Do Institutions Rule?

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The quality of institutions has a profound impact on the rate of economic growth and development in a country. In an essay ambitious in both scope and purpose, Elin Thora Ellertsdottir outlines the importance of different types of institutions with regard to issues such as foreign aid and the resource curse. Her conclusion emphasises the futility of trying to analyse an institution in isolation from other important factors.

Introduction

> *"I wish to assert a much more fundamental role for institutions in societies; they are the underlying determinant of the long-run performance of economies."*
> *(North, 1990, p.107)*

Institutions can be defined as the 'rules of the game' and are widely believed to be important for economic growth and development. We live in a world that is uncertain and institutions are an attempt to control our environment and minimize transaction costs (Soysa and Jütting, 2006). They are 'humanly devised constraints that shape human interaction' (North, 1990, p.3). In order to address the question of whether institutions rule, we will examine their importance for economic growth and development. Moreover, we will discuss the potential ways of improving institutions to achieve greater development and the challenges we face in doing so. Finally, to further determine the importance of institutions we explore their relationships with foreign aid and natural resources. Although, first it is important to outline different types of institutions and how they interact with each other.

Classification

Institutions can be divided into formal and informal types, and categorised by the areas of economics, culture and politics (Soysa and Jütting, 2006). Formal institutions are the written 'rules of the game' and consist of laws and regulations, constitutions, charters, property rights and even governance. They are enforced in an official manner by a third party, which is usually state-governed, such as the police, courts, judges, and bureaucrats. Enforcement procedures can involve fines or criminal punishment. In contrast, informal institutions are unwritten, socially shared rules that are created and enforced in an unofficial manner (Helmke and Levitsky, 2003). They include socially sanctioned norms of behaviour, such as attitudes or traditions. Furthermore, they consist of extensions, elaborations and modifications of society's formal rules that exist outside of the official structure. Informal institutions are mostly self-enforcing through a system of cooperation, obligation, shaming, boycotting, gossip and internalized norm adherence (Soysa and Jütting, 2006).

Initially, the study of institutions was focused on formal institutions. Since then, the equal importance of informal institutions has come to light. Informal institutions can be divided into four categories according to their interactions with formal institutions. Complementary informal institutions enhance the effectiveness of formal institutions and address problems that are not dealt with in the written rules. Examples include operating procedures and norms that help complex formal institutions to function successfully. Accommodating informal institutions have a tempering effect on formal rules and are useful for actors who dislike outcomes of written rules but are unable to change them. So although accommodating institutions may not enhance efficiency, they can moderate the desire for change and thus increase the stability of formal institutions. An example is when Costa Rican party leaders created 'informal devices' to convince legislators to participate in constituency service despite the ban on re-election. Competing informal institutions create incentives that are incompatible with formal rules. This can occur with the introduction of ineffective formal institutions that fail to take values, customs and other informal institutions into account. An example is when imposition of European legal systems in many post-colonial countries created 'multiple systems of legal obligation'. Finally, substitutive informal institutions aim to achieve outcomes that formal institutions have failed to bring about. An example is when the Peruvian army abandoned highland territories during the Shining Path insurgency and peasants decided to create various informal institutions to provide public goods and keep order (Helmke and Levitsky, 2003).

To sum up, studies of informal institutions in developed countries tend to concentrate on complementary and accommodating institutions due to formal institutions being more effective in advanced countries. In contrast, studies of informal institutions in developing and post-communist countries focus mainly on substitutive and competing institutions (Helmke and Levitsky, 2003).

Institutions and Development

Institutions are believed to positively affect economic growth and thus promote development. Yet, the determinants of development are complex and interconnected. Positive development outcomes depend strongly on the interaction between institutional outcomes, human behaviour and exogenous factors like environmental conditions, geography, and history (Soysa and Jütting, 2006).

Most modern OECD countries have developed effective institutions to protect property rights, enforce contracts and ensure peace and stability. They have implemented formal institutions to control state power, such as parliaments, judiciaries, or federalist institutions. Moreover, they established norms and values that promote cooperation. This encourages exchange between people and interest groups. Still, only a small number of countries developed these effective institutions. Most other countries have ineffective institutions that are detrimental to development and economic growth (Shirley, 2005). This raises the question: why were few countries able to establish effective institutions which promote growth? The new institutional economics perspective lists four reasons for underdeveloped institutions. These are:

- Colonial heritage, where countries inherited poor institutions from their col onizers.
- Colonial heritage plus, where countries had valuable resources or people that could be enslaved, which attracted colonizers to design institutions to extract resources.
- Political conflict, where countries had little political competition and allowed their rulers build institutions designed for their own selfish interests.
- Beliefs and norms, which were hostile to markets or generated mistrust, dis couraging the building of institutions that foster investment and trade (Shirley, 2005).

Identifying which institutions have a positive effect on development is difficult. A large number of variables turn out to be significant, including political rights and democracy, property rights, civil liberties, and institutions that encourage cooperation (Aron, 2000). Despite the large number of studies conducted on the impact of institutions on development and growth, there are still a few important gaps in the literature. Often, there is a lack of clear and consistent definitions of institutions. Their definitions range from narrow to broad. Furthermore, studies that address the effect of institutions in a country case study are frequently missing an analytical framework. Also, these studies often lack specific policy recommendations (Jütting, 2003).

In conclusion, formal and informal institutions work together to shape development outcomes. If the main goal of institutions is to lower transaction costs and help people cooperate, governments have an obvious incentive to encourage institutional building in order to stimulate development. Still, governments often cause more harm than good by imposing their will on the people. They would be better off by fostering open environments that allow people to cooperate in solving collective problems (Soysa and Jütting 2006).

Reforms

Changing formal institutions without considering the underlying informal institutions, such as cultural norms and values can have detrimental consequences. The implementation of democratic formal institutions in developing states has proved ineffective in achieving the governance outcomes associated with democracy in richer countries. This can be due to cultural factors concerning education, governance, corruption, or gender relations being very resistant to change (Bauer, 1988). Furthermore, beliefs and norms are incredibly difficult to change, which could also explain why underdeveloped countries cannot achieve growth by simply importing institutions that have proved successful elsewhere (Shirley, 2005). Once again, in the words of Douglass North (1994):

> "*Economies that adopt the formal rules of another economy will have very different per formance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful Western economies to third-world and Eastern European economies is not a sufficient condition for good economic performance."(North, 1994: 366)*

There are several examples of this failure, including former French colonies in Africa adopting the French educational and bureaucratic systems, and Latin American countries copying the United States' constitution (Shirley, 2005).

Changing a country's institutional system requires caution and consideration for its existing cultural and religious norms. There is no single blueprint that is guaranteed to deliver development. Policies that are optimal in one country may fail miserably in others (Soysa and Jütting, 2006).

Attempting to impose the blueprints of idealised versions of Western institutions on developing countries is called institutional monocropping (Evans, 2004). Its attractiveness as a model for institutional change is understandable due to the basic institutions of OECD countries being, in fact, related to development in those countries. They are also institutions that richer countries can understand, which might attract foreign investors. Nevertheless, it is not difficult to understand why monocropping has failed. Imposing a new set of formal rules without simultaneously reshaping the distribution of power can be troublesome. Ha-Joon Chang (2002) refers to monocropping as 'kicking away the ladder'. He argues that the institutions being imposed on developing countries are not those that characterized today's richer countries during their periods of development. Lastly, clear evidence for the ineffectiveness of monocropping is the decline in the growth rates of developing countries over the past twenty years. If the method were effective for achieving development, we would expect to have seen increasing growth rates (Evans, 2004).

The disappointing results of monocropping indicate that moving towards increased local input and experimentation might be the best option for securing institutional quality. Economists such as Amartya Sen and Dani Rodrik argue than an alternative solution to monocropping would be to foster institutions that improve citizens' ability to make their own choices and encourage public discussion. Several economic examples suggest this could improve developmental performance. Two of the best-known examples are from the state of Kerala in India, and the city of Porto Alegre in Brazil (Evans, 2004).

To conclude, changing formal institutions involves changing the written 'rules of the game' and although it may be challenging, it is certainly possible. Changing informal institutions, however, can prove to be incredibly difficult. Still, governments do have the power to influence mass audiences through educational content and campaigns. However, they often struggle to affect religious practices, traditions, or family life. Civil society groups have been successful in changing some types of behaviour, for example, Amnesty International has worked to spread the norms of human rights across borders (Soysa and Jütting, 2006).

Institutions and Foreign Aid

Aid accounts for a very high percentage of some countries' government budgets, especially in Sub-Saharan Africa (Bräutigam and Knack, 2004). Still, there has been much debate over the effectiveness of foreign aid to developing countries. William Easterly (2001) went so far as to argue that 'the 1000 billion dollars spent on aid since the 1960s, with the efforts of advisors, foreign aid givers, the International Monetary Fund, and the World Bank, have all failed to attain the desired results' (Easterly, 2001: 1). In contrast, the advocates of aid argue that Africa is stuck in a poverty trap and requires foreign aid to escape that trap (Birdsall, 2007). Theory provides conflicting evidence on the matter. On one hand, aid can help governments escape binding revenue constraints, allowing them to strengthen local institutions and grant wage increases to civil servants. Furthermore, aid personnel often provide an important service by managing government programs. Foreign aid success stories include South Korea, Taiwan and Botswana (Carlsson, Somolekae and van de Walle, 1997). On the other hand, continuous aid over long periods of time could potentially hinder the development of good governance in two ways. Firstly, through the weakening of institutions: this can occur due to the high transaction costs accompanying aid, the problem of 'poaching', the effect of aid on the budget process, and the obstruction of opportunities to learn. Secondly, large amounts of aid can create incentives that impede solutions to collective action problems (Bräutigam and Knack, 2004).

The institutional destruction inflicted on weak African countries by foreign aid has not gone unnoticed by researchers. Furthermore, the aid community itself seems to acknowledge the problem (Bräutigam and Knack, 2004). The World Bank stated that 'donors may fragment central capacity for policy formation, entering with ministries into bilateral deals on multiple projects without determining whether their cumulative effects are collectively sustainable or mutually consistent' (World Bank, 1997: 84).

Institutions and Natural Resources

The relationship between a country's natural resources and its income levels has been the topic of several empirical studies. These studies often observed that countries rich in natural resources tend grow more slowly than resource-poor countries. This is often referred to as 'the curse of natural resources' (Sachs and Warner, 2001). Sachs and Warner did not acknowledge the role of institutions in this resource curse. However, Mehlum, Moene and Torvik (2006) test the hypothesis that institutions are a deciding factor for the resource curse. They first note that many countries with high growth rates, such as Australia, Canada, Norway, and Botswana, are rich in natural resources. This raises the question: why, among countries with high levels of natural resources, do some experience high growth rates and others low growth rates? To address this question they tested their theory that the quality of institutions is a determining factor. They used data from 1965 to 1990 on average economic growth and resource abundance. Their sample contained 42 countries which are rich in natural resources. They examined the relationship between GDP growth and natural resources in all the countries. The results show that, in general, a resource curse does exist. However, when they divide the sample into countries with bad or good institutions, the results indicate that this curse is only present in countries with bad institutions (Mehlum, Moene and Torvik, 2006).

Conclusion

Institutions can be divided into formal and informal institutions. Formal institutions are written rules and consist of property rights, laws, constitutions and governance. They have official enforcement mechanisms, which are usually state-governed. In contrast, informal institutions are the unwritten rules of society. They include norms, beliefs, values, attitudes, and traditions, and are mostly self-enforcing. Institutional quality is an important determinant of economic growth and goes a long way in explaining the variation in incomes across countries. Furthermore, it is believed that institutions positively influence development. However, identifying which institutions have this effect proves to be challenging. Several variables turn out to be significant, including democracy, property rights, and institutions that encourage cooperation. So, how can we reform the institutions of developing countries in order to stimulate their economic growth? When changing formal institutions we must consider underlying institutions such as cultural norms and values. Therefore, we cannot simply impose blueprints of idealized Anglo-American institutions on developing countries and hope for growth. This method is called monocropping and has proved incredibly unsuccessful and detrimental to developing countries so far. An alternative solution could be to seek ways of fostering institutions that improve citizens' ability to make their own choices and encourage public discussion.

Foreign aid accounts for a high portion of some developing countries' GDP and there has been much debate over its effectiveness and influence on institutions. Some believe aid is necessary for underdeveloped economies, while others believe it is destructive to their institutions, thus causing more harm than good. Much research has also been done on the relationship between a country's natural resources and its income levels, culminating in the theory of 'the resource curse'. Some scholars find no decisive role for institutional quality in 'the curse', while others believe it is a deciding factor in whether countries rich in natural resources are able to sustain high growth rates or not.

It is clear from the existing literature that institutional quality wields great power over economic growth and development. When examining ways to stimulate growth in developing countries, it is imperative to consider institutions, both formal and informal. Designing formal institutions for underdeveloped countries that take into account each country's norms, values and traditions could go a long way in promoting development. Thus, we can conclude that institutions are of utmost significance.

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