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The Nature of Institutional Impediments to Economic Development

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University of California, Berkeley

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Department of Economics

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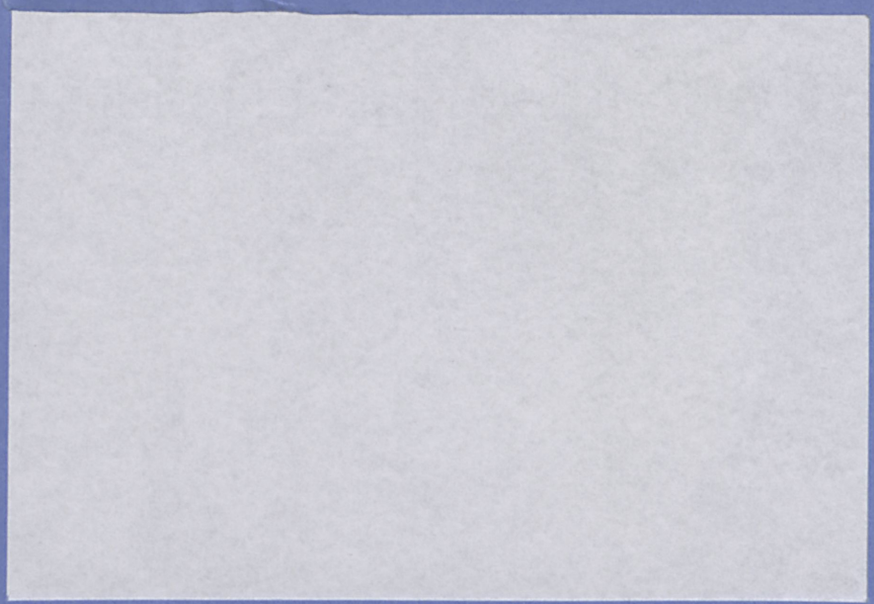

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Abstract

In the literature on the new institutional economics it is now standard to refer to the deficiencies of the legal and contractual systems and of the regulatory state as blocking economic progress. In understanding the history of underdevelopment of countries like India one, however, needs to go beyond these obviously important issues and focus upon institutional impediments that are outcomes of distributive conflicts and the collective action problems they exacerbate. These collective action problems arise both at the level of the state (inefficient interventionism may only be a symptom of those underlying problems) and at the level of the local community.

The Nature of Institutional Impediments to Economic Development*

by

Pranab Bardhan

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I

With the decline of the pervasive influence of Walrasian models in economics in recent years it is now generally recognised that "institutions matter" and that the associated incentive structures substantially influence economic performance. But beyond this general agreement there are still many differences among reasonable people on which institutions affect the process of development and how. In particular, different institutional economists emphasize different institutional impediments to development. The purpose of this paper is to bring these contrasting positions into the open and express some of the concerns of the "old" institutional economists (emphasising distributive conflicts) in a somewhat newer format, while drawing examples from the process of Indian economic development. For our present purpose we define institutions very generally (and vaguely) as social rules, conventions, and other elements of the structural framework of social interaction.

The new institutional economics literature points to some very important features of institutional failures that cause or prolong underdevelopment. This particularly refers to legal and contractual structures and rules of third-party

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* I received valuable comments on an earlier draft from Avinash Dixit, Avner Greif, Margaret Levi, Dilip Mookherjee, Douglass North, and Jeffrey Nugent. Remaining errors are no doubt due to my laxity in following up on all of their suggestions.

enforcement which are necessary for most arms'-length market transactions. Let us follow a by now well-known account, as in North (1981; 1990). In a small, closed, face-to-face peasant community transaction costs are low, but the production costs are high, because specialization and division of labor are severely limited by the extent of market defined by the personalized exchange process of the small community. In a large-scale complex economy, as the network of interdependence widens the impersonal exchange process gives considerable scope for all kinds of opportunistic behavior and the costs of transacting can be high. In Western societies over time complex institutional structures have been devised to constrain the participants, to reduce the uncertainty of social interaction, in general to prevent the transactions from being too costly and thus to allow the productivity gains of larger scale and improved technology to be realized: these institutions include elaborately defined and effectively enforced property rights, formal contracts and guarantees, trademarks, limited liability, bankruptcy laws, large corporate organizations with governance structures to limit problems of agency, and, as Williamson (1985) has emphasized, of incomplete contracting, etc. Some of these institutional structures are non-existent or weak or poorly devised and implemented in less developed countries. The state in these countries is either too weak to act as a guarantor of these rights and institutions and/or much too predatory in its own demands, posing a threat to them. The state is often captured by special-interest groups and lobbies who do not have, to use Olson's (1982) phrase, an "encompassing interest" in the productivity of the society and may thus prolong socially inefficient property rights.

The preceding paragraph provides a capsule summary of some of the major insights generated by the new institutional economics literature in our understanding of underdevelopment as an institutional failure. I happen to agree

with much of this diagnosis, but in this paper I shall focus, to a large extent, on my differing emphasis on (a) institutional impediments as outcomes of distributive conflicts and (b) the collective action problems they exacerbate and (c), in view of the critical coordination needs, on a more complex and nuanced role of the state, which many states fail to perform, but some succeed. Recent Indian economic history will provide the context of the discussion.

II

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

In pre-colonial India, while more in-depth research on these lines cries out to be done, there is plenty of evidence that, contrary to the description popularised by colonial sociology of an inert, caste-ossified, "Asiatic" society under an Oriental despotic state, there was a vigorous and far-flung mercantile economy operating with some indigenous institutions of trust and commitment in long-distance trade and credit. These institutions included negotiable credit instruments like the *hundi* (or bills of exchange), caste-based mercantile family firms and their branch agencies (*kothis*), mercantile *panchayats* (local courts), multi-caste assemblies of 'respectable merchants' which adjudicated business disputes and imposed penalties for breaches of trust (firms kept lists of creditable merchants whose credit notes -- *sahajog hundis* -- could expect a rapid discount in the bazaar), multi-caste trading corporations of merchants and bankers, townsmen and religious specialists, associations of wholesale commission agents (*arethias*) and insurers (*bimawallas*), and so on.

Just as the merchant guild in medieval Europe had a positive role, beyond its narrow cartelising operations, in securing merchants' property rights and thus facilitating exchange and market integration and in governing and coordinating relations between merchants, their various towns and the foreign towns with which they traded, the Indian castes served economic functions much beyond the restrictive practices of rent-seeking distributive coalitions they are sometimes associated with -- for example, in Olson (1982).[1] Caste-based mercantile associations and courts provided credible mechanisms of commitments, enforcement and coordination which facilitated the process of impersonal commercial exchange. One should also note that many sociologists, following the writings of Marx and Weber on India, have assumed that the caste system has

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[1] Mokyr (1990) also ascribes India's technological backwardness largely to the caste system.

paralysed the development of wider solidarities in Indian economic life. Recent historical research has questioned this narrow view. For example, describing the mercantile culture around Benares in North India in the eighteenth century, Bayly (1983) writes:

> "While the mercantile population possessed a consciousness of caste and caste institutions which were more or less effective in matters of ritual, this did not preclude the formation of wider merchant organisations and bonds of trust which stretched across the boundaries of caste. . . . Most trades were multi-caste ventures, and in their dealings with each other or with the authorities, merchants needed common institutions . . . . Conceptions of status and mercantile honour also overrode caste for it is evident that trade and credit relations over long distances could not have survived without them. 'Credit-worthiness', having one's *hundis* accepted in the bazaar, keeping regular commercial books, being frugal rather than 'expensive': these were the measures of respectability which are mentioned regularly in commercial cases and they are witness to a consistent mercantile 'public opinion'. At the pinnacle of merchant society stood the members of the Naupatti Sabha (Society of Nine Sharers) themselves who functioned as a final panel of arbitration among merchants on matters such as debt, the division of assets in family partitions, bankruptcy, and the status of mercantile custom on legal instruments . . . . To all intents and purposes then, an ad hoc 'law merchant' existed. Excommunication remained the usual sanction for caste assemblies, but what were the sanctions available to this wider mercantile opinion ? . . . The failure of one's credit in the bazaar was a sentence of commercial and sometimes of physical death. But the sanctions of Hindu religion were also available. Oaths were made in Ganges water and in the name of tutelary deities, or with the witness of a Gosain (belonging to an ascetic order) who was technically above caste and kin. . . . The ultimate sanction was to have Brahmins mutilate themselves before the door of a debtor in order to heap spiritual demerit on him (*dharna*); this was only the most

dramatic instance of the role of popular religion in reinforcing mercantile trust."

Examples of the use of religious morality in sanctioning business conduct in other parts of the world include the Confucian code of ethics among Chinese businessmen in Southeast Asia and Islamic moral code among the 'trading diasporas' in West Africa.

III

But, of course, inspite of all the indigenous institutions of a thriving mercantile economy in pre-colonial India, the process of development of sequentially more complex organizations suited for industrial investment and innovations as is familiar from the history of the West was aborted and India was, at the time of Independence in 1947, and still is one of the poorest countries in the world. I shall desist from blaming it all on the policies of the colonial administration, not because I think they are unimportant (in some ways, particularly in terms of their 'sins' of omission rather than commission, I believe they are crucial in explaining the performance of the Indian economy over the last century and a half), but because in this paper I want to keep away from the familiar litany of nationalist historiography and confine myself to a discussion of indigenous institutional impediments to development and link up with my critical assessment of the literature on the new institutional economics in its own terrain.

Greif (1994) concludes his comparative study of the distinct trajectories of economic organization of two pre-modern societies, the Maghribi traders of the eleventh century and the Genoese traders of the twelfth, by pointing our

attention to the fact that the Maghribis' "collectivist" organisation (based on multilateral reputation mechanisms and informal codes of conduct and enforcement) resembles that of contemporary developing countries, whereas the Genoese "individualistic" organisation (based on bilateral punishment with more formal methods of communication and enforcement) resembles that of the developed West. The latter system is presumably more likely to induce formal, i.e. legal and political, institutions of enforcement which facilitate industrial capital formation and innovations. The pre-colonial Indian mercantile organisations were clearly of the former type based on multilateral reputation and communal enforcement. The legal and contractual structures were more formalised in the colonial period (the joint-stock companies with limited liability came only after the middle of the nineteenth century, around the same time they came in vogue in Britain, long after in the United States), but many of the modern Indian business houses were an outgrowth of the earlier mercantile family firms.

The dramatic success story of rapid industrial progress in South-east Asia in recent decades, often under the leadership of Chinese business families who are organised under similar "collectivist" principles, makes one wonder how much of an institutional impediment this form of economic organisation really is. As the Loury (1977)-Coleman (1990)-Putnam (1993) emphasis on the importance of 'social capital' as a major determinant of economic performance gets more recognition in the social sciences, one hopes there will be more work on the mechanisms through which this form of capital works in Chinese-led entrepreneurial organizations. In a study of 72 Chinese entrepreneurs in Hong Kong, Taiwan, Singapore, and Indonesia Redding (1990) shows how through specific social networks of direct relationship or clan or regional connection they build a system dependent on patrimonial control by key individuals, personal

obligation bonds, relational contracting, and interlocking directorships.[2] As Ouchi (1980) had noted some years back, when ambiguity of performance evaluation is high and goal incongruence is low, the clan-based organisation may have advantages over market relations or bureaucratic organisations. In clan-based organisations goal congruence (and thus low opportunism) is achieved through various processes of socialisation; performance evaluation takes place through the kind of subtle reading of signals, observable by other clan members but not verifiable by a third-party authority.

In general institutional evolution in poor countries is usually judged in terms of deviations from the 'right' path of institutional development that brought about "the Rise of the West"; in view of the rise of the East in the last half century (and the prospects of what some people have started calling the forthcoming Asian century), the time may have come to rethink about the canonical model of institutional development from the point of view of economic growth and consider how the "collectivist" organization may be reshaped in particular social-historical contexts to facilitate industrial progress and if clan-based or other particularistic networks can sometimes provide a viable alternative to contract law and impersonal ownership. In East Asia in general (including Japan) corporate transactions have often been relation-based rather than rule-

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[2] As Redding (1990) points out:
" Many transactions which in other countries would require contracts, lawyers. guarantees, investigators, wide opinion-seeking, and delays are among the overseas Chinese dealt with reliably and quickly by telephone, by a handshake, over a cup of tea. Some of the most massive property deals in Hong Kong are concluded with a small note locked in the top drawer of a chief executive's desk, after a two-man meeting."
Of course, as may be expected, such systems are somewhat constrained by too much reliance on centralised decision-taking and control, internal finance, relatively small scale of operations, and in case of large organisations a tendency to subdivide into more or less separate units, each with its own products and markets.

based, and the state, as we note later, has played a much more active role particularly in the financial market, compared to the Western countries.

North (1990) points out that some of the traditional institutions of exchange (he gives the examples of caravan trade or the North African *Suq*) did not evolve into more complex organizations as in early modern Europe because they lacked the inherent dynamic linkage with other institutions that would insure against the moral hazards, adverse selection and enforcement problems of the expanding exchange process: "there is no incentive to alter the system". But as North would probably agree that such explanations are ultimately inadequate and somewhat circular. We cannot explain underdevelopment in terms of such institutional atrophy, because it is quite possible that the traditional institutions of exchange did not evolve in North Africa because of low growth in the volume of trade and the low rate of return for the traditional bazaaris from devising new institutions to reduce enforcement costs. In empirical work in institutional history there is this perpetual identification problem.

IV

A major institutional deficiency that blocked the progress of the mercantile into the industrial economy in India as in other poor countries relates to the financial markets. Even when mercantile family firms thrived in their network of multilateral reputation and enforcement mechanisms, the latter were not adequate for supporting the larger risks of longer-horizon industrial investment. These firms, by and large, had limited capacity to pool risks and mobilise capital of the society at large in high-risk high-return industrial ventures. The usual imperfections of the credit and equity markets emphasised in the literature on

imperfect information are severe in the early stages of industial development. The investment in learning by doing is not easily collateralizable and is therefore particularly subject to the high costs of information imperfections. The role of the government can become very important here, as Gerschenkron had emphasized for the late industrializers of Europe. There are, of course, cases, even in India, of how coordination and mutual support among merchant families helped the transition to the industrial economy without much help (actually, with some hindrances) from the colonial government; for example, as Bayly (1983) notes:

> "In Ahmedabad, the one case of a 'traditional' merchant city which industrialised from inside, it was several of the leading families who controlled resources and status within the trade guilds who went into the cotton mill ventures. No small man could go it alone. But if the leaders of the community who could themselves call on a wide range of security and information made the initial move, then others would follow ".

More often such coordination in investment and risk-taking on the part of the merchant families was missing. Here clearly is a case of 'strategic complementarities' and positive feedback effects resulting in multiple equilibria.[3] This is particularly important when externalities of information and the need for a network of proximate suppliers of components, services and infrastructural facilities with economies of scale make investment decisions highly interdependent and raising capital from the market for the whole complex of activities particularly difficult.[4] Historically, in some countries the state has

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

[4] For an account of the great financial difficulties faced by enterprising groups like the Tatas at Jamshedpur or by Walchand at Visakhapatnam in

played an important role in resolving this kind of 'coordination failure' by facilitating and complementing private sector coordination. The colonial Indian state obviously did not.[5]

In much of the literature on the new institutional economics the importance of the state is recognised but in the narrow context of how to use its 'monopoly of violence' in the enforcement of contracts and property rights one the one hand and at the same time how to establish its credibility in not making confiscatory demands on the private owners of those rights on the other.[6] In the successful cases of East Asian development (including that of Japan) the state has played a much more active role, intervening in the capital market sometimes in subtle but decisive ways, using regulated credit allocation (sometimes threatening withdrawal of credit in not so subtle ways) in promoting and channelling industrial investment, underwriting risks and guaranteeing loans, establishing public development banks[7] and other financial institutions, encouraging the development of the nascent parts of financial markets, and nudging existing firms to upgrade their technology and to move into sectors that fall in line with an overall vision of strategic developmental goals . In this process, as Aoki, Murdock, and Okuno-Fujiwara (1995) have emphasised, the state has enhanced

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pre-Independence India, see Ray (1979).

[5]In the early decades of this century the managing agency system in India provided some role in promoting, underwriting and financing new firms, but it fell into disrepute on account of interlocking industrial collusion and exclusivity, and was abolished after Independence.

[6] The French poet Paul Valery is reported to have said: " If the state is strong it will crush us; if it is weak, we will perish".

[7] In the theoretical literature Armendariz de Aghion (1995), drawing upon the model of Dewatripont and Maskin (1995), show that in a private decentralised banking system banks tend to underinvest in and under-transmit expertise in long-term industrial finance. A public development bank can reduce these problems if conditions like targeting of development bank intervention, co-financing arrangements and/or coownership with private financial institutions are attached to government sponsorship.

the market instead of supplanting it ; it has induced private coordination by providing various kinds of cooperation-contingent rents.

One should not, of course, underestimate the administrative difficulties of aggregate coordination and the issues of micro-management of capital may be much too intricate for the institutional capacity and information processing abilities of many a state in Africa, Latin America, South Asia, and even East Asia (if one thinks of the Philippines, for example).[8] Nevertheless, I think institutional economics will be richer if we admit the possibility of a more nuanced theory of the state, beyond the oversimplifications of either the Marxist theorist's class-driven state or the public choice theorist's rentier or predatory state. Some of the success stories of state-led industrialization in the history of the last century and a half (starting with the classic case of Meiji Japan) suggest that the impulses that shape major policies and actions by the state elite can sometimes be fuelled not merely by motives of self-aggrandizement but also by what Miliband (1983) calls its 'conception of national interest'.

Olson (1993) has modified the theory of the rent-maximizing or predatory state by pointing to the smaller distortionary effects of the 'stationary bandit' as opposed to the 'roving bandit' (i.e., the state as organized crime has more stake in the prosperity of its subjects than the state as petty, decentralized theft). He shows that a self-interested ruler with an 'encompassing' and stable interest in the domain over which his coercive power is exercised will be led to act in ways that are consistent with the interests of society and of those subject to that power. Formally speaking, Olson's ruler maximizes his own objective function subject to the reaction function of the ruled and so in the process the ruler internalises the

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

economic cost of his impositions in accordance with that reaction function. The ruler is thus a Stackelberg leader, even though Olson does not quite characterise him as such. In contrast, one can say that the weak or the 'soft' state is a Stackelberg follower; it cannot commit to a particular policy and merely reacts to the independent actions of the private actors like special-interest groups. Thus it is easy to see[9] that compared to the 'strong' state ('strength' defined as ability to credibly precommit), the 'soft' state will have too much of undesirable interventions (creating distortions in the process of generating rent for the lobbying groups), and by the same logic, will have too little of the desirable interventions (as in the case of market failures or the kind of coordination failures we have alluded to above), since the state does not take into account or internalise the effects of its own policies. So the distinction between a 'strong' state (as in much of East Asia) and a 'soft' state (as in much of Africa or South Asia) is not in the extent of intervention, but in its quality. (For a discussion of the issue of quality of intervention, see Bardhan (1990)).

An important example of the strong state's ability to precommit like the Stackelberg leader arises in the case of the popular infant-industry argument for protection. At the time when such protection is initiated, by the very nature of this argument for temporary protection, it is granted for a short period until the industrial infant stands up on its feet. But in most countries infant industry protection inevitably faces the time inconsistency problem: when the initial period of protection nears its completion the political pressures for its renewal becomes inexorable, and in this way the infant industry soon degenerates into a geriatric protection lobby. In the recent history of the strong states of East Asia, however, there have been some remarkable instances of the government

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[9]For a simple but illuminating demonstration of this result, see Rodrik (1992).

withdrawing protection from an industry after the lapse of a preannounced duration, letting the industry sink or swim in international competition.[10]

V

The difficult issue is to figure out the factors that predispose a state or a political coalition to have an 'encompassing interest' in economic performance of the country as a whole, or, to put it differently, what helps in the making of a strong state. There are many path-dependent factors (deeply historical, cultural and geo-political) that determine the process of formation of a strong or a weak state. But there are some patterns decipherable from a comparison of East Asia with South Asia which may be important from the point of view of the political economy of what is called a developmental state.

Many political scientists have pointed to the remarkable insulation of the technocratic elite in charge of policy-making in the successful East Asian states from the ravages of short-run pork-barrel politics (ignoring, for the time being, the policies with respect to some relatively small sectors like that of protected rice farmers). Authoritarianism is neither necessary (examples: many sectors in postwar Japan, Austria, or the Scandinavian countries) for such insulation nor sufficient (examples: many states in Africa and Latin America in recent history). Among the enabling conditions for this insulation Evans (1995) emphasizes the

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[10]For an example of how the government in Taiwan imposed an import ban on VCR's in 1982 to help out two of the main domestic electronic companies, and withdrew it after eighteen months when they failed to shape up to meet international standards, see Wade (1990).
Jeff Nugent has pointed out to me that with the recent advent of democracy some of these precommitments have become somewhat weaker, as, for example, in the case of the promised withdrawal of protection of small manufacturing enterprises against competition from the chaebols in South Korea.

Weberian characteristics of internal organization of the state like highly selective meritocratic recruitment and long-term career rewards for members of the bureaucracy. The post-Independence Indian case (where these Weberian characteristics are present to a reasonable degree) suggests to me that equally important are the mechanisms of promotion and transfer: on the one hand, the strong officers' unions in the Indian administrative services make sure that once recruited the officer is regularly promoted more on the basis of seniority than performance, on the other hand, powerful politicians who cannot sack you can make life unpleasant for you by getting you transferred to undesirable jobs and locations.

But insulation of the technocratic elite has its costs in terms of efficiency. Apart from the loss of localized information and accountability (to which we shall come back later) that this entails, bureaucratic insulation makes it difficult to attain flexibility in dealing with changes in technical and market conditions (and may thus discourage risk-taking) and also in correcting wrong decisions. This flexibility has been achieved in East Asia by fostering a dense network of ties between public officials and private entrepreneurs through deliberative councils (as in Japan or South Korea) or through the tightly-knit party organization (as in Taiwan), allowing operational space for negotiating and renegotiating goals and policies and for coordinating decisions with remarkable speed. Such government-business relations (with the state retaining its privileged position as a senior partner in the relation) not merely facilitate sharing of information and risks, they also provide a framework for compromise and rent-sharing within the business elite. Evans (1995) has described this networked insulation of the top bureaucracy as the 'embedded autonomy' of the state, which he regards as key to the success of the East Asian state. But is such 'embedded autonomy' of the state elite feasible in societies that are more heterogeneous and unequal than Japan,

South Korea, or Taiwan? As we know from Olson (1965), heterogeneity makes collective action problems more difficult. The relevant collective action problem here is that of formulating cohesive developmental goals with clear priorities and avoiding prisoners' dilemma-type deadlocks in the pursuit of even commonly agreed upon goals. Not merely do societal differences in rule obedience and organizational loyalty -- for a discussion of the multiple equilibria in their evolution process, see Clague (1993) -- matter in this context (palpable differences in this respect between North-east Asia and South Asia are commonly remarked upon), but it is also important to keep in mind the different backgrounds of structural conflict in civil society. When wealth distribution is relatively egalitarian, as in large parts of East Asia (particularly through land reforms and widespread expansion of education), it is easier to enlist the support of most social groups (and isolate the radical wings of the labor movement and the petty bourgeoisie) in making short-run sacrifices and coordinating on growth-promoting policies.

When society is extremely heterogeneous and conflict-ridden as in India and no individual group is powerful enough to hijack the state by itself, the democratic process tends to instal an elaborate system of checks and balances in the public sphere and meticulous rules of equity in sharing the spoils at least among the divided elite groups. (For an analysis of the developmental gridlock in India as an intricate collective action problem, see Bardhan (1984)). There may be what is called institutionalized suspicion in the internal organization of the state (in the Indian case enhanced no doubt by the legacy of the institutional practices of the colonial rulers suspicious of the natives) and a carefully structured system of multiple veto powers. The tightly integrated working relationship of government with private business which the 'embedded autonomy' of Evans involves is very difficult to contemplate in this context. Not merely is

the cultural distance between the 'gentleman (or the lady) administrator' and the private capitalist rather large in India (though it is declining in recent years), but much more important is the fact that in the Indian context of a plurality of contending heterogeneous groups a close liaison and harmonizing of the interests of the state with private business would raise an outcry of foul play and strong political resentment among the other interest groups (particularly among organized labor and farmers), the electoral repercussions of which the Indian politicians can afford to ignore much less than the typical East Asian politician. While cozy relations between the state and private capital remain inherently somewhat suspect in such political regimes in general, there is, however, some interesting sectoral variability. There are some sectors in the Indian economy where a shared vision and some consensus building on encompassing development projects have not been absent, and it is very important to study the preconditions and modalities of such instances. The comparative study in Evans (1995) of the emerging relationships between the state and private industrialists in Korea, Brazil and India in the new information technology sector (electronics and telecommunications) is thus quite instructive.

Another important aspect of the quality of state intervention in East Asia has to do with the use, by and large, of clear, well-defined, pre-announced rules of performance criteria. In South Korea, for example, the heavy involvement of the state in directing investment through credit allocation has been largely successful because of its strict adherence to the criterion of export performance. Through this precommitment device the strong Korean state has used the vital disciplining function of foreign competition in encouraging quick learning and cost and quality consciousness among domestic enterprises, something that is conspicuously absent in many other interventionist regimes.

While it is easy to see that transparent and pre-announced rules rather than discretion, and credible commitment devices can be very important for efficiency and long-term investment particularly in states prone to 'capture', one should also keep in mind, as Laffont and Tirole (1994) indicate, that commitment may allow the government in one period to bind governments in subsequent periods to a rent-generating contract with a firm with which the politicians in the former government have colluded but which is not beneficial for the country as a whole.[11] In a multi-period model if the state actors who behave like a Stackelberg leader with a presumed encompassing interest have some chance of being thrown out of office (in future elections or otherwise), commitment may act as a rent-perpetuating device. While Laffont and Tirole correctly point out that concern of the incumbent government for reelection will reduce the probability of collusion, elections after all are highly imperfect as disciplining devices.

Thus the 'strength' of a state in the sense of the ability to credibly commit itself to developmental goals is clearly not sufficient. It may not even be necessary: the remarkable economic success of Italy over three decades (until very recently), with a notoriously weak and corrupt government heavily involved in the economy, is an obvious counterexample. Nevertheless the correlation between growth performance and state 'strength' (in the sense defined above) is probably quite robust. It is, of course, possible, that economies in their most successful phases have less political conflict (most groups are doing well without political exertion, and the few losing groups are bribed) and therefore their governments have an appearnce of 'strength'; their commitments are not challenged or reversed by political action. This may give rise to a

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[11]In India this kind of argument was cited in the recent political controversy around the Enron power project in Maharashtra.

selection bias. This is an important issue that needs to be examined with detailed historical data. The determined way the Korean state has handled various macroeconomic crises, say, in the seventies (the two oil shocks, massive foreign debt , inflation, etc.) suggests to me that the Korean state's 'strength' is not just a reflection of the success of the economy.

In most situations the state is neither a Stackelberg leader nor a Stackelberg follower. Neither the state actors nor the private interest groups usually have the power to unilaterally define the parameters of their action. Both may be strategic actors with some power to influence the terms, and the outcome of the bargaining game will depend on their varying bargaining strengths in different situations. Under the circumstances it is important to strengthen the accountability mechanisms on both sides, as Przeworski (1995) emphasizes. On the one hand, credible commitment devices and rules (including constitutional safeguards) may be necessary to insulate some of the economic decision-making processes from the marauding lobbies of special-interest groups; on the other hand, institutional arrangements like an independent office of public accounting and auditing, an election commission with powers to limit (and enforce rules on) campaign contributions and to conduct fair elections, citizens' watchdog commitees providing information and monitoring services, an office of local ombudsman with some control over the local bureaucracy, etc. can help in limiting the abuse of executive power and providing a system of punishments for undesirable government interventions in the economy and rewards for desirable interventions. In a country like India where most of the economy is still in the informal sector and dispersed in far-flung villages, such accountability mechanisms have to be reinforced by informal institutions at the local community level, an issue to which we shall come back in the last section of the paper.

VI

The history of evolution of institutional arrangements and of the structure of property rights often reflects the changing relative bargaining power of different social groups. North (1990), unlike some other transaction cost theorists, comes close to this viewpoint traditionally associated with Marxist historians. He points to the contrasting and path-dependent processes of change in bargaining power of the ruler versus the ruled in different countries particularly in the context of the fiscal crisis of the state. Despite some of the similarities between England and Spain at the beginning of the sixteenth century, North traces the differential subsequent evolution of economic institutions, and consequently in economic growth, in the two countries to the differential development of power of the ruler vis-a-vis the constituents (represented by the English Parliament and the Castilian Cortes, respectively) in the history of the two countries. He also finds a reflection of this difference in the institutional evolution of the English North American colonies compared with that of the Spanish colonies in South America, with similar economic consequences.

The relative bargaining power of different social groups changes with changes in material conditions and in ideology or cultural belief systems (which only slowly adapt to changes in material conditions). The major historical change in material conditions that is usually emphasised is that in relative prices which change with population growth or decline and improvements in production or military technology. This acts as a main motive force for institutional changes in history primarily by inducing the development of property rights to the benefit of the owners of the more expensive factor of production. For example,

demographic changes altering the relative price of labor to land lead to the incentive for a redefinition of property rights on land and a rearrangement of labor relations. North (1981), and Hayami and Ruttan (1985) give several examples from European and recent Asian history respectively. But from Brenner's (1976) analysis of the contrasting experiences of different parts of Europe on the transition from feudalism (those between Western and Eastern Europe and those between the English and the French cases even within Western Europe) we know that changes in demography, market conditions and relative prices are not sufficient to explain the contrasts. Changes in relative prices may at most change the costs and benefits of collective action for different social groups (creating new opportunities for political entrepreneurs), but they cannot predetermine the balance of class forces or the outcome of social conflicts. Brenner shows that much depends, for example, on the cohesiveness of the landlords and peasants as contending groups and their ability to resist encroachments on each other's rights and to form coalitions with other groups in society. Hayami and Ruttan (1985) refer to the case of mid-nineteenth century Thailand, where the expansion of international trade triggered a rise in rice prices which led to a major transformation of property rights: traditional rights in human property (corvee and slavery) were replaced by more precise private property rights in land. But one should not forget that the expansion of grain trade in the sixteenth and seventeenth century Poland (the rise in grain prices fuelled particularly by expansion of Dutch demand) was quite compatible with the relapse into serfdom. There are other examples of institutional stagnation or retrogression following upon expansion of trade in more recent colonial history.

The 'old' institutional economists (including Marxists) often used to point out how a given institutional arrangement serving the interests of some powerful group or class acts as a long-lasting block to economic progress. In contrast, the

property rights school as well as the transaction cost theorists often underestimate the tenacity of vested interests and the consequent persistence of dysfunctional institutions. The costs of collective action on the part of potential gainers of a socially beneficial institutional change may be too high. This is particularly the case, as we know from Olson (1965), when the losses of the potential losers are concentrated and transparent, while gains of the potential gainers are diffuse (or uncertain for a given individual, even though not for the group, as suggested by Fernandez and Rodrik (1992)). There are two kinds of collective action problems involved here: one is the well-known free-rider problem about sharing the costs of bringing about change, the other is a bargaining problem where disputes about sharing the potential benefits from the change may lead to a breakdown of the necessary coordination.

Given the enormity of the collective action problem and the differential capacity of different groups in mobilisation and coordination, institutional arrangemens are more often the outcome of strategic distributive conflicts in which groups with disproportionate resources and power try to constrain the actions of others, rather than the outcome of a society's decentralized attempt to realign the property rights and contracts in the light of new collective benefit-cost possibilities as is the presumption in much of the new institutional economics.[12]

VII

The classic example of inefficient institutions persisting as the lopsided outcome of distributive struggles relates to the historical evolution of land rights

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[12]For an earlier exposition of this point of view, see Bardhan (1989), and Knight (1992).

in developing countries. In most of these countries the empirical evidence suggests that economies of scale in farm production are insignificant (except in some plantation crops) and the small family farm is often the most efficient unit of production. Yet the violent and tortuous history of land reform in many countries suggests that there are numerous road blocks on the way to a more efficient reallocation of land rights put up by vested interests for generations. Why don't the large landlords voluntarily lease out or sell their land to small family farmers and grab much of the surplus arising from this efficient reallocation? There clearly has been some leasing out of land, but problems of monitoring, insecurity of tenure and the landlord's fear that the tenant will acquire occupancy rights on the land limited efficiency gains and the extent of tenancy. The land sales market has been particularly thin (and in many poor countries the sales go the opposite way, from distressed small farmers to landlords and money-lenders). With low household savings and severely imperfect credit markets, the potentially more efficient small farmer is often incapable of affording the going market price of land. Binswanger, Deininger and Feder (1995) explain it in terms of land as a preferred collateral (and also carrying all kinds of tax advantages and speculation opportunities for the wealthy) often having a price above the capitalized value of the agricultural income stream for even the more productive small farmer, rendering mortgaged sales uncommon (since mortgaged land cannot be used as collateral to raise working capital for the buyer). Under these circumstances and if the public finances are such that landlords cannot be fully compensated, land redistribution will not be voluntary.[13] Landlords resist land reforms also because the leveling

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[13]Mookherjee (1994) shows , in a complete contracting model with the presence of incentive-based informational rents and endogenous credit rationing arising from wealth constraints, that there are additional arguments why a voluntary transfer of land ownership will not take place in

effects reduce their political power and their ability to control and dominate even non-land transactions.

India has a long history of exactions from the tiller of the soil by the state and a whole array of revenue collecting intermediaries. In this century land has gradually passed from absentee landlords to medium-sized cultivator-owners (more slowly in eastern India than elsewhere), but the distribution of operational holdings as well as ownership remain quite concentrated, inspite of the built-in egalitarian forces generated by inheritance practices of subdivision of the family land. The overwhelming majority of the peasants are landless or marginal farmers and insecure tenants. The labor cost advantage of the small farmer in productivity is outweighed by the severe constraints of access to credit, marketing, technological information, and above all to controlled supply of water, a crucial factor in a country where large parts are either semi-arid or floodprone. The dismal failure of the colonial and (to a smaller extent) of the post-colonial state in most parts of the country has largely been in the area of providing public goods like irrigation and drainage, education and health, and infrastructural facilities like roads, power and extension services, and in grappling with credit market imperfections. Added to this are the adverse consequences of the post-colonial state's price, trade and regulatory policies for the farmers.

But along with this set of government failures in Indian rural development one must recognize the institutional failure at the local level. This failure, often ignored in the ideological state-versus-market debates, is that of local self-governing institutions and the resulting lack of accountability and legitimacy at the local level. Even when the state in the last four decades has spent vast sums of money on irrigation, education, health and subsidised credit, the programs are

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the market even when it is socially more efficient.

usually administered by a distant, uncoordinated and occasionally corrupt bureaucracy, insensitive to the needs of the local people, and often very little reaches the intended beneficiaries of the programs. One reason why public investment in irrigation has been more effective in Korea than in India is, as Wade (1994) has indicated, that the local community organizations in the former country have been by and large more vigorous in working with (and putting pressure on) the irrigation bureaucracy. This lack of community coordination in India is acute not just in water allocation from public canals and maintenance of field channels, but also in unregulated private groundwater pumping leading often to salinity and depletion of fragile aquifers.

As in water management so in other local public projects like environmental protection, prevention of soil erosion, regulated use of forests and grazing land, and public health and sanitation, local community-level institutions that can play a vital role in providing an informal framework of coordination in design as well as implementation are largely missing in most parts of India. There is also enough evidence that the serious problem of absenteeism of teachers in village public schools and of doctors in rural public clinics would be significantly less when they are made accountable to the local community rather than to a centralized bureaucracy. Subsidised credit is administered through government and semi-government agencies who do not have enough local information about the borrower and so they insist on collaterals which ration out many of the potentially productive poor; these agencies do not have access to the systems of peer monitoring and social sanctions that local community institutions can provide.

This local institutional failure is another example of the severity of collective action problems in India. I believe extreme social fragmentation in India (brought to boil by the exigencies of pluralist politics) makes cooperation in

community institution-building much more difficult than in socially homogeneous Korea, Taiwan and Japan. There is also some scattered evidence that community-level institutions work better in enforcing common agreements and cooperative norms when the underlying property regime is not too skewed and the benefits generated are more equitably shared. Putnam's(1993) study of the regional variations in Italy also suggests that 'horizontal' social networks (i.e. those involving people of similar status and power) are more effective in generating trust and norms of reciprocity than 'vertical' ones. One beneficial byproduct of land reform, underemphasized in the usual economic analysis, is that such reform, by changing the local political structure in the village, gives more "voice" to the poor and induces them to get involved in local self-governing institutions and management of local public goods. In Indian social and political history when in situtations of extreme inequality local organizations have been captured by the powerful and the wealthy, instances of subordinate groups to appeal to supra-local authorities for protection and relief have not been uncommon: the intervention by the long arm of the state even in remote corners of rural India have been in such cases by invitation and not always by arbitrary imposition.

In the economics literature the complex relationship between inequality of endowments and successful collective action is still an underresearched area (I am currently involved in a research project exploring the theoretical and empirical issues in the context of cooperation in the management of local commons). On the one hand there is the well-known suggestion of Olson (1965) that in a heterogeneous group a dominant member enjoying a large part of the benefits of a collective good is likely to see to its provision even if he has to pay all of the cost himself (with the small players free-riding on the contribution of the large player); on the other hand, there are cases where the net benefits of

coordination of each individual may be structured in such a way that in situations of marked inequality some individuals (particularly those with better exit options) may not participate and the resulting outcome may be more inefficient than in the case with greater equality; besides, the transaction and enforcement costs for some cooperative arrangements may go up with inequality.

In general, there need not always be a trade-off between equality and efficiency, as is now recognised in the literature on imperfect information and transaction costs; the terms and conditions of contracts in various transactions that directly affect the efficiency of resource allocation crucially depend on who owns what and who is empowered to make which decisions. Institutional structures and opportunities for cooperative problem-solving are often foregone by societies that are sharply divided along economic lines. Barriers faced by the poor in the capital markets (through a lack of collateralizable assets which borrowers need to improve the credibility of their commitment) and in the land market (where the landed oligarchy hogs the endowments of land and water) sharply reduce a society's potential for productive investment, innovation and human resource development. Under the circumstances, if the state, even if motivated by considerations of improving its political support base, carries out redistributive reform, some of it may go toward increasing productivity, enhancing credibility of commitments and creating socially more efficient property rights. Even the accountability mechanisms for checking state abuse of power at the local level work better when the poor have more of a stake in the asset base of the local economy. By dismissing all state-mandated redistribution as mere unproductive rent-creation, some of the new institutional economists foreclose a whole range of possibilities.

When talking about the institutional impediments in the Indian economy particularly in the context of attempts at economic reform in recent years, the

discussion usually veers around the impediments posed by various government failures: in overregulating the private economy, in denying autonomy and sheltering inefficiency of operations in the vast public sector, in jeopardising the viability of the public financial institutions through a system of massive credit subsidies that have built-in disincentives to invest wisely or to repay promptly, in labor laws that make deployment and readjustment in organised sector employment in response to changing market and technical conditions extremely difficult, and in general in not being able to provide a tight legal framework for contract enforcement without which a market economy cannot function properly. All this is very important and rightly emphasised in the literature, but in this paper I have focused on some other institutional failures which are important, some of them even outside the as yet small formal sector of the economy.

We started with the historical role of 'collectivist' mechanisms of Eastern mercantile economies (as opposed to the more formal Western institutions) and the critical coordination role the state can play in the leap from the mercantile to the industrial economy. The difficult question is to figure out the factors that can potentially predispose a state to have an encompassing interest in the economic performance of the country and the conditions under which the state frequently fails. The institutional arrangements of a society are often the outcome of strategic distributive conflicts among different social groups, and inequality in the distribution of power and resources can sometimes block the rearrangement of these institutions in ways that are conducive to over-all development. I have drawn particular attention to the inevitable collective action problems in this rearrangement, both at the level of the state (which underly the difficulty of breaking out of the policy deadlock of which inefficient interventionism is only a symptom) and at the local level (which make provision and management of crucial local public goods highly inefficient).

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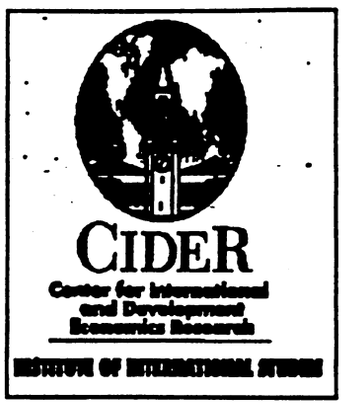

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