Institutional Economics of Development:
A Critical Assessment

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Some historical background of institutional economics of development

In this Lecture I shall try to

- **unbundle the complex of institutions important for development, going beyond the narrow focus of the current institutional economics literature on security of property rights**

- **speculate on the processes of institutional change, or *lack* of change, in particular on the central question, in my judgment, of institutional economics of development-- *why do dysfunctional institutions persist over long periods of time***

- **have some discussion of governance institutions and bring out in this context a central dilemma: autonomy vs. accountability**

Our focus all through will be on the role of distributive conflicts in shaping institutions

I

Security of property rights is clearly crucial in maintaining incentives for investment and innovations (examples: trap-setting in hunter-gatherer society, eviction of sharecropping tenant, insider abuse in corporate governance)

But the preoccupation of the literature with the institution of security of property rights, often to the exclusion of other important institutions, severely limits our understanding of the development process

- **The institutions in the standard view have mainly a *constraining* role, constraining the state or other parties from intervening with our property rights. But there are many cases of *enabling* institutions which have a somewhat different role: a community or a state institution may enable many common people to do things which they could not do by themselves in isolation.**

(Echo here of the philosophers' distinction between 'negative' and 'positive' liberty)

  - **Role of participatory institutions (for example, in the management of local environmental resources, or in worker participation in firm management, or in maintaining ethnic networks of trade and long-distance credit)**

  - **Role of coordinating institutions. 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 organizations -- all can play different roles, sometimes conflicting and sometimes complementary, in overcoming these coordination failures, and the need for such mechanisms remain important, even if private property rights were to be made fully secure.**

- **In history, securing property rights for some has often meant dispossessing others (enclosure movement in England, land titling programs in Africa sometimes supplanting traditional farming rights of women, etc.).**

  In South America, in contrast with many parts of North America, property rights in land were often bestowed on people who were politically influential but not necessarily good farmers. This led to polarization and conflicts with poor peasants, which served neither efficiency nor equity.

In general, contract theory tells us that when contracts are incomplete, attempts to enforce private property rights may weaken the mechanisms of prior cooperation among resource users (say, of previously common or weakly-defined property). In particular, a central characteristic of most private property rights is their tradability, and tradability (particularly to outsiders) may undermine the reliability of a long-term relationship among users of a resource.

- **Property rights are sometimes 'too secure' for some, when they are not tempered with regulation of restrictive business practices and entry-deterring investments by incumbents to forestall the entry of potential future producers**

- **In the fast growth of the last three or four decades in East Asian countries, more than formal rule of law and guaranteed security of property rights (which were often rather weak), prudent rulers, though sometimes corrupt and authoritarian, have succeeded in providing for a predictable and durable**

contractual environment for private business to thrive.

II

One of the as yet inadequately resolved issues in institutional economics in the context of underdevelopment is why dysfunctional institutions often persist for a long time. Why doesn't the social evolutionary process select 'fitter' institutions?

In the recent literature on applications of evolutionary game theory to institutional change it is recognized that while efficiency generally contributes to a differential advantage in replication, it is highly unlikely that efficiency and success in replication will always go together, particularly because of

(a) the positive and negative interactions of one institution with other institutions (involving their complementarity and crowding-out) and

(b) that the payoffs to adherence to particular institutions are dependent on adherence by others.

In the new institutional economics literature what is considered to be the major stumbling block to realizing potential gains from institutional change is a *political commitment problem* (particularly in the sense of those in power finding it difficult to commit to not using that power).

In this context North, Weingast, and many others have prescribed a *strong but limited* government—a government that is strong enough to secure property rights, enforce contractual laws and maintain stability, but at the same time it commits not to transgress and make confiscatory demands.

While not denying that such self-binding mechanisms may have played an important role in Western history, I think it is possible to argue that they are neither necessary nor sufficient for economic development.

- **They are not sufficient, as there are other (technological, demographic, ecological and cultural) constraints on the development process, not all of which will be relaxed by the rulers disabling themselves.**

- **They are not necessary, as a few non-Western success stories (Japan since Meiji Restoration, Korea and Taiwan since 1960, coastal China since 1980, etc.) suggest; in most of these cases while the rulers often adopted prudent policies (and sometimes even acquired reputation to this effect), they were far from disabling their discretion.**

One has to be careful to avoid circularity in defining a strong state, not to define strength in terms of state performance. Instead we may define the 'strength' of a ruler (or a ruling group) as the ability to credibly pre-commit and think of him (her) as a Stackelberg leader, in a model where the ruler maximizes his objective function subject to the reaction function of the ruled.

A standard principal-agent model can be used here.

Suppose the ruler (the principal) provides a public input G (say, some infrastructural facility), which along with L, the labor put in by the ruled or the citizens (agent), produces the national output.

The ruler maximizes his net revenue [τF(G,L) - G] where τ is (for simplification) a linear tax rate and F is a production function with usual properties. But the principal/ruler cannot observe or control the labor effort put in by the agent/ruled. The latter decides on L, taking τ and G as given, to maximize [(1 - τ) F(G,L) + W(1 - L)], where let us suppose the agent has the opportunity to use part of his or her labor effort in the underground economy (which the long arm of the ruler does not reach) at a given compensation rate of W.

The first-order maximizing condition for the agent defines an implicit function, L*(τ, G).

We can now write the principal/ruler's objective as maximizing [τF(G,L) - G] with respect to τ and G, subject to L= L*(τ, G)

If one now writes out the first-order condition in the ruler's maximization with respect to τ, one can easily show that as the ruler takes into account the distortionary effect of the tax rate on labor supply, his chosen tax rate is less than the maximum possible rate.

If the marginal product of labor increases in G (i.e. the cross-partial derivative in the production function F is positive), the ruler will provide more of the public input G than if he were to take L as a parameter and did not take into account the complementarity between G and L.

Thus in this model the ruler maximizes his own objective function subject to the reaction function of the ruled, and in the process the ruler internalizes the economic costs and benefits of his actions in accordance with that reaction function.

In contrast one can say that the weak state is a Stackelberg follower: it cannot commit to a particular policy and merely reacts to the independent actions of the private actors such as special-interest groups.

We can then say that, compared to the strong state, the weak state will have *too much of undesirable interventions* (creating distortions in the process of generating rents for the special interest groups), and, by the same logic, will have *too little of the desirable interventions* (as in the case of coordination failures), since the state does not take into account or internalize the effects of its own policies.

So the distinction between a strong state (as in much of East Asia) and a weak state (as in many parts of Africa, South Asia and Latin America) lies not in the *extent* of intervention but in its *quality* (and thus the nature of commitment).

Note that in this approach the beneficial role of a strong state goes beyond the North-Weingast ideal of a *strong but limited* government. (Also my approach is different from the definition of strong and weak state in Acemoglu (2005) in terms of durability of government.)

III

The issue of commitment arises in a big way in governance institutions, for example in the literature on regulation in public utility pricing and standards. In many developing countries the regulatory authority does not have effective autonomy in terms of functioning or funding—the political leaders cannot credibly commit not to interfere with the work of a regulatory body, and opportunistic renegotiation of contracts is frequent.

Example from India in water and electricity pricing

Sometimes the opposite complaint is heard that the regulatory authority is not accountable to the public or is captured by the special interests of the regulated firm (through various means, including the lure of post-retirement jobs for the regulating bureaucrats—*amakudari*).

This is a central dilemma of governance institutions: ***a trade-off between commitment (to autonomy) and accountability*.**

On the one hand…..

One needs institutions of credible commitment to insulate the system from the marauding special interest groups and partisan or faction politics.

- **In particular, long-term investment projects or economic policy decisions that have consequences over a prolonged period will not get off the ground without such commitment (a major constraint on private investment in infrastructure in India, for example)**
- **Even outside the economic sphere rule of law requires the system to display some degree of commitment that civil servants and the police are not at the mercy of ruling politicians. (Examples from Latin America, India)**

In the macro-economics literature this is usually emphasized in the context of central bank independence, but the problem is much wider.

On the other hand…..

Too much insulation often means too little accountability. This leads to high-handed arbitrary governance, leading to abuses and waste.

Even when the administration is benevolent, large-scale development projects directed from above by an insulated modernizing elite are often

- **inappropriate technologically or environmentally**
- **far removed from or insensitive to local community needs and concerns**
- **failing to tap the large reservoir of local information, initiative, and ingenuity**

These projects often treat poor people as *objects* of the development process, and end up primarily serving as conduits of largesse for middlemen and contractors, and also encourage widespread parasitism on the state.

In developing countries where much of the economy is in the vast informal sector and dispersed in far-flung villages and small towns, the accountability mechanisms are particularly important at the local community level.

In some sense the dilemma of *commitment vs. accountability* is best resolved at the local level. If commitment is necessary for long-term projects, it may be easier to persuade the local people to make sacrifices for projects that are to benefit them in the long run.

- **-more transparency of benefits**
- **-possibly more trust and peer monitoring**
- **-collective action may be easier in resisting populist pressures**

In contrast, individuals and groups may perceive more uncertainty in the trickle-down from future growth arising out of large-scale centrally administered projects, and they may instead opt for the bird-in-hand of current subsidies and short-term benefits

Accountability is also more direct at the local level, if the local democratic processes work. More local vigilance on issues where more local stake is involved ("it's our money you are wasting or stealing!"). Electoral sanctions are more effective at the local level, than at the central level where multi-dimensionality of electoral issues dilutes responsibility.

But the downside of local accountability:

- **local capture, as collusion of local elite groups or sectarian interests easier than at the central level**
- **sometimes more corruption**
- **because of agglomeration, more scarcity of administrative talent and technical expertise**

But, hopefully, there is also learning by doing in local democratic processes.

The probability of elite capture, of course, depends on

- **the initial levels of inequality (both social and economic)**
- **how lop-sided the nature of political competition is at the local level, and**
- **how free is the flow of information about the functioning of governments, and about the entitlements and allocations at the local level**

IV

The issue of inequality brings us to our final point:

A major stumbling block to beneficial institutional change in many poor countries lies in the distributive conflicts and asymmetries in bargaining and mobilizing power among social groups

The 'old' institutional economists (including Marxists) used to point out how a given institutional arrangement serving the interests of some powerful group or class acts as a long-lasting barrier to economic progress.

The 'new' institutional economists sometimes understated

- **the tenacity of vested interests**
- **the enormity of the collective action problem in bringing about institutional change, and**
- **the differential capacity of different social groups in mobilization and coordination.**

The collective action problem can be serious even when the change would be ultimately Pareto-superior for all groups. There are two kinds of collective action problems involved:

- **one is the well-known free-rider problem about sharing the costs of bringing about change**
- **the other is a bargaining problem where disputes about sharing the potential benefits from the change may lead to a breakdown of the necessary coordination**

Theoretically, what is the distinction between an institutional failure that is the outcome of a coordination failure (that we have emphasized before) and that due to a collective action problem?

Perhaps it is that the persistence of coordination failure can be rectified by a "big push" or a tipping from one Nash equilibrium to another, but once you reach the new equilibrium there are self-reinforcing forces in operation.

But collective action problems often not merely require a new agency or arrangement, the solution is often not self-reinforcing. The new institutional equilibrium may unravel more easily.

One major way of unraveling of an institutional equilibrium, say in the delivery mechanism of public goods, is through the 'secession of the rich', when with the exit of the rich from the user group of the public service, political support for the older equilibrium collapses. This is one way inequality affects the institutional equilibrium.

There are cases where an institution, which nobody individually likes, persists as a result of a mutually sustaining network of social sanctions when each individual conforms out of fear of loss of reputation from deviance.

The problem is particularly acute when, which is more often the case, there are winners and losers (either in absolute or relative terms) from a productivity-enhancing institutional change. There are two broad classes of problems here:

- **information problems (like uncertainty about who the potential winners are *ex ante*) and**
- **commitment problems (the inherent difficulty that the potential gainers cannot credibly commit to compensate the losers *ex post*)**

In weakly institutionalized polities of developing countries the commitment problems may be particularly severe.

Acemoglu and Robinson (2006) 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 example from 19th-century history when in Russia and Austria-Hungary the monarchy and aristocracy controlled the political system but feared replacement, and so they blocked the establishment of 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 some evidence of how in societies with high inequality at the outset of colonization 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 tended to perpetuate those institutions and policies that atrophied development.

The classic example of inefficient institutions persisting as the lopsided outcome of distributive struggles relates 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.

One commitment device could be compensating landlords with long-term government bonds, but it sometimes does not work

- **with the government's limited ability to tax the gainers, and**
- **low credibility of promises not to inflate away the value of bonds**

Also, compensating at market prices of land does not fully capture the landlord's loss of social and political power and economic power in non-land transactions. Busch and Muthoo (2002) has a model where inefficient land institutions persist because land redistribution may adversely affect a landlord's bargaining power in other markets (labor or credit).

That collective action problems in orchestrating institutional change from a low-level to a higher-level equilibrium are rendered particularly difficult by distributive conflicts are now slowly being recognized in both the macro and microeconomic literature.

[In macroeconomic comparisons of East Asia and Latin America in the last quarter of the twentieth century the point has been made that when wealth distribution is relatively egalitarian, as in large parts of East Asia (particularly through land reforms and widespread expansion of education and basic health services), it has been somewhat easier to enlist the support of most social groups (and isolate the extreme political wings of the labor movement) in making short-run sacrifices at times of macroeconomic crises and coordinating on stabilization and growth-promoting institutions and policies.

Below the aggregative or macro level there are many local self-governing institutions (either elected local government bodies in charge of delivering local public goods like roads, extension service, and public health and sanitation, or rural community organizations in charge of management of local environmental resources or urban neighborhood associations in charge of crime-watch or cultural-cum-social solidarity promoting activities), where distributive conflicts may sometimes lead to institutional failures.

(For the last few years I have been working on several papers on the theoretical and empirical relationships between inequality and collective action at the local level).]

The hypothesis that high inequality predicts a high probability of 'bad' institutions, and the latter in turn predict low income could in principle be tested, but in practice it is quite problematic. Inequality, after all, is highly endogenous.

One instrument variable in cross-section data analysis some people suggest in this context is factor endowment (like population density in some historically early period) as a predictor of inequality.

The idea behind this that in areas of labor abundance relative to land and other resources workers and peasants have weak political power, and equality of political power may have been difficult to establish.

But political inequality and economic inequality may not be closely associated. (This is corroborated by a finding of Acemoglu et al (2007) on the basis of data from the state of Cundinamarca in Colombia).

It may, of course, be the case that, other things remaining the same, in areas where labor is scarce, labor may be valued more highly and thus there may be less economic inequality, as has been argued by Engerman and Sokoloff (2002) in their comparison of North America with the tropical parts of Latin America.

But other things are often quite different. Land abundance and labor scarcity have not helped Africans in the same away as North Americans for various historical reasons. Also, by this logic compared to Latin America and Africa, Asia (where density of population has been higher) should have more economic inequality, not less, as is actually the case. (This may have something to do with differential inheritance practices, for example).

A historical density of population variable therefore likely to be a 'weak instrument' for economic inequality

Another complicating factor is the nature of political competition and the context-specific and path-dependent formations of political coalitions. An interesting example of this in terms of comparative historical analysis of contrasting institutional development of factor endowment-wise similar countries in Central America is provided by Nugent and Robinson (2005).

In a more statistical analysis of data from 89 villages in contemporary West Bengal, Bardhan and Mookherjee (2006) find that political competition is more effective in bringing about land reforms and pro-poor targeting of programs than the redistributive ideology of the ruling party in the local governments.

In conclusion,
instead of summarizing the diverse range of issues in critical assessment of the current literature on the institutional economics of development that I have emphasized in this Lecture,
let me end with a comment on an implication of the central question of the persistence of (dysfunctional) institutions for future work on institutional economics. The persistence of something in history clearly makes the application of an empirical identification strategy easier, and has been used as such, but it leaves open two issues in the study of institutional economics.

- **One is that the procedure, widely adopted, of instrumenting recent institutions by referring to some historical fact is flawed because institutions change over time. An instrument for the initial institutions need not be a valid instrument for the current ones. As has been commented in connection with the use of 'colonial settler mortality' in Acemoglu, Johnson, and Robinson (2001) as an instrument for current property rights institutions, if good institutions are more likely to survive in more affluent countries, then institutional quality today is still endogenous with respect to income.**

- **Secondly, we need more theoretical models that can simultaneously handle the realistic case of some institutional durability on the one hand along with the possibility of institutional change on the other, under different conditions with respect to perceptions of costs and benefits of resisting change on the part of the incumbent elites (in response to changes in the technological, political-organizational and international environment).**