

# Policy Brief

NUMBER 6, 2007

## Overview

The volume *Institutional Change and Economic Development* fills some important gaps in our understanding of the relationship between institutional changes and economic development. It does so by developing new discourses on the 'technology of institution building' and by providing detailed case studies—historical and more recent—of institution building. It is argued that functional multiplicity, the importance of informal institutions, unintended consequences, and intended 'perversion' of institutions all imply that the orthodox recipe of importing 'best practice' formal institutions does not work. While denying the existence of universal formulas, the volume distills some general principles of institutions building from theoretical explorations and case studies.

Written by Ha-Joon Chang

© United Nations University, 2007

ISBN 1814-8026

ISSN 978-92-808-3043-9

Licensed under the Creative Commons Deed "Attribution-NonCommercial-NoDerivs 2.5"

## *Stranger than Fiction? Understanding Institutional Changes and Economic Development*

**M**AINSTREAM ECONOMISTS USED TO TREAT INSTITUTIONS AS MERE 'DETAILS'. When they were criticized for the 'one-size-fits-all' approach of the Structural Adjustment Programme that ignored international differences in institutions, the World Bank and the International Monetary Fund used to retort that what is good economics in the US is good economics in Ghana or Ecuador.

### **Institutions Matter—Suddenly**

Then suddenly from the mid-1990s, everyone started emphasizing the role of institutions in economic development. Even the IMF and the World Bank have come around to the view that institutions matter. The IMF put great emphasis on reforming institutions of corporate governance and bankruptcy management during the 1997 Asian crisis, while the World Bank's 2002 annual report (*Building Institutions for Markets*) focused on institutional development, albeit from a rather narrow point of view, as indicated by its title.

There are a few reasons behind this dramatic change in the intellectual atmosphere. First, the institution-free technocratic reform programmes of the 1980s have almost universally failed. Second, a number of devastating large-scale financial crises in developing countries around the turn of the century (Mexico in 1995, Asia in 1997, Russia in 1998, Brazil in 1999, Argentina in 2002) have prompted debates on the need for reforming a range of institutions in order to prevent and deal with such crises (financial, corporate governance, bankruptcy, labour market, and social welfare institutions). Third, there have been increasing attempts by the developed countries to 'harmonize' institutions across countries in the name of introducing 'global-standard' institutions to developing countries. Fourth, there have been some important theoretical developments in institutional economics—not only the rise of the orthodox (neoclassical) New Institutional Economics but also of a variety of heterodox institutional theories.

**About the Author**



*Ha-Joon Chang* is Reader in the Political Economy of Development, University of Cambridge, and directed the UNU-WIDER research project ‘Institutions for Economic Development: Theory, History, and Contemporary Experiences’.

**‘Stranger than Fiction’?**

Despite the heightened interest in institutions, there are still some important gaps in our understanding of the relationship between institutional change and economic development.

First of all, we still do not know which institutions in exactly what forms are useful for economic development in which contexts. For example, everyone may agree that a ‘good’ property rights system is essential for economic development, but what is in fact a ‘good’ property rights system? That it is not necessarily Western-style private property rights system should be clear from the excellent economic performance of China over the last two decades.

Second, even when we can identify a particular institution as beneficial in a given context, we often do not know how we can build such institution. The standard recommendation is to import ‘best practice’, or ‘global standard’, institutions wholesale. Yet, the volume shows, successful institutional changes typically emerge as a mixture of country-specific innovation and chance developments as well as deliberate learning from the more advanced countries.

forms of political resistance to different taxes may be overcome; and how best an effective tax collection machinery can be built.

Second, we need more case studies of institution building—historical and more recent. Real life experiences of institution building are often ‘stranger than fiction’—that is, they are often more imaginative than what theoreticians have suggested on the basis of broad generalization and abstract reasoning.

**Against ‘Institutional Mono-tasking’**

Institutions can, and do, serve multiple functions. For example, budgetary institutions serve functions such as investment in productive assets (e.g., physical infrastructure, R&D facilities), provision of social protection (the welfare state), and increasing macroeconomic stability (e.g., through its ‘automatic stabiliser’ function).

The functional multiplicity of institutions makes the task of institution building complicated, as there is no inevitable relationship between a desired function and an institutional form. Unfortunately, in the mainstream discourse on institutions

Everyone may agree that a ‘good’ property rights system is essential for economic development, but what is in fact a ‘good’ property rights system?

In order to fill these intellectual gaps, we first need to develop new discourses on what may be called the ‘technology of institution building’. For example, it is not enough to say that developing countries need better fiscal institutions. We need to be able to tell them, for example: which forms of taxes are more appropriate in which economic and political contexts and for what social purposes; how different

and development, there has been a tendency to assign a single function to each institutional form, or what Thandika Mkandawire aptly called ‘institutional mono-tasking’ in the project conference—the central bank should focus on inflation control, corporate governance institutions should serve the interest of the shareholders only, etc.



The failure to understand the functional multiplicity of institutions means a failure to fully exploit the potential of an institution. Epstein's chapter shows that there are many 'developmental' functions that the central bank can and have played (e.g., support for government-targeted industries, promotion of the financial sector), but that they have become increasingly neglected because of the currently dominant view that the sole function of the central bank is to guarantee price stability.

'Institutional mono-tasking' also makes it easier for particular interest groups to hijack certain institutions and make them work mainly to their advantages, when those institutions can, and should, serve other interests too. Lazonick's chapter shows how shareholder-oriented institutions of corporate governance have allowed shareholders to assert their interests over those of other stakeholders in the firm and of the broader society.

Moreover, 'institutional mono-tasking' increases the danger that countries import certain institutions for one function without thinking about their other functions. For example, a developing country may import shareholder-oriented corporate governance institutions, thinking that the only roles for corporate governance institutions are to control

### 'Appearances can be Deceptive'

The absence of one-to-one mapping between forms and functions of institutions means that 'appearances can be deceptive', when it comes to institutions. This is because institutions do not function in a vacuum but interact with other institutions—as evidenced by the frequent failure of many imported institutions to take root.

The problem of compatibility will be more severe in relation to informal (that is, non-codified) institutions. When introducing a new institution, it may be possible to change all the 'surrounding' *formal* institutions by re-writing all the relevant laws, but it is impossible to change the informal institutions (e.g., customs, business practices) in a short span of time.

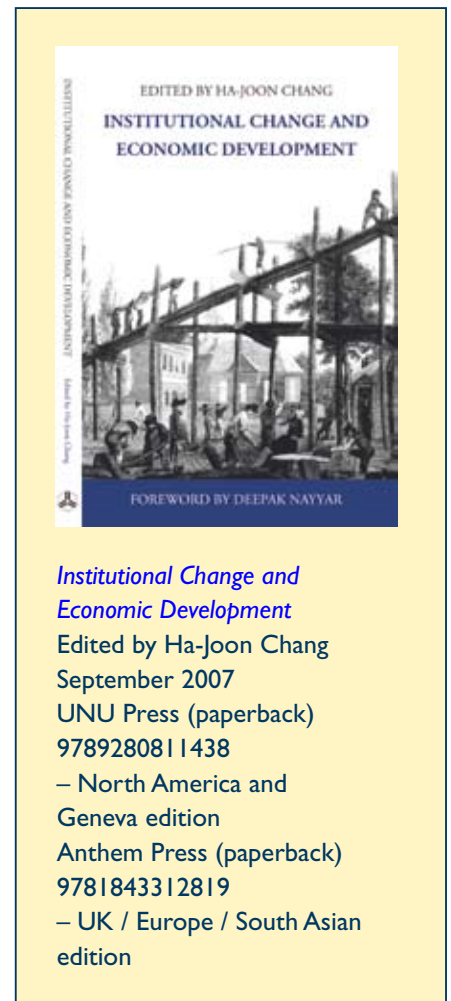
Using the example of Malaysia, whose common-law tradition was compromised by the all-powerful Prime Minister's desire to use East Asian-style administrative guidance arising out of the civil law tradition, Woo shows in her chapter that the formal legal system cannot fully determine how decisions are made and conflicts resolved. Zhu's chapter also clearly demonstrates that, despite the apparent differences in their formal institutional forms, the actual institutional matrixes that have supported rapid economic transformations in China and Taiwan are remarkably similar to each other.

Definition of rights and obligations is ultimately a political act; no institution, including the market, can be seen as being free from politics

managerial excesses and to prevent expropriation of minority shareholders by dominant shareholders. However, the imported institutions may ill-serve other functions—for example, the management of conflict with workers or local communities.

### The Political Origins of Institutions

Institution building cannot simply be a technocratic exercise. All institutions, including the market (which is often assumed by mainstream economists not to be an institution) are defined in



*Institutional Change and Economic Development*  
 Edited by Ha-Joon Chang  
 September 2007  
 UNU Press (paperback)  
 9789280811438  
 – North America and Geneva edition  
 Anthem Press (paperback)  
 9781843312819  
 – UK / Europe / South Asian edition

relation to the structure of the rights and obligations of the relevant actors. As the definition of those rights and obligations is ultimately a political act, no institution, including the market, can be seen as being free from politics.

David and Mach show how the Swiss central bank was created as a mixed (part public and part private) company with majority shares owned by the Cantons, to allay the fears by the private sector and the Cantons of dominance by a centralized public institution. Burlamaqui, Pereira de

applicability. For example, few would recommend that developing countries create institutions that repress the poor to emulate the British economic success in the eighteenth century. Nor would anyone argue that the South African experiences shows us that we need exclusionary politics in order to build a good tax base. However, as we shall soon see, institutions can be used for purposes that were not originally intended, and therefore the 'darkness' of their origins need not keep us from using them for better purposes.

## Few would recommend that developing countries create institutions that repress the poor to emulate the British economic success in the eighteenth century

Souza, and Barbosa Filho shows how political compromises have affected institutional reform in Brazil, whose solutions have affected the subsequent evolution of the economy—the effect of wage indexation on subsequent episodes of inflation being the best example.

The volume shows that the politics involved in institution-building process can often be very unpleasant. The efficient tax institutions of early modern Britain fuelled its imperialist expansion and repression of lower classes at home in the name of protecting private property (O'Brien). The American federal system, while allowing the 'losers' of the nineteenth-century globalization to partially protect themselves, also preserved institutions that persecuted the blacks and the poor in the southern states (Rauchway). The South African tax system's exceptional ability (among developing countries) to tax the rich ultimately originated from the country's shameful history of apartheid (di John).

At one level, these 'dark' origins of certain institutions limit their

### 'Red vs. Expertise'

Having emphasized the importance of politics in institutional changes, it has to be pointed out that political compromise alone is not enough in making positive and durable institutional changes. The chapters by Epstein on the central bank and Toye on modern bureaucracy show particularly well that 'technocratic' details matter greatly in determining the benefits and the sustainability of institutions.

The analogy will be a family having an internal feud over what kind of house they will build in their plot of land. Deciding the kind of house they want to build is arguably the most important first step that may require a lot of fights and compromises ('politics'). However, even if the family was able to forge a durable consensus on the kind of house to build, without skilled architects and builders ('technocracy'), it may not be able to build a good house that will last.

In other words, the emphasis on politics should not be misinterpreted as a denunciation of technocratic expertise in the Maoist fashion ('red' over 'expertise'). Poor 'technical' design of an institution may ultimately undermine its political legitimacy by creating discontent even among its main beneficiaries (e.g., the poor design of a state pension system may ultimately discredit state pension itself).

The emphasis on the role of human agency brings us to the issue of the role of ideas in institutional change. If human actors are not automata responding to structurally-determined incentives, their ideas—how they perceive their interests, what their moral values are, how they think the world works, what actions they think are possible and impossible, and so on—matter a great deal.

## Institutional reform may be more effectively initiated by introducing desired economic activities than by introducing the desired institutions

### Structure vs. Human Agency

In the mainstream theory of institutional change, there is no real human agency. In the theory, material interests that motivate people to change institutions are pre-determined by 'objective' economic (or even natural) conditions. Therefore, there is no meaningful choice, because what a 'rational' actor will choose is already structurally determined. However, history has developed the way it has because someone somewhere made choices that were *not* 'obvious' according to the structural parameters.

For example, Kiiza shows, Botswana has developed well because its political leaders made certain deliberate political decisions about the appropriation of diamond rent and its use. Evans points out that, despite similar economic and social conditions, the political elites of Guatemala in the nineteenth century decided to concentrate property in a small class of landlords while their counterparts in Costa Rica opted for a more broad-based property ownership, with very different consequences for growth, income distribution, and social peace.

Sometimes ideas can be used as tools by human agents in their attempt to change institutions in the way that they prefer. Lazonick shows how the American professional managerial class has been able to use the shareholder-value ideology, which identifies it as main targets of restraint, in a way that allowed it to build institutions that enrich itself (e.g., stock options).

However, ideas are not merely tools that human actors cynically manipulate in order to make the institutional changes that they prefer. Institutions affect the ideas that human actors hold, and therefore they shape the human actors. In other words, ideas may not be totally manipulated by human actors. Zhu's chapter shows how the 'socialist' institutions of Taiwan and China have subsequently affected the way their policymakers behaved, while Woo's chapter shows how the centralized political and bureaucratic institutions made the Korean policymakers liberalize the economy after the 1997 crisis often through illiberal means.



### **Unintended Consequences and Intended Perversions**

Emphasizing human agency does not imply that those who plan and implement institutional changes can be certain about the consequences of their actions. There are unintended consequences of institutional change.

Unintended consequences may be positive or negative. Toye shows that the US Tenure of Office Act (1820) gave the President and the Senate the power to re-appoint every office in the government, with the laudable intention of preventing the emergence of an official aristocracy able to pass office on to its children. However, it also had the negative unintended consequence of preventing the development of modern bureaucracy. Rauchway shows that the inability (and unwillingness) of the US federal government to impose fiscal discipline on the state governments produced the positive unintended consequences by encouraging the development of investment banking.

The failures of certain institutions to serve their original functions may not always be unintended. Some actors may deliberately chose to use them for purposes other than the original ones. When discussing how patents may be turned into vehicles of rent-seeking (as in the case of Britain at the time of Adam Smith) or even an obstacle to innovation (as in the recent extension of patents to the genetic level), Reinert shows how there can be 'institutional perversion'.

However, 'institutional perversion' need not be a negative thing. For example, the chapter by di John shows that, despite its 'dark' (apartheid) origins, the (rather effective) institutions of taxation in South Africa are slowly beginning to be used for redistributive purposes. Such 'perversion' may be considered positive

by many people. An institution need not have a 'noble' pedigree in order to be utilized for good purposes.

### **The 'Technology' of Institution Building**

The volume emphasizes the diversity of institutions across time and place. However, this should not be interpreted as saying that there are no common principles in the 'technology of institution building' that can be applied across countries.

One principle that is relatively well-known is that institutions may suddenly become obsolete because of some new challenges arise that they cannot meet. Evans shows this when discussing the case of Botswana, where the lack of mobilization mechanisms in the old institutional arrangement proved to be the major obstacle to the country's management of HIV/AIDS crisis.

A less well-known principle that the volume identifies is that institutional reform may be more effectively initiated by introducing desired economic activities than by introducing the desired institutions. Reinert's chapter argues that 'an institutional system is mainly moulded around the needs determined by the mode of production, not the other way around' and therefore that policymakers should target 'the kind of activities that would bring the right kinds of institutions, not the other way around'. This is an extremely important antidote to the currently prevalent thinking that development can be promoted by introducing the 'right' kind of institutions.

Moreover, even when we agree that some institution is likely to be 'good' for almost all countries at least for some purpose, there is always a danger of what Reinert calls 'institutional overdose'. Chang's theoretical chapter show that, even if some protection of

private property is absolutely necessary, it is wrong to infer from that the stronger the protection is the better it is, as the conventional wisdom goes. In the same way life-saving or health-giving drugs can turn into poisons if taken in too large quantities, an ‘overdose’ of an institution that may be beneficial at some level may be harmful for economic development.

### Concluding Remarks

The volume shows that there is no universal formula for institutional change that will promote economic development. Functional multiplicity, the importance of informal institutions, unintended consequences, and intended ‘perversion’ of institutions all imply that importation of ‘best practice’ formal institutions does not guarantee any particular positive outcome, even assuming that the imported institution can actually take root in the importing country.

The fact that there is no set formula, however, should not make us think that there is nothing we can do to improve the quality of institutions in developing countries.

First of all, being late-comers, developing countries have the benefit of being able to imitate institutions that exist in the more developed countries—of course, with due local adaptations—and thus cut down the costs associated with developing new institutions *de novo*.

Second, historical experiences show that countries do not have to start with high-quality institutions. Institutional development is partly a consequence, rather than a cause, of economic development. Moreover, it is perfectly possible to improve the quality of institutions while the country is developing its economies, with both of them feeding into each other.

Third, despite the difficulties of identifying a better ‘technology of institution building’, there are some general principles that may be extracted that can help countries build better institutions. For example, if it is difficult to change deep-rooted institutions through political means, it may be possible to change them by introducing new economic activities that create demand for different kinds of institutions. For another example, we can take heart from the fact that some institutions with ‘dark’ political origins have been ‘perverted’ into serving good purposes.

There is no universal formula for institutional development. However, even in this inherently complex area, it is possible to extract some general principles and enrich our empirical knowledge, especially if we are willing to go beyond the rather narrow theoretical and empirical confines of today’s orthodox discourse on institutions.

### Table of Contents

#### *Institutional Change and Economic Development*

Edited by Ha-Joon Chang

Foreword by Deepak Nayyar

1. *Institutional Change and Economic Development: An Introduction*, Ha-Joon Chang

Part I: Theoretical Overview

2. *Understanding the Relationship between Institutions and Economic Development—Some Key Theoretical Issues*, Ha-Joon Chang

3. *Extending the ‘Institutional’ Turn: Property, Politics and Development Trajectories*, Peter Evans

4. *Institutionalism Ancient, Old, and New: A Historical Perspective on Institutions and Uneven Development*, Erik Reinert

Part II: Evolution of Particular Institutions

5. *Modern Bureaucracy*, John Toyne

6. *Central Banks as Agents of Economic Development*, Gerald Epstein

7. *Corporate Governance, Innovative Enterprise, and Economic Development*, William Lazonick

8. *The Political Economy of Taxation and Tax Reform in Developing Countries*, Jonathan di John

9. *The Rule of Law, Legal Traditions, and Economic Growth: The East Asian Example*, Meredith Jung-En Woo

Part III: Country Experiences

10. *State Formation and the Construction of Institutions for the First Industrial Nation*, Patrick Karl O’Brien

11. *The Role of Federalism in Developing the US during Nineteenth-Century Globalization*, Eric Rauchway

12. *Institutions and Economic Growth: The Successful Experience of Switzerland, 1870–1950*, Thomas David and André Mach

13. *The Rise and Halt of Economic Development in Brazil, 1945–2004: Industrial Catching-up, Institutional Innovation and Financial Fragility*, Leonardo Burlamaqui, José A.P. de Souza and Nelson H. Barbosa-Filho

14. *Rethinking Import-Substituting Industrialization: Development Strategies and Institutions in Taiwan and China*, Tianbiao Zhu

15. *Developmental Nationalism and Economic Performance in Africa: The Case of Three ‘Successful’ African Economies*, Julius Kiiza



The World Institute for Development Economics Research (WIDER) was established by the United Nations University (UNU) as its first research and training centre and started work in Helsinki, Finland in 1985. The Institute undertakes applied research and policy analysis on structural changes affecting the developing and transitional economies, provides a forum for the advocacy of policies leading to robust, equitable, and environmentally sustainable growth, and promotes capacity strengthening and training in the field of economic and social policy making. Work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

## INSIDE: Policy Brief

### *“Stranger than Fiction? Understanding Institutional Changes and Economic Development”*

Institutions matter, but what are good institutions, how do they emerge or how do we build them?

World Institute for Development  
Economics Research  
of the United Nations University  
Karajankalliokatu 6 B  
FIN-00160 Helsinki  
Finland  
Tel. +358-9-6159911  
info1@wider.unu.edu  
www.wider.unu.edu

