The New Institutional Economics and Third World Development

Edited by

John Harriss, Janet Hunter and Colin M. Lewis

ROUTLEDGE

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London and New York

First published 1995
by Routledge
11 New Fetter Lane, London EC4P 4EE

Reprinted 1998

Simultaneously published in the USA and Canada
by Routledge
29 West 35th Street, New York, NY 10001

First published in paperback 1997

Typeset in Garamond by Michael Mepham, Frome, Somerset
Printed and bound in Great Britain by
Intype London Ltd

British Library Cataloguing in Publication Data
A catalogue record for this book is available
from the British Library

Library of Congress Cataloguing in Publication Data
The new institutional economics and Third World
development/edited by John Harriss, Janet Hunter
and Colin M. Lewis.
p. cm.
Includes bibliographical references and index.
1. Institutional economics. 2. Economic development. 3.
Developing countries–Economic policy. I. Harriss, John. II
Hunter, Janet. III. Lewis, Colin M. HB99. 5.N493 1995
338.9'009172'4–dc20

95–1523

ISBN 0–415–11823–9

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PREFACE AND ACKNOWLEDGEMENTS

The conference from which this collection originates was organised under the auspices of the Third World Economic History and Development Group and hosted by the Department of Economic History and Institute of Development Studies at the London School of Economics and Political Science in September, 1993. Financial support was obtained from the Overseas Development Administration, the Suntory/Toyota International Centre for Economics and Related Disciplines and the British Academy. Their assistance is gratefully acknowledged.

The conference demonstrated with great clarity the congruence of interest amongst development theorists, policy-makers and historians of economic change. It is to be hoped that this volume reinforces the existence of common interests between those concerned with the present and the past, not just because they may happen to study the same geographical areas but because there are valid topics of intellectual debate and disciplinary approach which are common to both sides. The tone and content of debate at the conference illustrated the benefits to be derived from such an exchange.

The integrity of this volume – and indeed the success of the conference – owes much to the willingness of contributors to engage in a dialogue with each another. A particular debt is owed to Douglass C. North, Robert Bates and John Toye, who presented keynote papers at the conference, for their enthusiasm and encouragement, but we would like to extend our thanks to all those who participated in the event, including those who presented papers not included in this volume. The success of any conference rests on the willingness of all participants to engage in debate. We would also like to thank other staff in the Department of Economic History and the Development Studies Institute who helped with the organisation of the conference and the production of this manuscript.

J.H., J.H., C.M.L.

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INTRODUCTION

Development and significance of NIE

John Harriss, Janet Hunter and Colin M. Lewis

The importance of the new institutional economics (NIE) has been confirmed by the award of the Nobel Prize for Economics first in 1991 to Ronald Coase, whose seminal papers on 'The Nature of the Firm' (1937) and on 'The Problem of Social Cost' (1960) are widely referred to here, and then in 1993 to Douglass C. North, who contributes the following chapter in this book. The 'new institutionalism' is important for perhaps three reasons above all. First, it is an emerging body of theory which starts out within the frame of neo-classical economics, but offers answers to what have otherwise remained as puzzles in neo-classical theory. One of these puzzles, which, as Toye explains in his chapter, 'acted as a catalyst of the NIE', is the problem of the existence of the firm as an administrative and financial organisation – to which Coase offered an answer in his essay of 1937. So the NIE is important as a major development within the dominant paradigm of modern economics. Second, it is important in the context of economic policy in the 1990s because it has challenged the dominant role ascribed to the market by the orthodoxies of the last ten years or so. Thus, as Bates puts it in his chapter in this book, '[Those] who had emphasised the importance of market failure in development economics find in the new institutionalism new justification for their interventionist beliefs.' However, the NIE does not simply reintroduce the state and revive the sterile confrontation between 'state' and 'market'. Rather – as Toye explains – it shows that neither state nor market is invariably the best way in which to organise the provision of goods and services. Also, it offers 'a set of tools to inform institutional design'. Herein lies much of the importance of the new institutionalism for the study of development. Third, its significance for development studies relates to another factor which underlies the contemporary prominence of NIE. In a period in which 'grand theory' in the social sciences has generally been on the retreat, it claims to offer just such a grand theory of social and economic change – a theory of development in terms of appropriate institutional change (which fosters further economic growth).

The NIE is, moreover, a body of economic theory which ascribes an important role to ideas and ideologies, and one which is accessible to other social scientists, seeming to open up the terrain of genuinely inter- (not just 'multi-') disciplinary enquiry. This aspect is reflected in the fact that contributions to this book have been written by political scientists and historians as well as by economists. Among other things, the NIE provides scholars with a means of dealing rather more rigorously with the issue of distinguishing between the real world and individuals' and groups' perceptions of it. The question of 'mental models' plays a prominent part in the historical chapters, and suggests the possibility that the NIE can go a considerable way toward bridging a very real gulf between the perfectly rational actors of neo-classical theory and the often seemingly irrational decisions of economic actors in history – a problem which scholars such as Scott attempted to address through the concept of the moral economy of the peasant (Scott 1976). Mental models, however, offer another perspective on how to deal with market interaction and transaction costs. Phrases such as 'market failure' and 'market imperfections' dominate the study of late-developing economies. They also feature largely in – and are fundamental to – the NIE, given the focus on production externalities, public goods, imperfect information and the free-rider problem. Institutions, for economic historians such as North, are the way in which economies cope with 'market failure'. Thus, by attempting to incorporate the concepts of public/rational choice into economic decision-making, NIE not only tries to suggest something about the relationship between the individual and the collective in rational decision-making, but also appears to offer an explanation as to why the evolutions of individual countries differ from each other. And this, perhaps, is the fundamental dilemma of the scholar of economic change – to find a position on the spectrum which at one end argues that the development of every economy is unique, and at the other argues, like Marx or Rostow, that there is a universality about economic development, from which economies are incapable of deviating.

WHAT IS THE 'NIE' AND WHY IS IT SIGNIFICANT IN MODERN ECONOMICS?

North (Ch. 2, this volume) tells us that NIE

> builds on, modifies, and extends neo-classical theory to permit it to come to grips and deal with an entire range of issues heretofore beyond its ken. What it retains and builds on is the fundamental assumption of scarcity and hence competition – the basis of the choice theoretic approach that underlies micro-economics.

Thus the NIE retains the neo-classical axioms of methodological individualism but rejects certain very restrictive assumptions in the notion of 'the market' that is central to neo-classical economics: namely, the conception of the market:

> as an abstract realm of impersonal economic exchange of homogeneous

> goods by means of voluntary transactions on an equal basis between large numbers of autonomous, fully-informed entities with profit-maximising behavioural motivations and able to enter and leave freely.
>
> (Harriss-White, Ch. 6 this volume)

The NIE starts from the reality that information is rarely complete, and that individuals have different ideas (or mental models) of the way in which the world about them works. Transactions thus have costs associated with them which are assumed not to exist in the neo-classical model: these are the costs of finding out what the relevant prices are, of negotiating and of concluding contracts, and then of monitoring and enforcing them. Institutions are broadly defined as means of reducing these information and transaction costs.

North also argues that institutions are formed precisely to reduce uncertainty in human exchange. Institutions – notably property rights in the North view – are thus crucial determinants of the efficiency of markets. He attributes this basic insight to Coase, who argued that the existence of 'real-world' firms' actual administrative organisations – as opposed to the abstraction of 'the firm' as an economic actor in general equilibrium theory – stems from the fact that they allow for the reduction of information and transaction costs. This leads to the recognition, uncomfortable for some economists, that markets are only one type of social device for settling the terms of transactions, and that the performance of markets may be judged against that of other devices. To summmarise, the NIE is a development of neo-classical economics to include the role of transaction costs in exchange and so to take account of institutions as critical constraints on economic performance.

North adds yet another aspect that is of central importance. This is that the NIE modifies the 'rationality postulate' of neo-classical economics which maintains that values are given and constant and that individual economic agents select the most efficient means of maximising rationally chosen ends. North, however, argues here that individuals make choices on the basis of their mental models. Drawing on Boyd and Richerson (1985), North has shown that these are in part culturally derived, differ widely, are not easily changed and give rise not to the one determinate position of general equilibrium theory but potentially to multiple equilibria (North 1990a: 37). As the chapters by Clarence-Smith and Greenhill – on cocoa production and the Brazilian coffee trade respectively – show, mental models can sustain systems that are anything but efficient.

A further perspective on the origins and significance of the NIE is suggested by Bates. He, possibly echoing Toye, who refers to the over-arching concern in classical economics with the problem of the reconciliation of private passions and public interests, maintains that the key argument of the new institutionalism is the claim 'that institutions provide the mechanisms whereby rational individuals can transcend social dilemmas'. By 'social dilemmas' he refers to those kinds of problems which arise when choices made by rational individuals yield outcomes that are socially irrational. This is a real-world problem quite beyond the definitional framework of the abstract world of general equilibrium theory. Bates also alludes to ways in which institutions such as property rights resolve problems of market failure (for example, those arising from production externalities), how non-market institutions resolve problems that undermine the creation or the maintenance of public goods, and how information costs give rise to different types of contracts. For Bates, then, the 'core logic' of the new institutionalism is that 'Rational individuals, confronted with the limitations of individually rational behaviour, create institutions that, by creating new incentives or by imposing new constraints, enable them to transcend these limitations' (Ch. 3, this volume).

WHAT IS 'NEW' ABOUT NIE?

The NIE is 'new' because there is an older school of institutionalism in economics. Rutherford argues that the old institutionalism was largely rooted in North American traditions associated with, amongst others, the work of Thorstein Veblen, John R. Commons, Clarence Wendell and Allan Grunchy. This approach pointed to a dichotomy between business and industry and between institutional and technical aspects of an economy. It sought to analyse societal and organisational constraints on, or reactions to, innovation and the diffusion of new technology. As implied above, questioning assumptions of equilibrium embedded in orthodox theory, the old institutional economics (OIE) maintained that economics systems evolved as a result of adjustments to existing institutions provoked by technical change (Rutherford 1994: 1–3). In his chapter in this book, Stein provides a direct account of the origins of NIE. He shows that older institutionalists like Commons and Veblen 'reject the emphasis on rational-maximising self-seeking behaviour of individuals which is at the heart of both neo-classical economics and new institutionalism'. More controversially, Stein asserts that institutions are less instrumental and should be envisaged more as settled habits of thought common to the generality of man. As indicated, North inclines to these ideas in his chapter when he refers to the enduring qualities of the different mental maps with which individuals confront the world, and argues (problematically for Stein) that the NIE refutes the postulate of instrumental rationality. Although Toye refers in his note 4 to the emphasis in this older school on descriptive 'realism', and is critical of its lack of a theoretical framework, Stein finds more insight in the OIE than the NIE in his critique of structural adjustment policies in Africa. He argues that the latter is flawed because of its 'capture' by neo-classical theory, and that this '... limits its understanding of how capitalism operates and by implication how to design institutions to build markets in African countries'. Stein is critical of the NIE focus on firms as transaction-costs minimisers, and the failure to provide an adequate explanation of firm-level innovation. On the other hand, he argues that a differentiation between types of capitalism based on the organisation of firms, in part founded on an attempt to take account of response to innovation, constitutes the strength of the OIE. This, of course, may be disputed and it remains unclear whether the OIE offers a convincing theoretical explanation for the occurrence of innovation. Moreover, as manifest in the implicit tension between chapters by Handoussa and Stein in this volume, the specifics of the links between NIE and OIE are a subject of continuing debate.

In sum, the OIE may be presented as descriptive, holistic and behaviourist and the NIE as formalist and reductionist. In ideological terms, the former can be depicted as collectivist and lacking technical rigour, the latter as anti-interventionist and excessively devoted to highly mathematical rational choice modelling. Nevertheless, institutionalists – old and new – are concerned with the determinants of change over time. In neo-Schumpeterian fashion, NIE presents change as evolutionary while attaching greater importance to the role of the individual, thereby acknowledging a larger debt to classical economics. This accounts for its emphasis on legal systems, property rights and organisations. Hence, too, the importance attached to public choice theory and the empowerment of the individual agent, and to rent-seeking behaviour and distributive coalitions, processes that reduce or increase transaction costs and positively or adversely affect income distribution and therefore impact on economic efficiency. Thus, as indicated above, whereas classical theory seeks to analyse an economy at a particular moment and takes little cognizance of peculiarities of time and place, institutionalists examine process and seek to explain why some economies have advanced and others have not. This is an aspect of the approach that has always commended institutionalism to historians. Moreover, it is an explicit incorporation of the political and the social into analyses of the formation of institutions that has generated interest in institutional economics amongst social scientists. These characteristics, given the multi-disciplinarity of a large part of the existing literature, also point to the relevance of NIE for future research on Third World development.

THIRD WORLD DEVELOPMENT

Proponents of both OIE and NIE have drawn on the development experience of areas of the Third World. James Street has attempted to establish parallels between old-school US institutionalism and Latin American structuralism associated with the writing of Raúl Prebisch, approaches which, according to Street, are particularly appropriate to the study of sub-Saharan Africa and Latin America (Street and James 1982). Though the technological process was paramount for old institutionalists, while structuralism centred on the mechanics of exchange, both were concerned with the impact of these conditions on the frameworks within which development occurred. Post-Second World War Africa and Latin America were presented as 'frontier' regions of rapid population growth and physical space, where imported technology would interact with existing cultures to produce growth-oriented institutions. In less optimistic vein, for North Third World countries provide examples of anti-development frameworks. Statist regulation, ill-defined property rights and other constraints restrict rather than stimulate economic activity. These conditions result in rent-seeking and redistribution, not rising productivity. Organisations that operate within Third World institutional frameworks are not inefficient; they are efficient at making a society more unproductive (North 1990a: 9).

Arguably, it is the focus upon the interaction between institutions and organisations in some of the most recent NIE writing that makes the NIE approach especially relevant for students of long-run Third World development. If some exponents of the 'old' institutionalism were particularly exercised by the impact of technical change on institutions (defined as regulatory systems of formal laws, informal conventions and norms of behaviour) and early 'new' institutionalists were primarily interested in the behaviour of organisations (that is, individual agents, groups, firms, businesses, collective bodies and so forth), recent contributors have stressed the inter-dynamics between institutions and organisations. In quite different ways Haber and Khan show how distinct institutional arrangements can shape organisational behaviour and how alternative sets of organisational responses may impact on institutions. Consequently, while it may be argued that to a large extent growth is institutionally path determined, agents being conditioned by prevailing cultural norms and possibly deflected from behaviour that is optimal or maximising, this does not preclude individual organisations acting as agents for institutional change. Similarly, novel productivity-enhancing institutions can emerge almost spontaneously, triggered by minimal individual initiatives, and are not invariably rooted in collective behavioural change. This implies a greater recognition of cultural – institutional – diversity and the prospect of positive institutional change resulting from a range of individual actions, presuming that action to be largely driven by optimising rationality. This points to the need for further research on market formation (or failure) – in particular the creation of a framework for individual maximisation, the role of the state in setting and policing the game rules and the influence of interest groups – organisations – in shaping institutions in the Third World. Two of the chapters in this book examine a particular organisation – the plantation – in terms of the interplay between organisations and institutions. Clarence-Smith demonstrates that the survival of cocoa plantations was largely due to the existence of dominant interests able to exert political influence, rather than to economic rationality in a sector of agriculture where the economics of production might well have dictated sharecropper rather than estate operation. Similarly, in Brazil, planter power ensured that the response to market failure was official action in support of rent-seeking rather than measures 'to improve the working of the markets' (Greenhill). This analysis is extended by Haber in his analysis of regulatory regimes and the provision of industrial finance.