overall positive impact on the informal economy at less than 1% of significance, but exerts a negative impact[61] in those countries with medium and high effectiveness of controlling corruption. However, the negative impact is not significant in the high performance group. Countries with low effectiveness in controlling corruption are treated as reference group, and the coefficient for these countries can be calculated from the other coefficients and remains negative.

Specifications (5) and (6) of table 4.5 present the regression results using the interaction term of institutional incongruence with control of corruption without building dummy variables. The marginal impact of institutional incongruence on the size of the informal economy depends both on the interaction term and institutional incongruence. The cut-off values of CONTROL_OF_CORRUPTION, that is, the value of control of corruption for which ∂(CONTROL_OF_CORRUPTION)/∂(INCONGRUENCE)=0, is 3.77, implying that in approximately a third of the countries in the sample, increased institutional incongruence is associated with the smaller informal economy. The effect of institutional incongruence is not significant in the OLS model with the interaction term of two continuous variables (CONTROL_OF_CORRUPTION and INCONGRUENCE). However, it is statistically significant in the 2SLS model.

I also extend the benchmark model, considering the substitution effect of institutional incongruence and targeted government policies on the size of the informal economy[62]. Due to limited space, the regression results for this model are presented in table 4.6. I create the INITIATIVE_HIGH dummy to denote those countries that take two or more categories of

[61] See footnote 59 for explanation.

[62] The estimation equation now takes the form: $IE_i = \alpha + \beta \cdot CONTROL_i + \gamma \cdot INCONGRUENCE_i + \sum_{k=1}^{q-1} \delta_k (INCONGRUENCE_i \cdot INITIATIVE_{kq_i}) + \sum_{k}^{q-1} \theta_k \cdot INITIATIVE_{kq_i} + \varepsilon_i$

where q=2 and $INITIATIVE_{kq}$=(INITIATIVE_LOW, INITIATIVE_HIGH)

targeted policies and initiatives, and the INITIATIVE_LOW to denote those countries that have less than two initiatives. The interaction term of institutional incongruence and INITIATIVE_HIGH dummy show whether the impact of institutional incongruence on the informal economy depends on the proactivity of the government in the respective group of countries. As the overall trend line is downward sloping, that is, the larger informal economy is observed in those countries with a higher degree of institutional incongruence (or a lower value of INCONGRUENCE), the impact is expected to be positive (in signs) in those countries with a high number of initiatives. Therefore, the expected sign of the interaction term is positive. The dummy INITIATIVE_LOW is not included in the regression and treated as a reference group.

Table 4.6: Regression results: The impact of institutional incongruence on the size of the informal economy in 45 countries, considering targeted government policies

Dependent variable: Informal economy (IE) (log)	OLS	2SLS
	q=2	q=2
	(1)	(2)
INCONGRUENCE	-0.925**	-1.831***
	(0.391)	(0.554)
INCONGRUENCE*INITIATIVE_HIGH	2.217***	3.084***
	(0.700)	(1.110)
INITIATIVE_HIGH	-1.802***	-2.284***
	(0.475)	(0.725)
GDPPC (log)	-0.155**	-0.150
	(0.058)	(0.053)
URBAN (log)	0.039	-0.005
	(0.171)	(0.159)
LABOR_PARTICIPATION (log)	-0.418	-0.543
	(0.396)	(0.378)
_cons	6.811***	7.967***
	(1.904)	(1.870)
F-statistics of excluded instruments		14.49
P-value of overidentification test		0.7221
N	45	43
R^2	0.6065	0.5633
p	0.0000	0.0000

Robust standard errors are in parentheses; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$; higher values of two instrument variables used in the Two Stage Least Squares (2SLS) estimation are moral value and work value built on the results of the World Values Survey 2005-2008. Work value is the mean of the answers for question V120, asking the respondents to show their attitudes for the statement "Hard work brings success" on a ten-point scale from 1= completely agree to 10=completely disagree. Moral value is the mean of the answers for question V199, asking the respondents to show their attitudes for the statement "Avoiding a fare on public transports" on a ten-point scale from 1= never justifiable to 10=always justifiable.

Table 4.6 shows that the results of both OLS and 2SLS regressions support the fourth hypothesis that institutional incongruence exerts a negative impact on the size of the informal economy where government is more proactive and flexible in taking initiatives to restrain or support the growth of the informal economy while the overall impact is positive[63]. The aggregated effect of institutional incongruence on the informal economy in the INITIATIVE_HIGH countries is calculated by adding the coefficient of INCONGRUENCE (-0.925) and that of the interaction term, INCONGRUENCE*INITIATIVE_HIGH, 2.217. The aggregated effect (-0.925+2.217=1.292) is strong and positive. The F-test of excluded instruments and the P-value of overidentification test, 14.49 and 0.7221, respectively, and the statistically significant coefficients of the instrument variables, all support the validity of the instruments in the 2SLS regression.

Table 4.7 presents a supplementary check of robustness. I build another variable of institutional incongruence, the INCONGRUENCE3 variable, which is measured by the percentage of the population selecting up to point 3 on a 10-point scale from 'never justifiable' to 'always justifiable' for question V200 in the WVS 2005-2008, with the high percentage representing a general trend of bias against tax cheating and the less incongruent perceptions of the illegitimacy of the informal economy by the government and actors. In general, the results of the models using INCONGRUENCE3 as the main independent variable are consistent with those of the model using INCONGRUENCE. However, when CONTROL_OF_CORRUPTION is controlled for, the coefficients of INCONGRUENCE3 is of negative but significant at 11.9% in specification (5). It is also insignificant in the 2SLS regression of specification (6)[64]. However, specifications (7) and (8) show that the impact of institutional incongruence on the informal economy in those countries with high governance performance of corruption is significant. Although the aggregated impact of institutional incongruence on the size of the informal economy (-1.714+1.407=0.307) is negative, but it is

[63] See footnote 59 for further explanation about the sign of impact.

[64] It should be noted that we use two different instrumental variables, moral value index and cloud coverage, for the 2SLS regressions using INCONGRUENCE3 as the independent variable. One instrument in the model of INCONGRUENCE, work value, is no longer statistically significant in the robustness test. Moral value is a 10-point scale index built on two questions of the World Values Survey 2005-2008, V198 and V199, asking the respondents to show their attitudes for the statement "Claiming government benefits to which you are not entitled" and "Avoiding a fare on public transports" on a ten-point scale from 1= never justifiable to 10=always justifiable. Cloud coverage (percentage) is measured by Mitchell et al. (2004). These instrumental variables are also employed by Torgler and Schneider (2007).

Table 4.7: Robustness check: The impact of institutional incongruence on the size of the informal economy in 45 countries

Dependent variable: Informal economy (IE) (log)	OLS Low incongruence	OLS High incongruence	OLS	2SLS	OLS	2SLS	OLS[a]	2SLS	OLS	2SLS	OLS	2SLS
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(9)	(10)
INCONGRUENCE3	4.378**	-2.163**	-0.913*	-1.515*	-0.805	-0.952	-1.714**	-2.423**	-0.642	-0.875	-1.050**	-1.354*
	(1.917)	(0.913)	(0.470)	(0.796)	(0.506)	(0.792)	(0.013)	(1.205)	(0.508)	(0.698)	(0.510)	(0.760)
CONTROL_OF_CORRUPTION					-0.329***	-0.326***						
					(0.067)	(0.073)						
INCONGRUENCE3* CONTROL_OF_CORRUPTION22							1.407	1.824*				
							(0.103)	(0.960)				
CONTROL_OF_CORRUPTION22							-1.154**	-1.375**				
							(0.025)	(0.585)				
INITIATIVES									-0.205***	-0.200***		
									(0.074)	(0.071)		
INCONGRUENCE3* INITIATIVE_HIGH											1.961***	2.152**
											(0.696)	(1.064)
INITIATIVE_HIGH											-1.642***	-1.756**
											(0.479)	(0.697)
GDPPC (log)			-0.230***	-0.222***					-0.138**	-0.138**	-0.141**	-0.136**
			(0.064)	(0.052)					(0.059)	(0.055)	(0.055)	(0.053)
URBAN (log)	-0.546**	-0.352*	0.055	0.047	-0.024	-0.026	-0.286*	-0.295*	0.027	0.024	0.015	0.010
	(0.225)	(0.174)	(0.249)	(0.175)	(0.120)	(0.160)	(0.061)	(0.175)	(0.169)	(0.160)	(0.149)	(0.154)
LABOR_PARTICIPATION (log)	-0.847*	-0.111	-0.205	-0.190	0.052	0.052	-0.386	-0.341	-0.289	-0.281	-0.302	-0.279
	(0.467)	(0.469)	(0.416)	(0.407)	(0.385)	(0.411)	(0.335)	(0.458)	(0.409)	(0.383)	(0.398)	(0.371)
_cons	4.890	6.810**	6.486***	6.880***	4.715**	4.832**	7.500***	7.899***	6.274***	6.428***	6.587***	6.723***
	(3.414)	(2.662)	(2.217)	(2.031)	(1.993)	(2.113)	(0.001)	(2.310)	(2.018)	(1.917)	(1.864)	(1.787)
F-statistics of excluded instruments				16.79		16.36		12.39		15.38		1489
P-value of overidentification test				0.7453		0.8364		0.9464		0.5224		0.2825
N	20	25	45	45	45	45	45	45	45	45	45	45
R^2	0.3580	0.2917	0.4738	0.4590	0.4800	0.4791	0.3310	0.3177	0.5764	0.5742	0.5840	0.5807
p	0.0011	0.0650	0.0000	0.0000	0.0000	0.0000	0.0013	0.0090	0.0000	0.0000	0.0000	0.0000

Robust standard errors are in parentheses; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$. [a] reports the P-value of the t-test.

Higher values of INCONGRUENCE3 represent lower degrees of institutional incongruence, or higher degrees of institutional congruence.

Low institutional incongruence countries are those with the 50% highest congruence between government and citizens about the legitimacy of informal economic activities, and high institutional incongruence are those with the 50% highest congruence. Two instrument variables used in the Two Stage Least Squares (2SLS) estimation are moral value index and cloud coverage. Moral value is a 10-point scale index built on two questions of the World Values Survey 2005-2008, V198 and V199, asking the respondents to show their attitudes for the statement "Claiming government benefits to which you are not entitled" and "Avoiding a fare on public transports" on a ten-point scale from 1= never justifiable to 10=always justifiable. Cloud coverage (percentage) is built by Mitchell et al. (2004).

much smaller than the impact without controlling for CONTROL_OF_CORRUPTION, -1.233. These findings highlight the substitutive effect of institutional incongruence and control of corruption on the size of the informal economy.

Table 4.7 also presents the regression results of the relationship between INCONGRUENCE3 and the informal economy, considering government initiatives in specifications (9) and (10). There is no difference between this model and the one using INCONGRUENCE as the independent variable. In general, both support the fourth hypothesis that institutional incongruence exerts a negative impact on the size of the informal economy where government is more proactive in taking initiatives targeting the informal economy while the overall impact is positive[65]. The aggregated effect of institutional incongruence on the informal economy in the INITIATIVE_HIGH countries is calculated by adding the coefficient of INCONGRUENCE (-1.050) and that of the interaction term, INCONGRUENCE*INITIATIVE_HIGH, 1.961. The aggregated effect (-1.050+1.961=0.911) is strong and positive. The F-test of excluded instruments and the P-value of overidentification test, 14.89 and 0.2825, respectively, and the statistically significant coefficients of the instrument variables, all support the validity of the instruments in the 2SLS regression.

4.4.3. Discussion

Managing tensions between the state and the informal economy: From paradox lens to systems lens

The introduction of this chapter has pointed out some limitations of the paradox lens as a tool to manage the tension between the state and the informal economy. In particular, governance based on paradox lens might make the informal economy disconnected with the national economy and increase institutional incongruence. The empirical analysis in 45 developed and developing countries has found that the relationship between institutional incongruence and the informal economy is heterogeneous and subject to the degree of informality perception incongruence, governance performance, and initiatives to minimize the incongruence. The case study of targeted policies and initiatives in these countries has shown a change in attitudes of the government and society towards the legitimacy of the informal economy. Many countries do not increase sanctions nor invest in detection technology to control the

[65] See footnote 59 for further explanation about the sign of impact.

informal economy, but they have taken various initiatives to prevent the participation in informal income-generating activities or support the transition of informal enterprises and workers to the formal economy and seek to improve their competitiveness after their transformation. Among supporting initiatives, campaigns with the participation of both the state and citizens are conducted to change social attitudes towards the informal economy.

Table 4.8: The informal economy from paradox lens and systems lens

Paradox Lens		Systems Lens
Institutionally incongruent	**Perception**	Institutionally congruent
The juxtaposition of contradictory systems	**Organization**	An open multilevel system
Illegal and/or unregulated	**Legality**	Legal and regulated
Illegitimate	**Legitimacy**	Legitimate
Relying on formal institutions to solve the tension between the state and the informal economy	**Dealing with tension**	Relying on both formal and informal institutions to solve the tension between the state and the informal economy through
An excluded part of the national economy	**Identification**	An integrated part of the national economy
Private order	**Governance**	Public order
Few Mainly based on deterrence/prevention/ignorance	**Targeted policies**	Diversified A combination of various tools (deterrence, prevention, campaigns, and transition and growth support)
Policy making is not associated in a change in thinking	**Behaviour to change**	Proactively coming up with new ideas, concepts, techniques, and tools in response to a change in thinking in policy-making
Large size	**Informal economy**	Small size

This is a shift from viewing the informal economy with a paradox lens as a contradictory system coexisting with the formal economy in its own order to the use of the systems lens which considers the informal economy as a subsystem in an open multilevel system. Systems thinking is defined as an approach to solving problems by viewing the problems as parts of a whole complex system rather than reacting to specific parts or outcomes (Forrester 1961, Simon 1979, 1982, Checkland 1981, Perrow 1984, Senge 1990). Systems thinking has been studied in many sciences, including management and organization sciences. From systems lens, poor governance, organizational failure, and mal-adaptation to change are caused by the discrepancy between limited cognitive skills of individuals and the complexity of the systems they are supposed to manage. This is what we observe the variation in the density and diversity of targeted government policies and initiatives for the informal economy associated with a change in applied thinking underlying those policies in 45 developed and developing countries. Those countries that are successfully adaptive to a change in the perception of the role of the informal economy in the national economy also have a small size of the informal economy. A summary of the difference in the boundaries of the informal economy and targeted government policies in two groups of countries – those adopting a paradox lens and those with a systems lens – found from the case study and empirical analysis is presented in table 4.8. It suggests that the systems thinking might effectively deal with the tension between the state and the informal economy and should be the basis for making targeted policies for the informal economy, particularly in those countries with large informal economies in the percentage of the GDP and/or the labour force.

4.5. CONCLUSION

This chapter has made a first attempt to deal with the relationship between institutional incongruence - or the discrepancy in how the state and economic actors perceive what economic activities are legal and/or legitimate and what are not - and the informal economy. I hypothesized that the participation in informal income-generating activities is only an expression to institutional incongruence (supporting the complementary relationship between institutional incongruence and the informal economy), but institutional incongruence and the informal economy are substitutes in those countries with low incongruence, effective control of corruption, and diversified targeted government initiatives. The empirical findings are more or less in line with these hypotheses, although the results depend to some extent on how institutional incongruence is measured.

The findings of this chapter contribute to the lack of comparative institutional literature in the investigation of the relationship between informal institutions and economic development in general and that between institutional incongruence and the informal economy in particular. The policy implications of this chapter is obvious: institutional incongruence, in general, has a complementary effect on the size of the informal economy, but acts as a substitute in those countries with a low level of incongruence or with good governance of corruption or with high proactivity in taking initiatives to minimize the perception gap about the legitimacy of the informal economy. Finally, I also discussed the implication of the findings for the future of the informal economy, which will necessarily become more integral to the national economy through a change in the philosophy of policy makers concerning the informal economy from a paradox lens to a systems lens.

APPENDIX

Table A4.1: Case study summary: Changes in government policies towards the informal economy before 2007[66]

Country	Targeted government policies and initiatives	Sources
ARG	1. A single tax has replaced VAT, income tax, and social security contributions in 1998. 2. Special Social Security Regime for Domestic Employees in 2005 3. Registering workers: National Program for Employment Regularization (PNRT), Program for the Simplification of Employment Registration 4. Identifying tax obligations by means of online platforms	Bertranou et al. (2013)
AUS	1. The Cash Economy Task Force in Australia: education campaigns 2. Tax reform: The New Tax System- Australian Business Number to curb the informal economy. 3. Voluntary disclosure schemes 4. Automatic data matching 5. The Taxation Office operates two telephone lines for tax evasion detection	ATO (1998), Bajada (2002)

[66] A long version of case studies in 45 countries will be provided on request.

	6. The latest internet-based technologies are utilized to facilitate the face-to-face interactions between government officials and entrepreneurs. 7. Interest and fines up to 110% are applied for detected informal actors.	
BRA	1. The Integrated System of Taxes and Contributions for Micro and Small Enterprises (SIMPLES) implemented in 1997 unifies the collection of federal tax payments and social security contributions.	Capp et al. (2004)
BUL	1. Mandatory registration of individual employment contracts and minimum social insurance thresholds was introduced by the government in 2003 2. The national "From social assistance to employment" programme 3. Improve the protection of fundamental employment rights for workers without contracts.	Tomev (2004)
BFA	1. Informal Sector Support Fund (FASI) 2. Employment Promotion Support Fund (FAPE) 3. Department on Support and Monitoring of the Informal Sector in the Ministry of Youth and Employment 4. Vocational training 5. The Private Sector Development Policy Letter 6. The Burkina Faso House of Enterprise (MEBF) created in 2002 supports project promoters in formalizing their business through Enterprise Formality Centres (CEFORE).	Burkina Faso (2007)
CAN	1. Underground Economy Initiative was launched in 1993. 2. Voluntary disclosure policy 3. Local and regional hotlines 4. Regular use of data matching 5. Impose a penalty of up to C$ 25,000 for failing to file a tax return and sentence an individual to a jail term of up to five years. 6. The Revenue Agency uses various ways to educate people and	Bajada (2002)

	businesses about their tax obligations. 7. The Tax Alert initiative launched in 2005. 8. National awareness advertising campaign – 'Get it in Writing'.	
CHL	1. Strengthen tax administration and reduce compliance costs 2. Simplify procedures for business registration and local regulations 3. Strengthen sanctions for non-compliance 4. Electronic invoicing, starting and closing a business 5. Training programmes such as Programa de Nivelación de Competencias Laborales and Escuela Taller	Contreras (2008)
CHN	1. "Informal Labour organisations" and "employment service organisations" schemes initiated in Shanghai 2. Special protective measures and policies such as social insurance, training opportunities for employers and employees working in the informal economy, preferential tax policies, risk insurance and credit support with the City Employment Promotion Fund.	Howell and Singh (2002)
COL	1. Business Service Centers (Centros de Atención Empresarial, CAE): business registration in one step, one day, one place, with one interaction, one prerequisite, and at a minimum cost from 2001.	Oviedo (2009)
CYP	1. The Assessment and Collection of Taxes (Amending) Law 135 (I)/2005 2. Introduce penalties for the late submission of tax returns and for the non-payment of taxes.	Christofides (2007)
EGY	1. Productive Families Scheme (PFS) 2. Small Enterprise Development Organization (SEDO) 3. Community Development Programme (CDP) 4. National Bank for Development (NBD) 5. The Credit Guarantee Corporation (CGC)	Mahdi (2002), Williams and Renooy (2008)
ETH	1. Support the creation of micro activities through FEMSEDA entrepreneur training, the Dire Dawa REMSEDA, the Addis	Gurtoo and Williams (2009)

	Ababa weavers' training project, and technical vocational education and training (TVET) systems to informal economy needs. 2. Simply registration and licensing procedures, revise investment law, and create new support agencies at the regional and national level.	
FIN	1. The 'tax credit for domestic help' scheme 2. Tax allowance for household services 3. Obligatory personal ID in construction 4. Transitory restriction on free movement of workers	Williams and Renooy (2008)
FRA	1. Coordinated strategy against undeclared work 2. Universal service employment cheque 3. Enterprise service employment voucher 4. Tax incentives 5. Campaigns 6. Partnership arrangements 7. Active Labour market programmes (including wage and employment subsidies, tax credits, training and retraining, help with job search, provision of Labour market information and integrated employment services (one-stop shop)) 8. National Committee on Combating Undeclared Work 9. Sanctions have also been strengthened.	Williams and Renooy (2008)
GEO	No initiatives	
GER	1. Lower tax and insurance for low-wage employees 2. Start-up premium 3. A Mini-job Centre: the registration of mini-jobs and the collection of contributions. 4. Social partner agreements to fight undeclared work 5. Public subsidy for entrepreneurial business start-ups 6. Tax enforcement unit for undeclared work	Williams and Renooy (2008)
GHA	1. The Ghana Skills Development Initiative (GSDI) 2. UT Bank, based in Accra, was set up to cater to the financial needs of smaller businesses in Ghana, including those	UT Bank

	operating as part of the informal economy.	
GB	1. VAT Incentive Scheme 2. Community Links' approach to undeclared work 3. Construction Industry Scheme 4. Hartlepool 'informal to formal' pilot project 5. Street UK 6. HM Revenue & Customs' campaign 7. Gangmasters Licensing Authority 8. Gangmaster licensing awareness campaign 9. Joint Shadow Economy Teams, Joint Fashion Industry Teams 10. Test-trading scheme	Williams and Renooy (2008)
GUA	No initiatives	PILAR (2009)
IND	1. Special tax regime for small businesses 2. Voluntary Disclosure Scheme (Amnesty Scheme) 3. Administrative support 4. Infrastructural facilities and services 5. The National Commission for Enterprises in the Unorganised Sector (NCEUS) 6. Recognize some services such as TV repair and auto repair as formal economic activity	Kundu (1999), Gurtoo and Williams (2009), Gurtoo (2009)
IDN	1. The National Social Security System Act 2. The Tripartite Decent Work Country Programme for the period 2004-2005 3. Street Vendor Management program was introduced in 2005.	Angelini and Hirose (2004), Mishra (2010)
IRA	1. Enforce tax payments by ranking Iranian families by three clusters and data matching	NikopThe (2003)
JPA	1. National Pension Scheme 2. Acknowledge certain petty traders, small producers and a range of casual jobs as formal income-generating activities 3. The ILO/Japan Multi-bilateral Programme 4. Low tax and regulatory burden	Alter Chen et al. (2001), Georgiou (2007)
JOR	1. The Development and Employment Fund (DEF) 2. Labour substitution incentives	Charmes (2010)

	3. Micro-credit schemes 4. Programmes of expansion of social security coverage	
MAL	No initiatives	Xavier (2008)
MLI	No initiatives	
MEX	1. The Fast-track Business Creation System (Sistema de Apertura Rápida de Empresas, SARE)	Oviedo (2009)
MOL	No initiatives	ILO (2008)
MOR	No initiatives	
NET	1. Tax and social security incentives: Regulation of domestic work 2. Tax incentives: The Tant Agaath-Regeling ('Rich Aunt Agatha' Arrangement) 3. The Decision 'Social Security Self-Employed' 4. The 'Melkert Plan', a programme was implemented in 1998 to subsidise the wages of declared domestic cleaners 5. Cleaning Services for Private Persons Arrangement 6. Active Labour market programmes 7. Agreements requiring employers to use only genuine temporary employment agencies 8. Reductions in the burden of administration and sanctions	Williams and Renooy (2008)
NEZ	1. Increase sanctions 2. Change social attitudes 3. Use the latest internet-based technologies to improve the face-to-face interactions between government officials and entrepreneurs 4. Committee on the Informal Economy 2002	Bajada (2002)
POL	1. Employment of migrant workers without work permits 2. First Job programme 3. Voluntary Work Teams 4. Amnesty for illegal migrants 5. First Business programme 6. Employment legality controls 7. Regulations for legalising domestic work	Williams and Renooy (2008)

ROM	1. Builders' Social Fund 2. Sectoral campaigns of the Labour Inspectorate 3. Employment subsidies, non-reimbursable loans and reduced social security contributions 4. A flat tax rate, the reform of the Labour code, and a higher minimum wage 5. National campaigns against informal work	Preda (2004), Parlevliet and Xenogiani (2008), Williams and Renooy (2008)
RUF	1. Introduce a tax reform in 2001	Williams and Rodgers (2012)
RWA	No initiatives	National Employment Policy of Rwanda (2007)
SAF	1. Provide premise and business supporting services to the garments sector 2. Informal Economy Policy, targeting street traders 3. The Small Business Project in South Africa 4. Accelerated and Shared Growth Initiative South Africa (ASGISA): strategies targeting the regulatory environment which relates to informal economy issues 5. Technical vocational education and training (TVET) systems 6. The Skills Development Act, Skills Education Training Authorities (SETAs)	Kenyon (2007) De Ruiter (2009)
SWI	1. Intensify its fight against moonlighting – a Swiss term of the informal economy 2. Enforce sanctions, simplify registration with tax and social security agencies 3. Campaigns to increase social commitment to avoiding moonlighting	Schneider (2011)
THL	No initiatives	
TRI	1. Government's Policy Framework for Sustainable Development 2. Micro-finance, micro-credit, and micro-enterprise development 3. Skills Development Programmes, the National Employment	Artana et al. (2007)

	Service (NES), and the On-the-Job-Training (OJT) Programme.	
TUR	1. Tax reforms 2. The Ministry of Labour coordinates with the police to grant work permits 3. Extend social security to own-account workers 4. Amnesty for regularisation	Williams and Renooy (2008), Dayioglu and Hakan (2009)
UKR	1. The State Program of Deshadowization of Ukrainian Economy (Program) in 2000; The Main Principles of Bringing Money Circulation Out of the Shadows in 2001 2. Increase sanctions	
US	1. Simplified procedures and a voluntary disclosure system 2. The 'offer in compromise' enables revenue departments to accept a compromise on previous undeclared earnings 3. Enforce administrative penalties 4. Improve data matching 5. Tax helplines	Nightingale and Wandner (2011)
URU	No initiatives	
VNM	No initiatives	Cling et al. (2010)
ZAM	No initiatives	

Source: Williams and Renooy (2008) for several European countries and the author's content analysis of publications (including reports, journal articles, working papers, and case studies published by international organizations (i.e., International Labour Organization (ILO), the World Bank, the International Monetary Fund (IMF), the Organization of Economic Cooperation and Development (OECD), European Commission, the United Nation (UN), European Employment Observatory (EEO), or Eurofound), national labbour and regulatory administrative agencies and scholars with their articles identified with ABI Inform and Emerald search engines in their databases (i.e., Proquest, EBSCO, Elsevier Science, Emerald, and Science Direct)) .

Sample: 49 countries

Argentina (ARG), Australia (AUS), Brazil (BRA), Bulgaria (BUL), Burkina Faso (BFA), Canada (CAN), Chile (CHL), China (CHN), Colombia (COL), Cyprus (CYP), Egypt (EGY), Ethiopia (ETH), Finland (FIN), France (FRA), Georgia (GEO), Germany (GER), Ghana (GHA), Great Britain (GB), Guatemala (GUA), India (IND), Indonesia (IDN), Iran (IRA), Japan (JAP), Jordan (JOR), Malaysia (MAL), Mali (MLI), Mexico (MEX), Moldova (MOL), Morocco (MOR), Netherlands (NET), New Zealand (NEZ), Poland (POL), Romania (ROM), Russian Federation (RUF), Rwanda (RWA), South Africa (SAF), Switzerland (SWI), Thailand (THL), Trinidad and Tobago (TRI), Turkey (TUR), United States (US), Ukraine (UKR), Uruguay (URU), Vietnam (VNM), Zambia (ZAM).

GENERAL CONCLUSION

The introduction of this dissertation has proposed three issues of governance that are mostly neglected in mainstream economics paradigms: the lack of empirical studies of informal governance institutions, the interdependence of formal and informal institutions, and the impact of informal institutions on the adjustment of the economic political order.

I believe that the four chapters of the dissertation have contributed elements of answers to above questions. Chapter 1's conceptual framework of the dynamics of informal governance institutions strongly supports the view that formal institutions are not sufficient to achieve economic success, but they should be embedded into existing informal institutions in order to be successfully enforced. Understanding the nature of the relationship between formal and informal institutions will certainly be helpful in designing institutions that are conducive to economic growth in the next stage of reforms.

Chapter 2 attempts to evaluate the mutual effect of formal and informal dimensions of administrative decentralization on the quality of local government in 64 provinces in Vietnam during 2006-2008. The empirical analysis in this chapter shows that there is no evidence of the complementary or substitutive relationship between formal and informal decentralization over the past two decades since this institutional reform took place. Instead, the formally decentralized system of public goods and service provision accommodates the informal one, and informal decentralization in public order provision tends to compete with the existing and ineffective formal system, particularly in the area of the protection of property rights, enforcement of contracts, transparency and reduction of corruption. The findings of this chapter imply that Vietnam's economic reforms in the next stage should give priorities to improving the effectiveness of legal procedures and rules, making informal institutions complementary rather than rivalrous with or free riding on weak formal institutions.

Chapter 3 has shown how the adjustment of the economic political order takes place in the multilevel organization of providing public order and public goods and services from the central level to local level of government in Vietnam. Under decentralization, the followed-up institutional fragmentation and competition between sub-central governments seem to lead to race to the bottom when many national issues are addressed in an ad hoc and dissonant manners. The case study of Vietnam's accountability system and empirical analysis of all legal documents made by 35 provincial governments of Vietnam published in their Official Gazettes from 2006 to 2009 show that some provincial governments are more proactive and

responsive to local needs than the others, even when they have to violate central rules and regulations. The empirical analysis both in this chapter and chapter 2 has supported the argument that formal mechanisms alone are not sufficient to create incentives for public actors to make private efforts to full accountability. It should be accompanied with other informal ones to fill in accountability deficits of the formal system. In this chapter, some informal alternatives of accountability mechanisms such as identity-based and performance-based mechanisms are suggested to be tactfully incorporated into the kit of governance strategies to achieve higher accountability and efficiency.

Chapter 4, similar to earlier chapters, continues to contribute to the lack of comparative institutional literature in the investigation of the relationship between informal institutions and economic development in general and that between institutional incongruence and the informal economy in particular. The empirical analysis of 45 developed and developing countries finds that institutional incongruence, in general, has a complementary effect on the size of the informal economy, but acts as a substitute in those countries that have a low level of incongruence, good governance of corruption or high proactivity in taking initiatives to minimize the perception gap about the legitimacy of informal economic activities. This findings show that those countries that have the small informal economy are changing their attitudes towards informal economic actors, seeking to integrate them into the national economy and making more targeted policies to support their competitiveness.

All of the four chapters of this dissertation lead to an interesting implication of an adjusting economic political order: the important role of informal institutions endogenously evolved to support the well-functioning of the formal institutional frameworks. The economic success of some emerging countries such as China or Vietnam, where institutions of economic governance of democratic and advanced countries are absent or just recently informally acknowledged to limited extent, and the failure of other developing countries transplanting the recipes of the US and international institutions imply the need to adjust the economic political order. Changes in the attitudes and policies of governments around the world towards the informal economy are partly contributing to the shift of the economic political order. It should be noted that informal institutions are not sustainable, so they are only considered as a strategy of partial institutionalization.

However, this dissertation has just analyzed the adjustment of the economic political order at the macro level. It still leaves the question of adjusting the political economic order at the microeconomic level open to future research.

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