Institutional Economics of Development:
Some General Reflections

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I

Institutional Economics is now a thriving subject in development, as it should be, since the major difference between the economics of rich and poor countries is arguably in the different institutional framework we implicitly or explicitly use in understanding or analyzing them. Other substantial differences, say in geography or culture or history also work sometimes through institutional differences. As institutional economics of development is a vast subject, in this paper I shall confine myself to a subset of institutional issues, still keeping the range rather broad, broader than most of the other chapters in this book.

In this chapter, after a brief foray into the history of economic thought regarding institutions particularly in development economics, I shall mainly try to (a) unbundle the complex of generic institutions important for development, going beyond the narrow focus of the current institutional

economics literature on security of property rights; (b) speculate on the processes of institutional change (or lack of change), in particular on what should be a central question of institutional economics of development-- *why do dysfunctional institutions persist over long periods of time*-- and focus on the impact of distributive conflicts in this context; and (c) wrap up with a reference to a central dilemma in governance institutions and some suggestions for future research. Our focus all through will be on the role of distributive conflicts in shaping institutions.

Most recent papers on institutional economics start with North (1990), or at most with Williamson (1985), of course ignoring a long tradition of institutionalist literature going all the way back to the German Historical School in the latter part of the 19th century, and the role played by Marxist economics (as a major discourse on how economic institutions are shaped by technology and changed by collective action) and that by the American institutionalists (like Veblen) in the early part of the 20th century. In our own field of development economics, most discussion of institutions these days also starts with North, and then jump to the cross-country empirical literature, most widely cited of which is Acemoglu, Johnson and Robinson (2001). Professional memory or attention span in Economics is always rather short, but most remarkably so in this case, as North (1990) was immediately preceded by at least two decades of vigorous economic analysis of institutional arrangements in developing countries. It started with the literature on sharecropping, followed by a proliferation of analysis of institutions in rural land, labor, credit, insurance, and some general inter-

linked markets. By the end of the 1980's or early 1990's two multi-author volumes of essays on rural institutions, *The Economic Theory of Agrarian Institutions*, Bardhan ed. (1989), and *The Economics of Rural Organization*, Hoff, Braverman and Stiglitz eds. (1993), came out, putting together (and extending) some of the results of the rich literature on rural institutions in developing countries that had come up in the preceding two decades. Another collection of essays, *The New Institutional Economics and Development*, Nabli and Nugent eds. (1989), put together various applications of transactions cost analysis to problems of development, both rural and urban (with application to case studies in Tunisia).[1] There is hardly any trace of this literature in the recent outpourings on the institutional economics of development.

There may be two reasons for this. One is that North's Nobel prize in institutional economics deflected attention away from the micro analysis of the earlier literature to large macro institutions in trying to understand why historically some countries have developed and others not, quickly buttressed by the massive amounts of cross-country regressions on the basis of the easily downloadable international data that became available in the last decade or so. The second reason is that while the earlier literature was to a large extent theoretical, the recent dominant trend is in the empirical direction in development economics (as in all of Economics). Yet it is worth pointing out that the earlier micro literature was also significantly empirical, as there were many attempts to quantify the impact of institutions or the determination of institutional choice. For example, the impact of land tenure

[1] A fourth collection of essays on Institutions and Development was edited by I. Adelman and E. Thorbecke for a symposium in the September 1989 issue of *World Development*.

on farm productivity was carefully estimated in the articles by Bell (1977) and Shaban (1987), testing the competing models of sharecropping with Indian micro data. Variations in forms, contractual terms, and extent of tenancy were empirically examined by Matoussi and Nugent (1989) with Tunisian household-level data, Bardhan (1984) with Indian household-level, farm-level, region-level, and state-level data, and by Morooka and Hayami (1989) with plot-level data in a village in western Java, and by Otsuka (1991) and by Roumasset (1984), both with farm-level data for the Philippines. Variations in farm labor institutions (including those of labor-tying arrangements) were analyzed by Bardhan (1983) with Indian region-level and household-level data; the impact of ownership security on investment was analyzed by Feder and Onchan (1987) with farm-level data in Thailand; the impact of indigenous land rights on agricultural productivity was analyzed by Migot-Adholla, Hazell, and Place (1991) with farm household data in sub-Saharan Africa; the impact of changes in rules of credit access on productivity was estimated by Carter (1989) with farm-level data in Nicaragua; the role of credit arrangements in risk-pooling was analyzed by Udry (1990) with household-level data in Northern Nigeria; the impact of reform of collective rights on productivity and resource allocation was empirically analyzed by Carter (1984) with farm-level data for Peruvian agriculture and by Lin (1987) with province-level data for China. And so on.

Some (though not all) of these empirical attempts did not pay as scrupulous attention to the identifying strategy in econometric estimation as we do today, but they represented a considerable amount of advance. For that matter much of the recent macro empirical literature on institutions on the basis of cross-country regressions is also flawed, largely on account of

unobserved heterogeneity, use of necessarily coarse instrument variables, and poor data quality and cross-country comparability[2]. As Pande and Udry (2005) point out in their survey[3], the cross-country empirical strategy cannot disentangle the specific institutional channels through which an outcome is affected or the impact of institutional changes on it.

II

Following the leadership of North, the recent literature has shown how important secure property rights are in encouraging investment and innovations, allowing for the investor and the innovator to reap the harvest of their efforts.[4] There is, however, a general impression in much of this literature that if one can get the rule of law that protects property rights (and preferably, the laws themselves are of the Anglo-Saxon type which are supposed to protect minority shareholders against insider abuse in the corporate sector), the market will take care of much of the rest. This preoccupation of the literature with the institution of security of property rights, often to the exclusion of other important institutional issues, severely limits our understanding of the development process. I shall shortly come back to this, but let me immediately note that different social groups may be interested in different types of property rights; for example, the poor may

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[2] For a discussion of this, see Bardhan (2005), Ch. 1.

[3] This otherwise good survey misses out on much of the large micro literature on institutions in the 70's and 80's.

[4] Security of property rights also facilitates access to credit, and thus production and trade.

care more for simple land titles or relief from the usual harassments by local goons or government inspectors, whereas the rich investor may care more for protection of their corporate shareholder rights against insider abuses or for banking regulations, and a general 'rule of law' (or 'legal origin') variable is too crude to capture these differences. In general, as Pande and Udry (2005) point out with an example from Ghana, the incentives provided by a given institutional setting often vary with individuals' economic and political status.

Secondly, in history securing property rights for some has often meant dispossessing others. For example, the rights of enclosure in England eliminated the traditional land use rights of many of the poor villagers; in 19th century US the security of property rights was ensured superseding communal tribal rights in land traditionally enjoyed by the Native Americans; in recent years in Africa the land titling programs have sometimes dispossessed women of their traditional farming rights. In South America, in contrast with many parts of North America, property rights in land were often bestowed on people who were politically influential but not necessarily good farmers. This led to polarization and conflicts with poor peasants, which served neither efficiency nor equity.

In general, when contracts are incomplete, attempts to enforce private property rights may weaken the mechanisms of prior cooperation among resource users (say, of previously common or weakly-defined property). In particular, a central characteristic of most private property rights is their tradability, and tradability (particularly to outsiders) may undermine the

reliability of a long-term relationship among users of a resource.[5] Similarly, the market-enhancing features of securing rights in one market (say, credit) may undermine implicit contracts in related transactions where markets are weak (say, insurance): Kranton and Swamy (1999) give an example of how the British introduction of court enforcement of contracts in agricultural credit markets of the Bombay Deccan in the nineteenth century reduced lenders' incentives to subsidize farmers' investments in times of crisis, leaving them more vulnerable in bad times with formal insurance markets largely absent.

Thirdly, in the fast growth of the last three decades in East Asian countries, particularly China and Indonesia, more than formal rule of law and guaranteed security of property rights (which were often rather weak), prudent (though corrupt and tyrannical) rulers have succeeded in providing for a predictable and durable contractual environment for private business to thrive. In the East Asian business environment (for example, among Chinese business families in south-east Asia) the transactions between private parties have been governed less by court-enforced private property rights, more by implicit relational contracts and reputational incentives. But the relation-based systems of governance become weaker as the scale of economic activity expands.

Fourthly, institutions in the standard view have mainly a *constraining* role, constraining the state or other parties from intervening with our property rights. But there are many cases of *enabling* institutions which have a

[5] See Seabright (1993) for an elaboration of this argument.

somewhat different role: a community or a state institution may enable many common people to do things which they could not do by themselves in isolation. Social networks, community organizations, network of government extension services and local experimental stations, a national innovation system that facilitates training and technology absorption, etc. are a few examples of many such enabling institutions. This distinction between constraining and enabling has a family resemblance to the distinction philosophers make between 'negative' and 'positive' liberty, discussed in depth in the literature around the famous essay by Isaiah Berlin (1969). In one strand of this literature, recently a 'third' concept of liberty has been introduced --see Skinner (2002)—which emphasizes the need for democratic institutions that promote civic participation. Consistent with (though not always aware of) this literature, there are many economists who emphasize the importance of participatory institutions (as opposed to merely constraining institutions), particularly in the management of local environmental resources (like forests, fishery, irrigation) or in worker participation in firm management, or in maintaining ethnic networks of trade and long-distance credit (think, for example, of the 'community responsibility system', discussed by Greif (1997), in preserving multilateral reputation mechanisms in late medieval commerce around the Mediterranean).

Fifth, historically the way the various *coordinating institutions* in a society function has made a big difference in development. In general, economies at early stages of development are beset with coordination failures of various kinds, and alternative coordination mechanisms -- the state, the market, the community organizations -- all can play different roles, sometimes

conflicting and sometimes complementary, in overcoming these coordination failures, and these will remain important even if private property rights were to be made fully secure. Also, these roles change in various stages of development in highly context-specific and path-dependent ways. To proclaim the universal superiority of one coordination mechanism over another is naive, futile and a-historical.

Markets are superb coordination mechanisms in harmonizing numerous non-cooperative interactions and in disciplining inefficiency and rewarding high-valued performance. But when incentives and control rights are misaligned (on account, say, of initial asset ownership differences constraining contractual opportunities), and there are important strategic complementarities in long-term investment decisions, markets fail to coordinate efficiently. The implications of 'imperfections' in, and sometimes the non-existence of, credit and insurance markets are severe for the poor, sharply reducing a society's potential for productive investment, innovation, and human resource development. The state can provide leadership for (and put selective incentives and pressure on) individuals interacting cooperatively in situations where non-cooperative interactions are inefficient. But the state officials may have neither the information nor the motivation to carry out this role; they may be inept or corrupt, and the political accountability mechanisms are often much too weak to discipline them. In the context of these pervasive market and government failures it is often pointed out that a local community organization, if it has stable membership and well-developed mechanisms of transmitting private information and enforcing social norms among its members, has the potential to provide sometimes more efficient coordination than either the

state or the market. But community organizations 'fail' too when they are 'captured' by elite (or sectarian) interests, or are hamstrung by the secession of the rich and the talented from local communities, and they may face covariate risks and costs of small scale.

Thus all the three types of coordination mechanisms have their strengths and weaknesses, and they sometimes work in mutually conflicting ways. State versus market is, of course, the staple of traditional left-right debates. For the community organizations many will point out how bureaucratic as well as market processes encroach upon or weaken the viability of traditional community management, say, of environmental resources, based on peer monitoring in proximate groups, and so on. But it is also important to keep in mind that their relationships need not be adversarial, that these three types may have institutional complementarities in many situations. There are many cases of public-private partnerships (for example, in joint-venture industrial or trading firms or collaborative research in crops, vaccines and drugs), of community organizations using market processes (for example, business-NGO partnership in Bangladesh in improving access to telecommunications in rural areas), and of community organizations linking up with the government (as, for example, in India in the case of joint forest management between the forest department of the government and local communities, or of SEWA, the well-known self-employed women's organization, covering health-related risks of its members through the government-owned insurance companies, utilizing the larger risk-pooling advantages of the state -- or increasingly of the market, as the insurance sector in India has been partially denationalized). Institutional economics will be much richer if we widen the horizon of our discussion beyond

institutions that secure private property against expropriation and admit a variety of institutional arrangements to cope with many different kinds of development problems.

III

One of the as yet inadequately resolved issues in institutional economics in the context of underdevelopment is why dysfunctional institutions often persist for a long time. Why doesn't the social evolutionary process select 'fitter' institutions? In general there are certain regularities in the evolution of institutions as social agents repeatedly face the same type of social problems and adapt their behavior, but there are no necessary social welfare maximizing mechanisms in the evolutionary process. In the recent literature on applications of evolutionary game theory to institutional change--see, for example, Bowles (2004) -- it is recognized that while efficiency generally contributes to a differential advantage in replication, it is highly unlikely that efficiency and success in replication will always go together, particularly because of (a) the positive and negative interactions of one institution with other institutions (involving their complementarity and crowding-out, as illustrated in the preceding paragraph) and (b) that the payoffs to adherence to particular institutions are dependent on adherence by others.

Before we proceed any further we should clarify a question about 'efficient' or 'inefficient' institutions that some economists are prone to ask. We want

to be upfront about *not* necessarily referring to Pareto-efficiency. We'll more often regard a movement toward a productivity-enhancing institution to be a change in the right direction. The Pareto criterion and insistence on unanimity are much too stringent (and politically a non-starter) for most discussions of institutional change. In any case when one is in search of Pareto efficiency, to make the compensating transfers from gainers to losers incentive-compatible in a situation where the valuation of gainers and losers is private information, it may be extremely difficult to change institutions even with no frictions at all in bargaining (beyond this information problem).[6]

In the new institutional economics literature what is considered to be the major stumbling block to realizing potential gains from institutional change is a political commitment problem (particularly in the sense of those in power finding it difficult to commit to not using that power). Looking over the last few hundred years of history North, Weingast,[7] and many others have focused on a particular political mechanism of credible commitment that made much of the difference between the success story of Western Europe and North America and the stagnation in large parts of the rest of the world over this period. This mechanism essentially involved self-binding by the rulers (like the king giving up royal prerogatives, increasing the powers of the Parliament, etc. in 1688 in England) in the former regions credibly committing themselves to be non-predatory and thus securing private

[6] See Mailath and Postlewaite (1990) for a demonstration of this in the case of collective action on a public project.

[7] See North and Weingast (1989). For some empirical criticisms of the argument for English history, see Carruthers (1990) and Clark (1995).

property rights and allowing private enterprise and capital markets to flourish. The standard prescription in this literature is for a *strong but limited* government—a government that is strong enough to secure property rights, enforce contractual laws and maintain stability, but at the same time it commits not to transgress and make confiscatory demands.

While not denying that such self-binding mechanisms may have played a very important role in Western history, I think it is possible to argue that they are neither necessary nor sufficient for economic development. They are not sufficient, as there are other (technological, demographic, ecological and cultural) constraints on the development process, not all of which will be relaxed by the rulers disabling themselves. They are not necessary, as a few non-Western success stories (Japan since Meiji Restoration, Korea and Taiwan since 1960, coastal China since 1980, etc.) suggest; in most of these cases while the rulers often adopted prudent policies (and sometimes even acquired reputation[8] to this effect), they were far from disabling their discretion.

What does one mean by a 'strong' state? One has to be careful in avoiding circularity (or endogeneity) involved in definitions that in some way include aspects of state performance in development. We may instead define the 'strength' of a ruler (or a ruling group) as the ability to credibly precommit

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[8] As Acemoglu (2003) points out in a model of repeated games where reputation may act as a substitute for commitment contract, its efficacy depends on the patience and time horizon of the rulers. This is related to the point made by Evans (1995) on the importance of meritocratic career bureaucrats ('Weberian') with a longer time horizon in South Korea compared to the bureaucrats in Latin America more dependent on short-term political patronage.

(measurable, however crudely, in terms of some aspects of the prior political-bureaucratic structure and pre-announced decision rules) and think of him (her) as a Stackelberg leader, in a model where the ruler maximizes his objective function subject to the reaction function of the ruled. In the process the ruler internalizes the economic costs and benefits of his actions in accordance with that reaction function. In contrast one can say that the weak state is a Stackelberg follower: it cannot commit to a particular policy and merely reacts to the independent actions of the private actors such as special-interest groups. We can then say that, compared to the strong state, the weak state will have too much of undesirable interventions (creating distortions in the process of generating rents for the lobbying groups), and, by the same logic, will have *too little* of the desirable interventions (as in the case of coordination failures), since the state does not take into account or internalize the effects of its own policies. So the distinction between a strong state (as in much of East Asia) and a weak state (as in much of Africa and South Asia) lies not in the *extent* of intervention but in its *quality*.[9] This also means that the beneficial effects of a strong state go beyond the North-Weingast ideal of a *strong but limited* government.

The East Asian state has often played a much more active role, for example, acting as a catalyst and coordinator for long-term finance in industrial

[9] This idea was informally expressed in Bardhan (1990), and given a somewhat more formal exposition in Rodrik (1992) and Bardhan and Udry (1999). In a recent paper Acemoglu (2005) has used a different definition of strong and weak states which I have not found very useful. In his model the ruler is politically strong if he is not easily replaceable. I think authoritarian Korea was a strong state and democratic India was a weak state, not so much because the leaders were more easily replaceable in the latter, but the main issue is that in India extreme heterogeneity of interest groups buffeted the state often to go back on its long-term commitments and goals. Japan and Scandinavian countries have often demonstrated aspects of strong states in my sense, but leaders being easily replaceable makes them weak states in the Acemoglu sense.

development. It intervened in the capital market sometimes in subtle but decisive ways, using regulated entry of firms and credit allocation (sometimes threatening withdrawal of credit in not so subtle ways) in promoting and channeling industrial investment, underwriting risks and guaranteeing loans, establishing public development banks and other financial institutions, encouraging the development of the nascent parts of financial markets, and nudging existing firms to upgrade their technology and to move into sectors that fall in line with an overall vision of strategic developmental goals[10]. In this process, as Aoki, Murdock, and Okuno-Fujiwara (1997) have emphasized, the state has enhanced the market instead of supplanting it; it has induced private coordination by providing various kinds of cooperation-contingent rents. In early stages of industrialization when private financial and other related institutions were underdeveloped and coordination was not self-enforcing, the East Asian state created opportunities for rents conditional on performance or outcome (in mobilization of savings, commercialization of inventions, export 'contests', and so on) and facilitated institutional development by influencing the strategic incentives facing private agents through an alteration of the relative returns to cooperation in comparison with the adversarial equilibrium. (Such contingent transfers are akin to the patent system, where the monopoly rent is contingent on successful innovation). Of course, the state sometimes made mistakes and did not always succeed in picking 'winners', but the opportunities created allowed for experimentations for firms and trial-and-error in their exploring of new directions. The pre-stipulated performance

[10] For a recent account of the role of the state in facilitating and engendering coordination, networking, and technology upgrading in the electronics and information technology industry in Taiwan, see Lin (2003).

criteria used in East Asia often included export success, which in a world of international competition kept the subsidized firms on their toes and encouraged cost and quality consciousness.

One should not, of course, underestimate the administrative difficulties of such aggregate coordination and the issues of micro-management of capital may be much too intricate for the institutional capacity and information processing abilities of many a state in Africa, Latin America, or South Asia. There is also the problem of how credible the commitment of the state is in implementing the contingent transfer and actually carrying out the threat of withdrawing the transfer when performance does not measure up. In this the states in Africa, Latin America, or South Asia have often been rather lax, compared to East Asia, and the contingent transfers have soon degenerated into unconditional subsidies or entitlements for favorite interest groups. One should also be wary, as the East Asian experience of financial crisis (or the weakness of the Chinese financial sector) warns us, about the moral hazard problems of too cozy a relationship[11] between public banks and private business (state-owned enterprises in the Chinese case) and the political pressures for bail-out that a state-supported financial system inevitably faces.

[11] As the recent financial crisis in the US illustrates, cozy relationships between the regulators and the regulated in the financial sector are not unfamiliar in the US.

IV

In the previous section we criticized the widely-held view that the clue to persistence of dysfunctional institutions lies in the inability of the state to commit to non-intervention. The history of underdevelopment suggests that a major (but by no means the only) stumbling block to beneficial institutional change in many poor countries lies in the distributive conflicts and asymmetries in bargaining and mobilizing power among social groups. The 'old' institutional economists (including Marxists) used to point out how a given institutional arrangement serving the interests of some powerful group or class acts as a long-lasting barrier (or 'fetter', to quote a favorite word of Marx) to economic progress. As was suggested in Bardhan (1989) and Knight (1992), the 'new' institutional economists sometimes[12] understated the tenacity of vested interests, the enormity of the collective action problem in bringing about institutional change, and the differential capacity of different social groups in mobilization and coordination. The collective action problem can be serious even when the change would be ultimately Pareto-superior for all groups. There are two kinds of collective

[12] North (1990) is an exception in this tradition. He points to the contrasting and path-dependent processes of change in bargaining power of the ruler versus the ruled in different countries, particularly in the context of the fiscal crisis of the state. In an earlier historical literature on the transition from feudalism in Europe, Brenner (1976) had provided a major departure from the usual analysis of transition in terms of demography or market conditions: he provided a detailed analysis of the contrasting experiences of transition in different parts of Europe (those between western and eastern Europe and those between the English and the French cases even within western Europe) in terms of changes in bargaining power of different social groups or in the outcomes of social conflicts. Brenner shows that much depends, for example, on the cohesiveness of the landlords and peasants as contending groups and their ability to resist encroachments on each other's rights and to form coalitions with other groups in society

action problems involved: one is the well-known free-rider problem about sharing the costs of bringing about change, the other is a bargaining problem where disputes about sharing the potential benefits from the change may lead to a breakdown of the necessary coordination. There are cases where an institution, which nobody individually likes, persists as a result of a mutually sustaining network of social sanctions when each individual conforms out of fear of loss of reputation from disobedience.[13] Potential members of a breakaway coalition in such situations may have grounds to fear that it is doomed to failure, and failure to challenge the system can become a self-fulfilling prophecy.

The problem may be more acute when, which is more often the case, there are winners and losers from a productivity-enhancing institutional change. The costs of collective action of such a change may be too high. This is particularly the case, as we know from Olson (1965), when the losses of the potential losers are concentrated and transparent, while gains of the potential gainers are diffuse[14] (or uncertain for a given individual, even though not for the group, as suggested by Fernandez and Rodrik (1992)). There is also the inherent difficulty, emphasized by Dixit and Londregan (1995),that the potential gainers cannot credibly commit to compensate the losers *ex post*.[15]

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[13] For a well-known static analysis of such a case, see Akerlof (1984). For a more complex model in terms of stochastic dynamic games explaining evolution of local customs or conventions, see Young (1998). Bowles (2004) provides an interesting extension of the Young model where institutional tipping is not generally induced by mutation-like accidents of behavior but rather results from intentional collective action of people. In this context he shows how highly unequal conventions may be difficult to dislodge.

[14] As Machiavelli reminds us in *The Prince* (1513), Ch. VI, ‘the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new’.

[15] Of course, some societies may be able to develop in repeated situations appropriate norms of compensation to losers, but preservation of such a norm itself may require collective action.

Ideally, the state could issue long-term bonds to buy off the losers and tax the gainers to repay. But in many developing countries there are serious limitations to the government's ability to tax, and its credibility in keeping inflation under control, and the bond market is thin. There is also the fear losers have that once they give up an existing institution, they may lose the *locus standi* in lobbying with a future government when the promises are not kept ('exit' from a current institutional arrangement damaging their 'voice' in the new regime in future), and so they resist a change today.

One can also formalize the obstruction by vested interests in terms of a simple Nash bargaining model, where the institutional innovation may shift the bargaining frontier outward (thus creating the potential for all parties to gain), but in the process the disagreement payoff of the weaker party may also go up (often due to better options of both 'exit' and 'voice' that institutional changes may bring in their wake), and it is possible for the erstwhile stronger party to end up losing in the new bargaining equilibrium (how likely this is will, of course, depend on the nature of shift in the bargaining frontier and the extent of change in the disagreement payoffs).[16] As Acemoglu and Robinson (2006) have emphasized, it may not be rational, for example, for a dictator to carry out institutional changes that safeguard property rights, law enforcement, and other economically beneficial structures even though they may fatten the cow which the dictator has the power to milk, if in the process his pre-existing rent-extraction machinery has a chance of being damaged or weakened. He may not risk upsetting the current arrangement for the uncertain prospect of a share in a larger pie.

[16] This is the case even if we abstract from the usual case of deadlocks arising in bargaining with incomplete information, with possible misrepresentation of the 'type' of the bargaining players.

Acemoglu and Robinson develop a theory where incumbent elites may want to block the introduction of new and efficient technologies because this will reduce their future political power; they give the example from 19th-century history when in Russia and Austria-Hungary the monarchy and aristocracy controlled the political system but feared replacement, and so they blocked the establishment of institutions that would have facilitated industrialization. These replacement threats are, of course, often driven by extreme inequality in society.

In explaining the divergent development paths in North and South America since the early colonial times, Engerman and Sokoloff (2002) have provided a great deal of evidence of how in societies with high inequality at the outset of colonization institutions evolved in ways that restricted to a narrow elite access to political power and opportunities for economic advancement. Initial unequal conditions had long lingering effects, and through their influence on public policies (in distribution of public land and other natural resources, public investment in primary education and other infrastructure, the right to vote and in secret, patent law, corporate and banking law, etc.) tended to perpetuate those institutions and policies that atrophied development. Even in countries where initially some oligarchic entrepreneurs are successful in creating conditions (including securing their own property rights) for their own economic performance, as long as that oligarchy remains powerful, they usually get away with raising entry barriers for new or future entrepreneurs, and this blocks challenges to their incumbency and thus sometimes new technological breakthroughs. See Acemoglu (2008a) for a theoretical analysis of this kind of dynamic

distortion in oligarchic societies even when property rights are protected for the initial producers.

The classic example of inefficient institutions persisting as the lopsided outcome of distributive struggles relates to the historical evolution of land rights in developing countries. In most of these countries the empirical evidence suggests that economies of scale in farm production are insignificant (except in some plantation crops) and the small family farm is often the most efficient unit of production. Yet the violent and tortuous history of land reform in many countries suggests that there are numerous road blocks on the way to a more efficient reallocation of land rights put up by vested interests for generations. Why don't the large landlords voluntarily lease out or sell their land to small family farmers and grab much of the surplus arising from this efficient reallocation? There clearly has been some leasing out of land, but problems of monitoring, insecurity of tenure and the landlord's fear that the tenant will acquire occupancy rights on the land have curtailed efficiency gains and the extent of tenancy. The land sales market has been particularly thin (and in many poor countries the sales go the opposite way, from distressed small farmers to landlords and money-lenders). With low household savings and severely imperfect credit markets, the potentially more efficient small farmer is often incapable of affording the going market price of land. Binswanger, Deininger and Feder (1995) explain it in terms of land as a preferred collateral (and also carrying all kinds of tax advantages and speculation opportunities for the wealthy) often having a price above the capitalized value of the agricultural income stream for even the more productive small farmer, rendering mortgaged sales uncommon (since mortgaged land cannot be used as collateral to raise

working capital for the buyer). Under these circumstances and if the public finances (and the state of the bond market) are such that landlords cannot be fully or credibly compensated, land redistribution will not be voluntary.

Landlords resist land reforms also because the leveling effects reduce their social and political power and their ability to control and dominate even non-land transactions.[17] Large land holdings may give their owner special social status or political power in a lumpy way (so that the status or political effect from owning 100 hectares is larger than the combined status or political effect accruing to 50 new buyers owning 2 hectares each). Thus the social or political rent of land ownership for the large landowner will not be compensated by the offer price of the numerous small buyers. Under the circumstances the former will not sell, and inefficient land concentration persists.

An important aspect of political rent, that is overlooked in the usual calculations of the surplus generated by a given institutional change, is that all sides are often really interested in *relative*, rather than absolute, gain or loss. In a power game, as in a winner-take-all contest or tournament, it is not enough for an institutional change to increase the surplus for all parties concerned to be acceptable. One side may gain absolutely, and yet may lose relative to the other side, and thus may resist change. If, in a repeated framework, both sides have to continue to spend resources in seeking (or

[17] Busch and Muthoo (2002) develop a model where land redistribution may adversely affect a landlord's bargaining power in *other* markets (labor or credit). The inability to make binding commitments prevents the poor from committing not to exploit their increased bargaining power following land redistribution; and, of course, being wealth-constrained they cannot compensate the landlords upfront either. The greater is the degree of inequality in the players' bargaining powers the more likely it is that inefficient institutions will persist.

preserving) power or improving their bargaining position in future, and if the marginal return from spending such resources for one party is an increasing function of such spending by the other party (i.e. power seeking efforts by the two parties are 'strategic complements'), it is easy to see why the relative gain from an institutional change may be the determining factor in its acceptability.[18]

That collective action problems in orchestrating institutional change from a low-level to a higher-level equilibrium are rendered particularly difficult by distributive conflicts are now slowly being recognized in both the macro and microeconomic literature. In macroeconomic comparisons of East Asia and Latin America in the last quarter of the twentieth century the point has been made that when wealth distribution is relatively egalitarian, as in large parts of East Asia (particularly through land reforms and widespread expansion of education and basic health services), it has been somewhat easier to enlist the support of most social groups (and isolate the extreme political wings of the labor movement) in making short-run sacrifices at times of macroeconomic crises and coordinating on stabilization and growth-promoting institutions and policies.[19] Rodrik (1998) cites cross-country evidence for his hypothesis that the economic costs of external shocks are magnified by distributional conflicts that are triggered, and this diminishes the productivity with which a society's resources are utilized.

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28. For a model of power-seeking on these lines to explain why two parties may not agree to obviously mutually advantageous transactions, even when there are simple enforceable contracts and side transfers of fungible resources to implement them, see Rajan and Zingales (1999).

[19] See, for example, Campos and Root (1996).

Below the aggregative or macro level there are many local self-governing institutions (either elected local government bodies in charge of delivering local public goods like roads, extension service, and public health and sanitation, or rural community organizations in charge of management of local environmental resources or urban neighborhood associations in charge of crime-watch or cultural-cum-social solidarity promoting activities), where distributive conflicts may sometimes lead to institutional failures. In areas of high social and economic inequality the problem of 'capture' of even elected local government bodies by the local elite can be severe, and the poor and the weaker sections of the population may be left grievously exposed to their mercies and their malfeasance[20]. Thus one beneficial byproduct of land reform, underemphasized in the usual economic analysis, is that such reform, by changing the local political structure in the village, gives more 'voice' to the poor and induces them to get involved in local self-governing institutions. In other cases, the problem of elite capture may be less, but that of elite 'exit' is quite serious in causing the erosion of political support from the provision of local public goods. When, for example, the rich do not send their children to local public schools and do not use the local health services, the public provision structure often crumbles as is familiar in both rich and poor countries.

Similar problems, arising from inequality, may afflict local non-government, often informal, community organizations in developing countries. The relationship between inequality and collective action (both in the sense of participation in a regulatory group organization and that of contributing to

[20] For a theoretical analysis of the elite capture problem in the context of decentralization, see Bardhan and Mookherjee (2006).

provision or conservation of some common resource) is an under-researched area in economics. For a brief survey of the theoretical and empirical literature on this question, see Baland and Platteau (2006). Here let us generally note that while the effect of inequality is in general ambiguous, there are many cases where the net benefits of coordination for each individual may be structured in such a way that in situations of marked inequality some individuals may not participate or contribute to the cost of collective action, and the resulting outcome may be more inefficient than in the case with greater equality[21]. Inequality may also lead to bargaining disputes arising from the distribution of benefits of collective action, as we have mentioned above. Besides, the negotiation and enforcement costs for some cooperative arrangements may go up with inequality. In such situations collective institutional structures and opportunities for cooperative problem-solving may be foregone by societies that are sharply divided along social and economic lines.

In this section I have enumerated the various processes through which initial inequality may result in the persistence of dysfunctional institutions in poor countries. The hypothesis that high inequality predicts a high probability of 'bad' institutions, and the latter in turn predict low income could in principle be tested, but in practice it is quite problematic. Inequality, after all, is highly endogenous at the macro level, and any such exercise will be afflicted by the same kinds of problems as the ones Banerjee and Duflo (2003) have pointed

[21] See Bardhan and Singh (2004) for a model where cooperation is beneficial in providing a public infrastructural facility, but subject to defection, and is supported by trigger strategy punishments in a repeated game. The paper explores the relationship between the nature of cooperation (size and composition of coalitions) and underlying inequality in the distribution of private productive assets.

out about the cross-country regressions on inequality and growth. In cross-section data one possibility is to use density of population in some historically early period as an instrument for predicting high inequality. As can be seen in the cross-country regressions reported in Bardhan (2005), weak political rights today are associated with high density of population in 1500, possibly indicating that in areas of labor abundance relative to land and other resources workers and peasants have weak political power, and equality of political power may have been difficult to establish. But political inequality and economic inequality may not be closely associated. It is, of course, likely to be the case that, other things remaining the same, in areas where labor is scarce, labor may be valued more highly and thus there may be less inequality, as has been argued by Engerman and Sokoloff (2002) in their comparison of North America with the tropical parts of Latin America. But other things are often quite different. Land abundance and labor scarcity have not helped Africans in the same away as North Americans for various historical reasons. Also, by this logic compared to Latin America and Africa, Asia (where density of population has been higher) should have more economic inequality, not less, as is actually the case. This may have something to do with inheritance practices. China and India, unlike Western Europe, North America and Latin America, historically did not have primogeniture, but equal partition (among sons) and subdivision of land, so there is a built-in tendency in Asia toward equality. There are also other factors involved. A historical density of population variable is therefore likely to be a 'weak instrument' for economic inequality.

V

One of the other factors referred to above is the nature of political competition and the context-specific and path-dependent formations of political coalitions. An interesting example of this in terms of comparative institutional-historical analysis is provided by Nugent and Robinson (2005). Holding constant both colonial background and crop technology, they compare the divergent trajectories in institutions (particularly in terms of protection of small holder property rights) and growth in two pairs of former Spanish colonies in the same region (Costa Rica and Colombia, on the one hand, and El Salvador and Guatemala, on the other) producing the same principal crop (coffee). The political fragmentation of elites often helps in overcoming obstacles to institutional development. In Costa Rica, for example, the elites of different towns were induced to compete with each other for popular support which they did by offering private property rights to smallholders. In El Salvador and Guatemala, on the other hand, the national elite remained unified in opposition to such an institutional change, and instead went in the direction of mass land expropriation and militarized plantation societies. Institutional economics will be richer with more such comparative historical studies. In a more statistical analysis of data from 89 villages in contemporary West Bengal, Bardhan and Mookherjee (2006b) find that political competition is more effective in bringing about land reforms and pro-poor targeting of programs than the redistributive ideology of the ruling party in the local governments.

Political competition, however, can sometimes lead to competitive populism. There is an inherent dilemma of governance institutions involved here. On the one hand, one needs institutions of credible commitment to insulate the system from the populist pressures of special interest groups and partisan or faction politics[22]. In particular, long-term investment projects or economic policy decisions that have consequences over a prolonged period will not get off the ground without such commitment. Even outside the economic sphere rule of law requires the system to display some degree of commitment that civil servants, judges, and the police are not beholden to the ruling politicians. (Examples may be given from appointments of civil servants as political patronage in Latin America, or even India, where meritocratically appointed civil servants are dependent on politicians for promotion and transfers). In the macro-economics literature this is usually emphasized in the context of central bank independence, but the problem is much wider. (It should be added that there are reputational substitutes for mandatory independence of central banks, as the examples of not-so-independent central banks in postwar Japan, China and India in the matter of inflation control suggest).

On the other hand too much insulation often means too little accountability. This leads to high-handed arbitrary governance, leading to abuses and waste. Even when the administration is benevolent, large-scale development projects directed from above by an insulated modernizing elite are often (a) inappropriate technologically or environmentally, (b) far removed from or insensitive to local community needs and concerns, and (c) failing to tap the

[22] For a theoretical model of competitive populism (as one of the costs of political competition), see Bardhan and Yang (2004).

large reservoir of local information, initiative, and ingenuity. These projects often treat poor people as *objects* of the development process, and end up primarily serving as conduits of largesse for middlemen and contractors and their political patrons, and also encourage widespread parasitism on the state among the beneficiaries. In developing countries where much of the economy is in the vast informal sector and dispersed in far-flung villages and small towns, the accountability mechanisms are particularly important at the local community level.

In some sense the dilemma of commitment vs. accountability is best resolved at the local level. If commitment is necessary for long-term projects, it may be easier to persuade the local people to make short-run sacrifices for local projects (like village roads, schools, health and sanitation, drinking water projects) that are to benefit them in the long run. There is more transparency of benefits, possibly more trust and peer-monitoring among a small group of face-to-face people, and collective action may be easier in resisting populist pressures. In contrast, individuals and groups may perceive more uncertainty in the trickle-down from future growth arising out of large-scale centrally administered projects, and they may instead opt for the bird-in-hand of current subsidies and short-term benefits. Accountability is also more direct at the local level, if the local democratic processes work. Electoral sanctions are more effective at the local level, than at the central level where multi-dimensionality of electoral issues dilutes responsibility. There is also more local vigilance on issues where there is more local stake ("it's our money you are wasting or stealing")[23].

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[23] Olken (2005) finds from a field experiment in over 600 Indonesian villages on village road projects funded from above that increased grassroots monitoring tends to reduce theft of money that was supposed

Decentralization of governance in the sense of devolution of power to local governments is now in vogue in many countries. There is now a substantial literature on the pros and cons of decentralization, some of which has been surveyed in Bardhan (2002). In particular, the problem of local capture by collusive local elite groups or sectarian interests has often been mentioned. How acute this problem is depends, again, on the initial levels of inequality (both social and economic), how lop-sided the nature of political competition is at the local level and on the context-specific and path-dependent formations of political coalitions.

In this chapter we started by showing how the recent institutional economics of development literature has ignored the substantive microeconomic institutional literature of the 70's and 80's, and been preoccupied with the macro impact of the institutions of security of property rights, to the neglect of other important institutions in the development process, particularly the participatory and coordinating institutions. We then show that the central problem of the persistence of dysfunctional institutions may have less to do with the political commitment problem of the rulers not being able to bind themselves against making confiscatory demands, but more to do with underlying distributive conflicts.

Let us end with a comment on an implication of this central question of institutional persistence for future work on institutional economics. The persistence of something in history clearly makes the application of an

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to be paid as wages to the villagers (but no so much the theft of the money supposed to be spent in procurement of materials from elsewhere). Such evidence for better performance of decentralization in the pro-poor targeting of *private* goods, in contrast to targeting of more public services, may also be found in Bardhan and Mookherjee (2006a) for rural West Bengal.

empirical identification strategy easier, and has been used as such, but it leaves open two issues in the study of institutional economics. One is that the procedure, widely adopted, of instrumenting recent institutions by referring to some historical fact is flawed because institutions change over time. An instrument for the initial institutions need not be a valid instrument for the current ones. As Przeworski (2004) has commented on the use of 'colonial settler mortality' in Acemoglu, Johnson, and Robinson (2001) as an instrument for current property rights institutions, if good institutions are more likely to survive in more affluent countries, then institutional quality today is still endogenous with respect to income.

Secondly, we need more theoretical models that can simultaneously handle the realistic case of some institutional durability with the possibility of institutional change, under different conditions with respect to perceptions of costs and benefits of resisting change on the part of incumbent elites (in response to changes in the technological, political-organizational and international environment).[24] The spread of Green Revolution, say, in eastern India is a case in point. Initially, when the new technology became available, a lot of economists pointed to the oligarchic landlord-moneylender nexus of the region as a long-standing substantial institutional block. But over time in some parts of the region this nexus got weaker as the rate of return from investment in new technology improved with a package program of public and private irrigation infrastructure, credit, information, land reform, and social learning. The same question of institutional persistence

[24] For the beginnings of a coherent theoretical explanation of the coexistence of frequent changes in political institutions with the persistence in certain aspects of economic institutions, in terms of a model with a Markov regime-switching process with state dependence, see Acemoglu and Robinson (2008).

and change is now relevant in pondering the question why the Green Revolution has been so slow in Africa so far. In general continuity and change is a complex dialectic process in institutional life that we need to be able to analyze better.

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