# The role of institutions in economic development

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## Introduction

Institutional Economics deals with the interplay between the market forces and institutional factors. It does so in several ways. It studies: the determinants of institutions and evolution over time (institutional evolution), the effects of a given set of institutions on economic efficiency and their distributional implications (institutional preconditions) and finallly, how institutions should be constructed in order to obtain optimal or maximal economic performance (institutional design). Institutional economics has developed along two different lines.

On one hand, we find ***neo-institutionalists*** which in several respects follow the tradition of 'old' institutionalists such as Veblen, Myrdal and Galbraith. Neo-institutionalists focus on development processes and have a macro-economic perspective. They have their own association - Association of Evolutionary Economics and the main journal is Journal of Economic Issues. Neo-institutionalists do not consider individual preferences as given. Instead, they are seen as influenced by a given institutional context. Institutions basicly limit the fundamental insecurity concerning the future. Institutionalized routines and customs gives society and markets in particular predictability and stability, and paradoxically this in turn is a precondition for the necessary flexibility. Neo-institutionalist theories show substantial affinity to recent marxist theories concerned with the institutional foundations of capitalist societies. I can just mention the French School of Regulation with in fact studies how social institutions (or modes of regulations) determine the specific form of capitalism. They focus on customs, practices and rules of game that make sure that in defiance of contradictory and conflicting relations between agents in capitalist society, a coherence of expectations and strategies of these agents in fact occur. A similar approach can be found among American scholars studying SSAs - Social Structures of Accumulation (Gordon, Bowles, Edwards and Weisskopf).

On the other hand we find the ***New Institutional Economics (NIE)***, which encompasses such theories as property rights theory, transaction cost theory, imperfect information theory and collective action theory. The relevant journal is Journal of Institutional and Theoretical Economics. NIE has to do with static effects of given institutions on the behavior of actors and they try to come up with or suggest new institutional designs. Further it destinguishes itself from the neo-institutionalists in being more micro-economic oriented. Focus is on individual preferences and behavior on one hand and group outcomes on the other. Individuals are potentially opportunistic. Unilateral action procduces inferior outcomes. This implies the existence of potential gains from effective mutual agreement. Social organization have two simultaneous problems : the "size of the pie" and the "division of the pie". Actors have a common interest in expanding the pie but conflictual interests in dividing it. Some of this theorizing deals with the state and is often called Neo-classical Political Economy. It destinguishes itself from neo-classical economics by its assumption that the state, far from being " an exogeneous force, trying to do good", is at least partially endogeneous and the politics it institutes will reflect interests in society. Further focus is shifted from productive activities towards unproductive activities - the so-called rent-seeking and direct unproductive activities (DUP). The economicst have been particularly interested in unproductive activities arising from policy interventions of various kinds. One can identify three major stands in this literature: l) collective choice analysis, 2) public choice analysis and finally 3) international trade and development analysis. In this lecture we will only deal with these three schools. Collective choice analysis is taken up in relation to industrialization referring to Mancur Olson. Public choice theory is presented in relation to agricultural development , referring to Robert Bates. Finally, the international trade and development school is taken up by referring to Gustav Ranis arguments concerning the institutional foundations of the success of the Newly Industrializing Countries in East Asia

**Institutional economics in agriculture**

In the academic tradition which I have been brought up with, Institutions have not played any significant role in the understanding of development processes within agriculture. However, retrospectively I can see I have implicitely dealt with institutions in two ways:

1. As part of the social, economic and political superstructure regulating human acivities within certain areas providing options or constraints for various social groups' development activities. As such institutions, so to speak freeze concepts for human interaction in a given time period, they acquire a certain degree of autonomy and the institutions themselves might eventually become obstacles which are changed in the historical development process. Using John Martinussen's concepts from yesterday, institutions conceived in this way are manifestations of structures.
2. As concrete organizations in flesh and blood organizing production, commercialization etc. In John Martinussen's conceptualization, they are institutions as actors in their own right.

In the first way I conceive institutions, I shall refer to a major study made by OECD: Economic Policies and Agricultural Performance of Low-Income Countries, from 1987.

***Concept of institutions*** from OECD study. The study looks at agricultural performances in six selected low-income countries. Mali and Burkina Faso in the Sahel, Kenya and Tanzania in East Africa and Nepal and Sri Lanka in Asia. The selected countries are considered to be representative for low-income countries in Africa and Asia. As they have been without major natural or political disasters for the past 20 years they are considered representative for analysis on how institutions and policies influence agricultural performance. The study considers institutions as one of three major factors influencing the performance. They look upon these factors as concentric circles whereby the outer ring consists of external and internal conditions and constraints on agricultural performance.

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| <u>Internal constraints:</u> | natural environment:<br>-climate<br>-natural ressource endowment<br>demography<br>training of skilled labour<br>political stability |
| <u>External constraints:</u> | the world market and changes in terms of trade. This can be linked to internal constraints if natural ressource endowment only allow export of, say, two items with falling world market prices.<br><br>External debt<br>Foreign aid. Conditionalities, structural adjustment policies etc. |

***Institutional and structural framework in agriculture*** is the next concentric circle, which they divide into two:

Structures and organization of <u>production</u>

Ex: land reforms, collectivization, villagization etc. determining the conditions of production and regulating relations between capital and labour, production for sale or home consumption etc.

Structure and organization of distribution and commercialization.
Ex: market development in general, commodity boards, cooperative movements etc. Here again we have to distinguise between commodity boards as manifestations of structures regulating commercialization, price policies etc. of certain products and marketing boards as concrete actors.

The next concentric circle consists of ***macroeconomic policies*** and ***agricultural sector policies*** which are formulated within the institutional framework. Defining institutions as a set of rules and regulations, formal or informal, which govern the behaviour and activities of individuals and groups, formulation of policies only have room for manueuvre within that set of constraints which consists of the established institutions.
Ex of macro policies: Exchange rates, fiscal policies, structural adjustment policies (might be considered as an external constraint). etc.
ex. of agricultural sector policies: price policies, import/export regulations, agricultural terms of trade etc.

Seen through these concentric circles the OECD Study assess the agricultural performance in the selected countries with a view to establish the role of institutions and the room of manueuvre for policies to enhance agricultural performance. This then is assessed according to the contribution of the agricultural sector in national development, such as:
At the most aggregated level: the flow of net ressources (agricultural surplus) to the rest of the economy, which then is disaggregated into its contribution to the major development objectives, such as:

- improved food consumption and food security
- employment and poverty alleviation
- balance of payment
- net output for investments outside agriculture

*Robert H Bates* has become famous for his 10 year old analysis of what frustrate agricultural producers in Africa creating hunger catastrophes and the general agricultural crisis. As a good American, Bates considers lack of incentives as the main factor explaining the reluctance of the farmers to produce enough. The lack of incentives is created by a systematic disfavourization of the peasants at the three markets they are dependent on for their wellfare. The market where they sell their products either for export or for the local market, the market where they buy their agricultural inputs and thirdly the market where they buy their industrial consumer goods. With the definition from the new institutional economics of a market *"as a system of economic and social interaction characterized by an institutional framework regulating the activities of the participants"*, Bates' analysis points out how agricultural institutions are created and used by urban elites to appropriate an agricultural surplus for investments in the cities and to create a better urban life. Bates stresses that his analysis supports Liptons urban bias theory by revealing that agricultural policies in Africa and macro-economic policies influencing agricultural performance are not formulated by incompetent bureaucrates (the poor fools know no better), but are deliberately formulated by screwed and unscrupulous urban elites who use the agricultural institutions to:

- absorb an agricultural economic surplus which can be used for investments in industries
- promote agricultural export production to earn foreign currency to be used by the manufacturing industries and by the conspicuous consumption of the same urban elites
- to keep the prices low of local food stuf for the urban working class in order to keep industrial wages low and avoid urban unrest.

Bates gives a long list of examples how agricultural institutions in Africa have been used and policies formulated to extract a surplus from the farmers to be used by the urban elites. The marketing boards established under colonial regimes and utilized by the colonial powers for example to finance their wars in Europe gained momentum after Independence to finance ambitious industrialization programmes and political prestige projects. The Cocoa Marketing Boards in Ghana and Nigeria are good examples of this. The Caisse de Stabilisation in the former French colonies, were created to stabilize the prices paid to the farmers to avoid disincentives to the farmers when world markets prices were low. Bates' analysis reveals how the producer prices often were 20-30 or 40 percent of world market prices, but never more than 100%, so the prices were stabilized at a considerable lower level than the world market prices.

Bates shows how these revenues were used to institutionalize the bureaucrazies living from the agricultural surplus. They use their political power to intervene the market forces. One example how this can be done is that by lowering producer prices they are creating a superficial low supply which they have the power to distribute, whereby corruption comes in to allocate the scarce supply. This administratively generated rent is considered by many as one of the main factors of the African malaise.

Let me try to illustrate what I have said about institutions in agriculture as an abstract phenomena accommodating those agents of development having the political power to formulate macro economic and agricultural policies which exploit the natural production potentials and utilize the options in the world market for their own benefits, by using a bit of my own research work from the Tea, sugar and tobacco production in Kenya. Where I have up to now talked about institutions in an abstract manner as *"rules, enforcement characteristics of rules, and norms of behaviour that structure repeated human interaction"* (D.C. North: Institutions and Economic Growth: An Historical Introduction, WD, Sept.89) I shall now talk about institutions as coinciding with organizations in flesh and blood, or institutions as actors.

Kenya is a very good example of the importance of institutions to promote production, especially by creating a market for the crops. With rich natural endowment for the production of a variation of crops, in 20% of the country, it was easy for the colonizers to enhance the marketed surplus from agriculture by establishing the necessary institutions for commercialization of crops and for distributions of inputs. KFA (Kenya Farmers Association), as one example, was very instrumental in that respect towards the large scale farmers in the white highland as long back as the 20ties and 30ties. Coffee cooperatives were started by the large scale white settlers during that period as well but they were also rather successfull to incorporate the many small scale african farmers who started coffee production after the ban was lifted in the fifties. However, another remarkable innovative institution was created in the early sixties, just around Independence. That was the KTDA. Up to that time Kenya had become a major teaproducer and exporter, but all produced on large scale tea estates owned by big multinationale corporations, and commercialized through these corporations, such as Brooke Bond having tea plantations in Sri Lanka and India as well and was at the same time the main tea distributor for the European market. By creating KTDA, small scale farmers got the opportunity to grow tea and have it commercialized through that organization.

KTDA regulated the sphere of production by distributing the right to grow a plot of land with tea among the smallholders within the tea growing zones. They distributed loans which they obtained from the World Bank and other international donororganizations for fertilizers and other inputs. They purchased the tea leaves through a net of buying centres, manufactured it on small tea factories widespread in the tea growing zones and finally commercialized the made up tea at the local market, as well as at the London auctions. The farmers are paid a price per kg immediately after delivery and then a second payment once a year according to the prices obtained for their tea at the auctions.

KTDA subtracts a fee for administration, but otherwise no other taxes are imposed on the tea farmers and they obtained, in the beginning of the 80ties when the research was carried out an average of 70-75% of the price obtained at the tea auctions. The system created an impressive growth in tea production and tea export from Kenya, as well as a substantially increased income for a rapid growing number of small holders.

KTDA as a parastatal is some kind of a success story among agricultural institutions in Africa, and is as such different from the examples provided by Bates from marketing boards in West Africa but was also different from what was going on in the two other products analysed in this research work.

Sugar had been growned on private basis by kenyas of indian origin on large scale estates since colonization. After Independence, international companies, like the British Bookers International, were invited to grow sugar based primarily on small holders in a contract farming system. This created:

- -tremendous increase in sugar production
- -tremendous increase in cash income among small holder contract farmers
- -paternalistic regulations on production
- - wage labour in disguise.
- -taxes imposed by sugar board.
- -private management, but Government major share holder.

Tobacco had not been grown before BAT introduced it in the beginning of the seventies.

- - again paternalistic regulations of production increasing the production very rapidly.
- - private company making the profit, but heavy taxes to make money for the Government and at the same time ensure that the farmers do not get a too high income compared to other farmers in the tobacco growing areas.

KTDA, the sugar organizations, BAT in tobacco, all illustrate what Ruttan in his article on Institutional Innovation and Agricultural Development, identifies as one of the main sources of institutional change, namely the need of institutions to promote increase in agricultural production from higher yields per unit of land area as an alternative to expansion of land area which in many places is no longer possible. This, Ruttan says, is the most dramatic change in agriculture since the neolithic women invented it.

**Summary: Some methodological aspects of institutions.**

To sum up, institutional analysis are very important in understanding how social groups manage to control production and accumulation at various levels, and how these institutions themselves can be important obstacles in the development process as they become manifestations of structures.
At the aggregated level, the relationship between abstract institutions (such as property rights, market forces etc.) and macro economic and agricultural policies must be analysed. At the lower level it is important

1. to map out institutional network between producers and consumers regulating:
   production
   marketing

2. to map the money flow from consumer price to producer price to reveal where accumulation is taking place which will necessitate:

3. an analysis of relations between organizations, agricultural policies (and broader macro economic policies) and social groups to reveal underlying class structures (urban bias, comprador bourgeoisie etc.) shaping the institutional framework and agricultural policies.

**Institutional economics and industrial development in Newly Industrializing Countries**

Agricultural policies in Africa (and India) and the squeezening of peasant producers is one important area of interest in New Institutional Economics applied to development studies. Industrial policies and industrial performance is another issue area, which I am going to approach now by giving two examples og such an intitutional analysis.

Studies of industrial policies have been much more concerned with Latin America and East- and Southeast Asia. They address the question: why have the Latin American countries performed so poorly in comparison with East and Southeast Asian countries? Why have most Latin American countries defaulted in its external debt? Why is it that high inflation and baslance- of-payment crices are such common features in Latin America but not in East and Southeast Asia? Instead of taking a voluntarist approach by just referring to bad luck and bad judgement, neoclassical economist have become increasingly interested in determinants of policy choice. Instead of viewing policy making as an exercise in unconstrained optimation policy, choices are viewed as outcomes of constrained maximation problems faced by politicians. The Smithian metaphor of "the invisible hand" guiding self-interested individuals to achieve social good has been replaced by a clourful metaphor of the "invisible foot" symbolizing the welfare-reducing effects of competitive self-interested behavior in the political arena over re-distribution.

Economists thus increasingly have moved beyond pure economics into the political economy of political change. ***Ranis*** is an example of an economist going beyond pure economics into the structural and political constraints faced by politicians in less developed countries. His starting point is that while most developing countries have extended ISI beyond its simple level by means of protection, the newly industrializing countries of East Asia have obtained their success by a more pronounced external orientation and a greater willingness to subject themselves to the discipline of the various markets. They have left ISI in due time and their superior economic performance can be related to a market and liniar trend towards liberalization of the various markets. So, why has different countries made substantially different policy choices? Ranis explains outstanding East Asian growth(and equity) performance by reference to both initial conditions in these countries and the flexible institutional choices. In order to explain different policy and organisational choices he emphasizes two essential ***initial conditions*** *-"the maturity of the initial nationalism"* and *"resource endowment"* Most LDCs have started out from a heterogeneous population with no common focus on national development objectives. Instead, the newly independent governments has artificially created a unifying atmosphere by proclaiming the government be able to ""take care of everything" in situations where, in fact, it is able to take care of very little effectively." (ibid,p.110) and in underevaluating the benefits of participating in the international economy. During the inevitable phase of importsubstition industrialization such synthetic *nationalism* has resulted in an extreme version of ISI with a substantial control-oriented institutional and organizational package. Though often including a dosage of egalitarism, these growth promoting policies have implied the manufacture of profits by a strategy of - often "under the table" - transfer of income among social groups - the loosers being the politically less powerful social groups such as consumers, unorganized workers and especially rural entrepreneurs and farmer(ibid pp.107-11 andp.118 and Ranis 1989,pp. 1545- 47)
In contrast, East Asian NICs had the opportunity to take advantage of an organic (mature) nationalism that leads to the regional,political and ethnic integration of a population,which then supports the government without expecting too much from it (Ranis 1989,p1446). "Given the institutional precondition,there was less need in East Asia to select a particular class to receive particular favors through a direct allocation system, e.g. import licenses, overvalued exchange rates, cheap credits, tariff protection, and all the other well-known discretionary decisions which determine who shall live and who shall die." (ibid). Therefore,the East Asian NICs have gone through a milder version of primary import

substitution and have had more fredom to make a substantial policy shift at the end of its termination.

The second initial condition has to do with the presence or absence of*natural resources*. In natural-resources-abundant countries the liberalization process will be a slow process,as natural ressource based production and export gives a greater supply of economic rent which again implies a greater temptation for governments to transfer them under the table to the public sector and to favoured private parties and invites various private sector participants to fight over and obtain such unearned rents (Ranis and Fei p. 108,p.110 and p.131-32). Furthermore,the slow liberalization process is disturbed by the the exogenous shocks stemming from the turbulent international marked for exports of natural ressources.Conversely, the natural-resources-scarce East Asian NICs had good opportunities to avoid rent seeking activities and thus enact milder import substitution policies and to follow a linear liberalization trend at the beginning of export orientation.

Although initial conditions, including the institutional heritage, was important and conditioned organizational and policy choice, Ranis also emphazises a dynamic factor *-the proper institutional actions* taken by policy makers. In East Asian NICs they have taken flexible institutional choices resulting in an accomodating institutional structure - accomodating to the changing economic environment (the changing human resource capabilities) rather than an obstructing institutional structure responding to the natural desire of various interest groups.The different phases of the transition growth required different institutional and policy choices Therefore,Ranis stresses that the role of the state did not diminish In fact he argues that the role of government became more important in the course of the transition process towards modern growth( Ranis 1989, p.1447 and Ranis and Fei 1988,p.106).

"The East Asian NICs recognized that a strong government was essential, but that its willingness to exercise self-restraint in selecting the areas in which it could or could not effectively intervene represented the key to building an accomodating institutional structure. In the absence of this institutional capacity, the path to modern growth becomes much more difficult for the developing countries, and much more painful for the vast majority of the populations" (Ranis 1989 p.1453)

***Mancur Olson*** is a leading figure in ***collective choice analysis.*** Olson is weellknown for his two book "The logic of collectice action" from 1965 and " The rise and decline of nations" from 1982. Olson starts out from a theory of groups. The central argument is that large groups of rational actors would not organize to pursue their common interests. The reason is that such interests are public goods, so that their provision to anyone in the group means the provision to everyone. This results in each rational individual trying to become a "free rider" by contributing nothing to the group while enjoying the fruits of the contributions of other. Olson then has developed a new version of this theory by increasing the level of aggregation. He now considers the nation as a group, the many organized interests as individuals, and the size of the national income as a public good. The free rider argument is now extended to organizations. It is suggested that a typical lobby in a society is more likely to be a narrow special interest group or a so-called "distributional coalition", since the benefits of any resources spent by the group to expand society's output have to be shared with the rest of society. Interest groups tend to choose to become free riders.

Stable societies are likely to accumulate more such distributional coalitions over time- coalitions struggling to maximize their share of national income rather than finding ways of increasing this income. Distributive coalitions make decisions more slowly than their members. They slow down the capacity to introduce technical change, the capacity to reallocate resources in response to changing conditions and thereby reduce the rate of economic growth. Finally,distributional coalitions increase the complexity of regulation, the role of government and redistribute the national product ,not necessarily to the benefit of the poor.

In relation to the East Asian NICs, Olson the claims that they have recent histories that have been inimical to the development of distributional coalitions, and have relatively liberal trade policies as well. Concerning the latter , the argument goes that with free trade national boundries are weakened, hence the large interest groups diminishes. Internationalization checks the accumulation of distributional alliances. Olson also mention that South Korea and Taiwan did not have freedom to develop independent interest groups while they were Japanese colonies.

**Concluding remarks**

I have just presented two examples of new institutional theory applied to industrial development in the NICs.The two contributions share some questionable assumptions and put forward some questionable propositions. Firstly, they more or less directly share the conviction that unconstrained competitive markets are efficient. Secondly, they search for very abstract universal laws and theoretical generalizations based on variables that cannot easily be assessed - distributional coalitions, synthetic nationalism etc.. This often leads to explanations that are at best particularistic, that are often empirically inaccurate and that establishes a fairly loose framework of ideas about capitalist development. In relation to Ranis absence or presence of natural resources and the maturity of nationalism probably could be developed into arguments having some explanatory power, but I would put much more emphasis on the capacity of the state to isolate itself from societal groups in an instrumental sense. Such extraordinary relative autonomy of the state certainly have some affinity to Olson's notion of the absence of distributive coalitions. The precise relationship between the institutional level and economic performance however should put much more emphasis on the specific nature of existing "growth" or "productive" coalitions" in the NICs. At this point one could probably find much more inspiration in the neo-institutional and marxist oriented institutional theories than in the new institutional economics literature.

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