

Institutions and Development

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I Unbundling of Institutions

It is now common in the institutional economics literature to define institutions in the very general sense of rules of structured social interaction. In any society there is, of course, a plethora of such rules (including those that undergird even a so-called free market economy). In the context of economic development the focus is on those rules that act as a substitute for missing markets in an environment of pervasive risks and severe transaction and information costs that individuals and groups face in their economic transactions with others. In the literature on rural development at the micro-level there have been many attempts to understand institutions like land tenure, informal arrangements for credit and risk-sharing, and interlocking of credit contracts with those for future delivery of labour services or output, in the context of missing credit, insurance and futures markets and imperfect enforceability of various formal contracts. (For an overview of some of the major theoretical issues in this literature and empirical references, see Bardhan and Udry, 1999.) Radical economists have often cited some of these production relations in a poor agrarian economy as institutional obstacles to development; but if we carry out a programme of abolishing them without paying attention to their micro-economic functional rationale, we may not always help the intended beneficiaries of such programmes. Merely abolishing land tenancy by legislation, for example, often drives tenancy underground or leads to pre-emptive eviction. On the other hand, understanding an institution in terms of its functional role under a given set of constraints, is neither to condone the constraints nor to claim

an adequate explanation of the mechanism of the historical emergence of the institution-- something that some institutional economists have not always been careful about.

In the recent literature (see Acemoglu, Johnson and Robinson, 2002 and Rodrik, Subramanian and Trebbi, 2002) there have been some interesting attempts to quantify the effects of institutional quality on economic performance at the macro level, using cross-country statistical analysis, and to determine the relative importance of geographical as opposed to institutional factors in explaining differential economic performance in different parts of the world. Those who emphasise geography as destiny, more than institutions, point to the disease environment of the tropics, types of crops and soil, transportation costs, etc. which afflict many of today's poor countries. But others point out that many such geographically handicapped countries were relatively rich in 1500 (the Moghal, Aztec, and Inca empires occupied some of the richer territories of the world in 1500; Haiti, Cuba, and Barbados were richer than the US in early colonial times). This 'reversal of fortune' obviously has more to do with colonial history and the legacy of extractive institutions put in place.

In much of this literature the institution that is emphasised most in explaining differential economic performance is that of ensuring security of private property rights against the predatory state or other marauding individuals and groups. The empirical literature has tried to quantify the effect of the property rights institutions - or what is called in this literature the 'rule of law' variable - on economic performance from cross-country aggregative data. Since these institutions may be endogenous (i.e. economically better-off countries may have more of those institutions, rather than the other way round), the literature tries to resolve the identification problem by finding exogenous sources of variations in those institutions.

What is often ignored in this literature is that the ‘rule of law’ involves actually a whole bundle of rights, and we need to ‘unbundle’ it. For example, one part of ‘rule of law’ may involve various democratic rights of political participation, association, mobilisation, and expression of ‘voice’. An analysis of cross-country variations in human development indicators (which includes education or health variables like mass literacy or life expectation) shows that an institutional variable measuring ‘voice’ or participation rights may be just as important as that measuring security of property rights as an explanatory variable—(see Bardhan, 2004, chapter 1). In other words, the part of ‘rule of law’ that refers to democratic participation rights may explain a significant amount of variations in human development indices across countries. Those who emphasise property rights often ignore the effects of participatory rights, and there is some obvious tension between these two types of rights included in the standard package of ‘rule of law’.

II Comparative-Historical Analysis

In contrast to the quantitative empirical literature a comparative-historical analysis of institutions in the development process for Western Europe and North America has been tried by North (1981,1990) and Greif (1992,1997). North has pointed to the inevitable trade-off in the historical growth process between economies of scale and specialization on the one hand, and transaction costs on the other. In a small, closed, face-to-face peasant community, for example, transaction costs are low, but the production costs are high, because specialization and division of labour are severely limited by the extent of market defined by the personalised exchange

process of the small community. In a large-scale complex economy, as the network of interdependence widens the impersonal exchange process gives considerable scope for all kinds of opportunistic behaviour and the costs of transacting can be high. Greif examined the self-enforcing institutions of collective punishment for malfeasance in long-distance trade in the late medieval period and explored the institutional foundations of commercial development, which involved inter-temporal and interspatial transactions among people largely unknown to one another. These often required multilateral reputation mechanisms supported by frameworks of credible commitment, enforcement and coordination.

Many developing countries in the world have a long history of indigenous mercantile institutions of trust and commitment (based on multilateral reputation mechanisms and informal codes of conduct and enforcement) - examples of such institutions of long-distance trade and credit abound among mercantile families and groups in pre-colonial and colonial India, Chinese traders in Southeast Asia, Arab 'trading diasporas' in West Africa, and so on. But these relation-based traditional institutions of exchange in developing countries often did not evolve into more complex (impersonal, open, legal-rational) rules or institutions of enforcement as in early modern Europe. As the scale of economic activity expands, as the need for external finance and managerial talent becomes imperative, and as large sunk investments increase the temptation of one party to renege, relational implicit contracts in traditional clan-based organisations and reputational incentives become weaker. As Li (2003) has pointed out, relation-based systems of governance may have low fixed costs (given the pre-existing social relationships among the parties and the avoidance of the elaborate legal-judicial and public information and verification costs of more rule-based systems), but high and rising marginal costs (particularly of private monitoring) as business expansion involves successively weaker relational links.

A major institutional deficiency that blocked the progress of the mercantile into the industrial economy in many poor countries relates to the financial markets. Even when caste-based or clan-based mercantile firms thrived in their network of multilateral reputation and enforcement mechanisms, the latter were often not adequate for supporting the much larger risks of longer-gestation large sunk-cost industrial investment. These firms, by and large, had limited capacity (either in terms of finance or specialized skills) to pool risks and mobilise the capital of the society at large in high-risk high-return industrial ventures (their own reinvested profits and trade credit from suppliers were not enough).

The usual imperfections of the credit and equity markets emphasised in the literature on imperfect information are severe in the early stages of industrial development. First of all, the investment in learning by doing is not easily collateralizable and is therefore particularly subject to the high costs of information imperfections. At an early stage when firms are not yet ready for the securities market (with its demands for codifiable and court-verifiable information), there is often a need for some support and underwriting of risks by some centralised authority (with, of course, its attendant dangers of political abuse). There is also the problem of interdependence of investment decisions with externalities of information and the need for a network of proximate suppliers of components, services and infrastructural facilities with large economies of scale. Private financiers willing and able to internalise the externalities of complementary projects and raise large enough capital from the market for a critical mass of firms are often absent in the early stage of industrialization. Historically, the state has played an important role in resolving this kind of coordination failure by facilitating and complementing private sector coordination - as the examples of state-supported development banks in 19th-century France, Belgium, and Germany, and more recently in Japan, Korea, Taiwan and China suggest. There are, of course, many

examples of state failures in this respect and politicisation of financial markets in other developing countries.

In general, economies at early stages of development are beset with coordination failures of various kinds, and alternative coordination mechanisms - the state, the market, the community organisations - all play different roles, sometimes conflicting and sometimes complementary, in overcoming these coordination failures, and these roles change in various stages of development in highly context-specific and path-dependent ways. To proclaim the universal superiority of one coordination mechanism over another is naive, futile and a-historical.

III Persistence of Dysfunctional Institutions

Finally, a crucial question in institutional economics is: why doesn't a society discard its inefficient institutions and adapt its legal and institutional set-up to facilitate productivity-enhancing innovations? Such innovations have gainers and losers, but in most cases the gainers could potentially compensate the losers. The problem is that it is politically difficult for the gainers from a change to credibly commit to compensate the losers *ex post*. There may not exist an easy way whereby politicians and powerful social groups could make a deal with the rest of society, giving up some of their control on existing rules and institutions that are inefficient, allow others to choose policies and institutions that bring about improvements in productivity, and then redistribute part of the gains to those politicians and groups. Such deals have severe commitment problems; those in power cannot credibly commit to not using this power in the

process, and others cannot credibly commit to redistribute once the formerly powerful really give up their power for the sake of bringing about new rules and institutions.

A central issue of development economics is thus the persistence of dysfunctional institutions over long periods of time, as we discuss in Bardhan (2004), chapter 2. In particular, the history of underdevelopment is littered with cases of formidable institutional impediments appearing as strategic outcomes of distributive conflicts. Acemoglu and Robinson (2002) develop a theory where incumbent elites may want to block the introduction of new and efficient technologies because this will reduce their future political power; they give the examples from nineteenth century history when in Russia and Austria-Hungary the monarchy and aristocracy controlled the political system but feared replacement and so blocked the establishment of rules and institutions that would have facilitated industrialization. These replacement threats are, of course, often driven by extreme inequality in society.

In explaining the divergent development paths in North and South America since the early colonial times, Engerman and Sokoloff (2002) have provided a great deal of evidence of how in societies with high inequality at the outset of colonization rules and institutions evolved in ways that restricted to a narrow elite access to political power and opportunities for economic advancement. Initial unequal conditions had long lingering effects, and through their influence on public policies (in distribution of public land and other natural resources, the right to vote and in secret, primary education, patent law, corporate and banking law, etc.) tended to perpetuate those institutions and policies that atrophied development. The classic example of inefficient rules and institutions persisting as the lopsided outcome of distributive struggles relates, of course, to the historical evolution of land rights in developing countries. In most of these countries the empirical evidence suggests that economies of scale in farm production are

insignificant (except in some plantation crops) and the small family farm is often the most efficient unit of production. Yet the violent and tortuous history of land reform in many countries suggests that there are numerous road blocks on the way to a more efficient reallocation of land rights put up by vested interests for generations.

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