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Understanding Underdevelopment: Challenges for Institutional Economics from the point of view of Poor Countries

by

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I

In the development literature two recent strands of institutional economics have been influential. One is associated with the theory of imperfect information: the underlying rationale of institutional arrangements and contracts (formal or informal) are explained in terms of strategic behavior under asymmetric information among the different parties involved. This theory has been fruitfully used in modeling many key agrarian and other institutions in poor countries, which are seen to emerge as substitutes for missing credit, insurance and futures markets in an environment of pervasive risks, information asymmetry, and moral hazard. It started with the literature on sharecropping, then on interlocking of transactions in labor, credit, marketing, and land lease, on labor tying, on credit rationing, on joint liability in group lending schemes, and so on. For examples and overviews of the models, see the edited volumes by Bardhan [1989a], by Nabli and Nugent [1989], and by Hoff, Braverman, and Stiglitz [1993].

The other school, associated primarily with North [1981, 1990] and Greif [1992, 1997], concentrates on comparative historical analysis of development processes (mainly in Western Europe and North America). North has pointed to the inevitable tradeoff in the historical growth process between economies of scale and specialization on the one hand, and transaction costs on the other. In a small, closed, face-to-face peasant community, for example, transaction costs are low, but the production costs are high, because specialization and division of labor are severely limited by the extent of market defined by the personalized exchange process of the small community. In a large-scale complex economy, as the network of interdependence widens the impersonal exchange process gives considerable scope for all kinds of opportunistic behavior and the costs of transacting can be high. Greif examined the self-enforcing institutions of collective punishment for malfeasance in long-distance trade in the late medieval period and in a comparative study of the Maghribi and the Genoese traders explored the institutional foundations of commercial development.

In Western societies over time complex institutional (legal and corporate) structures have been devised to constrain the participants, to reduce the uncertainty of social interaction, in general to prevent the transactions from being too costly and thus to allow the productivity gains of larger scale and improved technology to be realized. These institutions include elaborately defined and effectively enforced property rights, formal contracts and guarantees, trademarks, limited liability, bankruptcy laws, large corporate organizations with governance structures to limit problems of agency, and, what Williamson [1985] has called *ex post* opportunism. Some of these institutional structures are non-existent or weak or poorly devised and implemented in less developed countries. The state in these countries is either too weak to act as a guarantor of these rights and institutions and/or much too predatory in its own demands, posing a threat to them.

Both of these strands of institutional economics have provided major insights in the micro-foundations of institutional arrangements in developing countries and in our understanding of underdevelopment as an institutional failure. Both underline the multiplicity of equilibrium, given the strategic interactions that result in the institutions as equilibrium outcomes, allowing for historical initial conditions and cultural beliefs (that coordinate agents' expectations) influencing the selection of a particular equilibrium. At the same time it is clear that the literature has barely scratched the surface of an as yet largely unexplored story in poor countries. Particularly lacking are theoretically-informed inductive historical analyses of institutional change (or atrophy) in these countries, of the kind that Greif has so incisively carried out for late medieval Europe. In this paper we only speculate on a few broad analytical themes that have not been paid enough attention in the theoretical institutional economics literature: in particular, (a) the process of persistence of dysfunctional institutions in poor countries, (b) institutional impediments as outcomes of distributive conflicts, (c) the collective action problems these conflicts exacerbate, and (d) in view of the critical need for coordination, a more complex and nuanced role of the state, which many (though not all) states fail to perform.

II

Beyond the face-to-face village community the institutions a society develops (or fails to develop) for long-distance trade, credit and other intertemporal and interspatial markets, where the transactions are not self-enforcing, provide an important indicator of that society's capacity for development. In this context the analysis of North [1990], Milgrom, North, and Weingast [1990], Greif [1992], and Greif, Milgrom, and Weingast [1994] have brought to our attention the importance of several institutions like the Merchant Guild (for example, those in Italian city-states or inter-city guilds like the German Hansa), the Law Merchant system (like private judges recording institutionalized public memory at the Champagne fairs which provided an important nexus of trade between northern and southern Europe), and the Community Responsibility System in the Mediterranean and European trade during the late medieval commercial revolution in the period between the eleventh and the fourteenth century. These institutions facilitated economic growth by reducing opportunism in transactions among people largely unknown to one another and providing a multilateral reputation mechanism supported by frameworks of credible commitment, enforcement and coordination.

Greif has suggested that in informal enforcement of mercantile contracts those dependent on bilateral reputation mechanisms (i.e. where the cheater is punished only by the party that is cheated) are usually more costly than multilateral reputation mechanisms (where punishment is inflicted by a whole community to which the party that is cheated belongs) or a community resposibility system in which a whole community is jointly liable if one of its members cheats. In the case of bilateral reputation mechanisms simple efficiency-wage considerations suggest that in order to keep a long-distance trading agent honest he has to be paid by the merchant (the principal) a wage higher than the agent's reservation income, whereas in more "collectivist" forms of enforcement this wage need not be as high, as the penalty for cheating is higher or peer monitoring makes cheating more difficult. But in a world with information asymmetry, slow communication, and plausibly different interpretations of facts in a dispute, an uncoordinated multilateral reputation mechanism may not always work, and may need to be supplemented by a more formal organization to coordinate (expectations and response of different members of the collectivity) and enforce. In medieval Europe the merchant guild provided such an organization. In governing relations between merchants and their various towns and the foreign towns with which they traded they had the ability to coordinate merchants' responses to abuses against any merchant and to force them to participate in trade embargoes. This credible threat of collective action from the guilds enabled the medieval rulers to commit to respecting the property rights of alien merchants, and thus facilitated exchange and market integration.

Many developing countries in the world have a long history of indigenous mercantile institutions of trust and commitment (based on multilateral reputation mechanisms and informal codes of conduct and enforcement) -- examples of such institutions of long-distance trade and credit abound among mercantile families and groups in pre-colonial and colonial India, Chinese traders in Southeast Asia, Arab 'trading diasporas' in West Africa, and so on. In pre-colonial India, for example, Bayly [1983] cites many cases of caste-based (and sometimes even multi-caste) mercantile associations and *panchayats* (or local tribunals or arbitration panels), which acted much like the merchant guilds and the law merchant system respectively of medieval Europe, over a vigorous and far-flung mercantile economy. Credit instruments like the *hundi* (or bills of exchange), even though their negotiability was not recognized in formal courts of law, governed trade across thousands of miles. Firms kept lists of creditable merchants whose credit notes -- *sahajog hundis* -- could expect a rapid discount in the bazaar. While Bayly writes about these community institutions primarily around the so-called burgher cities of Allahabad and Benares in pre-colonial north India, Rudner [1994] studies the south Indian caste-based mercantile organization of the Nattukottai Chettiars in the colonial period whose elaborate system of *hundis* over long distances (with the caste elite firms or *adathis* acting as the clearinghouses), collective decisions on standardization of interest rates, and caste *panchayats* with customary sanctions provided the basis of indigenous banking networks spread out in large parts of south India and British south-east Asia.

The institutional economics literature, however, suggests that the traditional institutions of exchange in developing countries often did not evolve into more complex (impersonal, open, legal-rational) rules or institutions of enforcement as in early modern Europe and emphasizes the need for such an evolution. But the dramatic success story of rapid industrial progress in Southeast Asia in recent decades often under the leadership of Chinese business families suggests that more "collectivist" organizations can be reshaped in particular social-historical contexts to facilitate industrial progress, and clan-based or other particularistic networks can sometimes provide a viable alternative to contract law and impersonal ownership. In a study of 72 Chinese entrepreneurs in Hong Kong, Taiwan, Singapore, and Indonesia Redding [1990] shows how through specific social networks of direct relationship or clan or regional connection they build a system dependent on patrimonial control by key individuals, personal obligation bonds, relational contracting, and interlocking directorships.[1] As Ouchi [1980] had noted some years back, when ambiguity of performance evaluation is high and goal incongruence is low, the clan-based organisation may have advantages over market relations or bureaucratic organisations. In clan-based organisations goal congruence (and thus low opportunism) is achieved through various processes of socialisation; performance evaluation takes place through the kind of subtle reading of signals, observable by other clan members but not verifiable by a third-party authority. Of course, as may be expected, the arrangements in these Chinese business families are somewhat constrained by too much reliance on centralised

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[1] As Redding [1990] points out:
" Many transactions which in other countries would require contracts, lawyers. guarantees, investigators, wide opinion-seeking, and delays are among the overseas Chinese dealt with reliably and quickly by telephone, by a handshake, over a cup of tea. Some of the most massive property deals in Hong Kong are concluded with a small note locked in the top drawer of a chief executive's desk, after a two-man meeting." (One hears similar stories about the Hasidic diamond traders of New York and about firms in industrial districts in Northern Italy).

decision-taking and control, internal finance, small pool of managerial talent to draw upon, relatively small scale of operations, and in case of large organisations a tendency to subdivide into more or less separate units, each with its own products and markets. A major problem of "collectivist" systems of enforcement is that the boundaries of the collectivity within which rewards and punishment are practiced may not be the most efficient ones and they may inhibit potentially profitable transactions with people outside the collectivity.

In general, in the history of most developing countries, even when the indigenous institutions of a mercantile economy thrived, the process of development of sequentially more complex organizations suited for industrial investment and innovations as is familiar from the history of the West did not take place. Contrary to usual practice I shall desist from blaming it all on colonial or neo-colonial policies, not because I think they are unimportant, but because in this paper I want to keep away from the familiar litany of nationalist historiography and confine myself to a discussion of indigenous institutional impediments to development and link it up with my critical assessment of the institutional economics literature in its own terrain.

A major institutional deficiency[2] that blocked the progress of the mercantile into the industrial economy in many poor countries relates to the financial markets. Even when caste-based or clan-based mercantile firms thrived in their network of multilateral reputation and enforcement mechanisms, the latter were often not adequate for supporting the much larger risks of longer-horizon industrial investment. These firms, by and large, had limited capacity (either in terms of finance or specialized skills) to pool risks and mobilise the capital of the society at large in high-risk high-return industrial ventures. The usual

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[2] Another equally important institutional deficiency in this context relates to the agrarian institutions, which we comment upon in section III, that can provide a sustainable rural base for industrialization programs.

imperfections of the credit and equity markets emphasised in the literature on imperfect information are severe in the early stages of industial development. The investment in learning by doing is not easily collateralizable and is therefore particularly subject to the high costs of information imperfections. The technological and pecuniary externalities in investment between firms (and industries)--emphasized analytically (though difficult to pin down empirically) in early as well as more recent development literature-- give rise to 'strategic complementarities' and positive feedback effects resulting in multiple equilibria.[3] This is particularly important when externalities of information and the need for a network of proximate suppliers of components, services and infrastructural facilities with economies of scale make investment decisions highly interdependent and raising capital from the market for the whole complex of activities particularly difficult.[4] Historically, in some countries (for example, in postwar East Asia) the state has played an important role in resolving this kind of 'coordination failure' by facilitating and complementing private sector coordination.

In this context one may note that Gerschenkron [1962) had emphasized the role of state-supported development banks for the late industrializers of Europe in the 19th century. Government-supported development banks (like the Credit Mobilier in the 19th century France, or after the first World War, Credit National in France and Societe National de Credit a l’Industrie in Belgium, or after the

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[3] This has a long history in the postwar development literature from Rosenstein-Rodan [1943] to Murphy, Shleifer and Vishny [1989]. For more recent theoretical contributions to this literature, see the special issue on 'Increasing Returns, Monopolistic Competition, and Economic Development' in the *Journal of Development Economics,* April 1996.

[4] Motivated by some historical examples from 19th century continental Europe, Da Rin and Hellmann [1996] show in a model with complementarities of investments of different firms that private banks can act as catalysts for industrialization provided that they are sufficiently large to mobilize a critical mass of firms, and that they possess sufficient market power to make profits from costly coordination. These necessary conditions were not met, for example, in the case of unsuccessful industrial banks in Spain and Russia in the 19th century. In a model of decentralized banking system Dewatripont and Maskin [1995] show that banks tend to underinvest in long-term projects which involve large sunk costs requiring co-financing by several banks. This is because such co-financing leads to a free rider problem in monitoring by each bank.

second World War, Kredintaltanlt fur Weidarufban in Germany, Japan Development Bank and the Korea Development Bank) have played a crucial role in long-term industrial finance and acquisition and dissemination of financial expertise in new industrial sectors in periods of large-scale reconstruction and acute scarcity of capital and skills in past and recent history. But their experience in other developing countries (say, in India or Mexico in recent decades) has been mixed at best. Armendariz de Aghion [1999] points out that unlike in the former cases (particularly in France, Germany, and Japan), in the latter cases the development banks have often been controlled by the government in an exclusive and heavy-handed way, without scope for co-financing (or co-ownership) arrangements with private financial intermediaries (which help risk diversification and dissemination of expertise), and without the opportunity to specialize in a small number of sectors (that helps acquisition of specialized expertise in financing projects in targeted sectors). This is even apart from the usual moral hazard problem in subsidizing the sometimes necessary losses the pioneering development banks will make, and the ever-present dangers of loan operations getting involved in the political patronage distribution process.

Thus in the crucial leap between the mercantile economy and the industrial economy the ability of the state to act as a catalyst and a coordinator in the financial market can sometimes be important. In much of the literature on the new institutional economics the importance of the state is recognised but in the narrow context of how to use its power in the enforcement of contracts and property rights one the one hand and at the same time how to establish its credibility in not making confiscatory demands on the private owners of those rights on the other. This dilemma is implicit in the standard recommendation in this literature for a "strong but limited" government. It is, however, possible to argue that in the successful cases of East Asian development (including that of Japan) the state has played a much more active role, intervening in the capital market sometimes in subtle but decisive ways, using regulated credit allocation (sometimes threatening withdrawal of credit in not so subtle ways) in promoting and channelling industrial investment, underwriting risks and guaranteeing loans, establishing public development banks and other financial institutions, encouraging the development of the nascent parts of financial markets, and nudging existing firms to upgrade their technology and to move into sectors that fall in line with an overall vision of strategic developmental goals . In this process, as Aoki, Murdock, and Okuno-Fujiwara [1995] have emphasised, the state has enhanced the market instead of supplanting it; it has induced private coordination by providing various kinds of cooperation-contingent rents. In early stages of industrialization when private financial and other related institutions were underdeveloped and coordination was not self-enforcing, the East Asian state created opportunities for rents conditional on performance or outcome (in mobilization of savings, commercialization of inventions, export 'contests', and so on) and facilitated institutional development by influencing the strategic incentives facing private agents through an alteration of the relative returns to cooperation in comparison with the adversarial equilibrium.

One should not, of course, underestimate the administrative difficulties of such aggregate coordination and the issues of micro-management of capital may be much too intricate for the institutional capacity and information processing abilities of many a state in Africa, Latin America, or South Asia.[5] One should also be wary, as the more recent East Asian experience of financial crisis warns us, about the moral hazard problems of too cosy a relationship between public banks and private business and the political pressures for bail-out that a state-supported

[5] As the example of Japan in recent years shows, when the technologies become more complex and the exploration of new technological opportunities becomes highly uncertain, the state loses some of its efficacy in guiding private sector coordination, as pointed out by Aoki, Murdock, and Okuno-Fujiwara [1995].

financial system inevitably faces. Nevertheless, I think institutional economics will be richer if we admit the possibility of a more nuanced theory of the state, beyond the oversimplifications of either the Marxist theorist's class-driven state or the public choice theorist's rentier or predatory state.

III

One of the as yet inadequately resolved issues in institutional economics in the context of underdevelopment is why dysfunctional institutions often persist for a long time. Unlike the followers of the property rights school, who often displayed a naive presumption of the survival of the ‘fittest’ institution, the two strands of institutional economics I have identified at the beginning of this paper are quite clear in not ascribing optimality properties to the institutions as (Nash) equilibrium outcomes. North [1990], Bardhan [1989], and others have pointed to the self-reinforcing mechanisms for the persistence of socially suboptimal institutions when path-dependent processes are at work. Borrowing an idea from the literature on the history of technological change, one can see that there are increasing returns to adoption of a particular institutional form -- when, the more it is adopted, the more it is attractive or convenient for the others to conform on account of infrastructural and network externalities, learning and coordination effects, and adaptive expectations -- and a path chosen by some initial adopters to suit their interests may ‘lock in’ the whole system for a long time to come, denying later, maybe potentially more appropriate, institutions a footing.

In this path-dependent process North, more than others, has emphasized how the interaction between the ‘mental models’ the members of a society possess and the incentive structure provided by the institutions shapes incremental change.[6] The path-dependent process is also made more complicated by the frequent cases of unintended consequences in history. More than a century back Menger [1883] made a distinction between ‘pragmatic’ and ‘organic’ institutions. The former are the direct outcome of conscious contractual design -- as in the institutional models in the theory of imperfect information or transaction cost -- while the latter, like in Menger’s theory of the origin of money, are comparatively undesigned, and they evolve gradually as the unintended and unforeseeable result of the pursuit of individual interests. Elster [1989] has referred to intermediate cases, where an institution may have originally come about unintended, but agents when they become eventually aware of the function an institution serves for them, consciously try to preserve it from then on.

In the new institutional economics literature the major stumbling block to realizing potential gains from trade is political. Looking over the last few hundred years of history North, Weingast,[7] and others have focused on a particular political mechanism of credible commitment that made much of the difference between the success story of Western Europe and North America and the stagnation in large parts of the rest of the world over this period. This mechanism essentially involved self-binding by the rulers (like the king giving up royal prerogatives, increasing the powers of the Parliament, etc. in 1688 in England) in the former regions credibly committing themselves to be non-predatory and thus securing private property rights and allowing private enterprise and capital markets to flourish. While not denying that such self-binding mechanisms can play a very

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[6] One related example may be cited from the comparative study in Guinnane [1994] of credit cooperatives in German and Irish history. The Raiffeisen agricultural credit cooperatives that were successful in nineteenth-century rural Germany provided a model for the introduction of similar organizations in Ireland in 1894. But they did not succeed in Ireland partly because the social and cultural norm of mutual monitoring and collective punishment among members of a cooperative, which worked in rural Germany, did not in the Irish countryside.

[7] See North and Weingast [1989]. For some empirical criticisms of the argument for English history, see Carruthers [1990] and Clark [1995].

important role in history, I think it is possible to argue that they are neither necessary nor sufficient for economic development. They are not sufficient, as there are other (technological, demographic, ecological and cultural) constraints on the development process, not all of which will be relaxed by the rulers disabling themselves. They are not necessary, as a few non-Western success stories (Japan since Meiji Restoration, Korea and Taiwan since 1960, coastal China since 1980, etc.) suggest; in most of these cases while the rulers often adopted prudent policies (and sometimes even acquired reputation to this effect), they were far from disabling their discretion. Major economic transactions in the successful East Asian cases have often been relation-based rather than rule-based. While charges of cronyism have been bandied about in the diagnosis of the recent Asian financial crisis, the more long term success stories even with relation-based systems cannot be denied.

The political stumbling blocks to beneficial institutional change in many poor countries may have more to do with distributive conflicts and asymmetries in bargaining power. The “old” institutional economists (including Marxists) used to point out how a given institutional arrangement serving the interests of some powerful group or class acts as a long-lasting barrier (or ‘fetter’, to quote a favorite word of Marx) to economic progress. As has been suggested in Bardhan [1989] and Knight [1992], the new institutional economists sometimes[8] understate the tenacity of vested interests, the enormity of the collective action problem in bringing about institutional change, and the differential capacity of different social

8 North [1990] is an exception in this tradition. He points to the contrasting and path-dependent processes of change in bargaining power of the ruler versus the ruled in different countries, particularly in the context of the fiscal crisis of the state. In an earlier historical literature on the transition from feudalism in Europe, Brenner [1976] had provided a major departure from the usual analysis of transition in terms of demography or market conditions: he provided a detailed analysis of the contrasting experiences of transition in different parts of Europe (those between western and eastern Europe and those between the English and the French cases even within western Europe) in terms of changes in bargaining power of different social groups or in the outcomes of social conflicts. Brenner shows that much depends, for example, on the cohesiveness of the landlords and peasants as contending groups and their ability to resist encroachments on each other's rights and to form coalitions with other groups in society

groups in mobilization and coordination. The collective action problem can be serious even when the change would be Pareto-superior for all groups. There are two kinds of collective action problems involved: one is the well-known free-rider problem about sharing the costs of bringing about change, the other is a bargaining problem where disputes about sharing the potential benefits from the change may lead to a breakdown of the necessary coordination.[9] There are cases where an institution, which nobody individually likes, persists as a result of a mutually sustaining network of social sanctions when each individual conforms out of fear of loss of reputation from disobedience.[10] Potential members of a breakaway coalition in such situations may have grounds to fear that it is doomed to failure, and failure to challenge the system can become a self-fulfilling prophecy.

The problem may be more acute when, which is more often the case, there are winners and losers from a productivity-enhancing institutional change. The costs of collective action of such a change may be too high. This is particularly the case, as we know from Olson [1965], when the losses of the potential losers are concentrated and transparent, while gains of the potential gainers are diffuse[11] (or uncertain for a given individual, even though not for the group, as suggested by Fernandez and Rodrik [1992]). There is also the inherent difficulty, emphasized by Dixit and Londregan [1995], that the potential gainers cannot credibly commit to compensate the losers *ex post*.[12] Ideally, the state could issue long-term bonds to buy off the losers and tax the gainers to repay. But in

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[9] While most economists identify the collective action problem with the free rider problem, political philosophers like Elster [1989] and behavioral economists working with ultimatum games like Rabin have emphasized the bargaining problem arising from unequal benefits.

[10] For a well-known static analysis of such a case, see Akerlof [1984]. For a more complex model in terms of stochastic dynamic games explaining evolution of local customs or conventions, see Young [1998].

[11] As Machiavelli reminds us in *The Prince*, [1513], ch. VI, "the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new".

[12] Of course, some societies may be able to develop in repeated situations appropriate norms of compensation to losers, but preservation of such a norm itself may require collective action.

many developing countries there are serious limitations to the government's ability to tax, and its credibility in keeping inflation under control, and the bond market is thin. There is also the fear losers have that once they give up an existing institution, they may lose the *locus standi* in lobbying with a future government when the promises are not kept ('exit' from a current institutional arrangement damaging their 'voice' in the new regime in future), and so they resist a change today that is potentially Pareto-improving (in the sense that the gainers could compensate the losers).

One can also formalize the obstruction by vested interests in terms of a simple Nash bargaining model, where the institutional innovation may shift the bargaining frontier outward (thus creating the potential for all parties to gain), but in the process the disagreement payoff of the weaker party may also go up (often due to better options of both 'exit' and 'voice' that institutional changes may bring in their wake), and it is possible for the erstwhile stronger party to end up losing in the new bargaining equilibrium (how likely this is will, of course, depend on the nature of shift in the bargaining frontier and the extent of change in the disagreement payoffs).[13] As Robinson [1995] has emphasized in his theory of predatory states, it may not be rational, for example, for a dictator to carry out institutional changes that safeguard property rights, law enforcement, and other economically beneficial structures even though they may fatten the cow which the dictator has the power to milk, if in the process his pre-existing rent-extraction machinery has a chance of being damaged or weakened. He may not risk upsetting the current arrangement for the uncertain prospect of a share in a larger pie.

[13] This is the case even if we abstract from the usual case of deadlocks arising in bargaining with incomplete information, with possible misrepresentation of the 'type' of the bargaining players.

The classic example of inefficient institutions persisting as the lopsided outcome of distributive struggles relates to the historical evolution of land rights in developing countries. In most of these countries the empirical evidence suggests that economies of scale in farm production are insignificant (except in some plantation crops) and the small family farm is often the most efficient unit of production. Yet the violent and tortuous history of land reform in many countries suggests that there are numerous road blocks on the way to a more efficient reallocation of land rights put up by vested interests for generations. Why don't the large landlords voluntarily lease out or sell their land to small family farmers and grab much of the surplus arising from this efficient reallocation? There clearly has been some leasing out of land, but problems of monitoring, insecurity of tenure and the landlord's fear that the tenant will acquire occupancy rights on the land has limited efficiency gains and the extent of tenancy. The land sales market has been particularly thin (and in many poor countries the sales go the opposite way, from distressed small farmers to landlords and money-lenders). With low household savings and severely imperfect credit markets, the potentially more efficient small farmer is often incapable of affording the going market price of land. Binswanger, Deininger and Feder [1995] explain it in terms of land as a preferred collateral (and also carrying all kinds of tax advantages and speculation opportunities for the wealthy) often having a price above the capitalized value of the agricultural income stream for even the more productive small farmer, rendering mortgaged sales uncommon (since mortgaged land cannot be used as collateral to raise working capital for the buyer). Under these circumstances and if the public finances (and the state of the bond market) are such that landlords cannot be fully compensated, land redistribution will not be voluntary.

Landlords resist land reforms also because the leveling effects reduce their social and political power and their ability to control and dominate even non-land transactions. Large land holdings may give their owner special social status or political power in a lumpy[14] way (so that the status or political effect from owning 100 hectares is larger than the combined status or political effect accruing to 50 new buyers owning 2 hectares each). Thus the social or political rent of land ownership for the large landowner will not be compensated by the offer price of the numerous small buyers. Under the circumstances the former will not sell, and inefficient (in a productivity sense, not in terms of the Pareto criterion) land concentration persists.

Of course, even in the context of increasing returns to land ownership in terms of political rent, land concentration is not always the unique or stable political equilibrium. Much depends on the nature of political competition and the context-specific and path-dependent formations of political coalitions. An interesting example of this in terms of comparative institutional-historical analysis is provided by Nugent and Robinson [1998]. Holding constant both colonial background and crop technology, they compare the divergent institutional (particularly in terms of small holder property rights) and growth trajectories of two pairs of former Spanish colonies in the same region (Costa Rica and Colombia, on the one hand, and El Salvador and Guatemala, on the other) producing the same principal crop (coffee). Institutional economics will be richer with more such comparative historical studies (instead of more cross-country regressions).

An important aspect of political rent, that is overlooked in the usual calculations of the surplus generated by a given institutional change, is that all

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[14] In an interesting paper Baland and Robinson [1998] have formalized this increasing returns in political benefits from land ownership in terms of a model of voting with Shapley Value which determines the political rents each landlord gets as a function of the number of workers whose votes he controls; since a single peasant is very small relative to the size of the landowner, in a wide set of circumstances the single vote he has is never pivotal electorally. As Baland and Robinson note, the analysis is similar if instead of voting, they took the case of the collective action problem of numerous small peasants in deriving political benefits.

sides are really interested in *relative* , rather than absolute, gain or loss. In a power game, as in a winner-take-all contest or tournament, it is not enough for an institutional change to increase the surplus for all parties concerned to be acceptable. One side may gain absolutely, and yet may lose relative to the other side, and thus may resist change. If, in a repeated framework, both sides have to continue to spend resources in seeking (or preserving) power or improving their bargaining position in future, and if the marginal return from spending such resources for one party is an increasing function of such spending by the other party (i.e. power seeking efforts by the two parties are 'strategic complements'), it is easy to see why the relative gain from an institutional change may be the determining factor in its acceptability.[15]

IV

If distributive conflicts constitute an important factor behind the persistence of dysfunctional institutions, they also make collective action difficult at the level of the central state agency (for example, in its coordinating of macro-economic policy) and at the level of local governments and community organizations (for example, in the provision and management of local public goods). At the macro level collective action is necessary in formulating cohesive developmental goals with clear priorities and avoiding prisoner's dilemma-type deadlocks in the pursuit of commonly agreed upon goals. When wealth distribution is relatively egalitarian,

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15 For a model of power-seeking on these lines to explain why two parties may not agree to obviously mutually advantageous transactions, even when there are simple enforceable contracts and side transfers of fungible resources to implement them, see Rajan and Zingales [1999].

as in large parts of East Asia[16] (particularly through land reforms and widespread expansion of education and basic health services), it has been somewhat easier to enlist the support of most social groups (and isolate the extreme political wings of the labor movement) in making short-run sacrifices at times of macroeconomic crises and coordinating on stabilization and growth-promoting policies[17]. There is some cross-country evidence[18] that inequality and other forms of polarization make it more difficult to build a consensus about policy changes in response to crises and result in instability of policy outcomes and insecurity of property and contractual rights.

The contrast between Northeast Asia and South Asia is instructive in this respect. When society is extremely heterogeneous and conflict-ridden as in India and no individual group is powerful enough to hijack the state by itself, the democratic process tends to instal an elaborate system of checks and balances in the public sphere and meticulous rules of equity in sharing the spoils at least among the divided elite groups. (For an analysis of the continuing fiscal crisis and developmental gridlock in India as an intricate collective action problem in an implicit framework of non-cooperative Nash equilibria, see Bardhan [1984, 1998]). There may be what sociologists call 'institutionalized suspicion' in the internal organization of such a state (in the Indian case enhanced no doubt by the

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[16] This is, of course, not unique to East Asia. In fact a major institutional lesson that Morris and Adelman [1989] draw from their historical research on the 19th-century development experience of 23 countries is similar:
"Favorable impacts of government policies on the *structure* of economic growth can be expected only where political institutions limit elite control of assets, land institutions spread a surplus over subsistence widely, and domestic education and skills are well diffused".
[17] Campos and Root [1996] emphasize this point: "In contrast with Latin America and Africa, East Asian regimes established their legitimacy by promising shared growth so that demands of narrowly conceived groups for regulations that would have long-term deleterious consequences for growth were resisted. In particular, broad-based social support allowed their governments to avoid having to make concessions to radical demands of organized labor."
[18] See Keefer and Knack [1995). Rodrik [1998] cites cross-country evidence for his hypothesis that the economic costs of external shocks are magnified by distributional conflicts that are triggered, and this diminishes the productivity with which a society's resources are utilized. This is also related to the literature on inequality and delayed stabilization in Latin America. See, for example, Alesina and Drazen [1991].

legacy of the institutional practices of the colonial rulers suspicious of the natives, and an even earlier legacy of the Moghal emperors suspicious of the potentially unruly *subadar*s and *mansabdar*s, the local potentates) and a carefully structured system of multiple veto powers. The tightly integrated working relationship of government with private business which characterizes much of East Asia is very difficult to contemplate in this context. Not merely is the cultural distance between the 'gentleman (or the lady) administrator' and the private capitalist rather large in India (though it is declining in recent years), but much more important, in the Indian context of a plurality of contending heterogeneous groups a close liaison and harmonizing of the interests of the state with private business would raise an outcry of foul play and strong political resentment among the other interest groups (particularly among organized labor and farmers), the electoral repercussions of which the Indian politicians can afford to ignore much less than the typical East Asian politician. It is difficult for the ruling groups in India to have what Olson [1982] called an ‘encompassing interest’ (i.e. a structure that can internalize the distortions caused by its own policies). In general at the level of the macro political economy, inefficient and uncoordinated state interventionism (which is usually the villain in the schematic scenario of public choice theory) is often a symptom of deeper conflicts in society.

Below the aggregative or macro level, even more acute is the institutional failure at the local community level in many poor countries, and this is often ignored in the broad state-versus-market debates. The day-to-day livelihood of vast masses of the poor in the world, particularly in rural areas, crucially depends on the provision of local public goods (roads, extension service, power, irrigation, education, public health and sanitation, etc.) and the management of the local commons (forests, fisheries, grazing lands and so on). Yet well-functioning institutions of local self-government are often non-existent, and development programs are usually administered by a distant, uncoordinated, and occasionally corrupt central bureaucracy, unaccountable and insensitive to the needs of the local people.

On grounds of leaving decision-making in the hands of those who have information which outsiders lack and increasing the flexibility of public programs with respect to local conditions, the case for decentralization or devolution of authority to local governments is very strong, but , apart from the usual administrative problems of coordinating across jurisdictions, and lack of local revenue-raising and technical capacity, a major problem that hinders most schemes of decentralized governance is related to distributive conflicts.[19] In areas of high social and economic inequality, the problem of ‘capture’ of the local governing agencies by the local elite can be severe, and the poor and the weaker sections of the population may be left grievously exposed to their mercies and their malfeasance[20]. The central government can also be ‘captured’, but there are many reasons why the problem may be more serious at the local level. For example, there are certain fixed costs of organizing resistance groups or lobbies: as a result the poor may sometimes be more unorganized at the local level than at the national level where they can pool their organizing capacities. Similarly, collusions among the elite groups may be easier at the local level than at the national level. Policy making at the national level may represent greater compromise among the policy platforms of different parties, and so on. When local governement is captured by the powerful and the wealthy, instances of subordinate groups appealing to supra-local authorities for protection and relief are not uncommon. The intervention by

[19] See Bardhan and Mookherjee [1998] for a theoretical framework for appraising the various trade-offs involved in delegating authority to a central bureaucracy as opposed to an elected local government, for delivery of public services from the point of view of targeting and cost-effectiveness of public spending programs in developing countries.

[20] This should be familiar in the United States, where movements in favor of ‘state rights’ diminishing the power of the federal government have been interpreted, with some historical justification, as regressive, working against poor minorities.

the long arm of the state from above in remote corners of a poor country have been in such cases by invitation, and not always by arbitrary imposition (as is usually implied in the public choice or the new institutional economics literature).

The same problem clearly afflicts local (non-government) community organizations in management of the local commons. Extreme social fragmentation in India, for example, makes cooperation in community institution-building much more difficult than in socially homogeneous Korea or Japan. There is also some scattered evidence that community-level institutions work better in enforcing common agreements and cooperative norms when the underlying property regime is not too skewed and the benefits generated are more equitably shared. Putnam's [1993] study of the regional variations in Italy also suggests that 'horizontal' social networks (i.e. those involving people of similar status and power) are more effective in generating trust and norms of reciprocity than 'vertical' ones. One beneficial byproduct of land reform, underemphasized in the usual economic analysis, is that such reform, by changing the local political structure in the village, gives more "voice" to the poor and induces them to get involved in local self-governing institutions and management of local commons.

Economists belonging to the property rights school would, of course, point out the basic inefficiency of resource use in the commons. They favor the establishment of well-defined private property rights over the common resources, which is to generate incentives for greater internalization of externalities and for careful husbanding of resources by the private owners. But even if we ignore the serious distributional consequences of privatization of common property resources, particularly in the form of disenfranchisement of the poor --from the enclosure movement in English history to the current appropriations of forests and grazing lands in developing countries by timber merchants and cattle ranchers, it has been the same sad story-- it is possible to argue that privatization can create important problems even from the point of view of efficiency. As Seabright [1993] has pointed out, when contracts are necessarily incomplete, attempts to enforce private property rights may weaken the mechanisms of cooperation that previously existed among the users, who may have shared implicit non-contractual rights in the common property resource, in two important ways.

First, privatization typically shifts the bargaining power sufficiently in favor of those who acquire the property rights so that the parties may no longer share enough interdependence -- or what Singleton and Taylor [1992] call 'mutual vulnerability' -- to make cooperation credible. In fact when privatization is perceived as unfair by the dispossessed previous users, it can lead some of these users to irresponsible and destructive practices, and ultimately everyone, including the owner of the newly created property right, may be worse off. Secondly, a central characteristic of most private property rights is their tradeability, and tradeability may undermine the reliability of a long-term relationship among beneficiaries of a resource. Relationship-specific investments in the maintenance and preservation of a resource may thus be discouraged.[21] A self-governing local community may thus actually have efficiency advantages over both the bureaucratic and the private market mechanisms. Over the bureaucratic mechanism it has the local information advantage. Over the private market mechanism it has the above-mentioned advantages in cases of incomplete contracts. A local community organization, particularly if it has a stable membership and well-developed structures of transmission of private information and norms among the members, and if it has the power of social sanctions to enforce agreements, has the potential of providing a more efficient coordination

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[21] Seabright [1993] is, however, careful to stress that the circumstances under which this problem occurs are somewhat special. Long-term implicit contracts are not weakened by the mere fact of tradeability of property rights in assets; it is tradeability plus a sufficient likelihood of the presence of potential new owners with different out-of-equilibrium payoffs that is the key factor.

device. There are several documented examples of successful local community-level cooperation in management of common property resources -- see Ostrom [1990] for examples from different parts of the world. There are, of course, more numerous cases of failure of such cooperation in poor countries.

Going back to the issue of distributive conflicts and possible failures in the management of the local commons, in the economics literature the complex relationship between inequality of endowments and successful collective action is still an underresearched area. On the one hand there is the well-known suggestion of Olson [1965] that in a heterogeneous group a dominant member enjoying a large part of the benefits of a collective good is likely to see to its provision even if he has to pay all of the cost himself (with the small players free-riding on the contribution of the large player); on the other hand, there are cases[22] where the net benefits of coordination for each individual may be structured in such a way that in situations of marked inequality some individuals (particularly those with better exit options) may not participate and the resulting outcome may be more inefficient than in the case with greater equality. Besides, the transaction and enforcement costs for some cooperative arrangements may go up with inequality.

In general, contrary to the presumption of much of mainstream economics, there need not always be a trade-off between equality and efficiency, as is now recognised in the literature on imperfect information and transaction costs. The terms and conditions of contracts in various transactions that directly affect the efficiency of resource allocation crucially depend on who owns what and who is empowered to make which decisions. Institutional structures and opportunities for cooperative problem-solving are often foregone by societies that are sharply divided along economic lines. Barriers faced by the poor in the capital markets

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[22] For a theoretical exploration of these cases see, Baland and Platteau [1997, 1998] and Dayton-Johnson and Bardhan [1997].

(through a lack of collateralizable assets which borrowers need to improve the credibility of their commitment) and in the land market (where the landed oligarchy hogs the endowments of land and water) sharply reduce a society's potential for productive investment, innovation and human resource development. Under the circumstances, if the state, even if motivated by considerations of improving its political support base, carries out redistributive reform, some of it may go toward increasing productivity, enhancing credibility of commitments on the part of the asset-poor and creating socially more efficient property rights. Even the accountability mechanisms for checking state abuse of power at the local level work better when the poor have more of a stake in the asset base of the local economy. By dismissing all state-mandated redistribution as mere unproductive rent-creation some of the new institutional economists foreclose a whole range of possibilities. On the other hand, the state in trying to correct inequities has to be careful about incentive compatibility issues and its own political and administrative limitations. In general the state, the market and the local community are all highly imperfect coordinating mechanisms, and each can do some things better than others, while each fails miserably in some matters.

In this paper we started with the historical role of 'collectivist' mechanisms of Eastern mercantile economies (as opposed to the more formal Western institutions) and the critical coordination role the state can sometimes play in the leap from the mercantile to the industrial economy. The difficult question is to figure out the factors that can potentially predispose a state to have an encompassing interest in the economic performance of the country and the conditions under which the state frequently fails. Much of the new institutional economics literature focuses on various, undoubtedly important, government failures; in particular, the failure to provide mechanisms of credible commitment to secure property rights. In this paper we try to point attention to other kinds of institutional failures which may be equally important. The institutional arrangements of a society are often the outcome of strategic distributive conflicts among different social groups, and inequality in the distribution of power and resources can sometimes block the rearrangement of these institutions in ways that are conducive to over-all development. We have drawn particular attention to the inevitable collective action problems in this rearrangement, both at the macro level of the state (which underly the difficulty of breaking out of the policy deadlock, of which inefficient interventionism is only a symptom) and at the local level (which make provision and management of crucial local public goods highly inefficient).

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