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# **Institutions and Development: What we (think we) know, what we would like to know\***

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## ABSTRACT

This paper takes the form of an extended literature review, outlining the key ideas that will need to be developed further in the course of the IPPG Research Programme. After an extended introduction, the next two sections are conceptual, the former elucidating key concepts and definitions, the latter examining various approaches to the analysis of institutions relevant for economic growth. The paper then reviews much of the available evidence linking institutions and growth and covers in some detail the evidence regarding economic institutions: confirming that institutions matter. However, the findings from different studies are far from consistent in terms of identifying exactly what it is that matters. Given the prevalence of weak or poorly functioning states amongst the poorest countries of the world, this paper also reviews literature on the political aspects of development, particularly in relation to the role of institutions; likewise, it selectively illustrates the ideas of earlier sections through the discussion of two topics: trade policy and the institutions needed for it to work well; and institutions that make for a good business environment. The final section outlines some preliminary working hypotheses about institutions and development. While emphasising pro-poor growth throughout, the paper finds that growth itself is a fundamental, necessary condition for achieving pro-poor growth. Given that, a serious analysis of institutions and growth must pay attention to the need for institutions that foster and promote profit-seeking accumulation (without which little sustained growth is likely to occur).

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Keywords: Institutions; pro-poor growth; weak states; cultural issues; institutional matrix; investment and accumulation.

## CONTENTS

	PAGE
The IPPG Programme	4
Recent Reports	5
General	5
Africa	7
Outline of the Paper	8
Concepts and Meanings	9
Growth and Pro-Poor Growth	9
Institutions Supporting Economic Growth	11
Conceptual Approaches to the Analysis of Institutions	14
Informal Trading Models	15
Game Theory Approaches	16
Co-ordination Failures	18
New Institutional Economics	18
Regulation of Market Participants	20
Management of Risk	21
Institutional Emergence and Evolution	22
Dynamic Processes and Selection	24
What do we Know?	25
Institutions and Growth	25
Economic Institutions and Growth	25
The Macroeconomic Literature	25
Microeconomic Studies and their Lessons	30
Political Institutions	31
Institutions - Illustrations	33
Trade Policy	33
The Business Environment	36
Hypotheses and Conclusions	42
Useful Ideas	42
Hypotheses and Further Work	43
Further Work	44
References	46

# 1. THE IPPG PROGRAMME

The Institutions and Pro-Poor Growth Research Programme (IPPG) is based upon the following *Big Idea*<sup>1</sup>:

*We hypothesize that Pro-Poor Growth (PPG) depends critically on the interactions of formal and informal political, social, and cultural institutions with economic institutions. Together, these interactions constitute an institutional matrix which may either enhance or constrain PPG. This programme seeks to identify, understand and promote institutional interactions which support the achievement of PPG.*

This broad approach follows from the recognition that 'institutional mono-cropping' does not work: the same formal institutions may have different outcomes in different contexts, and comparable, valued outcomes may be achieved with different institutional sets (see Evans, 2004). It has also become clear that the effective promotion of both economic growth and pro-poor growth involves more than the deployment of appropriate economic policies.

Accordingly, our task will be to identify historically and comparatively, those institutional sets and contexts which enhance PPG and those which do not; to study how such patterns of institutional interaction change, or can be helped to change; and to explore the conditions under which coalitions of stakeholders may be encouraged to adapt, adopt, negotiate and change institutional matrices for PPG, given very different starting points, endowments, possibilities and constraints.

Given the central objective of this research programme to explain the circumstances and institutional settings most favourable to PPG, the overarching questions to be addressed are these:

- How are the institutions that affect economic growth, and its distribution, established, sustained and changed?
- What determines their effective functioning? How is this related to the social, cultural and political matrix from which they arise and in which they operate?
- How do institutional interactions influence economic growth, the pattern of growth and, specifically, the possibilities for pro-poor growth?

We interpret PPG, broadly, to mean economic growth that enhances the capabilities of poorer people, which may be achieved both through the ways in which growth is brought about and also through more equitable distribution of its benefits.

Whether formal or informal, public or private, institutions are relatively stable social arrangements (embodying rules, norms or conventions) possessing a number of special features:

- they regulate behaviour in ways which, in the short run, often conflict with individual preferences; they are based on shared expectations and meanings, derived from custom and legal provisions that establish trust;
- they are best thought of as 'repeated games' in which most types of interaction occur many times.

Given these features, many institutions are likely to have the character of public goods, this implies that the 'supply of institutions' generated by the market mechanism left to itself is unlikely to correspond with social efficiency. By 'supply' in this context, we mean both the question of whether a given institution or type of institution would be created at all by the market, and how more detailed issues such as the scale and coverage of the institution are concerned – for instance, wealthy people might well provide themselves with services to protect their property rights, but such services might not extend to the poor (indeed, in the worst case, the property rights of the poor might be neither recognized nor protected).

There is evidently a potential role for the state in creating institutions which the market does not provide and in regulating in the public interest those which it does. On the other hand, in considering the state we should avoid the error of supposing it to be an inherently beneficent agent, in some sense external to 'the economy' per se; whatever specific country we care to examine, this naive and simple approach does not prove to be especially helpful. What turns out to be critical for successful growth is a state that is effective and competent within its spheres of authority, but whose discretion and power are subject to effective institutional constraints (see World Bank [2005b] chapter 8).

Nevertheless, well functioning market-type economies do generally have institutional arrangements – taking surprisingly diverse forms – that provide for the key economic functions concerned with the allocation of property and protection of property rights; facilitating transactions (including through the establishment and protection of diverse business forms, through the operation of various forms of network); and permitting economies of scale and specialization; they also require political institutions to enable the negotiation of competing claims and interests, and to establish the legitimacy of their economic institutions. The resulting interactions between the economic and political spheres are usually extremely complex, giving rise to many possible equilibria in terms of the stable and sustainable institutional arrangements that can arise, this gives rise to the important and difficult question, namely how do we explain the particular institutional configuration that does arise in a given country? Moreover, even when countries appear to have similar formal institutions in place, the outcomes in terms of economic performance, the

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1. These paragraphs are drawn from the original IPPG application to DFID, since that document provides a careful statement of the basic ideas underlying our research.

functioning of specific markets and so on can diverge sharply; in order to explain such differences between countries, it is necessary to investigate the informal social practices and understandings (Douglass North's 'templates') that influence how formal institutions really work.

## 1.1 Recent Reports

Several reports from national governments, the international institutions, various commissions and working groups, and so on, have been published in the last few years; most of these reports – usually in amongst much discussion of other issues – offer suggestions about institutions and their possible role in economic development, and some of what they say on this topic is of great interest. However, we are not convinced that these voluminous reports have, even collectively, fully addressed the fundamental institutional 'problems' of development. Accordingly, we simply note here for reference what seem to us the most striking institutional findings of these studies, since this will assist us in identifying the significant lacunae that our own research will seek to fill.

The reports we refer to here are the following:

### a) General

*Economic Growth in the 1990s: Learning from a Decade of Reform*. World Bank (2005).

*Equity and Development, World Development Report 2006*. World Bank (2005).

*Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries*. AFD, BMZ, DFID and World Bank (2005).

*International Cooperation at a Crossroads: Aid, Trade and Security in an Unequal World*. Human Development Report 2005, UNDP.

*World Economic Outlook, 'Chapter 3: Building Institutions'*. IMF (September 2005).

### b) Africa

Ndulu and Connell, (May 2005), *Policy Plus: African Growth Performance 1960–2000*. AERC (draft)

*Our Common Interest: Report of the Commission for Africa*, (2005).

Sachs et al., (2004), *Ending Africa's Poverty Trap*.

Fafchamps et al., (2001), *Towards a Growth Strategy for Africa*.

Collier and Gunning, (1999), *Explaining African Economic Performance*.

### 1.2.1 General

For many poor countries, the 1990s proved a difficult decade – many failed to grow, or grew very slowly, sometimes despite appearing to follow conventional policy prescriptions and having an appropriate legal and institutional framework in place; others grew unexpectedly quickly without adhering to conventional models, China being the most remarkable instance of this phenomenon. Thus in *Economic Growth in the 1990s: Learning from a Decade of Reform*, the World Bank sought to study this diverse experience, set it in the context of a longer period of growth experience, and learn some lessons. The report noted a resurgence of interest in the role of institutions in supporting growth process and in the complexity of the linkages between growth and fairness (or equity), still not well understood<sup>2</sup>; however, it was found that the reforms implemented in many countries during the 1990s had often paid insufficient attention to key institutional reforms that would have enabled markets to function better than they did. Moreover, the report stresses: 'To sustain growth requires key functions to be fulfilled, but there is no unique combination of policies and institutions for fulfilling them.' (pp. 12)

There are many countries, for instance, where uncontrolled government discretion has proved disastrous by facilitating rent-seeking and the outright plunder of national resources, but the implication to draw is not that such discretion should be wholly rule bound; rather, governments must be able to use discretion where it matters for the economy, but should be subject to effective checks and balances. In practice, this is one of the most difficult issues for a country to get right, and is one we return to later. Simple policy 'packages' are also not very useful without extensive adaptation to local conditions and it can prove more productive to undertake policy experiments, to learn from mistakes, and to identify binding constraints on growth. On specific policy domains, both trade openness and extensive privatization are generally desirable, but they can be implemented in many different ways and in a given country the most appropriate will depend sensitively – but unfortunately in a manner that we are still far from understanding fully – on the local institutional conditions.

Both *Equity and Development* and *Pro-Poor Growth in the 1990s* focused on the complex connections between growth, inequality and poverty; the former does so as a review of the entire world economy, with particular attention directed towards the developing world; while the latter sums up lessons from fourteen detailed country studies undertaken as part of the OPPG Research Program.<sup>3</sup>

*Equity and Development* draws attention to the huge waste of human potential associated with the enormous inequalities that exist, both within and between countries. These inequalities concern both

2. Many simple, and not so simple, hypotheses about these linkages have been investigated for various countries. Mostly, they have not been supported by the empirical evidence, or have been supported only weakly. There is clearly a lot more to learn in this field, as is demonstrated by the excellent and very thorough volume of studies. (Cornia, 2005)

3. OPPG refers to Operationalizing Pro-Poor Growth; the OPPG Research Program was a joint venture between the World Bank, and the official aid agencies of the UK, France and Germany.

assets (e.g. access to and/or ownership of land and other fixed or movable property) and current incomes (formal or informal sector wage rates, income in kind, etc.), those at the 'bottom of the heap' in a given country frequently lacking access to basic education, decent health services, potable water and other basic resources. The result is that poor people frequently die earlier, remain poorer and their surviving children inherit the same poverty that they themselves endured: hence the cycle of poverty and deprivation in which many people in the world's poorer countries are trapped.

The report therefore recommends many concrete measures to help release people from this trap, at the same time, and more importantly for the present study, it notes the institutional and political conditions that can make otherwise highly desirable changes extremely difficult to achieve. As the report's lead author, Francisco Ferreira, has pointed out, 'Inequitable institutions impose economic costs. They tend to protect the interests of politically influential and wealthy people, often to the detriment of the majority. This makes society as a whole more inefficient. If the middle and poorer groups are not able to exploit their talent, society loses opportunities for innovation and investment.' Moreover, extreme inequality itself reinforces the institutions that sustain it, since the wealthy have access to political power while the poor are frequently – in effect – disenfranchised. Breaking through the resulting political barriers to pro-poor change thus presents a serious challenge.

The OPPG country studies reported in *Pro-Poor Growth in the 1990s* confirmed the view that poverty reduction tends to occur more rapidly in countries that are growing faster, though poverty fell faster still where active pro-poor policies were also in place. In agriculture, five key policy interventions were found to be effective in improving earnings (and hence reducing poverty), namely (pp. 5):

- Improving market access and lowering transaction costs.
- Strengthening property rights for land.
- Creating an incentive framework that benefits all farmers.
- Expanding the technology available to smallholder producers.
- Helping poorer and smaller producers deal with risk.

Outside agriculture, four types of policy measure were highlighted in many of the country studies (pp. 8):

- Improving the investment climate.
- Expanding access to secondary and girls' education.
- Designing labour market regulations to create attractive employment opportunities.
- Increasing access to infrastructure.

Most of these measures, whether in agricultural or other sectors, can only be put into effect through the implementation of institutional innovations tailored to the specific characteristics of a given country. Moreover, in designing effective pro-poor growth strategies, it is naturally very important to understand the barriers that stop poor people from improving their economic situations and that these barriers can differ greatly between countries.

Though acknowledging the vital role that governments in developing countries themselves must play in fostering growth and reducing poverty in their respective countries, the focus of the UNDP's latest Human Development Report, *International Co-operation at a Crossroads*, concerns three areas where enhanced support from the rich countries would be enormously valuable; these areas are: aid, trade and security. The report documents the extent of poverty and inequality across the world, arguing that excessive inequality is damaging for growth prospects, but in our view its most useful contribution lies in its emphasis on the above three issues where the rich countries themselves need to be taking serious action. On aid, for instance, the report argues that aid volumes need to rise substantially; that aid should be delivered more efficiently; and that aid programmes should involve 'country ownership' far more than they have in the past. In principle, the rich countries have signed up to such an agenda, though to date their concrete progress towards meeting the agreed goals has been halting, to put it mildly. On trade, after noting the declining share of world trade accounted for by Africa, and the weak trade performance of Latin America, the report argues for fairer trade rules and for an end to rich country subsidies (notably to agriculture) and trade restrictions. Indeed the on going Doha round of world trade negotiations is supposed to contribute to just such a result, though unfortunately at present (early 2006), the prospects for a successful conclusion to these negotiations do not look especially favourable. In places, the report undermines its general argument by offering weak analysis, referring to the 'problem' of falling world coffee prices and implying that the 'international community' should have been more active in 'solving' it, but this is surely nonsense – for unless all coffee producing countries agreed to set up a strongly policed cartel (which would include somehow stopping other countries from entering the market), there is no way of keeping prices up while more and more farmers are willing to supply the market at current low world prices. In a market like this, equilibrium world prices will only rise when general incomes in poor countries have risen enough to ensure that farmers will only produce coffee when it offers them much higher incomes than at present: rich countries have no control over this. On security, of course, it is true that violent conflicts – both internal and international – have left many countries stranded in poverty. Africa has suffered particularly badly from such conflicts since independence, but it is not alone; the UNDP report is quite right to point to weak and failing states as one explanation for the prevalence of conflict in recent decades, and we return to this issue later in the paper. Often, wealth from minerals and other natural resources has provided the funding to initiate or sustain local wars, and attempts to control such

trade have not enjoyed much success. Developing regional capacity to intervene to manage conflict, and strengthening UN capabilities can both be helpful, but the world's willingness to finance peace-keeping missions and to give them strong, effective mandates, has only occasionally risen to the challenge of events. Thus at an international level, enormous institutional and political innovation is needed to address the issues of concern here; vital though it is, this topic lies well beyond the limited scope of this paper.

Last, we refer to the very useful empirical paper from the IMF, *Building Institutions*. This chapter sketches some theory of institutional change, then uses a new database of 'institutional transitions' to perform a detailed econometric analysis: transitions to stronger market institutions generally resulted in increased growth of per capita GDP, a higher ratio of private investment to GDP and improved productivity growth; whereas institutional transitions were found to be more likely to take place in countries that were very open to trade, that enjoyed greater press freedom (this possibly serving as an indicator of political accountability), whose neighbours had better economic institutions, and where general educational levels were higher. On factors determining the quality of the resulting institutions however, the econometric findings were less clear, except that trade openness and political accountability remained significant. Three external factors that might be considered to influence and support such transitions were also examined, namely external anchors, aid, and transparency. By 'external anchors' we refer to the prospect of EU membership (an interesting case, but not relevant to the world's poorest countries), and the implications of WTO membership or membership of some regional trade grouping; in Africa, the New Partnership for Africa's Development (NEPAD) might come to provide a form of external anchor if it can offer a combination of clear benefits and credible commitment. On aid, the empirical evidence is very mixed – on the one hand, aid can obviously relieve some financial constraints, but it can also enable governments to delay reforms and can be used as a substitute for taxation; poor delivery can also impose heavy administrative burdens on already weak states. Transparency refers to the variety of mechanisms that can be devised to enhance accountability, from the press, to the activities of NGOs and information dissemination to facilitate local monitoring of government, etc. These are all valuable tools, but as with many aspects of institutional reform, directions of causality are not clear. For though the encouragement of transparency might indeed foster useful institutional reforms, in some countries there has to be a strong commitment to reforms already in place before one can realistically expect to see high levels of transparency – in other words, it can be a mistake to regard transparency as some form of 'independent' factor; rather, it can often form part of the reform process itself, part of the new institutional structures that need to be built.

### 1.2.2 Africa

The African Economic Research Consortium (AERC) has carried out a number of important country studies of African growth performance over the past few years (the Africa Growth Project), and is now bringing these together into a major new study of African development, likely to be published in 2006 or 2007. *Policy Plus: African Growth Performance 1960–2000* is a (draft) overview chapter for this study, reporting on the continent's dismal growth performance since 1960. Only two countries experienced rapid growth of per capita GDP over the four decades from 1960 to 2000, namely Botswana and Mauritius, everywhere else experienced either slow economic growth, or even witnessed a decline. This is the background against which observers refer to an 'African crisis'; the chapter does elicit some general lessons – notably the need to avoid policy mistakes (this may sound a banal and obvious point, but it cannot be repeated often enough, in our view); the need to mitigate the adverse effects of the so called 'natural resource curse' and locational disadvantage; and the implications of Africa's delayed demographic transition – but it has little to say on the institutional theme of the present paper.

It was this sense of a crisis-facing Africa that motivated the British Government to establish its Commission for Africa in 2004, the Commission's Report, *Our Common Interest*, makes recommendations in five areas: governance and capacity-building; peace and security; investing in people; growth and poverty reduction; and more and fairer trade. Under capacity-building, the Report makes the important point – neglected in virtually all other recent studies of Africa – that Africa's system of higher education urgently needs rebuilding, both to strengthen the continent's capacities in science and technology and to provide the high-level staff needed to improve governmental functioning in many countries. Aside from better staffing though, states need to be more accountable to their people and the region needs much stronger institutions to prevent, limit and manage conflicts – in parts of Africa, undoubtedly the main reason for development failure. This part of the puzzle is unavoidably one that Africans themselves have to find ways of solving. On investing in people, the Report calls for major commitments to improve basic education, rebuild health-care systems, and scale up capacity to cope with the HIV/AIDS epidemic, all points, strongly supported, in *Ending Africa's Poverty Trap*. Specifically on economic development, the Report proposes massive increases in infrastructural spending, efforts to improve the investment climate and focused support for agriculture and SMEs, both seen as likely drivers of development. In addition, it urges changes both in trade-related policies (such as tariffs, non-tariff barriers, and the like) and in the associated institutional arrangements (customs practices, bureaucratic barriers, corruption, etc.) affecting trade. As we discuss later, enormous institutional changes will be required if Africa is to succeed in significantly improving its investment climate – we agree, however, that this is the key to Africa's future.

However, contrary to other reports, *Ending Africa's Poverty Trap* is not convinced that Africa's governance is especially bad, given income levels and other conditioning factors. Rather, it considers sub-Saharan Africa to be held back by a form of poverty trap, characterized by five factors:

- 1) high transport costs and small market size;
- 2) low productivity agriculture;
- 3) high disease burden;
- 4) adverse geopolitics; and
- 5) slow diffusion of technology from abroad. (pp. 130–1)

The paper sees the way out in terms of a massive, aid-supported investment push to improve infrastructure, improving agricultural productivity, etc. – effectively and drastically lowering the transactions costs of business, while also raising productivity levels – targeted at achieving the already agreed Millennium Development Goals (MDGs), and managed in such a way that most of the new money would be invested rather than simply consumed. Success, in our view, will also entail significant improvements in the institutional frameworks supporting economic activity in most countries, though this aspect is not discussed in depth in the paper.

*Towards a Growth Strategy for Africa* also emphasizes the vital need for growth as the only route out of poverty, with such growth supported by a strong export orientation (which, in turn, should not be excessively fettered by restrictive 'rules of origin' – see section 5.1 below). Given the former colonial focus on exports back to the respective home countries, what is still lacking in Africa is adequate infrastructure to support trade between countries within the continent; moreover, the business and investment conditions are quite poor due to pervasive institutional weaknesses. While the authors consider that the expansion of manufactured exports will be the fundamental 'growth engine', they accept that only a few countries will choose, or will be able, to take this path in the next decade or two, with most of Africa continuing to rely on primary exports (mostly of agricultural goods). Successful development in this sector will likely entail an initial concentration on a few areas and crops with high potential, supported by big improvements in technology, input quality, reliable supplies, quality certification and related enhancements of the facilitating institutions. Aside from what Africa itself needs to do, agricultural exports from Africa to the OECD countries also face diverse and highly restrictive constraints as a result of rich-country policies to protect their farmers; such restrictions are very damaging to the developing world.

Last, we turn to *Explaining Africa's Economic Performance*; this study reviews the standard growth regressions that highlight Africa's lagging performance, then looks behind the data to identify the underlying reasons. By investigating economic behaviour at a very microeconomic level – in terms of farms and firms – the authors demonstrate how economic agents have adapted to Africa's perceived risky environment, with farmers often retreating to subsistence and the informal economy as a survival strategy; firms in other sectors struggle to survive and are rarely able to grow or invest much, with the result being a self-reinforcing stagnation. It is argued that neither farmers nor owners of other types of firm have yet produced the social institutions that help to manage risks, achieve co-ordination, and hence enable investment and growth to occur. We return to this important finding later in the paper.

### 1.3 Outline of the Paper

In the light of these preliminaries, this paper will take the form of an extended literature review designed to identify significant omissions and shortcomings in the available literature, with a view to formulating hypotheses and approaches – both conceptual and empirical – that will guide much of the subsequent research undertaken by the IPPG project. Accordingly, the paper is structured as follows: sections two and three are conceptual, the former elucidating the key concepts and definitions that we need to deal with, the latter examining various approaches to the analysis of institutions relevant for economic growth; thus section two reviews the literature that helps us to understand both what we mean by growth, and more specifically, the notion of pro-poor growth that lies at the heart of this research. It also begins the process of defining some basic notions concerning institutions. Section three provides some analysis of mostly micro-level institutions to clarify some of the issues and concerns that arise whenever institutions fail, function poorly, or are simply absent altogether. The section also examines some dynamic aspects of institutions, such as how they form, how they change, and how they disappear (or are superseded by new forms).

Section four reviews much of the available evidence linking institutions and growth; to do so, the section is divided into two parts: the first (section 4.1), is concerned with economic institutions and it surveys the extensive macro-level literature on the linkages between institutions and growth, mostly based on the cross-section econometric analysis of many countries for various periods. As we shall see, evidence can be found to support the view that institutions matter, but findings from different studies are far from consistent in terms of identifying exactly what it is that matters – indeed some writers doubt whether we are justified in saying much at all. While often very interesting, moreover, studies at this level frequently arrive at policy recommendations that are too broad and general to be especially operational – useful advice needs far more refinement.

Unavoidably, however, much of what we examine and consider to do with the institutions supporting economic development has to face up to the reality of weak states. Such states fail to deliver what we normally think of as the fundamental pre-requisites for successful development, namely peace and



order. Several states in sub-Saharan Africa quite evidently belong in this category of weak or failing states, moreover, states fail either through what we might term 'absence', where what there is of a state structure is simply incapable (for whatever reason) of delivering vital public goods; or by deliberately adopting a policy of predation (see Evans, 1995). In the latter case, the elite devotes its energy to creaming off economic surpluses, e.g. from mineral exploitation and the like; predatory states rarely create the conditions for successful growth.

What we need to understand is what it means (for the general population) to belong to such a state; how states fail or choose to be weak in either of the above senses; what can be done to strengthen a weak state to render it more capable of performing the tasks vital for economic development; and ways in which aid and other interventions can 'work around' the weakness of the state and still deliver something useful for its poorer citizens (preferably while simultaneously enhancing state functioning). The notion of 'power' plays a key role in parts of this analysis; much of section 4.2 is devoted to this vital topic, and it necessarily extends well beyond economics into the domains of politics and social anthropology.

Section five selectively illustrates the ideas of sections two – four, through the discussion of two topics: trade policy and the institutions needed for it to work well; and institutions that make for a good business environment. Sections one – five, form the basis for the hypotheses brought together in section six, which also concludes the paper.

## 2. CONCEPTS AND MEANINGS

### 2.1 Growth and Pro-Poor Growth

By *economic growth* in a given country, we normally refer to growth of (real) GDP or (real) GDP per capita, largely because GDP is the most comprehensive measure of economic output produced in the territory concerned, and because it is an economic statistic regularly published by most countries around the world according to agreed conventions and procedures. That said, the use of GDP data is subject to a number of shortcomings that need to be borne in mind both when studying trends in a given country, and even more, when making cross-country comparisons. For brevity, we simply list the principal shortcomings of GDP measures that are relevant to the theme of this paper, with, at most, very short comments:

- In most countries, official GDP data only includes the so called formal economy, comprising those businesses and other economic activities that are officially registered or otherwise known to the statistical authorities. The informal sector is either omitted altogether, or estimated with very wide margins of possible error. If the informal sector were very small, say 5–10% of (official) GDP, then this point might not matter, but in many less developed countries, the informal sector (including agricultural production for own consumption) is estimated to account for at least a third, and often over half of total output (and hence income).

- When rates of investment are very low (say under 5% of current GDP), the current level of real GDP may not be sustainable since gross investment is likely to fall short of economic depreciation, implying that the capital stock is deteriorating. Under these conditions, current GDP becomes a misleading indicator of the general 'health' of the economy concerned.

- For some countries, the living standards of the population are greatly influenced by inflows of remittances sent back to their families by migrant workers. Where this factor is important, the relevant income concept is GNI, which is essentially GDP plus net income from abroad – thus if our concern is with living standards GNI is the appropriate concept; if our concern is more with domestic production then GDP is the more suitable measure.

- In periods of rapid inflation (such as faster than 20–30% p.a.), real GDP is hard to measure with great accuracy, since it becomes increasingly difficult (and subject to significant uncertainty) to decompose the change in nominal GDP into a price change component and a real component.

- Strictly, of course, a focus on living standards would entail neither of the above measures (GDP, GNI) since they include too much; rather, we might be more interested in directly measuring the consumption by the population, and then studying its trends and dynamics within and between countries. The relevant concept, then, is the sum of: a) personal (or household) consumption (usually denoted C in simple macro models); and b) that part of the government's demand for goods and services that can be attributed to individual households – in this item one would include primary education and health services, for instance, but would probably exclude much of public administration and defence spending.

- In practice, most of the above points are often side-stepped through the assumption that all the relevant variables are likely to grow (or decline) roughly in proportion, in which case the use of GDP and GDP-per-capita measures at least reveals the correct trends. However, some of the relevant proportions will differ between countries, so cross-country comparisons using the GDP indicator will always be rather suspect; and they can also change over time. Moreover, in an economy that is putting itself in a position to sustain more rapid growth, the investment ratio is likely to be rising and domestic consumption will – for a time grow more slowly than GDP. Hence an economy that is clearly putting itself in a stronger long-term position might appear to be performing badly for a while in terms of improvements in the population's living standards; among other things, this indicates some of the dangers attendant upon using aggregate economic indicators.

As various papers related to the OPPG initiative have indicated (see Cord et al. [2003] PovertyNet website, [www.worldbank.org/poverty](http://www.worldbank.org/poverty)), Pro-Poor Growth (PPG) can be thought of in two main ways.

According to the relative definition, PPG occurs when economic growth is accompanied by shifts in the distribution of income that favour the poor; in contrast, the absolute definition sets a much weaker condition, namely that economic growth must be accompanied by improvements in the real incomes of poor people (without anything being specified regarding changes in the income distribution). Both definitions are seriously problematic, not least because experience around the world reveals enormous diversity in the patterns of growth, poverty reduction, changes in income distribution, and so on; this diversity means that one cannot simply avoid the problem of choosing a workable definition of PPG by claiming that all reasonable measures of PPG are likely to be highly correlated and move together – for quite simply, this is not the case.

The OPPG initiative opted to use the absolute definition, while being fully aware of its limitations, for it means that any growth is considered to be PPG provided that the poor benefit at least a little – so GDP growth of 6% p.a. with the poor experiencing a 0.5% p.a. increase in their incomes is just as much PPG as GDP growth of 2% p.a. with the poor gaining 7.5% p.a. In contrast, the relative definition would not have regarded the first of these examples as PPG, while the second clearly would be a case of PPG.

A decade or two ago, much of the development economics literature, as well as the international financial institutions providing the bulk of the aid to developing countries, placed greatest emphasis upon achieving economic growth. This literature often talked in terms of countries progressing from a low savings/low investment/low growth equilibrium to a high savings/high investment/high growth path, with the hope that in time this more rapid growth would also prove to be sustainable. For the poor, the presumption was that they would benefit from general economic growth through some form of 'trickle down', though the precise mechanisms through which this was supposed to happen were rarely specified in any detail. One suspects that the mechanism was sometimes little more than 'a wish and a prayer'! However, while growth in some countries clearly benefited the poor, in others it didn't appear to, and in the worst performing regions of the world – notably much of sub-Saharan Africa (SSA) – average per capita incomes stagnated or even fell, with the income of the poor faring even worse. Against such a background, it was perhaps not too surprising that the emphasis in the 'development community' gradually shifted away from income growth towards lifting people out of poverty; one result of this shift to focusing on poverty reduction was the development of the PRSP process by the International Monetary Fund and World Bank (see IMF, 2004); especially for its poorest members, the Bank and Fund – for the past decade or so – now increasingly link their financial support to issues and priority areas highlighted in the most recent Poverty Reduction Strategy Paper (PRSP) for the country concerned. Moreover, the Papers themselves are supposed to be 'owned' by the relevant country, rather than being largely imposed from outside (by well meaning agencies). How far this is true in practice must be quite variable, but the intention is surely a sound one.

More recently, the first of the Millennium Development Goals (MDGs) set the world the target of reducing by half, by 2015, the number of people living on under \$1 per day (in 1990, the number living on no more than \$1 per day was roughly 1.2 billion people). As reported in UN (2005), however, while some parts of the world are well on track to meet this MDG, notably Asia (due to rapid economic growth in China, and more recently in India), other regions, especially large parts of Africa, have actually seen poverty increase during the 1990s. Such experience makes it very understandable why the issue of 'poverty' should have attracted the attention it has in the last decade. A further factor that has recently pushed poverty up the international community's policy agenda has been the intensified security concerns aroused by the 9/11 terrorist atrocity in New York<sup>4</sup>, as the poverty associated with failed states is now increasingly seen as a security threat to the world.

By now, despite all the reservations about growth processes and their hugely diverse impact upon income distribution, and in particular upon the welfare of the poor, it is evident that the only way to improve the lot of the poor in the longer term, and in a sustainable manner, is through growth of GDP – and the faster the better. Redistributing and reallocating the existing 'pie', for instance through various social, health and educational programmes directed preferentially towards poor people, can undoubtedly confer short-term benefits on some very vulnerable people, but most of these benefits cannot be sustained unless the 'pie' itself is growing. This important message is essentially what is summed up in the new development 'mantra' of Pro-Poor Growth – for what this really means is that where we have choices, we would certainly like growth to benefit the poor, but in any event we must generate growth since that is the only known way to benefit poorer people in the long run. This general approach, moreover, is supported by the interesting empirical study of Kraay (2005), who decomposed changes in a suitable poverty measure into three components due to: (a) rapid growth of average incomes; (b) high sensitivity of poverty to overall growth; and (c) poverty-reducing pattern of growth in relative incomes – as Kraay points out – we know relatively little about how to design policy to influence (b) and (c), but we know a good deal more about (a).

In this somewhat extended discussion, we have referred to '*the poor*' and '*poverty*' several times without being sufficiently precise – this is not the place for a full analysis of these terms, about which there is a massive literature and considerable controversy – in the simplest terms, however, members of

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4. On 11 September 2001, two planes that had been hijacked by terrorists were flown into the twin towers of New York's World Trade Centre and a third was flown into the Pentagon.

a given population can be ordered (from lowest to highest) according to their income,  $y$ , with distribution function  $F(y)$  and corresponding probability density,  $f(y)$ . Then if the total population is  $N$ , and the poverty line (i.e. in the income level below which people are considered to be living in poverty) is set at  $\tilde{y}$ , then the number of people in poverty is:  $H = NF(\tilde{y})$ ,  $H$  being the so called *headcount measure* of poverty.

This is the MDG approach, with the poverty line,  $\tilde{y}$ , set at an income level of just \$1 per day. Other poverty lines that might be more suited to the conditions of a given country can be defined analogously. Based on this concept of poverty, Pro-Poor Growth is then growth in a country's real GDP that is accompanied by a reduction in  $H$ <sup>5</sup>. In our subsequent research we shall usually employ this notion of poverty, along with its implied definition of PPG, because it is practically and operationally manageable for the countries we wish to study. Naturally, we are aware of various limitations of the approach; some of these are listed here for reference:

- Measuring incomes, and hence identifying the poor and assessing their numbers, can be subject to considerable uncertainty because much of their income might take the form of production for own use or other types of informal activity that might not be picked up adequately in official statistics (hence some of the poor might be a bit better off than we think).
- The headcount measure tells us nothing about the distribution of income within the group of those categorised as 'poor'; hence when growth occurs, it also tells us nothing about changes in this distribution – for instance, some very poor people could get better off while still remaining poor; also, those coming out of poverty might have initially been very poor (incomes a long way below  $\tilde{y}$ ), or they might have been just on the margins of poverty (incomes already close to  $\tilde{y}$ ). The headcount measure does not allow us to distinguish between these situations.
- The headcount and other simple measures of poverty measure individuals' (or households') welfare in terms of their (disposable?) incomes. At times, though, this is obviously an incomplete measure, since if public infrastructure (such as roads, primary schools, availability of potable water, availability of electricity supply, etc.) improves in a given area, one would surely wish to claim that people's living standards were improving. This aspect of the poverty reduction agenda requires further consideration.
- The approaches to poverty measurement that we have been discussing are unavoidably static, and this can further limit their usefulness – for instance, people move in and out of poverty as their circumstances change and there are also life-cycle effects; some of these effects mean that, at least, for some people, being poor for a time should not be regarded as so serious, in social welfare terms, as it is for others. Some of the observed incidences of poverty at any given date is a consequence of people's own deliberate choices, it is therefore endogenous rather than wholly exogenous, a fact that affects the proper interpretation of poverty measures. For a discussion of this sort of issue in a UK context, see Burgess et al. (2006).
- Last, there is substantial diversity within the category of 'the poor' and the simple approaches we have been discussing tend to neglect this fact – for instance, employment-generating growth is helpful for those poor of working-age since it offers the prospect of new jobs, this being the main route for raising their incomes; for those beyond working-age, especially those not in receipt of an adequate pension (and in most very poor countries this is the majority of the old), incomes only rise through redistribution within families or wider kinship or community groups, and this channel for raising incomes can prove quite fragile and insecure. For the sick and disabled, of any age, the path to higher incomes is the most uncertain of all, as in most poor countries, good public income guarantees either do not exist or are ineffectively delivered to the groups concerned.

## 2.2 Institutions Supporting Economic Growth

As we shall see, there is abundant evidence that 'good institutions' are helpful for economic growth and development, though it is far less clear what exactly we ought to mean by the term 'institutions' or how we might identify 'good' ones. In other words, the evidence that institutions are helpful does not take us far in terms of pinning down which institutional forms are either necessary or even desirable. Here, we merely try to elaborate and clarify some basic definitions by way of introducing the conceptual analysis of Section three.

It is perhaps as well to begin with some observations: first, our positive knowledge about institutions is quite limited, for although we know of a few instances of institutional configurations that appear to work, and we can also point to a few instances of blatant institutional failure, this is not enough to derive positive recipes for success that could be widely applicable; second, specific economic 'models', typically comprising eclectic mixes of policies and institutions – such as those represented by the so called *Washington consensus*<sup>6</sup>, or the EU's *acquis communautaire* – are only capable of transplantation to other countries to a very limited extent, and under very special conditions. For instance, the latter, the *acquis*

5. Note, however, that Kakwani et al. (2004) suggests a more sophisticated approach, based on the notion of the 'poverty equivalent growth rate', a measure that takes account of the distribution of the gains from growth across the population. However, while conceptually interesting, we seriously doubt the operational applicability of this approach.

6. There are many relevant references. A good starting point is Williamson (200); for a more critical perspective, see Teunissen and Akkerman (2004) and Stiglitz (forthcoming).

*communautaire*<sup>7</sup>, is being comprehensively adopted by all new and soon-to-be member states of the EU, often at high cost and with great difficulty; but it works for the countries concerned for some special reasons: (a) the new countries share much of the same culture and history as existing member states; (b) all possess tolerably competent states that accept limitations upon their powers and are (more or less) familiar with the rule of law; and (c) the new countries see their EU membership as a strong political imperative, part of a 'return to Europe', and part of the process of protecting themselves against possible future intervention from the East (notably, from a possibly resurgent Russia). It is this imperative that makes the adoption of the *acquis* by new members so interesting theoretically, since it illustrates how external factors and incentives can be very powerful in bringing about rapid institutional change; the powerful *external anchor* serves to discipline the domestic political 'game' in the relevant countries.

In the absence of these special conditions, the *acquis* is frankly not a model that could sensibly be recommended to anyone, since it embodies numerous economically damaging rigidities and controls, is very complex and costly to operate, and some of its requirements – such as costly agricultural subsidies and absurdly high environmental standards – only make sense for already rather prosperous countries. Even within the EU itself, the shortcomings of the model are acknowledged, since they provide the motivation for the Lisbon Agenda<sup>8</sup>, (the process whereby the EU seeks to become the most economically dynamic region in the world through boosting R&D spending and undertaking reforms to foster economic flexibility). So far, however, the Lisbon Agenda is making little headway in the face of established political interests (rich countries, it seems, enjoy the luxury of being able to afford economic foolishness, and are reluctant to change). For the present IPPG Research Programme, therefore, we take the view that such comprehensive models are not of much relevance, though we do not exclude the more informal option of learning from near-neighbours...

Third, there is no agreed and 'standard' model of institutions, instead, as we show in the next section, there is a plethora of partial models and approaches drawing on diverse mixes of economics, political science, social anthropology, and other disciplines. The available material is enormously interesting and offers some valuable insights into the factors that can enable institutions to function well or badly; it does not as yet, however, offer much that is capable of extensive generalization, or application to many different countries. At present, the institutional framework underpinning the economy of each country we study has to be examined in its own terms, albeit guided and structured somewhat by the analysis presented in this paper. Economic institutions are needed to perform certain tasks (or meet certain needs), they can possess varying levels of internal structure and coherence, and links between institutions add a further layer of complexity into the picture. It is often useful to distinguish between institutions and organizations, though much of the literature we have surveyed does not make this distinction at all or only does so inconsistently. Likewise, institutions are not policies.

As we outlined in the previous section, institutions can be formal or informal, public or private; they are relatively stable social arrangements (embodying rules, norms or conventions) possessing a number of special features, including regulating the behaviour of economic agents; drawing on shared expectations and meanings; and often taking the form of 'repeated games'. In thinking about the *institutions* relevant for economic outcomes, we need to conduct analysis at several different levels. The first is that of *social norms* or *customs*, which certainly includes the following three aspects:

1. honesty in performing agreed economic transactions or tasks;
2. trust between economic agents; and
3. confidence about third-party economic behaviour (incl. behaviour by the state and its agencies).

The second concerns assets and the rights associated with them, such as:

1. property and the protection of property rights;
2. business forms (e.g. limited liability firm, co-operative, etc.) and their protection;
3. business contracts, the associated rights and responsibilities, and their protection; and
4. freedom to initiate and conduct business, with limitations on state regulation at start-up, freedom from fears of expropriation (especially) in the event of success.

These merge into the third level, comprising of the actual *institutional forms* established to protect various rights, limit state behaviour, and so on; this includes diverse types of formal constraint on state intervention into the economy (via constitutional provisions, judicial review, appeals to higher courts, or other mechanisms). In the economic sphere, institutions govern the following major areas:

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7. Interestingly, there are few completely clear statements of the *acquis*, perhaps not surprisingly since it is estimated to run to over 80,000 pages (in the English version) of the laws, regulations, policies, etc., that govern the EU. A list of the 31 chapters of the *acquis* can be found on the FCO website ([www.fco.gov.uk](http://www.fco.gov.uk) - under Britain and the EU).

8. For information on the re-launched Lisbon process, see the EU's website, specifically the address [www.europa.eu.int/growthandjobs/index\\_en.htm](http://www.europa.eu.int/growthandjobs/index_en.htm)

Group of Institutions	Function	Specific Examples	Typical Formal Regulating Agency <i>Informal</i>
Property rights	Establish rights: decide between competing claims Inform non-owners, police and exclude	Land tenure  Inheritance law  Patents, copyright, IPR	Land registries <i>Oral history</i>  Probate registry <i>Custom</i>  Patent Offices
Reciprocity: facilitating transactions	Establish rules of exchange, respect for contracts Provide information Reduce or re-allocate risk Facilitate transactions when some markets are missing	Weights, measures, standards  Contract law; dispute arbitration  Public information on markets  Physical provision and organization of markets (e.g. auction rings, stock exchanges, trade networks, futures markets)  Banking conventions, instruments (letters of credit, etc.)  Auditing and accounting conventions	Standards bureaux  Civil courts Arbitration councils <i>Elders</i>  Market information agencies <i>Word of mouth, personal observation</i>  Local authorities Stock exchanges/bourses <i>Customary points for exchange (crossroads, etc.)</i>  Bank regulatory agencies  Professional associations of accountants
Co-operation: economies of scale	Allow - interactions within organizations - collective action and co-operation	Laws on limited liability  Laws on bankruptcy  Competition policy  Regulations on co-operatives, charities, civil associations  Auditing and accounting conventions  Employment regulations	Register of companies  Ditto?  (equivalent of the Monopolies & Merger Commission  Co-operatives ministries, bureaux <i>Social norms of co-operation</i>  Professional associations of accountants  Min. labour, employment tribunals <i>Custom</i>

**Table 1. Institutional Forms and Possible Implementations (Formal and Informal)**  
(suggested by Steve Wiggins, ODA)

These institutions, in practice, are commonly embodied in particular *organizational forms* (hence the common conceptual confusion between institutions and organizations) such as firms, courts, business associations government departments and the like, but many are not, and indeed cannot be – for instance, the notion of ‘honesty’ cannot be embodied in an organization, but if, in a given society, most people engaging in some economic activity are honest, then transactions costs are greatly reduced as compared

to another society where people are either not very honest at all, or only adhere to such precepts within narrow family and kinship networks. In the 'honest' society, many economic transactions will be possible that could never take place in the 'dishonest' society, offering the former society the possibility of becoming significantly more prosperous; this and similar points will be explored further in the next section.

Further, in most cases, an institution is not some special form of *economic policy*, thus a policy decision to change a tax rate, or set the price for a public utility, is simply that – a policy decision; its effects are mediated through various economic organizations such as departments of government, firms, and the like; and the ultimate impact of the policy change will in turn be influenced by the institutional framework within which the policy change was enacted – for instance, are we dealing with an economy where economic agents habitually pay their due taxes, and if not are there any effective penalties? Do they generally pay their utility bills, and if not can they be denied service? Similar questions always arise at the very micro-level where policies take effect (or don't take effect, as the case may be).

In many of the empirical growth studies referred to later, there are one or more variables that seek to measure some notion of institutional quality – as Rodrik (2004a) points out, this is quite a hazy notion for many reasons – notably, what the laws and formal regulations in a given society say might differ greatly from what actually happens 'on the ground' when they come to be implemented, hence simply studying the formal level of the system will often be a poor guide to real behaviour. Some studies acknowledge this by using surveys of investor perceptions as the basis for their measures of institutional quality, unavoidably subjective though these are, what they claim, in effect, is that institutions are what investors (or other suitable groups of agents) think they are. Since we emphasized shared expectations as part of the definition of expectations, this use of perceptions can easily be defended, however, it does leave unexplained exactly how a particular set of expectations comes to form and be sustained, in a given society; this is an aspect of institutions that we need to study further in our own research.

For the transition economies the European Bank for Reconstruction and Development (EBRD), in its annual *Transition Report*, seeks to measure the progress of each country towards the conditions of a well functioning market-type economy. It does so through a series of so called transition indicators covering such aspects of transition as price liberalization, privatization, development of financial markets, and so on; each indicator is measured qualitatively, albeit using a numerical scale running from 1 (indicating almost no change from the conditions of central planning) to 4\* (indicating equivalence to a market economy). For its legal reforms measure, the EBRD uses two indicators: one assesses progress in terms of 'laws on the books'; the second assesses how effectively these laws are implemented (including how effectively the courts function); for some countries, such as Russia, the divergence between these two measures can be substantial.

The EBRD approach to institutional quality, of course, does beg several questions, namely:

1. Do we actually possess a clear conception of the 'ideal' market economy towards which the transition economies are supposed to be evolving?
2. Are we, in any case, justified in assuming that all the transition economies wish to follow this type of evolution?
3. How do we measure institutional quality in a way that avoids subjective interpretation, and avoids mixing up objective institutional features with the performance outcomes (since if a market works well it is tempting to assign a high 'score', even if some of the institutional features may actually be quite 'bad')?

It seems to us quite hard to give clear answers to these questions for many transition countries. Usually, when we think of institutional quality we tend to think of gradations along a scale of broadly similar institutions, but this might not always be the right way to think about the issue; rather, it might be more appropriate to think of wholly different institutional solutions to a given problem. To use a nice analogy (suggested by Adrian Leftwich), instead of thinking of something like 'good car vs. bad car' we might do better to think of 'donkey vs. car'!

### 3. CONCEPTUAL APPROACHES TO THE ANALYSIS OF INSTITUTIONS

There is now a rapidly growing and very diverse literature on modelling economic institutions of various types, some of this being quite formal and technical, some being more descriptive in nature. The fields of political science and social anthropology are also contributing more and more to our understanding of institutions and how they function, the former mostly at a more macro-level through concepts such as power, interest groups, and the like; and the latter at a much more micro-level, via notions like trust, custom, social hierarchy, and so on. Taken as a whole, however, it must be conceded that we remain very far from possessing what might be called a 'general theory of economic institutions'; instead, the existing literature offers numerous fragments and conceptual contributions that illuminate different aspects of the institutional framework, with nothing remotely comprehensive.

Accordingly, the most useful way of proceeding here is simply to illustrate through examples what seem to us to be some of the most interesting models and ideas from the recent literature, though in doing so, we shall be extremely selective.

### 3.1 Informal Trading Models

In thinking about institutions, a natural starting point would be issues of property rights and business contracts, since these are fundamental for any economic activity extending far beyond production for individual or family subsistence. Despite this, it must be admitted that even today, few microeconomics textbooks used in our universities even mention any of the institutional underpinnings of the analysis they contain,<sup>9</sup> though a notable recent exception is Bowles (2004).

In states where the 'rule of law' is well established and economic agents expect laws to be enforced sufficiently, often with compliance without costly co-ercion – at least for most agents, most of the time – to be an equilibrium strategy, markets commonly work well. The formal legal arrangements are there in the background, but for most economic transactions they are rarely invoked. In weaker states, or states where trading practices have not (yet) been formalized, various informal mechanisms have been devised to facilitate trade; some interesting examples of these mechanisms that have been studied in some depth include the Maghribi traders' – a group of Jewish traders operating from the eleventh century – management of trade between Muslim North Africa and (mostly) Christian Europe (see Greif, 2005 and 2006), and the Law Merchant of medieval Europe (see Braudel, 1985).

Dixit (2004) formulates a number of stylized, but very interesting, trading models that function in settings where the state is either weak or wholly absent. Here we shall simply pick out some examples to illustrate the approach, taking care to keep the presentation as simple as we can (see also the review article, Rauch [2005]). The models are quite abstract, so readers should be warned that some of the assumptions made may appear 'strange' and unfamiliar, to say the least; nevertheless, they illuminate some important issues.

The first model involves a uniform distribution of traders arranged around a circle of circumference  $2S$ ; the number  $S$  is therefore a measure of size of the trading network. Traders separated by distance  $x$  have probability of meeting proportional to  $e^{-ax}$ , and if they do meet, the gains from trade between them are proportional to  $e^{\theta x}$ . The numbers  $a$  and  $\theta$  are fixed parameters, both assumed to be positive; a larger value of  $a$  means that traders are relatively more likely to meet close neighbours; a smaller value means they have more chance of meeting someone further away. Trade is assumed to be more beneficial the greater the distance between the traders, on the grounds that more distant trade partners are likely to have different things to trade, and there is more scope for comparative advantage to come into play. The model has two periods and traders can cheat or be honest (in a sense to be specified); if a trader cheats in the first period, the probability that another trader at distance  $y$  learns of the cheating in time to take it into account in his second period trading is proportional to  $e^{-\beta y}$ ; essentially, this describes the communication technology. For the resulting analysis to make sense, we then need the following:  $a > \theta > 0$ , and we expect  $a$  and  $\beta$  to be roughly equal.

An equilibrium in this model is characterised by a distance,  $X$ , the 'extent of honesty'. If in period 1, two matched traders are closer together than  $X$ , then they trade honestly; otherwise they cheat. In the latter case, they gain more 'now', but risk encountering a partner in period 2 who has heard about their cheating, and who would then decline to trade with them – this exclusion from the market is the potential punishment for cheating, but note that there is no outside institution to enforce it. It is the existing traders who enforce the 'equilibrium', depending upon who cheats and who learns about it in the next trading period.

Models of this sort commonly have multiple equilibria, each sustained by its own  $X$  and the expectations that support it. However, it is interesting to identify the largest possible  $X$ ; this will depend on the various parameters of the model, including the network size,  $S$ , so we write it in the form:  $X(S)$ . If the trading network is not 'too large', it turns out that honesty is the best policy for everyone; but as the network get larger, this is no longer the case. Specifically, there is a critical network size  $S^*$  with the property that:

if  $S \leq S^*$ , then  $X(S) = S$  (complete honesty); and

if  $S > S^*$ , then  $X(S)$  is a decreasing function of  $S$ , eventually declining to  $X^*$ .

This last part of the result is, as Dixit himself points out, initially quite a surprise; what it says is that as the trading network expands beyond the critical size  $S^*$ , traders find that the region within which honesty remains an equilibrium strategy actually gets smaller, though it never falls below  $X^*$ . The determination of the critical numbers  $S^*$  and  $X^*$  is moderately technical, and for details the reader is referred to Dixit (2004).

When there is an external enforcement mechanism, one might expect that the outcome of the model could be improved, especially for 'large' trading networks. Enforcement involves some form of auditing or monitoring of traders' behaviour, and might be carried out by an organization such as a trade association; if there is such an association, we assume that all traders are required to join, for a fee of  $c$  (the analysis gets a lot more difficult if some traders can elect not to join). Since monitoring is not free, it is unambiguously harmful for small networks where self-regulation already works well, but as the network gets larger ( $S$  increases), it eventually becomes worthwhile to undertake monitoring. For an intermediate range of network sizes, self-regulation is imperfect, but external monitoring is too expensive

9. How often, for instance, do we trouble to stress the institutional basis for elementary supply and demand analysis, a full account of which would entail discussion of property rights, contracts and enforcement mechanisms, risk and notions like trust and honesty?

to be worthwhile. However, even in the last case, if  $c$  is too high then the net benefits (per trader), from trade in a large network with monitoring, may never be as high as the best that can be achieved in a smaller network with self-regulation. Hence rather than paying for external monitoring, it can actually be more efficient to split up a big network into a set of smaller ones of size  $S^*$  (or less), and rely entirely on self-regulation.

So far we have studied trading with two possible enforcement mechanisms: the first was self-regulation based on information flows and the exclusion of traders found to be dishonest; the second was a more formal approach using costly monitoring. What happens if neither of these mechanisms is available? As Dixit (2004, pp. 97) argues, 'economic problems are also economic opportunities', and he proceeds to sketch a model in which there is an equivalent to the Law Merchant (referred to as LM): a private agent who charges a fee for providing information about traders' past behaviour. If a trader cheats, the partner can complain to the LM and seek a judgement against the cheater, again for a fee – the cheater may either comply with the judgement or not, but if not the non-compliance is recorded by the LM as another instance of cheating. There is no external enforcement here. If the market works at all, it is due to the personal reputation of traders, enhanced by the services of the LM. The resulting model is fairly simple, but it can be enriched somewhat by allowing for some degree of asymmetry between traders (e.g. distinguishing between buyers and sellers), including different types of trader behaviour and by including public information.

Having looked at trading networks, we will now examine the private protection of property rights as explored in Dixit (2004, ch. 5). In principle, property rights to assets can concern any or all of: control over use; entitlement to the resulting income stream; and the right to transfer control or entitlement (wholly or partially) to someone else; but the simplest model in this area is an economy with just two agents, each of whom owns one unit of resource, and who can allocate it between three activities: production ( $X$ ); protecting his asset against the other agent ( $Y$ ); and efforts to gain control over the other agent's assets ( $Z$ ). Then for each agent ( $i = 1, 2$ ), there is a resource constraint of the form:  $X^i + Y^i + Z^i \leq 1$ . Resources used in production produce output  $(X^i)^a$ , where the parameter  $a$  lies between 0 and 1; it indicates how rapidly decreasing returns to scale take effect.

If an agent uses defensive resources  $Y$  to protect himself against attacking resources  $Z$ , the fraction of his output that he keeps,  $\sigma$ , is given by:

$$\sigma = Y^\beta / (Y^\beta + \theta Z^\beta) \quad (1)$$

where  $\beta$  and  $\theta$  are fixed parameters;  $\beta$  lies between 0 and 1 and indicates how rapidly decreasing returns set in in fighting activities (either defence or attack), while  $\theta$  reflects the effectiveness of attack relative to defence.

Notice that we have assumed here a completely symmetrical setting; agents are identical in all respects and have access to the same technology both for production and fighting; they only gain satisfaction from consuming output ( $X$ ), and not at all from either attacking or defending assets ( $Y$  or  $Z$ ). It would be easy, of course, to amend the parameters to make the model less symmetric, but this complicates the algebra while yielding little additional insight. Clearly, in the symmetrical version of the model, the best outcome is one where both agents use all their resources for production (and hence consumption), and there is no fighting at all. Thus:

$$X_1 = X_2 = 1; \text{ and } Y_1 = Y_2 = Z_1 = Z_2 = 0 \quad (2)$$

Unfortunately, without the help of some external coercive power, this nice outcome is not sustainable as an equilibrium, since whichever agent chooses to undertake no defence is vulnerable to even the most modest of attacks. The non-co-operative (Nash) equilibrium in this model takes the following much less pleasant form:

$$X_1 = X_2 = \frac{a(1+\theta)}{a(1+\theta) + 2\beta\theta} \quad (3)$$

$$Y_1 = Y_2 = Z_1 = Z_2 = \frac{\beta\theta}{a(1+\theta) + 2\beta\theta}$$

Suppose, for instance that  $a = \beta = 0.8$ , and  $\theta = 2$  (indicating that attack is twice as effective as defence), then  $X_1 = X_2 = 3/7$ , implying that more than half of the society's resources are wasted on protecting property and attacking it. Though obviously highly undesirable, no other allocation is sustainable without some mechanism in place to make productive resources 'safer', thereby encouraging more to be devoted to production rather than fighting. The state could provide one such mechanism, as could a variety of private sector arrangements. As always, checks and balances are required to answer the classic question, *quis custodiet ipsos custodiet?*

### 3.2 Game Theory Approaches

The models we have just been sketching all used the techniques of game theory to characterize and compute solutions, though for expositional reasons this feature remained very much in the background.



Aoki (2001) takes the view that game theoretical methods are indispensable for the study of social and economic institutions and his entire book is devoted to an exposition and demonstration of that basic thesis. In our view, it would be unwise to commit ourselves to such a strong position in this paper, since although extremely powerful and illuminating, the approach is not without its limitations; game theory – even with its relatively recent extensions covering evolutionary and repeated games – does not offer us (or certainly not yet) the general theory of institutions that we are still lacking. Nevertheless, Aoki (2001) does offer some interesting models, from which we outline a small selection. The first shows how customary property rights – such as the right to hunt game in some area with limited capacity – can become established and sustained as the equilibrium of a simple game. A development of the analysis shows how linking two types of allocation problem can strengthen the participation incentives and hence support what Aoki calls a *community norm*; the example he gives is of a village with an irrigation system that requires maintenance each year, this being done as a community activity: families can either co-operate or shirk, but even in the latter case they cannot feasibly be excluded from using the water. However, families also contribute to the production of various social goods for the village; again they can choose to contribute or shirk, but in the latter case they can be denied access to the social goods. Then if the irrigation problem and the social goods production are linked, in the sense that families who fail to contribute to irrigation works are excluded from access to social goods, the incentives to shirk are greatly reduced and there is more chance that the community will be able to establish an equilibrium in which all families contribute to both activities: this then becomes the *community norm*.

Historically, a variety of mechanisms has evolved to support trade and markets in settings where there is imperfect – and often asymmetric – information among traders and between buyers and sellers, where there no state to provide the external enforcement needed to ensure honest and fair behaviour. Some of these were noted above when we examined Dixit's models, and Aoki (pp. 61) lists: 'personal trust, traders' community norms, clientage and club norms..., private third-party enforcement', among others. In any given economy, one can observe different mechanisms being used to support trading equilibria in different markets, perhaps reflecting the simple fact that where alternatives exist, there is no reason to expect the same one to emerge as the equilibrium in every market. Likewise, in some markets one observes more than one mechanism in place, for instance private negotiation to settle trade disputes or compensation issues, with recourse to the courts also employed sometimes. In such cases there is likely to be a form of complementarity between the mechanisms, neither being credible and effective without the other; courts are usually too slow and expensive to serve as the sole mechanism, while private arrangements are not likely to be credible without reference standards set by court decisions.

Moving to a more complex level of analysis, Aoki (2001) analyses various forms of organizational architecture and hierarchy, characterized by diverse combinations of local and systemic information. Models in this area are frequently of the principal-agent type, and issues arise over who (which agent) should own or control the assets required to undertake a required set of tasks. For the most part, the analysis highlights issues rather than providing convincing solutions, organizational architecture remaining a difficult and very much unsettled topic.

The next level up is the state itself, and Aoki's 'theory of the state' sees it as a stable equilibrium in the domain of polity (Aoki [2001] ch. 6). The starting point for his approach is the observation that: 'as market exchanges expand, the nation-state tends to emerge as a primary... third-party enforcement mechanism for protecting property rights and enforcing contracts.' (pp. 151) While at first sight this might appear somewhat simplistic, it is actually a very powerful idea (though not the whole story, of course); three prototype models of the state are studied, namely the democratic state, the predatory state, and the collusive state and we will now consider these models in a simple, unifying framework.

We suppose there is a government and just two private agents, A and B. Suppose that the government's only task is to protect property rights, which can be done at a cost of  $2t$  (representing a tax of  $t$  paid by each private agent); each private agent then enjoys utility (net benefit) of  $(G-t)$ . If this arrangement works, we have the so called *minimalist state*, but why should it work? And if it does, under what conditions? For the state might seek to secure more benefits for itself by expropriating (through an extra tax, or simply through outright theft) more resources (in amount  $a$ ) from, say, agent A. In the face of this state policy, agent A can either submit or resist; and if he resists, agent B can either decline to offer support (in effect, he submits), or he can also resist. Resistance costs each agent a sum,  $c$ , while the state's predatory behaviour reduces private sector efficiency by an amount  $2\Delta$  ( $\Delta$  for each private agent). Only when both agents resist can they jointly overcome the state's predatory behaviour; they then impose a large cost on the government,  $C$  (which might correspond to loss of office, for instance). Since the picture we are building up is already becoming quite complex, we sum it up here in the following matrix of payoffs.

the non-transgressed	Resist	Submit
the transgressed		
Resist	$2t - C, \Gamma - c - t, \Gamma - c - t$	$2t + \alpha, \Gamma - \alpha - c - \Delta - t, \Gamma - \Delta - t$
Submit	Not applicable	$2t + \alpha, \Gamma - \alpha - \Delta - t, \Gamma - \Delta - t$

**Table 2. Payoffs in Models of Government**

Source: Aoki (2001), p.154 (correcting an error in his table)

Note: In each cell, payoffs are listed in the order: government, agent A, agent B

Then we can distinguish several cases:

a) Suppose  $\Delta \leq c$  (the deadweight loss from state predation is less than the cost to B of joining A in resisting the predation). Then the best strategy for B is indeed to submit, and knowing this, A also submits to avoid the conflict cost,  $c$ . In a multi-period model, the state can then prey on A or B more or less at random, and neither will resist. This is the *predatory state*.

b) Suppose now that  $\Delta > c$  and  $\Delta < c + \alpha$ , then the government can still succeed in expropriating A by offering B a side-payment (essentially, a bribe) of size  $s$  not to resist. The bribe will succeed – and hence benefit both B and the government – provided that  $s$  lies in the range:  $\Delta - c \leq s < \alpha$ . Thus B and the government collude in violating A's property rights. Hence this is referred to as the *collusive state*.

c) In both the above cases, private agents A and B were unable to credibly commit to resist state predation. Suppose now that the government has imperfect information about the agents – so in each period, if it decides to engage in predation, it simply chooses a 'victim' at random (it only does this if it has not experienced strong resistance in the past; otherwise it respects property rights); private agents co-ordinate resistance; then in equilibrium, everyone's property rights are respected, and we have the *democratic state*. Notice that the government can only credibly commit not to engage in predation if it knows that the private agents can credibly commit to resist such predation successfully if it occurred. As is well known, it is never sufficient simply for the government to pass suitable laws regarding property rights; the laws must be enforced and the government's own actions effectively constrained.<sup>10</sup>

### 3.3 Coordination Failures

The above analysis of types of government concerned one form of co-ordination failure, but Bardhan (2005) gives many more examples and outlines some simple models to illustrate his thinking. The more striking models are those that consider decision-making about possible reforms in a setting where there are three types of voter: poor, middle-income and rich, in proportions that might differ across districts. In a one-period model, there is not much of interest to say, but in a multi-period context, reforms in one period might influence the preferences of one or another group in subsequent periods, in ways that could be disadvantageous to others – for instance, middle income voters might initially ally themselves with the poor to push through reforms from which they expect to benefit, then when they have secured the first stage and received their benefits, they might switch allegiance towards the rich, in order to block further redistribution of gains towards the poor; fearing just such an outcome, the poor might well choose not to ally themselves with the middle-income group in the first place and therefore reform could be stopped altogether. The issue here is the inability of the middle-income group to commit credibly to the original redistributive policies.

Bardhan (*ibid.*, pp. 31) highlights two types of collective action-problem that can arise even with reforms that can deliver benefits to all groups in society: (a) the free-rider problem of sharing out the costs of change; and (b) the bargaining problem of sharing out the benefits of reform, especially acute where, as in the above example, some agents cannot credibly commit to behave *ex post* in ways that they might promise *ex ante*. Very much the same type of coordination failure also helps to explain the persistence of 'bad' institutions; in a multi-period model with only two types of agent, poor and rich, Bardhan examines these failures and shows how social norms can be established and help to sustain an equilibrium, he also considers variants of the model with side payments allowed, or with the possibility of punishing agents who fail to co-operate.

### 3.4 New Institutional Economics

On the face of it, the so called New Institutional Economics (hereafter, NIE) should have a great deal to teach us about our core theme of institutions and their roles in promoting or blocking economic development. At the level of an entire economy, and at a relatively general conceptual level, this

10. It is nevertheless worth remarking, as Bardhan (2005) has done, that even when government power is not constrained in this way, it sometimes happens that a leader might promote development and gain a reputation for doing so successfully.

expectation proves to be correct, but as a source of deeper and more detailed analysis that might support our subsequent empirical work, NIE has less to offer. There are many good expositions of the main ideas of NIE, but a useful one for our purposes is that provided by North (2005). At the political level, this stresses the importance of 'order' as a fundamental condition for economic growth, and suggests that the necessary order can be consensual or authoritarian. The relevant 'order' establishes a stable structure of exchange relationships, both political and economic, forming an *institutional matrix*. The system requires both credible commitment by the state to conform to 'rules of the game', together with conformity to system norms and rules by economic and political actors.

Since many features of NIE were developed as a reaction to the perceived shortcomings of traditional Neo-Classical Economics (NCE), it is useful to compare the two. We do this in Table 3, below:

<b>Neo-Classical Model</b>	<b>New Institutional Economics</b>
Exogenously given factors: rules, norms, preferences	Partially endogenous factors: rules, norms, preferences
Agents: individuals	Agents: individuals, interest groups
Processes: exchange	Processes: exchange, bargaining, co-ordination
Sites: markets	Sites: markets, social institutions
Transactions costs: usually assumed to be zero, or simply neglected	Transactions costs: central to NIE, but in many instances virtually impossible to measure; also, the use of the transactions costs idea sometimes verges on the tautological
Risk and uncertainty: NCE can be extended to deal with risk in the sense of situations characterized by a (somehow) known probability distribution	Risk and uncertainty: NIE recognizes the fundamental fact of uncertainty in the sense of unknown probability distributions; but actually offers limited means of dealing with the resulting difficulties (see Dequech, 2006)
Institutions: usually offers weak/limited explanations of institutions	Institutions: offers good explanations of the persistence of certain configurations, but less good at explaining how/why they arise

**Table 3. Comparing NIE and NCE**

Source: Suggestions from Junior Davis

In addition, as North's Nobel Prize Lecture makes clear (North, 1993), an important feature of NIE is its emphasis on learning over time. Institutions provide the framework of incentives and opportunities for learning to occur, and as people learn they sometimes think of new ways of organizing economic transactions, and try to create new institutions to support such innovations. Society's established rules and behavioural norms make this – usually – a slow and difficult process. Moreover, for change to occur, those with new ideas need to have some opportunity to gain political influence, since otherwise the society could take the form of a 'top layer', an elite dominating the polity, ruling over an increasingly disaffected mass of citizens unable to influence anything important. Around the world there are many examples of such societies; they are not noted for their dynamism and innovative capacity. Lastly, Williamson (2000) reviews NIE and presents an interesting diagram of four levels of social analysis; since it helps to integrate some of the above points, we reproduce it here (Figure 1). In the diagram, Level 1 is the domain of social theory; Level 2 concerns the spheres of property rights and positive political theory; Level 3 covers transactions cost economics; while Level 4, is the most operational and immediate, and includes the concerns of neo-classical economics and agency theory (including principal-agent analysis). In terms of this framework, Williamson suggests that NIE is mostly about Levels 2 and 3; Level 1 is a lot more difficult, and as Figure 1 shows, changes more slowly: this explains why, when changes occur in a society at Levels 2 and 3, they often fail to have the expected effects, since their impact is also mediated through the customs and norms that prevail in Level 1.

LEVEL	FREQUENCY (YEARS)	PURPOSE
L1	100–1,000	Non-calculative Spontaneous
L2	10–100	Get the institutional environment right 1 <sup>st</sup> order economising
L3	1–10	Get the governance right 2 <sup>nd</sup> order economising
L4	CONTINUOUS	Get the marginal conditions right 3 <sup>rd</sup> order economising

Figure 1. Four-Level Framework for Institutions

Source: Williamson (2000), pp. 597

### 3.5 Regulation of Market Participants

Proponents of 'the market economy' often give the impression that all that is needed for an economy to work well is for markets to be open and free, enabling agents to conduct their economic transactions in ways that are mutually advantageous and hence beneficial for the society concerned. Sometimes this does indeed suffice, but as the experience of the former communist countries shows very clearly, it often does not; to work well, or even to work at all, many markets need an appropriate institutional infrastructure to support them, which may sometimes be fairly generic, and sometimes specific to a given market.

In order to understand this, it helps to think of specific examples. Within a given country, let us consider in turn the markets for basic foodstuffs (unprocessed); processed foods; energy sources, including electricity; property such as houses or business premises; a financial asset such as a share or bond. Basic foodstuffs in poor countries are often either grown by the farmers for their own families (subsistence), or are traded locally to supply the non-agricultural population, often through informal networks and markets; most food processing involves firms of some sort, and these can be small and local (such as a bakery, a dairy, a small grain miller, etc.) or more substantial and capital intensive (such as a canning factory, a bottling plant, etc.) – already at this level, more formal institutions are needed to enable business to be conducted smoothly, and not only must this concern property rights, contracts, etc., but also such matters as technical standards, health and safety issues, and environmental pollution: in other words a whole list of issues that markets left to themselves usually fail to manage in the social interest.

In many rural areas, energy supplies are mostly derived from wood and dried animal dung, and involve few or no market transactions, but in more developed rural areas, and in towns and cities, oil for

vehicle fuels and electricity for lighting, machinery and domestic appliances all become more important. Firms producing energy are often in state ownership or, if privatized, few in number and dominant in the relevant markets. Hence in the absence of regulation, one cannot expect to observe especially desirable market behaviour unless fear of competitive market entry is enough to discipline the incumbent firms. This is not likely, so in practice regulation is required to enforce economically sound and fair pricing, to control joint use of networks, and to ensure adequate levels of investment, etc.

For property markets to work, it has to be clear what people are allowed to do with the property that they own and how this is regulated – through local custom and practice, national-level legal provisions, and so on. More importantly, there needs to be some form of register or record of who owns what, something that can be very local and informal – if all the relevant property transactions are themselves small, local and bound by established conventions – but something more formal is needed for larger transactions involving parties from beyond the immediate locality. The lack of such property registers led to a great deal of injustice in the countries of the former Soviet Union in the early 1990s, when many people found themselves dispossessed of what they thought was their property, because they had no documentation to prove their title.

Financial markets are even worse since there is nothing tangible, other than a piece of paper (or sometimes nowadays, not even that, perhaps merely an electronic record), that people can point to as evidence of owning anything worthwhile. Since the result is huge opportunities for cheating and fraud, such markets cannot survive long without regulation, but there is always a tension between the need to regulate and control, and the desire of market participants to introduce new 'products' and other innovations that might enable them to by-pass existing rules.

At the level of generic institutions, one expects to find institutions that provide for traders' honesty and the reliability of service or product delivery; these can be informal in the case of networks of traders linking farmers to local markets, as we discussed above, or more formal when many firms are involved, transactions more impersonal, and legal mechanisms might be needed to enforce contracts. Where there are larger firms, some quickly discover that the easiest way to make money is to manipulate markets rather than trading competitively within them; this is why all the more developed countries possess institutions to oversee competition policy and to regulate firms' market behaviour. Many developing countries, especially those that have grown rapidly in recent decades, have such institutions, and they often work well. Poorer countries also often have them, but where the state is weak, competition policy is subject to corrupt dealings to protect incumbent firms; under these conditions, inefficient incumbents secure protection, entry by new firms is blocked, and markets function very poorly as a result.

Much more specific institutional forms are needed to regulate such markets as those for electricity – rather than discuss this in great detail, let us simply point to the key questions that must be faced:

- a) How are prices set and who has the power to set them?
- b) If customers do not pay, can they be denied a service? If not, are there any other penalties for non-payment?
- c) How are producers expected to finance their investment?
- d) How is the industry organized as between generation, the national or regional power grid (if there is one), and local distribution, and who determines this?

Many of these decisions are unavoidably political, and in many countries governments are unwilling to permit them to become the province of technocrats, whether these are ministry officials or the staff of a notionally independent regulatory agency. While politicization of the sector confers upon the government the power to reward its supporters with favourable prices or other benefits, the situation can result in some expensive mistakes – for instance, in part of the former Yugoslavia some years ago, in the course of carrying out a study funded by the British government, one author discovered that an aluminium factory was set for privatization on the basis of a ten-year agreement providing for a very low electricity price; on further investigation we estimated that the proposed price would almost certainly bankrupt the electricity company (or require a massive bailout), so we advised against the privatization. Luckily, our advice was taken.

### 3.6 Management of Risk

In developed economies, we only occasionally think about risk in our every-day lives. True, we do insure our houses, our valuable household goods, and our cars; we also often insure our lives to protect partners or other loved ones, but most of us do not insure against other risks, such as unemployment or ill health, since we know that there is an adequate (if not stunningly generous) social benefit system in place, and we may also take the view that it would not take long to find alternative employment if the need arose. Even in such markets as that for credit, many people can borrow modest amounts without security, and a lot more if they offer suitable collateral (such as a house, or government bonds), with the resulting funds available for either personal consumption or private business development. Of course, people and firms do make mistakes or experience bad luck, and disasters do happen both at an individual level (e.g. my house could burn down) and for a whole community (e.g. an unexpectedly severe flood, or a landslide), but even here, there are public and private mechanisms in place to mitigate losses and facilitate recovery.

For most poor countries, none of the above is true. Individuals, communities and firms face extraordinarily high risks, especially in parts of sub-Saharan Africa, and the result is that for many families it is economically rational to concentrate on subsistence agriculture; for firms, the corresponding result is that most remain small. In the African context, Collier and Gunning (1999) examine the impact of risk as part of a wider study of African growth: in semi-arid regions, they note that complete crop failure is a significant risk and that farm output is highly variable from one year to the next, with negligible scope for insurance, and few assets to provide collateral against loans, as land is not very valuable, and livestock can be stolen or might fall ill. The result is that farms seek to protect themselves either through diversification (*ex ante* adjustment) or through consumption smoothing (*ex post* adjustment); the former is costly because it foregoes the benefits from specialization; the latter because the main way to do it is through holding food stocks after good harvests, which are vulnerable both to losses from pests, and to theft. In many countries, investment is perceived as risky because it attracts predation (violence), in this difficult context, it is now better understood that traditional social networks at the local level, mostly based on kinship, can be economically efficient. On the other hand, and from a more dynamic perspective, these networks have the drawback that they have probably inhibited much of the social learning that would be needed greatly to raise productivity in the longer term.

For firms, a parallel story can be told: firms also endeavour to reduce risks and to accommodate what they cannot avoid, many face unreliable suppliers; hold large stocks to keep production going; rates of investment are generally low, and a significant fraction of what does occur is spent on generating equipment, because the public supply is often extremely prone to interruptions; and many firms only deal with customers they know and trust, because contract enforcement is usually very poor. Clearly, all of these responses to risk either raise costs or limit the effective market. The crucial role of risk in creating and maintaining poverty in many countries has been analysed in depth by Dercon (2002, 2005a, 2005b), who emphasizes that the sorts of choices referred to above – to reduce or mitigate risk – are not usually the result of people's preferences regarding risk (such as extreme risk aversion), but are simply a consequence of their circumstances, which consist of extremely severe downside risks (to production, output, income, etc.) in conditions where most risks are uninsurable due to the absence of suitable institutions. Moreover, some of the risks people have to deal with are due not only to the incidence of natural calamities, but also to specific institutional weaknesses – in other words, bad institutions, can themselves, exacerbate risks and hence help to lock people into poverty.

### 3.7 Institutional Emergence and Evolution

Turning next to more dynamic aspects of institutions, some difficult questions immediately arise, notably:

- a) How do particular institutions arise?
- b) Why do we observe such a wide diversity of institutional forms?
- c) How and why do institutions persist once established?
- d) how do institutions evolve over time?
- e) why do we commonly observe the survival of apparently inefficient institutions?

Examining these questions is our task for this section, though for space reasons we shall do no more than sketch some partial answers.. At a very microeconomic level, Fafchamps (2002) studies contractual and trading practices and shows how and under what conditions 'relational contracting spontaneously emerges.' Even when formal market institutions are absent, cheating is deterred. In practice, many markets around the world operate as a two-tier structure, with an informal fringe operating on a cash-and-carry basis (anonymous trading) surrounding a core of larger, more sophisticated traders and producers in long-term relationships with each other (relational contracting). Core firms are often linked through other social networks related to clan, political or religious affiliation; such networks provide the information needed to sustain and monitor the economic relationships.

Fafchamps (2002) then develops a model with many agents, who are either *competent* or *incompetent* – in known proportions, but the type of a given agent is not directly observable. For any given transaction, agents play a form of prisoners' dilemma game (PD), in which for each party, the options are comply (i.e. fulfil the contract) or breach (cheat); not contracting at all can be interpreted as cash-and-carry trade. With contracting, competent agents can be encouraged to comply in a repeated game, while incompetent agents always cheat. To model this market over time, it is assumed that incompetent agents are replaced by new agents at the end of each period; that agents can screen their partner (to find out his type) for a cost of  $c$ ; that even in long-term relationships a fraction of agents will switch partner each period; and that a competent agent has a probability  $(1 - \theta)$  of going bankrupt in a given period. It is well known that the resulting type of model possesses multiple equilibria based on different configurations of agents' expectations, but Fafchamps imposes a fairly reasonable bilateral rationality condition which ensures that the efficient, symmetric equilibrium with relational contracting is the one that emerges. Other possible strategies, such as excluding those who cheat from future contracts (shunning) and only contracting with agents who belong to the same (social) network are also examined. It is important to emphasize that all of the equilibria that arise in these models are inefficient; either many traders only operate on a cash-and carry basis, which has high transactions costs, or risks of contract breach prevent certain profitable trades

from occurring, or potentially valuable trades do not occur because it is too costly to verify agents' type or past trading behaviour. Fafchamps (2004) explores various models of the above type and confronts them with evidence from several African countries, finding that the models appeared to illuminate well many features of the observed markets; thus trading equilibria can emerge and be sustained even when formal institutions are either absent or not functioning well.

In the literature on stability of institutions, scale economies and network externalities are commonly cited as reasons why institutions are resistant to change, even when clearly inefficient (to an outside observer). For Aoki (2001), however, it is more important to look for factors internal to a given institutional configuration and connected to the shared beliefs that support whatever equilibrium arises therein. In this context, institutions can resist change for several reasons:

- institutions are viewed as shared systems of beliefs that shape agents' strategic interactions, and small or slow changes in external conditions need not change these beliefs;
- established institutions encourage agents to develop skills and/or accumulate assets that are particularly valued in that institutional configuration, and such behaviour reinforces existing institutions;
- institutions confer political power on agents in ways that also tend to reinforce what is already established; agents seeking significant change may lack both resources and the political leverage to achieve it;
- existing institutions may be inter-linked in ways that ensure that each is reinforced by expectations and agents' behaviour in turn encouraged by the others.

Taken together, these points help to explain resistance to institutional change, but that leaves an even trickier question, namely how do institutions actually change? It cannot be something simple like merely change a law here and there; rather, agents' beliefs and expectations need to change, possibly their sets of feasible actions, and they need to focus on and move towards a new equilibrium configuration. Often this is very difficult and can involve a period of great confusion and uncertainty while agents try to work out what a new equilibrium might look like, what behaviours are now appropriate, and so on. The transition from communism and central planning to democracy and a market-type, capitalist economy in Central and Eastern Europe since 1990 provides an unusually interesting case study of exceptionally rapid and comprehensive institutional change. The market economy gave a clear focus around which new behaviour by economic agents could be organized; even so, the extent of the needed institutional changes was mostly not fully understood, and many mistakes were made along the way; those countries that had the prospect of early EU membership did best, since they were required to adopt the EU 'model' (as noted above), while parts of the former Soviet Union that lacked a clear market model to guide them often failed to reform either politically or economically.<sup>11</sup>

In a fairly technical paper, Acemoglu (2005b) examines mechanisms that can result in inefficient economic institutions and explores factors that can permit them to persist over time; his basic framework is one of an elite running the political system and seeking (probably among other things) to enrich itself, which it can do using one of three strategies: *revenue extraction*, *factor price manipulation* and *political consolidation*. In the first strategy, the elite set taxes on middle class producers simply to extract resources (revenue) from them; in the second, the elite tax middle class producers because they compete for certain inputs with the elite, and the latter wishes to secure lower factor prices for itself; in the strategy, the elite simply wants to stop the middle classes from becoming too rich and (hence) powerful, so it taxes them in order to impoverish them. While all three strategies are likely to be inefficient, revenue extraction is least damaging since the elite has an interest in having the middle classes become more productive; hence a strengthening of the state to make it more efficient at revenue extraction is likely to improve the overall efficiency of the economy. In the context of the resulting infinite-horizon model, only a limited set of economic institutions, which either constrain taxation and redistribution (essentially, this sets some limits on state predation), or directly regulate the technology available to middle class producers, is considered. The economy contains three types of agent in fixed proportions, workers, middle class, and the elite (the proportions are 1 to  $\theta^m$  to  $\theta^e$ ); the latter two groups engage in production, both investing and employing workers to do so.

After studying equilibria for a polity with elite control, Acemoglu (2005b) also considers the alternatives of middle class control (in which, to simplify matters, he assumes  $\theta^m = \theta^e$ ) and democracy (in which he assumes  $\theta^m = \theta^e < 1/2$ , so that workers are in the majority). The preferred solutions depend on whether the middle class or the elite are more productive, as one would expect; suppose the middle class is more productive, but the elite are in control politically; the elite will not voluntarily concede control to the middle classes unless they are adequately compensated, but there is no credible way of providing such compensation; hence the economy can be locked in a state with inefficient political institutions. A similar argument can be used to show how political institutions that were appropriate at one stage of an economy's life can become inappropriate later, with much needed change being effectively blocked. Suppose the middle class has the option of threatening to force change, a policy that is costly to itself and,

11. Even as central planning was disintegrating before the final collapse of the Soviet Union, one author recalls interviewing firms in Russia, some of which were actively trying to figure out how to operate in a market-type environment, while others were simply waiting for their next instructions from Gosplan (which never came).

if successful, disastrous for the elite. The elite could respond by offering concessions (in effect, bribing the middle class not to revolt), by repression, or by voluntarily ceding *de jure* political power to the middle class. The last can happen because, under some conditions, the outcome for the elite under a middle class government achieved without a revolt is likely to be superior to what they could achieve if forced out of office. When political stakes are very high, such as when there are large resource rents to be captured by whoever is in power, repression to block institutional change is the more likely outcome.

### 3.8 Dynamic Processes and Selection

Continuing with dynamics, in all economies there are many important categories of decision that involve what we call *selection processes*, the operation of which can have an enormous effect on the performance of a firm, a sector and ultimately on an entire economy. Significant examples of selection processes include:

- investment project choice (i.e. selecting – and financing – ‘good’ projects, and rejecting ‘poor’ ones [see Sah and Stiglitz, 1986]);
- entry of new firms in a given market, exit of unsuccessful ones, and growth of (at least some) survivors;
- shifting resources from unproductive and inefficient sectors to more productive ones;
- selection of people for jobs, and within organizations, and the corresponding promotion processes (including how to manage those who perform unsatisfactorily);
- selection of people for different levels of education and training.

By definition, the more familiar static economic models largely ignore these processes; there is a modest literature on each one, but very little directly focused on the problems of developing countries. Hence, for the moment, we only offer some brief remarks and observations, noting that this field is one that merits much more research.

All investment projects are risky, and economic growth depends on a high proportion of selected projects turning out successfully – if selection processes are too severe, many good projects will be turned down; if too lax, poor ones will be selected too often. In practice, the mix of good and bad projects that gets selected depends on the relevant organizational architecture. Of course, many investments are self-financed or are funded by family and friends, and in such cases investor incentives are well aligned with those of their funders, and information about the project is likely to be shared reliably. In other cases, where external funding from a bank or from shareholders is needed, information about the project is less fully shared and there can be opportunities for cheating; moreover, project promoters could favour excessively risky projects (if bankruptcy allows them to walk away from most debts), or projects that facilitate corruption, over the more straightforwardly productive ventures. Hence designing an institutional framework to foster efficient investment decisions is quite difficult; it is also exceptionally important for successful growth, including pro-poor growth.

The same is true for the entry and exit of firms – of course we want to see lots of new firms entering most markets, and we know that it is not efficient to protect failing firms and prevent their exit from the market; and that too little competition is ‘bad’, since incumbent firms might be able to block entry of new firms (as often in Russia during the 1990s), or might be protected in various ways by regional or national elites (e.g. through guaranteed markets). Under these conditions, incumbent firms have at best weak incentives to perform well and improve productivity over time. On the other hand, too much competition is also ‘bad’ since even firms with the potential to perform well might be reluctant to take the risk of undertaking R&D or major investments, since they might not be confident of surviving long enough to reap the rewards. Consequently, excessive competition could result in good firms being forced out of business by incoming good firms, resulting in unnecessary and inefficient ‘churning’ of the firm population, accompanied by limited gains in productivity, output and other performance indicators; but managing markets in such a way as to foster strong, but not overly strong, competition is a surprisingly delicate matter, not tremendously well understood and thus not extensively studied – the requisite institutional conditions particularly, require much new research.

Clearly, shifting resources from low productivity to high productivity sectors can generate a period of rapid economic growth even if the expanding high productivity sectors are using relatively out-dated technology. However, this ‘method’ of achieving growth needs to be approached with some caution – for instance, a supply-side approach can be quite harmful if a government notes that industry is often more productive than agriculture, promptly neglecting the latter, seeking to promote industry in various ways; usually, the result is economic disaster on a massive scale, possibly even more so if, within the favoured sectors, the government attempts to select so called ‘winners’. On the other hand, if expanding demand either at home or in export markets is resulting in the rapid expansion of certain high productivity sectors, then this expansion can draw off labour from low productivity sectors, benefiting the entire economy; such a demand-side approach to structural change has more promise, since it allows the market to make the relevant economic judgements. Neither the selection of expanding sectors, nor even the identification of so called low productivity sectors, can safely be left in government hands; the government’s key role here is to set the environmental conditions in such a way that market forces can result in good choices, again a matter of careful institutional design.



At a more microeconomic level, selection processes arise both in the job market, and in the education and skills market. In either case one can readily envisage (and indeed observe) a variety of possible mechanisms – for example, jobs in a given organization could go to members of the same clan or ethnic group; certain elite or high status groups could be favoured; or selection could be based more or less heavily on indicators of merit or competence. How an organization performs is likely to depend considerably on what selection method is used, though it is worth remarking that historically, selection on merit is a relatively recent idea. Given the importance of getting a job, whatever selection method is employed, also sets up incentives for cheating – such as pretending to belong to a favoured group, pretending to have qualifications that one does not have, cheating in examinations, and so on – accordingly in evaluating any particular selection method, it is crucial to consider the wider environment, including the opportunities for cheating that it may provide.

### 3.9 What do we Know?

From the above quite wide-ranging discussion, it is apparent that while we lack anything approaching a 'general theory of institutions', we already know a good deal about *simple institutions* in simple settings; there are literally dozens of models, from which we have selected a very small sample to illuminate some key ideas about trading networks, contracts, co-ordination difficulties, and so on, etc.; we encountered, especially from the discussion of the New Institutional Economics (NIE), the useful concept of an *institutional matrix* based on a stable structure of exchange relationships, both political and economic; we drew attention to some aspects of thinking about institutions that have figured less prominently in the recent literature, particularly *responses to risk* and the need for institutions to help individuals and firms manage it efficiently; and we also discussed important aspects of *institutional dynamics*, where recent research has made some very useful contributions. This included the discussion of *selection processes*, where it was emphasised that devising institutions to ensure a high volume of investment, with a strong tendency to select efficient and productive investment projects, was critical for achieving sustained economic growth, and hence pro-poor growth.

## 4. INSTITUTIONS AND GROWTH

### 4.1 Economic Institutions and Growth

#### 4.1.1 The Macroeconomic Literature

Understanding the massive differences in per capita income around the world, mostly measured as differences in average per capita income between countries,<sup>12</sup> is an enormous intellectual challenge. As fairly recently as a couple of centuries ago, between-country differences in living standards were nowhere near as large as they are in the opening years of the twenty-first century; accordingly the differences we see – and measure – today must have come about as a result of some countries growing faster than others, not merely for a few years, but sustained over decades and in a few cases even centuries. As Rodrik (2003) explains, only in this way could such large inter-country inequalities have opened up in the world economy. It is important to investigate the factors that could explain such gross inequalities for two reasons:

a) to understand the economic, political, social history of the world economy up to the present day, notably the growth processes that brought the world to the present levels and distribution of incomes; and far more importantly:

b) to derive from this understanding lessons for the future – in particular lessons that might assist the present poor countries of the world to achieve more rapid economic growth and to sustain it for decades, enabling them to catch up to the income levels and accompanying living standards of the present-day developed countries.

For economists familiar with neo-classical growth theory, and its more modern extension into theories of so called endogenous growth, the natural starting point for thinking about economic growth in the context of development is through the supply side, via the basic concept of the production function. At its simplest – and most aggregated level – this represents a country's real GDP ( $Y$ ) as a function of the available capital stock ( $K$ ) and labour force ( $L$ ), thus:

$$Y = F(K, L) \quad (4)$$

This equation 'explains' a country's level of income ( $Y$  itself, or per capita income,  $Y/L$ ) in terms of  $K$  and  $L$ . Likewise, changes in  $Y$  – i.e. economic growth (or decline, if negative) – are explained in terms of  $K$  and  $L$ , together with the rates of change in  $K$  and  $L$ .

Within this framework, countries are likely to be poor if they possess low levels of capital stock ( $K$ ),

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12. We realise, of course, that within-country inequality, as measured for instance by Gini co-efficients, can also differ greatly between countries; and that even medium-income countries can contain many very poor people within their borders if their income distribution is highly unequal. Some attention must therefore be paid to within-country inequality when we discuss Pro-Poor Growth (PPG) later on, but in this section it is set aside while we focus on broader country differences.

or capital stock per worker ( $K/L$ ), suggesting that all they need to do to get richer is to raise the rate of investment and accumulate enough capital. However, the productivity of capital turns out to depend not only on the number of workers available, but on their quality, usually measured through a mixture of educational indicators and work experience variables. In this sense, capital and labour are complementary inputs (an instance of point (v), listed below). Then in equation (4), one might replace  $L$  with a new variable,  $L^*$ , representing the labour force adjusted for the quality of the labour input. Again, the policy implication is simple: get people educated to sufficiently high levels and economic growth will not be far behind.

A presumption in (4) to which we should now draw attention is the following. This is that the underlying production function denoted by the symbol,  $F(\cdot)$ , is essentially the same everywhere, in other words that all countries have access to the same technology. Now, even the most casual observation of the world quickly reveals that different countries do not use identical technology, and that even when they do, they operate it with vastly different efficiency levels. Taking the efficiency point first, the organization of work in different countries can result in more or less equipment down-time, faulty products, errors in providing services, and so on; so what appears superficially to be an identical technology can prove to be viable in one country or firm, loss-making elsewhere, even when wage rates and other cost elements are very much the same (so this is not an argument about relative prices, on which see below).

Interestingly, Devarajan et al. (2002) show that investment in Africa, for example, has not yielded notably high returns in recent decades, and uses this finding to suggest that one cannot attribute Africa's low growth merely to low investment. While we accept that this is one inference that can be drawn from the data, since raising unproductive investment benefits no-one, we see the key issue here as that of understanding *why* investment productivity has been so low, and then identifying *what needs to change* to make it more productive.

Turning to the differences in technology, to some extent this might be a matter of *gradual adjustment*, where industries contain mixes of 'old' and 'new' technology, and at any given time different countries will have different proportions of 'old' and 'new'. Also, one might argue that the prevailing *relative prices* could result in the adoption of different technologies, even when the underlying technical knowledge is essentially uniform. Thus countries that have a long history of not taxing energy can be expected to adopt energy-intensive methods of production, as is indeed the case in most of the countries that resulted from the break up of the Soviet Union in 1991; likewise, one might expect countries with low wages to adopt relatively labour-intensive technology. However, the returns to capital should then be relatively high, stimulating rapid rates of capital accumulation and aggregate economic growth, but empirical studies do not always suggest that the returns to capital in poor countries are high, and even where they are we do not always observe the expected accumulation. Accordingly, in our view, neither the gradual adjustment nor the relative prices of technological differences between countries fits what we observe, at best they only offer partial explanations. Rather, it appears to be the case that different countries have effective access to very different technologies, in other words we should think of the production function for a country as  $F_i(\cdot)$ , where the suffix  $i$  denotes the country – then we should ask the question, why do different countries have access to such enormously different technologies? Many reasons can be put forward to explain this situation. Some potentially important ones are listed below, then briefly discussed:

(i) Restrictions on technology transfer by the developed countries, through such methods as patenting; however, much of the relevant technology is not even codified in the manner implied by this point, rather it is based on implicit or 'tacit' knowledge.

(ii) Trade restrictions and other barriers to innovation imposed by either sending or receiving countries.

(iii) Lack of spending on R&D and the adaptation of technology to suit local conditions in technology-receiving countries.

(iv) Lack of knowledge about available technologies on the part of poor countries.

(v) Lack of the complementary resources - such as infrastructure (both physical and institutional), and skilled manpower - needed to make modern technology productive.

Point (i) is surely not to be taken very seriously, since much good technology is not protected by patents, and what is protected means, at worst, that countries have to license the technology concerned or wait until patents expire. Either way, the result is that some countries will lag behind the countries most advanced technologically, but not necessarily with a lag increasing over time – barriers to technology exports by the more developed countries might explain some differences in equilibrium income levels, but it is hard to see why this should materially influence the achievable growth rates (which is what matters for long-term improvements in living standards).

Point (ii) is a reminder that countries are not distinct 'islands', but are part of the world economy in which trade is a vital element (whereas equation (4) is really a model of a closed economy). However, trade, whether in items of modern technology or anything else, faces a variety of barriers and restrictions, some of which result from deliberate choices by the participating countries (e.g. tariffs); some of which are natural (transport costs for land-locked countries); and some are by-products of political strife (e.g. closed or impeded borders due to civil strife and the like) – we shall have more to say on this complex and important topic in section five. Other aspects of point (ii) are connected to the role of governments, since these may choose to restrict or encourage the development and/or import of technology, the extent

of local adaptation and the training of personnel capable of undertaking such adaptation, etc.

R&D spending as a fraction of GDP varies greatly around the world and is not much correlated with either income levels or GDP growth rates except in the most prosperous countries where high income, high R&D spending and slow but positive growth rates (typically in the range 1–3% p.a.) appear to go together. For the richest countries, already at or close to the world technological frontier, spending on R&D is increasingly perceived as essential to sustain growth, with the EU, the USA and Japan constantly monitoring each other's spending levels; this is a competition without clear 'winners', except perhaps those countries that are content to be technologically advanced largely on the basis of imported technology. For small countries their trade dependence forces them to specialize quite narrowly, so even quite advanced countries might only be technological leaders in a handful of niche areas, importing everything else they need. To do this successfully, however, they require both an institutional framework that encourages innovation and the use of new technology, and sufficient highly skilled manpower to enable new technology to be adapted to local conditions and used effectively.

In most poor countries, none of these conditions holds; there is little R&D capacity, an institutional framework not especially conducive to innovation, and very poor supplies of sufficiently skilled manpower. Hence point (iii) is partly right, but incomplete; it needs to be supplemented by point (iv), on information, and point (v) on complementary resources. As regards information, it is a perhaps surprising fact of the modern world, despite the internet and other tools of communication, that information about novel or alternative technologies does not flow particularly freely around the world. Partly there is a problem of *information overload*, in the sense that too much information is almost equivalent to no information; partly there is a genuine problem of *incomplete information* in many countries, since unreliable electricity supply and few or no modern computers seriously limits internet access (especially, but not only, in rural areas); and conventional sources of information such as books, technical journals (both academic and sectoral), research papers and the like are hardly available due to funding limitations, and lack of educated people to demand such material.

More interestingly, even in settings where the flow of information is, in principle, pretty much unrestricted, information is not really free since absorbing and using it always costs time and possibly other resources, and therefore economic agents – whether firms or government agencies – will only 'discover' and then use that information about available technologies which they have the incentives to pursue. This simple point makes clear that new technology will only be sought out when agents feel it will be to their benefit, and this in turn depends on their economic circumstances in terms of trading opportunities, the tax regime, the competitive environment, legal and regulatory conditions, etc. Hence whether modern technological information is 'discovered', studied and used for economic benefit in a given country depends very sensitively on quite detailed features of the environment that prevails there.

The final point (v) on complementarity is a mix of bad news and good news: the bad news is that it implies that countries with low productivity need to be improving everything at once, since quality workers (for example) apparently only deliver high productivity when linked to good capital, with business supported by a nice legal framework (properly implemented) and sound infrastructure that functions with little or no corruption, and operating in a clear fiscal framework. This approach to policy, however, is all too reminiscent of old-style World Bank thinking where policy advice took the form (and sometimes, unfortunately, still does) of long lists of measures and policies to be introduced 'now', all at once. Since for many countries, such an approach is beyond their reasonable capacity to implement, it is fortunate that we can now emphasize the good news; this is the simple point that, while it would be nice to implement a package like that of the previous paragraph, our attention should be focused not on some 'ideal', but on what is actually needed to get growth going in a given country, and to help create conditions where it can be sustainable – and this is often simpler than the supposed 'ideal'. Though complementarities do mean that different elements in the growth 'model' should – in the long-run – change together, this might not be the problem in a given situation; rather, it might turn out that one or other element of the 'model' is the key blockage to growth. To give effective policy advice then, or advice on institutional reforms and the like, what is needed is to identify the relevant blockage, and focus on policy measures that can help to ease or remove it. This point is brought out strongly in Rodrik (2004b), where a distinction is made between the policies (including institutional changes) needed to kick-start growth, and those needed to sustain it over a longer period. Removing blockages is essentially what Rodrik has in mind when he discusses kick-starting the growth process in a given country.

The diagram below (Figure 2), illustrates the points being made here. If the starting point is at A, then to raise output from  $Y_0$  we have to move from A to A', which involves increases in both inputs K and L (or simultaneous reforms in two areas) - this is the case of complementarities. If the starting point is at B, then output can be raised simply by adding capital (or reforming one area) to move to B'. While the underlying 'model' is still characterized by complementarity, increasing one resource is sufficient to yield growth, which is what we mean by referring to this as the case of blockages, therefore to promote growth, the 'trick' in this case is to identify the source of the principal blockage (needless to say, actually identifying the relevant blockage in a given country is unlikely to be easy).

In the preceding analysis, we have referred, several times, to institutions as candidates for one of the groups of factors explaining the growth performance – or lack if it – in various countries. Now we turn our attention to growth regressions and other recent studies that seek to provide some empirical substance

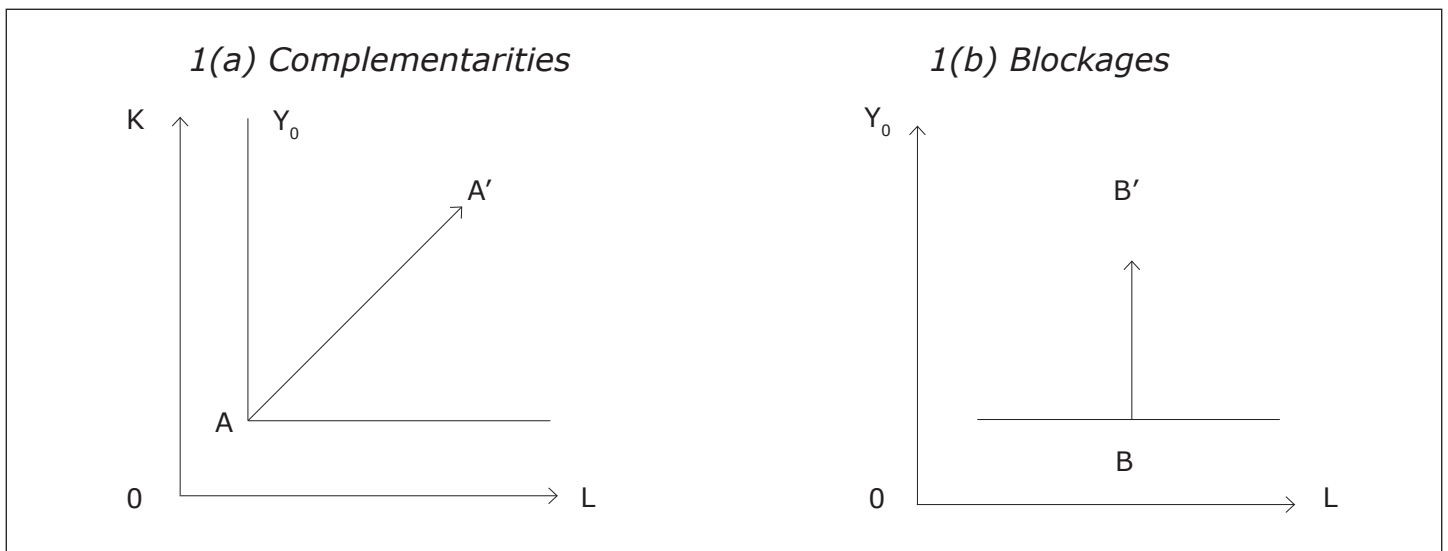


Figure 2. Complementarities and Blockages

to diverse hypotheses about growth and development, including hypotheses about the role and importance of institutions.

A useful starting point is provided by Dixit (2005), since this paper looks at what we know about growth and development, with a strong focus on institutions. Dixit notes that the recent empirical literature includes many studies that investigate historical and geographical factors that might influence economic growth, such as papers by Rodrik (2004a), Acemoglu et al. (2001 and 2002) and Hall and Jones (1999), among others. The emphasis in this literature is on how the relevant history or geography has conditioned institution-formation, this in turn being seen as the proximate 'cause' of economic growth. Thus history and/or geography are seen not so much as directly causing growth, but as only influencing it indirectly via institutions. Dixit largely accepts this line of thinking, despite being far from convinced by the econometrics involved<sup>13</sup> – this is perhaps fortunate, since countries cannot do anything to change their respective history or geography!<sup>14</sup>

Moreover, as Acemoglu et al. (2004) emphasize, some natural 'experiments' can be found to demonstrate the limitations of historical and geographical explanations of economic development; these authors point to the postwar division of Korea into two states with similar histories and income levels up to the point of division, but with enormously divergent experiences since, with North Korea remaining very poor and the South becoming substantially more prosperous in just a few decades. The second example is the so called 'historic reversal', the observation that prior to European colonization, many of the wealthiest regions of the world were close to the equator; while the wealthiest nations are now mostly in temperate zones, this observation does show that proximity to the equator is far from fatal for (relative) prosperity.

Returning to Dixit (2005), he then proceeds to challenge many of the standard 'recipes' for policy reform and institutional development that can be found in recent academic literature on development; he does so by highlighting contrasting pairs of institutions or policies, citing studies showing that one or other member of the pair is vital for growth, the selected pairs being shown below in Table 4. The conclusion can only be that we have to be more modest in our claims (since we know less than we would like to think), including being alert to what can actually be implemented in a given situation. A related lesson is the need to beware of jumping on the latest development 'success story' bandwagon, since experience of recent decades shows that these rarely last.<sup>15</sup> A more nuanced approach will prove more useful, not forgetting Dixit's 'Napoleon Prescription' – namely the need for a good deal of luck – we return to this point later.

13. He is far from alone in questioning the econometrics of growth regressions. See, for example, the excellent paper, Brock and Durlauf (2001). Rodrik (2005) also provides a critique of regressions of growth on policies by arguing – correctly in our view – that economic policies are strictly endogenous, which makes the standard regressions, and even more their interpretation, highly suspect. Sachs (2003), however, uses a variable representing susceptibility to malaria to show that certain geographical factors can affect income levels directly; and Levine (2005) finds evidence that both legal traditions and endowments influence the form of property rights protection adopted by various countries.

14. Thus being landlocked (like Botswana), remote from major markets (like New Zealand), lying close to the equator (like Brazil), being suited to plantation agriculture (like parts of Malaysia or the Philippines), possessing valuable natural resources (such as Nigeria) or possessing few resources (like Japan); or having been colonised by the British (such as Uganda) or the French (such as Ivory Coast), and so on are not per se sufficient conditions for either being or remaining poor.

15. This remark includes both the reference to particular countries as models of successful development strategies (as referred to by Dixit), and the numerous single-factor strategies that can be found in the literature – such as import substitution, export-led growth, agriculture first, and so on. Each strategy might work in certain countries for certain (limited) periods, but none comes close to being a universal panacea.

Contrasting Pairs	
Democracy	Authoritarianism
Formal governance institutions	Informal governance institutions
Comprehensive and rapid reforms	Sequential and gradual reforms
Imitation of other countries' institutions	Institutional innovation
Crises – good for reforms and institutional development	Crises – bad for reforms
Population level/growth/density – good for growth	Population growth – bad for growth

Table 4. Alternative Approaches to Institutions and Policy (from Dixit, 2005)

So without entering into a detailed discussion of literally dozens of interesting papers on the broad theme of this section, what do the macroeconomic and often heavily econometric approaches to the analysis of growth processes tell us about the role of institutions in growth? Since many issues of detail are taken up elsewhere in the paper, we confine attention here to a list of what we think are the key points:

- There is certainly a *positive association between institutional quality and aggregate economic growth* as revealed by many studies, but there remain many uncertainties:
  - How to measure the relevant institutional variables, notably the quality of key institutions; this is especially difficult given that institutional strength is quite a subjective notion. Thus property rights in China are not at well protected at a formal, legal level, but most people believe that their established rights are in fact secure and act accordingly.
  - Which institutions are in some sense 'critical'.
  - Directions of causality – while institutions 'cause' growth, there might be some reverse causality when growth fosters demands for improved institutions.
- There is much less evidence on the connections between *institutions and pro-poor growth*, though our understanding is improving as a result of studies reported in the next section.
- On specific *economic institutions*, there is some evidence that the following are particularly important:
  - Protection of property rights and business contracts (this can be formal or informal).
  - Openness to trade, engagement with the world economy.
  - Supportive conditions for investment.
  - Good business environment.
- On *political institutions and the state*, what appears to be crucial is not so much the presence of democratic structures as such, but features such as:
  - Political public goods (e.g. peace, law and order).
  - The formal character of the polity (e.g. does the President have a veto? Does the Constitution say anything about property rights or gender? How is the constitution changed? Must the president retire after one or two terms? Etc.).
  - The formal character of *de jure* power. Does the state call the shots or is it having to negotiate with other centres of informal *de facto* power (perhaps traditional, perhaps even armed)?
  - The ability of the government to commit credibly to particular announced policies.
  - Effective constraints on government to limit its ability to renege on previous commitments and to constrain rent-seeking/predation.
  - Limited corruption.
  - Government seeking to pursue developmental goals rather than predatory (rent-seeking) ones.
- *Institutions generally change slowly* and their impact on growth is usually quite long-term, hence regressions of growth on institutional change (in the same or a very recent year) rarely pick up strong effects. The interesting exception here is the economies in transition in the early 1990s when big institutional changes occurred rapidly and – following a severe post-communist recession in most countries – soon had a large impact on growth rates. Even so, interactions between institutions and practices that can be rapidly changed, and those – often based on long-established customs and traditions – that at best only change slowly, can complicate both the process of bringing about effective change, and hence its impact upon economic growth.
- Economic policies can change more rapidly than institutions generally do, and their impact on growth – both positive and negative – can be more immediate. However, there is little evidence that

policies *per se* have much impact upon economic growth in the long-run except indirectly through their impact upon the key 'factor' inputs (capital, labour, land) and institutions.

#### 4.1.2 Microeconomic Studies and their Lessons

At the microeconomic level it is usually very difficult to identify the impact on economic outcomes of particular policy changes adopted at national or regional level, and even harder to distinguish the impact of policy *per se* from that of specific features of the institutional environment within which the policies are being implemented. In the past few years, however, a number of studies have been carried out and published in which ways are found to cut through some of these difficulties; these studies address issues of information and accountability; incentives and job performance; and the impact of corruption and some are based on randomized field trials of particular policies, where a new policy is applied to certain areas and not to others. While a potentially powerful technique, since in economics it is not often that we can carry out experiments of the sort that are usual in the natural sciences, this approach also has its limitations, not the least of these being that there are many areas of policy that could not readily be studied in this way.

The role of local information in improving policy implementation was highlighted in a very interesting study of secondary schools in Uganda, reported in Reinikka and Svensson (2004), who found that central government allocations of non-salary funds to secondary schools were barely correlated at all with the sums the schools actually received: some schools initially received zero funding, and in some instances they were unaware that they should have been receiving something; other schools received half or more of their central allocation, with a few even receiving more than had been assigned to them at the centre. On the way down the local government hierarchy, one has to assume that funds not reaching the schools were being diverted either to other components of local government spending (indicating that local preferences differed from those of the centre) or to local political elites (forms of patronage). So how was this problem dealt with? Quite simply by disseminating, at the local level, information about the funding allocations to individual schools; unsurprisingly, the resulting improvement in local information resulted in a massive improvement in the funding actually reaching the schools and though some of the allocated funds were still diverted on the way down the system, it was far less than before. A side issue not discussed in the paper is this: if local patronage obligations and/or local preferences were not themselves changed by this provision of better local information, what happened to other parts of the local government budgets following this reform? Were other funds diverted instead of the schooling funds? Unfortunately, we have no information about this, only questions; the point is that the local institutional environment remained unchanged following the improvement in information flows about school budgets, so it would be a reasonable expectation that some adjustment could occur via other budget components.

That such displacement can occur following a well intentioned policy reform is indicated in a recent study of customs reform in the Philippines (Yang, 2005). Enforcement measures against a particular method of evading customs duty were strengthened, but it was done selectively – only import shipments from certain countries were subject to the tougher enforcement measures, while there was no change in the enforcement over shipments from other countries – the new policy was set up, in effect, as a form of experiment. As expected, the strengthened enforcement did indeed result in a significant drop in the use of the targeted means of duty avoidance, however, it also turned out that importers took advantage of other means of duty avoidance, notably by diverting shipments to enter the country through duty-exempt export processing zones. Such displacement was greater for shipments where the normal tariff rates would have been high, and where the volume of imports was large and Yang (2005) suggests that this effect might be due to a 'fixed cost' associated with shifting to a new method of avoidance. Overall, there was no evidence that the new policy reduced the total extent of duty avoidance.

Olken (2004) examines local-level corruption in Indonesia and explores the impact of different forms of monitoring; the study takes the form of a randomized field experiment that investigated over 600 village road projects and the extent of corruption was measured by comparing the official expenditure reports submitted by each village with estimates prepared by engineers who could assess the prices and quantities of all inputs. Two methods of monitoring were applied, namely a government audit, and grass-roots participation in monitoring; different methods were applied to different projects, the selection being done randomly. Increasing the probability of a government audit (from a base of 4% up to 100%) did cut estimated theft from these projects by about 8% of total expenditure, a significant improvement that leads Olken to conclude that such audits would be cost-effective. Enhanced grass-roots participation in monitoring also changed village behaviour, but in a more complex way: there was much less (estimated) theft of workers' wages, but this was largely offset by increased theft of materials. The author concluded that this form of monitoring was not effective in policing what are regarded by the villagers as 'public goods', namely materials provided to the project from outside the village.

The experience gained from the past decade or so of field experiments is nicely summarised in Duflo (2005), which reviews a range of studies that test hypotheses about incentives, social learning and inconsistent time preferences. An example of such a study, looking at the problem of teacher absence in parts of India, is provided by Duflo and Hanna (2004): despite the fact that teachers in rural India can lose their jobs if they are absent from their posts without good reason, penalties are rarely applied – the consequence being that absence rates are extremely high. In the study, 120 informal, one-teacher

schools formed the sample; of these, a randomly chosen 60 schools benefited from a financial incentive programme aimed at reducing teacher absenteeism. In these schools, teacher attendance was monitored each day as follows: using a tamper-proof camera, the teachers had to have their photo taken by one of the children at the beginning and end of each school day, the photos showing the time and date, teacher pay was then based on the attendance as recorded in this way. In the remaining schools, no special measures were taken.

The introduction of the incentive programme proved remarkably effective. Teacher absence as measured by unannounced spot checks in all 120 schools remained at the high rate of 42% in the schools not benefiting from the programme, but fell sharply to 22% (so still fairly high) in the 60 schools with special financial incentives based on attendance monitoring. Moreover, the improved teacher attendance had significant measurable effects on the children's achievement levels, with higher test scores and improved admission rates to regular schools.

## 4.2 Political Institutions

Politics is so critical for economic growth and development in many countries that we cannot avoid at least a cursory review of key issues; political aspects of institutions, however, are taken up in much greater depth in the companion paper, Leftwich (2006). Here, therefore, our focus can be relatively limited, confining itself to three topics:

- what do states need to do;
- what constraints should there be on state power; and
- what are the implications for economic development of weak or failing states.

### What do states need to do?

Fukuyama (2004, pp. 23) offers a four-level characterization of 'stateness' in terms of:

- a) organizational design;
- b) political system design;
- c) legitimization; and
- d) cultural and structural factors.

This is essentially the supply side of the political market-place, if we may express it that way. More problematic is the corresponding demand side, since political institutions will not be built or sustained if there is a lack of effective demand from the relevant political actors. In this context, external agents seeking to push for change, e.g. through conditionality in aid programmes, often fail to deliver the change they expect, and such efforts can even be counterproductive; likewise, 'capacity-building' efforts and the current mantra of 'local ownership' of aid programmes can turn out not to mean a great deal if these processes do not engage with serious demands from the country concerned. However states function, they affect the opportunities and the incentives facing diverse private actors, whether households or firms. More prosaically, they set the framework within which private economic activity can occur – states are about power, and constraints on that power sufficient to provide private economic agents with the confidence to go about their business.

The evolution of states is highly path-dependent and culturally influenced, that said, for a state to have a chance of promoting development, it does have to offer some basic services to its population. We think of states as possessing a monopoly on the means of violence within their borders (referring to such forces as the army, border guards, police, other security services), in return for which they should deliver basic public services (health, education, transport infrastructure, and the like), as well as the rule of law (protecting property rights, contracts, and so on); this is akin to what Khan (2004) terms the 'service-delivery model' of the state. Moreover, states should deliver these services without excessive (or the wrong sorts of) rent-seeking and corruption, and with an acceptable degree of competence. The trouble is, as many have observed in the past, that a state strong enough to deliver the above services is also strong enough to break contracts and expropriate resources from its citizens – so how can we reach a credible social compact, where both state and citizens respect each other's spheres of influence? Greif (2005), for instance, strongly emphasizes the need for institutions that constrain the state – for otherwise, no one will feel safe enough to come to market and engage in profitable trade.

I have put forward here a relatively normative conception of the state, but making a state work like this is very difficult, and in many countries where it 'works' tolerably well, the evolution has occupied decades or even centuries, with episodes of war and instability often forming part of a very painful 'social learning process' – for instance, how do we engender a culture in which 'the army does not engage in politics'? How do we ensure that the rule of law is deeply embedded in a society? How can we stop armed militias and other groups from disrupting the orderly functioning of a given society? These questions are partly about the need for constraints, to which we now turn.

### What constraints should there be on state power?

The importance of constraints on state power is highlighted in Acemoglu et al. (2005), who argue that for European states, the growth of Atlantic trade was much more effective in promoting economic growth where there were already significant limitations upon the power of the monarchy; for this ensured that the rising merchant classes captured a large share of the profits of trade, giving them the confidence to

invest and further develop their scale of operations.

Political disputes are commonly about distribution, so an important issue concerns how to constrain these sufficiently to foster growth, since in the long run, getting a bigger pie is far better than fighting over the division of today's pie, but in the short run, often, the easiest way to get more income is to steal it from someone else, which states have the power to do! And this is commonly done around the world, by many governments, as is discussed extensively in Fafchamps (2000), who refers to a variety of common mechanisms such as looting and theft; taking advantage of commodity price fluctuations; and the formation of cartels controlled by members of the elite. In such conditions, the state becomes, quite simply, a vehicle for the enrichment of the elite.

There are two types of condition can constrain this process: first, at a very basic level, the state might have to deliver at least some minimal level of services to the population in order to avoid the threat of revolt or insurrection. This is likely, in most cases, to form quite a mild constraint; in any event, it might suffice for the state to engage in patronage, basically rewarding its own supporters at various levels, rather than delivering services to the entire population. A model that examines some of the important trade offs in this area, in a context where resource rents are important, is presented in Collier and Hoeffler (2005). Second, a variety of institutions, mostly quite high-level ones, might be in place to limit state action; from accounts of many developing (and, indeed other) countries over the past couple of decades, such institutions would include senior officers of the central bank, senior members of the judiciary (e.g. supreme court judges), audit committees of the parliament or government, heads of anti-corruption agencies, top levels of the tax and customs administration, and the parliament itself. However, in many countries where some or all of these agencies are in existence, they nevertheless fail to function as an effective check on state power, sometimes they are suborned by the ruling group, essentially bribed not to make trouble; sometimes top people are removed (and in more drastic instances, exiled or even killed) and replaced by people more willing to comply with the wishes of the ruling group.

So from the viewpoint of understanding political institutions, the interesting question is not so much whether such top-level bodies exist – since they mostly do – but to identify the forces and pressures that can enable them to work. In part this concerns cultural understandings, in the sense that, for instance, when a central bank governor reports that a certain proposed transaction is illegal or ethically inadvised, the advice would simply be taken; or when corruption is reported, it would be seriously investigated and punished. It also concerns issues like openness, transparency, accountability and publicity, thus an active media can be an important means of calling a government to account. However, this just removes us one step back in a possibly infinite regress – for how can we be confident that the media will be permitted to operate as they need to? And even if the media can function and are free to criticise the government, what then compels the government, specifically the core ruling group, to act? Unfortunately, there are no easy answers, and there is no readily available 'theory of government' to provide them.

### **Weak or failing states**

This brings us naturally to the problem of weak or failing states, one that has received far more attention from the world community since the 9/11 terrorist attacks in New York in 2001. Increasingly, fragile states are perceived as a potential source of world instability, and specifically as a danger to the developed world; regardless of the validity of this wider view, these states are most certainly a danger to their own people, since they almost never create the conditions in which significant economic development can take place, and in many instances failing states have overseen the steady impoverishment of their people. Not surprisingly, therefore, some of the leading aid agencies around the world have recently evolved specific strategies to govern their relationships with these states (see USAID, 2005).

As Wolf (2004) argued so forcefully, if the world community shrinks from intervention to start rebuilding the most glaring examples of failed states (e.g. Congo, Sudan, Somalia), then 'they must accept that they will share a planet with countries without law and people without hope.' On the other hand, as regards the process of helping failing states to become stronger, he did offer some pointers: (a) regulatory competition in the sense of competition between various 'state models' (such as occurred in Europe, historically); (b) adopting good policy such as economic openness and low (but enforced) taxes, can foster business activity and help build constituencies supporting development; (c) international organizations like the IMF and WTO can support countries who enter into binding commitments in some key areas of economic policy; and (d) well-targeted aid can help build basic economic infrastructure. Needless to say, none of this counts for much if the state concerned has, in effect, totally disintegrated, or if it is unashamedly set on a path of systematic predation.

Moore et al. (2005), summing up five years' research by the Centre for the Future State, draws on detailed, micro-level studies of several developing countries to come up with some pointers that are possibly somewhat more optimistic than the line taken by Wolf. Moore focuses on three areas: taxation and the way in which it helps to build accountability – of citizens to the state and vice-versa; the ways in which the poor can organize to make demands on the state and ways in which the state can usefully contribute to such a process; and new types of collaboration between the state and its citizens to provide local public services.<sup>16</sup> The emphasis throughout is on flexibility and experimentation, setting aside prior

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16. This aspect of decentralization and local accountability is also stressed in Bardhan and Mookherjee (2006).



or conventional views of 'how things should be done' taking advantage of local custom and practice rather than imposing external models; as when methods and models employed in more developed countries appear not to work when transposed to a new context, detailed local knowledge can often suggest alternative approaches more in keeping with the given institutional conditions.

While we often think we can pinpoint the failing states pretty well, it is worth pausing to consider whether this presumption is borne out by the empirical evidence. Accordingly, we examine the very interesting work on Africa, reported in Atiku-Abubakar and Shaw-Taylor (2003) (hereafter, AAST); weak states are characterized there in terms of structural inequality, comprising three aspects: economic differentiation, cultural inequality, and political inequality. The probability of communal conflict is then regressed on measures of these factors for 32 countries of sub-Saharan Africa, looking at conflicts in the period 1940–1989, and then since 1990. In the resulting logistic regressions, however, only the variables representing cultural inequality proved to be significant, and overall explanatory power was fairly weak; the study showed, therefore, that other variables not properly allowed for must form part of the explanation for internal conflict; one possibility discussed briefly was the prevalence and availability of small arms in a given region or country. It was also suggested by AAST that efforts to reduce economic differentiation should help to reduce the pressure for conflict due to cultural and political inequality.

For present purposes, we could argue that being a weak state is not just about the occurrence or otherwise of internal conflict – AAST only picks up part of the story – our concern is more with the capacity of a state to promote or obstruct economic development in a given country, and that was at best only tangential to the main focus of AAST. On the very issue of state capacity to promote development, Khan (2004) puts forward what he calls the 'social transformation model' of the state, which he contrasts with the 'service delivery model' referred to above; Khan's view is that a fundamental area of state failure in the developing world has been the failure to bring about the sort of social and political transformation required to transform poor, largely pre-capitalist societies into 'dynamic and essentially industrial, capitalist ones' (pp. 165). As he sees it, such transformations frequently entail a great deal of re-definition and re-distribution of property rights (often outright theft as far as the losers in the process are concerned) in order to create the institutional conditions that foster capital accumulation and growth. In this context, therefore, when we talk of protecting property rights, as the institutional literature often does, it matters whose property rights enjoy the resulting protection, just as it matters (for future development) what the owners so protected do with the assets that they have managed to accumulate (or steal). Thus a failing transformation-state might be one where the state and various associated elite groups manage to get hold of substantial volumes of assets without subsequently being motivated to engage in productive accumulation: a successful transformation-state, on the other hand, would be one where elites not only accumulate resources and assets, but where they are subsequently motivated to use them for investment and economic growth. This important distinction relates back to issues discussed in Khan (2000), to do with rents and their role in economic development. Contrary to the common, and perhaps over simple, view that rents are generally a 'bad thing', Khan argues that under suitable institutional and political conditions they can play a vital role in processes of economic growth, essentially by facilitating the mobilization of economic and social resources that is usually vital in getting growth going.

The resulting story of growth fostered by a transformation-state is inevitably very messy, indeed even extremely unpleasant, notably for the losers and consequently it does not sit very well in a context where pro-poor growth is the current focus of the development community, for growth through capital accumulation induced by asset re-distribution might not be pro-poor at all; after all, why should it be? All one can say, we suspect, is that once the dust has settled, when people have got used to the new distribution of assets and fast growth has been under way for a decade or two, then even the poor might start to reap some of the rewards – but we suspect this is not what the World Bank or IMF have in mind when they think of pro-poor growth.

## 5. INSTITUTIONS - ILLUSTRATIONS

In all specific areas, the main point concerns the complexity and multi-dimensional nature of institutional structures, organizations and policies, usually with lots of overlaps, varying degrees of co-ordination, and so on. These features can make it difficult to pick out the really key elements, identify major 'blockages', and therefore to design effective institutional and, to some extent, policy reforms. In this section, we illustrate these observations by discussing in some detail two areas: namely trade policy, and the business environment.

### 5.1 Trade Policy

Much of the more simple-minded policy advice on trade says little more than: 'liberalize, liberalize, liberalize!' Sometimes such advice might even be correct, but we suspect that it is often not (or not without qualification), and our suspicions are borne out by the increasing volumes of quite careful empirical work on trade, as we shall see shortly. As with any other policy domain, the impact of trade policy measures on economic performance depends both on other policies, and on subtle features of the institutional environment, including the political economy of the country concerned; moreover, trade policy itself is, in practice, considerably more 'multi-dimensional' and complex than is commonly assumed, especially in the theoretical literature.

Let us begin by remarking on the recent experience of economies in transition, using the countries of Central and Eastern Europe and the former Soviet Union as an example, since this is a region we are especially familiar with. For most of these countries prior to 1989 or 1991, their trade within the 'socialist block' was part of the central planning process, governed by detailed, quantitative agreements between each pair of countries, and not much influenced by profitability or comparative advantage; trade with market-economy countries was mostly subject to licensing, diverse quantitative restrictions, and complex, highly differentiated tariffs with little economic logic to justify them and the result was that across the whole region, these countries' share of world trade declined steadily from the 1950s onwards; and by the 1980s almost every country was experiencing economic stagnation – central planning did not prove to be an effective means of fostering sustained growth and rising living standards once an initial burst of rapid industrialization had occurred.

When transition began, many advisers took the view that the best way to deal with trade policy would be through a mix of removing the old controls and licensing requirements, and then simplifying and reducing tariffs; most countries actually did this very rapidly, though a few still control much of their trade even today. Many of the countries that reformed fastest were also liberalizing in many other areas at the same time, and this probably helps to explain why, following an initial shock associated with the disruption of their former 'socialist' trade, their trade bounced back rapidly; particularly, trade with western partners, including the EU, with some countries raising it by factors of three or more, within a few years.

The less successful countries, including many in the CIS (Commonwealth of Independent States), have also enjoyed rising trade from the mid-1990s, but much of their trade is with each other rather than with the wider world. Consequently they are not yet fully integrated with the world economy, a phenomenon noted in a recent comprehensive study of transition economy trade published by the World Bank, Boardman (2006), which acknowledges that much of the early advice on tariffs and trade controls has been taken, but that quite a number of countries in the region, both in the CIS and in South-Eastern Europe (SEE) still need what Boardman terms 'behind-the-border' reforms in order to strengthen trade. Such reforms are partly about aspects of trade policy itself, to do with export promotion, trade credits and the like (we refer to these below); and partly about other domestic policies such as competition policy and improving the business environment (see the next section) – in other words, policies and institutional developments that are not usually thought of as trade policy per se, but which have a big impact on trade, (with some recent empirical studies of trade policy around the world tend to support Boardman's concerns about the transition economy region).

Without going into minute detail, it is worth noting here the types of issue that commonly arise in connection with discussions of trade policy for developing countries – if nothing else, this will make clear just how much more is involved than the comparatively simple analysis of tariffs and quantitative restrictions (QRs). Other important issues include:

- export promotion and the provision of market information;
- trade credit and trade financing, which often involves a mix of services provided by the banking system and some government support;
- export credit guarantees, usually involving some public (government) support, now – important in reducing the risks associated with foreign trade operations;
- customs procedures and their administration, including fees (legal or otherwise), typical delays at borders, costs of border crossings, etc.;
- transport costs (including the quality and availability of roads or rail links; port facilities; airports, etc.); also the maintenance of these facilities);
- foreign exchange availability, restrictions on its use (if any), the exchange rate regime;
- foreign exchange deposit or surrender requirements in connection with foreign transactions, if any.

In addition to these 'domestic' points, many countries' trade also depends on the policies of their neighbours – for instance, in the case of landlocked countries that need access to markets, both in their region and around the world; unfortunately, for both political reasons, and as a result of seriously bad policies followed by their neighbours, too many countries face very severe difficulties in getting their goods to market at reasonable cost.

Many developing countries either belong to free trade areas (FTAs) of various kinds, or enjoy trade preferences offered by the EU, the United States, or other developed countries. Belonging to an FTA implies that the member countries cut to zero the tariffs on their mutual trade, either for all goods and services (ideally), or more often for an agreed subset of products; in the latter case, the excluded products simply have tariffs set by each individual country. While an FTA involves reciprocity, in the sense that each member offers trade concessions in exchange for equivalent concessions by the other members, a preferential trade agreement is, by definition, asymmetric; usually, the developed country or region (say, the EU) offers trade concessions such as duty-free access to its market for an agreed list of products while expecting either no concessions in return, or possibly more limited concessions.

Some countries belong to several different multi-country agreements, according to their trade policy, and since each will usually have a different list of 'preferred' products, and different conditions associated with them, the result can be a system that is both costly and difficult to administer, as well as being open

to corruption. Each individual agreement might appear to offer a given country an attractive opportunity, but taken together their operation can easily swamp the capacity of a poor, developing country with a relatively weak bureaucracy; especially since trade agreements usually include fairly complicated rules-of-origin and anti-dumping provisions, which themselves also require to be administered.

This is not the place for a full, technical discussion of such arcane provisions, but briefly, these terms mean that: (a) within an FTA, rules of origin would state that at least 50% of the produced inputs needed for an export from one member to another should come from FTA members; and (b) anti-dumping rules ensure that products from one member of an FTA cannot be sold in another at a price considered to be too low, specifically below some measure of production costs (this measure itself often being subject to enormous controversy). Given the complexity of these rules, one has to question whether participation in multiple trade agreements is actually a sensible idea.

However, one multilateral trade agreement to which most developing countries either already adhere, or are in the process of applying to join, is that represented by the World Trade Organization (WTO), formally established in 1995 (as a successor to the General Agreement on Tariffs and Trade, or the GATT). The WTO seeks to provide a clear, rules-based framework for the conduct of world trade, based on simple principles and offering a formal mechanism for resolving trade disputes. No one could pretend that the WTO is an ideal body, since its current practices embody or at least tolerate many extremely undesirable trade policies pursued by its members (especially the most developed countries) that involve highly preferential treatment of sectors such as agriculture, and the exclusion of developing countries from important markets; but in our view, the WTO, for all its imperfections, offers a far better option for the developing world than a return to high tariffs and an abandonment of rules. Within the WTO framework, there is provision for member countries to by-pass the standard most-favoured nation (MFN) principle by offering special trade preferences to other member states. The resulting Generalized System of Preferences (or GSP), as intended, has been used by the more developed countries to offer trade preferences to developing countries, with most OECD countries and many wealthy Arab states establishing GSP programmes. In practice, GSP programmes have their limitations: some are selective as to the countries included (e.g. the USA excludes certain countries on political grounds); and most are selective as to the product groups they include, with many not offering preferences in respect of low-technology items that the poorer developing countries might well be able to produce competitively – for instance countries in sub-Saharan Africa have benefited relatively little from GSP programmes, while countries such as Brazil and India have benefited significantly.

These observations raise several important questions: first, when thinking about economic openness of a country, how should we measure it? Second, in order to benefit fully from its engagement with the world economy, how open does a country need to be? Third, what does the empirical evidence tell us about the benefits of openness to trade? Fourth, what can be said about the connections between trade policies and institutions in a given country? We will examine these questions in turn.

## 1. Measurement

The point about wanting to measure trade openness is that it is not enough simply to study the policies that a given country has in place, or the institutions that allegedly support its trade, (since many countries claim to operate liberal trade policies when they quite clearly do not); it is more useful, in our view, to have measures of the outcome of trade policy. In other words, we wish to know how much trade a given country does, and since this depends on how large a country is, we usually scale trade by relating it to GDP ( $Y$ ), thus for a country exporting  $X$  in a given year, and importing  $M$ , the most common way of measuring its degree of openness is by the trade ratio ( $TR$ ), defined as:

$$TR = \frac{(X+M)}{Y}$$

The variables  $X$ ,  $M$  and  $Y$ , naturally, are all to be measured in compatible units, generally units of national currency for the given year – there are, of course, other measures of trading outcomes to be found in the relevant literature, but this is the simplest and the most widely used.

## 2. How open should a country be?

Empirically, we usually observe that when countries operate open and liberal trading policies, their degree of openness, as measured by the above TR indicator, is a decreasing function of country size, the latter being measured either by population or GDP; thus large countries like the US and India trade relatively little (in relation to their respective GDPs), with TR often below 50%; while small countries such as the Netherlands or Botswana often have very high values of TR (often exceeding 100%). Over time, there has been a tendency for trade ratios to rise in the world economy as more countries liberalize, greater advantage is taken of opportunities for local and regional specialization, and amongst the advanced countries in particular, the very nature of trade shifts towards increasing volumes of trade in similar products (e.g. cars exchanging for cars, rather than wheat for textiles).

However, these remarks are really dealing with the question how much trade would we consider 'normal' under given conditions, not whether this trade is desirable or efficient. Elementary trade models usually imply that some trade is better than no trade, and that complete free trade is likely to be best (for

a suitable measure of world welfare), but are much less explicit when the relevant comparison is between one set of trade restrictions in the world economy, and another set that might be a little less restrictive – theory provides very limited guidance in that situation.

### 3. Costs and benefits of openness

Accordingly, we turn to examine some of the recent empirical evidence. Many studies have been carried out showing that liberal trading conditions (measured in a variety of different ways) are, on average, associated with more rapid GDP growth; however, more careful study confirms what many had already suspected, namely that under certain conditions, opening an economy to increased trade can actually make many people in the economies concerned worse off. For instance, Bolaky and Freund (2004) studied the links between trade openness and growth by performing cross-country regressions on data covering more than 100 countries and found that in heavily regulated economies, increased openness could be associated with lower living standards. Two mechanisms appear to be at work here: firstly that in regulated economies, resource use is commonly highly inflexible, so that resources (including labour) do not readily shift into the sectors that would be most productive in international trade terms; and secondly that the mechanism involves forms of regulation that make the 'wrong' sectors appear to be profitable, so that resources do shift, but they move into sectors that cannot be competitive in the longer term. An example of this, from many of the transition economies, would be energy-intensive production, since this often developed in a period when domestic energy prices were extremely (and foolishly, in our view) subsidised.

In a related study, Chang et al. (2005) examine trade openness in a context where various complementary reforms may or may not have been undertaken. In one version of their model, for instance, they find that whether trade liberalization is desirable or not depends on the flexibility of the local labour market – some trade restrictions can help to protect workers against the otherwise damaging effects of labour market inflexibility, and conversely, if the labour market is sufficiently flexible, freer trade is unambiguously beneficial. More generally, they find that liberal trade needs accompanying domestic reforms to make factor and product markets flexible, the business environment more supportive (see next section), and public infrastructure more appropriate for an open economy.

Many developing countries maintain tariffs to protect certain domestic sectors, often using 'infant industry' arguments to do so; occasionally, this can indeed be a valid argument, but probably far less often than it is actually invoked. More importantly, it is not well enough understood that by protecting domestic sectors, countries are frequently harming their export prospects, not so much in these same sectors, but in sectors whose production uses inputs from protected sectors where costs have thereby been artificially raised. Tokarick (2006) investigates this phenomenon, and finds that the import tariffs often imposed by developing countries result in an implicit tax of around 12% on their exports; this is not an insignificant tax when we bear in mind that for many developing countries export growth is one of the key routes to employment expansion.

### 4. Trade and institutions

To this point we have been taking institutions as essentially given, and at most only examining possible interactions between trade policy and whatever domestic economic institutions happen to be in place, but the story is not that simple, since some features of the domestic institutional structure might be influenced by trading practices, making the domestic institutions at least to some extent endogenous. Do and Levchenko (2006) analyse this idea in a model that allows firms to have different preferences about institutional 'quality' (placed in quotes because there is so much scope for debate about what quality might mean in this context); they find that 'trade opening can worsen institutions when it increases the political power of a small elite of large exporters who prefer to maintain bad institutions.' In other settings, this would be seen as an instance of state capture by large firms – in this case firms engaged in exporting – for such firms, informal links with the government might well be more valuable than general institutional improvements that might benefit all firms (and possibly, among other things, result in fiercer competition for both domestic and export markets).

## 5.2 The Business Environment

As previously noted, institutional structures, organizations and policies are complex, if we consider the business environment in this context, we find a proliferation of different business environment studies and surveys using different indicators and models to reflect the institutional and PPG aspects of the business environment: the opportunities and incentives firms have to invest, create jobs and grow depend on expected profits; profits are influenced by costs, risks, and barriers to entry and competition; and governments can have a major impact on each of these three factors:

- Costs, through the regulatory burden and red tape, taxes, levels of corruption, infrastructure services, labour market regulation, and finance.
- Risks, through policy predictability, property rights, and contract enforcement.
- Barriers to competition, through regulations controlling start-up and bankruptcy, competition law, and entry to finance and infrastructure markets.

Without a sound business environment, new investment and improved productivity are unlikely to emerge from liberalization, changing enterprise ownership, reformed land tenure systems and privatization (Carlin et al. [2001]; Hellmann et al. [2001]).

In this section we review key business environment surveys, to identify common variables and features in developing and transition economies. To begin with, we consider what constitutes a 'good' business environment and how developing countries perform according to the business survey criteria and indices of business environment analyses; second, we consider the structure, size and composition of the enterprise sector and business environment in developing countries. Key issues include firm entry and exit, labour use, and the need to identify the conditions that enable the growth of firms. Finally we consider broader business environment issues focusing on regulation and privatization.

### Surveys of the Business Environment

There have been several business environment surveys published over the past 15 years; these can be divided into two types: (a) business environment surveys which are based on detailed surveys and empirical indicators of development, for example the *World Bank's Doing Business* in 2005 and 2006 surveys, and the World Bank and the European Bank for Reconstruction and Development (EBRD) *Business Environment and Enterprise Performance Survey*, known as BEEPS; and (b) business enterprise surveys which are more subjective and wide ranging such as the *Index of Economic Freedom* which is an annual report published by *The Wall Street Journal* and the Heritage Foundation.

*Doing Business in 2006* is the third in a series of annual reports investigating the regulations that enhance business activity and those that constrain it and provides analysis on those regulations that help create jobs and those that deter it, with new quantitative indicators on business regulations and their enforcement being compared across 150 developing and developed countries. *Doing Business in 2006* updates the indicators presented in previous reports on starting a business, hiring and firing workers, getting licenses, getting credit, protecting investors, enforcing contracts, and closing a business; two additional sets of measures are included, on paying taxes and trading across borders. The indicators are used to analyze economic and social outcomes, such as productivity, investment, informality, corruption, unemployment and poverty, and identify what reforms have worked, where and why. The report, surveyed 155 economies in ten areas including business regulations, taxes, trade costs, property rights and access to credit. Countries that rank at the very top in terms of the ease of doing business were not necessarily easy places to be a worker – for example, the United States and New Zealand were the only two countries in the rankings that imposed no requirement to give severance pay to workers who had been laid off. Overall, 99 countries, two-thirds of the *Doing Business* survey, brought in 185 reforms, with Eastern Europe introducing most, driven by European Union (EU) integration; according to the report, every country in Eastern Europe took at least one step to make things easier for business – five of the top reformers were from Eastern Europe, led by Serbia and Montenegro in the latest survey. By contrast, the Sub-Saharan Africa (SSA) region was the slowest reformer over the past year; while SSA, as a region, has made major progress on macroeconomic reforms, including reducing debt and inflation, the ease of doing business emerges as a key focus for the coming years – for example, registering property requires one step in Norway, but 16 in Algeria; to incorporate a business takes two days in Canada, but 153 in Mozambique; in Haiti, it takes 203 days to register a company, 201 days longer than in Australia; in Sierra Leone it costs 1,268 percent of average income, compared with nothing in Denmark; to register in Ethiopia, a would-be entrepreneur must deposit the equivalent of 18 years' average income in a bank account, which is then frozen; and in Lagos, Nigeria's commercial capital, recording a property sale involves 21 procedures and takes 274 days (*World Bank Doing Business in 2005*).

*Doing Business* is apparently easiest in New Zealand, Singapore and the United States, five other East Asian countries – Hong Kong (China), Japan, Thailand Malaysia and Korea – were among the top 30; as were the Baltic States. The report shows that better performance on the ease of doing business is linked with more jobs: the global leader on the ease of doing business, New Zealand, has 4.7 percent unemployment, but in Greece, an OECD country with the worst ranking on *Doing Business* indicators, the jobless rate is 10.9 percent. The report stresses that reforms will also lead to more jobs in the formal sector, because the benefits of being in the formal sector with easier access to credit and business development services will often outweigh other costs for business such as taxes (Kenyon and Kapaz, 2005). Firms that operate in the formal sector tend to have better access to credit and the legal system, which facilitates trade, so they benefit from the division of labour that underpins economic growth and welfare worldwide. Heavy strictures on business often fail even on their own terms: in developing countries, stringent building codes do not always produce safer habitation; higher tax rates do not always pull in more revenue; and the most tightly regulated labour markets do not afford the best protection to workers. Often, such burdens simply drive firms and workers into the informal economy, beyond the reach of inspectors, trade unions and the tax authorities. Furthermore, firms pushed underground are less productive: they cannot take advantage of economies of scale, because they often stay small to stay hidden. Kenyon and Kapaz (2005), using the World Bank's Investment Climate data for Brazil, show the extent of tax evasion and low productivity of informal sector firms;<sup>17</sup> they emphasize the benefits of regulatory compliance, reducing the costs of going formal, and tightening up of enforcement to improve the situation (Kenyon and Kapaz, 2005). The World Bank's *Doing Business in 2005* maintains that on average, formal companies produce 40% more

than informal enterprises in the same industries. Where complicated regulations make it difficult to set up a business formally or to operate a business, and do not enforce contracts or protect property rights, entrepreneurs will stay in the informal sector; therefore they have less of a chance to create jobs that eventually pay more and benefit from social protections.

The *Index of Economic Freedom* is an annual report published by *The Wall Street Journal* and the Heritage Foundation; the index measures how countries score on a list of 50 independent variables divided into ten broad factors of economic freedom.<sup>18</sup> The higher a country's score on a factor, the greater the level of government intervention in the economy and the less economic freedom there is. The Heritage Foundation's view (or more exactly, one should say hypothesis) is that countries with the most economic freedom also have higher rates of long-term economic growth and are more prosperous than are those with less economic freedom. These 50 variables are grouped into the following categories:

- Trade policy
- Fiscal burden of government
- Government intervention in the economy
- Monetary policy
- Capital flows and foreign investment
- Banking and finance
- Wages and prices
- Property rights
- Regulation
- Informal Market Activity (Shadow Economy)

Depending on their score, countries are then separated into four categories: Free, Mostly Free, Mostly Unfree, and Repressed.

The 2005 *Index of Economic Freedom*, ranks Hong Kong as the world's freest economy, followed by Singapore and Luxembourg. It postulates a direct link between economic freedom and prosperity, finding that the freest economies have a per-capita income of US\$29,219, more than twice that of the 'mostly free' at US\$12,839, and more than four times that of the 'mostly unfree'. However, it could be argued that an economic freedom index merely measures corporate and entrepreneurial freedom from accountability. The *Index of Economic Freedom* may also be a poor barometer of either freedom more broadly construed or of prosperity; its definition of economic freedom excludes political freedom. If we consider the two city-states, Hong Kong and Singapore, which top the index's list of 'free' countries, we find that Hong Kong is still without direct elections for its legislature or its chief executive, and a proposed internal security law threatens press and academic freedom as well as political dissent; in Singapore, freedom of the press and the right to demonstrate are limited: films, TV, and other media are censored, and preventive detention is legal. Moving further down the list of 'free' countries, the rankings are no better correlated with any ordinary definition of 'freedom' – for example, Bahrain (#20), where the king holds an effective veto over parliament and freedom of expression is limited, ranks higher than Norway (#29), whose comprehensive social insurance and strong environmental regulations pull down its score.

These results are not surprising, however, given the index's premise: the less a government intervenes in the economy, the higher its freedom ranking. In other words, minimum-wage laws, environmental regulations, or requirements for transparency in corporate accounting make a country less free, whereas low business taxes, and minimal regulation of occupational health and safety make a country more free.

The index's treatment of government intervention may also be flawed as it fails to take adequate account of industrial policy as a form of intervention; this means that the index overestimates the degree to which some of the fastest growing economies of the last few decades, such as Taiwan and South Korea, relied on the market and underestimates the positive role that government played in directing economic development in those countries by guiding investment and protecting infant industries.

Both the *Index of Economic Freedom* and the World Bank's *Doing Business* surveys consider a large informal sector to indicate less economic freedom because government restrictions may have driven that economic activity underground; developing countries tend to have large informal sectors while developed economies usually have relatively small informal sectors. However, this means the index systematically lowers the economic freedom index of developing countries while boosting the scores of developed countries, thus artificially correlating income levels with economic freedom. Moreover, the estimated size of the informal sector as a share of GDP has a tendency to decline, as countries get richer (Enste and Schneider, 1998).

It could also be argued that the index does not establish a strong correlation between economic

17. Schneider (2005) has recently estimated the size and development of the informal economy for 145 countries, including developing, transition and highly developed OECD economies over the period 1999 to 2003. The average size of the informal (shadow) economy (as a percent of 'official' GDP) in 2002/03 in 96 developing countries is 38.7%, in 25 transition countries 40.1%, in 21 OECD countries 16.3% and in 3 Communist countries 22.3%. Schneider (2005) maintains that an increased burden of taxation and social security contributions, combined with more labour market regulations is fuelling the growth of the informal economy.

18. Economic freedom is defined as the absence of government coercion or constraints on the production, distribution or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty (*Index of Economic Freedom*, Heritage Foundation, 2005).

freedom and growth – for example three of the fastest-growing countries in the world are mostly ‘unfree’, namely China, India, and Vietnam; they are ranked in the index at #112, #118, and #137 respectively. While all three countries have adopted market reforms in recent years that have improved their standing in the index, their trade policies and regulations remain ‘repressive’: how ‘free’ or ‘unfree’ a country is according to the index seems to have little to do with how quickly it grows.

Proving a correlation does not necessarily mean causation; it could be that increasing wealth causes the index to rise, and not vice versa – strong growth attracts foreign investment, which would automatically raise a country’s freedom score. Economic expansion can also raise the value of a country’s currency, and weakness can have the opposite effect; those could also affect international growth comparisons. Corruption lowers a country’s score, but when an economy is buoyant, corruption is often hard to notice.

The *Business Environment and Enterprise Performance Survey*,<sup>19</sup> known as BEEPS, is jointly conducted by the World Bank and the European Bank for Reconstruction and Development (EBRD). This survey of business managers and enterprise owners has been conducted by the two institutions every three years since 1999 (see Carlin et al. [2001]; and Fries et al [2003]; EBRD *Transition Report* [2005]); BEEPS is a survey of over 4000 firms in 22 transition countries that examines a wide range of interactions between firms and the state. Based on face-to-face interviews with firm managers and owners, BEEPS is designed to generate comparative measurements in such areas as corruption, state capture, lobbying, and the quality of the business environment, which can then be related to specific firm characteristics and firm performance.

According to the 2005 BEEPS, many of the reforms undertaken over the past three years are starting to pay dividends. The latest round of the survey shows that firms across the transition countries are benefiting from greater stability, both in the macroeconomic environment and with regard to regulatory policies (EBRD, 2005). By monitoring the pulse of the business community, the BEEPS provides a unique tool for comparing countries and for examining changes over time in how firms from all sectors perceive and experience their interactions with the state; understanding firms’ perspectives on the business environment helps clarify where reforms are working and where implementation may be lagging.

The Fries et al. (2003) analysis of quantitative measures of the business environment in BEEPS (2002) shows a strong association between business obstacles, added costs and constraints on business, such as corruption, private security protection or reliance on internal sources of finance. The BEEPS survey (2005), in addition to improvements in macroeconomic stability, shows that firms also report general improvements in the tax environment. According to firms in the survey, tax administration is less onerous than in 2002 and as a result tax evasion has eased, and unofficial payments related to taxes have become less frequent (EBRD, 2005).

As a whole, firms complain less about both access to and the cost of finance than they did in 2002; although firms still use their own funds as the primary source of financing new investments, they are increasingly using formal borrowing and the capital markets and relying less on informal borrowing. Firms also say that crime and corruption, as well as the burden of red tape, have reduced. As in previous surveys, the analysis of firm investment and growth shows that the quality of the business environment in 1999 (based on qualitative measures) and 2002 is significantly positively correlated with investment by firms during the period 1999 to 2001. It also shows that state capture significantly boosts the investment and real revenue growth rates of firms that engage in this activity, but retards the growth performance of other firms (see Carlin et al. [2001]; Fries et al. [2003]; EBRD [2005]).

However, some aspects of the business environment remain problematic: firms report an increased burden of labour regulations, an effect especially pronounced in the more advanced transition countries (Czech Republic, Hungary and Poland). In addition, firms are reporting that their employment levels are more distorted by labour regulations than had been the case in 2002 (Fries, et al., 2003). However, Kaufman (2005), utilising enterprise survey data from the World Economic Forum for the *Global Competitiveness Report*,<sup>20</sup> analyses the extent to which governance and corruption constitute one of the most important constraints to business development and competitiveness; he shows that a country that manages to reduce the extent of corruption as an obstacle to business by one standard deviation can expect, on average, to move up about 30 rank positions in its global competitiveness standing (among 105), dominating the payoff of alleviating any other obstacle to business operations. Kaufman (2005) challenges what he terms the ‘pettier’ forms of administrative bribery which the BEEPS and World Bank *Doing Business Surveys* consider, to address the costly challenges of ‘grander’ forms of corruption such as that related to public procurement, and the tendency for elite firms (sometimes foreign owned) and conglomerates to shape the business environment illicitly through influencing state laws, policies and regulations (Batra, et al., 2003).

19. See also the *World Business Environment Survey*, a project of the World Bank’s Investment Climate and Institute Units, which was administered to more than 10,000 firms in 80 countries in late 1999 and early 2000. Questions in the survey focused on the quality of the investment climate as shaped by domestic economic policy; governance; regulatory, infrastructure, and financial impediments; and assessments of the quality of public services.

20. The report includes the *Growth Competitiveness Index* and the *Business Competitiveness Index*, which provide a comprehensive assessment of the economic performance of several countries across different factors. The report’s methodology combines publicly available data with survey data that captures the perceptions and observations of business leaders in a given country.

## The Business Environment and its Regulation

There are very few estimates of the overall compliance costs of business regulation in developing countries, but a study by Bannock (2001) seems to suggest that they may be substantially larger as a percentage of GDP than in industrial countries. Even if the costs were the same in developing and developed countries, the opportunity costs of the scarce resources employed in compliance and non-compliance would bear more heavily in developing countries.<sup>21</sup> Using data derived from Djankov et al. (2001) on business entry regulatory costs as a proxy for all regulatory costs, it appears that these costs in SSA, as a percentage of GDP per capita (94% in SSA), are much higher than those in Central Europe (67%), South Asia (19.8%) and developed countries (3%). This is particularly apparent in developing countries where the informal sector is often larger than the formal sector and firm size tends to be on average much smaller than in developed countries. Some large-scale tax compliance cost, and other, studies for developed countries show that regulatory costs as a percentage of sales fall steeply with firm size (Fries et al., 2003; Bannock, 2001).

In former UK, French and Portuguese colonies of SSA much of the business regulation is based on (left-over) laws from the colonial era, with some of this legislation even excluding indigenous people from certain business activities. Some of the legislation has been modernized, but often to incorporate elements of employment protection legislation which typically applies to a small minority of the labour force in the public and formal sectors of the economy. Several studies have looked at how the business environment, particularly inappropriate regulations, have restrained growth in the formal and informal sectors of developing countries. Using the Amadeus database<sup>22</sup> of firms in Western and Eastern Europe, Klapper et al. (2004) study how the business environment in a country drives the creation of new firms. They focus on regulations governing entry, for example limited liability company registration procedures, maintaining that entry regulations hamper entry, especially in industries that naturally should have high entry; and that value added per employee in naturally 'high entry' industries grows more slowly in countries with onerous regulations on entry. The consequences of more restrictive entry barriers are seen, not in young firms, but in older firms, which grow more slowly and to a smaller size; thus the absence of the disciplining effect of entry has real, adverse effects. Interestingly, regulatory entry barriers have no adverse effect on entry in those countries classified as corrupt countries, only in less corrupt ones. Taken together, the evidence suggests that bureaucratic entry regulations are neither benign nor welfare improving. However, not all regulations inhibit entry; in particular, regulations that enhance the enforcement of intellectual property rights or those that lead to a better developed financial sector do lead to greater entry in industries that do more research and development (R&D) or industries that need more external finance. Klapper et al. (2004) find that barriers to entry are more effective in preventing firm creation in high-income countries, suggesting that their purpose may not be to screen-out the untrustworthy firms. Djankov et al. (2001a) use measures of the number of business entry procedures in 85 countries to consider institutional arrangements, business environment and economic growth. The data covers the number of procedures, official time, and official costs that a start-up firm must bear before it can operate legally; the official costs of entry are extremely high in most countries: the number of procedures for an average rich country is 6.8 against the rest of the sample average of 11.8, whilst meeting government requirements takes 24.5 days and 55.4 days respectively and Djankov et al. (2001) note that countries with heavier regulation tend to have higher levels of corruption and larger informal economies. Friedman, Johnson et al. (1999) develop measures of regulation and corruption showing that these are positively correlated with the share of the unofficial economy – across 69 countries, higher tax rates are associated with less unofficial activity as a percentage of GDP, but corruption is associated with more unofficial activity; however, higher tax rates do not appear to be associated with a larger informal sector. Schaffer and Turley's (2001) study of 22 transition economies shows that the effectiveness of tax collection (effective tax yields versus tax rates) is positively correlated with EBRD transition development indicators and inversely related to percentages of enterprise revenues paid in bribes. Hellmann et al. (2000) show, based on a survey of firms in 20 countries (BEEPS), that over 40% would pay additional taxes to eliminate corruption, crime and excessive regulations; only about 40% of respondents had confidence that the legal system would uphold contracts and property rights, though this varies considerably between countries; as a percentage of revenues, average bribes paid, and frequency of payment declines as firm size increases.

The World Bank (2003) World Business Environment Survey (WBES), an initiative led by the World Bank Group in 1999 and 2000, collected enterprise data from more than 10,000 firms in 80 countries; econometric analysis of responses to that survey suggests a strong association between corruption, financing, regulatory and tax constraints, policy uncertainty, and protection of intellectual property rights with firm-level performance, as measured by sales and investment growth and participation in the formal economy. The survey showed perceived constraints to be higher in developing countries than industrial countries and that GDP growth within each of the regional grouping of countries is negatively associated

21. By non-compliance we mean the time and money costs of paying bribes, harassment and confiscation suffered by informal sector firms. There are obviously difficulties in making comparisons of this sort where GDP does not fully capture informal sector output.

22. The Amadeus database (2001) is a commercial survey (mainly comprised of financial data) of five million public and private sector firms in 34 Eastern and Western European countries.



with the severity of constraints imposed by taxes and regulations.

The economics literature on privatization is characterized by two approaches: normative and positive; the normative view, as postulated by the World Bank and most donor agencies, is that privatization is necessary to curb waste, raise economic efficiency and develop the activities of the private sector via increased domestic and foreign ownership (see Newbery and Pollitt, 1997; World Bank, 2005). The eradication of Kornai's (2000) 'soft budget' constraints that make 'wasteful' public sector firms a major cause of fiscal imbalance to some extent pre-supposes benevolent governments and politicians. Many governments in developing countries are far from altruistic when abandoning a discretionary system for one where market forces determine performance; maximising aggregate welfare is usually a minor consideration. As the benefits of privatization take time to realise, the normative view provides a long-term rationale for private sector divestment. The positive view of privatization, when placed in a developing country context, is a politically charged subject, emphasis is placed on agency and credibility problems that are unleashed (in often weak states with poor institutional structures) and the income distribution implications of privatization. From the positive theory perspective, privatization only goes ahead when politicians see in it clear-cut economic and political benefits. Laffont and Meleu (1999) show that the speed of privatization is directly related to the shares that politicians, or their relatives, accrue in the privatized firms to compensate for loss of the rents they enjoyed in formerly state owned firms. Several studies have described similar outcomes in transition economy 'insider privatizations' conducted during the 1990s (see Earle and Estrin, 2003).

There is little literature which directly sets out the ways in which privatization affects poverty in developing countries; recent papers by Brown et al. (2004), Craig (2002) and Cook (2004) are among the few showing that privatization can exacerbate poverty by increasing pressure on prices and unemployment as well as by removing subsidies. Whilst there is some acknowledgement of the impact that downsizing the public sector has on poverty, these papers mainly advocate policy responses focused on improving enterprise efficiency; the costs of unemployment are usually left to social safety nets and this has been a contributory factor to large public sector layoffs and downsizing on privatization in developing countries (see Appiah-Kubi on Ghana and Craig on Zambia).

Despite the normative and positive distinctions, in reality the empirical position in the economics literature is not clear-cut. Several studies have found limited impact from privatization, whilst others have found that management and market structures (institutions) are more important than ownership – for example Boussofiene et al. (1997) argue that there is little evidence for any claim that privatization has caused a significant improvement in economic performance; on the other hand, Chang and Singh (1993) find that public enterprises range from the best to the worst in terms of efficiency. Galal et al. (1994) attempted to investigate the welfare impacts of privatization by examining the allocation of costs and benefits of ownership changes across interest groups in Chile, Mexico, the Philippines and UK; they studied twelve enterprises – three from each country covering telecommunications, transport, energy and freight sectors, and found that in only one case was there a net welfare loss from privatization (Mexicana de Aviacion). In order to isolate the effects of privatization, the researchers attempted to estimate the counterfactual, by estimating the results that would have emerged if enterprises had not been privatized and comparing these with actual outcomes. They found that regulation played a key role in restricting welfare losses which has important implications for countries where regulatory and institutional infrastructure are weak.

La Porta and Lopez-de-Silanes (1999) examined the performance of 200 privatized firms in Mexico, from the mining, manufacturing and services sectors; they constructed indicators for profitability, operating efficiency, employment and wages, capital investment, total output, prices and taxes, and for each firm they compared the value of the indicator in 1993 with the average value during the four years preceding privatization. They found that profitability increases after privatization, and that operating efficiency increases in terms of sales and income per employee. This was achieved by downsizing as 50% of employees were made redundant, suggesting that transfers from workers to shareholders plays a role in the apparent success of privatization (La Porta and Lopez-de-Silanes, 1999). They also found that wages for retained workers increased significantly, to match industry norms and reflected higher productivity; savings due to redundancies accounted for around 30% of the mean change in profitability that took place in the post-privatization period, but that output increased dramatically following privatization and staff reductions.

Newbery and Pollitt (1997) attempted to assess the net social benefits of the privatization and restructuring of the Central Electricity Generating Board which generated and transmitted all public electricity in England and Wales until 1990. Far from providing support for privatization, they found that the benefits of cost reductions accrued mainly to shareholders – consumers were actually worse off than they would have been under continued public ownership. The cost reductions themselves were large, largely due to significant downsizing, particularly in the coalmining industry, but also in the electricity industry itself. Clearly, privatization has its 'pros' and 'cons' in terms of a pro-poor growth strategy; however, in those countries with reasonably well developed institutional structures it has the potential to encourage positive improvements in the business environment and higher levels of service provision and efficiency through increased competition.

Most of the recent research on institutional aspects of the business environment in developing countries

has shown that if the rule of law can be enhanced, regulation lightened but enforced more rigorously, tax revenue collection improved and corruption reduced, all within a favourable macroeconomic environment (low inflation and public deficits, openness to trade), new business entry and growth would be encouraged. Private sector investment levels and enterprise development in developing countries can be either facilitated or hindered by the business environment, depending on how the latter impacts upon investment risks, entry barriers (including start-up costs) to economic activity, and/or production and marketing costs. Important dimensions of the business environment include the macro-economic situation, the degree of policy consistency and stability, direct and indirect taxation regimes, investment and licensing regulations, levels of bureaucracy, labour laws, corruption levels, security situation, and effectiveness of the judicial system, state of economic infrastructure, and availability and quality of enterprise support services. In some cases, public policy restricts enterprise activity by negatively affecting the business environment; examples include restrictions on artisanal fishing and shrimp capture, and regulations applying to the cooking and serving of food and drink (Davis, 2004).

## Conclusions

From this review of the business environment, a number of interesting lessons can be drawn, including some that we build on in the next section when we formulate hypotheses about institutions and development. For brevity, we simply list the key points with minimal commentary.

- Making it easier to do business is an important issue for many developing countries, and especially so in sub-Saharan Africa.
- There is abundant evidence to show that a better business environment results in more job creation.
- The formal sector is better for development than the informal in that, on average, formal-sector firms are larger, more productive and have better access to credit.
- State capture by incumbent firms inhibits economic change by boosting the growth of protected firms, retarding that of others, including new entrants.
- Generally, economies experience slower growth when the disciplining effect of entry by new firms is weak.
- Higher taxes and heavier regulatory burdens usually result in fewer formal sector firms, slower overall growth.
- Last, while privatization is normally beneficial, in weak states it can result in ownership structures that are not conducive to further development of the country concerned. It matters who the new owners are, and how the post-privatization industry or firm, especially in the case of major public utilities, is regulated.

From a list such as this, it is not hard to pull out some quite detailed policy recommendations concerning how to run an effective, flexible and productive business sector. However, this is not quite our main concern in this paper, since the resulting policy advice typically just touches the surface of the economy concerned, while failing to address the more intractable problems that arise from shortcomings of the underlying institutional infrastructure. For instance, we need to understand the political and social mechanisms through which entry by new firms comes to be problematic; it is insufficient simply to advise a country to 'make entry easier'. Likewise, we need to understand the mechanisms that make many poor countries build unbelievably complex business regulations that foster corruption, discourage business, and commonly fail to achieve even their stated objectives (which might be to regulate environmental pollution, to ensure product safety, etc.); also, is there a way of designing privatization that by-passes, especially in weak states, the established interests which often prevent it from working well, and gets companies out of state hands, operating more commercially? In doing so, is it always essential to compensate those in the elite who would thereby be the losers?

## 6. HYPOTHESES AND CONCLUSIONS

Having reviewed an extremely diverse and interesting literature on institutions and the roles they can play in development in general, and in relation to pro-poor growth in particular, it is now time to pull out a number of hypotheses that could form the basis for the mix of conceptual and empirical research that will be called for in later phases of the IPPG Research Programme. We structure this section by first recalling some of the ideas from the earlier discussion that seem to us especially useful and illuminating, after which we list – with some brief discussion – some hypotheses about institutions and their functioning that merit further study.

### Useful Ideas

- Basic ideas of property rights, contracts, trading networks, and their role in supporting and facilitating business activity.
- The idea of an institutional matrix with complex inter-connections between the economic, political, social and cultural spheres.
- Within the new institutional economics (NIE), the idea of a four-level structure for society, showing why changes at some levels can be blocked by lack of change at more fundamental ones (see Figure 1,

pp. 20).

- Difficulties of bringing about institutional change and the persistence of inefficient institutions, depending on the political configuration.
- The idea of a state that is competent and effective in fostering economic development (including creating the conditions for productive capital accumulation), while finding its powers effectively constrained and appropriately monitored by the structure of economic and political interests in which it is embedded.
- The difficulty of designing institutions to enable economic agents to manage risks efficiently, resulting in agents often being forced to adopt risk-avoidance strategies that are socially inefficient; and further, bad institutional design can exacerbate the risks that agents face, instead of ameliorating them.
- In the often quite dull, technical area of market regulation, the difficulties of designing and implementing competition policy in ways that avoid or by-pass major conflicts of interest, and which avoid unduly protecting incumbent firms.
- A more dynamic perspective on institutions suggests analysing selection processes in the economy; these are important in regard to investment decisions, the entry and exit of firms, and within the labour market.
- Thinking about GDP growth and poverty reduction, the idea of a growth model that focuses on institutional constraints, and proposing to kick start growth by removing the key institutional blockage (though we concede that identifying this is, in practice, extremely problematic).
- On foreign trade, the basic idea that for most poor countries a key problem is that they are nowhere near globalized enough, that they need to find more effective ways to increase their integration with the world economy (subject to the condition that suitable domestic policies are also in place).
- On the business environment, that the cost and complexity of doing business in the formal sector in poor countries needs to be brought down, implying that we need to gain a better understanding of the economic, political and social forces that make business regulation work as it does.

## Hypotheses and Further Work

Since the topic of institutions and development is, as we have seen, a remarkably broad one, it will naturally be necessary to focus further research fairly narrowly in order to achieve useful results within a reasonable timespan. Many issues that have been explored in earlier sections of the paper are therefore omitted from what follows, though this need not prevent some of them cropping up in the course of investigating the specific topics proposed below.

Accordingly, we now propose a set of hypotheses in four areas to help firm up the future research agenda of the IPPG Research Programme. These four areas are: (a) selection processes; (b) opening the economy; (c) political economy of the business environment; and (d) constraining state power. In all four areas, we envisage a mix of conceptual and empirical work, as we sketch below. The hypotheses are numbered from H1 to H11.

### a) Selection Processes

**H1** Economies in which the institutions that govern the selection of investment projects by firms, (whether privately owned, or commercial firms in the public sector) focus on objectives other than expected profitability; are expecting them to perform poorly, grow relatively slowly.

**H2** Protecting incumbent firms from domestic competition discourages the entry of new ones, slows down structural change, slows down economic growth.

**H3** It is well understood that too much competition damages business performance, while too little provides unduly weak incentives for innovation and business development (see Philips [1995], notably ch. 2). Hence designing the institutional framework for competition policy so that the amount of competition is about 'right' is exceptionally difficult, and any given arrangement is likely to prove effective for some sectors, much less so in others.

**H4** Selection for jobs can be based on various mixes of merit (usually measured by qualifications and relevant experience) and personal connections (belonging to the 'right' family, kinship group or ethnic group, coming from a wealthy and/or politically powerful family, etc.); and once employed, people can enjoy varying degrees of job security and performance requirements. Economic performance is likely to be better, the greater the role played by merit-based criteria in personnel selection, except possibly in very small, family firms.

### b) Opening the Economy

**H5** Most poor countries around the world are under-engaged with the world economy, and need to boost the shares of both exports and imports in GDP. The principal barriers to trade are not usually the standard policy instruments (such as tariffs – though these are often too high), but more often concern the institutional arrangements that govern trade (e.g. customs rules, procedures and practices; rules about technical standards and product quality; whether or not there is export support, export credit guarantees, and the like).

**H6** As a result of lobbying by incumbent firms, many developing countries restrict imports to provide protection, without fully appreciating the impact this has on entry and the competitive environment (see H2, above). In countries whose political institutions are particularly vulnerable to such lobbying,

import and overall economic growth tend to be slower than they otherwise could be, not least because such import protection acts as a tax on exports.

### **c) Political Economy of the Business Environment**

**H7** The cost and complexity of doing business is frequently too high, and discourages much potentially beneficial economic activity. The institutional arrangements that result in such high costs are therefore damaging to economic performance, but their persistence depends on aspects of the political-economic structure that are hard to change.

**H8** Lack of institutions to manage risk results in firms that remain too small (and often informal), farms that are over-diversified and technically inefficient. These conditions tend to result in low incomes, and low rates of income growth.

**H9** Whether privatization proves to be beneficial for the economy or not depends on post-privatization ownership structures (e.g. it is not usually particularly desirable for incumbent elites to end up as major shareholders) and on the quality of the regulatory and competitive environment in which the privatized firms then find themselves.

### **d) Constraining State Power**

**H10** Successful development usually requires the state to be both effective and accountable, in other words that the state faces real constraints on its powers. In many poorer countries there are formal constraints in place that prove to be ineffective when political or economic conditions become challenging, or where the elite group already in power encounters rent-seeking opportunities that it cannot resist. For formal constraints to work, it is critical that the expectations of both the elite and the general population are focused around the view that they will indeed work (self-fulfilling expectations).

**H11** External mechanisms (such as commitments to international bodies like WTO) can sometimes help to constrain the elite's exercise of its power, and when successful, this is likely to have a positive impact upon economic development.

### **Further Work**

To conclude the paper, we outline how we could investigate a selection of the above hypotheses about institutions and development, both conceptually and empirically.

We start with H2, on the issue of protecting incumbent firms. Conceptually, there is a need for further work on building models of industry structure at the level of a sector, with varying rates of entry and exit, varying growth rates of market demand and hence growth and development of incumbent firms, and with various assumptions about the extent and nature of competition from imports. All of this is quite difficult, we suspect, but also important in improving our understanding of how dynamic markets operate. Beyond what might begin as a set of fairly mechanical models, we also need to understand the political and social forces and pressures that lead to certain existing firms enjoying protection, and the implications of this protection for the rules governing both entry in general and imports in particular.

Empirically, this topic would be studied by selecting several sectors in a given country, or the same sector across several countries; in either case, one would take care to pick instances where the degree of incumbent protection was not expected to be same across the whole sample – for instance, we could study food processing firms across several countries; or in a selected country, study food processing, the large-scale construction industry, engineering firms (machinery producers), and mining firms (or some other selection, depending on the country). In any particular sector it would be necessary to assemble data on firm numbers and the size distribution, then select a sample of firms from which detailed information would be collected on age, measures of size, market and supply linkages, employment, and so on. In addition, for established firms we would want to know about their growth experience, their perceptions of the competition they face, incentives for growth or barriers to growth. Last, and quite possibly of greatest importance, we would wish to learn about each firm's links with other firms in the same sector, and its connections – formal and informal – with governing elites, the ruling political party, other top-level bodies. By analysing the results of this rather complex exercise in data collection, we would then be able to confirm or refute the initial hypothesis, and perhaps more interestingly, develop much more refined political-economy models of firm and elite behaviour to enable us to understand more deeply the phenomena being studied.

Next we consider H5, the issue of *engaging with the world economy*. At the level of general trade-related policies, of the sort that can be studied through multi-country econometric investigations, we already know a great deal. Gravity models reveal a lot about the likely – or most efficient – direction of trade for a given country, and other econometric studies already inform us that liberal trade, low tariffs and the like are, on average, beneficial for growth; so far so good. What we understand far less well is the nature of the micro-institutional architecture in various poorly performing countries, and the possible deleterious impact this can exert on trade flows in both directions. Thus in exploring H5, we would not wish to replicate econometric studies of the sort that have already been done quite extensively; rather, we would wish to develop political economy models to help us understand the processes through which trade comes to be restricted or poorly supported in many countries, then carry out surveys to test out the resulting models – for instance, it could be extremely useful (if, perhaps, a trifle dangerous) to carry out interviews at all levels of a badly functioning and relatively corrupt customs services, and compare findings

with a parallel study of a customs service that was thought to be relatively competent and effective.

The issue identified in H7 was the *cost and complexity of doing business*. The approach we would wish to pursue here would be very much the same as what we have just discussed for H5; in terms of the lessons that we would draw from such work, it is worth emphasizing that simple policy prescriptions such as 'cut corruption', 'simplify procedures' or 'reduce regulatory burdens' are known not to be effective for long, if at all. The question is why? In other words, our aim must be to go beyond such prescriptions to understand the institutional mechanisms that ensure, mostly, that procedures quickly get more complex again, simplified regulations are soon amended and extended, and the old situation recurs. It is only by thoroughly understanding these institutional mechanisms that we can hope to design approaches to institutional structure that can overcome the identified problems once and for all – an ambitious undertaking, but well worth pursuing, in our view.

A surprisingly interesting starting point for the study of the forces that commonly result in a recurrence of damaging microeconomic regulation, even in the wake of efforts to reform it, was provided by Kornai (1959). In this work, in our view probably the best book on the inner workings of old-style central planning, repeatedly Kornai shows how plan indicators increased in complexity, generating ever more blatant inefficiency, until finally there would be an attempt at reform and simplification: within a year or two, the inner pressures of the central planning system would combine to reproduce the former multiplicity of targets, with their associated inefficiency. It is a somewhat parallel study that we need to carry out for selected developing countries which are not, of course, trying to operate central planning, but which are presiding over very badly functioning market-type economies.

Finally, let us examine H11, *the role of external mechanisms in constraining state power*. External mechanisms include the role of the major IFIs such as the World Bank and the IMF through the various forms of conditionality they attach to their lending decisions, as well as the rules-based approach to international trade regulation as operated through the WTO. Moreover, within Europe it is known that the prospect of EU membership (for the countries that joined in 2004) exerted an amazingly strong disciplining effect on the domestic policies of the countries concerned, as well as on their accompanying institutional development. Less clear, but still sometimes significant, has been the impact of WTO accession and the commitments entered into as part of their respective Accession Protocols, on the evolving domestic policies of various countries. Hence, while it would be naïve in the extreme to imagine that these external mechanisms could significantly influence a country whose rulers were determined to loot a given nation's resources for their own benefit, in many less serious cases the 'external factor' might at least be capable of nudging elites to shift their domestic policies and their respective institutional supports in more sensible directions. To study this, we should probably adopt a case-study approach, selecting three or four countries and one or more international influences thought to be significant for each one: we might select the World Bank and Mali, studying the inter-relations between the Bank, country elites, and aid disbursement and project implementation on the ground; or we might choose to examine the role of WTO rules in shaping Bolivia's trade relations and trade practices.

Clearly, there is much to be done and a massive amount still to learn about institutions and development. We hope, though, that the research we carry out under the auspices of the IPPG Research Programme will help to throw more light on this important and difficult area.

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