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Course 11.946  
Reading Response # 8

**Questions:** *What are some of the important characteristics of the ways that firms and local government interact that are productive for economic development?*

The articles for this week's class clearly point to the importance of an affable relationship between firms and governments (local or national) because of the potential impact of stimulating economic development. In my opinion, there is a set of three key institutions that should be kept healthy in order to create speedy economic development. Governments and private firms are an important part of this development triangle and the third is civil society, which although not explicitly cited in these articles are nevertheless implicitly linked in the chain towards economic development. For the purpose of this assignment, I have synthesized three characteristics from the articles in answer to this week's reading assignment. The first characteristic is a good dose of social capital, especially the element of mutual trust and honesty that should oil relations between these three institutions. A balance of power in the political systems is the second and the third is transparency and efficiency in government operations.

All the articles highlight the mutually supporting relationship between firms and governments. Governments depend on the tax revenue from firms in order to provide adequate social services and capital infrastructure. Firms on the other hand need a stable environment with in which they can conduct their operations with some predictability. Uncertainty in the operational environment is a threat to any private investment initiative. This is why a great deal of mutual reinforcement between governments and firms is crucial to economy development. This is the main argument in Benno Torgler, article on "Tax Morale in Transition Countries". He hinges his essay on the intrinsic motivation for firms to pay taxes. In his view trust is the key factor that influences tax moral. According to him the best demonstration of this trust can be seen in how strong institutional controls and accountability are. He argues "institutions provide reduction of uncertainty by designing the structure of interaction". He also notes "if government tries to generate trust with well-functioning institutions, co-operation can be initiated or increased". Put in another way, if firms trust the government and the legal system, then the more they are willing to support the government not only by honoring their tax obligation but also by increasing their level of investment. Torgler illustrates this fact in his research by revealing that in Central and East European countries, trust in the government and legal system has created a higher tax morale because reforms in those countries have progress much faster than in Former Soviet Union countries where reforms are slower and hence tax morale lower. Also, in explaining the growing size of the unofficial economy, Johnson, Kaufmann, MacMilliam, and Woodruff also point out the inadequacy of the institutional environment as a key factor.

Torgler also raises the issue of transparency and efficiency with which government agencies conduct business as another characteristics that can define how interaction between the government and the private firms can help spur economic development. He mentions for example the high transaction costs in registering a business as a case of government inefficiency. Such inefficiencies in the form of what he calls “over-government” or “under-government” reduces the incentive for investment and lead to high level of a shadow economy. He recommends that governments should concentrate on developing systems (for example tax system) that facilitates rather than complicate compliance.

Johnson, Kaufmann, McMillian and Woodruff agree with Torgler in their article about the need for transparency and efficiency in government operations. They reviewed reasons given in current literature on why firms operate in the unofficial economy and emphasized amongst other reasons two important factors that point to the lack of transparency and efficiency in governments. One, official regulations are usually onerous and two, the high level of predator behavior by government officials (in the form of bribes). The authors found evidence in their empirical studies to support these claims.

The balance of power in the political system comes out heavily in the Vladimir Gel'man's article on Local autonomy in Russia. The case of balance in the political system is crucial to ensure that no one individual or group of individuals can control the machinery of state power to the exclusion of other groups, thereby creating instability. Vladimir uses a case of two cities, Saratov and Pskov in Russia to prove his point. Gel'man's showed that Pskov succeeded in political autonomy due to competitive voting for the political machinery where as Saratov failed to achieve autonomy because non competitive voting resulted into a zero-sum game to the benefit of the governor, Ayatskov. Gel'man's point is that a competitive political privilege is possible only to the extent that they are allowed by local autonomy and he encapsulates this point as follow: “The formation of local autonomy not only depends upon the emergence of local democracy, but also strengthens it. The lesson here is that because cities are mediators of economy development to the rest of the country, the more stable they are politically the better their ability to attract investment or stimulate innovation.

To conclude, a balance in the political system that ensures confidence in the institutions, for example the legal system, and the commitment of government officials to be transparent and efficient encourages and strengthens a better private sector engagement that eventually lead to a healthy economic development agenda.