Formal and Informal Institutions and Development

MARK C. CASSON, MARINA DELLA GIUSTA and UMA S. KAMBHAMPATI*

University of Reading, UK

Summary. — Our paper presents a critical review of the literature on institutional change and the role of institutions in economic development. We discuss the roles and interrelationships of formal and informal institutions and introduce a collection of papers addressing this topic in a variety of development settings.

Key words — formal and informal institutions, development, intra-country studies

The recent literature on the impact of institutions on development has largely concentrated on the impact that institutions, generally understood as formal and informal rules and regulations governing economic activity, including tax laws, legal regulations, political freedoms, ethnolinguistic fractionalization, religion, and infrastructure (democracy, authoritarianism, etc.), have on economic growth (Acemoglu & Johnson, 2005; Acemoglu, Johnson, & Robinson, 2001; Aghion, Howitt, & Mayer-Foulkes, 2005; Hall & Jones, 1999; Knack & Keefer, 1997; Miguel & Gertler, 2005; Miguel, Gertler, & Levine, 2006). Writing in 2005, Pande and Udry argued that while the findings of this literature are “of fundamental importance for development economists and policy practitioners in that they suggest that institutional quality may cause poor countries and people to stay poor,” (Pande & Urdy, 2005, p. 2) it is also plagued by the endogeneity of institutions to growth. We therefore need on the one hand to provide precise descriptions of the mechanisms through which institutions play a role in determining development outcomes, and on the other hand to move beyond cross-country studies to explore the heterogeneity of institutions in different countries, which is best achieved through studies based on micro-data.

This Special Issue aims to address both issues by drawing insights from institutional theory (e.g., North, 1990) and social theory (Coleman, 1988, 1990; Dasgupta & Serageldin, 2000; Putnam, 1993; Taylor, 1990) for studying institutions and development (Della Giusta, 1999, 2008; Della Giusta & Kambhampati, 2006). In the process, it presents a selection of papers highlighting the relationships between formal and informal institutions and development outcomes, concentrating largely on intra-country studies.

There exist different approaches to institutions and their evolution. According to the contractarian perspective, historically institutions emerged through a social contract between citizens and the state which delegated the use of violence to the latter in exchange for protection and social order. In this context, firstly defense, and subsequently political institutions began to become important, particularly those relating to governance. Over time, these institutions were supplemented by economic institutions like private property rights and markets, all of which stimulate economic growth (see Rodrik, 2000, 2005; Savoia et al., this volume). Of course, it is not only growth-igniting institutions that are required. Healthy systems, as Savoia et al. (this volume) argue, also require growth-sustaining institutions which will reinforce long-term economic development (as opposed to growth alone) and conflict management institutions, which will relieve social conflict.

Rather than concentrating solely on the ways in which formal institutions and organizations shape socio-economic outcomes, a development-orientated institutional perspective also needs to emphasize more explicitly the role of informal institutions in shaping formal ones (e.g., the law). It therefore needs to analyze the ways in which informal institutions (customs) gradually change the actions and interactions of agents in all sorts of social organizations (households, groups, villages, as well as firms and governments). It has long been clear that the evolution of institutions is driven by social institutions like gender, class, caste, and social capital. Pateman (1988), for instance, explains how within the social contract as normally described a contract that validates gender inequality is hidden. Mies (1999) raises a similar point in relation to caste and class.

North’s theory of institutional change explains that formal institutions are a crystallization of informal ones (North, 1990), and that both co-evolve through the operation of organizations (informal and formal social groups, from households and villages to networks, firms, parties, and governments). However, in his framework, institutions are designed by individuals who are acting rationally and free of constraints: “institutions are a set of rules, compliance procedures and moral and ethical behavioural norms designed to constrain the behaviour of individuals in the interests of maximising the wealth or utility of the principals” (pp. 201–202). Pande and Urdy (2005) contest the notion of “agency” embodied in this definition by arguing that institutions are often not “designed” and even when they are, their operation may be different to what was originally intended. They therefore argue that we should concentrate on de facto institutions rather than de jure ones. Extending this point, we argue that North’s “moral and ethical behavioural norms” are often embodied in informal institutions like religion and caste that determine the quality and sustainability of formal institutions like schools, labor markets, and the rules and regulations governing economic activity. Our approach in this Special Issue, therefore, sees informal institutions as norms and customs regulating socio-economic life, and we argue that crucially they determine each individual’s position relative to others (in the same way in which capabilities and functionings are constructed in Sen’s framework). These informal institutions must therefore be included in all socio-economic analyses of institutions.

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It is clear that informal institutions in developing countries play a very significant role in shaping formal institutions and in the operation of markets, and can emerge as the preponderant rules of interaction when formal institutions and markets fail. Jean-Philippe Platteau argues that economic specialization requires well-defined property rights, which must evolve over time. Practices and rules as well as the public agencies and moral environment which sustain trust are determined at least in part, if not largely, by the cultural endowment of societies as they have developed over their particular histories (Platteau, 1994). In our framework we would therefore say that an individual’s position vis-à-vis others and therefore their ability to access resources depends on historically and culturally determined power relations, which are continuously changed by people pushing the boundaries of what is feasible (empowerment processes, but also social and economic entrepreneurship). In this context, social capital becomes central (empowerment processes, but also social and economic entrepreneurship). In this context, social capital becomes central because the “power of an actor” is directly measured by “the social capital” available to the actor within that system, which is ruled by both informal and formal institutions: some actors only have access to primary and non-cross-cutting social networks which limit their sphere of action (e.g., poor, low-caste, or women in some contexts), others can access both cross-cutting social networks and institutional capital.

In the context of such an approach, the existing literature on institutions and development is limited in three ways:

1. It does not precisely define the respective roles of formal and informal institutions in development processes. Institutions are seen in very broad terms as relating to certain political or economic rules of behavior (e.g., protection against expropriation risk or government anti-diversion policies (Acemoglu et al., 2001) or country’s openness (Hall & Jones, 1999) or bureaucratic efficiency (Mauro, 1995). Very few authors consider informal institutions like caste, ethnicity (Esfahani & Ramirez, 2003; Mauro, 1995), or trust (Knack & Keefer, 1997).

2. It concentrates on the impact that institutions have on growth, rather than on development in broader terms. Thus, most of the existing papers are concerned with the impact on log GDP per capita (Acemoglu & Johnson, 2005; Acemoglu, Johnson, & Robinson, 2002; Acemoglu et al., 2001; Aghion et al., 2005) or output per worker (Claude, Keefer, Knack, & Olson, 1999; Hall & Jones, 1999). They concentrate on growth-igniting institutions rather than on growth-sustaining or conflict management institutions (Savoia et al., this collection). It is therefore not surprising that there are fewer papers on the impact on health (except for Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002) or education (Glaeser, La Porta, Lopez-de-Silanes, & Shleifer, 2004) or even broader measures of development like sustainability.

3. While this literature accepts the reverse causality that is from development to the quality of institutions within a country, it does so in the context of cross-country regressions and therefore attempts to instrument for such endogeneity. It is unable to analyze the impact of institutions on the quality and sustainability of other institutions and through them on broader development goals like poverty, inequality, or general well-being.

The papers in this special issue address the above-mentioned limitations of the existing literature in a number of ways. First, these papers investigate the relationship between formal and informal institutions. How do informal institutions like religion, caste, and gender influence formal institutions as well as access to resources? This is considered in the context of education (Asadullah and Chaudhury; Crost and Kambhampati), community organizations (Adhikari and Goldey), and the labor market (Harriss-White). Second, they investigate how formal institutions like property rights and market institutions (Granville and Leonard) and schools (Asadullah and Chaudhury; Crost and Kambhampati) influence broader growth (Granville and Leonard) and development outcomes (Harriss-White, Asadullah and Chaudhury, Adhikari and Goldey and Crost and Kambhampati) like access to public goods, social security provision, education, and the sustainability of community groups.

We begin the special issue by providing an overview of the existing literature and the gaps in this literature (Savoia et al.). We then move onto consider the traditional institutions like economic rules and regulations including property rights (Granville and Leonard) before extending beyond this to broader socio-cultural institutions like caste (Harriss-White; Crost and Kambhampati), religion (Asadullah and Chaudhury; Crost and Kambhampati), social capital and elite groups (Adhikari and Goldey). The special issue therefore aims to provide a broad view of institutions while at the same time extending the remit of these institutions away from purely economic outcomes toward broader socio-economic development outcomes.

1. PAPERS IN THIS VOLUME

We begin with a wide-ranging paper by Savoia et al. on inequality, democracy and institutions in which the authors provide a critical review of the existing research. While it is true that “institutional quality may cause poor countries and poor people to stay poor” (Pande & Urdy, 2005), Savoia et al. argue that institutional quality itself is determined by lack of equity in a society. Their basic thesis is that inequitable economies develop exploitative and inefficient institutions. They argue in this context that democracy matters because it could contribute to setting up institutions that guarantee equal opportunities for all. However, unfair wealth distributions can block the emergence of effective democracy because it makes redistribution too costly for the elites in power. In particular, the relationship between political democracy and inequality is important, because inequality shapes, and is shaped by, political institutions. The paper provides a useful framework for the papers that follow, highlighting as it does, the impact that inequality, in both economic and socio-political terms, has on the quality of institutions, a theme that is picked up by other papers in this issue including Harriss-White, Crost and Kambhampati and Adhikari and Goldey.

Granville and Leonard provide a more traditional analysis of the role played by growth-igniting institutions in a transitional economy, where new institutions are emerging and replacing existing ones. They argue that the spread of profit-making mentality in Russia has resulted in an increasing acceptance of market institutions. However, the pace of the transition has been uneven with some regions continuing to be dominated by the “old” institutions while others have almost fully transitioned to the new, market-oriented institutions. The authors draw on these regional differences to consider the role played by local protection of property rights and absence of federal laws and regulations in leading to increased innovation and growth in these regions. The institutions they are particularly interested in are legal protection for property rights like the Basic Law of 1993 and the Civil Code of 1994, strengthening of shareholder’s rights, corporate transparency, and a range of structural reforms like taxation and labor market rules. All these have been encapsulated into a weighted
investment risk measure of institutions, which in turn is hypothesized to determine technological change as measured by R&D expenditure. The paper therefore provides an analysis of the evolution of growth-igniting, market-oriented institutions across Russia and the impact they have on technological change.

Harriss-White’s paper provides an interesting contrast, both in its central concerns and in the approach used. The paper concentrates on informal institutions (the informal labor market as well as socio-cultural rules and regulations that dominate it) to the exclusion of the formal sector. It considers the role of the informal labor market as a conflict management institution which provides an element of social welfare in an economy where a more formal and comprehensive welfare network does not exist. Harriss-White categorizes the informal sector as the small firms that are not regulated as well as the activity that takes place in and around the registered, formal sector but is itself unregulated. She argues, as does the Special Issue, that the non-state institutions (gender, class and caste) express the identity of individuals and in the process influence the institutions of the state. The role of social policy is, therefore, to impact the outcome of tripartite politics between the tax payers, the state’s administrative bureaucracy and the constraints imposed by electoral politics. This argument is more formally tested in the papers by Crost and Kambhampati and Asadullah and Chaudhury on state policy relating to schools. Exemplifying this in the context of caste reservation in the labor market, Harriss-White argues that reservations have helped to entrench the importance of caste as a social institution for access to jobs and have reinforced the caste-based segmentation of the labor market, a result that is further corroborated in relation to the public provision of schooling in India (Crost and Kambhampati). She finds that social institutions pervade (re)distributive practices and determine well-being. The connections between institutions of identity and their regulation of informal work and informal obligations with respect to providing help in times of need is explored and Harriss-White finds that the social institutions (gender, life cycle, caste, class) structuring work also structure informal entitlements to care and support when people are unable to work. Out of direct reach of the state’s regulatory order, as well as practices of well-being and security in many markets depends upon institutions of social identity.

Adhikari and Goldey are concerned with the sustainability of institutions in Nepal. They find as Savoia et al. hypothesize that in the context of inequality within villages, community-based groups are less sustainable than they would be if greater equality in terms of social capital networks were to prevail. They begin with the implicit assumption that community groups perform a useful function and therefore their continued survival is “good” for development. In this context, they argue that the enhancement of social capital in the villages and in the groups is expected to help resolve problems in systems of collective governance. Such a social capital therefore performs a conflict management role. They define social capital as trust, norms of reciprocity, sanctions and networks, which allow cooperation at three levels—between individuals, at village level and at group level. The role of social capital in decreasing transaction costs of organizing activity and in allowing certain activities (like insurance, credit and even labor market monitoring) to function in the absence of formal market mechanisms is clear. Thus, having good links within a village allows the monitoring of loans or even allows the informal monitoring and enforcement of labor contracts, which formal institutions like banks and formal labor contracts may not be able to achieve. However, access to social capital may depend on the power position and location of the members and this power and inequality may sustain privilege and underpin disadvantage, which may in turn undermine the sustainability of the community groups. This echoes Savoia et al.’s argument that inequality will determine the quality of institutions. Adhikari and Goldey argue that this downside of social capital might help reinforce inequality or support anti-social behavior.

Crost and Kambhampati are concerned with the role of informal institutions (caste and religion) and formal institutions (the nature of democracy in the villages, extent of reservation) in the existence and quality of the public provision of education infrastructure, itself being an institution. Schools represent, as Asadullah and Chaudhury et al. also reiterate, a very significant aspect of most economies because of the consciousness building role that they perform in most societies. In this sense, schools represent institutions that will influence both growth and wider development outcomes. They therefore can be seen as growth-sustaining as well as conflict management institutions (see Asadullah and Chaudhury). Crost and Kambhampati consider whether school allocation in India is mechanistically determined by the size of the village and its prosperity or whether ethnic composition and local democracy also play a role. They find that upper caste villages have more primary schools and also have better equipped schools. Attempts to overcome such biases by reserving legislative seats for Scheduled Caste and Scheduled Tribe (SC/ST) groups depend, for their success, on whether the seat is reserved in a village that is itself a majority SC/ST village. In the latter case, schooling provision improves but if the village is not a majority SC/ST village, then schooling provision worsens. This reflects the possibility that access to public goods depends not only on the provision but also upon the perceived social and political entitlement to these goods. In this case, groups without such perceived entitlements may prefer direct transfers. The authors also find that the extent of political competition as reflected in turnover amongst the governing parties is consistently significant in determining schooling provision in a village. This result is reinforced by the fact that a higher margin of victory results in fewer teachers in the schools in the village well fulfilling the implied promise.

Asadullah and Chaudhury analyze the impact of religion on schools as well as the impact of these schools on social decisions. In a context where socially ignited violence is increasing, the role played by madrasas in managing conflict or reinforcing it is considered in some detail. This is done particularly with a view to considering whether graduates from these schools are more progressive or less. The paper examines the social impact of a madrasa (Islamic religious school) reform program in Bangladesh. Two key features of the reform that are considered are the change of the curriculum and the introduction of female teachers. The authors analyze whether the reform has contributed to improving social cohesion in rural areas or not. Using new data on teachers and female graduates from rural Bangladesh, they explore attitudes toward desired fertility, working mothers, higher education for girls vis-a`-vis boys, and various political regimes. They find that modern religious education is associated with attitudes that are conducive to democracy. However, in comparison with their secular schooled peers, madrasa graduates continue to have a perverse attitude toward working mothers, desired fertility, and higher education for girls. The authors also find that young people’s attitudes are linked with those of their teachers. Exposure to female and younger teachers leads to more favorable attitudes among graduates.
2. CONCLUSION

This Special Issue attempts to argue that the quality of institutions in a country will influence its development process, while at the same time, the process of development will influence the quality of these institutions. This inherent circularity between institutions and development is highlighted by all the papers in the Issue and is addressed in different contexts and in different ways by them. The Issue covers a range of institutions (formal and informal) as well as a range of outcomes (growth, development, and sustainability of institutions themselves). The volume begins with a critical review of the literature in the inequality, democracy, and institutions area (Savioa et al.), which discusses this circularity in some detail. This paper discusses macro level institutions (growth-igniting, sustaining, and conflict management institutions) and provides a framework within which informal and micro level institutions can be considered. The key contribution of our collection is in focussing clearly on the relationship between informal and formal institutions. The papers illustrate in a number of different contexts how informal institutions influence the nature and quality of more formal institutions, and how the two together are likely to influence the processes of development. We hope that this volume will inspire researchers in development and pave the way toward more rigorous study of this fascinating and so far under-researched field.

NOTES

1. This is a crystallization of informal rules of behavior and customs and therefore always potentially out of date, as argued by institutionalist law scholar Simon Deakin in the Handbook of Trust (Deakin, 2006).

2. It is clear that exclusive loyalty within primary social groups is not per se able to ensure material and immaterial benefits and can sometimes hinder the very possibility, as witnessed by the work on intra-household conflicts and unequal allocation (Chen & Woolley, 2001; Dobbelsteen & Kooreman, 1997; Lundberg & Pollak, 1994; Lundberg & Pollak, 2003; Schultz, 1990), by the exclusion at village level of the poorest from group-based microfinance (Morduch, 1999; Rogaly & Roche, 1998; Gomez & Santor, 2001; Paxton, 2006).

3. Networks of secondary associations with more heterogeneous membership (within which ties may cut across ethnic, caste, class, wealth, religion, location or other characteristics) have been described in the literature as key to accessing resources and opportunities, as well as being capable of complementing the role of the government and even providing a substitute in areas in which government policy is ineffective (Krishna, 2002).

REFERENCES


Douglas, & Thraen 2000) and the costs and benefits associated with family- or ethnic group based business networks (Ben-Porath, 1980; Haddad & Maluccio, 2005; Sivramkrishna & Panigrahi, 2001).


