INSTITUTIONS AND DEVELOPMENT

By Mary M. Shirley
1. THE CHALLENGE OF DEVELOPMENT

Developed countries are the exception, not the rule. Billions of dollars of aid and countless hours of advice notwithstanding, most countries have not been able to foster sustained growth and social progress. Increasingly research has shown that weak, missing or perverse institutions are the roots of underdevelopment. Cross-country regressions persistently demonstrate large and statistically significant correlations between institutional variables and growth, and in horse races between variables, an index of institutional quality “trumps” geography or trade as an explanation for growth (Rodrik, et al. 2002).

To meet the challenge of development countries need two distinct and not necessarily complementary sets of institutions: (i) those that foster exchange by lowering transaction costs and encouraging trust, and (ii) those that influence the state to protect private property rather than expropriate it. 1 The first set of institutions includes contracts and contract enforcement mechanisms, commercial norms and rules, and habits and beliefs favoring shared values and the accumulation of human capital. Among the second set of institutions are constitutions, electoral rules, laws governing speech and education, and legal and civic norms. Today’s underdeveloped countries must acquire these institutions under particularly difficult conditions -- in a global market competing with already developed countries (North 2002). Although there may be some advantages to

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1 I use the term development to mean countries which have achieved a level of per capita income that puts them in the World Bank’s high income category (above $9,266 in 2000), as well as high scores on selected social indicators (life expectancy at birth of over 70 years, infant mortality rate of less than 10 per 1000, adult literacy rates of 100%).
being a latecomer – witness Africa’s leapfrogging into cellular technology – the disadvantages usually dominate.

The vast majority of humans today live in countries that have failed to create or sustain strong institutions to foster exchange and protect property. Individuals in these countries enforce most bargains using informal mechanisms -- private armies; threats to reputation; ostracism from kinship, ethnic, or other networks, or the like – and they have little trust in or trade with people not subject to these mechanisms. The state is either too weak to prevent theft of property by private actors, or so strong that the state itself threatens property rights. In either case, entrepreneurs and organizations face a high risk that they will not be able to realize a return if they invest in specific knowledge, skills, or capital, so they refrain from investment, productivity is low, and the economy stagnates.

Why have so few countries been able to create and sustain the rules and norms that foster growth and social progress? Which institutions must function effectively if countries are to develop? How can poorer countries attain well functioning institutions? Can outsiders promote institutional development? The New Institutional Economics (NIE) has made some progress towards answering these four questions, but much remains unknown. Because the last two questions have been largely unaddressed, foreign

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2 Throughout this chapter I use North’s definition of institutions as the “humanly devised constraints that structure human interaction” including formal constraints such as constitutions and laws and informal constraints, such as norms, conventions and self-imposed codes of conduct (North 1990, p. 3). Organizations differ from institutions; “they are groups of individuals bound together by some common purpose to achieve certain objectives,” and include legislatures, firms, trade unions, churches, clubs, schools, etc. (Ibid.) Institutions are the “rules of the game in a society” while organizations are the players (Ibid). As for markets, Menard defines them as non-cooperative arrangements governed by the price mechanism that permit the voluntary transfer of property rights on a regular basis (Menard 1995). Although North’s definition is widely used in the scholarly literature, it is worth reiterating here because some in the aid community use the term in a different way. Definitions may be tedious, but they are not trivial. The failure to employ a standard concept of institutions creates problems in establishing the impact of institutions on development, and affects how aid agencies view their role, as I discuss later.
aid agencies have devised their own, seldom-successful solutions. In what follows I take
stock of how the NIE has answered these questions and propose research to fill the gaps
in our understanding. Before considering underdeveloped institutions I summarize
theory on how modern market institutions evolved; (readers interested solely in
underdevelopment may wish to skip this section).

2. HOW DO INSTITUTIONS EVOLVE AND ECONOMIES DEVELOP?

Institutions that Foster Exchange

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

Institutions determine whether transaction costs are low or high. The evolution of
institutions that lower transaction costs and encourage exchange can be described as
follows (drawing largely on North 1990, see also Bates 2001). Small communities
producing at low levels of specialization rely largely on face-to-face barter trade between

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3 Transaction costs include what Dahlman described as “search and information costs, bargaining and
decision costs, policing and enforcement costs” (Dahlman 1979, p. 148). They are the costs of finding a
trading partner, deciding on the terms of the trade, drawing up a contract, monitoring and enforcing a
contract, and the like.
individuals who know one another and who typically share kinship, ethnic, religious, or similar ties. Bargains are enforced by informal mechanisms such as family loyalties, ostracism, or coercion by private groups. Over time the group engaging in exchange tends to grow through natural population growth, urbanization, and migration and as more and more people begin to see advantages in trade. With the expansion in the size and geographic area of the trading group and the rise of urban centers, traders envision lucrative opportunities to do business with people who live even further away and do not belong to their networks. Merchants and investors seek more information about these unknown trading partners and better enforcement of bargains between strangers.

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

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

5 The pros and cons of informal versus formal institutions are reviewed in (Keefer and Shirley 2000).
To take advantage of these opportunities for profits and to respond to increased competition in home markets, some merchants look for new ways to trade safely with strangers. Trading parties begin to devise contractual safeguards; for example, one party might pledge an asset as a “hostage” that is forfeit if they renege on the agreement, much as people once enforced treaties by sending a family member to act as a hostage in a show of good faith (Williamson 1985, 1996). Merchants increasingly use written contracts, codes of conduct, standardized weights and measures, disclosure agreements, and enforcement through arbitration and courts.\(^6\)

Traders even today rely principally on private means to enforce contracts (Williamson 1985). And norms of trust and cooperation are still important in reducing transaction costs and fostering exchange (see for example Knack 1997, and the chapter by Keefer and Knack in this Handbook). But with increasingly impersonal exchange, private ordering and norms of conduct also require the support of third party rules and enforcement.

Where such institutions increase the certainty that contracts will be honored and property protected, individuals will be more willing to specialize, invest in sunk assets, and undertake complex transactions (North 1990, p. 34).\(^7\) Contract enforcement and property rights protection are not enough, however; where most citizens lack basic human capital and surplus income to invest – as they do in most underdeveloped countries today – specialization is unlikely. Where specialization does occur, knowledge becomes more widely distributed (Hayek 1979). Ever more complex institutions and

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\(^6\) For example, internal codes of conduct of fraternal orders of guild merchants evolved into merchant law and spread throughout the European trading area. Gradually enforcement was taken over by the state and the law integrated with common and Roman law (Milgrom, et al. 1990).

\(^7\) Written contracts and rules with third party enforcement do not necessarily reduce transaction costs. Litigation and legalism can be a hindrance to trade as well as a help.
organizations -- scientific rules, professional networks, universities – are needed to integrate productive knowledge (North 2002).

**Institutions that Protect Property**

With trade and specialization society’s wealth increases and demand for protection of property rights also increases, leading elites to accept an expanded government role, levies and taxes to cover policing expenses, and state monopoly over the use of force by demilitarizing private armies (Bates 2001, p. 65-66). Where the government is too weak to support contracts and protect property rights, exchange and specialization -- and therefore growth -- will be limited. But as state power grows a dilemma emerges: any state strong enough to protect property rights is also strong enough to expropriate them (North and Weingast 1989, Weingast 1993). Unless the state can credibly commit not to expropriate, risks under a strong state will be higher, lowering the incentive to invest. Accordingly, “… the development of free markets must be accompanied by some credible restrictions on the state’s ability to manipulate economic rules to the advantage of itself and its constituents.” (North and Weingast 1989, p. 808)

A state strong enough to protect property effectively is one that has a virtual monopoly on power, so effective limits are self-enforcing: rulers are motivated to tie their own hands. North and Weingast (1989) show how after the Glorious Revolution of 1688 the constraints on the English Crown were made self-enforcing. To persuade the nobles to help finance his wars and other activities, the King agreed to respect the

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8 For example, McGuire and Olson (1996) argue that an autocrat (or a majority in a democracy) will limit its redistribution of income from the citizens (or minority) to itself if the returns to taxing an increasingly productive economy over the longer term are greater than the returns to immediate confiscation. This only happens when the ruler’s (or government’s) perceived time horizon is sufficiently long to reap the benefits of non-intervention, however (McGuire and Olson 1996).
independence of Parliament and the Common Law Courts and to curb his power to confiscate property. He and his successors had incentives to comply; the Crown did not have a monopoly over force, plus Parliament agreed to implement fiscal innovations that assured the Crown adequate revenues (North and Weingast 1989). The Glorious Revolution laid the groundwork for representative democracy in England.

Democratic political institutions also depend on norms of trust and civic cooperation; as I discuss below. They help voters overcome collective action problems and monitor politicians and bureaucrats. They give credibility to government’s fundamental promises – to protect minorities from abuse by the majority, to allow opposition, to leave office when defeated in elections (see the chapter in this Handbook by Keefer and Knack). And they deter competitive elites from using the powers of the state to try to eliminate their rivals.

Federalism can be another self-enforcing curb on government expropriation (Weingast 1993). If local governments have regulatory authority and autonomy but cannot erect trade barriers against goods and services from other localities, then local governments will avoid expropriation or intervention, for fear that mobile resources will move to other, less restrictive jurisdictions. Federalism can have mixed effects, however, as I discuss later.

The most developed countries today are those that endowed the state with the power to enforce contracts, protect property rights, and assure stability and peace, and also developed mechanisms to control state power, such as independent parliaments and judiciaries, or federalism. These same countries evolved contractual mechanisms and cooperative norms to support expanding exchange among strangers, bargains among
competing interest groups, and growing investment in ever more specialized skills and assets. Increasing returns reinforced incentives in these societies to refine and strengthen the institutions that made these developments possible, except where “unanticipated consequences of choices, external effects, and sometimes [exogenous] forces” altered the path (North, 1990, p. 112).

The evolutionary path sketched above is neither linear nor inevitable. Only a few countries evolved the beneficial institutions described above; most others have institutions inimical to growth. The next section surveys the literature that tries to explain why.

3. WHY HAVE SO FEW COUNTRIES BEEN ABLE TO CREATE THE RULES AND NORMS THAT FOSTER GROWTH AND SOCIAL PROGRESS?

The NIE’s main reasons for underdeveloped institutions can be summarized as follows: 9

(i) Colonial heritage —countries inherited poor institutions from their colonial masters;

(ii) Colonial heritage plus – countries had valuable resources, people that could be enslaved, or land suitable to plantation agriculture, enticing colonizers to design institutions to exploit these endowments;

(iii) Political conflict – countries had too little political competition over their borders or between their elites and that allowed their rulers to build institutions to serve their selfish interests; and,

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9 A large literature explains growth without reference to institutions; Easterly provides an excellent critique of that literature (Easterly 2002).
Beliefs and norms — countries had beliefs and norms that were inhospitable to markets or engendered mistrust, preventing them from building institutions that encourage trade and investment.

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

Colonial Heritage

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

North (1990) has suggested that colonial powers created institutions that mirrored their own intuitional endowment. Spain transplanted its centralized government, large and interventionist bureaucracy, and protected property rights of favored nobility to Latin America, while England brought its decentralized, restricted government to its colonies in.
the New World. As a result the United States and Canada were better positioned to curb state power, create more competitive markets, and industrialize faster than Latin America. But why did the English heritage fail to benefit countries in Africa, the Caribbean or South Asia? And why have Spain and England converged over time to a greater extent than their former colonies?10

La Porta and his coauthors argue that a country’s legal heritage has a profound effect on its institutional endowment today (La Porta, et al. 1997, 1998, 1999). In their view common law signals intent to limit the state’s power, enforce contracts, and protect property rights, including the rights of investors with only a minority stake in a business. Civil law, particularly French civil law, can be seen as an instrument of a state prone to threatening property rights, establishing monopolies and squelching innovation, plus civil law provides less protection for minority shareholders.11 In their empirical tests French civil law, along with Socialist law, is associated with more government interventionism, greater bureaucratic inefficiency and less democracy than common law or German civil law.12 Beck and Levine’s chapter in this Handbook find further faults correlated with civil law: underdeveloped financial systems and an inflexible legal order that is less adaptable to changing economic conditions and plagued by inconsistencies. Since French and Spanish civil laws are similar to each other and different from English common law, these findings seems to support North’s contention about the effects of Spanish and English colonial heritage.

10 Location may be the reason for convergence. Stimulus from the rest of Europe played a key role in the development of England and the Netherlands in the Middle Ages (see North 2002), and benefited Spain in the 20th century.

11 Not all civil law traditions are the same: French civil law supports a larger bureaucracy and fewer constraints than German or Scandinavian civil law (La Porta, et al. 1999, p. 231). Socialist law is more interventionist than civil law.

12 The legal tradition variable is highly correlated with their religion variable but retains its significance when per capita income and latitude are included in the regression.
Although many analysts accept that legal heritage plays some role in development of other institutions, a strong argument that legal heritage determines current institutions is controversial (see the chapter by Beck and Levine for cites of some contrary views). No one has found a direct effect of legal origins on growth, and history seems to belie some of the virtues claimed for common law. Civil law was not a drawback in the past: by many measures France and other countries of continental Europe were more financially developed than the United States in 1913 (Rajan and Zingales 2003). Moreover, the US created the SEC and other regulatory structures precisely because the common law rules protecting investors were seen as weak (Roe 2002). Also puzzling is how distant legal origins matter so much when current commercial laws and enforcement in countries with similar legal traditions vary so widely (Pistor, et al. 2000). And why were the villains in this story, the colonial powers that brought civil laws to their colonies, able to overcome their own legal origins and develop when many of their former colonies could not? Berkowitz et al. (2002) suggest that how a legal system was initially received – whether through conquest, colonization, or imitation -- may have more influence on how it functions today than whether it is French, German, British or Scandinavian.¹⁴

¹³ Nor do the originators of the legal traditions idea claim a growth effect (Shliefer, comments at the Annual Meeting of the International Society for New Institutional Economics, Cambridge, MA, September 27, 2002. Beck and Levine’s chapter, however, cite studies showing that financial development “exerts a first order impact on long-run economic growth” and conclude that legal origins are a determinant of growth through their effects on financial institutions.

¹⁴ Although the authors of La Porta et al. (1998, 1999) are critical of imported institutions that are imposed without regard for local norms (Djankov, et al. 2002), they still view civil law as a more damaging import than common law.
Colonial Heritage Plus

Some authors try to improve on colonial heritage as an explanation for underdeveloped institutional endowments by adding initial conditions. Acemoglu and co-authors argue that European colonizers set up oppressive production methods or appropriated them from indigenous elites in richer areas that had a large population that could be enslaved and a climate that supported plantation agriculture or mining, such as Mexico, India or Indochina, and where diseases made colonization dangerous, such as Africa (Acemoglu, et al. 2001a, 2001b). Colonial Europeans also created or adapted tax and tribute systems designed to “concentrate political power in the hands of a few who used their power to extract resources from the rest of the population.” (Acemoglu, et al. 2001b, p. 14). In safer places where the population was relatively sparse and the land less suited for plantations, such as the US, Canada or Hong Kong, Europeans settled in larger numbers bringing with them beneficial institutions that supported private property and wider participation.

When industrialization began in the 19th century, their reasoning goes, formerly rich colonies burdened with these “extractive institutions” lacked secure property rights and provided few opportunities for technological and entrepreneurial innovation. There was a “reversal in fortune” because the better institutions inherited by formerly poor colonies allowed them to industrialize and grow more rapidly. Among former colonies, a 10 percent higher population density in 1500 is associated with a 4 percent lower per capita income today (Acemoglu, et al. 2001b).15 There are obvious problems with

15 Countries which were never colonized by Western Europe didn’t experience the reversal of fortune according to Acemoglu and co-authors (2001b). Rodrik, et al. (2002), however, find that institutional quality today among never colonized countries is as widely dispersed as among former colonies.
constructing reliable population indices for 1500, which the authors admit, but their test holds up with urbanization indices from different sources.

A more serious difficulty with this explanation is that it ignores the differences in institutional success among the colonial powers that North describes. In this story, the US would have developed equally well had it been colonized by Spain. Although the authors explain underdevelopment as the result of “extractive colonial institutions,” they do not directly test the causal relationship between growth and colonial institutions but between growth and disease plus population or urbanization. Nor do they detail which “extractive colonial institutions” so cripple societies that they stay poor for centuries. Finally, Europeans intensively settled some places such as the West Indies despite high mortality rates from dangerous diseases (Engerman and Sokoloff 2002b).

Sokoloff and Engerman (2000) argue that factor endowments explain why there are large differences in contemporary institutions between countries settled by the same colonial power: the United States and Jamaica or the northern and southern United States, for example. In their view, where soils, climate, and size or density of the native population encouraged plantation agriculture with slaves, elites were able to establish institutions that insured their ascendancy, “contributing to persistence over time of the high degree of inequality” (Sokoloff and Engerman 2000, p. 223). Three types of colonies evolved as a result: (1) those suited for extensive cultivation of (at the time) high valued crops like sugar using slaves (Cuba, Jamaica); (2) those with large native populations tied by history and local institutions to the land, where Spain granted a few nobles enormous blocs of land and tightly restricted migration (Mexico, Peru, Bolivia);

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16 Adding the identity of the colonial power to the estimate has little effect on the results, perhaps because their instrument (mortality rates of colonial settlers) captures the exogenous sources of variation in institutional quality.
(3) those ill suited to large scale agriculture because of climate and soils or because native populations were nomadic, sparse or militant, where larger numbers of European immigrants were allowed low cost access to small landholdings (Northern US, Canada) (Engerman and Sokoloff 2002b). In the first two kinds of colonies elites used their position of power to restrict access of non-elites to opportunities, reducing competition, discouraging innovation, and passing laws and policies that locked inequality in place. The pernicious influence of slavery -- slaves from Africa made up 60 percent of the more than 6 million people who migrated to the New World from 1500 to the end of the 18th century – also contributed to persistent disparities in wealth, human capital, and political power (Sokoloff and Engerman 2000, p. 220). Unlike Acemoglu et al., Engerman and Sokoloff (2002a) specify the institutions that evolve where initial conditions favored equality and homogeneity, such as rules that encouraged immigration, expanded the franchise, promoted secure and cheap land acquisition, and increased access to schooling and banking.

The colonial heritage arguments are more persuasive for the Americas than for other regions. Despite Asia’s generally greater economic equality and homogeneity, only Japan has attained US or Canadian levels of development. Most of Africa shares a low level of institutional and economic development despite differences in factor endowments, disparities between the French and English laws, or other variations in colonial legacy. Dangerous diseases that curbed European settlement are the reason Acemoglu and co-authors give for Africa’s general state of underdevelopment. They point to the differences between the rest of Africa and those safer colonies where more

17 The arguments of Acemoglu and co-authors sound somewhat similar; they too assert that climate will skew colonial heritage by determining whether a plantation crop like sugar can be grown or whether settlement is discouraged because mosquitoes carrying malaria are present.
Europeans settled because the risk of diseases was less: Rhodesia, South Africa, Kenya. But why then has Kenya not done as well as the US or much of East Asia? And what explains the recent economic declines in Rhodesia and South Africa despite their presumably superior institutional heritage?

**Political Conflict**

Some scholars, influenced by England’s Glorious Revolution, argue that Africa’s weak institutions resulted from too little political competition. By forcing England’s ruler to offer concessions to merchants and nobles in exchange for the necessary funds and fighters, wars over territory opened the way to more responsive and limited government there (North and Weingast 1989). According to Bates, the absence of this form of territorial conflict in the modern history of poorer countries, especially African countries, is an important reason for their underdeveloped institutions today. In his view, countries that became independent after the Second World War “faced fewer incentives to forge liberal political institutions,” because the international environment did not require them “to seek ways to get their citizens to pay for defense and other costs of government” (Bates 2001, p. 83).

Herbst (2000) similarly suggests that because land was so ample in Africa, precolonial African states did not fight to defend it, so they did not have to build effective bureaucracies to raise funds or make political concessions to their citizens to persuade them to support the war effort. States also never bothered to consolidate control over their outlying areas. Later, the colonial powers did little to build state institutions, except where there was a large European presence, but did introduce the concept of territorial sovereignty. They also drew national borders that created some states with
concentrations of different ethnic groups separated by vast stretches of largely empty territory that could shelter dissident armies, setting the stage for civil wars. After independence Western nations contributed to the stagnation of Africa’s institutions by preventing border disputes, which did not serve their Cold War interests, and propped up the region’s weak, even venal, governments with aid. Robinson (2002) disputes this view; he finds slavery and disease are more likely explanations for Africa’s underdevelopment. Pre-colonial African states may have organized themselves for slave raiding and predation rather than for providing public goods, while dangerous diseases kept Europeans from settling in great numbers and building less exploitive, more participatory institutions (Robinson 2002).

It’s not obvious that border conflicts would have produced institutions similar to those of advanced Western European states in Africa or other underdeveloped regions. England’s Glorious Revolution was not prompted solely by border wars. Other factors converged: for example, Christian beliefs made competition and the accumulation of wealth respectable at a time when a commercial class was emerging and trade and competition were becoming more important (North 2002). England’s king did not have a monopoly on power, which was why he had to make concessions to wage war. Nor are border conflicts a necessary condition for limited government; less involvement in border wars does not seem to have harmed progress towards limited government in Switzerland or the US.

Nugent and Robinson (2002) also emphasize political conflict among elites as a driving force for institutional development. They call attention to the diversity in income and institutions among developing countries with similar culture, religion, geography,
colonial history and factor endowments. Specifically, they ask: why are Colombia and Costa Rica richer than El Salvador and Guatemala? Their answer: because the elites in Colombia and Costa Rica were merchants rather than landowners. Even though the countries had similar agricultural potential, merchant elites in Colombia and Costa Rica were not motivated to run large coffee plantations, but the large landholders in Guatemala and El Salvador were. Colombia’s and Costa Rica’s merchant elites were polarized and granted property rights and the franchise to smallholder farmers to mobilize their support in their struggles for political power. Since smallholders are more productive in coffee growing, Nugent and Robinson argue, the organization of Colombia’s and Costa Rica’s coffee economies was more efficient. This story is intriguing but hard to generalize. Merchant elites don’t always compete or give concessions to win allies – Africa comes to mind – and the authors’ explanations for why elites were competitive merchants in one locale and collaborating landowners in another are highly case specific. Competing elites are not necessarily beneficial to growth: they sometimes engage in protracted wars that deter investment and specialization.

**Beliefs and Norms**

In other studies the determinants of development are religions, habits, or what we might call culture, which North (1994, p. 384) defines as “the intergenerational transfer of norms, values and ideas.” For example, Landes follows Max Weber in stressing the importance of culture in general and the Protestant Reformation in particular for spurring development.

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18 They argue that there are no scale economies in coffee growing and tending and picking is labor intensive and requires great care. Nugent and Robinson (2002) suggest that smallholders have better incentives to accumulate human capital necessary to improve their productivity further because they can capture part of the rent. The dominance of small holders could be due to the sparse populations in Colombia and Costa Rica compared to Guatemala and El Salvador. The authors cite the case of Nicaragua, which had similar population density to Colombia and Costa Rica, but developed large coffee plantations and expropriated the property of smallholders.
industrialization in Northern Europe. In his view, Protestantism generalized the virtues of “a new kind of man—rational, ordered, diligent, productive”; it promoted literacy, an appreciation of time, and tolerance and openness to new ideas (Landes 1998, p. 177-78). Landes asserts that Catholic and Muslim religions have often been detrimental to institutional development, despite little empirical support for this claim.  

North too stresses the evolution of religion and culture in shaping institutional change, but in a different way. To North, belief systems “are the underlying determinant of path dependence, one of the most striking regularities of history” (1994, p. 385). Beliefs are not static; for North it is the learning process by which belief systems evolve that matters. For example, Christian beliefs evolved to views that were hospitable to economic and political development, such as the view that legitimate government must be based on the consent of the governed. Ultimately, it is political competition that drives the evolution of beliefs in North’s view (1994, p. 387).

Greif focuses on what he terms cultural beliefs: the ideas and thoughts common to a group of individuals that “govern interaction between these people, and between them, their god and other groups” (1994, p. 915). By contrasting the individualistic cultural beliefs of the Christian Genoese and the collectivist cultural beliefs of the Jewish Maghribi traders mentioned earlier, he shows how beliefs affect institutional development. The Maghribis had a horizontal social structure and relied on partnerships, community ties, and “formal friendships” among cooperating traders to enforce their bargains. Genoa had a vertical social structure and merchants evolved bills of lading, written contracts, laws, and permanent courts to support bargains among traders. The

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19 One study finds that a predominantly Catholic or Muslim population is associated with poorer government performance, but this effect becomes insignificant when controls for per capita income and latitude are included (La Porta, et al. 1999).
Maghribis did not need these written documents and courts to enforce bargains; fears of losing reputation and ostracism worked just as well within their collectivist system. Ultimately, however, the Maghribis’ failure to develop formal contracts and laws enforced by impersonal courts confined their trade to their network, where their collectivist enforcement was effective, while the Genoese grew rich through extensive and expanding trade. Similarly, Raskov (2002) shows how the community-based norms of the Old Believers, a traditionalist religious group in Russia, initially fostered but eventually choked development of their textile industry. In these stories strong informal bounds supporting collective action stunted the formal institutions that underpin a modern market economy, even thought they may have supported economic growth for centuries in the past.

Not all norms or networks are harmful to the development of modern institutions. In modern economies legal systems and cooperative norms mutually complement and reinforce each other. Norms that encourage people to cooperate even with those with whom they have no family, business or other relational ties have economic payoffs in a number of studies surveyed by Keefer and Knack in their chapter in this Handbook. Putnam (1993) argues that the quality of local governments in Italy today can be traced back to the historical development of what he terms social capital, a network of associations that promote trust between strangers and helps overcome collective action problems. Localities with large numbers of associations that bring together people who are unrelated through kinship, religion or business, such as sports clubs and singing societies, have better local government institutions and stronger economic performance. Trust, a specific form of social capital, correlates strongly with growth and development
(Fukuyama 1995, Knack 1997). Knack (1997) shows that trust is also correlated with private investment, perhaps because it reduces the transaction costs of securing agreements.

Norms, beliefs and similar informal institutions seem to be deeply engrained and the product of intractable factors, such as a society’s history or its ethnic, religious, or linguistic heterogeneity. What can a society do if its culture is inhospitable? There are two factors associated with development-promoting norms that seem to be amenable to policy interventions: income equality and education (see Keefer and Knack’s chapter in this Handbook). Studies of East Asia suggest that the relatively high levels of education and income equality help explain why East Asian countries have grown faster and produced better social welfare measures than other less developed regions.

*All of the Above*

The reader may be struck by the variance in these explanations. Yet it could be that all of the factors just described play a role. The institutions that protect property rights and support strong market economies in Western Europe emerged gradually from a long and disorderly process of adaptation and experimentation spurred by competition and wars (see for example, North and Thomas 1973). Perhaps this organic progress toward efficiency would have happened more widely but was interrupted by colonialism’s transplants of institutions that were less well adapted to local norms, beliefs and environments (Djankov, et al. 2002). Or it could be that the fortuitous circumstances that produced a supportive institutional environment in today’s developed countries were simply missing in many other places. Additional research will be needed to sort out the effects of different determinants.
The explanations converge, by and large, on three points. Despite disagreement on the ultimate determinant of institutional development, they broadly agree on the proximate causes: (i) greater equality combined with (ii) sufficient political competition to limit the ability of rulers to expropriate. Authoritarian regimes where a consolidated, wealthy and despotic ruling group exploited a poor or enslaved workforce might have been more successful in organizing plantation agriculture, but also developed highly centralized and oppressive institutions inimical to competition, specialization, and industrialization. Where divided or less powerful ruling elites had to bargain with one another or seek support from ordinary citizens, they created institutions to secure bargains and curb their power to expropriate; this was reinforced where circumstances spread wealth more broadly and allowed greater access to education. To prosper, these societies had also to develop a state powerful enough to prevent battling warlords from plunging the country into civil war, but a state also checked by cooperative norms and institutions from becoming a tool by which rival elites eliminate their competitors.

Another point of convergence is the assumption that (iii) fundamental institutions endure for centuries. Countries have weak institutions for reasons deep in their past: colonial heritage can date back as far as 1500; norms may have even more distant origins. This invites pessimism. What is the chance for countries to develop today if underdeveloped institutions are produced by distant history; especially if, as Bates and Herbst suggest, foreign assistance has usually locked weak institutions in place? Persistent inequality amongst the world’s economies seems to support this pessimism (Pritchett 1997). Optimists counter with evidence that rapid growth in China, and to a lesser extent India, is reducing inequality and poverty among the world’s populations
Apparent rapid transformation of institutions in transitional economies also gives grounds for hope (see Murrell’s chapter).

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

4. WHICH INSTITUTIONS MATTER FOR DEVELOPMENT?

The persistent significance of institutions in cross-country growth regressions has spawned a mushrooming literature and converted a number of former skeptics. Pinpointing which institutions are fundamentally responsible for development has been tough, however. A host of variables turn out to be statistically significant. One survey found measures of development are significantly positively correlated with: protection of property rights and enforcement (seven studies), civil liberties (ten studies); political rights and democracy (ten studies); and institutions supporting cooperation, including trust, religion, and the extent of social clubs and associations (four studies); and negatively with political instability (15 studies) (Aron 2000).

Roll and Talbott (2001) conduct a horse race between 14 institutional variables, eliminating those that don’t hold up in multiple regressions, and still end up with nine variables that are highly significant

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

21 Aron also includes a number of studies that don’t measure the effects of institutions, but of socio-economic conditions such as ethnolinguistic diversity, social mobility, fertility rates, and the size of the indigenous middle class. These factors are viewed as proxies for weak institutions in some studies.
in explaining levels of gross national income per capita from 1995 through 1999.²² Property rights, black market activity (seen as a proxy for enforcement of rules) and regulation have the strongest relationship to per capita income; the first positive and the other two, negative. Also strongly positive are political rights, civil liberties and freedom of the press. Less important but still significant are government expenditures (positive) and inflation and trade barriers (negative).

Roll and Talbott’s study illustrates another dilemma: many of the variables are not institutions.²³ Secure property rights, for example, are outcomes, the result of a number of different institutions -- norms of conduct, religious precepts, historical traditions, laws and courts, and rules that check the state’s ability to expropriate (Keefer and Shirley 2000).²⁴ Others are socio-economic conditions -- ethnic fragmentation– or the results of economic policies – inflation, trade barriers, black market premiums. Conditions and policies are often defined as proxies for institutions. For example, trade barriers are treated as a proxy for poor government policies that might result from weak institutions to curb corrupt deals struck to protect cronies (Roll and Talbott 2001). The authors seldom provide evidence for why socio-economic or policy variables should be seen as

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²² The explanatory variables are: trade barriers, government expenditures, monetary policy (inflation), property rights, regulation, black market activity, political rights, civil liberties, and freedom of the press.
²³ In addition there are a number of methodological criticisms of cross country regressions in general, as well of those that use growth rates in per capita income (summarized in Hall and Jones 1999, and Roll and Talbott 2001) or levels of per capita income. (See for example, Temple 1999). The most serious problem is reverse causality: do stronger institutions lead to economic growth or do wealthier countries create stronger institutions? Because of data limitations, the institutional variables are usually measured at the end rather than at the beginning of the period under investigation, and as a result, reverse causality is hard to rule out. The study by Roll and Talbott attempts to overcome problem of reverse causality by identifying major democratic events (such as the introduction of elections) and undemocratic events (such as military coups or the suspension of elections) in individual countries, then tracking the growth in GNI per capita for ten years before and 20 years after the event. After a democratic event, countries began to grow more rapidly and growth continued to accelerate, while growth stagnated after a non-democratic event.

²⁴ (See also Rodrik, et al. 2002).
proxies for institutions rather than direct determinants, or for the link between, for instance, trade barriers and rules governing corruption.\footnote{25}

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

Perhaps it should not surprise us that cross-country regressions are poor tools to determine which particular institutions are necessary for a country to develop: it is a tenet of NIE that institutions are complex and context specific, the product of each society’s unique set of experiences (see North’s chapter in this Handbook). Growth regressions have, nevertheless, suggested some important empirical regularities. First, whatever these institutional variables are measuring, they typically explain a sizeable fraction of economic growth. Second, the convergence of findings give us greater confidence that institutions that increase political competition and civil liberties and promote cooperation have a statistically significant and positive association with per capita growth rates and income levels. This fits nicely with the finding of historical studies that high quality institutions today are rooted in greater equality, political competition and cooperative norms in the distant past.

\footnote{25 Rodrik et al. (2002) raise another objection to the use of policy and institutional variables in growth regressions. In their view measures of institutional quality already contain all the relevant information about policies.}
Given the problems inherent in cross-country studies of institutions, case studies seem a logical approach. But case studies tend to be sui generis. Jütting (2003) reviews cases studying the impact of institutions on natural resource management (6 case studies), conflict resolution (3), and market development (8). Although institutions are more precisely defined than in the cross sectional studies, they are still not always clear or carefully measured. A common finding is that norms and customs play a critical role, highly particular to local circumstances. For example, norms of behavior backed by community sanctions helped enforce contracts in Vietnam, but failed to protect the customary rights of women in Uganda (see Jütting 2003). Norms and beliefs are hard to measure in cross-country studies, further complicating the problem of defining which institutions are important to development.

Rodrik (2000) argues that since scholars cannot determine which institutions matter, democracy is the most effective way to mobilize local knowledge of how to develop better institutions. A large literature finds only an ambiguous relationship between democracy and growth, however.26 Democracies do grow at least as well as autocracies and some do significantly better, but on average they don’t outperform them.27 This ambiguity may arise because representative democracy can take many forms; how democracy functions is affected by whether it is parliamentary or

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

27 Democracies do better on other measures. Democracy reduces the volatility of economic performance (Alemida and Ferreira 2002, Rodrik 2000), and protects citizens from extreme abuses by the polity (Sen 1981).
presidential, has a unicameral or bicameral legislature, delineates large or small districts, has strong or weak political parties, uses proportional representation or winner-takes-all, or puts a short or long time limit on terms of presidents and legislators. These complexities are hard to measure in a way that lends itself to cross country comparisons. Measurement is further complicated when laws don’t reflect practice, which is more likely in countries with underdeveloped institutions.

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

Lack of trust or civic mindedness also undermines democratic rules; mistrust keeps citizens from cooperating to monitor politicians and bureaucrats, reduces the ruling party’s willingness to turn over power to the opposition, and impedes reform because government’s commitments are not credible. Bardhan (2000, p. 228) maintains that India is a prime example of a highly democratic country whose citizens have not been able to overcome collective action problems to ban together and require government to function more effectively. Indian society is “heterogeneous and conflict-ridden,” and because no individual group is “powerful enough to hijack the state by itself,” groups use the
democratic process to build an elaborate system of checks and balances and “meticulous rules of equity in sharing the spoils at least among the divided elite groups” (Ibid.).

Democracy requires supportive beliefs, norms, and constitutional institutions that are usually absent in non-democratic countries. How to install these beneficial preconditions is not well understood. Exhorting poor countries to adopt democracy is about as helpful as exhorting them to adopt other desirable traits, such as rule of law or property rights.

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

Cross-country growth regressions have demonstrated that institutions are a -- if not the -- determinant of development, but they are ultimately unsatisfying to those seeking specifics. Yet even if cross-country regressions were more specific, the lessons from successful countries will not necessarily assist others. Because they must fit a country’s beliefs and norms, successful institutions – democracy, federalism -- are not

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28 Informal rules may also curb the abuses of autocracies in ways that have not been well researched. The decision of the Pinochet dictatorship to hold a plebiscite on its rule and to restore democracy after losing is a case in point.
easily transferred from one context to another, which leaves open the question of institutional change.

5. HOW CAN DEVELOPING COUNTRIES CHANGE THEIR INSTITUTIONS?

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

Path dependency and the stickiness of beliefs and norms explain why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries. There are numerous examples of failure. Latin American countries copied the U.S. constitution, transitional countries emulated U.S. or European bankruptcy laws and commercial codes, former French colonies in Africa adopted the French educational and bureaucratic systems -- all with very different and generally disappointing results.
Successful institutional reforms require what Levy and Spiller (1994) term “goodness of fit” between the specific innovation and the country’s broader institutional environment, including its norms and beliefs. A “good fitting” institutional innovation would be one that does not depend on absent or weak institutions and is insulated from or adapted to perverse institutions as far as possible.

China’s “market preserving federalism” and township and village enterprises have been cited as good fits [Weingast, 1995 #223; Murrell’s chapter in this Handbook; Djankov, 2002 #106]. China’s federal system allowed provinces and local governments to experiment with different economic rules that could be tested through competition between localities as long as the dominance of the Communist Party went unchallenged (Weingast 1995). Some townships and villages experimented with rules that encouraged private investors to run government-owned enterprises. Formal and informal rules gave these investors -- mainly overseas Chinese with kinship ties to the locality -- considerable control over the staffing, management and survival of the enterprise in exchange for regular payments to the local government that “owned” the firm, allowing capitalistic incentives to flourish within an officially socialist system (Keefer and Shirley 2000).

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

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29 For example Chile required its state enterprises to operate as if they were private firms. Its rules worked to improve efficiency in Chile but failed to improve efficiency what introduced in other countries. The explanation for why these rules worked in Chile seems to be the supportive norms of its civil service. (See for example the chapter on Santiago’s municipal water in Shirley 2002).
A good fitting institution meets Williamson’s “remediableness criterion”: “…an extant mode of organization for which no superior feasible alternative can be described and implemented with expected net gains…” (Williamson 2002, p. 12, underlined in original). But the remediableness criterion, as Williamson points out, risks being “too deferential to the status quo” (Ibid). Reforms could be so tailored to initial conditions that they leave countries locked into inefficient institutions when superior improvements were indeed possible. How can we judge an apparently good fit? The appropriate counterfactual is not the status quo or some comparator country, and certainly not a fully developed, Western system of property rights, finance and law. Ideally, we should assess goodness of fit as part of a process of institutional change, and decide whether the direction of change is towards institutions that are more supportive of an efficient market economy and improved social development. This is exceptionally tough to do.

We can see an example of the problem this creates for NIE researchers in Levy and Spiller’s otherwise excellent study of telecommunications regulation. They describe an exclusivity agreement that gave the buyers of Jamaica’s state-owned telecommunications companies gave them a 25-year monopoly as politically necessary given the country’s weak institutions – a good fit. In their view exclusivity agreements allow countries to cross-subsidize poorer consumers, which helps overcome opposition to privatization; exclusivity reassures investors that government’s promises not to expropriate returns are credible; and exclusivity may be the only way to attract private buyers where institutional safeguards are weak. If exclusivity is a good fit, it comes at a

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30 Early evidence on China’s privatization of the township and village enterprises suggests that they have been supportive of further moves towards markets and development (Sonobe and Otsuka 2003)
31 (Spiller and Sampson 1995, p. 77-77) The authors do criticize the extent of the monopoly, and argue that competition in value added services and terminal equipment would not have affected the political feasibility of reform.
high price. Walston has shown that exclusivity agreements raise the price paid to purchase the telecommunications company but reduce investment and give the monopolist power to solidify its position, making it difficult to introduce competition when exclusivity ends (Wallsten 2000). Was exclusivity politically necessary? Less than a decade later two African countries (Ghana and Uganda) with weak or weaker institutions than the countries in Levy and Spiller’s sample did not have to use exclusivity agreements to convince investors to buy their telecommunications companies (Shirley 2001).

The specifics of institutional change fall through a gap in the literature; Levy and Spiller 1995 is one of the few attempts to grapple with the messy details of real institutional change. Given how quickly NIE has evolved from a time when institutions were not even included in most development models, the gap is not surprising. Unfortunately, foreign assistance agencies have entered this gap with their own assumptions about to develop institutions (see World Bank 2002, 2003).

6. CAN OUTSIDERS PROMOTE INSTITUTIONAL DEVELOPMENT?

Outsiders have changed deeply rooted institutions, usually by fomenting revolutions or invading, sometimes in consort with a powerful local reformer. 32 For example, Napoleon brought enduring changes to Europe’s legal, educational, health, and other institutions in a relatively short period of occupation. Force alone cannot explain Napoleon’s enduring impact. Some intellectuals and merchants were receptive to Napoleon’s innovations; dissatisfied with domestic institutions and inspired by the

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32 This section addresses whether outsiders have been able to promote sustainable improvements in the institutional environment by changing constitutions, norms of honesty or cooperation, enforcement mechanisms for laws and contracts, etc. It does not address the more successful record outsiders may have had of influencing changes in less embedded formal rules, such as the regulations governing electricity or water firms.
Enlightenment they saw his reforms as progressive, the heritage of the French revolution. Outsiders have also contributed to enduring institutional change in countries where powerful elites welcomed foreign ideas, such as Tsar Peter in Russia or Kemal Attiturk in Turkey. Absent a powerful local supporter, however, there are few insistences where aid or advice alone has made enduring improvements in another country’s embedded institutions. Some observers believe that aid may even have slowed institutional change by preventing political competition and preserving the power of local elites who might otherwise have been removed.

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

Aid projects try to reform institutions through conditionality: a list of specific changes that the country must enact before funds will be disbursed. But conditionality
does not fit well with what is known about institutional change. As we have seen, the NIE shows that institutions usually change as the result of a long and often painful process of competition and adaptation, changes that are only sustained if belief systems and norms change as well. Ruling elites often prefer pro forma changes so they can obtain funds without politically costly changes in deep-seated constitutional rules, norms and beliefs – the Samaritan’s dilemma. Where institutions are weak there are by definition few checks on rulers and conditionality will be met by passing laws without mechanisms for their enforcement; creating agencies without adequate staffing, budget or mandate; privatizing state enterprises without competition or competent corporate governance. A World Bank analysis of past projects concluded: “donor financing with strong conditionality but without strong domestic leadership and political support has generally failed to produce lasting change” (World Bank 1998, p. 4).

A good example of pro forma reform in exchange for aid is the “performance contract”. Performance contracts between a government and the managers of its state enterprises were championed by aid agencies as a way to improve performance of state enterprises by setting specific targets and giving managers incentives to achieve them (Shirley 1998). Shirley and Xu (1998) found that in five of the six cases they studied where governments signed performance contracts they failed to negotiate tough targets, demand necessary information, pay promised bonuses for good performance, impose promised punishments for bad performance, or provide promised autonomy to lay off workers or close plants. Targets were weak and distorted: even when they were achieved there was no improvement in total factor productivity, labor productivity, or return on assets (Shirley 1998, World Bank 1995). Yet because of the Samaritan’s dilemma
performance contracts were widely used in aid projects. Government officials liked performance contracts because funds could be disbursed against a tangible action with low political costs—the signing of the contract—and results gauged by a tangible outcome with low political costs—achievement of the targets. Aid agency staff had few incentives to scrutinize the effects of contracts on actual enterprise performance, since their staff members were rewarded for project approval and implementation, not subsequent performance improvements. High rates of staff turnover and constraints on staff time made scrutiny of such apparently successful projects even less likely.

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

Over time, the disappointing performance of many aid recipients has led aid agencies to discover institutions. A number of recent reports have stressed institutions, but most have failed to consider seriously the implications of institutions for foreign aid. The World Bank’s World Development Reports redefine institutions in an elastic way to include not only formal and informal rules, but also organizations (Wallsten 2000, World Bank 2002) and policies such as interest rates (World Bank 2002). These definitions make a mockery of efforts to measure the impact of institutions on markets or policies or the interactions between institutions and organizations; they also allow aid

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**Note:**

33 See, for example: World Bank (1998, 2002); Payne (2002); Quibria (2002).
agencies to characterize virtually any reform activity as institutional reform without radically changing their approach.

The foreign aid community generally assumes that institutions are malleable and can be changed through aid within the three to five year life span of a development project, or at most the 15 to 20 year span of several projects. Another premise is that well-intentioned outsiders can discover needed institutional changes and persuade governments to implement reforms and sustain them. The NIE literature described above suggests that these assumptions are wrong: (i) most institutional change is well beyond the time frame of even a series of aid projects; (ii) institutional change requires alterations in beliefs that cannot usually be pushed or purchased by outsiders; (iii) successful institutional adaptations have been engineered by insiders and sometimes work quite contrary to the conventional wisdom or best practice touted by the aid community; and, (iv) aid in the absence of a supportive institutional framework can create perverse incentives and prop up rulers who are opponents, not catalysts, of reform.

7. WHAT NEXT?

The robust institutions that support modern market economies emerged though a process of adaptation that apparently cannot easily be shortened or emulated. Even when manifestly harmful to economic growth and human welfare, embedded institutions usually change slowly, if at all. If these conclusions seem pessimistic, it may be the result of our current ignorance about institutions and development. While much is known about how institutions developed in Western Europe, there is far less good scholarship about institutional development in Third World countries. Cross-country studies have put institutional variables into mainstream models and produced some intriguing regularities,
but the devil is in the details and the details can be numerous. Ostrom (1999), for example, found 27 different boundary rules for managing common pool resources in different locations. Shirley (2002) found that the privatization of a city’s water supply system is not a single policy option, but an array of choices about regulations and contracts that played out quite differently in different environments.

What can be done to fill the gap? Thanks to a new generation of cross-country studies coupled with increasingly detailed databases, we are progressing in understanding how specific institutions affect specific behavior. A good example is Keefer’s study of how governments’ decisions to bail out banks during financial crises are determined by voter information, proximity of competitive elections, and checks or limits on government (Keefer 2001). Institutional variables in these analyses are still aggregated but far more sophisticated and complex. For example, Keefer measures checks as the number of veto players-- the number of organizations dominated by politicians with the motivation and power to veto policy choices. This is complex; for presidential systems, for example, he assigns one point to each house of the legislature, but zero if the president’s party has a majority and voters must vote for a partly list, not a candidate. Initially these studies will be messier, with smaller samples and lower significance than the usual well honed but unsatisfying cross-country growth regressions.

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

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

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

Mary M. Shirley is President, The Ronald Coase Institute. This paper has benefited greatly from comments by Philip Keefer, Bertin Martens, Claude Menard, Douglass North, Charles Oman, participants in a seminar at George Mason University and a panel at the International Society for New Institutional Economics, and an anonymous reviewer.

8. REFERENCES


