24. Institutions and Development

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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%).

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 611–638.

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.