IPPG Programme Office, IDPM,
School of Environment & Development,
University of Manchester,
Harold Hankin Building, Precinct Centre,
Oxford Road, Manchester M13 9PL
Telephone 0161 306 6438
Fax 0161 273 8829
www.ippg.org.uk

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by Paul Hare[1]

Economic Institutions Matter, But They Are Not the Full Story

Introduction

Research under the IPPG Programme is built around the premise that 'institutions matter' for economic development and growth. Though the questions as to which institutions matter, how exactly they matter, and why, are topics for our more detailed research, the fundamental hypothesis of our Programme remains the idea that when countries put in place the 'right' institutions, they are likely to grow and prosper. More fundamentally, our hypothesis is that: Pro Poor Growth (PPG) depends critically on the interactions of formal and informal political, social, and cultural institutions with economic institutions. Thus the shaping, form and functioning of economic institutions are embedded in and influenced by the wider matrix of institutions (including political and cultural ones).

Over the years, there have been many hypotheses put forward to explain why some countries are rich while others languish in abject poverty, and most importantly, to help us understand how poor countries can embark on sustained growth. Sometimes these hypotheses, mostly focusing on the economics of development, have taken on the appearance of fashions or fads in the development community – ideas such as the savings and foreign exchange gaps (the two-gap model); the two sector model with migration from rural to urban areas; the need for high rates of productive investment; the need to open up to trade and FDI, with a strong outward orientation; and so on, all come to mind in this context. Of course, the fact that these ideas were widely accepted for a time, and then fell out of favour, does not mean they were mistaken; rather, it reminds us that the development process is highly complex and still imperfectly understood. Each of the above ideas could still play a useful part in promoting development in the world's poorest countries, but taken individually none tells the full story.

The interesting question for the present Briefing Note is to consider whether the recent 'fashion' for paying attention to institutions is merely another attempt to come up with a fundamental explanation for issues of growth and development that we still don't understand as well as we would like to, or whether it really does deliver explanations for poverty and how to escape from it that are more powerful and illuminating than earlier ideas. To assist the reader to think about this question, some recent literature is reviewed in what follows.

Demographics and Culture

In A Farewell to Alms, Clark (2007) argues that if we used the World Bank conception of 'good economic institutions' – in terms of secure private property, protection for business contracts, low levels of inter-personal violence, low and fairly stable taxation – then England already met these conditions pretty well by about the thirteenth century. But the take off to modern growth with rising living standards did not occur for another five hundred years (!). Why not? Clark puts forward a fairly complex model to explain this, supported by extensive empirical evidence, mostly concerning England, but with comparisons across Europe and with India, China and Japan.

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For Clark, most human societies have operated according to Malthusian principles, with real living standards low and generally stable for centuries at a time. In such societies, any improvement in technology – and there was a steady stream of significant innovations for centuries before the Industrial Revolution – merely enables the given society to support a somewhat larger population at the established subsistence level. Against the background of this model, the fundamental development issue is how to break out of the Malthusian 'trap', how to get onto a sustainable growth path with rising per capita incomes.

To do so, several factors have to come together. These include working habits, the level of literacy, extensive trading opportunities, and the rate of improvement of technology. Clark shows that the typical 'working year' was already at modern levels prior to the Industrial Revolution – implying that people already had to work far harder than most hunter-gatherers in order to achieve their basic subsistence income. Second, literacy levels – well before any compulsory schooling – were higher than those in many present-day developing countries; and third, trading opportunities were provided by the developing American colonies (and later, by developments in India and elsewhere), which allowed Britain to import food to support the country's growing urban population once rapid industrialisation gathered pace (paying for the imports with exported manufactures).

The last part of the story, the pace of technological change, remains more of a puzzle. Clark does note that historically, the pace of technological advance was rarely more than 0.05% per annum, sufficiently slow for Malthusian adjustment mechanisms to predominate. The Industrial Revolution, albeit possibly more gradual than commonly supposed, involved a rise in the rate of technological advance to1% per annum initially, later rising further to the present day's 'normal' rate of 2–3% per annum. These all sound like quite small numbers, but even 1% per annum is 20 times faster than pre-industrial rates of progress, a truly massive rise in the pace of change. Accompanied by enough investment to equip workers with the newest technology, it is enough to double living standards every 70 years or so. This remark about investment, though not highlighted strongly in Clark's book, is critical for his argument, since this is what implemented the new technologies across the whole sphere of production.

So why England, and why in the late eighteenth century? Essentially, Clark proposes a demographic argument, based on the idea that birth rates were higher for the rich, the poor were not even reproducing themselves, and English society was characterised by steady downwards mobility. As a result, what Clark calls the middle class values of hard work, thrift, education and discipline gradually permeated the entire population. In other words, in terms of what was needed for successful industrialisation, demographic factors steadily improved the 'average quality' of the population. By the eighteenth century, the rise of science provided the basis for a huge increase in innovation across many sectors (though for some decades, textiles dominated), with a good quality workforce ready and waiting. Elsewhere, the demographic factors operated in the same direction but more slowly, and public attitudes to science were much less favourable.

In a roundabout way, therefore, Clark's story ends up resting on cultural factors brought about gradually by very long-term demographic change, a variant of Weber's ideas about the Protestant ethic. For countries not yet much developed, its message is quite sobering, since it implies that 'fixing institutions', without paying attention to the underlying culture – and the diverse agents who make it function – as it affects attitudes to education, work, savings and technology might not prove very rewarding.

Limited Access and Open Access Political Orders

North and his various associates (2006, 2007) have studied the various types of political order to be found in the world, and leaving aside the Primitive Order associated with small-group, hunter-gatherer societies, they identify two main types. These are the Limited Access Order (LAO) and the Open Access Order (OAO), both established to solve the fundamental political problem of controlling and limiting violence. The OAO is the one the developed world is most familiar with, being characterised by a pretty comprehensive and strictly enforced state monopoly over the means of violence (no private armies, political control over the military), open and democratic competition for political office, and the rule of law (see Dam, 2007); the latter not only means that property rights and business contracts are protected in law, but that the law applies to everyone, regardless of their social and political position. What North et al. are at pains to emphasise, however, is that OAOs are quite rare phenomena, and they argue that none of the countries of the developing world belong to this category of political order. As a consequence, they suggest that a good deal of the advice offered to developing countries is likely to be quite misguided or misdirected, since it tacitly assumes that the recipients of advice are indeed OAOs, when they are not.

According to North et al.'s alternative perspective, all developing countries are forms of LAO. 'Those countries in the limited access order (LAO) have social, economic, and political systems based on limited entry and rent-creation. Elites in limited access orders use rents to maintain order and to hold the social order together. The political system manipulates the economy to generate rents that bind the interests of economic actors to support the current political system.' (North et al., 2007, pp.3) This conception raises the question, where do the rents come from? Under feudalism, they mostly arise from land ownership and the assigned rights to a share of the proceeds. Under more modern systems, rents can arise from tax collection and the ways in which revenues are allocated; e.g. in many countries, funds are allocated preferentially to areas controlled by the ruling elite. Last, rents can arise from control over natural resources, or control over various forms of permit and license.

Within this type of order, it is then useful to distinguish a spectrum of possibilities, summed up in the three terms 'fragile', 'basic' and 'mature' LAOs. In a fragile LAO, virtually all the contenders for political dominance have access to the means of violence and are prepared to use them, with rents either too low or too unstable to provide adequate incentives for peaceful cooperation for any sustained period. Most of the states highlighted in Collier (2007) belong to this category of political order, as we elaborate below.

Violence is curbed more effectively in a basic LAO, with rents sufficient to elicit more consistently co-operative behaviour among the elite, outbreaks of disorder being relatively infrequent. So there is order, but it is unlikely to be especially democratic even if the outer trappings of democracy are present and events such as elections occur periodically. For the stability of such an order requires elite control over access to the political process, so there will be few political parties and those that exist can only prosper with the approval and support of some segment of the elite. Likewise, substantial civil society organisations will be few and far between since they, too, will be perceived as potential threats to the political order. Hence most civil society organisations that do exist will not be free and independent of the political framework; rather they will mostly be sponsored and controlled by existing elite groups. Present-day Russia fits this model quite well, as do countries like China, Vietnam, and parts of Latin America. Indonesia under Suharto – through GOLKAR, the single all-embracing party – did that too.

In a mature LAO, the compromises that limit violence are more firmly accepted and the political elite therefore feels itself to be more secure (not necessarily correctly, of course), and hence able to tolerate a more diverse set of organizations, including some that operate largely independently from the state apparatus. Botswana and Kazakhstan are examples of this type of order.

As North et al. are careful to emphasize, though, their terminology does not imply that there is a natural and more or less inevitable sequence, with states shifting from fragile to basic to mature LAO, and thence to a fully fledged OAO. States can easily get stuck in a particular configuration, sometimes for very long periods, and the transition processes from one stage to what one would think of as the 'next' stage are both poorly understood and very difficult. Nevertheless, thinking about political orders using the framework of these papers does suggest quite a fundamental re-think about aid. First, it focuses attention on issues to do with consolidating fragile and fragmented political orders, simply to get the state functioning better, delivering some public services to the population, and so on. Second, advice and support regarding institutions has to have regard to the nature of the prevailing order. For example, support for reforms to improve the rule of law and strengthen the judiciary might at first do little more than entrench the property rights of the ruling elite and so, from a pro-poor growth perspective, it might not seem very attractive. But we have to start somewhere, and a judiciary that learns to protect some property rights may in time evolve to protect everyone's. It is important, I would suggest, to think of these matters in quite a long-term perspective, with economic issues and the political order often interacting in surprisingly subtle ways to bring about gradual change.

Weak States

In terms of their political configuration, as we remarked above, the states we think of as 'weak' are typically fragile LAOs. Collier's The Bottom Billion focuses on these states, the 50–60 countries (Collier identifies 58, to be specific) that are home to the poorest people in the world, the people being left further and further behind as the rest of the world advances economically. Collier notes that most of the world is now developing, with incomes and living standards rising nearly everywhere, albeit at quite diverse rates. Millions of people have been lifted out of poverty in the past two-three decades, and many more will be in the next decade or so. Against this impressive achievement - perhaps the most successful period of development the world has ever seen – Collier seeks to identify the factors that still continue to hold back The Bottom Billion, the idea being that this should help to design more effective, better focussed aid.

On average, the countries he highlights are all small – if not always geographically, then certainly in terms of their economic weight. Collier identifies four main categories of country characteristic (he calls them 'traps') that, in his view, adversely influence country growth prospects. These are:

(a) The conflict trap, i.e. whether the country is engaged in civil war or some wider conflict, or whether important neighbours are engaged in such conflict.

(b) The natural resource trap, i.e. whether the country possesses abundant natural resources such as oil, gas, valuable metals, diamonds, etc. Interestingly, these endowments not only generate 'Dutch disease'-type phenomena, but they are commonly associated with plentiful opportunities for rent-seeking, corruption and bad governance. As a result, natural resources are often accompanied by slow economic growth, despite the potential benefits they offer.

(c) Being landlocked, especially with bad neighbours. The point here is that if there are limited local or regional markets and poor access to the wider world market, a landlocked country is unlikely to advance much by simply promoting industry and trade. At the extreme, it might be hard for such countries to embark on sustainable growth at all until their more favourably placed neighbours have already started to grow. Of course, being landlocked is not per se a bad thing, cf. Switzerland or Austria.

(d) Bad governance, notably in small countries. However good their policies and institutions, countries never grow faster than about 8–10% p.a. (with rare, brief, exceptions), but they can fail badly and rapidly if governments interfere foolishly in the economy; cf. the recent disastrous experience of Zimbabwe. This asymmetry makes good governance important not so much to promote growth, as to avoid economic disasters.

Conclusion

The three very different areas of recent research that have just been sketched have some interesting and significant implications for the way we ought to think about economic institutions in the IPPG Programme. The most important message, I think, is that while these institutions certainly matter for growth and development, the way in which they work depends critically on the following factors:

- Culture;
- The nature of the political order; and
- The combination of 'traps' that affect the economic prospects of a given country.

These factors seriously complicate the study and analysis of institutions. They imply that a 'one-size-fits-all' type of approach will not usually work, and limit our ability to develop broad, general findings applicable across a wide range of settings. Useful conclusions about institutions are only likely to emerge from explicitly multi-disciplinary studies that take account of the given country's cultural inheritance and norms, as well as the complexity of its political order.

Given this, economists such as the present author need to be more cautious than usual over some of the economic advice we often offer to developing countries. For instance, think of the common advice that countries should open up their economies to freer trade, and take advantage of the extensive business opportunities offered by increasing globalisation, etc. As a general message, something along these lines will often make good sense. But in a specific context, some hard thinking will be needed to tailor the advice to features of the country being advised. Thus in many countries, trade barriers are an important source of rents that are important for political equilibrium, so freeing imports could be both politically destabilising as well as economically damaging in the short term if indigenous firms are not sufficiently responsive to meet the new competitive challenge. These considerations have less weight if the initial focus of the new policy is on export promotion, so this might be a more effective way to embark on a policy of greater openness. Thus even if the general idea of openness is acknowledged to be correct, how we go about it will depend quite sensitively on a range of country characteristics, including those outlined in earlier sections of this Note.

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The IPPG Programme is a shorthand name for the *Research Programme Consortium on Improving Institutions for Pro-Poor Growth*, launched in September 2005.

The inspiration for the programme comes from two sources. The first is the recognition that 'institutions' – meaning relatively stable social arrangements and the formal rules, laws and conventions and informal norms that are associated with them – exercise an enormously important influence upon patterns and rates of economic development and change. The second is the concern that while it is by now clear that economic growth is a necessary condition for the sustainable reduction of poverty, it is not a sufficient condition for such reduction to take place. Consequently, if the Millennium Development Goals are to be achieved, it is necessary to think of ways whereby growth can be made distinctly pro-poor. 'Pro-Poor Growth' (PPG) means simply economic growth that is accompanied by improvements in the real incomes of poor people – economic growth that is actually driven, at least in part, by improvements in the incomes of poor people.

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