THE INSTITUTIONAL FRAMEWORK OF ECONOMIC DEVELOPMENT

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Abstract

This paper considers issues that are of relevance for the design and development of an institutional framework that is conducive to strong economic growth. It entails exploring answers to the following, hitherto not-much-discussed, questions: (1) What institutions are necessary for high-quality growth and development, and what form should they take? (2) How are these institutions acquired? and (3) What is the optimal sequence for implementing institutional reforms? The resolution of these issues is important for a better understanding of the role of institutions in the growth process, and for the formulation of strategies for implementing growth-oriented institutional reforms and/or institutional innovations.

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Introduction

The premise that a country’s economic growth is fundamentally related to the quality of its institutions is not a mere plausible theoretical construct; it is a well-substantiated empirical proposition. The various empirical works on this relationship have provided overwhelming evidence on the importance of the institutional roots of economic growth and the extent to which they help explain differences in economic performance across countries.\(^1\) A similar study has been done for the Pacific Island countries (PICs), the results of which accord well with these findings (Toatu, 2001 and 2002).\(^2\) Thus, given the unanimity in the findings of these various studies, the proposition that institutions are crucial for economic growth is manifestly evident.

However, there are still issues about institutions that have not been fully addressed and resolved. First, there has not been complete agreement over the institutions that are most crucial for high-quality growth and development. Also, there have been limited attempts to analyse and put in context the ‘best’ means by which these may be acquired. Moreover, even if countries are able to design an institutional framework that best fits their unique situations and development strategies, there remains the difficult task of determining the optimal order in which the individual components of the institutional framework should be implemented. For instance, should reforms of property rights be carried out before reforms of the legal system? Or should reforms of all institutions be carried out simultaneously? Finally, there have not been serious attempts to place in perspective the incentive-generating role of institutions, and how such incentives influence economic outcomes.\(^3\)

It is the objective of this paper, therefore, to address the institutional issues outlined above. The resolution of these issues is important for a better understanding of the role of institutions in the growth process, but more importantly for the development of an appropriate policy framework to underpin growth-oriented institutional reforms and/or institutional innovations.

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\(^1\) For example, Easterly and Levine (2002) and Rodrik (2002) find that institutions trump everything, including geography, trade, and policies. See also Knack and Keefer (1985), Scully (1988); and Rodrik (2000).

\(^2\) For instance, one of the regression results shows that a one standard deviation increase in the level of security over property and contractual rights produces an increase in income growth rates of approximately 3 percentage points.

\(^3\) In his book, Easterly (2001) highlights the importance of incentives in shaping optimal economic performance but he falls short of addressing how those incentives are created and sustained, and the role that institutions can play.
The structure of the paper is as follows. The next section, Section II, provides an analytic exposition of the role that incentives play in facilitating optimal economic behaviour. This sets the stage for the analysis of the incentive-generating function of institutions, which is discussed in Section III. Section IV identifies those institutions that are crucial for economic growth (the so-called ‘core’ institutions), and discusses briefly the criteria used in selecting those institutions, as well as the optimal order in which they may be implemented. Section V explains the modes by which institutions may be acquired. It also discusses the factors that give rise to the demand for and supply of institutions. Section VI attempts to clarify the interface between ‘governance’ and ‘institutions’ in the growth process. This is done to rectify misconceptions about the two concepts, which have been common in the literature. Finally, Section VII contains a summary and conclusion.

II. Incentives

The importance of incentives for optimal economic performance cannot be over-emphasised. Indeed economic agents, being rational, will generally do what is in their best interest.4 This incentive-compatibility principle underlies the effective functioning of a market economy. Yet, it is a principle that is often violated when formulating economic policies. For instance, public sector reforms and privatisation programs carried out in most of the PICs in the 1990s failed to make significant headway, largely because of the lack of an appropriate incentive structure that would make the public sector and private investors willing to undertake those initiatives.

It is useful to identify three main groups for whom setting the appropriate incentives is important for growth of developing countries. These are the private investors (including donors), public officials—i.e., those with power to manage the nation’s social and economic resources, and ordinary citizens. Private investors, in particular foreign investors, require an environment that gives them the confidence to invest and apply their skills and technology. The most important of these incentives are secure property and contractual rights and an effective judiciary system. Investors will be unwilling to invest if they will be faced by policy uncertainty, political instability, or state predation. Likewise, the donors require incentives for them to make good decisions on whether they should provide

4 However, whether this is Pareto-optimal or not is another question.
financial support to a country. The ‘incentive’ variables in this case include sound macroeconomic policies, political stability, and respect for democracy and the rule of law. Bureaucrats require appropriate incentives in order for them to be able perform their duties effectively—formulating and implementing rules and policies relating to the management of the nation’s resources. The incentive variables in this case include a fair remuneration structure; meritocratic systems for appointment, promotion, and performance evaluation; policy credibility; and overall good governance in the public sector. Failure to have in place these incentives is likely to lead to a public service that is corrupt, dishonest and incompetent. Finally, the ordinary citizens require incentives for them to be able to contribute effectively to the development efforts by utilising their own resources and skills. The incentive variables in this case include an effective property rights regime, a fair and honest government, a market-based economy, an effective judiciary, and an inclusive approach to development. Without these incentives in place, ordinary citizens will be unwilling to contribute effectively to the development efforts, knowing that their efforts will not generate benefits for them.

The structure of incentives depends, therefore, not only on what economic policies are chosen, but also on the institutional arrangements - on the legal systems that enforce contracts and protect property rights, on an uncorrupt bureaucracy implementing policies and rules and regulations, on political structures and constitutional provisions, and on the monitoring and enforcement of all these institutions. Ultimately, improvements in the economic environment through policy and institutional reforms are necessary for creating incentives to invest in physical and human capital, and to maximise returns to the nation’s capital and natural resources.

**Illustration**

By way of demonstrating why getting the right incentive, and the institutional environment that they reflect, is crucial for optimal economic performance, the paper focuses on the three key determinants of economic growth—physical capital, human capital, and technology - as professed by the neoclassical growth theory. The approach is to apply the *incentive-compatibility* framework to analyse why these resources have failed to bring about growth in the least developed countries as promised. The analysis brings to
bear the important role that institutions play in the provision of such incentives. As explained below, these economic resources and activities often do not yield optimal results because of the perverse incentives facing economic agents and policy makers.

(a) Capital Accumulation

If capital accumulation is one of the key determinants of growth, and if the developing countries were constrained from accumulating capital because they lack sufficient domestic savings, then, as mentioned, the solution to this problem is simply a matter of transferring surplus capital from the rich countries to the poor countries so that the latter can undertake productive investments. Foreign aid and foreign direct investment are the two channels through which such capital could be transferred to the developing countries.

The financing-gap approach, which is based on the Harrod-Domar growth model, first formalised the relationship between savings/investment and growth. The financing gap is defined as the difference between the required investment and the country’s own savings. Private financing is assumed to be unavailable to fill the gap, so donors fill the financing gap to attain a targeted growth rate. The model postulates that GDP growth is proportional to the share of investment spending (fixed investments) in GDP$^5$ - implying that GDP growth this year is proportional to last year’s investment/GDP ratio. This is a model that promises poor countries growth right away through aid-financed investment.$^6$

Despite its shortcomings, the financing-gap model remains very influential because the concept implicitly underpins the activities of most donors and multilateral agencies, and also because of its simplicity. However, it is an overly simplistic model. Its quick-fix approach is stunning: this year’s aid will go into this year’s investment, which will go into next year’s growth. So, according to this model, development is about a race between machines and motherhood. But as it has been proved over the years with respect to the experiences of most of the developing countries, this proposition does not hold up to empirical scrutiny. Various researchers have established that there were no significant linkages between investment and growth in most of these countries (e.g., Easterly, 2001),

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$^5$ The assumption was that machines were the only constraint to production and labour was in excess supply.

$^6$ The financing-gap approach may appear somewhat obsolete against the more modern growth models such as the Solow-Swan neoclassical model or the endogenous growth model. However, as explained above, the model is still very popular with most of the development agencies, including the World Bank.
including the PICs (see Box 1). Such findings tend also to raise questions about the effectiveness of aid as an instrument of development. Why has this been the case? An analysis of the incentives facing both the recipients of aid and the donors may provide an answer.

Consider first the incentives facing the aid recipients—the governments of the developing countries. Like everyone else, governments should invest when they know that such investments will generate good returns and that they can reap those benefits. Apart from authoritarian and dictatorship regimes, most governments have a limited time in office and therefore they know that they may never be able to reap all the benefits of their investments. Governments are therefore faced with a choice between two actions: to somehow prolong their time in power so that they can ‘reap their harvests’, or to simply ‘reap and run’.

Box 1: How the Financing-gap Model Works in the PICs

Table 1 below provides the relevant data for six PICs.

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<thead>
<tr>
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<tbody>
<tr>
<td>Fiji</td>
<td>2.5</td>
<td>0.3</td>
<td>4.1</td>
</tr>
<tr>
<td>Kiribati</td>
<td>1.6</td>
<td>39.3</td>
<td>8.1</td>
</tr>
<tr>
<td>Solomon Islands</td>
<td>4.4</td>
<td>14.6</td>
<td>5.4</td>
</tr>
<tr>
<td>Samoa</td>
<td>1.7</td>
<td>13.4</td>
<td>28.4</td>
</tr>
<tr>
<td>Tonga</td>
<td>2.6</td>
<td>14.6</td>
<td>9.1</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>2.6</td>
<td>14.6</td>
<td>5.5</td>
</tr>
<tr>
<td>Average</td>
<td>2.6</td>
<td>16.1</td>
<td>10.1</td>
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</table>


From the above table, two features stand out. First, there is no evidence of a one-to-one relationship between aid and investment. Second, direct link between public investment and growth in the subsequent periods does not show up.\(^7\) In fact, the reverse seems to be true—i.e., the higher the level of investment, the lower is the

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\(^7\) Public investment is used rather than gross investment to reflect the fact that aid is used mostly to finance public sector projects in the PICs. Because of lack of data, data on capital expenditure is used for public investment.
Whichever action they take, the resulting investment will always be less than optimal. For instance, they could use aid to finance projects that are clearly of no value to the economy, but that could strengthen their popularity with the electorate. A good example is a decision by a cabinet minister to locate an aid-financed soft-drink factory in his constituency even though that location is far away from the main commercial centres. Cases like this are counterproductive to development and may explain why the link between aid and growth or between aid and investment has been poor.

A caveat is in order at this point: that governments may behave in this socially sub-optimal manner does not necessarily imply that government officials or politicians are always rapacious rent-seekers. Rather their actions represent their ‘optimal’ response to the incentive structure they face. Put another way, government officials behave the way they do because there are no constraints in place to prevent them from acting improperly. The absence of such constraints gives them the incentive to exploit the system and to use aid resources to advance their own interests.
Next, consider the incentives facing the bilateral donors and/or the international lending agencies. Arguably, donors face the wrong incentives for disbursing aid. Most donor agencies and international lending agencies are set up with a separate country department for each country or a group of countries. The budget of this department is determined largely by the amount of resources it disburses to the recipient countries. Larger budgets are, therefore, associated with more prestige and more career advancement, and so staff in the country department have the incentive to disburse aid to countries even if the aid or loan conditions are not met.

Thus, the transfer of resources to poor countries as a means of inducing growth in these economies through the increased investment that it generates, is not a sufficient condition for sustained growth. Based on the incentive-compatibility analysis above, unless the right incentive structure is put in place the effective deployment and utilisation of these resources would be severely hampered, retarding their growth effects.\(^8\)

\(^8\) The right incentive structure is one that is compatible with the desire to undertake productive investments.
If investment in fixed assets has failed to provide a solution to the economic growth problems of the developing countries, would investment in human capital work? Again, the incentive argument prevails. Unless people have the incentive to take advantage of the education facilities and thereby invest in education, the pay-offs from investing in human capital would have minimal growth effects. Further, if there are no or limited job opportunities, the returns to education investment will be poor.

The importance of education to economic growth has always been recognised. In one of his addresses, the Secretary General of UNESCO describes the contribution of education as follows: ‘The level of education of the population of a particular country determines that country’s ability to share in world development, [and] to benefit from the advancement of knowledge.’\(^9\) Likewise, the 1997 World Development Report of the World Bank notes that a good part of the East Asian countries’ economic success was due to their unwavering commitment to public funding for basic education as a cornerstone of economic development.

In light of these affirmations of faith in education, it may come as a surprise to learn that the growth response to the dramatic educational expansion in poor countries over the last four decades has been very disappointing (Easterly, 2001). This is true also of the experiences of the PICs (see Box 2).

The failure of government-sponsored education to have any growth effect is once again due to the *dictum*: people respond to incentives. That is, if the incentives to invest are not present, expanding educational opportunities is worth little. Thus, in an economy where there are incentives to invest in education, students will apply themselves seriously to their studies, parents will monitor the quality of education, and teachers will face pressures to provide a quality education. Conversely, in a stagnant economy without incentives to invest, students will not bother about their studies, parents will often pull their children out of school to work on subsistence activities, and teachers will spend the school time as highly qualified babysitters.

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\(^9\) As cited by Easterly (2001).
Moreover, even if there are incentives to invest in education, such skills would be wasted or not productively used if the government is the principal employer, or if there is no new capital or technology with which to employ them. It is true that the establishment of a skilled workforce could provide the incentives for firms to invest. However, if government policy has destroyed the incentive to grow, this will more than offset the incentives to make other investments that the high skills could have otherwise created.

Thus, like capital accumulation, investment in human capital is not a sufficient condition for economic growth per se. Again, the fundamental cause of this failure is not that education is not important for growth but the lack of the appropriate incentive structure that would have made educational programs and policies effective.

**Box 2: Investment in Education in the PICs**

An overview of how the PICs have invested in education in the past decade and the effect this has had on the countries’ growth performance is provided in Table 2, which shows data on the PICs’ expenditure on education and their GDP growth rates.

<table>
<thead>
<tr>
<th>Education Expenditure 1990-95 (% GDP)</th>
<th>GDP Growth 1992-97 (% p.a.)</th>
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</thead>
<tbody>
<tr>
<td>Fiji 5.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Kiribati 11.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Marshall Islands 9.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>Samoa 3.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Tonga 7.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Vanuatu 4.9</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>Average 7.0</strong></td>
<td><strong>1.8</strong></td>
</tr>
</tbody>
</table>

**Source:** World Bank, 1998. *Enhancing the Role of Government in the Pacific Island Economies.*

As can be seen from the above table, the countries spent an average of 7 percent of GDP on education over the period 1990-95, which is quite large by less developed countries’ standards. However, the GDP growth rates of the countries in the period 1992-97 do not show any sign of positive correlation with education expenditure. In fact, the reverse seems to hold. Whether this lack of association is due to the fact that the PICs started out with a very low human capital base - which could explain the explosion in educational expenditures - or to ineffective educational policies and programs, is an empirical question that needs investigation.
(b) Access to Technology

One other component of the financing-gap approach to economic growth is the transfer of technology from the developed to the less developed countries. The argument has been that countries are poor because they have limited access to superior technology that could have enhanced their productivity. With physical capital brought about through investments would come new technology that would raise productivity. But how true is this claim in the light of the increasing globalisation that makes the world’s stock of knowledge and ideas available at little or no cost to all countries? In this age of globalisation, governments and investors in poor countries can acquire more advanced technologies either freely or on commercial terms. Given the unrestricted transfer of technology across countries, the proposition that countries are poor by virtue of their limited access to superior technology cannot be true. But then why are so many of the developing countries falling further behind in terms of the new technology and per capita incomes? Again, the incentive proposition applies. Unless foreign investors have the incentive to invest and transfer their technologies and domestic investors to purchase new technology from overseas, the developing countries will remain technologically deficient, and their economies will continue to be stagnant or grow only slowly.

Having explained the importance of incentives in fostering optimal economic behaviours and results, the important question to ask is: what are the means by which such incentives could be created and preserved? As explained in detail in the next section, institutions play a very important role in this respect. This is so because institutions affect human choices by influencing the availability of information and resources, by shaping incentives, and by establishing the basic rules of social and economic transactions.

III. Institutions

If institutions indeed matter to economic performance then, to be complete, a theory of economic growth must include a theory of institutional change. But what exactly are institutions, and how do they shape economic incentives? Various authors have defined the term ‘institutions’, but the definition provided by North (1981) appears to be the most popular. North defines institutions as ‘the set of rules, compliance procedures, and moral and ethical behavioural norms designed to constrain the behaviour of individuals.’ Thus,
institutions embody the basic rules that govern all public and private actions—from individual property rights to the ways in which communities deal with public goods.\textsuperscript{10} Note that to be considered as institutions, the rules have to be generally, though not uniformly, obeyed. Thus if the rules are generally ignored, they could not be referred to as institutions.

It is useful to classify institutions according to constitutional rules, operating rules, and normative behavioural codes. The \textit{constitutional rules} relate to the fundamental rules that establish the conditions of collective choice. These are the rules for making rules, and hence constrain rule-making. As such, these rules are costly to modify and tend to change more slowly than the operational rules that are derived from them. The \textit{operational rules} refer to laws, regulations, associations, decrees, and contracts, which affect the day-to-day decisions of individuals. Finally, the \textit{normative behavioural codes} include established customs, norms, and traditions that govern the way things are done in society. These rules are important in legitimising both the constitutional rules and the institutional arrangements.

Put together, institutions perform three important functions.\textsuperscript{11}

- \textit{They channel information about market conditions, goods, and participants.} Good information flows help entrepreneurs identify partners and high return activities—and assess their creditworthiness. They also help governments regulate well. Institutions falling within this category include accounting firms, credit registries, and government regulations on the freedom of the media.

- \textit{They define and enforce property rights and contracts, determining who gets what and when.} Knowing the rights one has to assets and income and being able to protect those rights are critical for market development, including the rights of the private sector in relation to the state. Also important is the availability of the means for effective settlement of disputes and enforcement of property and contractual rights. Examples of such institutions include constitutions, judicial systems, and the full array of social networks.

\textsuperscript{10} It is important not to confuse institutions with organisations, which may be the vehicles for implementing the institutions; or with governance, which is the art of providing effective institutions. See Section VI for a detailed discussion of this point.

• They increase competition in markets—or decrease it. Competition gives people incentives to do better, promoting equal opportunity. As such, competition spurs innovation and economic growth. Examples of such institutions include regulations governing financial institutions, competition laws, and commercial codes.

Through these three functions, all institutional structures affect the distribution of assets, incomes, and costs as well as the incentives for market participants and the efficiency of market transactions. By distributing rights to the most efficient agents, institutions can enhance productivity and growth. By affecting the incentives to invest, for example, through strengthening property rights, institutions can affect investment levels and adoption of new technology. By delineating market rights, such as through competition law, institutions limit producer rents and protect consumers from high prices. Finally, by clarifying rights for the disadvantaged in markets, institutions can directly affect the lives of poor people. For example, giving formal titles to poor people whose occupancy rights were not recognised by lenders allows them to borrow and invest.

In sum, how these rules are set and applied is crucial for the efficiency and effectiveness of institutions. As noted above, to the extent that institutions affect incentives for investment and innovation, they have the potential to either impede or enhance economic growth. For instance, if economic agents are heavily circumscribed by legal restrictions and bureaucratic inefficiencies, they would not have the incentive to invest or provide the sort of infrastructure or technology that is necessary for productive investment and growth. But how does one choose among the vast array of institutions available to select those that should have priority within a particular context? This is the subject of the next section.

IV. Selecting the ‘Core’ Institutions

While conceptually it is easy to define institutions and analyse the important role that they play in the economic growth processes, in practice it is not easy to identify the specific components of institutions that are most crucial to growth and development. This difficulty arises from the fact that there is no universally applicable mapping of institutions that would suit all contexts and situations. While one could take a cue from the types of institutions that prevail in the successful developed countries, there is no reason to suppose
that those economies have already exhausted all the useful institutional variations that could underpin healthy and vibrant economies. As Rodrik (2000) squarely puts it, ‘the institutional arrangements that we observe in operation today, varied as they are, themselves constitute a subset of the full range of potential institutional possibilities. There are always alternative sets of arrangements capable of meeting the same practical tests.’ Nevertheless, there are a number of cross-cutting principles essential in operationalizing an effective institutional configuration that is universally applicable.

Given the multitude of institutions that exist, it is necessary for ease of analysis to focus on the ‘core’ institutions. The core components of the institutional environment covered in this study are property rights, regulatory institutions, institutions for macroeconomic stabilisation, and legal institutions. In making this selection, three main characteristics of institutions are considered: (i) the extent to which these institutions have been applied in the successful economies; (ii) the extent to which these institutions play a central role in enhancing the effectiveness of the other institutions; and (iii) the extent to which these institutions affect the entire incentive regime. While it is true that society operates within a complex set of institutions that are intertwined and interdependent, there are those institutions that market systems or economic transactions just cannot do without. The four institutions listed above are such institutions. This selection is not very far out from what the President of the World Bank perceived as the most critical institutions, when he said:

‘Without the protection of human and property rights and a comprehensive framework of laws, no equitable development is possible. A government must ensure that it has effective systems of property, contract, labour, bankruptcy, commercial codes, personal rights laws, and other elements of a comprehensive legal system that is effectively, impartially, and cleanly administered by well-functioning, impartial, and honest judicial and legal systems’.

(World Bank 2001:117)

From the economic perspective, therefore, a strong institutional environment is one that includes all of the core institutions above—a strong property rights regime, well-regulated financial institutions, an effective and reliable legal system, and effective stabilisation institutions. What follows is a detailed discussion of these core institutions.
Following Barlow (1958), the term property rights can be defined ‘as the exclusive right of possessing, enjoying, and disposing of a thing, or as the exclusive right to control an economic good’. The term covers all types of goods and services, including labour, and does not refer to land rights only. Property rights are exclusive but not absolute rights. That is, individuals can hold property rights alone or share them with certain others to the exclusion of all other persons. But these rights are always subject to the controls and limitations vested in the state.

The three forms of rights ownership commonly referred to in the literature are communal ownership, private ownership, and state ownership. While it may be argued that there is no one superior ownership structure, private ownership has proved to be the most versatile form of ownership from the perspective of economic growth. The literature is awash with studies providing evidence that countries in which individual property rights are insecure have experienced difficulty in attracting investment and have constrained growth prospects (see, for example, Besley 1995; and Clague et al 1999).

The advantages of individual ownership over other forms of ownership, in particular, communal ownership, can be illustrated with respect to land rights as follows. Under a communal right system and in the absence of controls over the behaviours of members of the group, every person (owner of right) has the right to hunt, till, or mine the land. This structure has three important implications. First, it means that owners share equally the costs associated with any person’s exercise of his communal right on the land. In this case an individual would not care much about whether his activities would result in the over-hunting or overworking of the land, knowing that some of the costs of his doing so will be borne by the other owners. All that he is concerned about is his self-interest—the maximisation of his gains. Second, by the same token, one owner cannot exclude others from enjoying the fruits of his efforts since the ‘tree’ is on communal land. Finally, under communal ownership, the agreement of all owners needs to be sought before any major activity can be carried out on the land. As has occurred in many places, the dissent of only one owner can stop the proposed activity. This veto power raises both the transaction and information costs of developing the land. Thus, communal ownership has structural
inefficiencies and is prone to abuse and free-ride problems, which tend to reduce the incentives to undertake economic activities using the land. There may well be use made of the land but in these circumstances it will be sub-optimal.

The disadvantages of communal ownership outlined above are taken care of under the private/individual form of tenure. Private/individual tenure implies that society recognises the right of the holder of property right to exclude others from exercising the holder’s private right. From the perspective of land rights, it implies exclusivity of tenure and a secure land title. Because under this system individuals bear all the costs and benefits of the exercise of their rights, they have the incentive to utilise land efficiently and productively. A key aspect of private tenure is the saleability and transferability of rights/title, which makes it easier for owners of the rights to use or transfer their properties to more productive uses and raise credit through using the land as collateral. It is important to note that effective individual property rights to land can exist within a communal ownership regime through the establishment of a leasehold system. This was the system established in Fiji through the Native Land Trust Board (NLTB).

It should be noted that property rights, whether in the form of communal or private ownership, mean nothing unless they can be protected by the state. That is, owners must not only possess the ‘rights’; they must also have ‘control’ over their properties. The upshot is that securing property rights is not merely a matter of passing a piece of legislation; there must also be adequate mechanisms in place to ensure the enforceability and protection of those rights. This implies protection from arbitrary government actions, respect for the rule of law, a reliable and independent judiciary, and an effective bureaucracy with a competent police force.

Based on the foregoing analysis, a property rights regime is considered to be effective if it is capable of protecting and enforcing property rights, including the protection and enforcement of the exclusivity, saleability, and transferability of those rights.

Regulatory Institutions

The lesson that market freedom requires regulatory vigilance has been driven home by the experiences of the financial crises of the past decade occurring in the East Asian countries,
Ecuador, Mexico, Russia, Turkey and Venezuela. According to some analysts, financial liberalisation and capital account opening in these countries led to financial crises because of inadequate prudential and regulatory supervision on the banking institutions.\textsuperscript{12} In the PICs, the debacle of the National Bank of Fiji in the early 1990s, which cost the Fiji taxpayers over F$200 million (approximately A$180 million), was also the result of the absence of a strong prudential framework governing the operation of the banking and financial sector. These crises illustrate that a financial system is only as strong as its governing practices, the financial soundness of its institutions, and the efficiency of its financial structure.

Regulatory institutions play a key role in instilling and overseeing the implementation of the key components of a strong financial system referred to above.\textsuperscript{13} In general, the regulatory functions that these institutions perform include regulations designed to regulate the conduct of entrepreneurs, promote competition and investment, prevent fraudulent and unfair practices, and protect the consumers from arbitrary business practices.

These institutions are crucial, therefore, for the effective functioning of the economy in that they foster greater discipline and operational efficiency in the marketplace. By defining and making transparent the rules of the game, they provide a level playing field to all players in the economy, in particular the investors, thereby facilitating effective exchange and allocation of resources. Moreover, they foster good corporate governance by supplying relevant economic information to stakeholders on the one hand, and by restraining corporate enterprise managers and shareholders on the other hand.

Examples of the regulatory agencies include the central bank, investment and consumer commission, sectoral supervisors and regulators, deposit insurers agencies, and asset management companies. Examples of the regulatory statutes include such national laws as Anti-trust/-competition Acts, Financial Institution Acts, Fair Trading Practices Acts, Common Protection Acts, the Consumers Acts, as well as accounting standards - to name but a few.

\textsuperscript{12} See, for instance, Rodrik (2000); and Das and Quintyn (2002).

\textsuperscript{13} Note that regulatory institutions cover not only the regulatory agencies but also the national laws and regulations that underpin the effective functioning of the financial institutions.
In short, regulatory institutions are considered to be effective if they are able to protect the investors and consumers; ensure the integrity of markets; and promote stability within the financial system. Mindful that over-regulation could stifle investment, the existence of these institutions and the effectiveness with which they are applied can provide an environment conducive to the promotion of investment and productivity and, therefore, economic growth.

*Institutions for Macroeconomic Stabilisation*

These types of institutions include government institutions and policy instruments designed to foster macroeconomic stability in the economy. Macroeconomic stability generally refers to stability in the key economic fundamentals, namely, inflation rates, interest rates, exchange rates, as well as a viable balance of payment position. Having learned the hard way about the consequences of not having them, all advanced economies have come to acquire fiscal and monetary institutions that perform stabilising functions. The most important of these is a lender of last resort—typically a central bank— which guards against self-fulfilling banking crises, as already noted. Other institutions that may be appropriately classified under this category include a currency board, economic council, budget committee, and national laws (such as the Public Finance Act) framed to ensure the effective management of the country’s social and economic resources.

On other important component of this class of institutions, which is often ignored in the literature, is the *public service* or *civil service*. In most of the less developed countries (including the PICs), the government plays a commanding role over the economy, and thus the performance of the economy is largely dictated by what the government does. It is in this respect that the effectiveness of the government, as measured by the effectiveness of the public service and the quality of the people it employs, is of crucial importance to the performance of the economy. As underlined by Toatu (2002), a weak bureaucracy could undermine the integrity and effectiveness of the nation’s entire incentive regime with disastrous effects.

The capability of the government to manage the economy effectively is a function of not only the quality of its policies but also of the rules/institutions within which it operates. These rules include regulations relating to staff recruitment, promotion and
dismissal, remuneration, productivity guidelines and performance standards, codes of
behaviour, social insurance, and training and career advancement. These rules constitute the
institutional environment of public officials and shape the incentive structure that drives
their performance. Thus, if these rules are inadequate or improperly applied, the quality of
the public service is compromised, as would be the quality of government policies and their
implementation. And if these policies and programs are of poor quality, the effective
management of the nation’s economic resources would be severely inhibited, triggering
instability and disequilibrium conditions in the economy.

*Legal Institutions*

Legal institutions refer to the array of arrangements and systems relating to the
administration and application of law and justice in society. These institutions are of great
importance to the ordered functioning of society in so far as they provide the incentives that
provoke or prohibit certain actions. From an economic perspective, an effective legal
institution is an integral part of the production function of society. For instance, labour
cannot be effectively employed in the production process unless some rules as to how that
labour is to be applied and remunerated are determined. Likewise, crops are not sown and
harvested without duties and rights to work and of exchange.

Included under this class of institutions are the constitution, legislative processes,
electoral system, and the judicial system. An effective judiciary is often the most important
element, as the existence of genuine legal recourse underpins the credibility of other
institutions of the state and allows these institutions to be credibly challenged when needed.
For the judiciary to be really effective, however, it must be independent, have the power to
enforce its rulings, and is efficient.

Independence from the executive arm of government is the most important of these
conditions. Whatever the precise character of the judicial relations with the legislature and
executive, all countries rely on the judiciary to hold the executive accountable under the
law and to interpret and enforce the terms of the constitution. Without this independence,
the court system will be a sham, and there will be no proper legal recourse for restitution of
legal matters, such as disputes to or breaches of contracts.
It is important to note however that while judicial independence is important, it must not be allowed to come at the expense of accountability. Reforms may be necessary to raise judicial accountability. These include the setting and monitoring of judicial performance standards and ethical behaviour, introducing greater transparency in relations between judges and litigants, publishing trial records and judicial decisions, and introducing transparent methods of case assignment.

The effectiveness of the judiciary also depends on its decisions being enforced. In practice, this means that other branches of the government must consent to provide the resources needed for enforcement, including personnel authorised by law to serve court documents, to seize and dispose of property, and to turn the proceeds over to the winning party. The crucial components of these resources are a competent police force and an adequate prison system.

The third component of judicial effectiveness is organisational efficiency, which is needed to avoid long delays in clearing cases. This requires that the judiciary be adequately endowed with resources. Also, it may require the adoption of rules and laws that are procedurally efficient, i.e., rules that are simpler to administer and apply and therefore are likely to reduce the cost or increase the accuracy of using the legal system (Posner, 1998). Although this internal efficiency requirement of the judiciary is less critical than its independence and enforcement authority, a state beginning from a weak institutional base should consider building this aspect of judicial performance its first priority.

Prioritising Institutional Reforms

Having identified the ‘core’ institutions above, the next and most challenging task is to determine the optimal order in which reforms should be implemented. For example, should reforms on property rights precede reforms on the legal system, or vice-versa? Or should reforms on all institutions be carried out simultaneously? For policymakers, getting the right timing and sequencing of reforms is critical as misinformed decisions can severely impair the effectiveness of the whole reform program.

While there are no generally accepted blueprints that one could use to inform one’s decision about getting the right order, it is important to recognise that such things as
historical trajectories, stage of development, maturity of existing institutions, and other initial conditions play a crucial role in this decision. Thus, the sequencing of institutional reforms in the developing economies and transition economies is different from that for the developed countries. Even among the developing countries, the sequencing pattern may not be the same if these countries differ markedly with respect to their initial conditions.

Influenced by the experiences of the PICs, the approach recommended in this paper is to start the reform from the ‘center’ and then move to the periphery. This means that institutional reforms should begin by addressing, first and foremost, the institutional deficiencies within the central decision-making organ, namely, the bureaucracy, or simply, the government. This makes sense since decisions and policies that the bureaucracy makes have a strong influence on the integrity and effectiveness of the other institutions. For instance, with a corrupt bureaucracy the policies and commitments towards the protection of property rights will be severely undermined. Likewise, with an incompetent and dishonest bureaucracy, the independence and effectiveness of the judiciary will be hampered, possibly because of improper recruitment procedures or due to the inadequacy and unpredictability of resources to support its effective functioning. Thus, an ineffective bureaucracy could undermine the integrity and effectiveness of the entire incentive regime. It is important, therefore, that the rules governing the operation of the public service are reformed first before embarking on the other reforms.

Once reform of the bureaucratic institutions is complete, reforms of the legal system, the property rights regime, and the regulatory institutions can proceed—in this order. The logic of this sequence is obvious. That is, it is imperative that a strong judiciary is in place first, as without it the effectiveness and integrity of both the property rights and regulatory institutions will be inhibited. (But without an effective bureaucracy, i.e., strong institutions within the bureaucracy, the effectiveness of the judiciary will be severely undermined, as already explained). It should be emphasised that this suggested reform sequence is not a template that is universally applicable, but it is certainly one that might work best for the PICs.

V. How are Institutions Acquired?
The development and evolution of institutions are influenced by both exogenous and endogenous factors. On the one hand, the form and design of institutions may be shaped by external factors such as culture, geography, and history (e.g., colonial legacies). In this case, it is not easy to change the structure of institutions, such as in the case of communal ownership of land in the PICs. On the other hand, institutions may be the direct outcome of conscious effort, such as the governance process and the policies that a country adopts. National laws are one example of the latter type of institutions. In this case, institutions tend to be more mutable. In practice, however, it is often difficult to draw a line between these two types of institutions, as usually they are an amalgam of both forces.

To set the stage for discussion of the modes by which institutions may be acquired, it is necessary to review first the factors that give rise to the demand for and supply of institutions.

The demand for institutions or for institutional change is a function of the recognition that the existing arrangements leave potential gains uncaptured. If agents realise that by altering existing arrangements they could capture gains that cannot be obtained under the institutional status quo, they would demand change to the existing institutions or the creation of new institutions. This could be likened to a demand by producers for a better technology that would lower the cost of production of their goods, and hence increase their wealth.

The other important demand-side factors are relative product and factor prices, government policies and rules (including the constitution and laws), and the size of the market. For instance, changes in the policies and basic rules of the government can profoundly affect the expected costs and benefits of creating new institutions and hence the demand for them. The introduction of trade liberalisation, for example, raises the implicit value of land through increased demand for exports of the country’s agricultural products—leading to demand by land owners for a more secure property rights regime, which may involve a shift from a communal type of ownership to individual ownership.

15 See Feeney (1993) for a detailed discussion of these demand factors.
In general, the supply or creation of institutions is the responsibility of the state or the government. Accordingly, the supply of institutions depends on the willingness and capability of the government to provide new arrangements. There are a number of important factors that affect the capability and willingness of the government to provide new arrangements. These include the cost of the institutional design; the existing stock of knowledge; the expected costs of implementing the new arrangement; the effectiveness of existing institutions; societal mores; and the expected net benefits to the decision-makers (the politicians).\textsuperscript{16} For example, in reform of legal systems new arrangements usually require new legislation, or judicial interpretations, or both. If the environment in which a new legal institution might be supplied is such that highly skilled and sophisticated labour inputs are required, the high cost could discourage the authorities from implementing it.

The supply of institutions by the government in response to the demand of its citizens presupposes that the government has the willingness, capability and knowledge to provide such institutions. There are two avenues for acquiring institutions that the government could consider. The first possibility is to copy the types of institutions in operation in the more successful economies. To oversimplify, suppose there is a blueprint of institutional arrangements readily available that countries can import. The package might comprise the following directions: promote private ownership of properties, strengthen the judiciary’s independence and capability, respect the rule of law and democracy, put in place a regulatory framework conducive to investment and productivity, and rationalise the public service.

The second possibility is to design institutions from scratch, making them highly specific to local conditions. Specificity implies that the institutional repertoire available in the advanced countries may be inappropriate to the needs of the society in question. Thus, according to this approach, major institutional development by and large requires a process of investigation about local needs and capability.

Neither of these two modes of acquiring institutions is efficacious \textit{per se}, however. Even under the best possible circumstances, an imported blueprint requires domestic expertise and re-adaptation for successful implementation. On the other hand, even when

\textsuperscript{16} For fuller discussion of these supply factors, see also Feeney (1993).
local conditions differ greatly, it would be unwise to deny the possible relevance of institutional examples from elsewhere. There are always benefits from learning from the institutional arrangements prevailing elsewhere, even if they are inappropriate or cannot be transplanted. Building institutions from scratch is obviously very costly when imported blueprints can serve the purpose. As Rodrik (2000) eloquently puts it, ‘experimentalism can backfire if it overlooks opportunities for institutional arbitrage’. Thus, the best method of acquiring institutions would be the one that adopts a judicious combination of the two approaches outlined above.

It is worth emphasising that institutional change depends crucially on the government’s willingness to make such changes. This is what makes it very difficult to bring about institutional change. Leaders are in a strategic position to affect the supply of institutional arrangements and ensure that reforms and innovations are congruent with their interests. Therefore, if people in government benefit from the status quo, they will not be willing to make institutional change - unless they can see that they will be better off. A classical example is Thailand where the creation of precise and secure property rights in land was successful because it was in the interests of the elite decision-makers, who were also landowners and land speculators (Feeney 1993).

VI. Institutions and Governance

It is appropriate at this juncture to clarify the interface between institutions and governance to rectify misconceptions about the two concepts that have been common in the literature. To guide discussions, let’s begin by considering the definition of ‘governance’ (since ‘institution’ has already been defined in Section III above). Among the many definitions of governance, the one that appears to be the most appropriate for the purpose of this study is the one used by ADB (1995), as follows: ‘the manner in which power is exercised in the management of a country’s economic and social resources for development’. According to this definition, the concept of governance refers directly to sound development management, which encompasses the functioning and capability of both the public and private sectors, as well as the institutional framework for the conduct of both public and private businesses. In broad terms, then, governance refers to the art of providing effective national institutions. Note that irrespective of the precise set of institutions (rules) that a
particular government adopts, good governance is required to ensure that those institutions have their desired effect.

Juxtaposing the definitions of governance and institution, it is clear that while there is an element of commonality between the two concepts in that they relate to the same subject-matter, they are quite distinct. That is, while institutions are essentially about rules, governance is essentially about the setting of rules, the application of rules, and the enforcement and adjudication of rules. Based on this dichotomy, institutions can be viewed as a *stock* variable and governance as a *flow* variable. In this sense, institutions can be interpreted as the cumulative outcome of past governance processes and policy actions (including the exogenous factors already explained).\(^\text{17}\) The following diagram in Figure 1 below may help clarify this point.

**Figure 1: Institution—Governance Interface**

Thus, the two concepts are quite distinct and it is always useful in empirical work to keep them separate.\(^\text{18}\) One interesting question that may be posed is: which variable should one focus on in efforts to promote economic growth? If institutions are the main problems, i.e., either they are grossly defective or lacking in certain aspects, then efforts should focus on institutions rather than on governance. The presumption here is that a country has been operating on rules that are ineffective from the point of view of growth (‘a weak

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\(^{17}\) This interpretation excludes informal institutions, such as customs, norms and taboos, which are also important and usually self-enforcing.

\(^{18}\) Duncan and Pollard (2002) underscored this point in their ADB article on poverty reduction. On an econometric issue, Rodrik (2000) warned against the error of regressing income *levels* on institutional quality *and* policy. He argued that measures of institutional quality already contain all the relevant information about the impact of policies.
institutional framework’). On the other hand, if institutions are perceived to be adequate, then governance should be the focal point of action. That is, the presumption here is that the ‘rules’ are fine but it is the way that these rules have been applied that is the problem (‘poor governance’). The other scenario, of course, is when both the governance structure and institutions are inadequate. In this case, the appropriate course of action is to target both variables with emphasis on the variable that is perceived to be the root cause of the problem. In most cases, but not always, it pays to target institutions first and then the governance structure.

VII. Concluding Remarks

While a number of studies have provided compelling evidence underpinning the primacy of institutions over other factors in the growth process, these results provide little useful information that could inform decisions on the development of an appropriate policy framework for institutional reforms that should be implemented to promote growth. It is well to know that institutions matter for economic growth, but this does not necessarily mean that we also know what institutions are crucial for high-quality growth and development. Neither does it necessarily mean that we know the form that these institutions should take and the optimal sequence in which they should be implemented. Thus, from the perspective of practical policy work, there is a wide gap between what the results of these studies say and what needs to be done on the ground to make these results operationally relevant. This paper has sought to fill this void by addressing these key institutional issues.
References


