

Institutions and Development: A Statement of the Problem

Mary M. Shirley¹

Great effort and sums have been expended to help poorer countries develop their economies, often with disappointing results. Although over time the development paradigm has shifted from “get your prices right” to “get your institutions right,” the latter instruction has proved as useless as the former. In this essay I briefly review some of the literature explaining underdeveloped institutions and describe how institutional research might be made more helpful.

WHY ARE SOME COUNTRIES UNDERDEVELOPED?

At its roots, New Institutional Economics describes two essential types of institutions as critical for development: those that lower transaction costs and encourage trade, and those that direct the power of the state toward protecting property rather than expropriating it. Despite a growing literature in both branches, there is little consensus about why some countries have weak, missing or perverse institutions and what they can do to change these damaging institutions

In this section I describe one set of studies explaining weak political institutions as the product of: (i) colonial heritage, (ii) factor endowments, and (iii) political conflict between elites, and another that explains transactional problems as stemming from (iv) informal norms.

Colonial Heritage. North (North 1990) has suggested that former colonies have weak or strong institutions because of their colonial heritage. In particular, he argues that Latin America inherited dysfunctional institutions from Spain, while the United States and Canada benefited from their English heritage. Acemoglu et al. (Acemoglu, Johnson,

and Robinson 2001a, ;2001b) also stress colonial heritage, but without distinguishing between the colonizing countries. In their view, European colonizers used oppressive production methods in those relatively richer areas with a large native population that could be enslaved (such as Mexico, India or Indochina) or where diseases made colonization dangerous. They also created or adapted 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, Johnson, and Robinson 2001b, p. 14).² In poorer, safer places where the native population was relatively sparse (such as the U.S., Canada or Hong Kong), European colonialists settled in larger numbers and brought with them institutions that supported private property and wider participation.

Another set of studies (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1997); (1998);(1999) argue that legal heritage determines government institutions today. In this view common law signals intent to limit the state’s power, enforce contracts, and protect investors, including investors with only a minority stake in the business. Civil law provides less protection for property and can be seen as an instrument of a state expanding its power, threatening property rights, establishing monopolies and squelching innovation. Beck and Levine 2002 further argue that civil law is associated with less developed financial systems and an inflexible legal order that is less adaptable to changing economic conditions and plagued by inconsistencies. A direct effect of legal origins on growth has not been found, however, and most historical studies portray legal

¹ Excerpt from a draft chapter for *A Handbook of New Institutional Economics*.

²(Acemoglu, Johnson, and Robinson 2001a) finds that Europeans were less likely to settle in areas with a high risk of malaria and yellow fever, which are also more likely to prevalent, where there is high population density.

institutions as endogenous to political forces.³ Beck and Levine, however, cite 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 (Beck and Levine 2002). How the colonial masters were able to overcome their legal origins and develop when many of their colonies could not is unexplained, however. Moreover, Roe finds that regulatory structures, such as the SEC, arose in the US precisely because the common law rules protecting investors were seen as weak (Roe 2002).

Factor Endowments. Sokoloff and Engerman argue that factor endowments can explain why today there are different political institutions in places settled by the same colonial power (such as the U.S. and Jamaica). 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, thus, “contributing to persistence over time of the high degree of inequality.” (Sokoloff and Engerman 2000, p. 223) Factor endowment arguments, like colonial heritage, work well for the Americas, but are less convincing for Africa, where differences in factor endowments don’t seem to make much difference in the efficiency of current institutions. Nor do disparities between French and English institutional heritage seem to affect current relative levels of development in Africa.

Political Conflict. Bates attributes the underdeveloped institutions of Africa and some other poor countries partly to the absence of conflict over boundaries and trade. This conflict opened the way to more responsive and limited government in Western

³ Nor do the originators of the legal traditions idea claim a growth effect (Shliefer, comments at the Annual Meeting of the International Society for New Institutional Economics, Cambridge, MA, September 27,

Europe by forcing rulers to offer concessions to merchants and nobles in order to raise the funds and warriors they needed to wage war, as described by North and Weingast in the case of England's Glorious Revolution (North and Weingast 1989). In Bates' 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. 83-84). Nugent and Robinson also emphasize politics, arguing that polarization and political conflict among elites is the driving force for institutional development and explains why Colombia and Costa Rica have more favorable institutions than El Salvador and Guatemala (Nugent and Robinson 2002).

Informal Norms. Greif asserts that cultural beliefs influence individuals' economic behavior toward others, the social patterns of economic interactions and the development of value systems that affect behavior (Greif 1994, p. 915).⁴ He shows how divergence in beliefs and organization explains why Genova, and not the Maghribi traders, developed formal institutions and organizations to support collective actions and exchange, including contract law, permanent courts, and bills of lading. Other scholars argue that trust is important for growth and development because it reduces transaction costs (Knack 1997).⁵

WHICH INSTITUTIONS MATTER FOR DEVELOPMENT?

With some exceptions, both the studies described above and the institutional literature more broadly offer little guidance to countries seeking a path to development.

2002.

⁴ North argues that belief systems "are the underlying determinant of path dependence, one of the most striking regularities of history" (North 1994, p. 384-85). Ultimately, however, it is political competition that drives the evolution of beliefs in North's view see (North 1994, p. 387).

One problem is that many authors are not specific about which institutions they are talking about, and some are not particularly consistent in how they define an institution. The numerous studies using cross-country regressions to find which “institutions” have large and statistically significant relationships to growth have not helped matters. Among the variables found to be significant in these studies are protection of property rights and enforcement of contracts, civil liberties, political rights and democracy, and norms and institutions that support trust and civic cooperation (Aron 2000). But broad aggregate measures, such as rule of law or property rights, encompass many different specific formal and informal institutions.⁶ The widespread use of proxies (such as black market premiums and trade policy as proxies for corruption), further obscures the specific institutions at work. Another serious problem is the lack of good information about the details of institutions and institutional change in underdeveloped countries. While much is known about how specific institutions in Western European countries developed over time and how they function today, there is far less good scholarship about the particulars of institutional development in Third World countries.

WHAT NEXT?

One way to begin to fill the gap is to analyze specific changes in particular embedded institutions in developing countries and determine (a) what political and economic factors motivated change; (b) what factors determined the design of the reform; (c) what has been the effect of the institutional change on economic performance; and (d) what determines whether the change is sustained over time? Case studies can capture the rich texture of institutional details, but the number of independent variables that need to

⁵ Trust has also been tied to stronger political institutions; see (Putnam 1993).

be understood is daunting, and case studies cannot ascertain objectively which variables matter and which do not. Eventually, however, if the number of comparable cases mount, a meta analysis of cases may enable statistical testing.

Finally, it is a tenant of NIE that institutions are complex and country specific. Local scholars have a comparative advantage in understanding their own rules, norms and beliefs. This argues for more collaborative research, and efforts to build local scholars' capacity and motivation to study institutions in their own countries.

References

- Acemoglu, Daron, Simon Johnson, and James A. Robinson. 2001a. "The Colonial Origins of Comparative Development: An Empirical Investigation." *American Economic Review*, 91:5, pp. 1369-401.
- Acemoglu, Daron, Simon Johnson, and James A. Robinson. 2001b. "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution," MIT Working Paper 01-38.
- Aron, Janine. 2000. "Growth and Institutions, A Review of the Evidence." *The World Bank Research Observer*, 15:1, pp. 465-90.
- Bates, Robert H. 2001. *Prosperity and Violence: The Political Economy of Development*. New York: W.W. Norton & Company.
- Beck, Thorsten and Ross Levine. 2002. "Legal Institutions and Financial Development," Draft.
- Greif, Avner. 1994. "Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies." *Journal of Political Economy*, 102:5, pp. 912-50.
- Knack, Stephen and Philip Keefer. 1997. "Does Social Capital Have an Economic Payoff? A Cross-country Investigation." *Quarterly Journal of Economics*, 112:4, pp. 1251-88.
- La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance*, 52, pp. 1131-50.

⁶ The indices of government quality have also been criticized because they are subjective measures estimated by experts who may be biased by their knowledge of the economic conditions in the country.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. 1998. "Law and Finance." *Journal of Political Economy*, 106, pp. 1113-55.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. 1999. "The Quality of Government." *Journal of Law, Economics and Organization*, 15:1, pp. 222-82.

North, Douglass C. 1990. *Institutions, Institutional Change, and Economic Performance*. New York: Cambridge University Press.

North, Douglass C. 1994. "The Historical Evolution of Polities." *International Review of Law and Economics*, 14, pp. 381-91.

North, Douglass C. and Barry R. Weingast. 1989. "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England." *The Journal of Economic History*, 49:4.

Nugent, Jeffrey B. and James A. Robinson. 2002. "Are Endowments Fate?" Centre for Economic Policy Research Discussion Paper No. 3206.

Putnam, Robert. 1993. *Making Democracy Work: Civil Traditions in Modern Italy*. Princeton: Princeton University Press.

Roe, Mark J. 2002. "Institutional Foundations for Securities Markets in the West," Draft Prepared for the ASSA meetings, January 3-5, 2003.

Sokoloff, Kenneth L. and Stanley L. Engerman. 2000. "Institutions, Factor Endowments, and Paths of Development in the New World." *Journal of Economic Perspectives*, 14:3, pp. 217-32.

January 30, 2003