

Ashok Chakravarti



# Institutions, Economic Performance and the Visible Hand

*Theory and Evidence*



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Ashok Chakravarti

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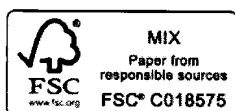
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# Institutions, Economic Performance and the Visible Hand

## About the author

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**Ashok Chakravarti** has been involved with the field of development for the past 30 years. During this period he has worked in an advisory role for the World Bank, USAID, DFID, UNDP, UNCTAD and other international agencies. In his last advisory position he was Chief of Party of a USAID-funded programme in South Sudan (2004–2007) that was focused on building institutions of democratic governance. Between 2002 and 2009,

he was a Visiting Fellow at Oxford University on several occasions. Since 2009 he has been attached to the Department of Economics, University of Zimbabwe, where he teaches an institutions-oriented curriculum to students of Development Economics and Macroeconomics.

# Preface

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My research agenda over the past ten years has focused on institutions and how the structure of economic and political governance affects economic performance and developmental outcomes. This interest was a direct consequence of my experiences as a development practitioner, mainly in Africa, where I have been managing institutional development programmes on behalf of various aid agencies since 1980. I found that these experiences strongly contradicted the standard economic models and development theories that emerged from these models. Consequently, my initial programme of research focused on the impact of aid on development and culminated in the publication of my first book entitled *Aid, Institutions and Development* (Edward Elgar 2005). In this study I concluded that the evidence indicated that aid in general has had a very limited impact on development. However, in countries with good economic and political institutions, where good governance and favourable macroeconomic policies are being followed, aid can have a much more significant impact.

Standard economic theory postulates that growth and development are a function of technology, and the level of resources – primarily physical and human capital – invested in a society. What I observed in the many countries I worked in was that the institutional framework of a society (i.e. the economic and political rules that govern its functioning) was far more important in determining economic outcomes. That conclusion was reinforced by the events surrounding the recent sub-prime related financial crisis and subsequent world recession. This crisis has shown that even highly developed markets in the advanced economies do not have self-regulating and self-equilibrating characteristics and cannot function efficiently without proper institutional and governance-related frameworks. My experiences, and recent economic events, led me to consider other more fundamental questions, such as: What is the real content of human economic behaviour? What are the institutions of good economic and political governance? Why do they encourage individuals and governments to act in a productive manner? And how do these institutions come into being? These in turn have resulted in this book.

In undertaking this study, I was privileged to have been given the opportunity to play a role in South Sudan's incipient institutional development. This gave me a first-hand insight into what institution building and institutional

change are all about. South Sudan became an independent country in July 2011, after a brutal civil war that commenced in 1956 and lasted over 50 years. During this period social order was primarily maintained through tribal structures and informal traditional institutions. At a formal level, the few governance structures introduced by the central government in Khartoum never achieved any level of credibility. Consequently, they never became established as functional institutions. In spite of the long period between 1956 and 2011, however, South Sudan did not see any evolutionary or endogenous development of its political or economic institutions. Rather, society became frozen in some sort of low-level homeostatic equilibrium. The fact of conflict does not change this assessment. Historically, after all, war and conflict have played a major catalytic role in many countries in bringing about the emergence of new institutions. But no such process was observed in South Sudan.

Thus when I went there in 2004 on behalf of a major international development agency, and found that the ruling group that had emerged through the civil war had progressive political and economic ideas and was interested in building a democratic capitalist society, following on from my research hypotheses, it seemed to me that what was required was an activist institutional engineering programme. My analysis of the historical experience of other developing countries that had achieved favourable institutional transitions indicated that in most cases successful institutional change was a result of the conscious efforts of small domestic ruling groups, or sometimes even external forces, inspired by progressive ideas and ideologies. Institutional change, particularly in the developing world, was therefore not a consequence of grand endogenous forces, but the result of good ideas, good leadership, and the conscious and forceful intervention of human agency. Subsequent consultations between the Sudan People's Liberation Movement and my agency resulted in the design and implementation of a major programme of institutional development that was led by the domestic elite and supported by external forces. This commenced in 2004 and is still ongoing. Chapter 8 discusses the successes and failures of this programme.

I am grateful to Piet Hein van Eeghen, Johann du Pisanie, John Teye, Geoffrey Hodgson, Takawira Mumvuma, Tony Hawkins and three anonymous referees for their comments on earlier drafts of the study. I am particularly indebted to Piet Hein van Eeghen and Johann du Pisanie for reviewing each individual chapter over a period of two years and providing me with suggestions and detailed comments. I dedicate this book, however, to the leaders and the brave people of South Sudan who fought repression and tyranny for over five decades – a fight that resulted in the death of over two million people – to win the right to create a society of their own choice. It is also dedicated to my colleagues, and to the many other external actors in South Sudan's institutional development programme since 2004, who lived in tents and *tukuls* (huts) in

40°C for extended periods of time; suffered from repeated bouts of malaria, bilharzia, and other tropical diseases; and, accepted AK47s going off, mines being found in close proximity, and ammunition dumps blowing up, all in order to engage the domestic leadership in an active dialogue to bring about institutional change that would prove favourable to economic and social progress.

**Ashok Chakravarti**

*Harare, Zimbabwe*

*November 2011*



# Contents

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<i>List of figures and tables</i>	vi
<i>About the author</i>	vii
<i>Preface</i>	viii
1 Introduction	1
2 The neoclassical model and its critique	11
3 The old and new institutional economics	35
4 Development strategies and performance: an overview	54
5 Institutions and governance: the new empirical evidence	74
6 Institutions in economic history	97
7 Discontinuous institutional change	122
8 Southern Sudan: a case study in discontinuous institutional change	147
9 Markets and institutions	170
10 Mechanisms of institutional transition	197
<i>Appendix</i>	210
<i>Bibliography</i>	214
<i>Index</i>	231

# Figures and tables

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## Figures

9.1	Institutions and market performance	183
9.2	Institutions and opportunism/predation	193
10.1	Institutions and economic rationality	200

## Tables

4.1	Per capita GDP growth rates 1950–2001	54
4.2	All developing country regions: per capita GDP growth rates 1975–2005	55
4.3	Savings and investment rates 1995–2005	66
4.4	Economic and political governance indicators	68
4.5	Sub-Saharan Africa: aid dependency ratios	72
4.6	Aid/gross capital formation 2006	72
5.1	Contribution of total factor productivity to growth of output	76
5.2	Decomposition of growth of output	77
5.3	Contributions of capital, human capital and productivity	78
5.4	Impact of economic and institutional variables on economic growth	82
5.5	Impact of democracy on economic growth	90
6.1	Per capita GDP levels and growth rates – major regions	97
6.2	Per capita GDP levels	98
7.1	Per capita GDP – annual compound growth rates	126
7.2	India – per capita GDP levels	131
7.3	India – per capita GDP growth rates since 1950	137
7.4	Number and assets of private firms 1988–2005	137

# 1. Introduction

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This study is about economic performance – both the long-run performance of developing countries, as well as short-run fluctuations in the advanced market economies. The neoclassical view, which continues to dominate mainstream economic theory, postulates that the problems of growth and development can be solved without reference to the institutional dimension of markets. Reflecting on this issue, Furubotn and Richter (2005: 1) state that ‘as the technical development of neoclassical theory has progressed and economic models have become increasingly abstract, institutional phenomena have received less and less attention’. The standard free market paradigm of this theory holds that unfettered markets are efficient and self-adjusting. Further, it is argued that given the natural ability of the market mechanism, under certain conditions which enable competitive markets to be established and optimality conditions to be achieved, interfering with its functioning will reduce the impact of existing resources on incomes and welfare. It is of course accepted that there are caveats to this paradigm. The existence of public goods or externalities can cause free markets to be sub-optimal. Unfettered markets can also be characterised by persistent unemployment. But as Stiglitz (2010: 17) indicates, although a considerable body of economic theory now exists which shows that unfettered markets do not yield efficient solutions even when small and realistic changes are made to the model – e.g. when there are information imperfections or asymmetries (Greenwald and Stiglitz 1986, Grossman and Stiglitz 1980) – this view continues to be the ‘ruling’ or ‘standard’ paradigm in economics. Thus, until very recently, such efficiently functioning and self-regulating free markets were seen as the basis for economic stability and growth in the advanced economies. However, the recent world recession, which commenced in 2007 with problems in the US sub-prime mortgage and financial markets, has seriously undermined the credibility of this model and necessitated a rethink on what constitutes a basis for good economic performance.

In the context of the economic development of poor countries, based on the same neoclassical vision, the adequacy of resources to create both human and physical capital is seen as being key to sustained economic growth. In recent years there has been increased discussions on the importance of a favourable institutional environment, and the need for good economic and political governance, for achieving improved and sustainable levels of growth and poverty

reduction. In spite of this, however, the fundamental strategies of development followed by the developing countries themselves, supported by World Bank and IMF programmes based on the Poverty Reduction Strategy and other similar approaches, have focused on the resource-based vision of development. Consequently, the weak growth observed in most developing country regions over the past 60 years has been ascribed to a lack of resources, or to inappropriate government policies and interference in markets, which it is argued will cause economic distortions and a misallocation of resources. In this model therefore, the problem of economic development is not one of the absence of an institutional framework or mechanisms to bring about the best use of available resources, but one that focuses on a paucity of the resources themselves. A significant consequence of this thinking has been that economic theory, policy and practice over the past 60 years have tended to underplay the role of institutions in influencing economic performance.

## NATURE OF INSTITUTIONS

Of course, writers in the neoclassical tradition accept that various types of economic, social and political institutions exist in a society and have an impact on social interaction. However, it is generally argued that such institutions are not very relevant when it comes to theorizing about economic behaviour and economic outcomes (Marshall [1920]1956: Appendix C). Even those in the neoclassical school who give greater significance to the role of institutions tend to assume that any institution that may be required to sustain free contracting amongst agents will emerge spontaneously and support the efficient functioning of the system (Hayek 1945, Hayek 1973, Menger [1883]1963). In a formal sense, therefore, the neoclassical model is based on an 'institution-free' view of the functioning of the economic system. The existence of a market and a 'ghostly' auctioneer is presumed (Toye 1995). However, such a market has no independent characteristics and no independent existence apart from the actors who trade within it. The market is, therefore, just a place where trading occurs and prices are formed, and the role of the auctioneer is to communicate the price information so that re-contracting can occur such that the market clears. In view of this, it is useful to start off by defining what we mean by institutions. An encompassing definition of institutions can be found in North (1989, 1990) who holds that institutions are the rules of the game of a society, or more formally the humanly devised constraints together with their enforcement characteristics that structure human behaviour. Institutions can be formal rules such as constitutions and laws, or informal constraints such as habits, customs or tradition. Generalizing this concept, Hodgson (2006) argues that social rules are the essence of an

institution. Institutions are thus systems of established and prevalent overt or implicit social rules that structure social interaction.

The debate on the nature and relevance of institutions is extensive. As the definitions above indicate institutions can be formal or informal, explicit or tacit, and they can include a wide range of entities such as codified laws, rules, conventions and norms. Contributing to this discussion, Aoki (2007) states that there are two views of institutions. In the first, institutions are seen as rules in a hierarchical order. These rules are pre-determined exogenously, outside the domain of economic transactions, and economic institutions, such as markets, operate within these constraints. The second is the endogenous view, in which the institutions or rules are seen to emerge spontaneously or be endogenously shaped from within the economic order. This debate suggests that to facilitate the discussion here, a more fundamental ontology of institutional reality needs to be elaborated upon. Such an ontology should help us to understand why institutions should be considered as central to the functioning of an economic system. In Searle (2005) we can find such an analysis. Searle states that there are facts or features of the world that exist independent of human thought and belief. These include physical and chemical phenomena and the relations that exist between them. On the other hand, there are those facts or features which exist as entities only relative to human feelings and attitudes, such as government, money, marriage, etc. The difference between these two groups is that the first set of features is observer independent, whereas the second set is observer dependent. On this basis Searle argues that an institution is any collectively accepted system of rules, procedures, practices, that enables us to create institutional facts, and that the nature of institutions is that they are deliberate human devices which have the capability of constraining or enabling human behaviour.

This ontology of institutional reality enables us to more accurately understand the fundamental nature of institutions and why they play a central role in influencing economic performance. Nabli and Nugent (1989) emphasize three characteristics of institutions which are of relevance. The first is their nature as rules and constraints on human behaviour. The second is their ability to govern the relations amongst individuals and groups. The third is their predictability, and through this characteristic, their ability to play an enabling role by providing a structure for repeated human interaction. As a consequence of these characteristics institutions not only limit the choice set of economic and political actors, but they also define the matrix of incentives that will influence and determine the manner in which human beings will behave. Following on from this view, Williamson (2000) argues that the problems of resource allocation and maximization, which are the central concerns of neoclassical economics, are in fact embedded in three higher levels of economic and social structure. All these levels influence human behaviour.

The deepest underlying level is that of social embeddedness, where informal institutions, customs, traditions and religion are located. These factors have a pervasive influence and change very slowly. The second level is that of the formal institutional environment. This includes constitutions, laws, the formal nature of the political system, property and contractual rights, etc. While much of the formal framework in the world today is a product of evolutionary processes, rare windows of historical opportunity to effect radical reforms in these institutions also occur as a consequence of social disorders, wars, occupations, or other breakdowns. The third level relates to governance structures. These are structures that have been crafted by human beings in order to take advantage of the incentives created by the other two levels of institutions and facilitate transactions between individuals and groups. They include the legal system where contracts are enforced; business enterprises of various types; political and civil associations; and other organizational structures.

Within this framework, the interaction between individuals and institutions can be seen as a two-way relationship. On the one hand individuals through collective action, which may be spontaneous or involving direct action, can bring about the creation of institutions that will reflect their ideas and beliefs. This has been termed as a process of upward causation. Hodgson (2006) indicates that the process of upward causation, whereby lower level changes fundamentally alter higher level structures, is widely accepted. However, as we have noted above, the reverse process by which institutions affect individual behaviour is equally significant. This is a process of downward causation originally hypothesized by the psychobiologist Roger Sperry (1964, 1969). Hodgson (2003, 2006) argues that this can take two forms. First, if there are systemic properties and tendencies, all processes at the lower level of an ontological hierarchy can be restrained by and act in conformity with the laws of the higher levels. In this case all individual aspirations, dispositions or constraints are influenced by system-wide processes. Second, there can be reconstitutive downward causation. In this case individuals and populations are not only restrained but also changed by the causal powers associated with higher levels of the hierarchy. Thus new institutions can lead to changes in behaviour and concordant habits based upon congruent purposes and beliefs amongst significant sections of the population, who initially may not have necessarily shared these beliefs and values. Downward causation is therefore an important mechanism through which institutions can influence and change human behaviour, and consequently impact on the performance of an economic system.

Based on the discussion above, we can state the three fundamental questions that this book seeks to answer:

- Is the exclusion of institutions from orthodox theory defensible from a theoretical point of view?

- What does the historical and empirical evidence tell us about the relative importance of institution-related factors in explaining modern economic growth and the more recent performance of developing countries? And can such factors be used to develop a useful model to explain the recent fluctuations in advanced market economies?
- How do the necessary institutions which underlie successful economic performance emerge? Do they come into being spontaneously based on endogenous forces, or are exogenous interventions – either in the form of shocks or direct interventions, important factors that bring about their emergence?

These questions are not new, and there is a substantial literature, some of which goes back to the 19th century, that has attempted to address them. This book's contribution is to review and consolidate the major themes and issues that have emerged from this literature, and in doing so to try to arrive at a set of more coherent hypotheses and consistent conclusions that may prove useful in explaining economic performance. Consequently the study neither intends nor claims to have taken into account the views of all authors who have written on this subject or the vast literature that is available covering all the relevant topics. Rather, only the major works in each area of concern have been considered and used in arriving at certain conclusions.

## METHODOLOGY

In terms of its analytical approach the study follows the inductive methodology embedded in the mainstream institutional economics literature (Greif 1998, 2006; North 1981, 1990; Olson 1965, 2000). In this literature it is accepted that whether in the natural sciences or the social sciences, any understanding of a phenomenon must start with good observation. Based on observation and fact, valid generalizations can then be drawn. Such generalizations may in turn be used to formulate working hypothesis or deductive theories. Therefore, the starting point for any serious theory that attempts to explain reality must be inductively derived generalizations.

In the case of economics, economic history provides the most reliable and varied set of observations about how economic processes function. For an economist, therefore, economic history is his laboratory. Economic history is not just narrative: the recent applications of statistical and econometric methods to large amounts of historical and cross-country data have generated a substantial quantum of empirical evidence. This evidence reveals which patterns or associations are recurrently found amongst the key variables that are considered important to the functioning of an economic system. In this

book, therefore, we shall use historical evidence, case studies and cross-country empirics to develop and buttress the arguments. However, as Greif indicates, such evidence is atheoretical. He states (2006: 309) that the purely inductive method which involves classifying and generalizing – whether through narrative or statistical method – is insufficient, because it does not inform us about what the lines of causation are. This is particularly so as many important variables that may play a key role in the functioning of the economic system are unobservable. As a result, a more useful approach here is to adopt a theoretically informed inductive method within which theoretical predictions are combined with historical narrative. In this way, theoretical insights drawn from a single or alternative hypothesis can be stated and tested against valid generalizations which have been arrived at on the basis of historical and empirical fact. If a correspondence is found between the hypothesis and the generalizations, then a realistic theory can be built in the confidence that reasonable and empirically grounded assumptions are being used to build this particular theory. The predictions of such a theory can then be used to test its validity and confirm the lines of causation between the variables which form part of the theoretical system.

Neoclassical economics does not take this approach. Hausman (1989) provides us with a historical overview of this subject. He indicates that the deductive method of neoclassical economics finds its origins in the classical thought of J.S. Mill ([1843]1949, [1836]1967). Mill's view was that basic psychological or technical laws were established through introspection or experimentation. Based on these premises, the economic implications can then be deduced and empirical verification conducted as to whether the deductively derived conclusions are valid or not. However, confidence in the theory is based on a direct confirmation of the assumptions rather than any serious tests of the implications. The neoclassicals agreed with Mill. Thus Robbins (1935) indicates that the basic premises of economics are well justified and empirical failures do not cast any doubt on their validity. Referring to the core rationality assumptions of neoclassical economics he states that they 'are so much the stuff of our everyday experience that they have only to be stated to be recognized as obvious' (Robbins 1935: 79).

This view was challenged by the positivists such as Hutchison (1938) and Popper (1959) who argued that economics should measure up to the standards of a responsible empirical science and accept only those theories that were well confirmed by the empirical data. According to the standards set by the positivists, the emergence of empirical studies which showed that individuals or firms do not behave in the manner postulated by microeconomic theory undermined the claim of neoclassical economics to be a scientific discipline. Friedman (1953) proposed a way out of these empirical difficulties. His interpretation of positivism was that a good theory was one that sought significant



and usable predictions, not an understanding or explanation of the phenomena. Thus he stated that a theory would be more fruitful the 'more precise the predictions, and the wider the area within which the theory yields predictions' (Friedman 1953: 10). In this approach, termed as instrumentalism, the validity of the underlying assumptions or principles is not very relevant, and assumptions that bear no relationship to reality are quite justified so long as they can generate a coherent theory which can then be tested against the facts. As Lucas (1986) put it, a theory does not have to have impeccable foundations. The axioms are abstractions and necessarily 'false'. However, the propositions need to have empirical validity to establish the range within which the abstractions will be adequate. Although many neoclassical scholars may prefer a more balanced approach wherein an effort is made to derive simplifying assumptions that capture the essence of reality, this instrumentalist methodology is deeply ingrained in neoclassical thinking.

My study rejects this positivist/deductive approach that underlies most of modern day neoclassical economics. As Hausman (1989) argues, Friedman's positivism (i.e. that the goals of science are exclusively predictive) is a contentious claim for which no justification has been offered. In fact, it stands to reason that unrealistic assumptions will result in false predictions, and when a prediction fails there is no way to employ a new theory without judging the validity of the original assumptions. Otherwise, the whole approach can degenerate into arbitrary guesswork. Discussing this issue, Clower (1994) indicates that in disciplines rooted in plausible inferences, such as physics and economics, the truth is of paramount importance. The aim is not to state and prove theorems but to proffer empirical conjectures that will persuade others of their plausibility in explaining phenomena. Such empirical conjectures based on plausible reasoning are the content of fact-oriented or inductive sciences. Clower also argues that opposed to this there can be hypothetico-demonstrative disciplines such as mathematics, in which the concept of truth is contained in formal ideas, and deductive methods are used to explore or discover what other propositions these ideas or axioms imply. Since economics claims to be an empirical discipline, the fact-based inductive approach is most appropriate. Clower (1995: 311) states that 'no empirical science has ever been generated by axiomatic thinking. One has only to mention Copernicus, Galileo, Newton and Einstein to see the absurdity of a contrary view'. We will argue in later chapters that the positivist/deductive approach in economics is misguided and harmful. One of its more recent consequences has been that it generated a model of the functioning of an economy, which in many ways can be considered as one of the causes of the present financial crisis and world recession.

The empirical analysis in this study focuses on economic growth, with growth performance being taken as a proxy for economic development. Of