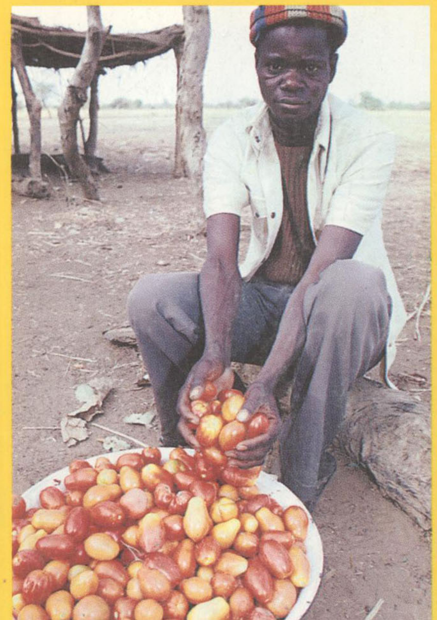
WORLD DEVELOPMENT REPORT 2002

Building Institutions for Markets



THE WORLD BANK

WORLD DEVELOPMENT REPORT 2002

Building Institutions for Markets

Published for the World Bank
Oxford University Press

Oxford University Press

OXFORD NEW YORK ATHENS AUCKLAND BANGKOK BOGOTÁ
BUENOS AIRES CALCUTTA CAPE TOWN CHENNAI DAR ES SALAAM
DELHI FLORENCE HONG KONG ISTANBUL KARACHI
KUALA LUMPUR MADRID MELBOURNE MEXICO CITY MUMBAI
NAIROBI PARIS SÃO PAULO SINGAPORE TAIPEI TOKYO
TORONTO WARSAW

and associated companies in

BERLIN IBADAN

Published by Oxford University Press, Inc.
200 Madison Avenue, New York, N.Y. 10016

Cover design by Debra Naylor, Naylor Design, Inc.
Cover photographs: top, © 2001 Stephen Simpson/FPG; middle,
© 2001 Stone/Paul Chesley; bottom, Yosef Hadar, World Bank.
Inside design and typesetting by
Barton Matheson Willse & Worthington, Baltimore.

Manufactured in the United States of America
First printing September 2001

ISBN 0-19-521607-5 clothbound
ISBN 0-19-521606-7 paperback
ISSN 0163-5085

Text printed on recycled paper.

Foreword

This *World Development Report* is about building market institutions that promote growth and reduce poverty, addressing how institutions support markets, what makes institutions work, and how to build them.

This theme is a natural continuation of last year's Report, which demonstrated that markets are central to the lives of poor people, that institutions play an important role in how markets affect people's standards of living and help protect their rights. This Report identifies how institutions can promote inclusive and integrated markets, and ensure stable growth and thus dramatically improve people's incomes and reduce poverty. It is about equal opportunity and empowerment for people, especially the poor.

Some countries have successfully harnessed market-oriented reforms to improve the welfare of all their people. But in other countries, markets have not given people as much incentive to engage in wider trade, the ability to use fully their skills and resources, and opportunities to increase their income.

Effective institutions can make the difference in the success of market reforms. Without land-titling institutions that ensure property rights, poor people are unable to use valuable assets for investment and income growth. Without strong judicial institutions that enforce contracts, entrepreneurs find many business activities too risky. Without effective corporate governance institutions that check managers' behavior, firms waste the resources of stakeholders. And weak institutions hurt the poor especially. For example, estimates show that corruption can cost the poor three times as much as it does the wealthy.

Addressing the challenge of building effective institutions is critical to the Bank's mission of fighting poverty. We recognize the central importance of institutions in the development process through the Comprehensive Development Framework, which stresses the interdependence of institutions with the human, physical, and macroeconomic sides of development.

The Report emphasizes the importance of historical context: where countries are today affects where they can go. It also takes a pragmatic approach to institution building, focusing on what can be done practically rather than on what should be done in an ideal world. Social and political factors affect the pace of change, and sweeping reforms are not always possible. It is important to work on the areas where opportunities present themselves; each step can take countries forward—if correctly designed. And smaller reforms can build constituencies for larger ones.

This Report recognizes that one size does not fit all in institution building and provides policy guidance on how to develop appropriate institutions. Building on the successes of countries, and learning from the failures, the Report provides a deeper understanding of market-supporting institutions and a better appreciation of how people may build such institutions. In identifying how to promote institutional change, it looks at the roles of private and public, and national, local, and international, actors. It draws on a wealth of research and practical experience from inside and outside the Bank, as well as on insights from many disciplines, presenting new research and data on institutions.

From these diverse sources, the Report distills four lessons on building effective institutions:

- Design them to **complement** what exists—in terms of other supporting institutions, human capabilities, and available technologies. The availability and costs of supporting institutions and capacity determine the impact of any particular institution. By understanding how institutions interact, we can identify priorities.

- **Innovate** to identify institutions that work—and those that do not. Sometimes this requires experimentation. Even in countries with similar incomes and capacities, innovation can create stronger institutions because of differences in local conditions, differences that range from social norms to geography. Countries can gain from expanding successful public innovations and adopting private innovations. But they must also have the courage to drop failing experiments.
- **Connect** communities of market players through open information flows and open trade. Exchanging information changes behavior. It creates demand for institutional change by holding people to account and by supplying ideas for change from outside the community. Linking communities of people in networks of information and trade is thus a priority for those building market-supporting institutions.
- Promote **competition** among jurisdictions, firms, and individuals. Developing country market actors often face too little competition, and changing this will significantly improve institutional quality. Greater competition modifies the effectiveness of existing institutions, creates demand for new ones, and increases choice for consumers. Competition among jurisdictions highlights successful institutions and promotes demand for them. Competition among firms and individuals does the same.

These broad lessons, as well as the detailed analysis and many examples throughout this Report, will help us and policymakers build institutions that ensure stable and inclusive growth and thus improve people's incomes and reduce poverty.

James D. Wolfensohn

This Report has been prepared by a team led by Roumeen Islam and comprising Arup Banerji, Robert Cull, Asli Demirgüc-Kunt, Simeon Djankov, Alexander Dyck, Aart Kraay, Caralee McLiesh, Russell Pittman; and Helena Tang, Nazmul Chaudhury, Jeffrey Hammer, Richard Messick, and Tatiana Nenova made additional contributions. The team was assisted by Theodora Galabova, Paramjit Gill, Yifan Hu, Olga Ioffe, Claudio Montenegro, Stefka Slavova, Mahesh Surendran, and LiHong Wang. Andrei Shleifer and Joseph E. Stiglitz provided valuable suggestions during the writing of the Report. Bruce Ross-Larson is the editor of the overview, chapter 1, and chapter 10. Andrew Balls provided editorial assistance. The work was carried out under the general direction of Nicholas Stern.

The team was advised by a panel of experts comprising Carl Anduri, Abhijit Banerjee, Kaushik Basu, Timothy Besley, François Bourguignon, Antonio Estache, Cheryl Gray, Avner Greif, Nurul Islam, Emmanuel Jimenez, Daniel Kaufmann, Michael Klein, Yingyi Qian, and Kenneth Sokoloff.

Many others inside and outside the World Bank provided helpful comments and wrote background papers and other contributions, and their names are listed in the bibliographical note. Much of the background research was supported by a generous grant from the Dutch government. Research was also supported by the Swiss Trust Fund. The World Bank Development Data Group contributed to the data appendix and was responsible for the Selected World Development Indicators.

The team undertook a wide range of consultations for this Report, from the initial outline to the final draft. During the Report's planning stage in 2000, a February workshop in Berlin and a July workshop in Washington, D.C. provided an exchange of ideas among academics and policymakers from around the world. During the drafting stage in 2001, a consultative meeting on the media was held in April, and a consultative meeting on judicial systems was held in May. In addition, the authors held consultations with a wider community that included nongovernmental organizations, holding meetings in Paris (with representatives from the French Conseil d' État, the Organisation for Economic Co-operation and Development, the French Development Agency, and the Competition Council); in London (Department for International Development, Overseas Development Institute, and nongovernmental organizations); and in Amsterdam (Amsterdam Institute for International Development). The team also conducted a series of videoconferences with audiences in Bangladesh, Brazil, Egypt, Japan, Mexico, Morocco, South Africa, and Thailand. A consultation with the International Confederation of Free Trade Unions was also held.

Rebecca Sugui served as executive assistant to the team; Leila Search as program assistant and technical support; and Shannon Hendrickson, Joanna Kata-Blackman, Mei-Ling Lavecchia, and Rudeewan Laohakittikul as team assistants. Maria Ameal and later Eva Santo Domingo served as resource management assistant.

Book design, editing, and production were coordinated by the Production Services Unit of the World Bank's Office of the Publisher.

Contents

PART III GOVERNMENT

PART IV SOCIETY

Boxes

Figures

Tables

Definitions and data notes

The countries included in regional and income groupings in this report are listed in the Classification of Economies table at the end of the Selected World Development Indicators. Income classifications are based on GNP per capita; thresholds for income classifications in this edition may be found in the Introduction to Selected World Development Indicators. Group averages reported in the figures and tables are unweighted averages of the countries in the group unless noted to the contrary.

The use of the word *countries* to refer to economies implies no judgment by the World Bank about the legal or other status of a territory. The term *developing countries* includes low- and middle-income economies and thus may include economies in trasition from central planning, as a matter of convenience. The term *developed* or *industrial countries* may be used as matter of convenience to denote the high-income economies.

Dollar figures are current U.S. dollars, unless otherwise specified. *Billion* means 1,000 million; *trillion* means 1,000 billion.

The following abbreviations are used:

EU	European Union
FDI	Foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
HIV/AIDS	Human immunodeficiency virus/ acquired immune deficiency syndrome
IPR	Intellectual property rights
NGO	Nongovernmental organization
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
R&D	Research and development
SMEs	Small and medium-size enterprises
TRIPS	Trade-Related Aspects of Intellectual Property Rights
WTO	World Trade Organization

PART I

Introduction

CHAPTER 1

Building Institutions: Complement, Innovate, Connect, and Compete

How do we account for the persistence of poverty in the midst of plenty? If we knew the sources of plenty, why don't poor countries simply adopt policies that make for plenty? . . . We must create incentives for people to invest in more efficient technology, increase their skills, and organize efficient markets. Such incentives are embodied in institutions.

—Douglass C. North, 2000

In the 11th century the Maghribi traders of North Africa wanted to expand business across borders, all around the Mediterranean. Trade in each center was free of formal regulations and restrictions, and competitive, with many buyers and sellers negotiating prices through brokers, open-bid auctions, and direct dealings. Cross-border trade also was generally free of formal regulations and restrictions. But it was fraught with uncertainty about selling prices, the quality on arrival, and the possibility of theft. Only if merchants traveled with their goods to distant markets could they ensure the safe arrival and sale of their merchandise. Such risks and costs naturally limited trade.

So in all major trading centers around the Mediterranean, the Maghribis set up overseas agents to represent their interests and exchange information about markets. Being from the same community, these agents were seen as trustworthy. And with fewer contractual problems, Maghribi merchants no longer needed to travel to ensure that they would not be cheated. Information flowed freely in this network bound by social ties. And the rules of the organization, although not written, were self-enforcing. Remaining in the coalition of traders best served each member's interests. Social ties cemented mutually beneficial business relationships, and cross-border trade flourished.

Today, a millennium later, people everywhere face similar problems in striving to improve their well-being through market activity. African entrepreneurs lack information about potential business partners. Poor farmers in Latin America lacking formal title to their land cannot use it as collateral to secure access to credit. Budding entrepreneurs in Central Asia, trying to start new businesses, run into political obstacles from established firms and the state.

Despite the problems, many people in rich countries and poor are engaged in productive—and rewarding—market activity. As *World Development Report 2000/2001* argued, income from participating in the market is the key to boosting economic growth for nations and to reducing poverty for individuals. This Report is about enhancing opportunities for poor people in markets, and about empowering them. What makes market activity rewarding and possible for some, and not others? Why are some market systems inclusive and integrated, allowing benefits to flow to the poor as well as the rich, the rural people as well as the urban? And why are other markets localized and segmented?

The Maghribi example illustrates some of the reasons. Markets allow people to use their skills and resources and to engage in higher-productivity activities if there are institutions to support those markets. What are these institutions? Rules, enforcement mechanisms, and organizations supporting market transactions. Extremely diverse across rich and poor communities and nations, they help transmit information, enforce property rights and contracts, and manage competition in markets. All market-supporting institutions do one or more of these things. And in so doing, they give people opportunity and incentives to engage in fruitful market activity.

This Report is about people building institutions that support the development of markets. The 2000/2001 Report underscores the importance of institutions in affecting poor people's participation in markets. This Report discusses both institutions that support growth and those that directly affect access of people left out of many market activities. It considers those institutions that provide opportunities for people and that empower them. It goes beyond the 2000/2001 Report by analyzing what institutions *do* to promote growth and facilitate access and by suggesting *how* to build effective institutions. And it emphasizes how institutions can help people make better use of the assets they own and how to accumulate more. In focusing on institution building, it does not devalue the importance of policy. But good policies are not enough. The details of institution building matter for growth and poverty reduction.

The Report contributes to existing work on institutions and markets in several novel ways. It provides a diagnostic framework for understanding how institutions support market activity. Bridging the gap between theory and evidence across disciplines, it also builds on existing evidence on the role of institutions and institutional change. It extends previous empirical work on institutional change to developing countries and presents a framework for institutional change. It confirms that one size does not fit all in considering institutional design. But it does more than that. It illustrates *how* to proceed in building more effective institutions. It provides policy guidance by taking a pragmatic approach. The aim is not to define what should be done in an ideal world, but what can be done in today's world.

In understanding what drives institutional change, the Report emphasizes the importance of history. Many developing countries have been nation-states for a short time compared with industrial countries. The evolution of nations teaches that building institutions takes time and that the process within each country may stall or reverse because of political conflicts or economic and social conditions. It offers lessons about the process of change and the importance of norms and culture in particular countries. Institution building is generally a cumulative process, with several changes in different areas building up to complement and support each other. This Report identifies elements of such a strategy. Even small changes can build momentum for future changes. The whole is greater than the parts, and even moderate progress in the parts can contribute to a better system to promote growth and reduce poverty.

Four main lessons emerge for institution building. The first two are about supplying effective market-supporting institutions. But supplying institutions is not enough. People must want to use them too. Thus, the second two lessons are also about creating the demand for such institutions, and about the forces for change within countries.

To ensure effective institutions:

- *Design them to complement what exists—in terms of other supporting institutions, human capabilities, and available technologies.* The reason? The availability and cost of supporting institutions, existing levels of corruption, human capacity and technology determine the impact of a particular institution. That is why institutions that achieve their goals in industrial countries may not do so in developing ones. Much of the important work in building institutions lies in modifying those that already exist to complement better other institutions and in recognizing what not to build in a particular context, as much as what to build. "Best practice" in institutional design is a flawed concept.
- *Innovate to design institutions that work—and drop those initiatives that do not.* Even in countries with similar incomes and capacities, innovation can create stronger institutions because of differences in local conditions—differences ranging from social norms to geography. Experimentation, which has some costs that must be recognized, can nevertheless help identify new and more effective structures. Countries can gain from expanding successful public innovations and adopting private innovations. But they must also have the courage to drop failing experiments.
- *Connect communities of market players through open information flows and open trade.* Exchanging goods and services outside existing networks and communities creates demand for market-supporting institutions. Exchanging information through open debate creates demand for institutional change by holding people to account, by changing behavior, and by supplying ideas for change from outside the community. Linking communities of people in networks of infor-

mation and trade is thus a priority for policymakers building market-supporting institutions.

- *Promote competition among jurisdictions, firms, and individuals.* Greater competition modifies the effectiveness of existing institutions, changes people's incentives and behavior, and creates demand for new institutions. Developing country actors may face too little competition, often because of current institutional structures. Changing this will improve the quality of other institutions. Competition among jurisdictions—for example, among different states within a country or between countries—highlights successful institutions and promotes demand for them. Competition among firms and individuals does the same.

This chapter first provides a framework for evaluating the role of institutions in supporting market transactions, growth, and poverty reduction. It then focuses on the four main lessons on institution building, followed by a discussion of the impact of political and social forces on institutional evolution.

Box 1.1
A poem on the problems of trade

If I knew you and you knew me
'Tis seldom we would disagree;
But never having yet clasped hands
Both often fail to understand
That each intends to do what's right
And treat each other "honor bright"
How little to complain there'd be

If I knew you and you knew me.
When'er we ship you by mistake,
Or in your bill some error make
From irritation you'd be free
If I knew you and you knew me.
Or when the checks don't come on time
And customers send nary a line,
We'd wait without anxiety,

If I knew you and you knew me.

Source: Who's Who in the Grain Trade 35 (June 20, 1922–23); cited in Bernstein 2001, *World Development Report 2002* background paper.

How do institutions support markets?

Small vendors engage in simple spot-market transactions, with buyers and sellers dealing face to face in fairly standard products whose quality is easy to verify. A rural vegetable market in a poor country is such a market. Large multinational firms exchange more differentiated products, facing greater difficulties in verifying quality and bigger separations in time and space between the *quid* and the *quo*. International exchange of food products is an example of such a market. Most economies have both types of markets—the first more common in developing countries, the second in industrial economies.

Developed markets, more global, inclusive, and integrated, offer more opportunity choice. Underdeveloped markets, more likely in poor countries, are more likely to be local and segmented. So, compared with farmers in Canada, poor farmers in Bangladesh have fewer opportunities—and far fewer formal institutions (such as banks and formal courts) to reduce their risks and increase their opportunities.

What limits market opportunities? Transaction costs from inadequate information, incomplete definition and enforcement of property rights, and barriers to entry for new participants.[1] What increases them? Institutions that help manage risks from market exchange, increase efficiency, and raise returns (boxes 1.1, 1.2, and 1.3).

Yet not all institutions promote inclusive markets. The Maghribis lowered transaction costs among themselves, but in so doing excluded other communities. Institutional designs that evolve through either historical circumstances or directed action by policymakers are not necessarily the best institutions for all society—or for economic growth and poverty reduction. Moreover, institutions that once supported market transactions can outlive their usefulness—for example, privatization agencies and bank restructuring agencies. The challenge for policymakers is to shape policies and institutional development in ways that enhance economic development. The Maghribis operated under a policy of free trade that enhanced their opportunities. It was to take advantage of these opportunities that they developed their institutions.

Clearly there is no unique institutional structure guaranteed to lead to economic growth and poverty reduction. Large firms in the United States and the United Kingdom are often publicly held, with dispersed ownership, and are widely traded. But that is not the case in other high-income countries such as France or Canada, where ownership structures are highly concentrated (figure 1.1). And to promote competition, policymakers can use quite different guidelines. In East Asia competition authorities consider a market share of 50 to 75 percent to be evidence of possible monopoly