24. Institutions and Development

MARY M. SHIRLEY

1. THE CHALLENGE OF DEVELOPMENT

Developed countries are the exception, not the rule. Billions of dollars of aid and countless hours of advice notwithstanding, most countries have not been able to foster sustained growth and social progress. Increasingly research has shown that weak, missing or perverse institutions are the roots of underdevelopment. Other explanations for development, such as investment, technological innovation, or years of schooling are not correlated with higher rates of economic growth (Easterly 2002). Instead, cross-country regressions persistently demonstrate large and statistically significant correlations between institutional variables and growth, and in horse races between variables, an index of institutional quality "trumps" geography or trade as an explanation for growth (Rodrik, et al. 2002).

To meet the challenge of development countries need an institutional framework that supports a market economy, which includes two distinct and not necessarily complementary sets of institutions: (i) those that foster exchange by lowering transaction costs and encouraging trust, and (ii) those that influence the state and other powerful actors to protect private property and persons rather than expropriate and subjugate them.[1] The first set of institutions includes contracts and contract enforcement mechanisms, commercial norms and rules, and habits and beliefs favoring shared values and the accumulation of human capital. Among the second set of institutions are constitutions, electoral rules, laws governing speech and education, and norms that motivate people to abide by laws and cooperate in monitoring government. Where property rights are insecure and transaction costs are high, investment will be channeled into activities with rapid returns and resources will be siphoned off as bribes or security. In such societies, individuals are likely to reap higher returns by rent seeking or war lording than by investing in production, innovation, or learning. Today's underdeveloped countries must acquire market-supporting institutions under particularly difficult conditions—in a global market competing with already

[1] I use the term development to mean countries which have achieved a level of per capita income that puts them in the World Bank's high income category (above $9,266 in 2000), as well as high scores on selected social indicators (life expectancy at birth of over 70 years, infant mortality rate of less than 10 per 1000, adult literacy rates of 100%).

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developed countries (North 2004 forthcoming). Globalization also aggravates the difficulties of building strong institutions by making capital flight and brain drain easier. Although there may be some advantages to being a latecomer—witness Africa's leapfrogging into cellular technology—the disadvantages usually dominate.

The vast majority of humans today live in countries that have failed to create or sustain strong institutions to foster exchange and protect persons and property.[2] Individuals in these countries enforce most bargains using informal mechanisms—private armies; threats to reputation; ostracism—and they have little trust in or trade with people not subject to these mechanisms. The state is either too weak to prevent theft of property by private actors, or so strong that the state itself threatens property rights and personal independence. In either case, individuals and organizations face a high risk that they will not be able to realize a return if they invest in specific knowledge, skills, or physical assets, so they refrain from investment; production, innovation, and productivity are low; and the economy stagnates. Despite countless reform attempts, many countries have not been able to break out of their low level equilibrium, in part because powerful economic and political actors have a stake in preserving the current institutions and in part because society's beliefs and habits support and sustain the status quo. Although learning from new experiences is key to institutional change, education will not necessarily provide a way out of this low level trap. As Easterly points out, the quality of education is different in economies that provide incentives to invest in the future. In such an economy, "students will apply themselves to their studies, parents will monitor the quality of education, and teachers will face pressure to teach" (Easterly 2002, p. 82). Where incentives to invest in the future are low, educational quality will be poor and there will be under-investment in learning and out-migration of high potential individuals.

Why have so few countries been able to create and sustain the rules and norms that foster growth and social progress? Which institutions must function effectively if countries are to develop? How can poorer countries attain well functioning institutions? Can outsiders promote institutional development? The New Institutional Economics (NIE) has made some progress towards answering

[2] Throughout this chapter I use North's definition of institutions as the "humanly devised constraints that structure human interaction" including formal constraints such as constitutions and laws and informal constraints, such as norms, conventions and self-imposed codes of conduct (North 1990, p. 3). Organizations differ from institutions; "they are groups of individuals bound together by some common purpose to achieve certain objectives," and include legislatures, firms, trade unions, churches, clubs, schools, etc. (Ibid.) Institutions are the "rules of the game in a society" while organizations are the players (Ibid.). As for markets, Menard defines them as non-cooperative arrangements governed by the price mechanism that permit the voluntary transfer of property rights on a regular basis (Menard 1995). Although North's definition is widely used in the scholarly literature, it is worth reiterating here because some in the aid community use the term in a different way. Definitions may be tedious, but they are not trivial. The failure to employ a standard concept of institutions creates problems in establishing the impact of institutions on development, and affects how aid agencies view their role.

these four questions, but much remains unknown. In what follows I take stock of how the NIE has answered these questions and propose research to fill the gaps in our understanding. Before considering underdeveloped institutions I summarize theory on how modern market institutions evolved.

2. How Do Institutions Evolve and Economies Develop?

Institutions that Foster Exchange

The current literature on the importance of institutions to exchange is rooted in Ronald Coase's theory of transaction costs.[3] As Coase pointed out, the effects of high transaction costs "are pervasive in the economy. Businessmen, in deciding on their ways of doing business and on what to produce, have to take into account transaction costs. " If the costs of making an exchange are greater than the gains which that exchange would bring, that exchange would not take place. . . " (Coase 1992, p. 197). When information is costly and property rights are poorly protected, contracts become hard to specify and enforce and transaction costs are high. Societies with persistently higher transaction costs have less trade, fewer firms, less specialization, less investment, and lower productivity.

The evolution of institutions that support a modern market economy can be described in the following way (drawing largely on North 1990, 2004). Small communities producing at low levels of specialization rely largely on face-to-face barter trade between individuals who know one another and who typically share kinship, ethnic, religious, or similar ties. Bargains are enforced by informal mechanisms such as family loyalties, ostracism, or coercion by private groups.[4] Over time the group engaging in exchange tends to grow through natural population growth, urbanization, and migration and as more and more people begin to see advantages in trade. Improvements in agricultural and industrial technology, medicine, and education combine to increase human control over their environment, improve nutrition, and reduce disease, contributing to population growth, urbanization and the rise of markets. With the expansion in the size and geographic area of the trading group and the rise of urban centers, traders envision lucrative opportunities to do business with people who live even further away and do not belong to their networks. Merchants and investors seek more information about these unknown trading partners and better enforcement of bargains between strangers.

[3] Transaction costs include what Dahlman described as "search and information costs, bargaining and decision costs, policing and enforcement costs." (Dahlman 1979, p. 148) They are the costs of finding a trading partner, deciding on the terms of the trade, drawing up a contract, monitoring and enforcing a contract, and the like.

[4] Private coercion can increase as well as decrease uncertainty. Bates (2001) describes how clashes between private security forces among kinship groups can lead to retaliation and a cycle of violence that spans generations.

Up to a point, parties to contracts may be able to rely largely on norms and networks to enforce agreements between strangers. Greif describes how the Maghribi traders used an extensive network of communication, social ties, a common language, and a common religion (Judaism), to share information on the behavior of their agents and to assure that dishonest agents were collectively punished (Greif 1993). This framework motivated agents to develop a reputation for honest dealing, allowing the Maghribi to safely rely on agents who were not part of their family or community. Enforcing bargains through networks and norms is still important today, but it has drawbacks. Since it is rooted in one group's history and culture it is not easily transferred, and if enforcement requires group membership, opportunities for lucrative trades between those not able to use the enforcement mechanism are lost.[5]

To take advantage of these opportunities for profits and to respond to increased competition in home markets, some merchants look for new ways to trade safely with strangers. Trading parties begin to devise contractual safeguards; for example, one party might pledge an asset as a "hostage" that is forfeit if they renege on the agreement, much as people once enforced treaties by sending a family member to act as a hostage in a show of good faith (Williamson 1985, 1996). Merchants increasingly use written contracts, codes of conduct, standardized weights and measures, disclosure agreements, and enforcement through arbitration and courts.

Traders even today rely principally on private means to enforce contracts (Williamson 1985). And norms of trust and cooperation are still important in reducing transaction costs and fostering exchange (see for example Knack and Keefer 1997 and the chapter by Keefer and Knack in this Handbook). But for increasingly impersonal exchange, private ordering and norms of conduct need to be strengthened with the support of third party rules and enforcement, as happened in Europe, for example, when the codes of conduct of guild merchants evolved into merchant law and was gradually integrated into the body of laws enforced by states (Milgrom, et al. 1990). Written contracts and rules with third party enforcement were important to expanding trade in Western Europe during the Middle Ages, even though they do not always reduce transaction costs. Litigation and legalism can be a hindrance to trade as well as a help.

In places where institutions increase the certainty that contracts will be honored and property protected, individuals will be more willing to specialize, invest in sunk assets, undertake complex transactions and accumulate and share knowledge (North 1990, p. 34). Contract enforcement and property rights protection are not enough, however. Where most citizens lack access to education or health services, literacy, and surplus time and income to invest—as they do in most underdeveloped countries today—specialization is unlikely. Where specialization does occur, knowledge becomes more widely

[5] The pros and cons of informal versus formal institutions are reviewed in Keefer (2000).

distributed (Hayek 1979). Ever more complex institutions and organizations—scientific rules, professional networks, universities—are needed to integrate productive knowledge. Without these integrative institutions, the returns to any one individual's investment in human capital will be lower because of the loss of externalities from the knowledge that other members of society have acquired.

Institutions that Protect Property and Persons

Economic and political order accelerates the expansion of exchange, while expanding trade in turn provides a payoff to centralizing power in the hands of a ruler who can assure order. The continual warfare in Europe following the collapse of the Roman Empire, for example, hampered trade in the Middle Ages, but where order permitted, towns become centers of expanding trade and rapid political change, as happened in North and Central Italy or the Low Countries in the tenth century (North 2004). The economic returns to order contributed to the gradual rise of nation states and the establishment of order over larger areas. The increase in the size of political units combined with changes in military technology to raise the cost of warfare and increase the revenue that states needed to survive (Ibid.). The efforts by rulers to raise more revenues from elites led to conflicts and in some instances compromises that increased the power of more representative institutions and helped develop stronger financial markets (North 2004, Rosenthal 1998).

These changes are supported by changes in societies' dominant beliefs and norms. Institutions are the product of intentional human efforts to give structure to an uncertain world, and are congruent with a society's dominant belief system on how the world operates (North 2004). Enduring changes in institutions only occur when this underlying belief system also changes congruently. Changes in beliefs do not drive institutional changes, rather some beliefs allow a learning process that permits beliefs to evolve as institutions change. For example, North argues that Christian dogma was able to evolve in ways that supported economic growth and technological innovation in Western Europe during the Middle Ages. The Christian view that nature should serve mankind supported technological improvements in agriculture. The Protestant Revolution changed beliefs in support of greater individual freedom and economic expansion in the Netherlands and England.

With trade and specialization society's wealth increases and elite demand for protection of rights also increases, including rights to control and protect real property, intellectual property and one's person. In exchange for protection of these rights and the establishment of order, elites accept an expanded government role, pay levies and taxes to cover policing expenses, and give the state a monopoly over the use of force by demilitarizing private armies (Bates 2001, p. 65–66). Where the government is too weak to support contracts, establish order, and protect people and property, exchange, specialization, investment in physical and human capital—and therefore growth—will be limited. Extreme examples of this can be seen currently in some African states that are too weak to curb rival warlords. But as state power grows a dilemma emerges: any state strong enough to protect property and people is also strong enough to expropriate and subjugate them (North and Weingast 1989, Weingast 1993). Unless the state can credibly commit not to expropriate elite rights, risks under a strong state will be higher, lowering the incentive to invest. Accordingly, "... the development of free markets must be accompanied by some credible restrictions on the state's ability to manipulate economic rules to the advantage of itself and its constituents" (North and Weingast 1989, p. 808).

The most developed countries today are those that endowed the state with the power to enforce contracts, protect property rights, and assure stability and peace, yet also developed mechanisms to limit state power, such as independent parliaments and judiciaries, or federalism. These same countries evolved contractual mechanisms and cooperative norms to support expanding exchange among strangers, bargains among competing interest groups, and growing investment in ever more specialized skills and assets. These institutions helped keep down transaction costs and curbed the ascendancy of any single interest group, which created widespread opportunities for employment and consumption and encouraged investment in human capital. Increasing returns reinforced incentives in these societies to refine and strengthen the institutions that made these developments possible, except where "unanticipated consequences of choices, external effects, and sometimes [exogenous] forces" altered the path (North 1990).[6]

Only a few countries exhibit the beneficial institutions described above; most others have institutions inimical to growth. And past economic success is no guarantee of wealth today; consider the currently underdeveloped economies of formally wealthy countries such as Egypt or China. The next section surveys the literature that tries to explain why underdevelopment is so widespread.

3. Why Have So Few Countries Been Able to Create the Rules and Norms that Foster Growth and Social Progress?

New Institutional Economics has made some progress in identifying plausible explanations for underdevelopment, but does not yet boast a satisfactory general explanation. Below I group the extensive literature on this subject into four categories:[7]

[6] England and the Low Countries were early examples of these developments in Western Europe, for example.

[7] A large literature explains growth without reference to institutions; Easterly provides an excellent critique of that literature (Easterly 2002).

(i) Colonial heritage—countries inherited poor institutions from their colonial masters;
(ii) Colonial heritage plus—countries had valuable resources, people that could be enslaved, or land suitable to plantation agriculture, enticing colonizers to design institutions to exploit these endowments;
(iii) Political conflict—countries had too little political competition over their borders or between their elites so their rulers were less motivated to appeal to the wider population for support in their battles and faced little effective opposition when they built institutions to serve their selfish interests; and,
(iv) Beliefs and norms—countries had beliefs and norms that were inhospitable to markets or engendered mistrust, preventing them from building institutions that encourage trade and investment.

Table one gives an overview of the studies in these categories.[8]

Colonial Heritage

Sometime during the last 600 years most of the countries that we call underdeveloped today were colonies, prompting some institutional economists to conclude that poor institutions are a colonial legacy. Since some richer countries were also colonized, a stint as a colony is not in itself inimical to institutional development. What features of colonial heritage might cause institutional failings?

North (1990) has suggested that colonial powers created institutions that mirrored their own. Spain transplanted its centralized government, large and interventionist bureaucracy, and hegemonic property rights of favored nobility to Latin America, while England brought its decentralized, limited government to its colonies in the New World. As a result the United States and Canada were better positioned to curb state power, create more competitive markets, and industrialize faster than Latin America. But this explanation fails to explain why the English heritage failed to benefit countries in Africa, the Caribbean or South Asia or why Spain and England converged over time to a greater extent than their former colonies.[9]

[8] These explanations focus on what Douglass North has termed the institutional environment, which includes beliefs such as religions; norms such trust or lawfulness; constitutionally determined government structures such as bicameral or unicameral legislatures; and legal systems, such as one based on law and modified by the legislature or one based on precedent plus law and modified by the judiciary plus the legislature. They pay less attention to presumable more malleable micro-institutions, such as commercial codes, standards of weights and measures, electoral laws, political party rules, and legislative and bureaucratic regulations. And, with some exceptions, they emphasize the institutions that direct and curb government power rather than those that directly enable exchange.

[9] Location may be the reason for convergence. Stimulus from the rest of Europe played a key role in the development of England and the Netherlands in the Middle Ages (North 2004), and benefited Spain in the 20th century.

Table 1. Summary of explanations for underdeveloped institutions

Explanations	*Summary*	*Authors*	*Drawbacks*
Colonial Heritage	Countries inherited poor institutions from colonial masters.	North (1990)	Countries with same colonial master but different outcomes.
	Common or civil law origins affect contemporary institutions.	La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1997, 1998, 1999)	Common law has no growth effect. Historical anomalies. Large differences in enforcement.
Colonial Heritage Plus	Countries had valuable resources/people and colonizers designed institutions to exploit them.	Acemoglu, Johnson, & Robinson (2001a&b)	Ignores differences among colonial powers. No test of casual effects of institutions. Africa?
	Interaction institutions & initial conditions created persistent inequality.	Engermann & Sokoloff (2002)	Better description of Americas than Africa or Asia.
Political Conflict	Countries had too little political competition over borders or between elites; allowed rulers to build institutions to serve selfish interests	Bates (2001), Herbst (2000)	Border or elite conflicts not only factors in institutional development.
		Nugent & Robinson (2002)	Case specific arguments hard to generalize.
Beliefs & Norms	Countries had beliefs & norms inhospitable to markets or trust; prevented them from building institutions to encourage trade & investment	North (1994, 2004) Greif (1994) Knack & Keefer(1997)	Hard to falsify. Leaves little room for reform.

La Porta and his coauthors argue that a specific aspect of colonial heritage—a common or civil law system—has a profound effect on a country's current institutions (La Porta, et al. 1997, 1998, 1999). In their view countries that inherited common law systems from the England developed institutions that were better at limiting the state's power, enforcing contracts, and protecting property rights, especially the rights of minority investors. Countries with civil law origins, particularly French civil law, developed a state more prone to threatening property rights, establishing monopolies and squelching innovation, and provided less protection for minority shareholders.[10] Beck and Levine argue in this Handbook that civil law legal origins are also correlated with underdeveloped

[10] Not all civil law traditions are the same: French civil law supports a larger bureaucracy and fewer constraints than German or Scandinavian civil law (La Porta, et al. 1999, p. 231). Socialist law is more interventionist than civil law. In their empirical tests French civil law, along with Socialist law, is associated with more government interventionism, greater bureaucratic inefficiency and less democracy than common law or German civil law.

financial systems, and financial system development is highly correlated with growth.

No one has found a direct effect of legal origins on growth, however, and history belies some of the advantages claimed for common law.[11] By many measures France and other civil law countries of continental Europe were more financially developed than the United States in 1913 (Rajan and Zingales 2003). Contrary to the legal origins argument that common law protects minority property rights better than code law, the US created the SEC and other regulatory structures precisely because the common law rules protecting investors were seen as weak (Roe 2002). Also puzzling is how distant legal origins matter so much when current commercial laws and enforcement in countries with similar legal traditions vary so widely (Pistor, et al. 2000). And why were the villains in this story, the colonial powers that brought civil laws to their colonies, able to overcome their own legal origins and develop when many of their former colonies could not? Berkowitz et al. (2002) suggest that how a legal system was initially received—whether through conquest, colonization, or imitation—may have more influence on how it functions today than whether it is French, German, British or Scandinavian.[12]

Colonial Heritage Plus

Some authors try to improve on the colonial heritage explanation by adding other factors. Acemoglu and co-authors argue that the kinds of institutions Europeans imposed in their colonies depended on the conditions they found there. In richer areas that had a large population that could be enslaved or a climate that supported plantation agriculture or mining, such as Mexico, India or Indochina, they created or adapted oppressive production methods and tax and tribute systems designed to "concentrate political power in the hands of a few who used their power to extract resources from the rest of the population." (Acemoglu, et al. 2001a, p. 14). In safer places where the population was relatively sparse and the land less suited for plantations, such as the Northern US, Canada or Hong Kong, Europeans settled in larger numbers bringing beneficial institutions that supported private property and wider participation. When industrialization began in the 19th century, their reasoning goes, formerly rich colonies burdened with "extractive institutions" lacked secure property rights and provided few opportunities for technological and entrepreneurial innovation. The

[11] Nor do the originators of the legal traditions idea claim a growth effect (Shleifer, comments at the Annual Meeting of the International Society for New Institutional Economics in Cambridge, MA on September 27, 2002). Beck and Levine's chapter in this Handbook, however, cites studies showing that financial development "exerts a first order impact on long-run economic growth" and conclude that legal origins are a determinant of growth through their effects on financial institutions.

[12] Although the authors of La Porta et al. (1998, 1999) are critical of imported institutions that are imposed without regard for local norms (Djankov, et al. 2002), they still view civil law as a more damaging import than common law.

better institutions inherited by formerly poor colonies allowed them to industrialize and grow more rapidly.[13]

Acemoglu, et al.'s explanation ignores the differences in institutional success among the colonial powers that North describes. In their story, the US would have developed equally well had it been colonized by Spain.[14] Also the authors explain underdevelopment as the result of "extractive colonial institutions," but they do not directly test the causal relationship between growth and colonial institutions. Nor do they detail which "extractive colonial institutions" so cripple societies that they stay poor for centuries. Most of Africa, for example, shares a low level of institutional and economic development despite differences in factor endowments, generally low population density, and other variations in colonial legacy. Dangerous diseases that curbed European settlement are the reason Acemoglu and co-authors give for Africa's general state of underdevelopment. They point to the differences between the rest of Africa and those safer colonies where more Europeans settled because the risk of diseases was less: Rhodesia, South Africa, Kenya. But Europeans intensively settled some places such as the West Indies despite high mortality rates from dangerous diseases (Engerman and Sokoloff 2002). Also Kenya has not done as well as the US or much of East Asia, and there have been recent economic declines in Rhodesia and South Africa despite their presumably superior institutional heritage.

Sokoloff and Engerman (2002) also argue that factor endowments explain why there are large differences in contemporary institutions between countries settled by the same colonial power: the United States and Jamaica or the northern and southern United States, for example. In their view, institutions are endogenous to the conditions the colonists found when they arrived. Where soils, climate, and size or density of the native population encouraged plantation agriculture with slaves, elites were able to establish institutions that insured their ascendancy, contributing to persistence over time of the high degree of inequality (Sokoloff and Engerman 2002). The pernicious influence of slavery—slaves from Africa made up 60 percent of the more than 6 million people who migrated to the New World from 1500 to the end of the 18th century—contributed to persistent disparities in wealth, human capital, and political power. Engerman and Sokoloff (2002) specify the institutions that evolve where initial conditions favored equality and homogeneity, including rules that encouraged immigration, expanded the franchise, promoted secure and cheap land acquisition, and increased access to schooling and banking.

[13] Among former colonies, a 10 percent higher population density in 1500 is associated with a 4 percent lower per capita income today (Acemoglu, et al. 2001a). Countries which were never colonized by Western Europe didn't experience this "reversal of fortune" according to Acemoglu and co-authors (2001a). Rodrik, et al. (2002), however, find that institutional quality today among never colonized countries is as widely dispersed as among former colonies.

[14] Adding the identity of the colonial power to the estimate has little effect on the results, perhaps because their instrument (mortality rates of colonial settlers) captures the exogenous sources of variation in institutional quality.

Engerman and Sokoloff's explanation also seems, superficially at least, to be contradicted by experience outside the Americas, especially the relatively higher income equality in some underdeveloped former colonies in Asia, and African countries' similar institutional failures across different factor endowments. These examples may not be counterfactuals but the results of differences in factor endowments, native institutions and imported institutions that can only be uncovered by assembling the same amount of highly detailed historical information that Engerman and Sokoloff amassed for the Americas. The application of their model to at least one other region would be an important area for future research.

Political Conflict

Some scholars argue that it is not colonialism that is responsible for weak institutions but too little political conflict of the sort that led elites in Western Europe to make compromises and build institutions to win supporters, raise revenues, and defeat foreign enemies. In particular the need to raise revenues to fight territorial wars contributed to England's Glorious Revolution in 1688 when merchants and nobles forced the King to offer concessions to the nobles and merchants in exchange for their credible promises to provide the funds and fighters the Crown needed to fight foreign wars (North and Weingast 1989). For example, the King accepted a permanent role for Parliament, which previously met at the Sovereign's whim, greater independence for the judiciary, and prohibitions against the Crown's arbitrary violation of personal liberties. According to Bates, the absence of this form of conflict with outside enemies over territory in the modern history of most poor countries, especially African countries, is an important reason for their underdeveloped state institutions today. Instead of wars to establish territorial boundaries as part of nation building, African countries engaged in extensive conflicts over slaves, mineral wealth, or ethnic rivalries. More recently foreign aid added to state weaknesses in his view. Countries that became independent after the Second World War "faced fewer incentives to forge liberal political institutions," because the international environment did not require them "to seek ways to get their citizens to pay for defense and other costs of government" (Bates 2001, p. 83).

Herbst (2000) similarly suggests that because land was so ample in Africa, precolonial African states did not fight to defend their boundaries, so they did not have to build effective bureaucracies to raise funds or make political concessions to their citizens to persuade them to support the war effort.[15] Instead, African states simply never bothered to consolidate control over their outlying areas. Later, the colonial powers made matters worse. They did little to build state institutions, except where there was a large European presence. They drew

[15] Herbst argues that external threats in South Korea and Taiwan enabled their states to extract more resources from their citizens and develop more efficient mechanism to collect resources and control dissident groups (2000, p. 115).

national borders that left opposing ethnic groups concentrated in urban areas separated by vast stretches of largely empty territory that could shelter dissident armies, setting the stage for continual civil war. Much like Bates, Herbst argues that Western nations contributed to the stagnation of Africa's institutions after independence by preventing border disputes, which did not serve their Cold War interests, and propping up the region's weak, even venal, governments with aid.

Robinson (2002) disputes this view; he finds slavery and disease are more likely explanations for Africa's underdevelopment. Pre-colonial African states may have organized themselves for slave raiding and predation rather than for providing public goods, while dangerous diseases kept Europeans from settling in great numbers and building less exploitive, more participatory institutions (Robinson 2002).

It's not obvious that territorial conflicts in Africa or other underdeveloped countries would have forced rulers to limit their power and create institutions similar to those that emerged in advanced Western European nations. According to North and Weingast, England's Glorious Revolution was not prompted solely by border wars. Christian beliefs made competition and the accumulation of wealth respectable at a time when a commercial class was emerging and trade and competition were becoming more important (North 2004). England's king had to make concessions to wage war because he did not have a monopoly on power; the elites had twice deposed the king before striking a bargain with William and Mary in 1688. Nor are territorial conflicts a necessary condition for limited or representative government; less involvement in border wars does not seem to have harmed progress towards democracy in Switzerland or the US. Border wars are not always beneficial for institutions; wars had damaging effects on institutional development for centuries in the Middle Ages, for example.

Nugent and Robinson (2002) emphasize a different kind of political conflict, conflict between elites, as a driving force for institutional development. They argue that Colombia and Costa Rica are richer than El Salvador and Guatemala because the elites in Colombia and Costa Rica were competing merchants rather than cooperating landowners. Colombia's and Costa Rica's merchant elites granted property rights and the franchise to smallholder farmers to mobilize their support in their struggles for political power. Since smallholders are more productive in coffee growing, Colombia's and Costa Rica's coffee economies were more efficient.[16] This story is intriguing but hard to generalize. Merchant elites don't always compete or give concessions to win allies—Africa

[16] They argue that there are no scale economies in coffee growing and tending and picking is labor intensive and requires great care. Nugent and Robinson (2002) suggest that smallholders have better incentives to accumulate human capital necessary to improve their productivity further because they can capture part of the rent. The dominance of small holders could be due to the sparse populations in Colombia and Costa Rica compared to Guatemala and El Salvador. The authors cite the case of Nicaragua, which had similar population density to Colombia and Costa Rica, but developed large coffee plantations and expropriated the property of smallholders.

comes to mind—and the authors' explanations for why elites were competitive merchants in one locale and collaborating landowners in another are highly case specific. Nor are competing elites necessarily beneficial to growth: they sometimes engage in protracted wars that deter investment and specialization.

Beliefs and Norms

In other studies beliefs, habits, or what we might call cultures explain why some countries developed better institutions than others.[17] For example, Landes follows Max Weber in stressing the importance of culture in general and the Protestant Reformation in particular for spurring industrialization in Northern Europe.[18] As we saw earlier, North also stresses beliefs, but in a different role, as an important influence on how people learn and the sorts of institutional changes which can be accepted.

Avner Greif shows how beliefs affect institutional development by contrasting the individualistic cultural beliefs of the Christian Genoese and the collectivist cultural beliefs of the Jewish Maghribi traders mentioned earlier.[19] As we have seen the Maghribis' horizontal social structure relied on partnerships, community ties, and "formal friendships" among cooperating traders to enforce bargains. Genoa, however, had a vertical social structure, and its merchants evolved bills of lading, written contracts, laws, and permanent courts to support bargains among traders. The Maghribis did not need written documents and courts to enforce bargains; fears of losing reputation and ostracism worked just as well within their collectivist system. Ultimately, however, the Maghribis' failure to develop formal contracts and laws enforced by courts confined their trade to their network, where their collectivist enforcement was effective, while the Genoese grew rich through extensive and expanding trade.[20]

Not all norms or networks are harmful to the development of market-supportive institutions. Norms that encourage people to cooperate even with those with whom they have no family, business or other relational ties have economic payoffs in a number of studies surveyed by Keefer and Knack in their

[17] North (1994, p. 384) defines culture as "the intergenerational transfer of norms, values and ideas.

[18] In his view, Protestantism generalized the virtues of "a new kind of man—rational, ordered, diligent, productive"; it promoted literacy, an appreciation of time, and tolerance and openness to new ideas (Landes 1998, p. 177–78). Landes asserts that Catholic and Muslin religions have often been detrimental to institutional development, despite little empirical support for this claim. One study finds that a predominantly Catholic or Muslim population is associated with poorer government performance, but this effect becomes insignificant when controls for per capita income and latitude are included (La Porta, et al. 1999).

[19] He terms cultural beliefs the ideas and thoughts common to a group of individuals that "govern interaction between these people, and between them, their god and other groups" (994, p. 915).

[20] Similarly, Raskov (2002) shows how the community-based norms of the Old Believers, a traditionalist religious group in Russia, initially fostered but eventually choked development of their textile industry. In these stories strong informal bounds supporting collective action stunted the formal institutions that underpin a modern market economy, even thought they may have supported economic growth for centuries in the past.

chapter in this Handbook.[21] Putnam (1993) argues that the quality of local governments in Italy today can be traced back to the historical development of what he terms social capital, a network of associations that promote a culture of trust between strangers and help overcome collective action problems. Social capital has mixed effects on trust in cross-country regressions, however, perhaps because of external costs imposed on non-members as Keefer and Knack describe in their Handbook chapter. For example, Indian villages with well organized associations were more successful in bribing public officials to increase their allotment of water at the expense of other villages (Wade, 1988 cited in Keefer and Knack's chapter in this Handbook).

Norms, beliefs and similar informal institutions seem to be deeply engrained and the product of intractable factors, such as a society's history or its ethnic, religious, or linguistic heterogeneity. What can a society do if its culture is inhospitable? Keefer and Knack suggest two factors that increase development-promoting norms: income equality and education (see Keefer and Knack's chapter in this Handbook). Studies of East Asia suggest that the relatively high levels of education and income equality help explain why East Asian countries have grown faster and produced better social welfare measures than other less developed regions. If North is correct that beliefs filter the information that people derive from experience then it will be hard for schooling alone to change beliefs. Some of the more effective schools in developing countries are those structured to inculcate current dogma (for example, religious schools that teach fanaticism). Public schools are themselves captives of their institutional environments and are as effective or ineffective as the institutional environment would lead you to expect. For example, on any given day a third of all teachers in Uttar Pradesh, India are absent; 70 percent of students who completed grade 5 in Bangladesh were not minimally competent in writing; and the 1994 Tanzania Primary School Leavers Examination found that four-fifths of students scored less than 13 percent correct in language or mathematics after seven years of schooling (World Bank 2004, p. 112). When and how education and income distribution interact to alter beliefs and cultures in ways that foster development is not well understood and deserves further study.

All of the Above

The institutions that protect property rights and support strong market economies in Western Europe emerged gradually from a long and disorderly process of adaptation and experimentation spurred by competition and wars (see for example, North and Thomas 1973). Perhaps this organic progress toward efficiency would have happened more widely but was interrupted by colonialism's transplants of institutions that were less well adapted to

[21] Trust, a specific form of social capital, correlates strongly with growth and development (Fukuyama 1995, Knack 1997). Knack (1997) shows that trust is also correlated with private investment, perhaps because it reduces the transaction costs of securing agreements.

local norms, beliefs and environments (Djankov, et al. 2002). Or it could be that the fortuitous circumstances that produced a supportive institutional environment in today's developed countries were simply missing in many other places. Additional research will be needed to sort out the effects of different determinants.

The explanations converge, by and large, on two points. Despite disagreement on the ultimate determinants of institutional development, they broadly agree on the proximate causes: (i) greater equality combined with (ii) sufficient political competition to limit the ability of rulers to expropriate. Authoritarian regimes where a consolidated, wealthy and despotic ruling group exploited a poor or enslaved workforce might have been successful in the past, when organizing plantation agriculture or mining was key to economic success, but their oppressive institutions were inimical to competition, specialization, and industrialization. Where ruling elites had to bargain with one another or seek support from ordinary citizens, they created institutions to secure those bargains that curbed their power to expropriate. If the payoff to the ruler from abiding by these constraints was larger than the payoff from reneging, the institutions became self-enforcing and endured. In some cases this trend was reinforced where circumstances spread wealth more broadly, allowed greater access to education, and encouraged the development of human capital. What created these fortuitous circumstances? More research is needed to sort out the role of factor endowments, knowledge, historical accidents, and the evolution of supportive norms and beliefs.

Several of the explanations summarized above assume that fundamental institutions endure for centuries. Countries have weak institutions for reasons deep in their past: colonial heritage can date back as far as 1500; norms may have even more distant origins. This invites pessimism. What is the chance for countries to develop today if underdeveloped institutions are produced by distant history; especially if, as Bates and Herbst suggest, foreign assistance has usually locked weak institutions in place? Persistent inequality amongst the world's economies seems to support this pessimism (Pritchett 1997). But optimists counter with evidence that rapid growth in China, and to a lesser extent India, is reducing inequality and poverty among the world's populations (Sala-I-Martin 2002).[22] Rapid transformation of institutions in transitional economies also gives grounds for hope (see Peter Murrell's chapter).

Thanks to the literature surveyed above, we are closer to understanding underdevelopment than ever before. Studies that look for distant determinants of institutional quality, however, tell us little about which specific institutions are necessary for a country to develop today. For that I turn to comparative studies of institutions and growth.

[22] Sala-I-Martin (2002) finds convergence, not divergence, when inequality is measured in terms of purchasing power and weighted by population because of the large proportion of people living in China who saw their incomes rise over the last decade. The disturbing stagnation of African economies explains why these countries account for over 95% of the world's poor (Sala-I-Martin 2002, p. 39).

4. Which Institutions Matter for Development?

The persistent significance of institutions in cross-country growth regressions has spawned a mushrooming literature and converted a number of former skeptics. Pinpointing which institutions are fundamentally responsible for development has been tough, however. A host of variables turn out to be statistically significant. One survey found measures of development are significantly positively correlated with: protection of property rights and enforcement (seven studies), civil liberties (ten studies); political rights and democracy (ten studies); and institutions supporting cooperation, including trust, religion, and the extent of social clubs and associations (four studies); and negatively with political instability (15 studies) (Aron 2000).[23] Roll and Talbott (2001) conduct a horse race between 14 institutional variables, eliminating those that don't hold up in multiple regressions, and still end up with nine winners—variables that are highly significant in explaining levels of gross national income per capita from 1995 through 1999.[24]

These studies suffer from several major problems. First, many of the explanatory variables are not institutions.[25] Secure property rights, for example, are not institutions but outcomes, the result of norms of conduct, religious precepts, historical traditions, laws and courts, and rules that check the state's ability to expropriate (Keefer and Shirley 2000).[26] Others are socio-economic conditions, such as ethnic fragmentation, or the results of economic policies, such as inflation, trade barriers, and black market premiums.[27] These conditions and policies are often treated as proxies for institutions in cross country regressions, but the studies seldom provide evidence that these variables should be seen as proxies rather than direct determinants of growth.[28]

[23] Aron also includes a number of studies that don't measure the effects of institutions, but of socio-economic conditions such as ethnilinguistic diversity, social mobility, fertility rates, and the size of the indigenous middle class. These factors are viewed as proxies for weak institutions in some studies.

[24] The winning explanatory variables are: trade barriers, government expenditures, monetary policy (inflation), property rights, regulation, black market activity, political rights, civil liberties, and freedom of the press.

[25] In addition there are a number of methodological criticisms of cross country regressions in general, as well of those that use growth rates in per capita income (summarized in Hall and Jones 1999, and Roll and Talbott 2001) or levels of per capita income. (See for example, Temple 1999). The most serious problem is reverse causality: do stronger institutions lead to economic growth or do wealthier countries create stronger institutions? Because of data limitations, the institutional variables are usually measured at the end rather than at the beginning of the period under investigation, and as a result, reverse causality is hard to rule out. The study by Roll and Talbott attempts to overcome problem of reverse causality by identifying major democratic events (such as the introduction of elections) and undemocratic events (such as military coups or the suspension of elections) in individual countries, then tracking the growth in GNI per capita for ten years before and 20 years after the event. After a democratic event, countries began to grow more rapidly and growth continued to accelerate, while growth stagnated after a non-democratic event.

[26] See also Rodrik et al. (2002).

[27] Rodrik et al. (2002) raise another objection to the use of policy and institutional variables in growth regressions. In their view measures of institutional quality already contain all the relevant information about policies.

[28] For example, trade barriers are treated as a proxy for poor government policies that might result from weak institutions to curb corrupt deals struck to protect cronies (Roll and Talbott 2001).

Even when the explanatory variable could arguably be described as an institution, another dilemma arises: typically the institutional variable is a broad aggregate. Many specific institutions are encompassed in a variable such as civil liberties: rules governing franchise, association, speech, information, privacy, property, and crime; as well as norms of trust and civic mindedness. Institutional quality measures usually aggregate subjective ratings of, among other things, rule of law, efficiency and honesty of the bureaucracy, and rules and motivation of government to protect property rights, which are themselves outcomes of a host of different specific institutions.

Cross-country regressions are poor tools to determine which particular institutions are necessary for a country to develop: we lack good aggregate measures of complex institutions or an understanding of how these institutions interact with specific country characteristics. Growth regressions have, nevertheless, suggested some important empirical regularities. First, whatever these institutional variables are measuring, they typically explain a sizeable fraction of economic growth. Second, institutions that increase political competition and civil liberties and promote cooperation have a statistically significant and positive association with per capita growth rates and income levels. This fits nicely with the finding of some of the historical studies reviewed earlier that high quality institutions today are rooted in greater equality, political competition and cooperative norms in the distant past.

Given the problems in finding good estimates of institutions for cross-country studies, case studies seem a logical interim approach. But case studies tend to be sui generis. Jütting (2003) reviews cases studying the impact of institutions on natural resource management (6 case studies), conflict resolution (3), and market development (8). Although institutions are more precisely defined than in the cross sectional studies, they are still not always clear or carefully measured. A common finding in these cases is that norms and customs play a critical role, but one highly particular to local circumstance. For example, norms of behavior backed by community sanctions helped enforce contracts in Vietnam, but failed to protect the customary rights of women in Uganda (see Jütting 2003).

Rodrik (2000) argues that since scholars cannot determine which institutions matter, democracy is the most effective way to mobilize local knowledge of how to develop better institutions. A large literature finds only an ambiguous relationship between democracy and growth, however.[29] Democracies do grow at least as well as autocracies and some do significantly better, but on average they don't outperform them.[30] This ambiguity may arise because representative

[29] See for example: DeHann and Siermann (1995), Brunetti (1997), Barro (1996), and Minier (1998). This may be because of the obvious problems of classifying a political system as democratic or autocratic, especially when some developing countries show high variability in their democracy ratings over time. Alemida and Ferreira (2002) argue that the variance in findings is caused by the greater volatility in the economic performance of autocracies compared to democracies. More autocratic regimes tend to be outliers, showing much better and much worse growth performance than more democratic regimes, largely because of much better or much worse policy choices.

[30] Democracies do better on other measures. Democracy reduces the volatility of economic performance (Alemida and Ferreira 2002, Rodrik 2000), and protects citizens from extreme abuses by the polity (Sen 1981).

democracy can take many forms; how democracy functions is affected by whether it is parliamentary or presidential, has a unicameral or bicameral legislature, delineates large or small districts that endow some interest groups with more or less disproportionate power, has strong or weak political parties, uses proportional representation or winner-takes-all, or puts a short or long time limit on terms of presidents and legislators. These complexities are hard to measure in a way that lends itself to cross country comparisons. Measurement is further complicated when laws don't reflect practice, which is more likely in countries with underdeveloped institutions.

Informal institutions also influence the functioning of democracy in ways that are seldom studied. Keefer (2002) finds that young democracies are prone to clientelism. Rather than take positions on policy issues or provision of public goods, politicians act as patrons and provide services to their clients (voters) to get reelected. By solidifying a support base of clients, they avoid being thrown out of office despite poor government performance. Over time clientelism tends to be replaced by more representative institutions, but the current flock of clientelist states may, temporarily, be sullying democracy's reputation.

Lack of a culture of trust or civic mindedness also undermines democratic rules. Mistrust may keep citizens from cooperating to monitor politicians and bureaucrats, reduce the ruling party's willingness to turn over power to the opposition for fear the new rules will abuse their power, and impede reform because government's commitments to compensate the losers are not credible. Bardhan (2000, p. 228) maintains that India is a prime example of a highly democratic country whose citizens have not been able to overcome collective action problems to ban together and require government to function more effectively.[31]

Democracy requires supportive beliefs, norms, and constitutional institutions that are usually absent in non-democratic countries. How to install these beneficial preconditions is not well understood. Exhorting poor countries to adopt democracy is about as helpful as exhorting them to adopt other desirable traits, such as rule of law or property rights. Moreover, even in a country with a strong representative democracy, growth may not be assured. Democracy acts as a check on government predation only if the government's policies are at odds with the majority's perception of how to enhance its welfare. Representative democracies may pursue policies that are popular but economically disastrous without any opposition from representative institutions (Rosenthal 1998). India, for example, prices water and electricity below operating cost, leaving utilities with inadequate resources to maintain the services or provide access to the poor. The political opposition to reducing these subsidies has proved insurmountable thus far, even though everyone loses from frequent disruptions in service.

[31] Indian society is "heterogeneous and conflict-ridden," and because no individual group is "powerful enough to hijack the state by itself," groups use the democratic process to build an elaborate system of checks and balances and "meticulous rules of equity in sharing the spoils..." (Ibid.).

Representative democracy is not the only institution that can allow choice of institutions and limit government; federalism can also have this effect.[32] Weingast (1995) suggests that China's federalist system placed checks on the elites and permitted experimentation among provinces that produced its successful innovations. Federalism is not always beneficial; it produced large budget deficits that slowed or reversed growth in Mexico and Argentina, for example (Careaga and Weingast 2000, Spiller and Tommasi 2000). Argentina's slide from a developed country at the end of the 19th century to an underdeveloped one today has been attributed in part to its federal system. Federalist institutions fashioned by the government of Juan Peron motivated provinces to free ride on the federal budget and politicians to focus on short term, sectarian interests (Spiller and Tommasi 2000).

Cross-country growth regressions have demonstrated that institutions are a—if not the—determinant of development, but they are ultimately unsatisfying to those seeking specifics. Successful institutional innovations—democracy, federalism—have been transferred from one context to another in some cases but not others, which leaves open the question of how to foster institutional change.

5. How Can Developing Countries Change Their Institutions?

The NIE has had less to say about institutional change, except that it is hard to accomplish. North's work suggests that a great deal of change occurs constantly at the margin, but the institutional framework is typically stable, except when change is imposed by force or revolution. This stability is the product of path dependency—those who make policy and design institutions have a stake in the framework they created and resist changes that may rob them of power or property. Even without this active opposition to change, societies evolve norms, networks and beliefs congruent with their formal institutions that resist dramatic change under many circumstance (North 1990). Formal institutions may be suddenly altered by revolution, invasion or crisis, but unless beliefs and norms also change the new status quo will be overturned after the revolution ends, the invaders leave, or the crisis subsides. Changes in beliefs and norms usually require a period of gradual learning, although education, research, and communication may speed adaptation in ways that are not well studied.

Path dependency and the stickiness of beliefs and norms explain why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries. There are numerous examples of failure. Latin American countries copied the U.S. constitution, transitional countries emulated U.S. or European bankruptcy laws and commercial codes, former French

[32] Informal rules may also curb the abuses of autocracies in ways that have not been well researched. The decision of the Pinochet dictatorship to hold a plebiscite on its rule and to restore democracy after losing is a case in point.

colonies in Africa adopted the French educational and bureaucratic system—all with very different and generally disappointing results.

Levy and Spiller (1994) argue that successful micro institutional reforms require what they term "goodness of fit" between the specific innovation and the country's broader, macro institutional environment, including its norms and beliefs.[33] A "good fitting" institutional innovation would be one that does not depend on absent or weak institutions and is insulated from or adapted to perverse institutions as far as possible. In their analysis an imported institution such as complex rules for regulating a privatized utility is not a good fit in a country that lacks essential supportive institutions such as checks on government's capacity to change the laws, strong bureaucratic rules and capability, and an independent judiciary able to hold the government to its contractual obligations.

China's "market preserving federalism" and township and village enterprises have been cited as good fits (Weingast 1995, Murrell's chapter in this Handbook, Djankov 2002). China's federal system allowed provinces and local governments to experiment with different economic rules that could be tested through competition between localities as long as the dominance of the Communist Party went unchallenged (Weingast 1995). Some townships and villages experimented with rules that encouraged private investors to run government-owned enterprises. Formal and informal rules gave these investors—mainly overseas Chinese with kinship ties to the locality—considerable control over the staffing, management and survival of the enterprise in exchange for regular payments to the local government that "owned" the firm, allowing capitalistic incentives to flourish within an officially socialist system (Keefer and Shirley 2000).

These adaptations may be good fits but they have disadvantages. They are poor substitutes for more efficient financial and legal systems. China's government-owned but privately-operated township and village enterprises stimulated markets, but were rife with corruption; China's "market preserving federalism" left large parts of the country behind.

A good fitting institution meets Williamson's "remediableness criterion": ". . . an extant mode of organization for which no <u>superior feasible</u> alternative can be described and <u>implemented</u> with expected net gains. . . " (Williamson 2002, p. 12, underlined in original). But the remediableness criterion, as Williamson points out, risks being "too deferential to the status quo" (Ibid). Reforms could be so tailored to initial conditions that they leave countries locked into inefficient institutions when superior improvements were indeed possible. How can we judge an apparently good fit? The appropriate counterfactual is not the status quo or some comparator country, and certainly not a fully developed, Western system of property rights, finance and law. Ideally, we should assess goodness of fit as part of a process of institutional change, and decide whether the direction

[33] For example Chile required its SOEs to operate as if they were private firms. Its rules worked to improve efficiency in Chile but failed to improve efficiency when introduced in other countries. The explanations for why these rules worked in Chile seems to be the supportive norms of its civil service. (See for example the chapter on Santiago's municipal water in Shirley 2002)

of change is towards institutions that are more supportive of an efficient market economy and improved social development.[34] This is exceptionally tough to do.

Learning plays an important role in changing norms and beliefs and thus supporting institutional changes in North's view (North 2004). Education and new ideas can play a powerful role when the setting is receptive, as in the impact of the Enlightenment in Western Europe. There are more recent examples as well: the emergence of a critical mass of well-trained economists working in universities and think tanks played an important role in structural changes in Latin America, particularly in Chile (Corbo, 2000), and the education of a number of Chinese in universities abroad had an important effect on the design of reforms there. But there are counter examples (India, perhaps), and the link between knowledge, learning, beliefs and educational reform is not well specified yet.

The specifics of institutional change fall through a gap in the literature; few studies attempt to grapple with the messy details of real institutional change. Given how quickly NIE has evolved from a time when institutions were not even included in most development models, the gap is not surprising. Foreign assistance agencies have entered this gap under the assumption that institutions can be changed by outside advice and funds (see World Bank 2002, 2003).

6. Can Outsiders Promote Institutional Development?

Outsiders have changed deeply rooted institutions, usually by fomenting revolutions or invading, sometimes in consort with a powerful local reformer.[35] For example, Napoleon brought enduring changes to Europe's legal, educational, health, and other institutions in a relatively short period of occupation. Force alone cannot explain Napoleon's enduring impact. Some intellectuals and merchants were receptive to Napoleon's innovations; dissatisfied with domestic institutions and inspired by the Enlightenment they saw his reforms as progressive, the heritage of the French revolution. Outsiders have also contributed to enduring institutional change in countries where powerful elites welcomed foreign ideas, such as Tsar Peter in Russia or Mustafa Kemal Attaturk in Turkey. Absent a powerful local supporter, however, there are few insistences where aid or advice alone has made enduring improvements in another country's embedded institutions. Some observers cited earlier believe that aid may even have slowed institutional change by preventing political competition and preserving the power of local elites who might otherwise have been removed.

[34] Early evidence on China's privatization of the township and village enterprises suggests that they have been supportive of further moves towards markets and development (Sonobe and Otsuka 2003).

[35] This section addresses whether outsiders have been able to promote sustainable improvements in the institutional environment by changing constitutions, norms of honesty or cooperation, enforcement mechanisms for laws and contracts, etc. It does not address the more successful record outsiders may have had of influencing changes in less embedded formal rules, such as the regulations governing electricity or water firms.

By promoting rent seeking and shirking aid can actually undermine the sustainability of the reforms it is designed to support. Buchanan termed this problem the Samaritan's dilemma (Buchanan 1977). The payoff is highest to the Samaritan if the Samaritan provides aid and the beneficiary responds by exerting high effort. But the payoff is highest to the beneficiary if s/he can receive the aid without increasing effort. The weaker a country's institutional framework, the more likely it is that this is the game being played. "When the recipient country is governed by officials who are primarily interested in seeking out opportunities for private gain, and few institutions are in place to keep these motivations in check, moral hazard problems can become substantial" (Ostrom, et al. 2002, p. 11). Moral hazard problems are exacerbated when the goal is institutional change because projects directed at changing institutions lack tangible outputs, making impact "more diffuse and hard to verify" (Martens, et al. 2002, p. 17).

Aid projects try to reform institutions through conditionality: a list of specific changes that the country must enact before funds will be disbursed. But conditionality does not fit well with what is known about institutional change. As we have seen, the NIE suggests that institutions usually change as the result of a long and often painful process of competition and adaptation, changes that are only sustained if belief systems and norms change as well. Ruling elites often prefer pro forma changes so they can obtain funds without politically costly changes in deep-seated constitutional rules, norms and beliefs—the Samaritan's dilemma.

Aid as presently constructed is a poor tool to change the deep-seated beliefs and norms that underlie many institutions. Sustained improvements in education, for example depend on curriculum choice; rules governing teacher selection, salaries and accountability; beliefs and norms about schooling (of girls, for example); and the like. These often politically sensitive and culturally bound elements are not likely to change because of conditionality and advice directed at central government ministries or incentives tied to financing for construction of schools, purchase of textbooks or technical assistance.

Over time, the disappointing performance of many aid recipients has led aid agencies to discover institutions. A number of recent reports have stressed institutions, but most have failed to consider seriously the implications of institutions for foreign aid.[36] The World Bank's World Development Reports redefine institutions in an elastic way to include not only formal and informal rules, but also organizations (World Bank 2002) and policies such as interest rates (World Bank 2002). These definitions make a mockery of efforts to measure the impact of institutions on markets or policies or the interactions between institutions and organizations; they also allow aid agencies to characterize virtually any reform activity as institutional reform without radically changing their approach.

The foreign aid community generally assumes that institutions are malleable and can be changed through aid within the three to five year life span of a development project, or at most the 15 to 20 year span of several projects. Another premise is that well-intentioned outsiders can discover needed institutional

[36] See, for example: World Bank (1998, 2002); Payne (2002); Quibria (2002).

changes and persuade governments to implement reforms and sustain them. The NIE literature described above suggests that these assumptions are wrong: (i) much institutional change is well beyond the time frame of even a series of aid projects; (ii) institutional change requires alterations in beliefs that cannot be easily pushed or purchased by outsiders; (iii) successful institutional adaptations have been engineered by insiders and sometimes work quite contrary to the conventional wisdom or best practice touted by the aid community; and, (iv) aid in the absence of a supportive institutional framework can create perverse incentives and prop up rulers who are opponents, not catalysts, of reform.

7. What Next?

New Institutional Economics has not answered the four questions I posed at the outset: Why have so few countries been able to create and sustain the rules and norms that foster growth and social progress? Which institutions must function effectively if countries are to develop? How can poorer countries attain well functioning institutions? Can outsiders promote institutional development? Historical analyses have produced a number of intriguing explanations, but no single argument is fully satisfactory; there are glaring gaps and some face major counterfactuals. Cross-country studies have put institutional variables into mainstream models and produced some consistent regularities, but the devil is in the details and the details can be numerous.[37] While much is known about how institutions developed in Western Europe, there needs to be more research on institutional development in Third World countries including research on what causes changes in norms and beliefs that underlie successful institutional reforms.

What can be done to fill the gaps in our understanding? Thanks to a new generation of cross-country studies coupled with increasingly detailed databases, we are progressing in understanding how specific institutions affect specific behavior. A good example is Keefer's study of how governments' decisions to bail out banks during financial crises are determined by voter information, proximity of competitive elections, and checks or limits on government (Keefer 2001). Institutional variables in these analyses are still aggregated but far more sophisticated and complex.[38]

It may be possible to fill the gap in our understanding with a pincer movement. Statistical analyses are already moving from aggregation to specificity;

[37] Ostrom (1999), for example, found 27 different boundary rules for managing common pool resources in different locations. Shirley (2002) found that the privatization of a city's water supply system is not a single policy option, but an array of choices about regulations and contracts that played out quite differently in different environments.

[38] For example, Keefer measures checks as the number of veto players– the number of organizations dominated by politicians with the motivation and power to veto policy choices. This is complex; for presidential systems, for example, he assigns one point to each house of the legislature, but zero if the president's party has a majority and voters must vote for a partly list, not a candidate. Initially these studies will be messier, with smaller samples and lower significance than the usual well honed but unsatisfying cross-country growth regressions.

case studies will need to move from sui generis to comparative. Case studies can be powerful tools when they are analytical narratives, cases that test hypotheses with methodological rigor and also describe historical context, norms and beliefs and institutional adaptations, all the rich nuances of the institutional setting (see Bates, et al. 1998). Comparative analytical narratives—cases using a common methodology and common conceptual framework to assess a larger sample—would allow us to identify regularities with greater confidence. Although the task seems daunting, there have been examples (see Ostrom 1990, Shirley 2002). Shirley (2002) used a comparative approach to analyze six case studies: it employed the same conceptual framework; applied the same questionnaire to individuals in the same positions in the same types of organizations; defined and measured the same variables in the same ways; and used the same methodology to measure welfare and other effects. Six cases are hardly enough to be sure of robust conclusions, but in combination with broader statistical analyses they can help us begin to sort out true causal variables from among the large array of statistically significant candidates. As the number of cases mount it may be possible to combine them and do a meta-analysis. There are difficulties: comparative case studies can be time consuming and expensive and selection bias continues to be a problem even with comparative case studies, since few researchers choose to study countries that are not reforming.

Deeper analysis of institutions **within** developing countries also holds promise. The Spiller and Tommasi study of Argentina is a good example of the analytical power of tools normally only used in developed countries for studying institutions in a developing context. Lack of reliable information can be a stumbling block to applying these tools in poorer countries, but lack of local researchers is often the more serious obstacle. In many developing countries, low pay, inadequate resources and a sense of isolation drive the best scholars away from research or out of the country. Those who remain face an uphill battle getting funding to build databases, undertake serious research and publish controversial findings.

A critical mass of local researchers is a prerequisite for understanding institutions fully, stimulating an informed debate, and fostering changes in belief systems, the first step to enduring institutional change. Since improvements in formal institutions hinge on changes in long held beliefs, the most important role for outsiders is to support this learning by helping build local knowledge and educational institutions while avoiding actions that fortify the defenders of the old order. Only when this minimum mass of human capital is in place will citizens of poorer countries begin to discover how to meet the challenge of development.

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