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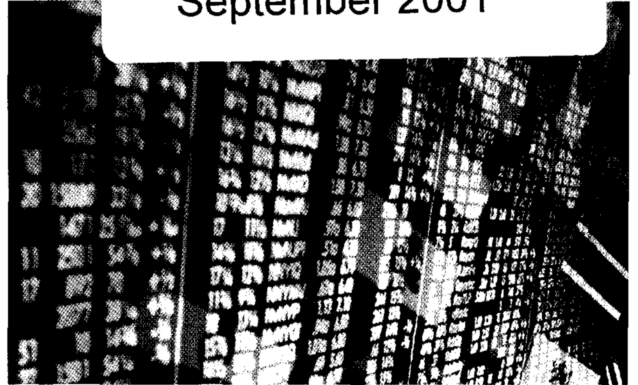
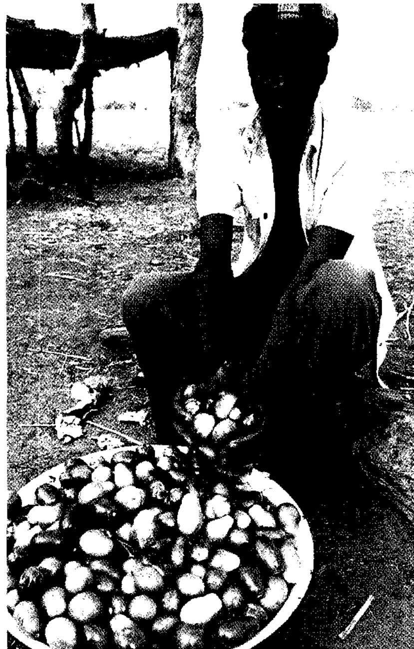


OVERVIEW

Building Institutions for Markets



THE WORLD BANK

BUILDING INSTITUTIONS FOR MARKETS

World Development Report 2002

Overview

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Building Institutions: Complement, Innovate, Connect, and Compete

How do we account for the persistence of poverty in the midst of plenty? If we knew the sources of plenty, why don't poor countries simply adopt policies that make for plenty? . . . We must create incentives for people to invest in more efficient technology, increase their skills, and organize efficient markets. Such incentives are embodied in institutions.

—Douglass C. North, 2000

In the 11th century the Maghribi traders of North Africa had a problem. They wanted to expand across the Mediterranean, but uncertainties hindered their plans—uncertainties about the prices in distant lands, the possibility of theft in transit, and the quality of goods on arrival.

Over time they came up with a solution. They set up a network of Maghribi agents in the major Mediterranean trading centers to represent their interests and exchange information about markets. Bound by social ties, they had information flowing freely among them. Theft and deceit were rare, because each member's interests were best served by staying in the network of traders. And membership was self-enforcing, even though there were no written rules.[1]

A millennium later, people everywhere face similar problems in striving to improve their well-being through market activity. African entrepreneurs cannot expand their opportunities because they lack information about potential business partners. Poor farmers in Latin America cannot use assets they own as collateral for bank loans. Budding entrepreneurs in Central Asia, trying to start new businesses, run into political obstacles from established firms and the state.

For these people, and others like them, markets don't work. That is, markets don't give them the incentive to engage in wider trade, the ability to use their skills and resources fully, or the opportunity to increase their incomes and accumulate assets.

Despite the problems, many people in rich countries and poor are engaged in productive—and rewarding—market activity. As *World Development Report 2000/2001* argued, income from participating in the market is the key to boosting economic growth for nations and to reducing poverty for individuals. This Report is about enhancing opportunities for poor people in markets, and empowering them. What makes market activity rewarding and possible for some, and not others? Why are some market systems inclusive and integrated, allowing benefits to flow to the poor as well as the rich, the rural people as well as the urban? And why are other markets localized and segmented?

Markets work if they have rules, enforcement mechanisms, and organizations promoting market transactions. Extremely diverse, these institutions transmit information, enforce property rights and contracts, and manage the degree of competition. And in so doing, they give people opportunity and incentives to engage in fruitful market activity. Where do such market institutions come from? States or communities can build them, and they can be formal or informal (table 1).

This Report is about people building institutions that support the development of markets. The 2000/2001 Report underscores the importance of institutions

Table 1
Examples of market-supporting institutions

Public	Private
• Judicial systems • Competition laws • Bank supervisory authorities • Disclosure requirements on companies • Formal land titles and laws governing inheritance	• Chambers of commerce • Credit registries • Moneylenders • Reciprocity among business partners • Land inheritance norms

in affecting poor people's participation in markets. This Report discusses both institutions that support growth and those that directly affect access of people left out of many market activities. It considers those institutions that provide opportunities for people and that empower them. It goes beyond the 2000/2001 Report by analyzing what institutions *do* to promote growth and facilitate access and by suggesting *how* to build effective institutions. And it emphasizes how institutions can help people make better use of the assets they own and how to accumulate more. In focusing on institution building, it does not devalue the importance of policy. But good policies are not enough. The details of institution building matter for growth and poverty reduction.

The Report contributes to the work on institutions and markets in several novel ways. It provides a diagnostic framework for understanding how institutions support market activity. Bridging the gap between theory and evidence across disciplines, it also builds on existing evidence about the role of institutions and institutional change. It confirms that one size does not fit all in considering institutional design. But the Report does more than that. It suggests how to proceed in building more effective institutions. It considers both how policymakers can design more effective institutions and how to bring about forces for change. It extends previous empirical work on institutional change to developing countries and presents a framework for institutional change. And it provides policy guidance, by taking a pragmatic approach. The aim is not to define what should be done in an ideal world, but what can be done in today's world.

In understanding what drives institutional change, the Report emphasizes the importance of history. Many developing countries have been nation-states for a short time relative to industrial countries. The evolution of nations teaches us that building institutions takes time and that the process within each country may stall or reverse because of political conflicts or economic and social conditions. It teaches us about the process of change and the importance of leadership, norms, and culture in particular countries. Institution building is generally a cumulative process, with several changes in different areas building up to complement and support one another. It is important to find areas in which to go forward; changes in one area can build pressures for change in another. Not all reforms are politically difficult for all countries. And the nature of what *is* difficult changes over time. The key is to move forward, and this Report identifies elements of such a strategy. The whole is greater than the parts, and even moderate progress in the parts can contribute to a better system to promote growth and poverty reduction.

Four main lessons emerge for institution building. The first two are about supplying effective market-supporting institutions. But supplying institutions is not enough. People must want to use them too. Thus, the second two lessons are also about creating the demand for such institutions and about promoting the forces for change.

To ensure effective institutions:

- *Design them to complement what exists—in terms of other supporting institutions, human capabilities, and available technologies.* The reason? The availability and cost of supporting institutions, existing levels of corruption, the degree of transparency, and underlying human capacity and technology determine the impact of a particular institution. That is why institutions that achieve their goals in industrial countries may not do so in developing ones. Much of the important work in building institutions lies in modifying those that already exist to complement other institutions, and in recognizing what not to build or transplant in a particular context, as much as recognizing what to build. "Best" practice in institutional design is a flawed concept.
- *Innovate to identify institutions that work—and those that do not.* Even in countries with similar incomes and capacities, innovation can create stronger institutions because of differences in local conditions—differences ranging from social norms to geography. Experimentation, which has some costs that must be recognized, can nevertheless help identify new institutional forms. Countries can gain from expanding successful innovations and adopting innovations

from the private sector. But they must also have the courage to drop failing experiments.

- *Connect communities of market players through open information flows and open trade.* Exchanging goods and services outside networks creates demand for market-supporting institutions. Exchanging information through open debate creates demand for institutional change by holding people to account, by changing behavior, and by supplying ideas for change from outside the community. Linking communities of people in networks of information and open trade giving access to markets is thus a priority for policymakers building market-supporting institutions.
- *Promote competition among jurisdictions, firms, and individuals.* Greater competition modifies the effectiveness of existing institutions, changes people's incentives and behavior, and creates demand for new institutions. Developing country actors often face too little competition, often because of current institutional structures. Changing this will improve the quality of other institutions. Competition among jurisdictions highlights successful institutions and promotes demand for them. Competition among firms and individuals does the same.

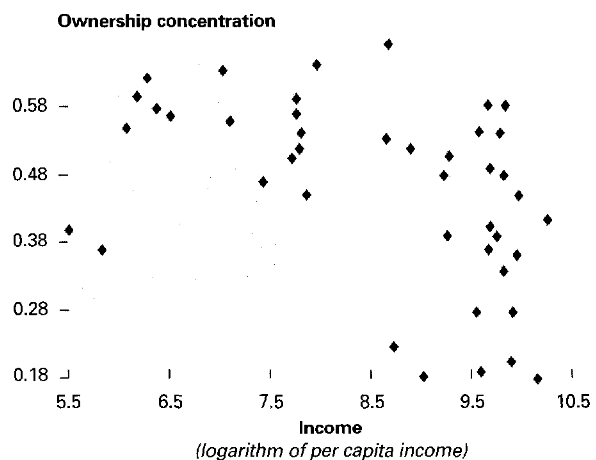
How do institutions support markets?

Small vendors engage in simple spot-market transactions, with buyers and sellers dealing face to face to trade fairly standard products whose quality is easy to verify. Large multinational firms exchange more differentiated products, face greater difficulties in verifying quality, and must span greater separations in time and space between one part of the transaction and the other. Most economies have both types of markets. But the first is relatively more common in developing countries, the second in industrial economies.

Developed markets—more global, more inclusive, and more integrated—offer more opportunity and choice. Underdeveloped markets, more likely in poor countries, tend to be more local and segmented. So, compared with farmers in Canada, poor farmers in Bangladesh have fewer opportunities—and far fewer formal institutions (such as banks and formal courts) to reduce their risks and increase their opportunities.

What limits market opportunities? The transaction costs stemming from inadequate information and incomplete definition and enforcement of property rights.[2] And barriers to entry for new participants. What increases them? Institutions that raise the returns from market exchange, reduce risk, and increase efficiency.

Figure 1
The concentration of ownership varies tremendously across countries



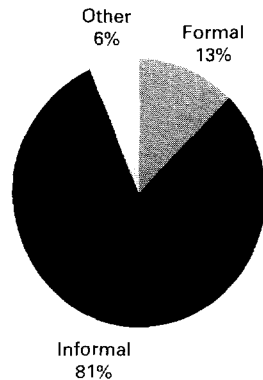
Note: Ownership concentration is measured by the combined stakes of the three largest shareholders in the 10 largest privately controlled firms.
Source: La Porta, Lopez-de-Silanes, Shleifer 1999.

Yet not all institutions promote inclusive markets. The Maghribis lowered transaction costs among themselves but in so doing excluded other communities. Institutional designs that evolve through historical circumstances or are directed by policymakers are not necessarily the best for all of society—or for economic growth and poverty reduction. For instance, state agricultural marketing boards, instead of helping farmers, have often resulted in lower incomes for them in Africa. And institutions that once supported market transactions can outlive their usefulness—for example, privatization agencies and bank restructuring agencies. The challenge for policymakers is to shape institutional development in ways that enhance economic development.

Institutional structures vary tremendously across countries and over time. Banks, firms, and farmers organize themselves and deal with one another in diverse ways. In some countries bankruptcy laws favor creditors—in others, indebted firms. In industrial countries, some firms have concentrated ownership; others, dispersed ownership (figure 1). Some farmers market their goods through cooperatives; others use contracts with traders.

The institutions of the state are equally diverse. In some countries governments are highly centralized; in others, much power is devolved to local governments.

Figure 2
Sources of borrowing, 1995–96: all households in Nepal



Note: "Other" includes microcredit nongovernmental organizations, rotating savings and credit associations, relief agencies, and other unspecified sources. The paper from which this figure was drawn also shows that poorer households access informal sources more often than richer ones.
Source: Besley and others, *World Development Report 2002* background paper.

And social norms and attitudes toward market transactions are diverse as well. In some countries, bankruptcy means an unshakable stigma; in others, it is business as usual.

Institutions do not need to take the form of formal laws or regulations. They can be informal arrangements, based on norms. These are important in business transactions in both rich countries and poor. Informal institutions are relatively more important than formal ones in poorer countries, and particularly in poorer areas. In Nepal, for instance, informal sources of finance predominate (figure 2), although richer households are more likely to use formal financial institutions. This reflects the typical situation of poorer countries, where most people operate outside the public or formal institutional framework. In such situations informal networks promote exchange.

Clearly, there is no unique path to growth and poverty reduction. The diverse institutional forms that exist in developed markets today have evolved in response to each country's particular history. Political, economic, and social forces mold public and private institutions. For example, in 19th century Japan the Meiji restoration brought with it a wide range of new ideas and new institutional forms. In Europe competition among states was a strong force for institutional change.[3] And politics within countries shaped the nature of their formal legal systems. In many of the poorest areas of the world today, productive institution building has been retarded by political and social conflicts. And in many of these countries formal institutional structures were transplanted by foreign settlers. Yet a key feature of all industrial market systems is a strong state that can support a formal legal system that complements existing norms and a state that itself respects the law and refrains from arbitrary actions.

Building effective market institutions is the central challenge for communities and economies—and that challenge is what this Report is about. It provides a framework for understanding how institutions support markets, what these institutions do, and how effective institutions to support markets can be built.

The Report's approach is pragmatic. It provides a guide for policymakers, by assessing the current research on institutional change and analyzing the experiences of contemporary historical institutional development across countries. It also provides new empirical evidence on institutions and institutional change in developing countries.

Market-supporting institutions do much to promote growth and reduce poverty (box 1). This Report builds on past Reports, especially *World Development Report 2000/2001*, which called attention to how market activity is central in promoting growth and providing opportunity for poor people. This year's Report focuses on what institutions do to promote market development that provides benefits for all—inclusive and integrated markets—markets that provide equal opportunity, that reduce risk, and that enable investment in higher-return activities.

A growing body of research links institutional success (and failure) to development over time and across countries. And a wide range of indicators captures the performance of different, often overlapping sets of institutions. For example, the success of the state in providing laws and the performance of the judiciary and police reflect how citizens and investors perceive the state as respecting property rights. Access to financial services and the sophistication of financial markets reflect how institutions protect the property rights of borrowers and lenders. High levels of corruption reflect the types of incentives that exist for politicians and civil servants to pursue their self-interest over the public good.

Positive relationships between economic development and these indicators of institutional success have been widely documented. But most studies do not establish

Box 1
Weak institutions hurt poor people

Through their powerful effects on economic growth, the institutions that support markets are an important force for poverty reduction. There is also growing evidence that the costs of institutional failure are often felt most by the poorest in society. Corruption is an especially regressive tax, with the poor hit hardest by even small demands for bribes or fees when they want public services.

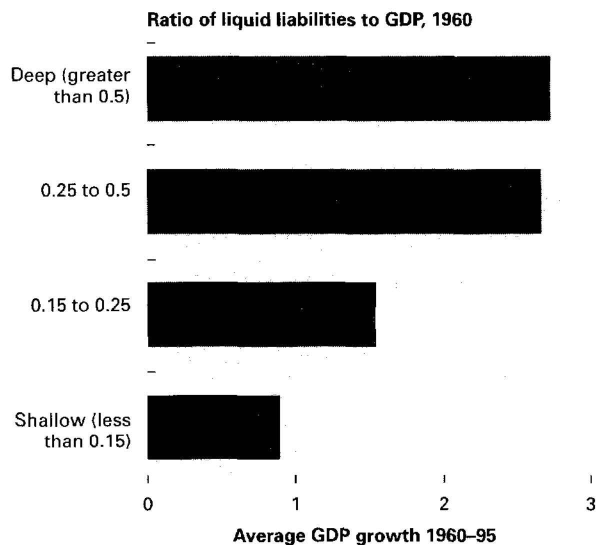
In far too many cases, the legal systems and the judiciary do not serve the poor well, as illiteracy and the inability to pay for legal representation put legal institutions beyond their reach. The failure of the state to protect property often hurts the poorest disproportionately because they cannot afford to take measures to protect themselves from crime. The failure of the institutions of public policy to deliver a stable macroeconomic environment also places greater burdens on the poor.

The poor are often most vulnerable to macroeconomic crises, and cross-country surveys indicate that poor people disproportionately rate inflation as one of their greatest economic concerns. And inadequate access to financial institutions that would enable the poor to save in good times and borrow in bad leaves them more vulnerable to economic downturns.

Nor do private institutions always serve the interests of the poor or disadvantaged in society. Private monopolies often charge high prices for essential goods, where competition would allow broader segments access to these goods. Local informal dispute resolution mechanisms may be biased against some groups. And networks or associations based on social connections exclude those who are not members.

Source: World Bank 2001.

Figure 3
Financial depth generates growth



Note: Figure based on partial scatter from the instrumented cross-sectional regressions in Beck, Levine and Loayza 2000.

links between specific institutions and specific outcomes. Instead, they highlight the wide variety of institutions that support markets. For example, income and the rule of law—encompassing the collective importance of property rights, legal institutions, and the judiciary—are highly correlated. For another example, the development of financial institutions predicts growth (figure 3).

What do institutions do?

To provide a framework that applies across the range of market-supporting institutions, this report cuts through the complexity of institutional structures by focusing on what they do. Understanding what they do is the first step to building effective institutions. Indeed, institutions do three main things:

- *They channel information about market conditions, goods, and participants.* Good information flows help businesses identify partners and high-return activities—and assess their creditworthiness. They also help governments regulate well. So institutions can affect the production, collection, analysis, verification, and dissemination (or withholding) of information and knowledge to participants in and among communities and markets. Examples of institutions that affect information sharing include accounting firms, credit registries, and government regulations on the media to restrict the dissemination of information.[4]
- *They define and enforce property rights and contracts, determining who gets what and when.* Knowing the rights one has to assets and income and being able to protect those rights are critical for market development, including the rights of the private sector in relation to the state. Institutions can reduce the potential for disputes and help enforce contracts. Examples include constitutions, judicial systems, and the full array of social networks.
- *They increase competition in markets—or decrease it.* Competition gives people incentives to do better, promoting equal opportunity. In competitive markets resources are more likely to follow the merits of a project than the social or political connections of an entrepreneur. A degree of competition also spurs innovation and economic growth. But while some institutions facilitate competition, others impede it. By

overregulating the entry of new business, governments can impede competition. And by organizing market activities around a closed group of participants—recall the Maghribis—opportunities for those in the group may increase, even though competition is stiffer, while the opportunities for outsiders decline.

Through these three functions, all institutional structures affect the *distribution* of assets, incomes, and costs as well as the incentives of market participants and efficiency of market transactions. By distributing rights to the most efficient agent, institutions can enhance productivity and growth. By affecting the incentives to invest, for example, through strengthening property rights, they can affect investment levels and adoption of new technology. By delineating market rights, such as through competition law, they limit producer rents and protect consumers from high prices. And by clarifying rights for the disadvantaged in markets, institutions can directly affect the lives of poor people. For example, giving formal titles to poor people whose occupancy rights were not recognized by lenders allows them to borrow and invest.

Effective institutions are those that are *incentive compatible.* Institutions with internal enforcement mechanisms are effective because there is a mutually recognized system of rewards and penalties. An important issue in the design of public institutions is ensuring that the incentives that are created actually lead to desired behavior. Take the example of deposit insurance, which is designed to protect depositors from the risks inherent in financial institutions (chapter 3). Experience has shown that deposit insurance can weaken the incentives of financial managers to lend depositors' funds prudently and can lead to excessive risk taking. In circumstances like this, complementary regulations are required to realign incentives, such as regulations to ensure that bank managers have a significant financial stake in bank performance.

Who builds institutions?

As economies develop, to support increasingly sophisticated transactions, institutions must also evolve. This evolution can come from changes in existing institutions, but it can also come from building or transplanting new institutions. Who builds such institutions? Governments, but also business and community actors and players in international markets.

When governments have built new institutions they have met with varying success. Contrast Poland and Russia in the 1990s. To promote market development, Poland's government moved quickly to clarify property rights between the state and private actors. It imposed hard budget constraints on state enterprises and promoted a dynamic class of entrepreneurs. Russia's government did not develop a clear delineation between private and public institutions—revealed by the continuing soft budgets for firms and widespread tax arrears.

Private interests can build institutions too. They can push for—or impede—institutional change, individually or in partnership. Banks, for instance, have lobbied for tougher financial supervision in Mexico. International investors worked with local groups to push for a commercial court in Tanzania in the 1990s.

International organizations can also be a force for institutional change. They too have had varying success in helping to build institutions well-suited to developing country needs. For instance, they have been instrumental in transmitting knowledge about different institutional designs across countries. But they have also advised on institutional reforms that have not been appropriate for a given country context.

How do you build effective institutions?

Recalling the framework of information, enforcement, and competition, policymakers building institutions need to assess what is inhibiting market development or leading to particular market outcomes. The key is to identify what type of institution is needed, rather than to assume that a particular structure is needed. Policymakers need to ask:

- *Who needs information on what?* For example, do bankers lack information on the creditworthiness of potential borrowers?
- *Are everybody's property rights—and contracts—clearly defined and enforced?* For example, do farmers have enforceable rights to land they use?
- *Is there too little competition—or too much?* For example, is an infrastructure monopoly inhibiting entry, or are firms not undertaking high-return research because they lack safeguards on intellectual property?

Once the institutional gap is identified, the next step is to design the appropriate institution. Both supply and demand factors are important. Moreover, as countries

change and develop, so will the appropriate institution. To be effective, an institution must be designed so that the incentives of market actors are aligned to achieve the desired outcome. Four key approaches toward institution building hold across all sectors and countries: complement what exists, innovate to identify institutions that work, connect communities through information flows and trade, and promote competition.

Complement what exists

Institutions that are effective in achieving their goals in industrial countries can have quite different outcomes in developing countries, which have fewer complementary institutions, weaker administrative capacity, higher per capita costs, lower human capital levels, different technology, and different levels and perceptions of corruption. By knowing how to adapt institutional design to these differences between industrial countries and developing countries when building or transplanting new institutions, or modifying existing ones, policymakers can increase the effectiveness of their institutions.

Regulations for business entry are a good example. In some developing countries, the cost of business registration is very high relative to GDP per capita (figure 4a).[5] The number of procedures required to register a business is also higher relative to that in industrial countries (figure 4b). Such high costs deter entry into the formal sector and reduce competition. Overregulation of business activity is another cost that may add to corruption in developing countries (figure 4c). For instance, a recent study finds that in many African countries, restrictive regulations and practices are often aimed at generating rents for officials and favored private agents or groups, constraining business in both agriculture and industry.[6]

In richer countries, by contrast, enforcement capacity is stronger, and information processing systems are better. So greater accountability for regulators means that regulations do not incur as many additional costs. As another example, judicial procedures for debt collection are very complex in poorer countries, on average, even without adjusting for enforcement capacity. Although some industrial countries also have complex procedures, they also tend to have complementary institutions that foster judicial efficiency. These are institutions, for example, that promote transparency, or incentives that judges and other parties in litigation face to resolve disputes efficiently.

Figure 4a
Cost of business registration (as percentage of GNP per capita) is higher for lower-income countries

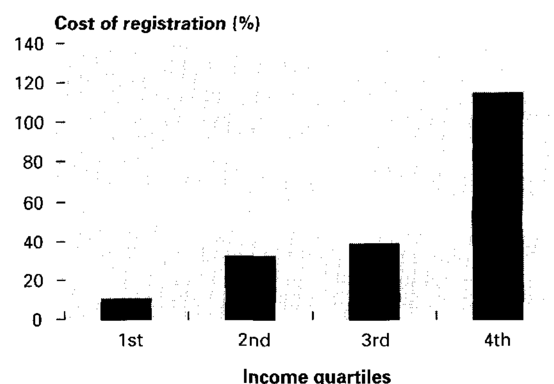


Figure 4b
Lower-income countries have more procedures

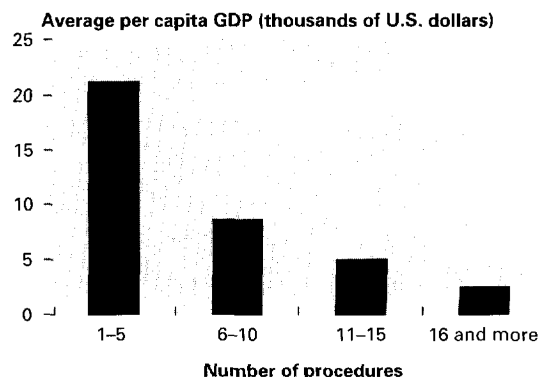
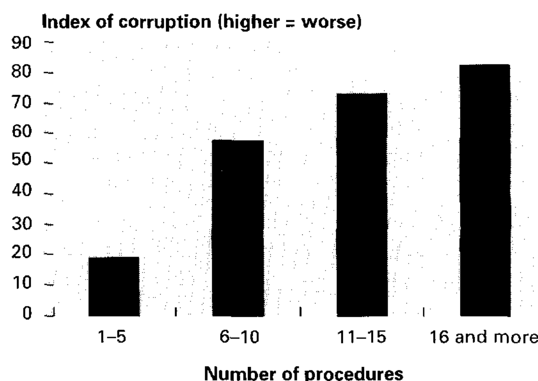


Figure 4c
More procedures are associated with higher corruption



Note: Costs are defined as official fees as a percentage of 1999 GNP per capita.
Source: Djankov and others, forthcoming, *World Development Report 2002* background paper.

Box 2
Private innovation supported by formal institutional change

In Bangladesh an economics professor had an idea—to help poor people help themselves, by giving them small loans to start businesses despite their lack of collateral or credit histories. He started the Grameen Bank in 1976 using his social connections in government to manage a village branch of a government bank. The success of these endeavors led the government to successively change the laws governing Grameen Bank, establishing it first as an independent entity with government control, then as an effectively private bank run by a public official, and finally as an effectively private bank run by an independent board of directors. Today Grameen Bank has branches in more than half the villages in Bangladesh, with over 2 million borrowers.

In Peru another innovative individual began with an experiment. He found that in Lima, it took 728 bureaucratic steps for a person with an informal right to housing to get legal title. He followed up with a 10-year public information campaign, proving to politicians that there was a "hidden consensus for reform" for simplifying the procedures for formalization. Faced with overwhelming public support for simplification, the Peruvian congress unanimously passed legislation to formalize titles. Today, a simple legal procedure for establishing land titles for poorer people works in parallel with the formal system.

These two stories show how the state can work with private actors to promote institutional innovation by directly supporting experiments—or at least by allowing them to proceed and be tested and then, if they are successful, by encouraging their growth. The stories also show the importance of other factors in promoting innovation. Social connections and networks reduce barriers to experimentation. Openness in information sharing provides the impetus to adopt successful experiments.

Source: De Soto 2000; Yunus 1997.

In developing countries, this suggests that simplification of existing procedures may be a way to enhance judicial efficiency.

Innovate to identify institutions that work

Even at similar levels of development, countries differ in many ways—in their norms, geography, and endowments. Innovation is often needed to accommodate those differences in the design of effective institutions. Policymakers need to support the innovations of private agents, replicating local successes and abandoning failures (box 2). Experimentation can help identify effective institutions—but there are also costs related to experimenting with institutional forms and these need to be recognized when making choices.

Because innovation can come from many sources, collaboration by the different actors in society is vital. In some cases greater local autonomy and participation can foster experiments that lead to innovation. Aguas Argentinas, a privatized monopoly that provides water and sanitation services in Buenos Aires, worked with local government, a low-income community, and a nongovernmental organization to create a new organizational form. The community was experimenting with two systems: a low-cost sewerage system and a double water system (with one connection to the network for small volumes of potable water, and another drawing on groundwater sources too salty for drinking but good for washing and bathing). The double water system was dropped at the experimental stage because it was too expensive to develop, while the sewerage system was maintained. And to expand its network for water, Aguas Argentinas took over those systems built at lower costs by the community, giving customers a discount on the price in exchange. In effect, it contracted out part of its work to consumers.[7]

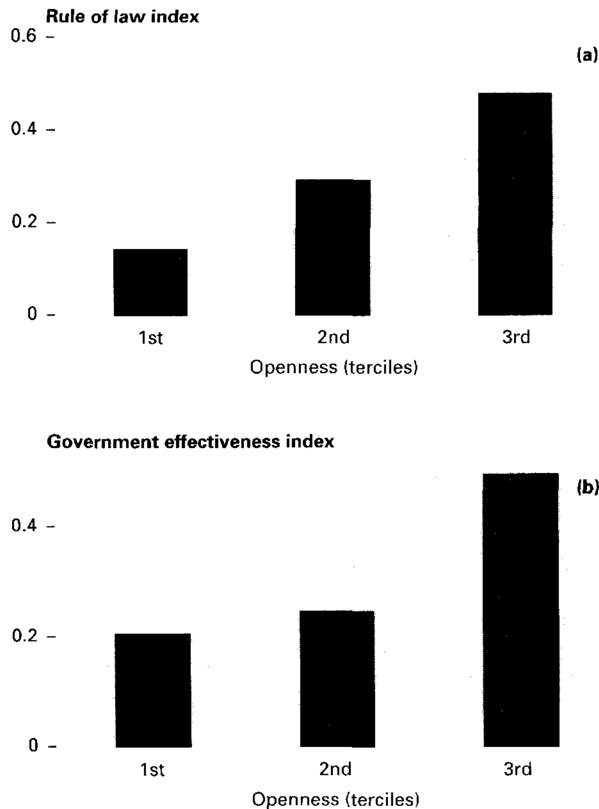
Innovation and experimentation occur on at least three levels: national public policy, private commercial practices, and local action by communities and civil society leaders. Local innovations have the advantage of being able to try many experiments simultaneously—with the successful ones replicated and the failures contained. But not all innovations can be left to local or decentralized communities—since local actions may have consequences across communities. And local elites may capture gains at the expense of others through new institutional forms.

Connect communities through information flows and trade

Open information exchanges and open trade create demand for market-supporting institutions. Open trade does more than enhance allocative efficiency, the advantage typically cited. It exposes:

- Market participants to a larger, more diverse group of trading partners, increasing the demand for formal institutions by domestic and foreign players to provide information and enforce contracts.[8]
- Firms to new technology and new organizational and managerial forms.

Figure 5
Greater openness and quality of institutions



Note: The figures show the partial relationship (after accounting for the effect of differences in the legal systems, ethnic diversity, GNP per capita, years that the country in question has been independent, country size, and inequality of income) between an indicator of rule of law/ government effectiveness and openness for over 100 countries in 1997–98. The countries have been divided into three groups of equal size.
Source: Islam and Montenegro forthcoming, WDR 2002 background paper.

Box 3
Institutional evolution of rice markets and standardization in Japan, 1600–1920s

In Japan's Tokugawa period (1600–1868), local private traders collected and marketed the rice shares of both the *daimyo* (feudal lord) and the peasant. The traders had to be big, since poor inland transport meant that rice was shipped in large sailing vessels and later steamships—a costly and risky venture. When the network of railroads was extended to local areas, locally segmented markets began to form a nationwide market. And with the economies of scale in transport and related risks, small traders could market their rice, using small shipments from many local centers.

The competition among small traders from different rice-producing regions increased the pressure to standardize rice grades. Better and more stable quality and standards ensured higher prices in urban markets. Groups of farmers and traders began taking the initiative by labeling the quality of rice in various regions. By 1900 these voluntary efforts were transformed into official regulations by local government agencies, which began to set standards for the packaging of rice shipped to other regions. By 1910 there were 33 rice-grading warehouses (*beiken soko*), managed by private companies or cooperatives, serving several purposes—inspecting, grading, repackaging, and storing.

Innovations in finance followed. As farmers and traders brought ungraded rice to the warehouse, it issued a "rice exchange note." The precursor to today's inventory credit, these notes were also used as collateral for loans from banks and pawnshops, easing capital constraints for farmers and traders.

More trade among different communities led to the developments of standards, first adopted by private traders and later by government. These early institutional changes promoted new institutions to support market exchange.

Source: Kawagoe 1998.

- Markets to greater competition, inducing institutional change.
- Countries to a different set of risks, possibly creating the need for additional institutions to manage the new risks.

Openness to trade and the exchange of ideas within countries and between countries has served as a catalyst for institutional change throughout history. Open countries also tend to have better institutional quality (figure 5). For example, at the turn of the last century, Thailand became a rice exporter, and the value of rice-producing land shot up. This spurred demand for the clarification of land tenure rights and the development of land registries so that land could be used as collateral. Possibilities for developing countries to export goods, agricultural and other, to developed country markets can strengthen institutions in the former and create the demand for new institutions.

Japan's experience in rice markets shows a similar pattern of institutional development (box 3). Open trade among communities stimulated the development of marketing institutions. The early institutional development originated in the private sector, but government later intervened to further expand the use of these standards and to facilitate trade.

Box 4
The media's role in reducing corruption in Peru

Even in a country with regulatory and informal controls on the press, the media can expose corruption and increase pressure for better governance. In September 2000 a local television station broadcast a video that showed the national security chief bribing an opposition member of Congress in return for voting for the incumbent government. The story spread rapidly in other publications, compounded by reports that the security chief was smuggling arms to Colombian guerrillas. The revelations led to his dismissal and in November 2000 to the resignation of the president. Following these events, the newly elected president announced his intentions to fight corruption.

This shows how the media can change the incentives for corruption for public officials. By providing information to the public, the media increase transparency of government action. The *risk of exposure* of corruption is therefore higher with effective media. The media also help build the public consensus required to fight corruption—creating the public disapproval that presses corrupt agents to resign—raising the *penalties for corruption.*

The open exchange of ideas also drives institutional change. Consider the media's exposure of a corruption scandal in Peru, leading to pressure for institutional reforms to combat corruption (box 4). By providing checks and balances on government and private agents, the media is an active force for change. In some cases the simple provision of information or sharing of knowledge can lead market participants to modify institutional structures. Policymakers play a large role in affecting the quality and flow of information in economies.

Promote competition—among jurisdictions, firms, and individuals

Competition among firms in product markets, among individuals, and among jurisdictions creates demand for institutional change.[9] It changes the effectiveness of existing institutions by affecting relative returns and changing the incentives of agents. For example, as competition in markets increases, traditional norm-based institutions may become inadequate or obsolete.[10] Competition can also reduce the effectiveness of closed groups, such as guilds or business networks, whose existence and effectiveness depend on superior access to such inputs as information. This can create the demand for new institutions or improve the quality of existing institutions by changing behavior. In places as varied as Thailand and Uganda, greater competition for land caused more land disputes and increased the demand for more formal procedures for recording transactions.

Firms competing in product markets, forced to increase efficiency, have the incentive to lobby policymakers to implement institutional changes that can lower their costs. But many existing structures limit or prevent competition. Rules governing entry in markets can limit competition. Competition also affects the distribution of gains among market players, and so increases the demand for institutional change among those who want to maintain their gains in the light of changing economic factors.

Competition can make formal institutions less necessary and reduce the burden on regulators. Municipal and large industrial users of power in Argentina, Brazil, Chile, and Peru enjoy competition from long-distance transmission lines carrying power from different generators—and thus require less regulatory protection. But competition can also complicate the regulation of infrastructure services. Before privatizing state monopolies in many countries, state infrastructure monopolies cross-subsidized poorer customers. After privatization their governments have struggled to balance regulation to protect poorer customers while maintaining the profitability of large providers. New initiatives, welcoming smaller, sometimes informal, entrants into the market can help to reach poorer consumers.

What affects the pace of change?

Institutional changes come from a shifting web of political and social forces. Supporting the existing institutions are constituencies that benefit from the status quo, and the politics of institutional reform demand that these constituencies be compensated for institutional change. Equally important, the effectiveness of institutional designs adopted by governments will be affected by the political distribution of power. For example, strong local governments can support regulatory agencies at the local level.

Sometimes policymakers wishing to embark on reforms may have to create new institutions rather than modify existing ones. Even though institutional change may be desirable, the costs of collective action—including those of information collection, enforcement, and competition—may be so great relative to perceived benefits that they would frustrate the formation of a new political coalition that would push for institutional change. But not all reforms are equally difficult politically. Some ineffective institutions may exist in part be-

Box 5
Institutions for markets and the comprehensive development framework

Since 1999 the World Bank has had a new approach to alleviating poverty: the comprehensive development framework. The framework seeks to improve development effectiveness by balancing macroeconomic requirements with the structural, human, and physical aspects of development.

Four interrelated principles underlie the framework:

- A long-term, comprehensive vision of development requirements and solutions.
- Greater country ownership of development strategies, based on participation and inclusion.
- Increasing the strategic partnerships and coordination among stakeholders.
- Accountability for development outcomes through measurement of results.

Taking a holistic approach, the framework explicitly recognizes the centrality of institutions in the development process. Structural aspects of development—an effective governance framework, a legal and judicial system, a financial regulatory system, and social safety net—are inseparable from macroeconomic, physical, and human factors. Emphasis on this interdependence means that identifying institutional bottlenecks and intersectoral linkages are a core part of sustainable development.

The framework extends to how institutions work. Ownership shifts responsibility for development from international agencies to country governments and their people. Greater coordination between internal and external stakeholders means that institutions must have more consultative processes and more selective intervention.

cause there are no interest groups pressing for change—not because some interest groups oppose change. Or it may be that those who would oppose change do not have much political sway. Whatever the reason, reforms in these areas could be accelerated. And as these reforms breed new constituencies and forces, they can create demand for greater change.

The structure of society—such as its inequalities and ethnic diversity—can also affect the pace of institutional reform. More polarized societies may find it more difficult to establish institutions that benefit broad segments of society. However, these are also the cases where formal public institutions are needed to bridge the gaps between groups with different norms. And in many instances, economic crises engender institutional reforms because they change the impact of political and social forces in the economy. Technological innovation, by changing relative returns to activities, also generates demand for new institutional forms.

As with the Comprehensive Development Framework (box 5), this Report takes a long-term view of development, and focuses on the importance of partnerships and cooperation in the development process. It also emphasizes the responsibility of country governments and citizens in the development process.

Market-supporting institutions are a big topic, for they are everywhere and varied. So much remains to be learned about them. This Report offers some guidance for policymakers distilled both from the history of institutional evolution and from the lessons of recent experience—the varied experiences of the transition economies in the last decade, the struggles in many poor countries around the world, and the successes of some of the emerging economies in the past decades.

The Report does not address all possible institutional problems in all possible fields. Instead, it focuses on sets of these institutions from many fields to show that the framework (inform, enforce, compete) and messages (complement, innovate, connect, and (again) compete) can be applied, regardless of the sector. It does not cover in detail issues that past *World Development Reports* have covered, unless there is new evidence in the field. This Report, one in a series looking at critical development issues, is a natural continuation of *World Development Report 2000/2001,* which discusses the central role of markets in the lives of poor people. It leaves some important issues for *World Development Report 2003,* which will focus on the development of human, natural, and environmental capital, as well as social cohesion and social stability.

Notes

1. Greif 1997.
2. North 1994; Coase 1937; Williamson 1985.
3. North 1993; Pistor and others 2000.
4. The *World Development Report 1998/1999: Knowledge for Development* discusses the importance of information-sharing institutions.
5. Djankov and others forthcoming.
6. World Bank 2000.
7. Baker and Tremolet 2000.
8. Scholars, including North and Weingast 1989, have written about the importance of trade in general in promoting institutional change.
9. North 1993.
10. Andre and Platteau 1998.

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This report is about building institutions that support markets which promote growth and reduce poverty. It analyzes the myriad of institutions—formal and informal, public and private—that people build and use to undertake activities that maximize returns and to manage risk in markets. These institutions range from unwritten customs and traditions to complex legal codes that regulate international commerce on the cutting edge of technology. Some developing countries have been able to harness such market-supporting institutions to improve the welfare of their people, but others have not yet achieved the same degree of success. Drawing on a wealth of research and experience from inside and outside the World Bank, this 24th edition of the *World Development Report* moves toward a deeper understanding of market-supporting institutions and a better appreciation of how people can build such institutions.

Building Institutions for Markets takes a two-step approach to institutional development. First, it contends that what is critical is focusing on the functions that market-supporting institutions provide and how they provide it rather than on particular structures. Looking at institutions in terms of the functions they provide rather than in terms of their structures helps identify institutional gaps. All market-supporting institutions affect both efficiency and distribution by doing three main things:

- Channeling information about market participants and goods
- Defining and enforcing property rights and contracts
- Increasing or decreasing the level of competition in markets.

Second, after identifying the institutional gap, the next step is to build the needed institution. The report goes beyond the recognition that one size does not fit all to develop an understanding of how to think about designing effective institutions in a particular context. There are four main lessons on building effective institutions. The first two are mostly about supplying institutions, while the second two are mostly about first creating the demand for such institutions:

- Design them to complement what exists—other supporting institutions, human capabilities, and available technologies
- Innovate to identify institutions that work—and drop those that do not
- Connect communities of market players through open information flows and open trade
- Promote competition among jurisdictions, firms, and individuals.

Building Institutions for Markets also includes Selected World Development Indicators, an essential reference on recent trends in development. Altogether, the report offers valuable insights and vital guidance for policymakers, researchers, and anyone with an interest in development.

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