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Institutions and development: the primacy of microanalysis

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Abstract: In recent years, there have been major advances in the empirical analysis of the link between institutions and development. However, a number of methodological problems – both theoretical and empirical – remain unresolved and have been well articulated by Ha-Joon Chang in his article 'Institutions and Economic Development: Theory, Policy and History'. These problems raise valid concerns about the policy relevance of the evidence arising from the studies. A more reliable approach to study the link between institutions and development and overcome the inherent problems of cross-country empirical analysis is to direct focus to microeconomic analysis of institutions. Such an approach avoids ideologically driven normative judgments about the superiority of particular institutional arrangements and also offers a more credible and tractable avenue to investigate institutional change.

1. Introduction

A relatively obscure field just a few decades ago, institutional economics has now become part of the mainstream in the economics profession. This is evidenced not only by the frequency of articles appearing in mainstream journals but also by the award of Nobel Prizes and other honors to scholars for their work on institutional economics during the last three decades. But it is probably in the field of development economics that advances in institutional economics has had the most significant impact, literally revolutionizing the field to become one of the more popular areas of economics research. International development institutions such as the International Monetary Fund and the World Bank that did not readily embrace the new field now lay heavy emphasis on the role of institutions in influencing development outcomes. The rise in the popularity of institutional economics is largely due to emerging empirical evidence based on various measures of institutional quality and that make use of rigorous estimation techniques. These studies claim to establish a strong link between measures of quality of institutions and development outcomes (see, for example, Acemoglu *et al.*, 2001, 2002; Cavalcanti and Novo, 2005). The cross-country evidence shows that it is the character of institutions that best explains the divergent development trajectories that we observe today. Using such evidence, Dani

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Rodrik *et al.* (2004) claim that the 'estimated direct effect of institutions on incomes is positive and large'. Likewise, William Easterly (2008) observes that a 'large research program in economics has established a persuasive link between institutions and economic development' (ibid.: 95). These views of the role of institutions in development are now widely accepted in the economics profession.

Ha-Joon Chang (2011), a leading scholar in the study of institutions, is not convinced that there is a *persuasive link* between institutions and economic development. He provides an excellent exposition of some of the key weaknesses of the purported strong link between institutions and economic development. These shortcomings include: the failure of the common approaches to unravel the causality between institutions and development; the seemingly universal obsession with the idea that only free markets backed by strong protection of private property rights can deliver economic development; the reliance on cross-country evidence that is largely based on poorly measured variables and estimation techniques that are flawed; and, finally, the fact that scholars seem to have a rather poor understanding of the process of institutional change. Chang's well-articulated arguments cast doubt on the relevance of the weight placed on the role of institutions in development. Thus, although there has been an emphasis on the need to reform institutions as a necessary condition for achieving sustained economic development, the empirical evidence used to arrive at this policy prescription, according to Chang, is founded on rather slippery ground.

Chang (2011) is not alone in criticizing current studies on institutions and development. A large number of other researchers have highlighted various weaknesses ranging from quality and consistency of data to the estimation methodologies (Jütting, 2003). In regard to the cross-sectional studies, the authors raise the issue of reverse causality and suggest that most studies have not adequately demonstrated whether institutions are exogenous or endogenous. By and large, researchers seem not to have been careful in isolating exogenous and endogenous variables or even outlining a coherent analytical framework. Likewise, researchers have raised concerns relating to the inherent biases and subjectivity of the measures of institutional quality. Thus, while there is wide acceptance that institutions are important in the development process, there is ample skepticism as to the validity of some of the claims made about the cross-country studies on the role of institutions in explaining differences in levels of development. Furthermore, interpretation of empirical findings is marred with vagueness and it is often not possible to decipher clear policy implications.

While it is in fact correct that the evidence of the link between institutions and economic development that is derived from cross-section studies suffers from a number of shortcomings, it would be wrong to suggest that these studies have no value. Economics is not a perfect science but the recent studies on the link between institutions and economic development have been instrumental in shifting the knowledge frontier substantially. These studies involve various innovations in estimation techniques and have added to our understanding of the

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channels through which institutions make an impact on development outcomes. Likewise, the measures of institutional quality, while admittedly subject to biases and measurement errors, represent improvements in our attempts to capture the quality of institutions. Rather than wholesale dismissal of the recent empirical studies, what we should note is that there are limits in what we can infer from the results but there are also important lessons that we derive from those studies.

2. Microanalysis of institutions

Granted that cross-section analysis of the impact of institutions on economic development has limits, I focus on what I consider to be the more fruitful approach to understand the role of institutions in development. I suggest that there is a need to refocus attention on positive microeconomic analysis of institutions. This was, in fact, for long the dominant approach in the study of institutions and seems to have been relegated to the back seat, especially in the present-day macroanalysis of institutions and development. Positive microeconomic analysis of institutions allows us to avoid ideological bias in the study of institutions, which is one of the primary criticisms directed at cross-section analysis. It is at the micro level that we are better able to disentangle the effects of various institutional arrangements. Many studies based on the microeconomic analysis of institutions have shown that institutions have a direct bearing on outcomes. Nevertheless, attempts to link macro-institutions and development are subject to serious aggregation errors. Finally, I suggest that to understand forces behind institutional change, it is important to focus on the historical evolution of the micro-institutions.

A source of problems when looking at the link between macro-institutions and economic development is the fact that we in essence ignore numerous micro-level institutions that are relevant to understanding human interactions and the process of exchange. Individuals interact with each other within the context of a myriad of institutions that influence their choices. These institutions include, for example, land tenure systems, out-grower agreements and various exchange contracts, all important institutional arrangements that make an impact on the economic outcomes. Furthermore, the best institutional arrangements in terms of reducing the costs of exchange will vary across sectors of the economy and also regions. It is only through the analysis of specific institutional arrangements that we can better link the character of institutions and development outcomes.

These micro-institutions cannot just be merely added together to come up with a macro-measure of the character of institutions. This is because their effects are not uniform across societies even in the same country. An illustrative example is the case of the impact of aid on economic growth and development. In the literature on the impact of foreign aid, a common observation is the micro–macro dichotomy, referring to the fact that evaluations of individual aid-funded projects seem to show positive results but when one looks at the aggregate aid

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flows to a country, there is hardly any detectable impact of aid. This has led many to conclude that aid has no impact on, say, growth or improvement on well-being. This appears to be also true of institutions. If we focus on specific institutions rather than the aggregates of institutions, we are able to detect if and how those institutions make an impact on, for example, exchange, investment, etc. Aggregating different micro-institutions in a country is bound to be imprecise and can also be meaningless.

Another example of why we must focus on microanalysis of institutions relates to the public delivery of services. Of course, access to quality services is an important aspect of determining development outcomes. Research has shown that delivery of quality services is not just a matter of resources but is primarily influenced by the quality of institutions and in particular the accountability relationships across the service-delivery chain between clients, providers and the policymakers. These relationships will vary from one setting to another even in the same country. These micro-institutions cannot just be merely added together to come up with a macro-measure of the character of institutions. To understand why the institutional arrangements, for example, across primary schools matter, we would need to analyze measures of institutional quality based on individual schools.

Chang (2011) is absolutely correct in his criticism of the modern-day prescription of strong protection of private property rights as the necessary institution for achieving development. Here again, microanalysis becomes informative. The foundation of institutional economics is the theory of transaction costs. In its simplest form, institutions emerge to minimize the transaction costs in exchange or in organizing various activities. From this perspective, development-friendly institutions are those that minimize transaction costs but such institutions need not be the same in all environments. It is clearly not necessary to approach the study of institutions from a normative perspective by broad prescriptions of which institutions are good or bad. An institutional arrangement that minimizes transaction costs of exchange amongst the Masaai of Kenya could be radically different from the character of institutions that minimize transaction costs amongst the Luo of Nyanza in the same country. In one case, community ownership of land could be the superior arrangement while contract farming could be the optimal one in the other.

Finally, using microanalysis, we are able to track changes in institutional arrangements as costs and benefits change. There is plenty of both theoretical and empirical evidence that shows how, for example, labor contracting changes over time or in response to changes to some shocks that affect costs and benefits.

3. Concluding remarks

Chang (2011) has raised pertinent questions concerning the burgeoning empirical evidence of the link between institutions and economic development. We

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have suggested that while the studies have indeed added significantly to our understanding of the role of institutions in development, there are limits as to what we can learn from cross-section analysis. We have proposed that we can learn more about the link between institutions and development and also institutional change by focusing on microanalysis of specific institutional arrangements.

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