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Understanding the Relationship between Institutions and Economic Development

Some Key Theoretical Issues

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Abstract

The paper tries to improve our understanding on the role of institutions in development by critically examining the current orthodox discourse on institutions and highlighting some of its key problems. After discussing some definitional problems, the chapter examines a number of problems in the orthodox literature arising from the widespread failure to distinguish between the forms and the functions of institution. Then it critically examines the excessive emphasis on property rights in the orthodox literature. Finally, it discusses a number of problems that arise from the simplistic view on institutional change that underlies the orthodox view on institutional persistence.

Keywords: institutions, forms and functions, institutional change, property rights

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1 Introduction

The issue of institutional development, or ‘governance reform’, has come to prominence during the last several years. During this period, the academic literature on institutions and development has exploded. And today even the World Bank and the IMF, which used to dismiss institutions as mere ‘details’ that do not affect the wisdom of the orthodox economic theory, have come around to emphasising the role of institutions in economic development. For example, the International Monetary Fund (IMF) put great emphasis on reforming corporate governance institutions and bankruptcy laws during the 1997 Asian crisis, while a recent World Bank annual report (*Building Institutions for Markets*, 2002) focused on institutional development, although from a rather narrow point of view, as indicated by its title.

Of course, the new attention paid to institutions in the orthodox literature should not be seen as the result of an innocent scholastic awakening. Rather, it is better seen as an attempt to cope with the continued failures of orthodox policies in the real world.

Despite the miserable failures of radical policy experiments through various structural adjustment programmes (SAPs) in developing countries and the big-bang ‘transition’ programmes in the former communist countries, the orthodox economists have refused to draw the most obvious conclusion, namely, that the orthodox policies, and the theories underlying them, are flawed.

At first, they tried to argue that the policy reforms need to be more extensive in order to succeed. When that happened and the good results still did not materialise, they started saying that policy reforms need time to work. However, after 15, 20 years of reform, even this line of defence has become difficult to maintain. So, now the orthodox economists use institutions to explain why ‘good’ economic policies based on ‘correct’ economic theories have so consistently failed. By talking about deficient institutions, they can argue that their policies and theories were never wrong, and did not work *only because* the countries that implemented them did not have the right institutions for the ‘right’ policies to work. In other words, the institutional argument is being mobilised as a means to protect the core tenets of orthodox economics in the face of its inability to explain what is happening in the real world.

In this paper, we discuss how the theory on the role of institutions in development can be improved, by critically examining the current orthodox discourse on institutions and highlighting some of its key theoretical issues. After a discussion of some definitional problems (section 2), I will discuss some problems arising from the widespread failure to distinguish between the forms and the functions of institution (section 3). Then I will critically examine the excessive emphasis on property rights in the orthodox literature on institutions and development (section 4) and discuss a number of problems that arise from the simplistic view on institutional change that underlies the orthodox view on institutional persistence (section 5).

2 Some definitional problems

One fundamental difficulty involved in the study of the relationship between institutions and economic development is that there is no widely accepted definition of institutions.[1] If we cannot agree on what we mean by institutions, it is difficult to imagine that we would have a consensus on what they are supposed to do, such as promoting economic development. When we have differences over the very definition of the term 'institutions', it is not surprising that we do not have an agreement on the relationship between institutions and economic development.

At the very general level, we may say that there are certain functions that institutions have to serve if they are to promote economic development, and that there are certain forms of institutions that serve these functions the best. However, the difficulty is that we cannot come up with an agreed list of the 'essential' functions nor an obvious match between these functions and particular forms of institutions.

The problem is that there are many different ways and different levels of abstraction in which the conceptual 'pie' may be cut. For example, in one of my earlier articles, I had identified three key functions of institutions in promoting economic development: (i) coordination and administration; (ii) learning and innovation; and (iii) income redistribution and social cohesion (Chang, 1998b). However, why just these three functions? Why not add encouragement of investment or, following Amartya Sen's approach, the function of developing human capabilities? Also, the conceptual 'pie' could be cut at many different levels of abstraction. For example, why not define the functions at less abstract levels, such as the lender of last resort or the smoothing of income fluctuation, and so on? In the end, there is no one right way in which the functions necessary for economic development are defined.

Moreover, even if we can agree on the list of functions that are essential for economic development, this does not mean that we can agree on the exact kinds and forms of institutions that we need in order to fulfil those functions.

First, one institution could be serving more than one function. For example, budgetary institutions typically serve multiple functions, such as investment in productive assets (e.g., physical infrastructure, R&D facilities), social protection (the welfare state), and macroeconomic stability (e.g., through the 'automatic stabiliser' function). For another example, political institutions could also perform a number of functions such as distillation of different opinions into a decision, conflict resolution, provision of social cohesion, and nation-building. No institution performs only one function.

Second, there are many institutions that serve the same function, although they would all serve other functions as well, which may or may not overlap. So, for example, macroeconomic stability is achieved not simply by an independent central bank solely focused on inflation (as the current orthodoxy goes) but also by a host of other

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1 For a very informative early discussion of the definitional problem, see van Arkadie (1990). Van Arkadie points out that institutions are used to mean both the 'rules of the game' and the 'organisations'. While the former sense of the term has become more prevalent since the time when van Arkadie wrote the article, we still use terms like the Bretton Woods *Institutions*, which uses the word institution in the latter sense.

institutions, including the budgetary institutions, institutions of financial regulation, and wage- and price-setting institutions. For another example, investment is encouraged not just by strong protection of property rights (as the current orthodoxy goes) but also by financial institutions (which will determine the availability of 'patient' capital), labour institutions (which have implications on productivity of the investment), and the welfare state (which provides 'insurances' against failure of investment).

Third, the same function could be served by different institutions in different societies (or in the same society at different times). For example, social welfare is typically achieved by the welfare state in most European countries. The same is provided by a combination of a (weaker) welfare state, company welfare schemes, family provision, and other means in East Asia. If we looked at the welfare state only, we may misleadingly believe that the level of social welfare provision in East Asia is much lower than what it is. For another example, discipline of lax corporate management is provided by the stock market in the Anglo-American economies, whereas it is provided by the main lending banks in countries like Germany and Japan.

For all of these reasons, it is impossible to come up with a single list of functions and forms of institutions that are desirable, not to speak of essential, for economic development. This, in turn, makes the exploration of the relationship between institutions and economic development extremely complicated. Any theorisation of the role of institutions and economic development will have to accept this limitation.

3 Forms vs. functions

Another big problem that dogs the current orthodox literature on institutions and development is its inability to clearly distinguish between the forms and the functions of institutions.

For example, if we look at the papers by Kaufmann et al. (1999; 2002; 2003) that compile all major 'governance' indexes (or the indexes of institutional quality), we find that these indexes often mix up variables that capture the differences in the *forms* of institutions (e.g., democracy, independent judiciary, absence of state ownership) and the *functions* that they perform (e.g., rule of law, respect for private property, enforceability of contracts, maintenance of price stability, the restraint on corruption).

In response to this confusion, some have argued that the 'function' variables should therefore be preferred over the 'form' variables. For example, Aron (2000: 128) argues that, in studying the impact of institutions on economic development, we should use what she calls the 'performance or quality measures' for institutions (or what we would call the function variables)**,** such as 'respect for contracts, property rights, trust, and civil freedom' rather than variables that 'merely describe the characteristics or attributes' of institutions (or what we would call the form variables). In other words, the functions that institutions perform may be more important than their forms.

I totally agree that particular forms of institutions do not guarantee particular outcomes, as we see in numerous failures of institutional transplantation. To put it another way, institutional forms may not matter that much, as the same function can be performed by different institutional forms, as I pointed out in the previous section.

However, this emphasis on functions over forms should not be taken too far. While a particular form does not guarantee the fulfilment of a particular set of functions, a complete neglect of forms makes it very difficult for us to make any concrete policy proposal. If we did that, we will be like a dietician who talks about eating a 'healthy, balanced diet' without telling people how much of what they should have. In other words, the emphasis on 'good' institutions may become empty without some statements on the forms to be adopted.

Having made this caveat, it should be emphasised that currently the orthodox literature errs on the other side – that is, there is simply too much fixation with particular forms. Such over-emphasis on forms is most vividly manifested in the so-called 'global standard institutions' (GSIs) argument (for a critic of this argument, see Chang, 2005).

The proponents of the GSI argument believe that there are particular (mostly Anglo-American) forms of institutions that all countries have to adopt if they are to survive in the ever-globalising world: political democracy; an independent judiciary; a professional bureaucracy, ideally with open and flexible recruitments; a small public-enterprise sector, supervised by a politically independent regulator; a developed stock market with rules that facilitate hostile MandA (mergers and acquisitions); a regime of financial regulation that encourages prudence and stability, through things like the politically-independent central bank and the BIS (Bank for International Settlements) capital adequacy ratio; a shareholder-oriented corporate governance system; labour market institutions that guarantee flexibility.

This form-fetish has led to a dangerous denial of institutional diversity, a move whose folly is evident in light of the bio-diversity argument seriously. This transformation of the orthodox discourse on institutions into another 'one-size-fits-all' discourse is really unfortunate. To the heterodox economists who had initially drawn attention to the role of institution, the whole point of bringing institutions into the analysis was to expose the limits of the 'one-size-fits-all' argument regarding economic policy that had been deployed by the orthodox economists.

Even more problematical is the way in which their preferred institutional forms are propagated by the powerful. The GSIs are increasingly imposed upon unwilling countries through what Kapur and Weber (2000) call 'governance-related conditionalities' of the Bretton Woods institutions and the donor governments.

It may be easy to criticise the one-size-fits-all approach of the GSI discourse and say that we should not be constrained by the forms too much, but then we should be able to present a menu from which policy-makers can choose (of course, always acknowledging that there is a room for innovation). Providing such a menu requires empirical knowledge of the diverse forms of institutions that perform similar functions in different contexts.

It may be equally easy to criticise the functionalist approach for being too abstract. The form-fetishists at least have a concrete suggestion to make, it may be said, even if it means exactly copying a particular form of institution that another country has, whereas the functionalists have nothing concrete to say. It may be easy to say that countries should have a rule of law or a professional bureaucracy, but how do policy-makers put those suggestions into practice? Once again, without some knowledge of real-life institutions, it is difficult to say anything useful in this regard.

In the end, there needs to be some balance between forms and functions in our thinking about the role of institutions in economic development – while we don't want to ignore the importance of institutional forms, we should not recommend vague things like 'good property rights system' either.

4 Which institutions? Property rights rules?

In the orthodox literature on institutions and development, property rights are accorded the most important role. It is because many of the developing and the transition economies lack a clearly-defined and secure private property rights system, it is argued, that the 'good' policies based on 'correct' theories recommended by orthodox economist have failed to work. This is because, according to this argument, in the absence of an appropriate guarantee for the fruits of their sacrifices, people would not make any investment, whatever the policies regarding macroeconomic balances, trade, and industrial regulations may be.

The emphasis on property rights in the orthodox literature is so strong that it has even attracted the criticism that it amounts to 'property rights reductionism' (Rodrik, 2004). This over-emphasis on property rights institutions is particularly problematic when the orthodox theory on the relationship between property rights and economic development suffers from a number of conceptual, theoretical, and empirical weaknesses.

4.1 The 'measurement' problem

To begin with, unlike some other institutions, such as the bureaucracy or the fiscal system, the property rights system is a complex of a vast set of institutions – land law, urban planning law, tax law, inheritance law, contract law, company law, bankruptcy law, intellectual property rights law, and customs regarding common property, to name only the most important ones. And being made up of such diverse elements, it is almost impossible to 'aggregate' these component institutions into a single aggregate institution called the property rights system.

Given the impossibility of aggregating all elements of a property rights system into a single measurable indicator, empirical studies tend to rely on subjective measures of the overall 'quality' of the property rights system. Many rely on surveys among (especially foreign) businessmen, 'experts' (e.g., academics, chief economists of main banks and firms, etc.), or even the general public, asking them how they assess the business environment in general, and the quality of property rights institutions in particular. Some use even more narrowly-defined concept like 'expropriation risk' (Acemoglu et al., 2001) – a notion that may have had some justification in the 1960s and the 1970s, when there were not infrequent seizures of private assets by governments, but not so any more today, when very few countries even contemplate expropriating private assets.

As we can imagine, these kinds of measures are very problematic, as the survey results they can be strongly influenced by the general state of business, rather than the inherent quality of property rights system itself (Rodrik, 2004). For example, a lot of people who were quite happy to praise the good business environment in East and Southeast Asia suddenly started criticising cronyism and other institutional deficiencies in these countries once the 1997 financial crisis broke out.

4.2 The ‘coverage’ problem

The orthodox discourse on property rights does not recognise all possible forms of property rights. It essentially recognises only three types of property rights – open access, pure private ownership, and state ownership – while ignoring other important forms of property rights.

For example, the literature on common-pool resources in environmental economics and that on ‘open’ software (or ‘shareware’) on the internet show that the absence of private property does not necessarily mean an ‘open access’ situation, where there is no property right for anyone. Unlike what is overlooked in the orthodox literature, there could be genuinely *communal property rights* that allow no individual ownership but are based on clear rules about access and utilisation (e.g., communal rules for gathering firewood in communally-owned forest, rules on how one may not make money out of a software building on the free ‘shareware’).

Moreover, post-socialist developments in China have shown us that there even could be *hybrid forms of property rights* – for example, the TVEs (township and village enterprises) are *de jure* owned by local governments but in some cases operate under *de facto* (although unclear) private property rights held by powerful local political figures.

4.3 Superiority of private property rights

The orthodox literature on property rights is based on a rather simplistic and biased theory of property rights that glorifies private property rights. In this discourse, it is believed that all effective incentives have to be private and predominantly materialistic and therefore that no form of property rights other than private property rights can provide adequate incentive for good performance.

However, there are enough theories that question whether only individualised materialistic incentives, and therefore private property rights, work (Simon, 1983; Basu, 1983; Etzioni, 1988; Frey, 1997; Ellerman, 1999). Unlike what is posited in the orthodox theory, human motivations are multi-faceted and there are just too many non-selfish human *behaviours* for us to explain without admitting a range of non-selfish *motivations* and without assuming a complex interaction between different types of motivations, both selfish and non-selfish.

At the empirical level, there are many examples that show the limits of the simplistic view on the superiority of private property rights. Once again, the recent Chinese experience, with a complex mixture of private, public, and hybrid ownership patterns, often with relatively unclear property rights (to add insult to the injury to the orthodox theory, so to speak), is an obvious counter-example. Countries like France, Austria, Finland, Norway, and Taiwan have extensively used state-owned enterprises (SOEs) in engineering their impressive economic developments after the Second World War. For another example, the famous Korean steel producer, POSCO, was set up in the early 1970s as an SOE in a country that does not even produce the raw materials (iron ore or coking coal) at a time when such act was a clear defiance of comparative advantage (the country’s main exports at the time were labour-intensive items like textiles and wigs) but went on to become the most cost-efficient steel producer in the world within a decade of its establishment and is now the second largest (now-privatised) steel producer in the world.[2]

4.4 Desirability of strong protection of property rights

In the orthodox literature, it is uncritically assumed that a stronger protection of property rights is always better. However, this cannot be true as a general proposition.

The fact that some protection of property rights is good does not mean that more of it is always better. While it is probably true that a very weak protection of property rights is bad, too strong a protection may not be good either, as it can protect obsolete technologies and outmoded organisational forms. If that is the case, there may be an inverse-U-shaped relationship, where too weak a protection is not good but neither is too strong one. Or alternatively it may be that, as far as it is above a minimum threshold, the strength of property-rights protection may not matter too much. Whatever the exact relationship is, the relationship between the strength of property-rights protection and economic development is not likely to be linear, contrary to what is assumed in orthodox theories.

Moreover, and more importantly from the point of view of economic development, the growth-impact of a particular property right may not be constant over time.

A particular property right may become good or bad for the society, depending on changes in the underlying technology, population, political balance of power, or even ideologies. Indeed, there are many examples in history where the preservation of certain property rights proved harmful for economic development while the violation of certain existing property rights (and the creation of new property rights) was actually beneficial for economic development.

The best known example is probably the Enclosure in Britain, which violated existing communal property rights by confiscating the commons but contributed to the development of woolen manufacturing industry by promoting sheep farming on the land thus confiscated. De Soto (2000) documents how the recognition of squatter rights in violation of the existing property owners was crucial in developing the American West. Upham (2000) cites the famous Sanderson case in 1868, where the Pennsylvania Supreme Court over-rode the existing right of landowners to claim access to clean water in favour of the coal industry, which was a key industry of the state at the time. Land reform in Japan, Korea, and Taiwan after the Second World War violated the existing property rights of the landlords but contributed to the subsequent development of these countries. Many people argue that nationalisation of industrial enterprises in countries like Austria and France after the Second World War contributed to their industrial developments, by transferring certain industrial properties from a conservative and non-dynamic industrial capitalist class to the professional public sector managers with a penchant for modern technology and aggressive investments.

The examples could go on, but the point is that, if there are groups who are able to utilise certain existing properties better than their current owners can, it may be better

[2] For further discussions on the political economy of SOEs, see Chang and Singh (2003).

for the society not to protect the existing property rights and to create new ones that transfer the properties concerned to the former groups. And in this circumstance, too strong a protection of certain (existing) property rights may become a hindrance to economic development. This is, of course, a main insight from Marx's theory of social evolution.[3]

To summarise, the security of property rights cannot be regarded as something good *in itself*. What is important for economic development is *not* the protection of all existing property rights at all costs, but the ability to decide which property rights to protect to what extent under which conditions.

5 Theories of institutional change

5.1 Institutional persistence and human agency

In the mainstream theories, once institutions are in place, they are seen as perpetuating certain patterns of human interaction. And as institutions are seen as being determined by immutable (or at least very-difficult-to-change) things like climate, resource endowment, and cultural tradition, these patterns become almost impossible to change, which introduces a 'fatalist' bias in the argument.

So, for example, temperate climate in the USA is supposed to have made small-scale land ownership the natural institution, which then led to greater demands for democracy and education, whereas the tropical climate in many Latin American countries led to latifundia-dominated agriculture, producing the opposite results (Engerman and Sokoloff, 1997; 2002). For another example, Botswana's consensus-oriented political culture with strong grass-root influence is supposed to have made its post-colonial leaders to create an inclusive property rights system, which promoted economic development (Acemoglu et al., 2003).

Now, at one level, persistence is what we should expect from institutions. Institutions are *meant to* be stable – otherwise they will have no use. And therefore some degree of self-reinforcing mechanism is inevitable when we look at the relationship between institutions and the economy. However, this view has a number of serious problems.

The first problem with this argument is that, a country's institutional complex contains various elements, and therefore can be described as pro-developmental, anti-developmental, or whatever we want, depending on which particular elements we choose to highlight. In this sense, explanations that rely on culture and institutions (as the embodiments of cultural values) can easily degenerate into *ex post* justifications.

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3 According to Marx, over time, societies evolve because 'productive forces' (technologies) outgrow the 'mode of production' (the property rights system), which become fetters that need to be thrown off if the productive forces are to develop further. Of course, he was wrong to build a teleological view of history upon it and he could have also more systematically incorporate things like ideologies and political power into his theory, but the insight behind the theory still remains valid.

The best example is Confucianism. If we highlight its emphasis on education, its notion of ‘heavenly mandate’ (which gives some important voice to the grassroots and justify dynastic changes), its emphasis on frugality, etc., you cannot have a better culture for economic development. However, if we emphasise its hierarchical nature (which is supposed to stifle creativity – Krugman, 1994), its penchant for bureaucracy, its despise for craftsmen and merchants, you cannot have a worse culture for economic development. Likewise, contrary to what Acemoglu et al. (2003) has done, it would be easy to identify anti-developmental elements of Botswanan traditional culture and institutions, if Botswana happened to be a failure.

The second problem with the orthodox argument is that there are almost always more than one ‘tradition’ in a country’s culture and institutions. France is now seen as always having been a country of *dirigiste* culture and institutions at least since the days of Jean-Baptiste Colbert, Louis XIV’s finance minister, but it was a very *laissez-faire* country between the fall of Napoleon and the Second World War – even more so than the then very liberal Britain in some respects (Kuisel, 1981; Chang 2002b).

The important thing is that for France liberalism was *not* an alien culture imported from the other side of the Channel. While many Anglo-Saxons regard liberalism as their unique contribution to world civilisation, liberalism is as much French as *dirigisme* – going back at least to the libertarian tendency in the French Revolution. France lurched towards liberalism in the nineteenth century as a reaction to the experience with Napoleon, while it revived its *dirigiste* tradition and its developmentalist tendency following the humiliation of the two world wars.

If there is more than one ‘tradition’ in a country’s culture and institutions, deliberate political choices, and the ideologies that influence such choices, become important in determining its developmental path.

Moreover, over the long term, ‘traditions’ are not immutable. Cultures and institutions themselves change, often dramatically. For example, contrary to the popular belief in the West today, the Islamic culture was more tolerant, scientifically-minded, and pro-commerce than the Christian ones until at least the sixteenth century. For another example, the Confucian societies, including China itself more recently, have defied cultural determinism to transform their ‘traditions’ (which had been believed to be anti-developmental until the 1950s) and engineer the biggest economic miracles in human history.

One reason for cultural and institutional shifts is that cultural/institutional changes and economic developments influence each other, with complex chains of causality. In the mainstream theories, where individuals are seen as being born with a pre-determined ‘preference’, the causality runs from culture/institutions to economic development. However, once we accept the ‘constitutive’ role of institutions, we begin to understand that the causality could run the other way – from economic development to institutional changes to individual ‘preference’ (Chang and Evans, 2005). Industrialisation, for example, makes people more ‘rational’ and ‘disciplined’. This is testified to by the fact that before their countries achieved a high degree of industrialisation, people like the Germans and the Japanese were described by visitors from more advanced countries as lazy, irrational, and even congenitally incapable of dealing with machinery, completely differently from their modern-day racial stereo-types.

Another, and possibly more important, reason for cultural/institutional shift is that, to paraphrase Marx, it is humans that change institutions, albeit not in the institutional context of their own choosing. In the mainstream theory, this is impossible because there is no real human agency. Material interests that motivate people to change institutions (e.g., pressure for democracy from small independent farmers) are pre-determined by 'objective' economic (or even natural) conditions, and therefore there is no real 'choice' in what we do (Chang and Evans, 2005). Or alternatively we are just carriers of cultural 'memes' – such as Botswanan 'democratic' political culture or Confucian 'work ethic'. However, in reality, people make choices that are *not* totally determined by their 'objective' economic interests. Ideas, and institutions that embody them, influence how people perceive their interests (and therefore there is no such thing as 'objective' interest in the final analysis) and sometimes even make people defy their own 'objective' interests because of the ideas they carry.[4]

To summarise, we can only break away from the cultural/institutional determininism so prevalent in the mainstream discourse only if we understand the complexity of culture and institutions, on the one hand, and accept the importance of human agency in institutional change. Only when we accept the multi-faceted nature of culture/institutions and the existence of competing cultural/institutional 'traditions' in a society, we begin to understand that what people believe and do matter in the real sense.

5.2 Imitation, adaptation, and innovation in institutional development

If we take institutions as 'technologies for social management', then there is a strong case for using the Gerschenkronian 'catching-up' framework in understanding institutional development in the developing countries. In other words, the late-developing countries can import institutions from the developed countries and thereby use 'better' institutions without paying for the same 'prices'.

For example, it took today's developed countries a few centuries of financial crises (and all the economic and human costs that come from them) before they developed the institution of central bank.[5] However, because they have introduced the central bank relatively at lower levels of economic development, today's developing have been better able to cope with financial crises than were today's developed countries at comparable levels of economic development.

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[4] One interesting example is the case of Korean planning agency, Economic Planning Board (EPB). Although it was the centre of government intervention until the 1970s, for various reasons many bureaucrats at the EPB adopted neo-liberal ideology since the 1980s. By the early 1990s, some EPB bureaucrats were even calling for the abolition of their own ministry. This flies directly in the face of the fundamental assumption of self-seeking in orthodox economics. Unless we accept the importance of human agency and the influence of ideologies on it, we will never be able to understand why these bureaucrats went against their 'objective' interests and campaigned for the reduction of their own power and influence. For further details, see Chang and Evans (2005).

[5] The need for the lender of last resort, and thus for the central bank, was perceived from at least the seventeenth century but it was only after hundreds years of unnecessary financial crises that the developed countries of today have come to set up the central bank – between the second half of the nineteenth century and the first half of the twentieth century. Most market-oriented economists until that time believed that central banking would be harmful because it creates what we these days call 'moral hazard' on the part of the borrowers (Chang, 2000).

Indeed, the developing countries today are enjoying higher standards of political democracy, human rights, and social development than what were achieved by today's developed countries at similar levels of *economic* development (i.e., same per capita income) thanks to their institutional imitation (for further details, see Chang, 2002a: ch. 3).

For example, in 1820, the UK was at a somewhat higher level of development than that of India today, but it did not even have many of the most 'basic' institutions that India has – universal suffrage (it did not even have universal *male* suffrage), a central bank, income tax, generalised limited liability, a 'modern' bankruptcy law, a professional bureaucracy, meaningful securities regulations, and even minimal labour regulations (except for a couple of minimal and hardly-enforced regulations on child labour in a few industries).

For another example, in 1875, Italy was at a level of development comparable to that of Pakistan today, but did not have universal male suffrage, a professional bureaucracy, an even a remotely independent and professional judiciary, a central bank with note issue monopoly, and competition law – institutions that Pakistan has had for decades. Democracy is an obvious exception in this regard, but despite frequent suspension of electoral politics, suffrage in Pakistan, when allowed, has remained universal.

For still another example, in 1913, the US was at a level of development similar to that of Mexico today. However, its level of institutional development was well behind that we see in Mexico today. Women were still formally disenfranchised and blacks and other ethnic minorities were *de facto* disenfranchised in many parts of the country. It had been just over a decade since a federal bankruptcy law was legislated (1898) and it had been barely two decades since the country recognised foreigner's copyrights (1891). A highly incomplete central banking system and income tax literally only just came into being (1913), and the establishment of a meaningful (not to speak of being 'high quality') competition law (the Clayton Act) had to wait another year (1914). Also, there was no regulation on securities trading or on child labour, with what few state legislations that existed in these areas being of low quality and very poorly enforced.

Of course, institutional imitation is rarely enough – in the same way technological imitation is rarely enough – to guarantee a successful institutional development.

More importantly, in the same way in which there are a lot of *tacit* elements in technology, there are a lot of tacit elements in institutions. So some formal institution that seems to be working well in an advanced country may be working well only because it is supported by a certain set of not-easily-observable informal institutions. For example, it will be difficult to introduce VAT in countries where people do not have the habit of asking for and issuing receipts. Or introducing the JIT (just-in-time) production system in countries where people do not have 'industrial' sense of punctuality will be impossible. And so on. If this is the case, importing the formal institution is not going to produce the same outcome because the importing country may be missing the necessary, supporting informal institutions.

So, in the same way in which imported technology needs to be adapted to the local conditions, some degree of adaptation is needed in order to make imported institutions work. The best example in this regard is the far-reaching institutional reform in early Meiji Japan (details can be found, among other things, in Westney, 1986: ch. 1). Having been forced open by the Americans in 1853, the Japanese realised that they needed to import Western institutions if they are to industrialise. After scanning the Western world, they imported institutions that they thought were the most effective with suitable local adjustments – the navy and the Post Office from Britain, the army and criminal law from Prussia, civil law from France, the central bank from Belgium. They also imported an American educational system but ditched it in favour of a mixture of German and French systems, after it was revealed to be ill-suited their country.

Of course, if imitation and adaptation were all we needed, other countries could have been as successful as Japan. Subsequently added to the imported institutions by the Japanese were lifetime employment system, enterprise union, long-term subcontracting network, the pre-war *zaibatsu* and the post-war *keiretsu* systems of enterprise grouping, and many other institutions that are 'unique' to Japan.

Same story of institutional innovation characterise many other 'success' stories – the American innovation in enterprise organisation based on the multi-divisional firm and interchangeable parts, the German innovation in enterprise governance in the form of co-determination, the Nordic innovation in industrial relations in the forms of solidaristic wage and centralised wage bargaining, and so on. Indeed, institutional innovation has been a major source of economic success in many countries.

Of course, this does not mean that culture/institutions can be changed at will. Jacoby (2000) emphasizes the role of legitimacy in the process of institutional change. Unless the new institution commands certain degree of political legitimacy among the members of the society in question, it is not going to work. And in order to gain legitimacy, the new institution has to have some resonance with the existing culture/institutions, which limits the possible scope of institutional innovation.

6 Concluding remarks

In this paper, I have reviewed some of the key theoretical issues involved in developing a good understanding of the relationship between institutions and economic development. The definitional issues, the failure to distinguish the forms and the functions of institutions, the excessive focus on property rights institutions, and the failure to build a sophisticated theory of institutional change have been pointed out as the major problems in the currently dominant literature on institutions and economic development.

While the very nature of the subject matter makes it unlikely that we will any time soon have a complete theory of institutions that will adequately address all the above-mentioned theoretical problems, identifying the problems with the currently dominant theory is the first step towards building such theory. As I have tried to argue throughout the paper, a more careful and ideology-free crafting of the basic concepts as well as a better knowledge of the historical and contemporary experiences are necessary if we are to make a progress in this regard.

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