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The Role of Institutions in Development

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Economists interpret "institutions" in at least two ways. Institutions can be the "rules of the game" (which provide the context—such as markets—in which actors make decisions), or they can be organizations (typically, systems of nonmarket relations). What is the role of public policy in influencing the rules of the game, and what is its role in public sector economic organizations? Informal conventions and informal rules of the game make institutions function differently than their formal structure might lead us to expect. Governments can intervene and influence the rules of the game, but their interventions should be based on an adequate perception of existing formal and informal arrangements and on processes of adaptation that were under way before intervention was initiated. The literature does not adequately explore the normative arguments for public economic organizations, nor has there been enough rigorous analysis of the causes of public sector failure. Many institutions are dysfunctional in terms of development, however, not because they are inefficient but because their intended purposes conflict with the requirements of economic growth. Diagnosing the causes of good or bad performance by public organizations could provide the basis for exploring a rational public sector organizational strategy.

Which government institutions and institutional interventions seem essential to growth, which can be helpful, and which are likely to obstruct growth? Such questions cannot be answered definitively, and answers cannot be applied universally: the observed failure or success of an institution in one national setting may reveal little about its potential performance elsewhere. But short of a checklist of "good" and "bad" institutions, a good deal of light can be thrown on what should be considered in appraising them. Strong institutional assumptions are often implicit in the design of programs and projects. The logical and empirical basis for such assumptions should be explored, even if the result is far from a cook book of recipes for effective institutions.

I. Institutions: Two Definitions

Two different, although related, meanings are given to the term "institutions" in discussions of development. The first is as rules of the game. The second is as organizations.

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Rules of the Game

The general meaning that informs much of the academic discussion of institutions is captured by Ruttan and Hayami (1984):

> Institutions are the rules of a society or of organizations that facilitate coordination among people by helping them form expectations which each person can reasonably hold in dealing with each other. They reflect the conventions that have evolved in different societies regarding the behavior of individuals and groups relative to their own behavior and the behavior of others. In the area of economic relations they have a crucial role in establishing expectations about the rights to use resources in economic activities and about the partitioning of income streams resulting from economic activity.

Similarly, Feeny (1988) quotes Douglas North (1981):

> Institutions are a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals.

In this definition "institutions" encompass the fundamental rules of the game within which the economic system operates. Economic historians have been particularly concerned with the broad changes in these rules that accompanied the emergence of modern capitalism—for example, the change in land tenure systems, the decline of serfdom, and the emergence of "free" labor.

Such broad issues might seem to have little operational interest for contemporary policymakers. But in fact the institutional context determining access to land, and relationships between farmers, landlords, workers, traders, and moneylenders has been long recognized as critical for rural project design. And the current fashionable concern with an "enabling environment" in which nongovernment actors can contribute to development emphasizes the importance of institutional factors in this sense (see Aga Khan Foundation 1987).

Organizations

Donor agencies tend to define institutions somewhat more narrowly, essentially as synonyms for organizations—government departments, state enterprises, banks, armies, hospitals, and the like (see van Rennin and Waisfisz 1988). Discussions of "institutional development" and "institution building" are therefore typically concerned with how to make organizations work.

The difference between the concepts has some interest from an analytical as well as a semantic point of view. Institutions in the "rules of the game" sense provide the context in which markets operate—influencing both their efficiency and distributive impact. Institutions define the terms under which the various actors in the market confront each other, molding their expectations and defining their rights. In this sense, economists should be very much at home with institutional questions, relating as they do to the central concern of neoclassical economics: the operation of markets.

The institution as organization is another matter. From the point of view of an economist an organization can be usefully defined as an area of activity within which the market does *not* coordinate the activities of the participants. An organization may be externally constrained by market factors, but its internal arrangements are coordinated by nonmarket instruments. Internal decision rules and incentive systems may be chosen to simulate the market, but even then the relationship between the actors is inherently different from that between independent actors in the marketplace.

The principal strengths of neoclassical economics derive from propositions of widespread applicability about markets. Not only is the underlying assumption of maximizing behavior plausible, but also the pressures of competitive markets force actors to perform in ways approximating such behavior as a condition for survival.

The tools of neoclassical economics cannot, however, be readily used to explain behavior *within* organizations. Bureaucratic (or organization) man is not different in inherent motivation or psychology, but the incentives and constraints he faces differ from those facing the actor in the market. (Hence, Israel 1987 seeks a prescription for improving institutional performance by creating a "competitive" institutional character.)

This being so, it is not surprising that early models used in the development of the study of business administration were borrowed from engineering (Turnerism), the military (line and staff organizational structures), and the social psychology of nonmarket behavior (Elton Mayo) rather than from economics, and that subsequent explorations by economists took account of nonmaximizing managerial behavior within the large firm.

The Influence of Informal Factors

In either definition of institutions there are both formal and informal characteristics to be considered. Access to land, tenant-landlord arrangements, and so on may be subject to legal provisions, but they may also incorporate informal conventions and understandings either not incorporated in the law or even at variance with formal legal provisions. And the behavior of organizations with the same formal structure (chain of command, job descriptions, and so on) may vary enormously depending on the informal environment.

Those of us who had the experience of working in the postcolonial twilight know that the operational characteristics of systems changed often when the formal structure did not because informal assumptions altered. Colonial civil servants were bound together by an "old boy" network from "home," informally exchanged information in the club, were little dependent on status in the local society, and had no family responsibilities in the local community. The local bureaucracy were connected by a different "old boy" network (although often a copy of the metropolitan model), were able to exchange information informally in a different social setting, were dependent on local society for status, and were faced with a network of extended family obligations.

Assumptions or expectations of behavior, in general currency but informally based, influence organizational behavior. In a system with little or no corruption, it will be equally difficult to ask for or to offer a bribe; in one where corruption is the norm it becomes routine to ask for a bribe and impossible to conduct business without offering one.

The influence of informal factors makes the transfer of organizational models from one setting to another risky. A particular "success" may be based on a successful congruence between the formal model and the informal setting, or it may even result from particularly propitious informal circumstances actually transcending inadequacies in the formal structure (for instance, charismatic leadership sustaining a flawed organization).

The same formal model may mean very different things in different settings. Cooperatives, for example, with a fairly standard legal constitution, perform quite differently in terms of operational efficiency and distributional consequences not only between countries but even within the same country.

This suggests that the design of programs on the basis of successful models should be approached with caution, be it the Kenya Tea Development Authority, the Grameen Bank, the Uganda Development Corporation (of the early 1960s)—all of which at one time or another have been proposed or used as organizational models. This caveat is particularly relevant for itinerant advisers, who may be well informed about "success stories" but not about the specific origin of the observed success or the relevant informal characteristics of the setting to which the model is to be transferred.

The absence of any single driving force (analogous to the market) determining organizational behavior plus the impact of informal factors on formal structures makes generalization difficult. It is therefore, as Nellis (1980, p. 413) notes, not surprising that early efforts to create a general theory of development administration failed.

The best line of attack, therefore, is probably not to seek out a grand theory of the role of institutions but to sort out the questions about that role relevant to the design and implementation of development programs. This is done here by first considering the general approach of economists to the role of institutions (section II). A discussion of institutions in the two senses defined above follows, with consideration of the rules of the game that influence and constrain the behavior of the various actors in the economy (section III) and of the effectiveness of government organizations (section IV). The discussion concludes with a commentary on the political economy of government approaches to institutional issues (section V).

II. Some Economic Interpretations of Institutions

Broadly, economists' questions about institutions cluster around four themes. The first concerns the origins of institutions. How far can economists offer an endogenous explanation of the origins of institutions? Explanation of origin may in turn relate to the identification of current function, although there is no necessary connection. Institutions may in their actual operation serve purposes quite different from those intended by their creators. Moreover, their role may change in response to a changing environment.

Economic institutions as rules of the game can be seen as defining the terrain over which economic actors maneuver. The second theme concerns how economic actors behave in a particular institutional setting, and how their behavior, as affected by that setting, determines the economic outcomes.

The third theme is normative. How does one evaluate the economic effectiveness of institutions? A straightforward response would be to apply the normal criteria of welfare economics. However, insofar as some institutions exist to meet social objectives which transcend, or are separate from individual welfare maximization, evaluation against individualist, utilitarian criteria is not uncontroversial.

The fourth theme relates to the practical concerns of policymaking. How can institutions be changed to perform better according to chosen criteria of evaluation? Exploration of the first three issues—the origins of institutions, the motivation and behavior of economic actors in the existing institutional setting, and institutional effectiveness—provides a foundation on which to tackle the fourth: institutional engineering.

The initial brief for this conference paper asked what light the various paradigms in economics throw on the role of institutions in development. An adequate answer to that question would demand a long essay on the history of ideas outside the competence of this author, but there is room to locate the issues in the context of at least some economists' ideas. Because, in a Kuhnian sense (Kuhn 1970), most of the literature usually identified in the World Bank milieu as "economics" falls within the neoclassical paradigm, approaches from within that paradigm are emphasized.

The issue of "institutions" was raised by the U.S. institutionalists, following an earlier tradition of the German historical school, arguing that propositions of economic theory (that is, of mainstream neoclassical economics) were highly relative and were based upon unstated institutional assumptions much less universal than implied by the theorizing. "Institutionalism" therefore challenged economic theory in its dominant form.

The Neoclassical Positions

In contrast to the institutionalist view, the "purist" defense of neoclassical economics, set out in great clarity over fifty years ago by Lionel Robbins (1931), defined economics as the study of the interrelation between means and ends through theories of choice of general applicability—potentially useful in exploring economic decisionmaking in all institutional settings. Within that vision, the concept of "institutions" can be applied to aspects of human organization that may be accepted as important but are not the subject of economic analysis as such. Like technology, tastes, or resource endowments, they were seen as exogenous to the economic model—data that influence parameters, constraints, or the definition of a social welfare function without themselves being a subject of study by the economist.

No economist would have claimed that political institutions or social attitudes are unimportant; the argument was rather that in the intellectual division of labor they were not the appropriate subject of study for the economist. The approach might be seen either as modest in the limited scope it claims for economics, or arrogant in its view of "economic analysis" as being sufficient to handle the "hard" issues.

There continues to be a great deal of work—even some practical analysis of policy and projects—within that "purist" tradition,[1] but neoclassical economics has also vigorously developed beyond the overly restrictive boundaries envisaged by Robbins, through what Jack Hirshleifer (1985) has described as "imperialist economics" (an unintended double entendre in this context).

The rational choice approach has thrust neoclassical economics in the direction of issues once considered noneconomic. Thus Hirshleifer quotes Gary Becker (1976):

> The combined assumptions of maximizing behavior, market equilibrium and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach

and goes on to add:

> It is this approach that has powered the imperialist expansion of economics into the traditional domains of sociology, political science, anthropology, law and social biology—with more to come.

This approach has both a positive and a normative element. Positively, it attempts to explain the behavior of a wide range of institutions in terms of the maximizing pursuit of self-interest by the actors in those institutional settings. Normatively, in light of such behavior, institutional performance is evaluated against the individualistic and utilitarian objectives that underpin neoclassical welfare economics.

In the development literature, the rational choice approach has informed the discussion of rent seeking in general and the analysis of state agricultural marketing in particular, and it has been extended to the analysis of household behavior, and so on.

Although its adherents are often drawn from the other end of the political spectrum, rational choice explanations of political and social behavior share many of the strengths and weaknesses of Marxist analysis. In particular, the attempt to endogenize institutional factors through explanations based on a

1. An important part of the thrust of Gunnar Myrdal's critique of the work of economists in Asia was concerned with economists' neglect of institutional questions. It is not difficult to find work equally subject to that earlier criticism.

strong element of economic determinism are shared characteristics of rational choice and Marxist analysis.

At its best, this sort of analysis provides powerful insights into the ways economic actors pursue their interests both through the market and through nonmarket institutions, and how this in turn affects the institutional context in which markets operate. It may, however, claim too much, taking too little account of factors other than the pursuit of economic self-interest that determine political and social behavior.

Another contribution within the neoclassical tradition is the market-failure—transactions-cost approach, which sees the existence and behavior of a number of economic institutions as resulting not from the effective operation of markets but from market failures that require nonmarket institutions (and sometimes nonmaximizing behavior) for their resolution. (On this point, see the discussion of institutions below and Bardhan 1988.)

This approach was developed in the context of the theory of the firm, following R. H. Coase, and has been used to explore such issues as vertical integration and antitrust policy in the context of the U.S. economy (see Williamson 1985, 1986). It has also provided the intellectual underpinnings for a burst of recent literature on rural institutions.

Some economists faced with institutional questions have called on other disciplines for a joint attack on the problem. In some heroic cases, the economist has taken on the task of acquiring the skills of those other professions (see, for instance, Hill 1986). Whether, in practice, multidisciplinary work has typically meant cross-fertilization or cross-sterilization of ideas can be debated. But it would take a very robust imperialist of economics to believe that the economist's tools are uniquely appropriate for analyzing all important development institutions.

Structuralist and Marxist Challenges

In the development debate, the earlier institutionalist criticisms of neoclassical economics were echoed in the structuralist[2] critique. Two observations were particularly influential: (1) that "Western" economics had many implicit assumptions regarding institutions, among other things, that undermined its applicability to economies in the developing world; and (2) that insofar as certain institutional factors constrained the effectiveness of policies, such rigidities had to be either incorporated into the analysis of policy or tackled by political or social reform.

Some aspects of the structural approach have similarities with, or even roots in, Keynesian economics. The structuralist differs from the strict neoclassicist in

2. This imprecise designation covers an enormous potential range of literature. Meier identifies Lewis, Myrdal, Prebisch, Singer, and Rosenstein-Rodan—six of the ten authors covered in *Pioneers in Development* (Meier and Seers 1984) as "introducing elements of structural analysis into their work." See also Furtado (1964) and Seers (1963).

regarding what the latter sees as transitory "market distortions" as fundamental characteristics of the system, for which neoclassical solutions are impracticable, at least in the absence of profound structural change (for a neoclassicist's view, see Little 1982).

Structuralists have been concerned with the persistence of archaic rural institutions (for instance, in the Latin American literature of the 1960s a backward rural institutional structure was seen to inhibit response to price incentives and thus contribute to inflation), which suggests the need for active land reform; with skewed distribution of wealth, which requires active redistributive policies; and with weak entrepreneurial institutions, which justify strong state intervention and protectionism.

Central to the structuralist policy agenda was the need for deep-seated institutional reform. The reforms in question demanded explicit examination of the political conditions in which they would be implemented. But when conducted, such analyses often revealed a pessimistic outlook for the reform agenda. (See de Janvry 1981, p. 146, for a succinct criticism of the structuralist thesis on agricultural stagnation in Latin America.)

Evidently the term "structuralist" as used here covers a wide range of ideas, united more by a common deviation from tenets of neoclassical economics than by a shared theoretical approach. In such terms, much early development economics (say 1945–65) could be described as structuralist (see Meier and Seers 1984). Since the mid-1960s there has been a revival and consolidation of a neoclassical approach to the subject (see Little 1982).

The other main challenge to the neoclassical paradigm is from Marxist analysis. Its strength lies precisely in its holistic ambitions, which have never allowed it to accept the boundaries traditionally defined for neoclassical economics.

Four strands of Marxist thought throw light on the question:[3] (1) the emphasis on the historical setting and the historical process of change; (2) the exploration of the interaction between institutions (superstructure), economic forces (forces of production), and social relations (the relations of production); (3) the focus on class interests and class struggles (rather than individual interest and welfare maximization through exchange); and (4) explicit consideration of the role of ideology.

Yet there is no more unanimity in the Marxist than in the neoclassical paradigm on any of the basic issues facing development economists. Thus Marxism, as much as neoclassicism, can inform both an activist and a deeply skeptical view of the potential role of the state in the reality of the developing world (see Baran 1957). In this regard, the neoconservative critique of the rent-seeking bureaucracy resembles that of Marxists who emphasize the corruption of the

3. The quick characterization of paradigms demanded by limits of space runs the obvious risk of vulgarization. The only way to do justice to each of the paradigms is to illustrate their use in tackling the problems discussed here: for instance, de Janvry's (1981) study of the agrarian questions in Latin America demonstrates the sensitive use of Marxist concepts.

neocolonial state: the pessimism of both is based on an economically determined explanation of political behavior, although for one the mainspring is individual or pressure group interest, and for the other the pursuit of class interest and the international context.

III. Government, Institutions, and the Market

It is by now generally accepted that a critical task of government, neglected in earlier models of economic planning, is to provide the "right" incentives to stimulate and guide the various actors in the economy—though views may differ as to what the right incentives are. A corollary to this view is that development policy must focus on the institutional arrangements that provide the setting in which the incentive system will operate.

Rules of the game which stand out as susceptible to government influence include: (1) rules defining private property rights and their allocation; (2) other rules and conventions governing the relationships between participants in the economic process (for example, those affecting the operation of the labor market); (3) rules and conventions defining the economic role of a hierarchy of social institutions (for example, local governments, trade unions, cooperatives and peasant associations, and churches); and (4) rules and conventions restricting participation in the economic process.

Potential government influence on the rules of the game is illustrated by reference to three important areas: property rights and rural development, institutional pluralism in decisionmaking, and the promotion of entrepreneurship.

Property Rights and Rural Development

Property rights (land rights and their interrelations with other institutional arrangements) have figured prominently in the discussions of agricultural development (Bardhan 1988). Changes in rural property rights, encompassing such issues as the decline (or survival) of serfdom and the enclosure of common land, have been central concerns for the historian, whether the neoclassicist exploring responses to changing economic opportunities and factor scarcities or the Marxist for whom relations of production in the rural sector are seen as defining the mode of production. Two questions particularly intrigue economists: (1) Why do differing property rights emerge to provide the framework within which economic decisions are made in rural areas? (2) What are the relative merits of alternative systems on both efficiency and distributive grounds?

One view is that, on the one hand, economic development has meant the displacement of one set of rural property rights by others more adapted to the emerging economic requirements, whereas, on the other hand, existing arrangements can and should be improved both in efficiency and distribution. This view has fueled the argument for rural institutional (land) reform. In reaction, the rationale of existing institutions has been explored to question whether they are as atavistic, inefficient, and disequalizing, as the reform agenda implies.

Property rights determining access to land are part of a complex of institutional arrangements providing the context for rural economic activity. These include institutional arrangements determining labor contracts and access to land, credit, and commodity markets; that is, the set of rules and conventions that define the relations between the various actors in the rural economy. A critical analytical concern is with the interlinkages between markets. Thus neoclassical economists have explored such institutions as sharecropping as part of a more general attempt to understand the role of property rights in light of transactions costs, or alternatively under conditions of imperfect information in interlinked factor markets. For the Marxists, the critical characteristic of the changing labor market, the emergence of "free" labor, is related in turn to changes in access to land and the expansion of commodity production.

There is a body of empirical literature which provides useful insights into the effectiveness of rural institutions. But the neoclassical theoretical literature has recently become so complex that it yields little policy guidance for the applied economist, other than that existing institutional arrangements are likely to be a good deal more complex, and their efficiency and distributional implications less straightforward, than at first sight.

It is particularly tricky to establish the actual status of rural institutions (see Feder and Noronha 1987). The concept of property rights in land is far from clear cut: often the requirements of rural economic activity lead to the useful development of a range of differing property rights relating to differing attributes of land; de facto practice may vary greatly from the de jure system; and the national system of statutory laws may coexist with local law and customs. The likely impact of statutory reform is therefore particularly hard to predict, since it is both difficult to delineate the existing structure to be replaced and even harder to forecast the de facto outcome of de jure proposals.

Thus while there has been a widespread presumption that a movement toward securely held registered title is economically desirable, recognition of the problems involved has been slower to emerge. For example, conferring land tenure rights on sedentary agriculturalists (already apparent occupants) may disrupt a system of pastoral seminomadism, based on rights of passage and of dry season grazing, which represented a sophisticated response to a particular ecological problem. Likewise, the allocation of land rights to an individual may misinterpret and disrupt arrangements within the family (displacing the rights of women, for example).

Views on what the best institutional structure may be for fostering growth vary and change; indeed, research on rural institutions seems to be widening the range of debate, as institutions earlier seen as barriers to progress are rehabilitated in light of a more sophisticated interpretation of their function.

Theories of endogenous institutional change, which argue that the institutions that provide the framework for the market tend to adapt themselves to changing market conditions, such as changing factor scarcity and relative factor productivity, suggest that informal institutional arrangements are likely to adjust to new conditions even without official sanction. This suggests that one official task should be to adjust formal rules to accommodate changes under way so as to improve the certainty of transactions by making them official. But there are dangers: formalizing informal arrangements—for instance, through land registration—will have its own effects, by shifting the access of different economic actors to the formal system—for instance, through land grabbing.

Institutional Pluralism

The rules of the game, besides defining property rights and acceptable contractual relationships, also define how and by whom the rules themselves are made. A recent collection of essays on institutional analysis and development (Ostrum, Feeny, and Picht 1988) argues that the institutional choice should be presented not as a dichotomy of state or market but as a pluralism of possible contractual relationships, both explicit and implicit. To quote (p. 456):

> Systems of governance can be constituted by conceptually simple but socially complex configurations of implicit or explicit contractual relationships. There is no theoretical reason why there must be a single centre that has exclusive authority to formulate and enforce rules in a society.

The volume is in the tradition of U.S. pluralism, favoring a diversity of social institutions as the desirable base for a democratic order, with a place for initiatives from many levels of society and not providing central government with undue concentration of power. Systems of decentralized decisionmaking and control might bring to bear user pressures as stimuli to performance not possible in a centralized bureaucracy.

Skepticism about the concentration of power in centralized institutions is not confined to neoconservatives: on the left, popular participation, workers' and peasants' movements, and other forms of grass-roots mobilization are seen both as virtues in themselves and as mechanisms to make institutions responsive to local conditions and needs.

Of course, while decentralized institutions may be more susceptible to local participation and control, by the same token they may be captive to the local structure of power. The drawbacks of centralized power—insensitivity to local needs and ignorance of local capacities—have their counterparts in the skewed access that can arise from local systems of power and prejudice.

The Promotion of Entrepreneurship

Another area to explore is the possible impact of government molding of the rules of the game on entrepreneurial initiatives. While not all would share the Schumpeterian view that entrepreneurship is central to capitalist development, entrepreneurial capacity is clearly important, and particular development successes seem to be associated with a concentration of entrepreneurial flair or capitalist "animal spirits."

Given their pivotal role in capitalism, entrepreneurship and entrepreneurial institutions would be expected to be central in neoclassical treatments of development. Yet entrepreneurship has found a more prominent place in the work of economic and business historians (see, for example, Iliffe 1983) than in the neoclassical theoretical tradition. This lack leaves at least some free market advocacy with a strange lacuna: the market sets the stage for successful private initiatives, but it is unclear from where the cast of characters is to be supplied.

The lack of an endogenous economic theory of entrepreneurship has made this an area in which economists have often been willing to traverse the multidisciplinary route. And in practice folk wisdom, which identifies particular social groups as being "entrepreneurial" in culture, is often influential. But folk characterization, and even learned identification of entrepreneurial groups, tends to be based on ex post recognition of performance. Stereotypes change very fast with changes in performance (see, for instance, Elkan's (1988) contrast of Tawney's negative characterization of Chinese entrepreneurship in 1932 with current perceptions). What is lacking is a good *predictive* model of entrepreneurial capacity to bring out ways of enhancing entrepreneurship through policy measures.

Theories that emphasize deep-seated psychological or cultural characteristics (see, for instance, McClelland 1961) do not seem particularly relevant for policy, as these variables are unlikely to be subject to policy influence over any useful time horizon (though McClelland's psychological interpretation of entrepreneurial capacity was incorporated in business training in India and elsewhere).

Are there specific ways in which government can influence the institutional context of entrepreneurship (other than the obvious panoply of economic policies and commercial laws that determine the broad incentives and constraints)? Elkan (1988) broadly concludes that there is none: the best policy is laissez-faire.

An acceptable role for private entrepreneurs is defined both by formal rules and informal signals. Here, not only the stated intentions of governments but the outcomes expected by the entrepreneurs are important. One interesting historical insight relates to the entrepreneurial role played by cultural, ethnic, or religious minorities, whose entry into certain entrepreneurial areas may be restricted but who, by the same token, in being politically excluded from easier avenues of advancement, are sometimes stimulated into a risk-taking innovative role.[4]

These considerations could lead to a bizarre (dialectical) conclusion about the virtues of discriminating *against* potentially entrepreneurial groups. More seriously, it would be interesting to know what conditions would be conducive to a nice balance in which a minority, pushed into entrepreneurship, is nevertheless

4. The East African Asians, for example, have had repeated experience as a minority community, first under British colonial rule, then in independent Africa, and now in Britain and North America, and have shown a high degree of entrepreneurial ingenuity in all three situations. At the same time, of course, the culture of a minority group may be more or less consistent with taking on a successful entrepreneurial role.

sufficiently accepted to be allowed to play the part effectively, and secure enough to take a long view of investment opportunities—as against a common situation of insecurity in which suspicion engenders precisely the short-term, capital-exporting behavior that reinforces the initial suspicion.

The view that entrepreneurship is likely to appear when other avenues of advance are blocked relates to two other observations. The first is that entrepreneurship often seems not to be highly correlated with formal educational achievement, in part because the able but uneducated are excluded from more secure avenues of social advance. Second, crises that erode bureaucratic incomes and frustrate the expectations of the educated elite may call forth considerable entrepreneurial response. This seems to be the case in the recent experience of a number of African countries.

Strangely, Marxist and related literature has tackled the long-term institutional issue of capitalist development more explicitly than neoclassical writing. The main thrust of the Marxist (and dependency) literature is to see the development of national capital and multinational enterprise as essentially antagonistic—with indigenous capital trapped in a stunted, essentially comprador role (see Baran 1957). In some Marxist writing this comprador role is extended to the state sector (Shivji 1973). But the opposite view has also been expressed in the Marxist literature (see Warren 1980; Sender and Smith 1986). It has been suggested, for example, that multinational business supported indigenous capital in the colonial period (as compared to settler colonialism; see Cowen 1979).

The propositions of neoclassical economics are most strongly developed in relation to the virtues of liberal international commodity markets. While no doubt for most neoclassical economists, the commitment to freely operating markets would extend to capital markets, there are different issues involved from those related to free trade in commodities. Albert Hirschman (1969) made the interesting point that quite different issues are at stake when a country specializes in the supply of one factor of production, labor, than when it specializes in producing a particular commodity.

The assumption implicit in much pro-free-market analysis is that there is a potentially complementary and supportive relation between multinational business and indigenous private enterprises, while in contrast the relation between state and private enterprise is likely to be competitive and antagonistic. Hence an institutional choice must be made between state and private enterprise.

Such a view is not, however, necessarily consistent with rent-seeking interpretations of political processes, which could equally well suggest that public corporations are likely to be responsive to private interests either bringing pressure through the political or administrative process, or engaging in commercial manipulation to gain access to potential rents. A large scale public sector, even if conceived in the context of a transition to socialism, can as well provide one path toward capitalism, depending on the role of the state system vis-à-vis incipient national capital.

IV. Government Economic Organizations

The discussion in *World Development Report 1983* (World Bank 1983) on "Management in Development" described the role of the state as follows:

> Some economic activities are universally recognized as the sole responsibility of the state; others, it is widely agreed, are best left to private initiative. Between these extremes governments have tended to expand their sphere of activity for a variety of reasons.

This statement implies some consensus about the state role in a considerable range of activities. Such consensus may exist from time to time, and in particular countries, but it often changes when big political shifts occur. In Britain, for example, there have been two major shifts since World War II.

Even activities on most "commonsense" lists of state responsibilities may in practice be far from universal state monopolies. Cases in point are police services, supplemented in many countries by booming private security services, and postal services, virtually displaced in some lines of business by private courier services. On the other hand, international experience yields examples of government involvement in virtually all areas of economic activity.

The origins of public economic organizations are extraordinarily diverse. Some spring from a systematic initiative to extend state influence; some emerge to handle problems of private bankruptcy, or as vehicles for political patronage; and aid donors themselves sometimes generate new institutions as a conduit for external funding. Many have probably been created for conventional reasons—in the colonial period, for example, reflecting metropolitan practice as much as local requirements or local interests. And perhaps as important as their origin is the tenacity with which public institutions, once created, defend their own survival (on this topic, see Bernard Schaffer, quoted in Lamb 1985).

Thus there is a wide diversity of government economic organizations. Among the reasons for this diversity are political factors, both ideological and, more prosaically, those that respond to the day-to-day needs of the political system.

It is surely a mistake to avoid recognizing this openly, by presenting the issue as largely technocratic—particularly since shifts in the international climate of opinion on this issue reflect shifting political winds in the industrial countries.

Nevertheless, the question of the appropriate form and role for government economic organizations cannot be sidestepped as simply political. Good or bad performance by government organizations is critical to growth, and particularly important for aid donors, because these organizations are the preponderant channel for aid. Despite the difficulties, the task of improving the performance of public economic organizations must be confronted.

The messy array of issues is tackled here by addressing three sets of questions: (1) What are the arguments for the existence of public economic organizations? (2) How should aid donors relate to institutional performance? (3) What are the factors that influence performance?

Arguments for Public Economic Organization

The most widely accepted role for public economic organizations is that of supplying goods—such as road services, public health, and agricultural extension—that the market cannot supply efficiently (because of externalities, the "free rider" problem, natural monopoly, and the like).

A second function, argued for specifically in relation to development, is for government enterprise to supplement an inadequate supply of private entrepreneurship: to demonstrate the viability of an activity so as to encourage involvement by nongovernment actors. Government enterprise here is seen as necessary to reduce the risk, lower the cost, and increase the profitability of private ventures in the context of economic backwardness.

A third view sees government organizations as an instrument for the transfer of surplus—in effect to tax or subsidize (for example, through agricultural marketing boards or state cigarette, match, and liquor monopolies). Here the justification may be administrative—that without the involvement of government organizations, the tax system would be inadequate to achieve the desired result. More cynically, it is easier to tax agriculture under the guise of providing a service, or stabilizing prices, than through overt levies.

A fourth function of public sector economic institutions is to further some policy intended to affect patterns of property holding in a society—either to encourage a general commitment to social ownership or to shift the balance of property ownership between different national or ethnic groups.

There are also regional arguments for public economic institutions, in the two different senses of promoting the development of backward regions or promoting cooperation between different nation-states in a regional grouping.

Other arguments could be listed, but these five encompass the main economic justifications for government economic organizations, and as such provide a basis for judging what is to be done about the complex array of them that exist.

Where there is a need that cannot be met by the market, the task of achieving efficient nonmarket economic management solutions must be confronted. That the state *should* undertake an activity does not guarantee that it will be able to do so effectively.

Where the objective is to change the balance of property ownership or the distribution of income, different lines of reasoning are possible. One possibility is that public economic organizations be subject to the market, along the lines of the Lange-Lerner model of market socialism: public managers having to respond to the market on the same terms as private managers, the public interest being that of a shareholder, and any deviation from a "pure" market solution being handled by explicit public subsidies or taxes.

Alternatively, the option of government intervention to achieve the intended result without the existence of a public economic organization could be explored—taxing, subsidizing, licensing, private ventures—or where the objective is wealth redistribution a once-and-for-all reallocation among private economic actors might be seen as an alternative (as in some land reforms).

Donors and Institutional Performance

Some governments command public economic organizations capable of implementing the government's intentions, others not. Bureaucracy may be reasonably effective in one ministry, parastatal, or sector, and quite ineffective in others. Why? And what determined changes in performance over time? For an institution such as the World Bank, acting as it does primarily through government institutions, appropriate answers to these questions are crucial, and errors of judgment in assessing administrative capacity are probably as important a cause of project failure as mistakes of economic calculus or technical design.

Israel (1987), analyzing the evidence on institutional performance from the World Bank's own project experience, found that institutional performance varied more across sectors and activities than among countries. He summarized the record as follows (p. 4):

> The most successful were found in industry, telecommunications, utilities and finance; the least successful in agriculture, education and services. Within institutions, technical and financial activities fared the best, while maintenance, personnel issues, and co-ordination were the least successful.

The study recounts the piecemeal explanations of differential performance found in the Bank's own operational evaluations and, finding them wanting, identifies two factors which he argues are decisive in explaining institutional performance in practice: "specificity" and "competition." Specificity is defined in terms of concreteness of objectives, means, and rewards, and the immediacy and transparency of the effects of an activity. Competition covers the influences that impel an organization to improve its performance. These are seen as including market pressure but also encompassing pressure from clients, beneficiaries, or suppliers, from the political and bureaucratic establishment, and from internal managerial measures to stimulate a competitive atmosphere within an organization.

Israel uses the empirical record of Bank projects to draw some plausible conclusions about ways to improve the performance of most institutions. But there are problems with using this evidence to judge the appropriateness of public institutions.

The first is that the evidence seems to suggest that institutions that work best more or less approximate to a modern industrial plant. Thus plantation projects in the Bank portfolio have worked better in Africa than projects that support smallholder agriculture.

Unfortunately, this does not tell us whether plantations or smallholder agriculture are the more reasonable vehicle for agricultural development in Africa. Smallholder agriculture might be (and, indeed, I believe is) superior on both efficiency and distributional grounds, although it does not respond readily to direct public institutional interventions. The fact that "modern institutions" have the characteristics of specificity and competitiveness does not mean that the best growth path is found by emphasizing such institutions, any more than the fact that wealthy countries are industrialized means that at a particular moment industrial investment should be emphasized.

A second problem is that the identified characteristics of effective institutions and the characteristics of institutions that would be considered appropriate for public sector attention often do not match—for instance, it is in the nature of some public goods that their supply lacks specificity. One is left with the awkward conclusion that the public sector is in part the residual legatee of activities that do not lend themselves to effective institutional performance.

But this need not be so alarming, as some of these activities may be quite satisfactorily handled by governments, even if they do not respond to systematic efforts to improve productivity, nor are plausible candidates for external assistance. Even though primary education is a low-specificity, low-competition activity, in most countries it is done quite well, sometimes in extremely difficult conditions. But there is no very good reason for external funding to be mobilized for primary education (except for textbook production—which can be organized in ways to meet the Israel criteria).

This brings out an important point that is sometimes overlooked: there is a difference between a worthwhile organization or activity and one that is an appropriate object for external assistance. The institutions that can productively use external support form a specialized subset of the group of viable or potentially successful institutions. Analysis is required at two stages. Is a public economic institution desirable, or likely to be effective? If so, is external assistance required, and does a candidate-funding institution have the competence (comparative advantage) to supply that assistance?

Evaluating the institutional performance of aided projects is tricky. Elaborately designed externally funded projects sometimes fail because they demand an unattainable level of managerial performance. And those that succeed might do so because they divert scarce managerial talent from other activities. If so, there are hidden costs, particularly where the response to a weak implementation structure is to use external funds to set up parallel institutions.

A Summary of Factors Affecting Performance

A bureaucracy can only be as effective as the tasks delegated to it allow: if it is called upon to undertake economic management tasks that are incoherent or inconsistent, and generate considerable potential rents, it is not surprising if its effectiveness or honesty is impaired. Declining institutional capacity can result when the state's efforts to control economic activity are overextended. Administrative performance is also likely to be correlated with a realistic system of material incentives, and with a decision system within the administrative structure that is able to locate responsibility and reward effective performance.

However, the capacity, loyalty, and honesty of bureaucracies vary for reasons that are not simply to be explained by material incentives or the availability of "rents." Organizations, including private businesses, survive because they can command a loyalty beyond what can be induced by the material incentives of a strictly market transaction.

In this regard, professionalism can be an asset to be used by public institutions. The continued delivery of some public services under the most appalling conditions is evidence of that. A professional ethic of commitment and service can generate performance in excess of that explainable by material incentives. The university at which this paper is being drafted survives, for example, through a combination of economic ingenuity and professional commitment of its academic staff in the face of a collapse in real salary levels. This is not to say that professional commitment is an inexhaustible asset, nor that professionals are impervious to material conditions. It would, however, be of interest to consider the conditions under which professional commitment can be created and nurtured, and those under which it is likely to be eroded or destroyed.

Understanding factors that affect the morale of organizations is the province of sociologists and management specialists. In practice those concerned with economic policy and the design of programs have to react to the observed operational capacity of organizations. Where there is weakness, the crucial judgment will be whether performance can be raised or not, which in turn depends on the diagnosis of sources of poor performance. Many explanations of organizational failure fall into three categories: the inadequacy of available inputs, inherent incapability, and avoidable inefficiency.

The inadequacy of available inputs. An example of the inadequacy of available inputs is that organizational weakness is often attributed to a lack of trained labor and weak management. Certainly many countries have labor shortages, and the case for training and technical assistance is unassailable—presumably most organizations in the world would perform better with more qualified personnel, and superlative management might make the most hopeless venture viable. But, after two or more decades of training and technical assistance, shortage of high-level labor is no longer so obviously the problem. For donors there is a real danger that inadequate labor supply is an attractive diagnosis because apparent cures (technical assistance and training) are readily at hand.

Inherent incapability. There are some economic tasks that public institutions may be inherently ill-adapted to handle—in particular, activities requiring decentralized risk-taking (some forms of agriculture; shopkeeping), combined with the need for considerable labor commitment. But this is no more than a casual observation. Unlike market failure, analyzed exhaustively by economists starting from the assumption that market solutions are best unless proved otherwise, "public institution failure"—identification of those activities that public economic organizations are not, a priori, likely to be able to handle efficiently—has attracted remarkably little systematic examination.

Such factors as risk, economies of scale, and standardization of the process determine the comparative advantage of public institutions. This is of some interest to donors, as the same question could be asked of their own interventions: what determines donor comparative advantage?

Avoidable inefficiency. Many activities that are properly the province of public institutions are not performed very well because of poor management. Available trained labor is used badly because of poor incentives, inefficient organization of work, inappropriate delegation of responsibility, and inadequate accountability.

Inherited civil service practices were often poorly designed to manage public economic activities in the first place and have deteriorated further under economic stress. Examples are rare of decisions to expand the role of public economic institutions that have been matched by adequate consideration of the managerial requirements.

Indeed incentive systems are often so poorly constructed and managerial practice so evidently inadequate that it is often surprising that public institutions work as well as they do. This makes it hard to use the empirical record to assess the intrinisic value of an organization, since more effective performance might be achieved with perfectly plausible managerial improvements.

V. The Political Economy of Public Institutional Interventions

The most telling case against many institutions is not that they are technically inefficient or poorly managed (although they may be) but that, in the political and administrative reality in which they operate, they end up pursuing objectives inconsistent with development.

For example, there are two quite distinct strands in the criticism of marketing boards in Africa. One is that they are expensive and inefficient, perhaps inevitably so. They are dysfunctional because they place a burden of bureaucratic overhead costs on the farmer. A quite separate argument is that their basic objective is to shift the terms of trade against agriculture, serving a political economy weighted against the farmer (see Bates 1981).

In other words, one must go beyond the assumption that government institutions are by definition pursuing the goals of national development to explore what determines the interests organizations work for in practice. This proposition applies as much to international institutions, and to bilateral donors, as to institutions in the recipient countries. "Interests" can relate to the play of foreign policy concerns of states, sectional economic interests brought to bear on aid programs, and the interests of aid officials, departments, and agencies in perpetuating their roles.

The view taken of the determinants of government behavior obviously influences normative judgment about the role appropriate for government institutions. One "rational choice" approach to the political economy of public institutions emphasizes "rent seeking" as a powerful motive force. If the main determinant of government behavior is pressure from rent seekers, it is not difficult to support a strategy of liberalization through confronting or buying out the vested interests in question (see Lal 1987).

A more structuralist (but still normative) view might explore the issue of market failure in a dynamic context, defining the appropriate role of government as promoting desirable structural change which would not spring from the unhindered play of market forces.

In the era of structural adjustment and privatization the view that the state needs to play an interventionist role in a backward economy is not fashionable, despite its respectable intellectual antecedents. And the question remains why governments would take on the task of structural transformation expected of them, rather than just using the vocabulary of "development" to cloak the practice of "rent allocation."

There is no simple answer to that question. Kleptocracies in which those who run government seem largely concerned to enrich themselves are not rare, but then again they are not typical.

Where the political process is such that leaders must satisfy competing interests to remain in power, the question to be addressed is the circumstances in which those interests coincide with a "developmentalist" rather than a parasitic rentier strategy (see Bates 1988). If leaders are more secure and enjoy some autonomy in decisionmaking, they will be much freer to make choices without reference to the short-term interests of pressure groups.

The counterpart in Marxist theory for the neoclassical concept of "rent" has been the role of "surplus" in the "accumulation process." Surplus is seen as a typical and necessary component of capitalist development, not as a transitory rent resulting from a deviation from an abstract, optimal rent-free equilibrium. The issue to be addressed is in what circumstances are surpluses likely to be channeled to productive uses. The purpose of many public sector initiatives could be seen not so much as creating rents as shifting the control of surplus from one group to another—for example, from multinational corporations to national hands, or from one national group to another.

In these terms, Marxist analysts might be roughly in agreement with neoclassical rent-seeking theorists about the interests served by particular policy initiatives, but the interpretation would differ in at least one profound respect. For the Marxist, state interventionism is understood as necessary to capitalist development. Whether capitalist development can succeed depends on whether the political and economic process is such that the surplus is at the disposal of national capital—either state or private—and as a result is used productively, or whether it is transferred outside the country or flows to domestic groups incapable of making productive investments.

John Kenneth Galbraith (1987) claims:

> Japanese who become business executives and high civil servants frequently began their lives as Marxists. There is no serious expectation of revolution, but the Marxian influence does have a significant consequence: it relieves

> Japanese economic and political thought of the notion of a social dichotomy, even conflict, between the market economy and the state, a theoretical conflict that has a strong hold on all American and British economic thinking. In Japan the state is indeed, as Marx held, the executive committee of the capitalist class; this is normal and natural. The result is an accepted cooperation between industry and government . . . that is unthinkable, to the extent that it is not thought subversive, in the American and British tradition.

Irrespective of whether this is an accurate description of the intellectual formation of the Japanese elite, the ideas are intriguing.

Examining the determinants of government policymaking leads into a related question—what are the political and institutional prerequisites for implementing a particular economic policy regime?

Advocates of free markets sometimes associate economic "freedom" with political freedom. There seems little empirical basis for such a view in poor countries where, often, the inequalities associated with freely operating markets and the austerities required for market-based macroeconomic solutions are as likely to be associated with authoritarian control as with democratic processes.

As a corollary, where pluralistic or fairly open political processes stand in the way of "correct" economic policies (removal of subsidies, devaluation, and so on) such policies could either be not politically sustainable or imply a change in political regime, which should be understood as an integral part of the policy package.

Normative assessment should take account not only of the impact of government institutions on economic outcomes, but also of the impact of economic developments on the evolution of institutions. Public economic institutions are not just to be seen as good or bad instruments for achieving an economic policy goal; they are also active in the choice of policy goals. As part of the social fabric, an institution may be seen as good or bad in itself, or in terms of social objectives not translatable into economic calculus.

The concept of "rent" depends on the acceptability of criteria for the definition of rent-free, earned factor income, in turn dependent on a view of policy as being concerned with maximization of individual welfare. While that provides a powerful tool for much policy analysis, it does not provide a basis for evaluating all social institutions.

There are also nonmaterial determinants of policy, which are not handled very well by neoclassical or Marxist analysis. Ethnicity, religion, and nationalism are much more influential than their place in the policy literature implies. This is conspicuous in dramatic events such as the breakup of Pakistan, the expulsion of the Ugandan Asians, the displacement of European farmers from the Kenya White Highlands, the recent conflict in Fiji, and the conflict in Sri Lanka; less obvious are the tensions from similar causes that underlie an often hidden political agenda in a much wider range of countries. Likewise, the relative ethnic and cultural homogeneity of the sucessful East Asian economies may be a crucial factor in their performance. Yet economists neglect these ethnic, religious, and nationalist influences, important and wide-ranging as they are. Partly, in the official literature, this is a matter of etiquette. But it is also true that economists find such matters hard to handle. Neither neoclassical economics, with its emphasis on individualism, nor Marxist economics, focusing on class interest, are well geared to analyze economic behavior motivated by awareness of ethnic or religious identities.

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PROCEEDINGS OF THE WORLD BANK ANNUAL CONFERENCE ON DEVELOPMENT ECONOMICS 1989

Comment on "The Role of Institutions in Development," by Van Arkadie

John Nellis

Professor Van Arkadie's paper presents useful, nonobvious reflections and insights on the relation between institutions and economic development. His analysis of a range of problems confirms that the topic is at once difficult and worth wrestling with.

The first problem, cogently confronted in the paper, is the breadth of the concept of institution. At the more concrete and applied end of the spectrum is the notion of institution as a synonym for organization: a power company, a department of a ministry, a development bank, a project management unit. When governments, the World Bank, and other donor agencies speak of institutions, this is normally what they mean. Analyzing the capacity of such organizations or institutions, diagnosing their deficiencies, and proposing reinforcing or corrective measures—this has been the standard practice of "institutional development," at any rate in the World Bank.

But there is a quite distinct, more abstract definition of institutions: as rules of the game—patterns of norms specific to a society, "compliance procedures" that lend predictability to expectations and, in Professor Van Arkadie's words, define "the terrain over which economic actors maneuver." Examples of these broader sorts of institutions are land tenure patterns, property rights, and legal systems. Less easy to define and far less easy to reform, these institutions are nonetheless profoundly important.

Thus, the analyst of institutions is confronted at once by the nitty-gritty of diagnosing deficiencies and changing detailed management and production procedures at the level of the firm, *and* by sweeping, near metaphysical issues such as the extent to which cultural variables influence economic outcomes. Conclusion one: the topic is enormous.

The second problem is that the question in its entirety lacks an analytical method, a conceptual framework capable of rendering it coherent. There is no organizing mechanism, such as the market, to order the different portions of the topic. Certainly, there is a lot of thinking going on, both in and outside the discipline of economics, to derive or construct such a device, and reams of paper have been produced on what is called "organizational economics," on public

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choice theories, analyses of transaction costs—various strands of "the new institutional economics." So far, by their own admission, they have produced a metaphor—suggestive, admittedly productive—but nonetheless a "metaphor for organizing thinking about technological and institutional change" (Feeny 1988, p. 162). Metaphors may be a necessary starting point, but: "If institutions matter—if they affect the performance of an economy—then . . . a theory of economic change must include a theory of institutional change" (Feeny 1988, p. 161). I believe the author and I would concur that we do not yet have such a construct. Conclusion two: the theory of the topic is underdeveloped. Whether it is "developable" remains to be seen.

The third and principal problem, very well handled in the paper, is that despite its intractability, the topic's importance is incontestable. And probably growing. The paper correctly notes that internal and external observers, from all perspectives, left, right, and center, are critical of institutional performance in developing countries. Criticisms now extend to all types of institutions, homing in more and more on the need to deal with and reform the broader, less tangible institutions—for example, the overwhelming need to ensure the enforceability of contracts; to establish operational notions of property, and how it can be used, consumed, and exchanged; the need to break the hold of excessive, counterproductive regulations, rent-seeking or otherwise.

I welcome Van Arkadie's insistence that the issue is not going to go away. It cannot be set aside by economists with the reductionist claim that institutions and their impact are someone else's concern; it cannot be ignored by developing-country governments that face increasing pressures to deliver a modicum of services to their populations; it cannot be overlooked by the World Bank in the hope that we can take the high road of defining policies and leave it to someone else—the borrower governments? the bilateral donors?—to implement them. So, a third conclusion: we in the Bank are in this messy business for the long haul, irrespective of whether we continue to emphasize adjustment or find our way back to primarily investment lending. Thus those who might prefer their development economics unsullied have been overtaken by events.

In illustration, an anecdote. In 1962, it was suggested to Arthur Lewis that a set of Indian cultural norms and institutions, the caste system, constituted a powerful and perhaps impenetrable barrier to economic development. Sir Arthur disagreed: "The love of money," he declared, "is a powerful institutional solvent. Many countries have indeed attitudes and institutions which inhibit growth, but they will rid themselves of these attitudes and institutions once their people discover that they stand in the way of economic opportunity" (Lewis 1962). The prose is splendid but the sentiment is simplistic and, alas, dated: a quarter of a century later many economists are inclined, with Van Arkadie, to admit that institutions, like prices, matter; that we have not paid sufficient attention to ways and means of improving the performance of organizations and the appropriateness of the broader institutions.

This brings me to my last point: the next and most crucial step in the process (and here, not surprisingly, the Van Arkadie paper is not too helpful) is to specify precise operational methods and tools by which to improve performance in institutions. A great deal of analytical review of how technical assistance for institutional development has been used—and misused—is about to come to fruition. Guidelines may reasonably be expected to come out of this work, a distillation of "best practice" in this subfield that will be of use to governments and donors. Such guidelines already exist for the reform of public enterprises, a *comparatively* manageable element of public sector institutional reform (see Shirley 1989 and Nellis 1989). And efforts are under way to do the same for budgeting and public expenditure (see Lacey 1989). Devising the appropriate techniques is perhaps less the job of the academic economist than of the government bureaucrat, the World Bank staff, and management specialists—though we in the practitioner community would gratefully accept any further assistance Van Arkadie and other academic economists might care to offer.

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PROCEEDINGS OF THE WORLD BANK ANNUAL CONFERENCE ON DEVELOPMENT ECONOMICS 1989

Comment on "The Role of Institutions in Development," by Van Arkadie

Pranab Bardhan

I agree with most of what is said in the paper. Essentially this critique supplements the paper, emphasizing institutional issues that Professor Van Arkadie did not go into very much—particularly from the point of view of rural development. I will try to discuss these issues in the perspective of economic theory, keeping in mind our primary focus on policy issues and empirical matters.

Until recently, mainstream economic theory has by and large ignored institutional issues—often stating central propositions with a false air of institutional neutrality. Of course, radical economists, economic historians, and other such wishy-washy characters among us have always made a noise about institutions being important, but much of mainstream economic theory has kept a safe distance from such polluting influences.

Fortunately that's no longer true. In the last ten or fifteen years, economic theory—particularly non-Walrasian neoclassical and non-neoclassical theory—is increasingly recognizing a whole range of problems that come up in analyzing institutions. We are now in the process of developing an endogenous theory of institutions that will help us understand the forces behind them. Our focus is, of course, on economic factors because our comparative advantage lies in analyzing them.

There is now a vast literature, which includes several points of view. The transactions costs theorists have taken one line, largely flowing from the seminal work of Ronald Coase; somewhat different, though related, is Oliver Williamson's work (1985). The Coase-Williamson literature on transaction costs concentrates on corporate structure and practices; more recently, the literature (see, for example, Bardhan 1989) has tended to focus on things like imperfect information, usually emphasizing the emergence of institutions as substitutes for missing markets—particularly for credit, insurance, and futures transactions—in an environment of pervasive risks, moral hazard, information asymmetries, and so on. The theme was first taken up in the literature on sharecropping, but now a whole range of rural institutions has been analyzed—in the labor, credit, and other markets.

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Radical economists often speak of institutional obstacles to development in poor agrarian economies and overlook the microeconomic rationale of these institutions' formation. Under certain informational constraints and missing markets, a given agrarian institution such as sharecropping may actually be serving a real economic function. Its simple abolition—often called for by radicals, who ignore the factors that gave rise to the institution in the first place—may not improve the conditions of the intended beneficiaries. The economics of what may be called "second-best reformism" may offer some important political lessons here, which are applicable to land reform, credit reform, and so on.

Although I generally favor the development in this fast-growing literature, I am increasingly doubtful about the direction it is taking. In the first place, this literature (with some notable exceptions) tends to assume the optimality of persistent institutions. That is, if you can explain an institution in terms of imperfect information and the like, something must be right with that institution, so we shouldn't tinker with it. Sometimes that is the right conclusion to draw but often it is not. It is possible to construct models in which you can show that dysfunctional institutions may persist for a very long time. All kinds of self-reinforcing processes are increasingly recognized now—not so much in development economics but in the new institutional economics literature—processes of the kind, for example, that George Akerlof (1984) has discussed in terms of social sanctions. Other self-reinforcing mechanisms have been recognized in a completely different literature, in the theory of technological innovations. There is the idea of what is called path dependence, for example, where a path chosen initially because it suited particular interests may lock the system in for a long time because of increasing returns to adoption, learning, and other kinds of bandwagon effects. These self-reinforcing mechanisms are just as important to the literature on institutional innovations as to that on technological innovations.

The new institutional literature also sometimes ignores that the new theory cannot completely supersede some of the emphasis of the earlier reformists. Much of the new literature assumes, for example, the framework of information symmetry and risk-sharing. But it cannot on that basis deny that a redistribution of assets or reorganization of the work process might lead to a superior equilibrium, since sometimes there would be less asymmetry of information and less need for risk-sharing.

The different strands in this literature share another methodological problem, having to do with functionalism—a problem not exclusive to development economics. If we can show that an institution helps a large number of people, we assume that somehow it will come about; we try to explain an institution by pointing to its benefits. The assumption of course ignores the enormous difficulty of getting the potential gainers to get their act together to somehow defeat the potential losers or vested interests. This collective action problem is familiar in the literature on the political economy of trade policy.

There are two kinds of collective action problem here. One is the well-known free-rider problem about sharing the costs of bringing about change. The other, less often talked about, has to do with bargaining about sharing not the costs but the potential benefits from the change, disputes about which may lead to a breakdown of the necessary coordination.

The collective action dilemma brings to mind another general problem of this literature: much of the focus is on efficiency-improving institutions, whereas historically considerations of efficiency have been less important than redistributive issues in processes of institutional change. Take the eighteenth-century enclosure movement in England, for example, which some literature in economic history has tried to explain. Enclosures have been explained as more efficient than the open field system that prevailed before. Now, there is no doubt that if an institution improves efficiency, pressures will be generated to bring it about—but redistribution has often been the crucial factor in this particular collective action problem. Mobilizing the relevant interest groups and tackling the bargaining and free-rider problems often turn on the redistributive effects of the particular institutional change, which are at least as important, if not more so, than the efficiency-improving effects.

There is an identification problem here. Hayami and Ruttan (1985) distinguish between demand for and supply of institutional change—demand coming from demographic and technological changes which generate pressures for institutional change; supply from political entrepreneurs who try to resolve the collective action problem. Although they recognize this distinction, Hayami and Ruttan often try to show how demographic and technological changes have brought about institutional changes in agriculture. There are several examples in the book and also in Hayami and Kikuchi (1982). Let me take just one example. The rapid expansion of labor-tying arrangements such as *kedokan* in many parts of Java in the late 1960s, which Hayami and Kikuchi attribute to population growth, can be explained from the "supply side" by reference to the drastic changes in the collective strength of the poor peasantry brought about by the bloody political changes of the 1960s. I am not saying that the supply side is more important than the demand side, but in observed historical instances sometimes it is difficult to identify whether demand for institutional change or resolution of the collective action problem in some way was responsible for the outcome. Often the two are interdependent.

Identification is a general problem in applying some of the rather sophisticated theoretical models from the institutional literature. When I was a student in development economics, one of the major issues that used to be discussed was "Are peasants rational?"—which always sounded a little silly to me. Now we have moved full circle: we have superclever peasants solving multistage, multiperiod game-theory models. I am in favor of applying more sophisticated reasoning to understanding processes we do not understand otherwise, but there are significant empirical difficulties. As we know, many of these game-theoretical results are highly model-specific and are not robust at all. An empirical testing of these models is extremely difficult: for the same observed phenomenon that you explain by one intricate game-theoretical model, you can find five other intricate or not-so-intricate models. There is a disproportion between theoretical and empirical work in this area which will crop up in all sorts of ways as we start testing the theoretical models.

Finally, on the role of the state, which is the real focus of Van Arkadie's paper: sometimes the literature is unduly preoccupied with the extent of state intervention when the more interesting subject is how, given the extent, the nature or quality of the intervention varies; even the same amount of intervention can bring about completely different outcomes.

I also think that the literature focuses too much on state versus private property regimes. In many aspects of development—including rural development and many of the looming environmental problems—we should pay more attention to "intermediate" institutions, such as small-group cooperatives, formal or informal. The history of cooperatives is by and large dismal: they have failed in many parts of the world. I am not talking about large collectives or the kind of cooperatives in Kenya discussed in Van Arkadie's paper. (In fact, one reason cooperative history is so often a history of failure is that cooperatives are often essentially the lower end of a big state bureaucracy or a front organization to milk the state cow.) I am talking about more genuine voluntary, small-group, self-help cooperatives that may get help from others but are more self-generative and self-sustaining. Successful examples of such groups exist in different countries.

Water management is one area that generates many externalities. How do village societies cope with internalizing them? How do farmers get together locally to resolve conflicts—or sometimes fail to resolve them—in allocation? East Asian history has many success stories about informal, traditional village community organizations in which all kinds of implicit cooperation have been going on for some time. Even in different parts of India I have seen scattered evidence of a remarkable amount of informal cooperation among farmers. These institutions are not listed as cooperative societies, and they often take rather soft institutional forms, but they have survived for a long time. Unfortunately, informal cooperatives are now fading away as the state, as a patronage-giver, becomes more important and intrudes into village life. Externalities of this kind are important in many other areas—environmental issues particularly come to mind.

We should study informal institutions involving cooperation to try to understand why they fail in many areas and why they succeed in some. I would urge those who are interested in these issues not to try to resolve them at general theoretical or aggregate statistical levels. I think this calls for many microlevel studies that include analyses of processes. We economists in our surveys are not very good at understanding processes. We get observation points on outcomes and analyze those outcomes. To understand processes, I think we have to give up our somewhat arrogant imperialist attitude toward other social studies and collaborate with others, such as anthropologists, and get on with more such microstudies.

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Floor Discussion of Van Arkadie Paper

Expanding on a theme in Van Arkadie's paper, one participant observed that economists tend to export into other countries organizations that do not fit the norms of people in those countries, yet expect them to succeed. Similarly, often the people are maximizing one thing and government imposes an organizational structure designed to maximize something else, producing inconsistencies. It would be more appropriate first to focus on what we are trying to maximize in a society and then to find the type of organizational structure to support that objective. Cooperatives are often well-matched to societal norms, but other institutions may not be. In a typical rural area in Africa, for example, credit and saving are linked. Individuals put their money together and give it to a person who needs capital, and it passes around. This informal system is an institution, one that links saving and investment with the objective of providing capital to generate production. Introduce a bank in a rural area where that system exists and you will get no saving, and economists will say the people and banks are risk averse—because they do not understand the system.

Acknowledging the validity of this observation, which he had also made in his paper, Van Arkadie suggested that in some situations one has to ignore or try to change the norms. The World Bank is in the business of lending to governments, for example, and does so on the assumption that the governments are not crooked. What happens when governments will not repay loans and are crooked? You could say, "That's their norm," or you could conclude that you are in the business of changing norms and trying to assert norms that may be at variance with the existing system.

Bardhan (discussant) elaborated on the subject of norms, noting their importance in the game-theoretic literature, particularly for repeated cooperative games of the prisoner's dilemma type. In repeated transactions, some codes of conduct become norms that people accept without thinking. The problem is, norms change. Economists don't have a very good theory of changing norms. They have interesting ideas about how norms change, but many economists' models of norms assume that all social norms are reducible to economic rationality, which is questionable.

One Bank participant thought that confusion about the meaning of "institutions" might be the result of historical accident, of someone somewhere using the term institutions when they meant organizations. Van Arkadie had developed

This session was chaired by Visvanathan Rajagopalan, vice president, Sector Policy and Research, World Bank.

the two definitions along parallel tracks—with marriage, societal norms, and the like along one track and with diagnoses of organizations along another—but perhaps there is no real link between the two meanings. Does one follow the other in terms of the sequence of development? Does the development and effectiveness of organizations—particularly the kinds of agencies the World Bank works with—depend upon a certain level of development of norms? If there is no such link, perhaps it would be more productive to discuss them separately, and we could get on with the task of considering organizational alternatives for development programs. Admitting that his work on this subject was new and transitional, Van Arkadie said he would have to think about whether the two subjects deserved separate discussion. His two definitions of "institutions" were an empirical reaction to the discourse; if separated, the question would be how the two meanings could be related at the analytical or theoretical level.

Nellis (discussant) said that the Bank working group that is producing a policy paper on institutional development is receiving many comments along two lines: (1) what you are attempting is ludicrously broad and (2) how could you have left out local government, decentralization, finance, tax administration, and so on?

A participant offered an explanation of why this field is theoretically underdeveloped and how to improve matters. Economists writing about rural institutions, for example, speak of utility-maximizing producers, production functions, risk, and asymmetric information—all elements of an urban sector theory, none of them specific to agriculture. Once you get specific about agriculture, suddenly, without a great deal of analytical apparatus, implications become apparent. In his own work, by looking at elements such as covariance of risk and the spatial dispersion of agriculture, the participant had shown that crop insurance is not likely to work and that rural financial institutions that confine their operations to agriculture would have trouble operating successfully. Introduce agroclimatic differences—for example, the high degree of covariant risk in semiarid, highly seasonal climates and the low degree of risk in humid climates that are not very seasonal—and you arrive at the differences anthropologists have long observed between the hierarchical family structures found in semiarid areas and the nonhierarchical family structures found in humid areas. Introduce differences among crops—whether the crop can be stored before being processed, for example—and you can predict which crops are suited for plantations and which are not. He strongly felt that economists writing about institutions systematically ignore simple technological and material conditions.

While agreeing with this comment, Van Arkadie felt that the difficulty lay in knowing which were the right questions for economists to look at. Take the plantation example just cited, for instance. In the 1960s Van Arkadie saw that sisal was a plantation crop, and coffee a smallholder crop in Tanzania. To him it seemed obvious and logical why this was so. Then he went to Brazil where he found coffee to be a relatively large-scale and sisal a relatively small-scale crop. As an economist one can say that some crops probably can't be produced by plantations, given various factor endowments or costs, or can only be produced inefficiently, so that under competition the plantation will not succeed and the smallholder will. But that does not explain why in some parts of the world certain crops are grown in plantations and others are not, without looking at the issues Bardhan introduced in his panel comments—about the nature of power in those societies at particular historical moments and the persistence of institutions once they're created, regardless of inefficiency or inequity.

Bardhan found covariant risks to be important for looking at rural institutions, but unlike the earlier participant, believed that many models already do use covariant risks, implicitly or explicitly. In the literature on credit markets, for example, covariant risk came up in considerations of whether the lender should be a village resident or someone from outside. This is related to the demographic question: when do we go to the village moneylender for credit and when to relatives far away who do not face the same covariant risks? In rural India (where, as in much of the world, marriage is an economic institution), it is assumed that a village bridegroom or bride will marry a distant villager, partly because in times of crisis you can fall back upon your new relatives or other relatives who are not facing the same risks.

A participant felt that institutions in the two senses that Van Arkadie had defined were clearly important, but it seemed to him unproductive to talk simultaneously about credit markets, marriage, and the way different parts of agriculture work. He recognized that there were many serious issues that needed positive analysis—for example, how the Indian caste system might function if it changed radically under economic pressure, or how people provide for social security without specific government intervention—but found it unsatisfactory to consider all of these things together, and suspected that was why Van Arkadie found it so difficult to write his paper. Economists should be more problem-oriented. He added a plea to avoid terms like "new institutional economics" or "new" anything as being pretentious, inaccurate (they were seldom new), and certain to go out of date quickly.

Bardhan concurred that concrete studies and more problem-specific discussions were preferable, but he felt that a general discussion made people more aware of the complexity of problems for which economists sometimes give simple-minded policy suggestions. Van Arkadie agreed with Bardhan, pointing out that economists attack particular problems carrying their own intellectual baggage, which every now and then they should examine.

A participant from the Bank asked Van Arkadie to elaborate on his statement that there are some things institutions can do that markets cannot do, and some things neither do well, since Van Arkadie had also talked about the importance of political economy for determining institutional purpose. Van Arkadie explained that he was talking about bias in judgment. He was amazed after twenty-five years' experience in Africa, at the persistent support for certain agricultural policies despite the lack of any empirical evidence that those policies were working. Why was that? If it was highly desirable to increase agricultural productivity, and it was evident that market forces would not do so, policymakers decide that something ought to—and therefore could—be done. The wish then fathers the support, and the persistence of support, often despite the lack of positive results.

Citing Harold Lasswell's definition of political science as the study of who gets what, when, where, and how, a participant suggested that if one accepts that institutions like the World Bank have been effective in specifying who, what, where, and when one transforms resource inputs into outputs, what the topic was addressing seemed to a political scientist to be simple: the feasibility of the question of how, which the Bank had addressed less successfully. The key variables are motivations and incentives (which, when expanded, cross over into culture, psychology, rules of the game, and so on). Institutions are simply the collective mechanism by which people pursuing their own interests transform inputs into outputs. Outcomes are more rational if the collective action is purposeful and less rational when it is the sum of anarchic activities—or something in between. If we assume that to accomplish our institutional ends we must control all the variables and come up with generic prescriptions, this may seem to be an unmanageable field. By focusing on process and recognizing that the complexity is largely in the location-specific way motivations and incentives manifest themselves, we can find out what motivates people in a particular context and come up with adaptive institutional solutions. Agreeing with this assessment, Van Arkadie observed that complaints are more often about action (or inaction) than about the analysis. As an observer of Bank policy missions he is struck by how often perfectly sensible, straightforward advice is not taken.

Another participant expressed the need for more guidance on how to conduct meaningful institutional appraisals. If in the absence of a theory of institutional change, one were to decide on a case-by-case basis whether or not to recommend institutional interventions—analyzing institutional microprocesses, the institution's political and technical purpose, its historical origins, its public and private influence, and various social, anthropological, cultural, ethnic, and political factors—what should the methodology be?

Two participants offered constructive criticism on current approaches to institutional change. The first participant suggested that economists at the World Bank and elsewhere should probably concentrate on public *economic* and *financial* organizations—concerning themselves with noneconomic organizations only to the extent of helping them use resources optimally. He believed there had not been enough empirical studies about optimal cost structures for noneconomic public organizations. When such an organization applies for grants or aid, lending institutions look at its financial profile and conclude that it is inefficient if they see that personnel costs and overheads exceed certain ratios. He felt that these ratios were drawn from the developed market economy experience and he wondered if these cost profiles can be applied without adaptation to noneconomic public organizations in developing countries. The participant also seconded Van Arkadie's recommendation that the World Bank support research into entrepreneurship, particularly studies about how to predict entrepreneurial responses to policies in developing countries.

The second participant urged a distinction between individual institutions and the structure of institutions. The performance of an individual institution depends on the structural arrangement of institutions. Under different arrangements performance will differ; this is probably one of the main reasons why an institution works in one society and not in another. He also urged more careful consideration of the cost of institutional change. A particular institutional arrangement may not appear rational, but if analysis suggests that the cost of change is prohibitive, the wiser course may be to live with inefficiency.

After observing that the Bank has paid increasing attention to institutional behavior important to policy change, Rajagopalan (chair) suggested that interdisciplinary research and analysis focus on giving development practitioners paradigms and criteria for evaluating institutional structures. Particular emphasis needs to be given to the efficient management of the public sector. Ownership was not the issue so much as performance, so he urged researchers to find ways to improve performance under different ownership patterns. Researchers should also try to identify the conditions that encourage entrepreneurs to emerge in underdeveloped economies. Analysts should clarify the effect of interactions between economic and noneconomic (including ethnic, religious, and nationalist) factors and their effect on such activities as regulation of public utilities and privatization. Finally, Rajagopalan urged more study of the implications of the increasing role of multinational corporations, trade unions, and international credit in the economies of developing countries.