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# **INSTITUTIONS AND ECONOMIC DEVELOPMENT: A SURVEY OF ASPECTS OF THE NEW INSTITUTIONAL ECONOMICS**

**By Dejene Aredo\***

## **ABSTRACT**

*In recent years, the New Institutional Economics, though yet at its formative stage, has gained currency among some economists and donor agencies like the World Bank. However, its subject matter and its relevance to current issues are little understood by many researchers interested in development problems. This paper presents a survey of the literature and a review of the current state of the New Institutional Economics (NIE) with a focus on its meaning, strengths, weaknesses and current argument about its role and importance in the development process. The paper underlines the importance of the NIE and identifies agenda for future research.*

## **1. INTRODUCTION**

The New Institutional Economics (NIE), though yet at its formative stage, has gained wide currency in recent years. Its importance was underlined with the award of the Nobel Prize to two leading institutional economists, Ronald Coase in 1991 and Douglas North in 1993. Currently, an increasing number of economists have shown interest in the NIE, as can be suggested by the volume of publications that are coming out. Non-economists, too, are perhaps interested in the subject because economists have finally come out with a school of thought that would provide a forum for an interdisciplinary discourse on the problems of development.

However, to the extent that the majority of economists and non-economists are concerned, one can argue that the NIE is little understood. Very few professionals appreciate the subject matter and the basic assumptions of this theory. Even the meaning of 'institutions' and why the adjective 'new' is included in the nomenclature of the theory may not be clear to those who want to know more about the subject.

The literature on the NIE, though impressive, is not readily available for a researcher and policy makers who want to acquaint themselves with its essential features.

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\* Associate Professor, Department of Economics, Addis Ababa University. The final version of this article was submitted in December 1999.

Moreover, most of the studies deal with conditions of industrial countries and they have limited relevance to the conditions of developing countries. Those studies which deal with the applications of the NIE to development problems (e.g. Nabli and Nugent 1989; Harriss *et al.*, 1995) are thick books of readings which do not provide a concise review of the various aspects of the NIE. Besides, the NIE is at its formative stage and periodic surveys are required to capture recent developments in the literature.

The purpose of this paper is to undertake a survey of the literature and a review of the current state of the NIE with a focus on its relevance to development problems. It is hoped that this review will improve our understanding of this newly emerging school of thought.

As it is beyond the scope of this paper to consider all aspects the NIE<sup>1</sup>, the following fundamental areas have received particular attention. The concept of the term 'institutions' is discussed (section two). This is followed by an exposition of the limitations of mainstream economic theory (section three). The importance and meaning of the NIE is then explained (section four). This is followed by a survey of the literature on the applications of the institutionalist approach to development (section five). The major findings of the study are summarized and concluding remarks provided (section six).

## **2. INSTITUTIONS: CONCEPTUAL PROBLEMS**

The term 'institution' has remained confusing since its emergence in development literatures in the 1950s and 1960s. Its definitions vary widely not only among disciplines but also within them (Blase 1973; Bienkowski 1981) (see Table 1). That is why Blase (1973) noted that 'while a single, all purpose definition of *institution* would be convenient, it does not exist, and the literature is not mature enough for its formulation at this time'. In a recent paper, a senior economist at the World Bank and in reference to her colleagues at the Bank, notes that 'they are confused by the different definitions used by different scholars of institutions' (Shirley 1997). Nabli and Nugent (1989), who provided the most authoritative work on the applicability of the New Institutional Economics (NIE) note that:

The consensus on the centrality of institutions to development has not been matched by one on its definition. Different authors have used quite different definitions each emphasizing quite different aspects or characteristics of the more general phenomenon.

Table 1. Selected Definitions of 'Institutions'

Author	Definition
Advanced Learners Dictionary	(An institution is) long-established law, custom, or practice (e.g. club or society; the habit of going to church on Sunday mornings).
Merriam Webster's Collegiate Dictionary (10 <sup>th</sup> ed.)	(An institution is) a significant practice, relationship, or organization in a society or culture (e.g. the institution of marriage), an established organization or corporation.
Veblen (1919)	Institutions are more settled habits of thought common to generality of man.
Hayami & Ruttan (1985)	Institutions are the rules of a society or organizations that facilitate coordination among people by helping them from expectations, which each person can reasonably hold in dealing with others. They reflect the conventions that have evolved in different societies regarding the behavior of individuals and groups relative to their own behavior and the behavior of others... There is a considerable disagreement regarding the meaning of the term 'institution'. A distinction is often made between the concepts of institution and organization. The broad view, which includes both concepts, is most useful for our purpose (p.94, including footnote).
Hodgson (1988)	Are institutions constraints only? Not at all: 'Institutions and routines, other than acting simply as rigidities and constraints, play an enabling role, by providing more or less reliable information regarding the likely action of others. Thus, the habits and routines formed by some individuals enable the conscious decision-making of others' (132-33).
Nabli & Nugent (1989)	For the present purpose an 'institution' is defined as a set of constraints which govern the behavioral relations among individuals or groups. Formal organizations such as labor unions and employers' organizations are institutions because they provide sets of rules governing the relationship both among their members and between members and non-members (pp.8-9).
North (1990)	Institutions are the rules of the game in a society or, more formally, are humanly devised constraints that shape human interaction. In consequence, they structure human exchange, whether political, social or economic (p3).
Pischke, (1991)	'Institutions as referred to the following discussion are formal organizations registered or chartered according to law' (p.110).
Rutherford (1994)	An institution is a regulatory of behavior or a rule that is generally accepted by members of a social group, that specifies behavior in specific situations, and that is either self-policed or policed by external authority.
Klitgaard (1995)	Many authors have noted that 'institutions' means both 'organization' and norms, even patterns of conventional behavior. I lament the confusion but have not discovered an antidote (p.12).
Pejovich (1995)	We define institutions as the legal, administrative and customary arrangements for repeated human interactions. Their major function is to enhance the predictability of human behavior (p.30).
Clague (1997)	Broadly defined, institutions can be many things. They can be organizations or sets of rules within organizations. They can be markets or particular rules about the way a market operates. They can refer to a set of property rights and rules governing exchanges in a society. They may include cultural norms and behavior... If the rules were generally ignored, we would not refer to them as institution (p.18).
Nee (1997)	At the theoretical center of the new institutionalist paradigm is the concept of choice-within-constraints. Institutions, defined as webs of interrelated rules and norms that govern social relationships, comprise the formal and informal social constraints that shape the choice-set of actors. Conceived as such, institutions reduce uncertainty in human relations.

Most authors belonging to the new institutionalist school accept the definition provided by Douglas North. This definition takes institutions as rules of the game or constraints that shape human interaction: 'Institutions are the rules of the game in a society or, more formally, are humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social, or economic' (North 1990:3). Pejovich (1995), in the same vein as North, defines institutions as 'the legal, administrative and customary arrangements for repeated human interaction.' Then, he notes that the major function of institutions 'is to enhance the predictability of human behavior.'

In further elaborating his definition of institutions, North notes that 'institutions' are the humanly devised constraints that structure human interactions (North 1996:344). He then classifies constraints into several categories, namely, formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics. Together, these define the incentive structure of societies and specifically economies.

Informal rules have their origins in the experiences, traditional values, ethos, religious beliefs, ethnicity and other factors that influence the subjective perceptions individuals form to interpret reality. They are part of the heritage or culture, which is transmitted from one generation to another through teaching and imitation (Pejovich 1995:31; Boyd and Richerson 1985). Formal and informal rules might operate side by side as in the case of marriage rules in Ethiopia, where customary rules are enforced along with the civil code.

Moreover, similar formal rules operating in different societies may produce different outcomes (Pejovich 1995:32). Collectivization of agriculture had different results in the former Soviet Union and Ethiopia, although the two countries adopted more or less similar blueprints. The Gramscian Bank model has worked well in Bangladesh but has produced different outcomes in Ethiopia (Dejene 1998). It has also been observed that 'informal rules have frequently outlived formal rules' (Pejovich 1995:32).

One definition problem is whether organization is part of institution or not. Two different, although related, meanings are given to the term 'institution' in discussion of development (Arkadie 1989:153). The first is as rules of the game. The second is as organization.

North makes a clear distinction between institutions and organizations. He writes that 'if institutions are rules of the game, organizations and their entrepreneurs are the players' (North 1996:345). Accordingly, organizations are made up of groups of individuals bound together by some common purpose to achieve certain objectives. Thus, organizations include political bodies (e.g. political parties, regulatory bodies, a city council), economic bodies (e.g. firms, family farms, cooperatives), social bodies (e.g. churches, clubs, associations), and educational bodies (e.g. schools,

universities). However, there are other renowned adherents of the NIE who take 'organizations' as 'institutions'. For example, Nabli and Nugent (1989:8-9) clearly indicate that 'organizations' are also 'institutions'. For them, formal organizations, such as labor unions and employers' organization are institutions because they provide sets of rules governing the relationships both among their members and between members and non-members.

Another definitional problem is the disagreement as to whether institutions can best be understood from a behavioral perspective or from rules perspective (Nabli and Nugent 1989). According to the former, institutions are complexes of norms of behavior that persist over time, by serving collectively valued purposes (Uphoff 1986). North and his followers, of course, propose the latter view.

Institutions can be also defined in terms of certain characteristics they possess (Nabli and Nugent 1989). The first of such characteristics is the nature of the rules and constraints of institutions. The second is their ability to govern the relations among individuals and groups. It was this definition that one authoritative paper emphasized: 'institution is defined as a set of humanly devised rules that govern and shape the interactions of human beings in part by helping them to form expectation of what other peoples will do' (Lin and Nugent 1995:2306-2307). The third is their predictability. That is, agents should expect rules and constraints to have some degree of stability; otherwise, they would not have an institutional character. Accordingly, 'institutions' may be reflected in the appearance of certain behavioral regularities or 'norms' (Lin and Nugent 1995:2307).

Some authors (e.g. Clague 1998:18) distinguish between different categories of institutions. These are (1) the constitutional order (which is stable in industrialized and in surviving communist countries and very unstable in Africa), (2) the institutional arrangements (which is widely discussed in the literature including this one), and (3) the cultural endowments (which change very slowly and are little discussed in the institutionalist literature, except in economic anthropology).

From the above, we can conclude that the literature suggests that, at present, there is no universal definition of 'institution'; it depends on the type of discipline to which an author belongs and on the purpose of the study. Accordingly, for this review, we adopt the definition provided by Nabli and Nugent (1989). The essence of this definition is that it takes 'institution' as a 'set of constraints which governs the behavioral relations among individuals or groups.' Accordingly, both formal and informal organizations are institutions because they embody rules that govern the behavior of individuals or groups. Moreover, 'cultural rules and codes of conduct are institutions' in so far as they can constrain the interactions between individuals and/or groups.

### **3. LIMITATIONS OF MAINSTREAM ECONOMICS**

The *raison d'être* of institutional economics emanates from the shortcomings of mainstream neoclassical economics. According to a leading advocate of the NIE (Eggertsson 1990: 4-5), there are at least three areas of inquiry that until recently have been largely neglected by economists of the neoclassical school. These are:

1. How do alternative sets of social rules (property rights) and economic organizations affect behavioral allocation of resources, and equilibrium outcome?
2. Why does the form of economic organization differ from one type of economic activity to another, even within the same legal framework? In general, what is the economic logic of various contractual agreements, such as the firm, that is used for organizing production and exchange?
3. What is the economic logic behind the fundamental social and political rules that govern production and exchange, and how do these rules change?

These and similar areas of inquiry are largely neglected by adherents of neoclassical economic theory because institutions are assumed away in this theory (see Table 2). That is, institutions are considered as given in conventional economic theory. In this theory, the 'institutional framework has almost invariably been taken as given, and in many cases has been even altogether omitted' (Nabli and Nugent 1989:9). Because it neglects institutions, 'neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development' (North 1996:342-43). Mainstream economists tend to leave the analysis of institutional constraints and opportunities to non-economists, like anthropologists, sociologists, historians, etc.

The shortcomings of mainstream economics are not limited to the neglect of institutional analysis. Time<sup>\*</sup> is another factor that is largely neglected by this theory. The implication of this point is that history is not a subject matter of neoclassical economics. But to appreciate the continuity of society's institutions and learn from the past, economists need the knowledge of history as noted by Douglas North (1990:7).

History matters. It matters not just because we can learn from the past, but because the present and the future are connected to the past by the continuity of society's institutions. Today's and tomorrow's choices are shaped by the past. And the past can only be made intelligible as a story of institutional evolution. Integrating institutions into economic theory and economic history is an essential step in improving that theory and history.

Moreover, conventional economic analysis grossly underestimates the role of institutional uncertainty in determining economic decision making, in particular, in developing economies as demonstrated by the case of Latin America (Borner *et al.*,

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<sup>\*</sup> Marshal is one important exception.

1992). Institutional uncertainty, defined as 'risk arising from a highly volatile institutional environment' (Borner *et al.*, 1992:17), means that there are no clear and irrevocable rules of the game. This reflects the permanent danger of expropriation or limitation of property rights. Insecure access to land provides a good example of institutional uncertainty (Dejene 1999). Other examples of such type of risks include unpredictable judiciary, discontinuities in the legal system, unstable tax systems, volatile macroeconomic variables (e.g. unpredictable exchange rates), insatiable administration, civil conflict, etc.

Table 2. Selected Critique of Mainstream Economics

Author	Critique
Hodgson (1988)	Before 'economic man' can choose and act, he must be fed, clothed, rested and be healthy. The choosing, acting agent of the textbooks has basic needs that must be satisfied before he can calculate, bargain and choose in the manner in which he or she is supposed (p.249).
Nabli & Nugent (1989)	In mainstream neoclassical economics, four main types of constraints have received considerable attention: individual preferences, technological opportunities, physical and human capital endowments and market opportunities. In such analysis, the institutional framework has almost invariably been taken as given, and in many cases has been even altogether omitted. The consequence of taking the institutional framework as given has been to leave the analyses of institutional constraints to non-economists... The explicit or implicit assumption of a given institution is, of course, especially unrealistic and limiting in the context of economic development, a process whereby institutions generally undergo substantial changes. The good of the NIE is to overcome these important limitations of mainstream neoclassical economics (p.9).
Solo (1989)	Neoclassical economics is a theory of individualized choice. It rests on and cannot do without the assumption of the self-seeking, self-optimizing choice of autonomous individuals. No doubt, such choice exists and can count for observed behavior in important sectors of the economy. But also there are decisions that are a function not of such individualistic choice, but that emanate rather through the policy-making processes of large, complex organizations (p.268).
Borner <i>et al.</i> (1992)	Traditional neoclassical growth theory is... not the appropriate framework (to explain the central forces of development for all countries), because it defines away many important determinants of growth by assuming the existence of the very institutions that are necessary preconditions for efficient markets (p.10).
North (1996)	Neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with the operation of market not with how markets develop. How can one prescribe policies when one doesn't understand how economies develop? The very methods employed by neoclassical economists have dictated the subject matter and militated against such a development. The theory, in its pristine form gave its mathematical precision and elegance, modeled a frictionless and static world. In the analysis of economic performance through time, it contained two erroneous assumptions: first, that institutions do not matter, second, that time does not matter (pp.342-43).

The condition of pure competition is taken as the core and essence of economic reality, although the neoclassical approach admits certain variants like the theories of monopoly, oligopoly or imperfect or monopolistic competition. More modern textbooks do treat recent variants like modeling with incomplete information (e.g. see Kreps 1990; Pindyck and Rubinfeld 1994). In fact, some of the recent concepts of the mainstream theory are capable of explaining aspects of development. For example, Winiecki (1996) used the theory of agency (adverse selection and moral hazard) to explain the inability of rulers in the former Soviet states to radically reform their economies. Similarly, researchers have used the concept of contractual choice to investigate contract enforcement problems in developing economies (e.g. see Manard 1998; Matoussi and Nugent 1989).

#### **4. THE MEANING AND IMPORTANCE OF THE NEW INSTITUTIONAL ECONOMICS**

The need to redress the shortcomings of neo-classical economics led to a new school of thought in economics namely: the school of institutional economics, which dates its origin back to the turn of this century when Thorestein Veblen undertook pioneering studies of issues relating to institutions.

##### **'Old' and 'New' Institutional Economics**

Two major traditions of institutionalist economics can be identified. The first is the American institutionalist tradition that began at the turn of the century and has continued to this day. This tradition, termed as 'old' institutional economics (by adherents of the 'new' institutional economics), has included the works of Thorstein Veblen, Westley Mitchell, John R. Commons, Clarence Ayres, Allan Gruchy, Marc Tool, Warren Samuels, and many others.

The second strand of institutionalist thought in economics is of relatively recent origin. It is termed as the 'new' institutional economics (by its followers). It is found in the works of writers like Ronald Coase, Douglas North, and Oliver Williamson. What is 'new' about the NIE is that 'there is an older school of institutionalism in economics' (Harriss *et al.*, 1995:4).

What are the differences between the 'old' and 'new' strands in the institutionalist tradition? It is beyond the scope of this study to dwell upon the vast studies dealing with this question (e.g. see Rutherford 1994). Here we would like to state that the NIE is a line of investigation that departs from but does not abandon neoclassical economics. In the words of Douglas North (1978) 'to abandon neoclassical theory is to abandon economics as a science.' The NIE attempts to save neoclassical economics by incorporating institutions into its analysis. Its critique of mainstream economics is largely a positive one. Thus, according to North (1995:17):

The new institutional economics is an attempt to incorporate a theory of institutions into economics. However, in contrast to the many earlier attempts to overturn or replace neoclassical theory, the new institutional economics builds on, modifies and extends neoclassical theory to permit it to come to grips and deal with an entire range of issues heretofore beyond its ken. What it retains and builds on is the fundamental assumption of scarcity and hence competition: the basis of the choice of theoretic approach that underlies microeconomics. What it abandons is instrumental rationality; the assumption of neoclassical economics that has made it an institution-free theory.

On the other hand, 'old' institutional economics, the purpose of which is critical inquiry and problem solving, departs radically from mainstream economics. Its areas of concern are: (1) pervasive concern with role and significance of conflict, coercion and power in economic and social life; (2) a rejection of price or market values as viewed by neoclassical economists; (3) a persistent interest in instability as opposed to equilibrium conditions; (4) a continuous preoccupation with externality or with social costs and benefits; (5) an early and systematic recognition of the central role of science and technology in economic and social life of society; and (6) a commitment to a critical analysis of the quality of individual and social life with a view to realizing a peaceful, democratic and prosperous society (Kapp 1988:99-100).

The methodology of 'old' institutional economics is quite different from that of mainstream economics. The former has always been concerned with the discovery and presentation of facts, depending heavily on statistics. For 'old' institutional economists 'all economic laws rest upon facts, not assumptions' (Witte 1988:32). These facts are not restricted to the domain of economic life only.

In arriving at conclusions 'old' institutional economists have generally relied upon inductive method rather than the deductive one, which is common with mainstream economics. They have 'relied far more on direct observation than model building and have not been content to make economics an exercise in logic' (Witte 1988:32). However, 'simply to identify institutionalism with empiricism is a mistake' (Ayres 1988:17). On the other hand, adherents of NIE view 'old' institutional economics 'as descriptive, holistic and behaviorist' (Harris *et al.*, 1995:5).

Old institutional economics, sometimes known as the 'historical school', is often criticized by its opponents for lack of a theory that would guide empirical investigations as succinctly put by Langlois (1986:5), an ardent follower of the NIE:

The problem with the historical school and many of the early institutionalists is that they wanted an economics with institutions but without theory; the problem with many neoclassicists is that they want economic theory without institutions; what we should really want is both institutions and theory (not only pure economic theory informed by the existence of specific institutions but also an economic theory of institutions).

According to Nabli and Nugent (1989:10), the two schools share a strong criticism of neoclassical economics for (1) its lack of attention to institutions and hence also non-

budgetary constraints, (2) its overemphasis on the rationality of the individual in decision-making, (3) its excessive concentration on equilibrium and statics as opposed to disequilibrium and dynamics and (4) its denial that preferences can change or that behavior is repetitive or habitual. Moreover, 'institutionalists (old and new) are concerned with the determinants of change over time' (Harris *et al.*, 1995:5).

### **Different Themes in NIE**

Leaving further details of 'old' institutional economics to the literature (Rutherford 1994; Hodgson 1988; Samuels 1988; Kapp 1988; Mayhew 1994; Witte 1988; Ayres 1988; Moller 1988), we will elaborate NIE, the subject matter of this study. In other words, we will attempt to briefly review the main issues and hypotheses pertaining to NIE. This will help provide a framework for the applications of the theory as indicated below.

There are different strands (Clague 1997:18-22), themes or approaches in institutional analysis. However, different authors tend to identify different strands. According to Nabli and Nugent (1989), there are two inter-related approaches: 1) the transaction costs and information costs approach and 2) the collective action approach. But Lin and Nugent (1995) drop the 'information cost approach and note that the NIE has two interdependent approaches, namely, the transaction costs approach (which analyses the demand for institutional innovations) and the collective action approach (which analyses the supply of institutional arrangements). The former contains different but interrelated themes. One such theme is concerned with the role of transaction costs (defined as costs of finding what the relevant prices are, of negotiating and concluding contracts, and of monitoring and enforcing them) in economic organization. The general hypotheses are that institutions are transaction cost-minimizing arrangements, which may change and evolve with changes in the nature and sources of transaction costs and the means for minimizing them. Thus, Lin and Nugent (1995) underline that the most basic function of institutions 'is to economize'.

Property rights (defined as an actor's rights, which are recognized and enforced by other members of society, to use and control valuable resources (Libecap 1996:31)), is a theme related to transaction costs theory. Well-defined and properly enforced property rights may reduce conflicts and facilitate co-operation thus resulting in a reduction in transaction costs. In this way, along with technology and other traditional constraints, institutional constraints enter into the decision process of individuals. In the presence of transaction costs, different systems of property rights yield solutions of differing efficiency. What is efficient in the presence of transaction costs may be quite different from that which is efficient in the traditional neoclassical economics without transaction costs.

Another theme, which is closely related to transaction costs, but which originated outside the institutionalist tradition, is concerned with incomplete information and asymmetries of information in particular. The problems of 'adverse selection' and 'moral hazards', which were first identified in the context of insurance markets, have been found to be relevant for a large class of problems where asymmetries of information are present between the parties to a contract. These problems, moreover, may lead to 'market failure' unless incentive mechanisms capable of overcoming them, such as appropriate forms of contract, are developed.

Collective action is defined as 'the conditions under which groups of people with a common interest will perceive that interest and act to achieve it' (Clague 1997:21). It is also concerned with the elimination of 'the free-rider problem.' The key issue in the collective action literature is to 'explain collective outcomes in terms of individual motivation', or, to put it differently, to explain the likelihood of success or failure of a given set of self-interested individuals in undertaking actions that may benefit them collectively. The theory of collective action has been concerned with public or collective goods or with common property resources (Nabli and Nugent 1989). For practical purposes it is useful to distinguish between three major themes within the NIE. These are the transaction costs, property rights, and collective action approaches.

### The Importance of the NIE

Institutions do structure economic forces and play an important role in expanding human choice—a fundamental goal of economic development. Institutions affect choice by influencing availability of information and resource, by shaping incentives, and by establishing the basic rules of social transactions. Institutional innovations contribute to development by providing more efficient ways of organizing economic activity (Ostrom *et al.*, 1989). In the words of Douglas North (1992), 'Institutions and the way they evolve shape economic performance.' According to Burki and Perry (1998:143) 'Well-defined institutions reduce transaction costs by ameliorating information and enforcement problems. Thus, they make possible the existence, efficiency, and depth of markets and organizations.'

The subject matter of the NIE is much wider than that of standard neoclassical economics (but narrower than that of 'old' institutional economics). Politics is relevant to economic growth and development because transaction is not costless. The NIE incorporates ideologies, ideas and politics into economic analysis without rejecting some of the fundamental postulates of standard neoclassical economic theory. In the words of Douglas North (1995:19):

[The NIE] extends economic theory by incorporating ideas and ideologies into the analysis, modeling the political process as a critical factor in the performance of economies, as the source of the diverse performance of economies, and as the explanation for 'inefficient' markets.

The basic assumptions of the NIE include the assumption of a situation of bounded rationality and the assumption that knowledge is very costly to obtain. Since decision-makers do not have perfect knowledge, opportunism (i.e. self-interest with guile) can and often exist (Acheson 1994:7).

Where does the importance of the NIE lie? According to Harriss *et al.* (1995), the NIE is important for perhaps three reasons. First, it is an emerging body of theory, which starts out within the framework of neoclassical economics, 'but offers answers to what have otherwise remained as puzzles in neoclassical theory.' Second, it is important in the context of structural adjustment policies of the 1980s and 1990s because it 'has challenged the dominant role ascribed to the market by the orthodoxy' of these decades'. Third, it attempts to offer 'a grand theory of social and economic change' at the very time when grand theories in the social sciences have generally been on the retreat.

Moreover, the NIE is a school of thought that has the potential for bridging the gap between economics and neighboring subjects like political science, history, sociology and anthropology. This is because these disciplines share institutional analysis with reformed economics, i.e. institutional economics. According to Harriss *et al.* (1995:1) NIE is 'a body of economic theory which ascribes an important role to ideas and ideologies, and one which is accessible to other social scientists, seeming to open up the terrain of genuinely inter-disciplinary inquiry.'

According to the followers of the NIE, institutions play the following roles in economic activities (Harriss *et al.*, 1995:3): (1) institutions are broadly conceived as a means for reducing information and transaction costs (for details see North 1992); (2) institutions are formed to reduce uncertainty in human exchange (e.g. see North 1995); (3) institutional analysis enables us to understand that individuals make choices on the basis of their 'mental models', (for details see North 1990; 1995); and (4) institutions provide the mechanism whereby rational individuals can transcend social dilemmas, where 'social dilemmas' refer to those kind of problems which arise when choices made by rational individuals yield outcomes that are socially irrational (Bates 1995). In short, the literature suggests that the NIE will improve our understanding of the development process (e.g. see (Harriss *et al.*, 1995)).

### **Limitations of the NIE**

The NIE does suffer from certain shortcomings. First, there has been no consensus regarding the meaning of 'institutions', as explained above. Second, the NIE is at its formative stage and, so far, it has no full-fledged theory or body of thoughts of its own. According to Acheson (1994:6), the NIE 'is moving so rapidly that no commonly agreed on set of principles has emerged.' Further, he argues, the NIE refers to 'the work of a loose collection of economists and political scientists interested in the generation of institutions from the behavior of individuals, and the ways in which these institutions influence the level of productive activity and exchange.' One

observer notes that 'the NIE is not yet capable of generating universal set of hypotheses concerning institutional changes...A theory in which anything is possible is a theory in which outcomes can't be predicted' (Herrick 1989:435). Similarly, Toye (1995:64) notes that, in some respects, 'the NIE is another example of the unfortunate tendency of some theorists to inflate a useful low-level theory until it becomes an unsuccessful global-historical generalization.' Toye, goes further and asserts that 'the main weakness of the NIE as a grand theory of socio-economic development is that it is empty.' Anthropologists and sociologists, who argue that the assumptions of the NIE are often unrealistic, provide further critiques of the NIE (e.g. see Acheson 1994:23-26).

But, does that mean the NIE should be rejected with respect to problems of development? No. Even Toye himself admits that 'the NIE represents an important breakthrough for development theory.' This is so not only because 'the NIE has brought about a major shift in the terms of the discourse about development' (that is, what Toye calls the 'linguistic argument'), but also the NIE makes a substantive contribution to the development discourse by providing 'exploration of opportunism' (rationally self-interested behavior in conditions of strategic interaction of decision-making, deficiency of information and uncertainty). According to Toye, the exploration of opportunism will have far-reaching consequences beyond the realm of game theory to which it has traditionally confined. But, to successfully go beyond the realm of game theory and elegant models and understand the real causes and nature of economic crises in Africa, economists need to learn more about related disciplines like history, anthropology, sociology, political science, etc. An understanding of the relevant aspects of these disciplines will help the economist appreciate the role of non-price variables in shaping human behaviour and determining patterns of resource allocation. For example, a knowledge of history enables us understand how the present is related to the past. This is what Douglas North calls 'path dependence' in institutional changes over time.

## **5. APPLICATIONS OF THE NEW INSTITUTIONAL ECONOMICS TO THE PROBLEMS OF DEVELOPMENT**

The NIE appears to be particularly relevant to the study of developing economies in general, and Africa, in particular, where non-market institutions and market failure (plus state failure) has been of particular importance.

Two of the major books of readings on the application of institutionalism to developing economies (Nabli and Nugent 1989 and Harriss *et al.*, 1995) have demonstrated the usefulness of this approach as an alternative to conventional models. Nabli and Nugent (1989:439) commented in the concluding part of their work that the NIE has almost adequately explained the Tunisian cases but both the framework and its application have to be modified to better suit developing countries.

Similarly, the authors of the other book (Harriss *et al.*, 1995:13) made the following observation:

The NIE is a significant theoretical contribution to development studies and confirms the vitality of the substantive study of history for analysts and policy-makers concerned with institutional change in the Third World. It is not, however, the philosopher's stone.

The relevance of NIE to development problems has been underlined by other scholars. Robert Bates (1995:35) noted that the 'new institutionalism now also plays (and will continue to play) a major role in the study of development.' Douglas North, an economic historian, argues that the process of economic development involves replacing inefficient institutions with institutions that promote growth. He further notes that institutions that reduce transaction costs are characteristics of advanced societies while inefficient institutions are characteristics of less developed economies. Regarding the latter case, in particular, he notes:

Opportunities for political and economic entrepreneurs are still mixed bag, but they overwhelmingly favor activities that promote redistributive rather than productive activity, that create monopoly rather than competitive conditions, and that restrict opportunities rather than expand them. They seldom induce investment in education that increases productivity (North 1990:9) (emphases, added).

In a remarkable statement, North (1995:21) emphatically argues that whether an organization (e.g. the state in Africa) has an incentive for promoting economic growth or selfish interest, at the expense of others, depends on the type of the prevailing institutional framework:

If the institutional framework made the highest pay-offs for organization's piracy, then organizational success and survival dictated that learning would take the form of being better pirates. If on the other hand, productivity-raising activities had the highest profits, then the economy would grow.

New institutional economics makes a radical departure from conventional theories of development in, at least, one important respect: it attempts to provide some clues as to how to get the economy moving in crisis-ridden or 'ailing economies.' In this light North provides three related propositions. First, he argues that privatization is not a panacea for solving poor economic performance as long as the informal norms and the enforcement characteristics of a country remain inefficient. Second, 'the heart of development policy must be the creation of policies that will create and enforce efficient property rights.' Third, 'adaptive efficiency' (i.e. flexibility) rather than price (allocative) efficiency should be the guide to policy. That is, a government should be capable of making adjustment in the context of evolving technological and demographic change as well as shocks of the system. More concretely, North (1995:23) notes that 'getting prices right only has the desired consequences when

agents already have in place a set of property rights and enforcement that will then produce the competitive market conditions.'

Moreover, North underlines that institutions that have succeeded to transform Western economies may not necessarily work in the context of developing economies such as that of Africa. In his words:

Transferring the formal political and economic rules of successful Western market economies to Third World and East European economies is not a sufficient condition for good economic performance. Privatization is not a panacea for solving poor economic performance (North 1995:25).

The literature on the applications of the NIE is thin<sup>2</sup>. For example, Alston and others (1996:1) note that 'the field (NIE) is long on theoretical analysis but short on empirical work.' Standard empirical analysis is limited to few works (e.g. Alston *et al.*, 1996). Similarly, Shirley (1997) observe that the field of applied institutional economics 'is relatively underdeveloped.'

Given this limitation, we will attempt to undertake a survey of the applications of the NIE to the problems of development. Following a review of themes in the NIE (see above), we classify the applied literature into four broad categories, namely (1) the NIE in general (Table 3), (2) transaction costs theory (Table 4), (3) property rights theory (Table 5), and (4) collective action theory (Table 6).

Some authors apply the NIE to the problems of development without necessarily providing specific thematic framework like transaction costs theory or property rights theory. In other words, in defining their frameworks, they use the NIE in general instead of focusing on a particular theme or approach.

The NIE, in general, has been applied to different types of problems of development (Table 3). For example, Feige (1990) elaborates the taxonomy of underground economies in developing countries using the general theory of the NIE and shows the relevance of the NIE to the analysis of the unofficial economy. Similarly, Kalmonovitz (1997) investigates how institutions influence the pace of economic development in a Latin American country, Colombia. He suggests that the justice system of a country influences the behaviour of economic agents. Handoussa (1995) considers redefinition of the role of the state in a developing country (Egypt) undergoing liberalization and structural adjustment. His study suggests, among other things, that the incomplete nature of legislative reforms and deregulation have obstructed competition and raised transaction costs thus retarding the pace of economic growth. Further, Sullivan (1997) attempts to show the linkages between the NIE and business sector development. He concludes that, among other things, trust and a shared understanding are of central importance in improving the business climate in developing countries. Leitmann and Baharougu (1998) use the NIE approach to examine the formal frameworks for infrastructure provision in Turkey's

Table 3. Selected Applications of the NIE, in General, to Development Problems

Study	Economy	Area of investigation	Central argument/major findings
Feige (1990)	Developing countries	Underground economies	Taxonomy of underground economies is elaborated based on the new institutional approach to economic development. The paper distinguishes illegal, unreported, unrecorded and informal economies and examines the conceptual and empirical linkages among them. Shows the relevance of the new institutional approach to the analysis of the Unofficial economy.
Feeny (1993)	Developed and developing countries	Economic history	Undertakes a nice survey of the application of the institutional approach to developing countries and to the economic history of the now developed countries. The survey has demonstrated the relevance of institutional economics to the conditions of developing countries.
Acheson (1994)	Rural economies of developing countries	Anthropology	Provides a survey of anthropological applications of the NIE to the conditions of rural societies. Important findings have emerged from the literature surveyed therein.
Clarence-Smith (1995)	Cocoa growing countries 1870s-1914	Efficiency of institutions	Shows that institutions are not usually set up to be socially or economically efficient and that they reflect the bargaining power of social and political actors, and that predominant cultural forms tend to maintain 'institutional path dependence.' Reinforce the argument that the state is a representative of the dominant interest groups within a society.
Handoussa (1995)	Egypt	Role of the state in economic development	Considers the redefinition of the role of the state in a developing country undergoing liberalization and structural adjustment. Shows, among other things, how the incomplete nature of legislative reform and deregulation and decentralization have obstructed competition, raised transaction costs and retarded economic growth.
Adams & Scaperlanda (1996)	Global	International economic issues	Examines international economic issues within the framework of Institutional Economics.
North & Weingast (1996)	Seventeenth century England	Economic growth	Provides account of the successful evolution of institutional forms that permitted economic growth to take place in early modern England. Shows that, in an economy where entrepreneurship is decentralized, economic actors will hold back on long-term investment unless the state make credible commitments to honor its contracts and respect individual ownership rights.
Kalmanovitz (1997)	Colombia	Determinants of economic development	Investigates how institutions influence the pace of economic development. shows how the justice system of a country influence the behaviour of economic agents.
Sullivan (1997)	Developing countries	Business sector development	Attempts to show the linkages between the new institutional economics and business sector development. Shows, among other things, that trust and a shared understanding are all of central importance in improving the business climate in developing countries.
Leitmann & Baharouglu (1998)	Turkey	Infrastructure	Reports on research that used the NIE approach to examine the formal frameworks for infrastructure provision in Turkey's spontaneous settlements. A key finding of the study was that formal rules are irrelevant and that, in the absence of formal rules, pressure arise that help to develop informal rules, which then result in certain behavioral pattern.

spontaneous settlements. A key finding of the study was that formal rules are, in some cases, irrelevant and that in the absence of formal rules, pressure arise that help to develop informal rules, which then result in certain behavioral pattern. Feeny (1993) undertakes a survey of the applications of the institutional approach to developing countries and to the economic history of the now developed countries. Clarence-Smith (1995), using evidence from cocoa-growing countries between 1870s and 1914, tests the hypothesis that institutions are not usually set up to be socially or economically efficient and that they reflect the bargaining power of social and political actors. This study reinforces the argument that the state is a representative of the dominant interest groups within a society. Adams and Scaperlands (1996) examine international economic issues within the framework of Institutional Economics and show the relevance of this theory to global economic relations. North and Weingast (1996), using the institutionalist approach, provide account of the successful evolution of institutional forms that permitted economic growth to take place in early modern England. The study shows that, in an economy where entrepreneurship is decentralized, economic actors will hold back on long-term investment unless the state make credible commitments to honour its contracts and respect individual ownership rights.

**The transaction costs theory**, is, perhaps, the most widely applied theme within the new institutionalist approach. This theme has been used by adherents of the NIE and by other as well. Table 4 presents selected literature on the applications of the transaction costs approach.

The transaction costs theory has proved to be a powerful tool in the analysis of various aspects of development problems. Wiesner (1997) attempts to link transaction costs with externalities and with rent-seeking behavior in developing countries, with particular reference to Colombia. The study underlines the relevance of rent seeking behaviour of economic actors in the analysis of development problems. Datta and Nugent (1989) provide a unifying transaction cost framework for explaining choices among different forms of contract in developed and developing countries, while Azabou *et al.*, (1989) describe and then analyze, from the perspectives of transaction cost theory, contractual forms employed in all segments of Tunisia's fishing industry. The latter study suggests that trends toward more capital intensive fishing would be accompanied by a switch from share contracts to wage contracts. Azabou and Nugent (1989) analyse tax farming arrangements in Tunisia, using the transaction cost approach. This approach convincingly explain why some seemingly anachronistic arrangements persist over time. Nabli *et al.*, (1989) apply the transaction costs framework to ownership form choices in Tunisian manufacturing industry and reveal the existence of opportunistic behavior such as tax evasion, quality-shirking, adverse selection other than those which have been considered in the existing applied literature. They show that transaction costs are capable of explaining the size and ownership form choices of private firms in various sectors of the Tunisian manufacturing industry. Using the transaction costs approach, Matoussi and Nugent (1989) convincingly explain why economic agents in certain

Table 4. Selected Applications of Transaction Costs Theory

Study	Economy	Area of Investigation	Central argument/major findings
Datta & Nugent (1989)	Developed and developing economies	Choice of contract	Provides a unifying transaction cost framework for explaining choices among different forms of contract. The study suggests that the theory of transaction costs can go a long way toward explaining choices among contracts and other institutional forms.
Azabou <i>et al.</i> (1989)	Tunisia	Fishing	The contractual forms employed in all segments of Tunisia's fishing industry are described and then analyzed from the perspective of transaction costs theory. The theory predicts that trends toward more capital intensive fishing would be accompanied by a switch from share contracts to wage contracts.
Azabou & Nugent (1988)	Tunisia	Taxation	The authors highlight the time periods in which fixed rent contracts known as tax farming were dominant in Tunisia as well as elsewhere. They then go on to explain how and why this seemingly anachronistic form of contract continues to dominate in one specific sector, namely the taxation of Tunisia's weekly markets. The explanation hinges on the extremely high transaction costs and risk-aversion on the part of the local governments to whom the tax receipts accrue.
Nabli <i>et al.</i> (1989)	Tunisia	Manufacturing industry	The authors application of the transaction costs framework to ownership form choices in Tunisian manufacturing industry reveals the need to consider forms of opportunistic behavior, such as tax evasion, quality-shirking, adverse selection, other than those which have been considered in the existing applied literature. Transaction costs are capable of explaining the size and ownership form choices of private firms in various sectors of Tunisian manufacturing.
Greenhill (1995)	Brazil	Role of the state in economic development	Undertakes a case study of state intervention in the Brazilian coffee before 1929, a policy intended to improve the coffee planter's market conditions. Shows that institutions improve efficiency by reducing uncertainty in human exchange but reflect social and political power.
Wiesner (1997)	Colombia	Externalities	Attempts to link transaction costs with externalities and with rent-seeking behavior in developing countries with particular reference to Colombia. The paper suggests that public sector rent seeking and the institutional arrangements that arise from such rent seeking should become the unit of analysis of development theory and practice.
Eleni (1998)	Ethiopia	Grain market	This work examines the consequences of the transaction costs of search on the emergence of the institution of brokerage in the Ethiopian grain market. The results reveal that traders with high costs use more brokerage while traders with high social capital rely on direct search, confirming that brokerage enables traders to minimize transaction costs. It demonstrates that transaction costs influence the emergence of market institutions and the heterogeneity of traders with respect to costs has important implications for the economic incidence of policies to reduce transaction costs.
Matoussi & Nugent (1989)	Tunisia	Sharecropping	Transaction costs theory has successfully explained why economic agent switched from wage and rent contracts to share contracts.

sectors switched from wage and rent contracts to sharecropping contracts. Eleni (1998), in a study of grain markets in Ethiopia, demonstrates that transaction costs influence the emergence of market institutions and the heterogeneity of traders with respect to costs has important implications for the economic incidence of policies to reduce transaction costs. Greenhill (1995), in a study of Brazilian coffee, demonstrates that institutions improve efficiency by reducing uncertainty in exchange arrangements.

**Property rights theory** is another approach that has been widely applied to various aspects of the development process. Selected applications of this approach are presented in Table 5. Clague and others (1997), using the property rights approach, present evidence from cross-country statistical analysis and explain differences in income, growth rates, and rates of investment in developing and developed countries. What emerges from this study is that differences in property rights and contract enforcement mechanisms are important part of the explanation why some countries prosper while others do not. Dejene (1999a) reviews the concept of 'property rights' and alternative forms of resource management regimes and provided evidence from rural Ethiopia. He shows, among other things, how property-rights regimes affect micro-level decisions of economic agents. Cheung (1996), using the property rights approach, analyze the process of regulation in a single market, i.e., rental housing in Hong Kong. This approach was also applied to a highly developed economy, USA, concerning regulations restricting the catch of Salmon (Higgs 1996) and the emergence of a brand-new property rights in response to the influence of a specific type of political organization (Riker and Sened 1996). Higgs suggests that government regulations can create a dynamic process that converges on high-cost outcomes while Riker and Sened (1996) argue that new types of institutional arrangements are often needed to exploit the wealth-enhancing potential of technological change. Libecap's (1996) study suggests that property rights become precisely defined as the value of a resource increases over time. The property right theory is also applied to environmental issues. For example, Berke (1996) demonstrates that there is no clear-cut verdict on the performance of natural resource management systems under different property-rights regimes, except that open-access is not viable in the long-term. In a similar fashion, Ensminger (1996) argues that many top-down approaches to establish private-property regimes for environmental resources have failed not only because they have imposed high transaction costs, but also because they are ill-adapted to the specific cultural context in which they are developed.

Table 5. Selected Applications of Property Rights Theory

Study	Economy	Area of investigation	Central argument/major findings
Cheung (1996)	Hong Kong	Market regulation	Looks at the process of regulation in a single market (rental housing). Using property right theory, showed the unintended side effects of regulation and explored how, in a complex world, actors may respond to regulations with adjustment at various unexpected margins and create outcomes that generate further institutional change.
Higgs (1996)	USA	Fishing	Analyze the causes and consequences of the regulations restricting the catch of salmon in the Pacific Northwest. Shows how government regulations can create a dynamic process that converges on high-cost outcomes.
Riker & Sened (1996)	USA	Role of the state in economic development	Studies the emergence of a brand-new property rights and stressed the relative role of political organizations in their creation. Shows that new types of institutional arrangements are often needed to exploit the wealth-enhancing potential of technological change.
Libecap (1996)	USA	Value of resources	Quantitatively tests the hypotheses that, up to a point, property rights become precisely defined as the value of a resource increase. The paper is concerned with the timing and emergence of particular legal institutions. Describes and quantify the progression of property law from general rules to highly specified statutes and court verdicts.
Clague et al (1997)	Developed and developing countries	Determinants of economic development	Presents evidence from cross-country statistical analysis and explains differences in income, growth rates, and rates of investment. Shows that societal differences in property rights and contract enforcement mechanisms are important part of the explanation why some countries prosper while others do not.
Dejene (1999 a)	Ethiopia	Land question	Reviews the concept of 'property rights' and alternative forms of resource management regimes and provides evidence from rural Ethiopia. Explains how property rights regimes affect micro-level decisions of farm households.
Berkes (1996)	Developed & developing countries	Ecological systems	Argues that the focus on property rights expands the scope of ecological economics to consider a three-way linkage incorporating social, institutional, and cultural dimensions. Demonstrates that there is no clear-cut verdict on the performance of natural resources systems under different property-rights regimes, solution. Needed are combinations of property-rights regimes and a diversity of property rights institutions that can be adapted for specific circumstances.
Ensminger (1996)	Africa	Culture & property rights	Illustrates the relationship between culture and property rights in the context of attempts by African governments to change property rights in land. Many top-down approaches to establish private-property regimes for environmental resources have failed not only because they have imposed high transaction costs, but also because they are ill-adapted to the specific cultural context in which they are developed.

**The theory of collective action** is rarely applied to problems of development. Perhaps, the only major applications of the theory are found with reference to the Tunisian economy (see Table 6). With reference to Tunisia, Bsaies (1989) provide an institutional explanation for the failure of the country to introduce modern education during the nineteenth and twentieth centuries. Nugent (1989) identifies and explained variations on the theme of Olson (1964) with reference to producer organizations. The author explains not only the relatively late appearance and overall weakness of producer organization in Tunisia but also the observed variations in their relative strength from one group to another over time. Azabou *et al.*, (1989) analyses the degeneration in the wholesale market of Tunis and the role of porters' union in that process. The theory has explained the relative strength of the porters' union vis-à-vis the other relevant groups and the union's choice of instruments for collective action. Bechri (1989) analyses the functioning of the credit market in general and interest rate determination, in particular. Grissa (1989), using Olson's interest group theory explains the determinants of both the level and the structure of interest rates in Tunisia. Brett (1995), using evidence from Uganda, argues that progressive change is not random, but a response to a widespread willingness among people to set aside self-interest and demonstrate high levels of altruism where they can be made to recognize the need for and possibilities of collective action. This finding obviously contradicts one of the basic assumptions of orthodox neoclassical economics i.e. maximization of self-interested individuals. Ostrom (1990) explores whether and how common-pool resources can be organized in a way that avoids both excessive consumption and administrative cost. She questions the argument that the problem of over-consumption is solved by privatization or enforcement imposed by outside force (government). The author argues forcefully that other solutions exist and that stable institution, of self-government can be created if certain problems of supply, credibility, and monitoring are solved. Using a revised version theory of collective action Dejene (1999) explores possibilities for explaining problems of economic integration in Africa. He demonstrates that institutional factors, more specifically failure of collective action, can explain the unsatisfactory performance of regional integration schemes in Africa. Ostrom *et al.*, (1994) explore empirically, theoretically and experimentally the nature of institutions that are developed to protect against overexploitation of resources. They question the notion of 'the tragedy of the commons' and demonstrate that the users of commonly held resources have in many instances overcome incentives to destroy resources and have developed long-enduring institutions that enabled them to utilize these resources more effectively. Wade (1988) shows how a common property resource system in India was managed entirely outside the formal governance system and how collective action was sustained by paying regular bribes to regional and national officials.

Table 6. Selected Applications of Collective Action Theory

Study	Economy	Area of investigation	Central argument/major findings
Wade (1988)	India	The management of common-pool resources (CPR)	Shows how a CPR system in India was managed entirely outside the formal governance system of India and how collective action was sustained by paying regular bribes to regional and national officials.
Bsaies (1989)	Tunisia	Education	<i>Provides an institutional explanation for the failure to introduce modern secular education in Tunisia during the 19<sup>th</sup> and early 20<sup>th</sup> centuries.</i>
Nugent (1989)	Tunisia	Cooperatives	<i>Identifies and explains variations on the Olsonian theme with reference to producers organizations. The author explains not only the relatively late appearance and overall weakness of producer organization in Tunisia but also the observed variations in their relative strength from one group to another over time.</i>
Azabou et al (1989)	Tunisia	Labor union	<i>Analyses the degeneration in the wholesale market of Tunis and the role of porters' union in that process. The theory has explained the relative strength of the porters' union vis-à-vis the other relevant groups and the union's choice of instruments for collective action.</i>
Bochri (1989)	Tunisia	Credit market action	Analyses the functioning of the credit market in general and interest rate determination in particular. Using Olson's interest group theory explained the determinants of both the level and the structure of interest rates in Tunisia.
Grissa (1989)	Tunisia	State enterprises	Using the theory of collective action, explains the evolution and performance of Tunisia's state enterprises.
Ostrom (1990)	Developed & developing countries	Management of common-pool resources	Explores whether and how common-pool resources can be organized in a way that avoids both excessive consumption and administrative cost. Questions the argument that the problem of over-consumption is solved by privatization or enforcement imposed by outside force (government). The author argues forcefully that other solutions exist and that stable institutions of self-government can be created if certain problems of supply, credibility, and monitoring are solved.
Ostrom et al (1994)	Developed & developing countries	The management of common- resources	Explores empirically, theoretically, and experimentally the nature of institutions that are developed to protect against overexploitation of CPR. Questions the notion of 'the tragedy of the commons' and demonstrates that the users of commonly held resources have in many instances overcome incentives to destroy the resources and have developed long-enduring institutions that enabled them to utilize these resources more effectively.
Brett (1995)	Uganda	Social problems	Argues that progressive change is not random, but a response to a widespread willingness among people to set aside self-interest and demonstrate high levels of altruism where they can be made to recognize the need for and possibilities of collective solution to problems of social breakdown through institutional reform.
Dejene (1999)	Africa	Regional economic communities	Explores possibilities for explaining problems of economic integration in Africa using a revised version theory of collective action. Demonstrates that institutional factors more specifically failure of collective action can explain the unsatisfactory performance of regional integration schemes in Africa.

In addition to the above, there are also cases where several strands within the NIE are combined for use as a framework for the analyses of development problems. For example, Bentancourt (1991), using the transaction costs theory, property rights, and public choice approach, examine the economic function of an institution in Cuba. Similarly, Stone and Paredes (1996) used a combination of transaction costs theory and property rights theory to examine the relationship between law and development in Brazil and Chile.

The above review has covered applications of the NIE to both developing and developed countries. It is evident from the table that a lot remains to be done in terms of coverage of the various economies of Africa. A single country, Tunisia, has received relatively a lot of attention simply because that country was the focus of the first applied work in the area of the NIE and development (Nabli and Nugent 1989).

Authors of the applied work have come from different disciplines such as anthropology, economic history, political science, and of course, economics. This confirms the argument that 'NIE represents the culminating intersection of a number of different lines of investigation, each interesting in its own right' (Nabli and Nugent 1989a: 1333).

Of the major central theoretical concepts or themes in the NIE, transaction costs theory and property rights are found to be the most frequently used ones in the applied works. Collective action theory is less frequently used. The most recent themes e.g. social capital theory (Ostrom 1997) are rarely applied to the problems of developing economies.

A survey of the literature suggests that the NIE has been applied to a wide range of topics or areas including the ownership and management of natural resources (Higgs 1996; Wynne and Lyne 1995; Alston *et al.*, 1996), plantation agriculture (Clarence-Smith 1995), role of the state in economic development (Handoussa 1995; Greenhill 1995; Booth 1995; Winiecki 1996; Riker and Sened 1996; Borner *et al.* 1992); international economic issues (Adams and Scaperlanda *et al.*, 1996), credit market (Floro and Yotopoulos 1991; Bechri 1989), the underground economy (Feige 1990), socialist economies (Bentancourt 1991), contractual choice and enforcement (other than credit) (Menard 1997; Datta and Nugent 1989; Matoussi and Nugent 1989; Azabou *et al.* 1989; Azabou and Nugent 1989), business sector development (Sullivan 1997), manufacturing industry (Nabli *et al.*, 1989), education (Bsaies 1989), co-operatives (Nugent 1989); altruism (Brett 1995); and infrastructure (Leitmann and Baharoughlu 1998). The NIE has the potential to explain areas that were traditionally considered as not being within the purview of mainstream economics (e.g. altruism, polity, and property rights).

### **A Note on Institutional Uncertainty and Investment Decisions in Africa**

The NIE has strong implications for Africa's development as suggested by the above review (e.g. see Handoussa 1995; Nabli and Nugent 1989; Dejene 1999a; 1999b; Brett 1995; Ensminger 1996; Eleni 1998). In particular, the Tunisian case (Nabli and Nugente 1989) has convincingly demonstrated the relevance of the institutionalist approach to the African case.

The relationship between institutional theories and the implementation of structural adjustment policies in Africa is investigated by Stein (1995; 1998), who argues that structural adjustment 'because it is derived from neo-classical economic theory which is basically a-institutional and therefore ill-equipped to promote the development of market institutions in Africa'. He suggests that 'if African governments are interested in economic reform that develops market institutions then they would be best advised to consult the institutionalist literature'.

The institutionalist approach has become so relevant to the African conditions that even the World Bank has in the 1990s, shown keen interest in it. Many of its recent publications (e.g. world Bank 1998a; 1998b) emphasize the importance of institutions in the development process. In fact, some authors (e.g. Jakobeit 1999) argue that the Bank has recently adopted a new approach to Africa's development and that institutionalism is at the center of this approach. Accordingly, in its future policy prescription, the Bank may give more attention to institutional factors such as laws and contract enforcement mechanisms, property rights, corruption problems, administrative capacity, etc.

Institutional uncertainty and investment in Africa is a topic that deserves special attention. Institutional uncertainty (defined as the risks arising from a highly volatile institutional environment i.e., there are no clear and irrevocable rules of the game) could be considered as one of the main factors retarding trade and investment activities in Africa as is the case in Latin America (Borner *et al.*, 1992). Institutional uncertainty assumes different types of risks including unpredictable exchange rate, price instability, inconsistent enforcement of contracts, an unpredictable judiciary, discontinuities in the legal system, corrupt practices, frequent changes of policies and guidelines, instability of local government, etc. At the level of the economic agents, institutional uncertainty manifests itself in two different forms: 1) unpredictability of government intervention and 2) lack of consistent enforcement of private contracts. In Latin America, uncertain rules and shaky enforcement bias the decision of individuals and firms in two ways: 1) a retreat to personal transaction with private enforcement mechanisms and 2) very short time horizons of decisions and strong preferences for present consumption instead of investment. At the root of institutional uncertainty in Latin America, Borner *et al.*, (1992) identify lack of control over the power of the executive because of a malfunctioning system of checks and balances and therefore excessive rent seeking. Rule of law is replaced by the discretionary power of the executive.

Private sector investment can also be deterred by other institutional factors such as lack of well functioning legal system and weak enforcement mechanisms, weakly defined and insecure property rights, underdeveloped capital markets, weak market information systems, rent-seeking behavior of officials (corruption), bureaucratic hurdles, frequent political interference in the private business, and lack of culture of dialogue between government and private sector.

An economist with the World Bank (Serven 1996) concludes that 'uncertainty and instability are important factors behind Africa's poor investment record over the last two decades. Serven notes 'the lack of realism' of some of the assumptions of the conventional investment theory and he underlines the relevance of a new view of investment which is based on the following three assumptions. First, most fixed capital investments are partly or completely irreversible (the initial cost of investment is at least partially sunk). Second, investment decisions have to face uncertainty about their future rewards. Uncertainty can be a powerful deterrent even for risk-neutral investors. Third, investors can control the time of investment, and postpone it in order to acquire more information about the future. Based on these assumptions, Serven constructed new models of investment decisions and presented empirical evidence from different countries.

One conclusion he reached is that, from the view point of investment, the stability and predictability of the incentive framework (relative prices, demand, interest rates, taxes) may be much more important than the level of the incentives themselves. This implies that huge incentive may be necessary to make investors forego the option to wait for more information and commit themselves to irreversible investment projects.

Africa's weak private investment performance is partly explained in terms of institutional uncertainty as formulated by Serven (1996). His conclusion is that, 'institutional reforms protecting property rights and fostering social consensus may be a promising avenue' at a more fundamental level than the policy reforms currently being implemented in Africa.

## 6. CONCLUDING REMARKS

This study has attempted to address conceptual problems pertaining to the term 'institutions', identify factors that led to the emergence of the New Institutional Economics (NIE), define the subject matter of the NIE and underline its importance in economic activities, and review the empirical literature on the applications of the NIE to problems of development.

What emerges from this paper is that the new institutionalism can provide us with important theoretical tools to understand development problems. The three major themes of the NIE, i.e. the transaction cost, property rights, and collective action

theories can more effectively address issues that have remained more or less puzzles when analysed using conventional approaches. The NIE is important because it challenges the dominant role ascribed to the market by the orthodoxies of the last two decades. Moreover, the NIE can, perhaps, bring an end to the isolation of the economist because, in the words of Harriss *et al.*, (1995:1-2), it is 'a body of economic theory which ascribes an important role to ideas and ideologies, and one which is accessible to other social scientists, seeming to open up the terrain of genuinely inter-disciplinary enquiry'.

Further research is required to investigate issues raised in this study concerning the theoretical and practical aspects of the institutionalist approach. It is not yet clear whether the NIE is a full-fledged theory (body of thought) or whether it is something eclectic, i.e. 'the work of a loose collection of economists and political scientists'. As the applied research on Africa is limited, there is a need to undertake more studies on the relevance of the theory to the real conditions of African economies. There is also a need to cover more areas of inquiry such as indigenous institutions and international economic relations.

## NOTES

This point was already noted by Nabli and Nugent (1989a: 1333): 'it would be a monumental task to synthesize it (NIE) in its entirety.' Also, we note that in this study we stick to the term 'the New Institutional Economics', although few writers like Eggertsson (1990) use the term 'neo-institutional economics'.

Here it should be noted that we are not considering standard econometric exercises which purport to have gone institutional (e.g. see Burki and Perry 1998).

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