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THE ROLE OF INSTITUTIONS IN ECONOMIC DEVELOPMENT

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Introduction

Growth and development cannot take place in an institutional vacuum. Economic maturity and the growth of markets require an institutional framework that allows transactions to take place in an orderly manner and in which agents know that the decisions they take and the contracts they make will be protected by law, and enforced. Savers, investors, consumers, entrepreneurs, workers and risk-takers of all kinds need a framework of rules if rational, optimizing decisions are to be made. They also need some guarantee of economic stability and certainty, which can be provided only by good governance and sound economic policy-making. The alternative to property rights, law and order and political stability is economic anarchy – and failed states (see Chapter 9).

This chapter deals with the role of formal institutions in general in providing an economic, political and social environment in which economies can flourish and prosper, and it considers some of the empirical evidence on the relationship between institutional development and economic development.

The role of institutions

Nobel Prize-winning economist Douglass North first brought to the fore the role of institutions in economic development. The modern exponents of the **primacy of institutions** are Dani Rodrik of Harvard University and Daron Acemoglu, Simon Johnson and James Robinson of the Massachusetts Institute of Technology. In his well-known book, *Institutions, Institutional Change and Economic Performance* (1990), North said:

> I wish to assert a fundamental role for institutions in societies: they are the underlying determinants of the long-run performance of economies – Third World countries are poor because the institutional constraints define a set of pay-offs to political/economic activity that do not encourage productive activity.

North (1990) also said that 'the inability of societies to develop effective low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World', because the absence of secure property and contractual rights discourages investment and specialization. Mancur Olson (1982) makes the same point in his classic book, *The Rise and Decline of Nations*.

It is possible to give both general and narrower, more formal, definitions of institutions. North (1990) describes institutions very broadly as the 'formal and informal rules [or norms] governing human behaviour'. A similar broad definition is given by Lin and Nugent (1995): 'a set of humanly devised behavioural rules that govern and shape the interaction of human beings, in part by helping them to form expectations of what other people do'. At a more formal, precise, level, institutions can be defined in terms of:

- the extent of property rights' protection
- the degree to which laws and regulations are fairly enforced
- the ability of government to protect the individual against economic shocks and provide social protection
- the extent of political corruption.

Without inclusive economic and political institutions, nations will fail, which is the central message of the path-breaking book by Acemoglu and Robinson (2012), *Why Nations Fail*. Inclusive institutions are necessary to challenge and constrain the political power of the elite, otherwise the elite use political power to protect the status quo and preserve extractive economic rents, which diminishes the incentive to innovate and invest. Inclusive political institutions lead to inclusive economic institutions and this is the basis for prosperity – a virtuous circle is started. Similarly, extractive rules are reinforcing in the opposite direction – plunder further empowers the elite. Countries differ in their economic success because of their different institutions; the rules influence how the economy works and the incentives that motivate people. Institutions explain why growth took off earlier in Europe than Africa, Latin America and Asia, and why there are many failed states today, particularly in Africa where autocracy is rife and the benefits of natural resources are siphoned off to an elite.

Incentives and price signals, so vital for a market economy, cannot function properly without institutional structures and rules of behaviour. As Rodrik (2008) says: 'markets require institutions because they are not self-creating, self-regulating, self-stabilising, or self-legitimising'. Which institutions are important and which are not will differ across space and time according to the history of a country, its geography, stage of development and its political aspirations, that is, what sort of society its people want. In small rural communities where everyone knows each other, the scope for cheating, fraud and not honouring contracts is limited. Transaction costs associated with the costs of information, negotiation, monitoring, coordination and enforcement of contracts are low, and communities survive by adhering to norms of behaviour; but economic development is limited through a lack of specialization. In contrast, in large, modern, industrial societies, where transactions are impersonal, there is widespread scope for opportunistic behaviour (Bardhan and Udry, 1999). Transactions (and therefore production) costs may be very high without institutional structures that curtail such behaviour, such as the enforcement of property rights and the rule of law, the provision of limited liability, the guarantee of contracts, patent protection and so on. With low transaction costs, firms and markets can concentrate on the job of investment in the knowledge that property rights are secure.

When economists undertake empirical work on the relation between institutional structure and economic performance, it is, of course, necessary to have quantitative measures of the important institutions being discussed and evaluated. Lumping all institutions together in a single index of 'institutional quality' would obscure the different channels through which institutions work.

There is no one set of institutions that will suit all countries, but there is a consensus among development economists that at least five main types of market-supporting institutions are necessary, if not sufficient, conditions for rapid economic progress (see Rodrik, 2000, 2008; Rodrik and Subramanian, 2008):

- property rights and legally binding contracts: market-creating institutions
- regulatory institutions: market-regulating institutions
- institutions for macroeconomic stability: market-stabilizing institutions
- social insurance institutions: market-legitimizing institutions
- institutions of conflict management: market-legitimizing institutions.

Rodrik (2000) highlights the following institutional arrangements that are conspicuously absent in poor countries:

- a clearly defined system of property rights
- a regulatory apparatus curbing the worst forms of fraud, anti-competitive behaviour and moral hazard
- a moderately cohesive society exhibiting trust and social cooperation

- social and political institutions that mitigate risk and manage social conflict
- the rule of law and clean government.

These five main prerequisites of a sound institutional structure for economic development are described briefly below:

1. **Property rights and legally binding contracts**: These are important because agents lack the incentive to invest and innovate if they do not have control over the return on the assets they accumulate. Intellectual property rights are particularly important to encourage invention. Control is more important than ownership. Formal property rights do not mean very much if there are not control rights; but control rights can spur entrepreneurial activity without clearly defined property rights (witness China).
2. **Regulatory institutions**: Markets fail if there is fraud or anti-competitive behaviour. Regulatory institutions are needed if markets are to function properly. When markets are liberalized, a regulatory framework is also required to avoid the consequences of risky behaviour, such as financial crises if the banking system is not properly regulated (as the world economy witnessed in 2008). Institutions to compensate for capital market imperfections and coordination failures must also be an integral part of a 'regulatory' framework for promoting innovation and growth. A good example of this is the way the state intervened to promote industrial development in South Korea and Taiwan in the 1960s and 1970s. All successful economies have an array of regulatory institutions that oversee different markets, such as the product market, financial markets and the labour market. Developing countries may need more regulatory institutions because market failures are more pervasive than in developed countries.
3. **Institutions for macroeconomic stability**: Monetary and fiscal policy institutions are necessary to provide an enabling environment in which private investment can flourish. Market economies are not self-regulating, and macroeconomic instability creates risk and uncertainty. The minimization of risk is vital if entrepreneurs are to take informed, long-term investment decisions. Financial markets are inherently unstable, which can have damaging real effects, and they need careful supervision. A central bank, a responsible banking system and fiscal prudence are all important ingredients of macroeconomic stability.
4. **Social insurance institutions**: These are necessary if individuals are to accept change. In rural, peasant societies on the margins of subsistence, change may spell disaster, but progress (particularly in agriculture) requires a willingness to take risks. Insurance against unemployment, crop failures and price fluctuations for agricultural commodities are all important if traditional agriculture is to be transformed. Economic reforms of any type, particularly in the process of liberalizing markets, will meet resistance if not enough attention is paid to creating social security institutions to protect the vulnerable. Social stability and cohesion within a market economy in the process of structural change require social insurance and safety nets.
5. **Institutions of conflict management**: Many developing countries have deep ethnic, tribal and religious divisions. Social conflict damages economies because it diverts resources from directly productive activities and creates uncertainty, which deters investment. To minimize conflict requires a full range of institutions – the rule of law, a fair legal system, a political voice for minority groups – which make it clear that the potential winners of social conflict will not benefit and potential losers will be properly safeguarded.

The question is: How are good institutions acquired? Because of history and the diversity of countries, there is no one unique set of institutions that can be prescribed for every country: 'there is no single mapping between the market and the set of non-market institutions required to sustain it' (Rodrik, 2000). Rodrik likens institutions to technical progress that allows countries to transform inputs into higher levels of output, shifting outwards a country's production possibility frontier. But technological blueprints that operate well in one context may not be appropriate in another – and so it is with institutions. A 'market economy' cannot simply be transposed from one country to another, at least not without some adaptation. As Rodrik and Subramanian (2008) put it: 'there is growing evidence that desirable institutional arrangements have a large element of context specificity arising from differences in historical trajectories, geography, political economy and other initial conditions ... institutional innovations do not necessarily travel well'.

Nor is it easy to bring about institutional change. There is a **collective action problem** that limits potential gainers from bringing about change in opposition to vested interests (Bardhan and Udry, 1999). One is the **free-rider problem** about sharing the cost of change; the other is the **bargaining problem** relating to sharing the potential benefits of change. It can be difficult for potential gainers to compensate potential losers, as in the case of land reform, for example. In these circumstances, the state has a role to play in fostering institutional change and development without destroying markets, or allowing itself to be influenced by special interest groups or corrupted by rent-seeking behaviour on the part of politicians and bureaucrats.

Rodrik (2000) argues forcefully that 'institutions need to be developed locally, relying on hands-on experience, local knowledge and experimentation'. Some institutional blueprints for some specific purposes may be borrowed (e.g. forms of financial regulation) because they are straightforward to implement and save costs, but others need to be built from scratch. Building from the 'bottom up' requires **participatory political institutions** that can use and assess local knowledge, so that the institutions created have consent and legitimacy. Institutions imposed from the 'top down' usually fail. Rodrik (2000) finds an association across countries between democratic political structures and economic success; but other studies are more agnostic.

Measuring institutions and the debate on institutions versus geography

To do serious empirical work on the impact of institutions on growth and development requires a measure of institutional development. But some care needs to be taken because if measures of institutional *quality* are used, a correlation with economic performance is almost certain to be found because the measures themselves are partly a function of the stage of development and economic success. Institutional measures are required that are devoid of 'quality'. The statistical way of putting the same point is that the institutional variables used should be strictly *exogenous*; but we know in practice that institutional development is partly a function of growth and development itself, making many institutional variables *endogenous*. To cope with this difficulty, one can either find instruments to proxy for present-day institutions (see below), or take the initial (or base) level of institutions as the independent variable, rather than the contemporaneous level. There are also other econometric difficulties in determining the impact of institutions. Many institutional variables are highly correlated with one another, so it is difficult to measure the separate influence of each, and many institutional measures are ordinal (they simply rank countries) rather than cardinal, which means that they do not measure the *magnitude* of the difference in the institutional variables between one country and another. Several different measures of institutions have been used in empirical work:

- **An aggregate governance index**, which is an average of six measures of institutions developed by Kaufman et al. (1999). These measures include:
  - *voice and accountability*: the extent to which citizens can choose their government and enjoy political rights, civil liberties and an independent press

- *political stability and absence of violence*: the likelihood that the government will not be overthrown by unconstitutional or violent means
- *government effectiveness*: the quality of public service delivery and competence and political independence of the civil service
- *regulatory burden*: the relative absence of government controls on goods markets, banking systems and international trade
- *rule of law*: the protection of persons and property against violence and theft, independent and effective judges, and contract enforcement
- *freedom from graft*: public power is not abused for private gain or corruption.

Each of these measures can be taken individually.

- **A measure of property rights and risk of expropriation** using the International Country Risk Guide (ICRG) and Business Environmental Risk Intelligence (BERI). These indices are used by Keefer and Knack (1995). The ICRG index includes a measure of expropriation risk, rule of law, repudiation of contracts by governments, corruption in government and quality of bureaucracy. The BERI index includes contract enforceability, nationalization potential and bureaucratic delays.
- **An index of democracy, political rights and civil liberties**, for example the Freedom House index of political rights and civil liberties (Gastil, 1983, 1986).
- **Political instability**, as measured by the number of revolutions and coups, and the number of assassinations (Barro, 1991).
- **An index of corruption** (Transparency International).
- **Economic freedom** (Heritage Foundation).
- **An index of social division**, for example, ethnic diversity.

Apart from Rodrik, Acemoglu et al. (2001, 2002) are the other foremost modern exponents of the view that institutions are of primary importance in understanding the development process, and why some countries are rich today and others poor. Acemoglu (2008) identifies three important characteristics of good institutions:

1. The enforcement of property rights and the rule of law, so that individuals have the incentive to save, invest and take risks (as argued above).
2. Constraints on those in positions of power so that they cannot expropriate the resources of a country for their own benefit.
3. Equal opportunities for all, so that everyone has the incentive to better themselves and to participate productively in society.

Acemoglu and his colleagues believe that the fundamental cause of differences in the levels of development across countries of the world lies in differences in the evolution of institutions (in particular, property rights), which has historical roots, and that it is possible to find an *exogenous* cause of variations in institutions today that is unrelated to the level of development itself (or geography); namely the way in which colonizers settled in countries in the seventeenth and eighteenth centuries. This is determined by the mortality rates of soldiers, sailors and missionaries in various parts of the world.

The model of institutional development proposed by Acemoglu et al. (2001) is that (potential) settler mortality determined the degree of settlement, the degree of settlement determined the type of early institutions, and that early institutions have determined current institutions and can explain current economic performance. In other words, mortality rates in countries during early colonial times can be used for predicting institutions and the level of per capita income across countries today.

Let us consider the theory in more detail, and then some of the evidence. The model is based on three basic premises:

1. There were different colonization policies, which created different types of institutions. At one extreme, in some countries (mainly in Africa), 'extractive states' were created with the main purpose of transferring as many resources as possible from the colony. Private property rights were not established and colonizers did not settle in large numbers. At the other extreme, in countries such as the USA and Australia, Europeans settled in large numbers and tried to replicate European institutions, with a strong emphasis on private property and checking the power of elites – political and vested interests.
2. The colonization strategy depended, to a large extent, on the feasibility of settlement, and particularly the incidence of disease and mortality.
3. The institutions created during the colonial period persisted after the colonies became independent.

Acemoglu et al. (2001) present a mass of evidence of how mortality rates affected the willingness to settle in the various colonies, and how the presence or absence of European settlers was a key determinant of the form colonization took. A great deal of historical evidence is also presented that the control structures set up during the colonial period in the 'extractive states' that were not settled, such as in Africa and parts of Latin America, have persisted to this day, while the institutions of protecting private property rights and law and order, which were established in settler countries such as Australia, Canada, the USA, Hong Kong and Singapore, have also persisted.

The measure of institutions today, used by Acemoglu et al. (2001) is a 'risk expropriation' index first used by Keefer and Knack (1995).[1] The index goes from 0 (lowest protection of property rights) to 10 (highest), measured for each country for each year. They test their model using 64 former colonies for which there are data on settler mortality in the nineteenth century, current protection against expropriation risk, and living standards for the period 1985–95. Using simple two-variable regressions shows:

1. A strong negative correlation between per capita income (PCY) today and settler mortality rates per 1,000 of population.
2. A strong positive relation between PCY and protection against expropriation risk today (the correlation coefficient exceeds 50%).
3. That the settler mortality rate explains 25% of the variation in the expropriation risk index.

When the endogeneity of the expropriation risk index (as the measure of institutional quality) is instrumented by the settler mortality variable, a significant negative effect on the current level of per capita income of countries is found, even controlling for other variables that might be correlated with settler mortality, such as the identity of the colonial power, natural resource endowments, soil quality, religion, temperature and humidity. In fact, Acemoglu et al. (2001) dismiss the effect of geography altogether (see below). Moreover, the strong results are not dependent on the heavily settled countries with good institutions, such as the USA, Canada, Australia and New Zealand, nor if African countries are excluded from the sample. When a dummy variable for Africa is used in the equation, it is not statistically significant, which leads Acemoglu et al. (2001) to conclude that Africa is poor not because of geography but because of poor institutions, inherited from the past because the colonial powers established 'extractive states'.

In a separate analysis, Acemoglu et al. (2002) try to support their theory by showing how the fortunes of countries between the sixteenth century and the present have changed because of **institutional reversal**. It is a fact that those countries that were relatively rich in the year 1500 are now relatively poor, and vice versa, and this is attributed to the two different types of institutional structures, discussed above, that were imposed on countries during colonial times. Economic prosperity in 1500 is measured by the rate of urbanization and population density. With either measure, there is a negative relation between prosperity in 1500 and the level of PCY today. The explanation given is that in previously poor areas, European colonialism led to the development of institutions of private property because the regions were sparsely populated, which enabled Europeans to settle in large numbers and develop new institutions to the benefit of all. By contrast, in previously prosperous areas, already more densely populated with powerful ruling elites, colonizers found it easier and more profitable to maintain or introduce extractive institutions. There was a ready workforce available and taxation was relatively easy. Besides, in the more densely populated regions, there was more disease and mortality rates were higher. The reversal of relative incomes took place in the eighteenth and nineteenth centuries, with societies with good institutions taking advantage of the opportunity to industrialize: 'the interaction between institutions and the opportunity to industrialise during the 19th century played a central role in the long-run development of the former colonies' (Acemoglu et al., 2002). The authors find a negative relation between measures of prosperity in 1500 and the risk of expropriation (insecure property rights) today. Some basic econometric results are:

- a 10 percentage point lower rate of urbanization in 1500 is associated with double the level of PCY today
- a 10% higher population density in 1500 is associated with a 4% lower PCY today.

Acemoglu et al. (2002) again dismiss the role of geography because geography is a 'constant' and predicts the persistence of economic outcomes. If geography is the most important factor in development, the most (least) prosperous areas prior to colonization should have continued to be the most (least) prosperous, but this is not the case. Geography cannot explain the reversal of fortunes. Acemoglu et al. (2002) recognize what they call a 'sophisticated version' of the geography hypothesis; that certain geographic characteristics that were inimical to successful economic performance in 1500 became less important later on when new crops and new technologies made temperate zones more productive than the more prosperous tropical zones (where civilization started), and transport costs fell. But they argue that there is no evidence that the reversal of economic fortunes between sets of countries in the eighteenth and nineteenth centuries was associated with agriculture or a more favourable transport environment. Reversal was most closely related to industrialization. Acemoglu et al. (2002) conclude: 'if you want to understand why a country is poor today, you have to look at institutions rather than its geography'.

But institutions and geography cannot be separated so easily. Geography, and its effects on disease, affects the type of colonization and therefore the character of institutions. Acemoglu (2008) effectively concedes this when he says: 'geographic factors also likely influenced the institutions that Europeans introduced'. Rodrik et al. (2004) attempt to tackle this issue empirically (see also Rodrik and Subramanian, 2008). They estimate a series of regressions relating the income levels of countries to measures of geography, institutions (and also the degree of economic integration), taking account of the endogeneity of institutions. Institutional development is measured by a composite indicator of the strength of property rights and the rule of law. Rodrik et al. (2004) reach the conclusion that:

> Quality of institutions is the only positive and significant determinant of income levels. Once institutions are controlled for, integration has no direct effect on income, while geography has but weak direct effects. These results are very robust.

Rodrik et al. (2004) claim that the quality of institutions overrides everything else, but also concede, like Acemoglu, that 'geography has a strong indirect effect through institutions by influencing their quality'. Thus, geography may be the ultimate determinant after all.

In fact, Sachs (2008) points out that the incidence of malaria itself is enough to account for the negative relation between the mortality rates of British soldiers in various parts of the world in the nineteenth century and low levels of per capita income today. Sachs is critical of the almost exclusive emphasis on institutions in explaining differences in economic performance between countries, as if nothing else matters: 'the barriers to economic development in the poorest countries today are more complex than institutional shortcomings ... both institutions and resource endowments are critical, not just one or the other'.

Another critic is Bardhan (2005a), who argues that there are other institutions that matter besides property rights and the rule of law, particularly **coordinating institutions** to overcome the coordination failures that are endemic in poor countries and require institutions to cope with them. They would remain important even if property rights were secure. In Bardhan's view: 'this preoccupation of the literature with the institutions of security and property rights, often to the exclusion of other important institutions, severely limits our understanding of the development process'. Bardhan doubts whether the mortality rate of colonial settlers really captures the major historical forces that determined the economic and social structure of colonies.

Think of the *differences* between countries today all with similar disease environments, such as Brazil, India or the Congo in Africa, let alone the countries that were never colonized, such as Ethiopia and Thailand. Countries had a history before colonization: Bardhan (2005a) calls this **state antiquity**, a term that refers to whether a country had a unified state structure or not. By this criterion, Asia ranks higher than Latin America and Africa, and in the latter, as a result of colonial rule, the postcolonial state was often incongruent with the precolonial political structures and geographic boundaries. This has been a major source of political turmoil and instability. In statistical analysis, Bardhan finds the state antiquity variable a significant determinant of differences in per capita income today (as well as settler mortality rates).

The role of democracy

Apart from the institutions versus geography debate, most empirical work on the role of institutions in economic development has been conducted on political instability and the impact of political structures and the role of democracy. The challenge for any government, whatever its structure, is to provide leadership in resolving collective action problems (Bardhan, 1993), which means a commitment to formulating and implementing development policies in the interests of all the people, to prevent groups going their own separate ways. Democracy can make this more difficult because politicians can succumb to vested interest groups and take short-term decisions. On the other hand, dictatorships may have no interest in maximizing total output, and may allocate resources very inefficiently. Democracy makes life difficult for corrupt elites. In the discussion of democracy and growth, it is also important to distinguish between democracy defined as free, multiparty elections on the one hand and civil and economic liberties on the other (Alesina and Perotti, 1994). Some non-democratic regimes in the first sense (e.g. China) give their citizens a lot of economic rights, and vice versa.

Early work by Barro (1991) measured institutional quality by the number of revolutions and coups in countries and the number of political assassinations. A negative relation was found between these measures and economic growth across a sample of 98 countries, controlling for other variables (see Chapter 4).

But political instability is not the same as the nature of the political system. Here, we shall highlight two major studies on the role of democracy by Rodrik (2000) and Barro (1996a, 2008). Rodrik examines data for 90 countries over the period 1970–89, using the Freedom House index of political rights and civil liberties (the Gastil index) as a measure of democracy, which ranks countries on a scale of zero to one. Rodrik draws four important conclusions:

- democracies deliver more predictable long-run growth rates
- democracies produce greater short-term stability
- democracies handle adverse shocks much better
- democracies promote a fairer distribution of income.

Democracies produce better outcomes in these ways because they produce superior institutions better suited to local conditions. There is little evidence that the average growth rate is higher in democracies than in more autocratic regimes, but the variance around the average is significantly lower in democracies. One reason for this is because adjustment to shocks requires managing social conflict, and democratic institutions are more efficient institutions for conflict management. Democracies deliver better institutional outcomes because they tend to create more equal opportunities for people, especially in the fields of health, education and employment opportunity, which manifests itself in a higher share of wages in national income. In general, therefore, democracy helps to build better institutions based on local knowledge: 'participatory and decentralised political systems are the most effective ones we have for processing and aggregating local knowledge. We can think of democracy as a meta-institution for building other good institutions' (Rodrik, 2000).

Barro (2008), on the other hand, is more circumspect about the impact of democracy. Most agree that democracy tends to follow economic development, rather than precede it; what is debated is the role of democracy in sustaining development once it has started. Barro argues that democracy can hamper growth in the early stages of development by the tendency of majority voting to support programmes that redistribute income from the rich to the poor, involving tax increases and other distortions that reduce incentives. Also, democracies may give in to pressure groups that redistribute resources to themselves; for example, agricultural lobbies, defence contractors and trade unions. On the other hand, and very importantly, democracy is a check on corrupt autocracies (dictators). In statistical work that examines the link between democracy and growth, Barro (2008) measures the degree of democracy using the Gastil index of political rights found in Gastil's publication, *Freedom in the World* (1983, 1986). The definition of political rights is: 'rights to participate meaningfully in the political process. In a democracy this means the right of all adults to vote and compete for public office, and for elected representatives to have a decisive vote on public policies.'

Barro's (2008) results suggest that the relationship between democracy and growth across countries is weakly negative, but not statistically significant. The most interesting finding is that there is evidence of nonlinearity; that is, more democracy increases growth when political freedoms are weak, but depresses growth when a moderate degree of freedom has been achieved (perhaps because, as said above, democracies give in to pressure groups and engage in more redistribution). Barro (2008) concludes that:

> democracy is not the key to economic growth ... advanced Western countries would contribute more to the welfare of poor nations by exporting their economic systems, notably property rights and free markets, rather than their political systems, which typically developed after reasonable standards of living had been attained.

Barro's conclusion concurs with that of Alesina and Perotti (1994) in their early survey of the political economy of growth, when they say: 'growth is influenced not so much by the nature of the political regime (democracy or dictatorship) as by the stability of the political regime ... transitions from dictatorship to democracy, being associated with socio-economic instability, should be typically periods of low growth' (see Case example 8.1).

Case example 8.1

Institutions and African economies

The current evidence for Africa is that the structure of political institutions influences the performance of economies, and that Africa's shift towards a greater degree of democracy has paid off in terms of improved economic outcomes. The democracy–growth relationship may, however, be nonlinear. For African economies, the initial transition to democracy can be fraught with risks of political disorder. It is only when African countries have reached 'advanced-level' democracy that we can expect increasing democratization to be growth-enhancing.

Resource rents have become a curse for many African economies. Research shows that large resource rents lead to more corruption, but that the effect is lower for more democratic countries. Nigeria presents a good illustration of the resource curse challenge. Despite the huge rents that have flowed from oil, there has been little economic development; instead, these rents have served to undermine the quality of institutions and to lower growth. To avoid institutions themselves becoming corroded by resource rents and undermining democracy, oil revenues could be distributed directly to the public. Nigeria has become more democratic since 2000, and there has been improvement in government effectiveness, regulatory quality, the rule of law, and the control of corruption, but, unfortunately, political stability and the absence of violence have deteriorated significantly, consistent with the observation that greater democracy may be associated with a higher risk of conflict – at least in the short-term.

Source: Based on Fosu, 2013.

The historical evidence for the now-developed countries, as documented by Chang (2003), would seem to support this broad conclusion. He considers six categories of institutions as they were in nineteenth-century developed countries – democracy, bureaucracy (including the judiciary), property rights, corporate governance institutions, financial institutions, and welfare and labour institutions – and reaches the following conclusions:

1. The now-developed countries did not develop on the basis of democracy. Universal suffrage only came in the twentieth century. Poor developing countries today are adopting suffrage at much lower levels of income than in now-developed countries.
2. Public offices and the judiciary were historically corrupt. Appointments were made not on merit, but through class or political connections, and the judiciary often lacked independence, dispensing justice according to class and race.
3. Property rights, such as contract law, company law, bankruptcy law, tax law and land law, were all lax historically. So, too, were intellectual property rights. Chang remarks with respect to patents, copyrights and trademarks: 'the protection fell well short of what is demanded in developing countries today'.

4. In most now-developed countries, modern corporate governance structures emerged after, rather than before, industrial development. There was no proper auditing of companies and no bankruptcy law, and competition laws did not properly exist until the twentieth century.
5. Banking regulation in the nineteenth century was very perfunctory, and banks only became professional lending institutions, serving all the people, in the early twentieth century.
6. Social security institutions to protect against change were virtually nonexistent.

The lessons of history are that many institutions deemed to be important for poor developing countries today emerged after, not before, economic development was taking place, and it took a long time for them to emerge in fully fledged form from the time of their perceived need. Chang (2003) is right to conclude, however, that this does not mean 'the clock should be turned back'; rather, that institutional development is not the sine qua non of economic development, and institutional reforms in developing countries should not be imposed from outside, but should be allowed to evolve naturally, internally.

This would accord with the central conclusion of Rodrik (2000), namely everything we know about economic growth indicates that large-scale institutional transformation is not so necessary for getting growth started, but that it is very important for sustaining it. This conclusion is based on the pioneering research by Hausmann et al. (2005) on 'growth accelerations'. The secret of economic success in the early stages of development is to find the 'binding constraints' on growth using 'growth diagnostics' (see Chapter 4). This does not require wholesale institutional reform.

Summary

- Institutional structures and rules of behaviour are a necessary condition for economic activity to flourish because incentives and price signals in a market economy cannot function properly without them.
- There are at least five main types of market-supporting institutions that are necessary, if not sufficient, conditions for rapid economic progress: property rights and legally binding contracts; regulatory institutions; social insurance institutions; institutions for conflict management; and institutions to secure macroeconomic stability.
- Poor countries are often characterized by a lack of trust and the rule of law; weak institutions to mitigate risk and manage social conflict; no clearly defined system of property rights; an inadequate regulatory apparatus to curb fraud and anti-competitive behaviour; and a lack of clean government.
- Without property rights and the rule of law, the incentive to invest, on which economic growth ultimately depends, is very weak.
- It is not easy to bring about institutional change. There is a collective action problem, which limits potential gainers from bringing about change in opposition to vested interests, including the free-rider problem and the bargaining problem of distributing the gains.
- It is not easy to measure institutional development and its impact on economic performance because institutional development itself is endogenous to economic development. An exogenous measure of institutions is required.
- Several different measures of institutions have been used in empirical work, such as a measure of property rights and risk of expropriation; an aggregate governance index; an index of

democracy, political rights and civil liberties; an index of political instability; an index of corruption; an index of economic freedom; and an index of social division.

- The economists Acemoglu, Johnson and Robinson believe that the fundamental cause of differences in the level of development across countries in the world today is the historical evolution of institutions, and that in those parts of the world where conditions were harsh, in Africa for example, colonizers created 'extractive states' with no firm property rights, while in other parts (e.g. the USA and Australia) colonizers settled in large numbers and built institutions conducive to development. Disease and mortality rates in the nineteenth century are taken as an exogenous institutional variable. The role of geography (a constant) is dismissed.
- If geography was the most important factor in development, the most (least) prosperous areas prior to colonization should have continued to be the most (least) prosperous, but this is not the case. On the other hand, geography, and its effects on disease and mortality, affected the type of colonization and thus the character of institutions. The role of geography is therefore controversial.
- Apart from the debate on institutions versus geography, most of the empirical work on the role of institutions in economic development has been conducted on the influence of democracy and political stability on economic performance.
- Rodrik finds that democracies deliver more predictable long-run growth rates, produce greater short-term stability, handle adverse shocks better, and promote a fairer distribution of income than non-democratic states.
- Chang shows, however, that the lessons of history are that many of the institutions that are argued to be important for developing countries today emerged *after*, not before, economic development was taking place; for example, democracy and property rights, contract law, company law, bankruptcy law and tax law. His message is that institutions should be allowed to evolve naturally, internally, and not be imposed from outside.

Chapter 8 Discussion questions

1. Why are institutional structures and rules of behaviour a necessary condition for economic activity to flourish?
2. What institutions do you think are the most important for encouraging investment in developing countries?
3. What is the importance of local knowledge in building appropriate institutions?
4. What are the major empirical problems of testing the relationship between institutions and economic development?
5. Briefly describe the Acemoglu, Johnson and Robinson theory of the link between colonialism, institutions and economic development.
6. Is it possible to distinguish the role of institutions and geography in explaining differences in the level of development between countries?
7. In what ways can democracy help and hinder economic development?

Note

1. Keefer and Knack's (1995) early study examined the impact of property rights on economic growth across countries in the period 1974–89, using composite indices of contract enforceability and risk of expropriation, and found a strong positive effect of property rights; stronger than the effect of political instability or measures of civil liberties.

Websites on institutions and market behaviour

Transparency International www.transparency.org
Heritage Foundation www.heritage.org
Center for Global Development www.cgdev.org
Freedom House https://freedomhouse.org/