PN-ABD-963

AGENCY FOR INTERNATIONAL DEVELOPMENT
PPC/CDIE/DI REPORT PROCESSING FORM

ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT

1. Project/Subproject Number

2. Contract/Grant Number
PDC-0092-G-SS-6090

3. Publication Date
10/89

4. Document Title/Translated Title
Rethinking Institutional Analysis and Development: Issues, Alternatives, and Choices (Executive Summary)

5. Author(s) Editors
1. Ostrom, Vincent
2. Feeny, David
3. Picht, Hartmut

6. Contributing Organization(s)
International Center for Economic Growth

7. Pagination
32p.

8. Report Number

9. Sponsoring A.I.D. Office
PPC

10. Abstract (optional - 250 word limit)

11. Subject Keywords (optional)
1.
2.
3.
4.
5.
6.

12. Supplementary Notes
Main document PN-ABD-214

13. Submitting Official
Frieda Martin

14. Telephone Number
415 981 5353

15. Today's Date
10/31/89

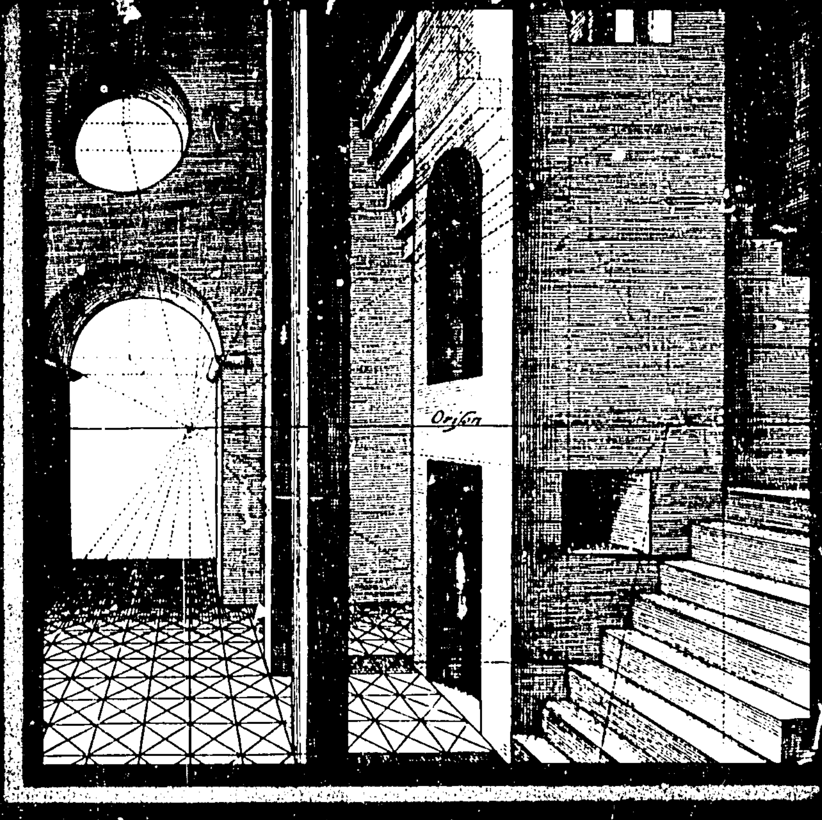
DO NOT write below this line

16. DOCID

17. Document Disposition
DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

INTERNATIONAL CENTER
for
ECONOMIC GROWTH



Issues, Alternatives, and Choices

EXECUTIVE SUMMARY

THE INTERNATIONAL CENTER FOR ECONOMIC GROWTH is a non-profit institute founded in 1985 to stimulate international discussions on economic policy, economic growth, and human development. The Center sponsors research, publications, and conferences in cooperation with an international network of correspondent institutes, which distribute publications of both the Center and other network members to policy audiences around the world. The Center's research and publications program is organized around five series: Sector Studies; Country Studies; Studies in Human Development and Social Welfare; Occasional Papers; and Reprints.

The Center is affiliated with the Institute for Contemporary Studies, and has headquarters in Panama and a home offic in San Francisco, California.

For further information, please contact the International Center for Economic Growth, 243 Kearny Street, San Francisco, California, 94108, USA. Phone (415) 981-5353; FAX: (415) 986-4878.

ICEG Board of Overseers

Executive Summary

RETHINKING INSTITUTIONAL ANALYSIS AND DEVELOPMENT

Issues, Alternatives, and Choices

Edited by
Vincent Ostrom
David Feeny
Hartmut Picht

International Center
for Economic Growth

Affiliated with the
Institute for Contemporary Studies

This is an executive summary of the book *Rethinking Institutional Analysis and Development*, edited by Vincent Ostrom, David Feeny, and Hartmut Picht, published by the International Center for Economic Growth in 1988 and distributed by ICS Press.

Inquiries, book orders, and catalog requests should be addressed to ICS Press, 243 Kearny Street, San Francisco, CA 94108, USA. Phone: (415) 981-5353. FAX: (415) 986-4878.

Distributed to the trade by Kampmann National Book Network, Lanham, Maryland.

ISBN 1-55815-050-1

Library of Congress Cataloging-in-Publication Data available

Preface

This study challenges traditional economic thinking, which has explained economic growth in terms of resources, technologies, and human preferences. Noting that economists have not been able to fully account for economic growth, the editors, Vincent Ostrom, David Feeny, and Hartmut Picht, argue that a fourth component—institutions—is the critical missing link. As the thirteen authors demonstrate, the influence of institutions is considerable: establishing the basic rules governing all public and private actions from individual property rights to the ways in which communities deal with public goods, and affecting distribution of income, efficiency of resource allocation, and the development of human resources.

A strong and thought-provoking case is made for considering the role of institutions in economic development. The editors of the book have collected a series of important papers addressing both a theoretical and a practical dimension of institutional choice. We hope that this volume will stimulate increasing numbers of scholars to delve into these issues.

This is an executive summary of the original book published by ICEG.

Nicolás Ardito-Barletta
General Director
International Center for
Economic Growth

Panama City, Panama
August 1989

Executive Summary

This book reexamines the institutional foundations and political arrangements of developing countries, attempts to demonstrate how the process of public choice can expand or diminish private choice, and contends that in all circumstances the political process will structure private choices through its influence on key economic institutions.

- Institutions structure economic forces and play an important role in expanding human choice—a fundamental goal of economic development. Institutions affect choice by influencing the availability of information and resources, by shaping incentives, and by establishing the basic rules of social transactions. Institutional innovation contributes to development by providing more efficient ways of organizing economic activity.

- An important distinction is made between market institutions for exchange of goods and services and political institutions for pursuit of common interests. Political development, the growth of democracy, and self-government come not from wealth, equality, or other empirical conditions, but from the nature of constitutional rules, which encourage free association to solve common problems.

- In clarifying the relationship between participation and development, it is important to note that much development effort fails because it does not provide for local participation. Local (or "traditional") communities have not survived for generations without evolving mechanisms for solving the social and economic problems that commonly confront them, and community organizations are more dynamic than centralized, large-scale hierarchies. There are certain cultural requisites for "group formation," and where these are missing—in ethnically diverse and poorly integrated economies, for example—the most effective organizations are likely to be small ones located at the community level. Many writers have found the erosion of local institutions to be caused by the spread of the market economy. This book, however, finds that a hierarchical constitutional tradition exploited by elites is a more important cause.

Economic institutions—or any other kind of institution—are a form of "public good" that structures exchange; thus the constitutional order also determines the character of the market economy. Regimes designed to maximize political control and rent seeking by the few may greatly inhibit opportunities for institutional innovation by individuals striving to capture personal opportunities for increased efficiencies and growth.

The problem of "getting prices right" to reduce scarcity or to achieve some other objective is not a regulatory issue, but is actually a matter of selecting the appropriate institutions. Market institutions depend on a publicly determined set of rules and rights that have their basis in the bonds and values of the political community.

The key problems facing the developing world today are sustainability and efficiency. Sustainability refers to the inability of developing countries to maintain the investments that have been made. As far as efficiency is concerned, the return on resources invested is unfortunately low in comparison with the needs. The articles in this volume offer various findings useful in approaching these problems.

- Much development effort is misdirected because of misdiagnosis.
- In developing countries the government sector has grown very rapidly in a context of considerable concentration of political power. Consequently, the institutions of representation and control are frequently unable to keep pace with the capacity of political and military elites to dominate economic choices.
- The development goal has been incorrectly stated as one of expanding the private sector, rather than of developing market institutions. A private sector dominated by an autocratic regime is not conducive to free enterprise in a competitive market economy.

9

Rethinking Institutional Analysis and Development

Only recently have we begun to understand in any systematic way how economic forces interact with the institutional and political arrangements at work in any society. This study is concerned with how those institutional and political arrangements affect economic development.

We had previously acquired a growing appreciation of how prices and markets shape economic development. Prices guide the allocation of resources in a society: the goods and services produced, how they are produced, and how they are distributed. If the price system works effectively, the allocation of resources will approximate the aggregate preferences of the community. Similarly, an effective price system will signal growing inefficiency in the economy and reward innovation and reallocation of resources to reduce those inefficiencies.

We are now finding that institutional structure is important because of its role in expanding human choice, which is a fundamental goal of economic development. To be sure, there are other sources that serve to expand human choice. Economic growth per se constitutes a significant expansion of human choice through the expansion of the resource base and the accumulation of capital. Improvements in human capital (education, technology, and health), which "empower" individuals, also expand choice. But institutional structure is a third component.

Institutions affect human choice by influencing the availability of information and resources, by shaping incentives, and by establishing the basic rules of social transactions. Institutional innovation contributes to development by providing more efficient ways of organizing economic activity, ways that often lead to fundamental restructuring of an economy.

Students of development have long been concerned with institutional arrangements and how they influence the rights of individuals and communities to exercise choice. A significant focus of this literature has been the detrimental impact of development on the choices of the small rural communities that were the bedrock of the "traditional" order. Much of the early sociological and anthropological literature focused on how the emergence of worldwide markets and the national state tended to destroy the efficacy of the local community. The local communities seemed powerless in the face of these enormous national and international forces. Furthermore, it was argued, the normative foundations of those national institutions, and their power, were at odds with those of the traditional society. As those institutions grew in strength, they undermined the values of reciprocity and ascriptive status on which these communities were organized, it was argued. Thus, the local communities began to lose even their ability to manage their own local affairs. It seemed to matter little whether the community prospered or became poorer in the modernizing process; the results were the same.

This perception gave rise to two different schools of thought in the development literature. One placed emphasis on restoring to the local community a degree of control over its own fate. This has been variously described as "community development," "decentralization," or "local participation." The second approach was to advance the new nation-state as the appropriate vehicle for restoring social control over the economy and the direction of change. Drawing on local adaptations of European socialism, this approach emphasized state capitalism, extensive regulation of the economy, and comprehensive planning. Neither of these solutions has been entirely successful, however. Both the national- and local-level institutions are characterized by inefficiency and exploitation.

In short, the existing institutional context has neither the broad-based participation of the population of the Third World in the processes of choice, nor an institutional environment in which resources are allocated in socially efficient ways that facilitate development. Our purpose is to examine the requirements for increasing participation and efficiency in social choices, after a thorough reexamination of the institutional foundations of developing countries.

Another role of institutional analysis in economic development lies in addressing the problem of "getting the prices right," which is important for a number of reasons. Even in the most effective of market systems, there is potential for "market failure." Market failure may result from the character of the goods in question (i.e., public goods), externalities, inadequate information or asymmetries of information, or high transaction costs.

Getting the prices right is also important because, as they grow in size and power, governments can cause distortions in the price structure through the impact of their authority and budgets. This is not to say that the effects of public policy are inevitably negative, but that, insofar as those policies are determined by nonmarket forces, they have great potential for becoming increasingly distorting in the absence of careful monitoring and control of policy measures.

While all economic institutions—capital markets, contract systems, property rights, etc.—order economic transactions by rules, they can contribute to deviations from pure market efficiency. Almost any institution engenders the germ of price distortion because of the inertia inherent in any established order. For example, institutionalized property rights may need significant alteration before new technologies can have a broad impact on productivity. Biotechnology and information systems are recent instances.

The role of institutional analysis in getting the prices right is especially important because fundamental price distortions are introduced by the constitutional order that forms the basic structure of the political economy. This occurs as the constitutional order determines the "representativeness" and "accountability" of those who exercise public authority, and also establishes the basic law governing the resolution of conflict among diverse groups, institutions, and individuals. Perhaps most importantly for the study of development, the constitutional order shapes the rate and direction of institutional change within the polity.

This study explores the impact of institutions and political arrangements on development. It illustrates how some institutional arrangements exacerbate market distortions and inefficiencies while others facilitate structural change and development. The insights offered serve to elucidate strategies that will improve the efficiency of institutional choices.

The Challenge of Institutional Analysis: Some Issues and Approaches

The authors focus on the identification and consequences of conditions that encourage the free association of individuals in pursuit of their common interests. An important distinction is made between market institutions, in which individuals and groups meet to enter into the exchange of goods and services, and political institutions, in which individuals associate to pursue common benefits.

The authors share a normative position, common in classical Greek philosophy, that the individual is only truly "free" or fully "developed" when he is "self-governed." The authors do not address the social-psychological literature, which raises questions about the existence of a generic human thirst for freedom. Rather, like the Greek philosophers, they take the position that human beings have a capacity for freedom that can either be nurtured (leading to self-fulfillment) or constrained (leading to slavery). The focus of attention, therefore, becomes social conditions and their impact on this desired self-fulfillment. This normative position leads them to seek circumstances in the developing world that truly promote self-governance. Instead, however, they find hierarchy with few checks, regimes that severely limit or discourage free association and experiments in self-governance, and powerful tendencies at work that concentrate power and authority.

One essay draws on Alexis de Tocqueville's argument that the prevalence of free association, which he found in North America, rested on the equality of conditions and the abundant resource base there. However, as with earlier attempts to correlate democracy and development, the empirical case here is difficult to validate. Thus, the ASEAN states, which have witnessed rapid growth and a significant reduction in poverty associated with that growth, have not been noteworthy for the growth of democracy. This leads to a conclusion, similar to Tocqueville's; the cause lies as much with the "spirit of the people" as with empirical conditions.

The general line of argument in the study lies in a different direction, however. It is not wealth, equality, or other empirical conditions, per se, that create the conditions of self-governance. Political development is not derivative from economic conditions, as has been argued fairly systematically in the social science literature for the past twenty years, but derives from the nature of the constitutional rules that govern collective action. The bedrock of self-governance, it is argued, is the capacity to experiment with various forms of association in order to solve common problems and pursue common goals. Individuals must be free to associate and to set the terms of that association. They must have the rights to appropriate the benefits of that association. They must be able, in extremis, to enforce the rules of that association. The constitution and the state can assist them in this by lending the authority of the state to encourage innovation and association. Or, at the other extreme, the state can monopolize authority, initiative, and resources.

But a population learns self-governance by practicing it, motivated by common problems and on terms found mutually agreeable. Under this approach local groups are the source of innovation, of lower-level rules, and of an existential appreciation of democracy. The sources of a "spirit of democracy" are essentially local and at the community level. Two observations are important here. First, this approach does not argue that "small is beautiful." As societies grow in scale and complexity, the scale of problems grows, transaction costs increase, and externalities multiply. In consequence, secondary or tertiary levels of association must evolve to deal with the society's needs. Second, this approach does not suggest that anarchy is the solution. Public, even national, authority is essential to establish and maintain the constitutional rules and deal with the largest-scale problems. But by implication, and consistently with the "mass society" literature of the 1950s and 1960s, if the community base is lost, the mass scale becomes inherently unstable.

This is essentially an American "pluralist" model of political development. It does not deny the importance of the development of the central nation-state; clearly, the emerging nations confront problems of national proportions. But it does suggest that if the institutions of the nation-state are developed at the expense of diverse and relatively autonomous local institutional change, the culture of democracy cannot be expected to emerge. One does not have to believe that all societies are "ready" for large-scale democracy—certainly the Greek philosophers did not believe that. Nor does one have to believe that the "modern" forms of association are inherently different from "traditional" forms, as did Ferdinand Tonnies, with his distinction between *Gemeinschaft* (community) and *Gesellschaft* (society), and the other classic writers on the sociology of development in Europe. In fact, the authors of this study seem to agree that one is well advised to build on forms of association known and understood by the local culture.

The authors have revived a set of questions that were eagerly pursued twenty years ago by Martin Lipset, Gabriel Almond, Reinhard Bendix, Ralf Dahrendorf, and others, concerning the relationship of political participation, group association, and democratic values to the development of modern society. But a number of issues still remain to be settled. B. R. Ambedkar was surely not the first to point out, in the arguments over untouchability in India, that the local community was not a font of liberal and humanitarian ideals, let alone of equity. Theodore Lowi has argued forcefully that the evils of abrogating public authority to "private" groups can be as great as the evils of excessive concentration of public power. Finally, although there is ample micro-level evidence, some presented in this volume, that local communities have a remarkable capacity to solve "development" problems, the evidence is less convincing at the macro level.

David Feeny develops a framework for making a bridge between the several contributions in this volume that focus on "constitutional" issues and the more general development literature. He builds this framework by bringing clarity and order to two critical components of the political economy of institutional change. The first component builds on the growing literature on "rent seeking," showing how power can alter economic rewards and incentives. Thanks to this component, it becomes possible to search for institutional rules that shape these incentives in ways that also increase overall economic efficiency and growth. The second component suggests the importance of providing a constitutional order that encourages institutional innovation and differentiation and is, therefore, consistent with rapid economic development.

Vincent Ostrom argues that the logical requirement for some form of public authority does not automatically lead one to conclude that a "Leviathan," or supreme sovereign, is essential to civil society. Rather, it is important to recognize that the development of the nation-state and its administrative apparatus in the developing world, to which international donors have contributed, is fraught with opportunities for rent seeking, exploitation, and tyranny. Four key sets of institutions (rules) can serve to restrain those tendencies: freedom of association; the right to property and free economic exchange; due process of law; and the capacity of communities to invest in "public goods" in a way that establishes some relationship between supply and demand. It is the key function of governance, he argues, to make the rules that govern these four processes. The rules should specify process, not content. They should be open and visible, not cryptic. Above all, political development must be viewed as a process that expands power—that is, expands society's capacity to identify and mobilize resources to solve problems—rather than concentrating it.

Nothing in this argument will alter the tendency of men to seek and exploit power. But insofar as the establishment of constitutional regimes is frequently an act of collective will that embodies the aspirations and assumptions of the founders, it can correct a fatal and critical misconception engendered by the nation-building literature. All civil society rests on stability, predictability, and order. However, it is essential to recognize that these requisites can be achieved as effectively—perhaps more effectively—by the stable and orderly evolution of the rules as by the concentration of power.

Sombat Chantornvong chronicles the single-minded strengthening of the state bureaucracy in developing countries, drawing heavily on Tocqueville to argue that democracy rests on three foundations: equality of conditions, laws, and the "spirit of the people." But the most critical contribution, according to the author's study of Tocqueville, comes from the experience of self-governance itself. The power of the author's argument rests in his demonstration that it is indeed possible to make a constitutional compact in which prosperity (based on sound macro policies) and social services (provided by the government) are exchanged for the concentration of power in the hands of the elite. Furthermore, it is possible to succeed. If democracy is to be defended, it must be defended in its own right—not as a cause of general economic development. Similarly, although one may find socioeconomic conditions that encourage free association, as have authors from Tocqueville to

Dahrendorf, the most important cause is a constitutional and legal order that permits and encourages it.

Elinor Ostrom picks a particular developmental problem, management of the "commons," to explore the issue of the role of changing associational forms in economic development. Contrary to much of the game-theory literature and other well-known arguments on the subject, Ostrom argues that the stark choice between privatization and dictatorship is not a necessary outcome of the dilemma of the commons. Rather, a review of the case studies reveals that people learn from their mistakes over time, even showing great ingenuity in crafting new institutional forms for resolving dilemmas. Secondly, the solutions are diverse, involving different combinations of technological advance, management procedures, adjudicative institutions, property rights, etc. In other words, even in the "worst case" of common property with enormous externalities, local ingenuity prevails over central dictates across a wide diversity of cultures.

Even more to the point, Ostrom argues that development projects and development administration, like game theory, deal with the static case of how to play most effectively within the rules. What is required, she concludes, is a "constitutional" level of analysis that permits us to modify the rules in order to foster better learning, institutional innovation, and problem solving at the local level.

Ronald Oakerson develops the case for the small, primary social unit as the source of experience in self-governance. It is in these settings that individuals learn about the interaction of self-interest and reciprocity that is the basis of political development. Because citizens first confront the problems associated with social change in the small, primary social unit, it is here that we find a great capacity for innovation and entrepreneurship in dealing with those problems. While Oakerson does not develop this point in order to make a case for the utility of free association to economic development (as does the literature on decentralization, participation, and development), such an argument is clearly engendered here. The constitutional order rests on rules of association and on the rules that govern changes in them. The management of development generally operates within the existing institutional rules, and this is the familiar arena for most development projects. But the most dynamic aspect of development is when the rules are exploited to formulate new institutional forms, or when the rules themselves evolve.

David Feeny develops the framework for institutional change that was briefly discussed above. Feeny argues that entrepreneurs, motivated by changing factor prices, develop new institutional arrangements that provide increased organizational efficiency and reallocate costs and benefits. However, institutional change is shaped by the society's power structure, which may inhibit innovation in order to protect elite interests. Feeny's recognition that political power influences the direction of economic change is hardly new. However, his attempt to bring power and economic development together within a single framework through the vehicle of institutional analysis represents a major advance in development theory.

Feeny points out that institutional change has the potential to alter both the distribution of income and the efficiency of resource use within the economy. There is ample evidence in the development literature of institutional changes that accomplish the former but not the latter and, in consequence, have little developmental impact. Yet income and its effects are a motivating force for innovation. The practical problem in development is to provide an environment in which incentives to innovate are channeled in socially useful ways that improve economic efficiency.

Feeny argues that the demand for institutional change is generated by the growing inefficiencies in the economy (indicated by price shifts), changing technology, the character of the market (including size), and the "constitutional" order (which shapes the way in which individuals and groups can assert and defend their respective interests). The "supply" of institutional change, in turn, also rests on the "constitutional" order insofar as it tolerates or constrains innovation in the rules governing association and changes in the distribution of costs and benefits. Feeny recognizes that the supply of institutional change depends on the "cost" of institutional design and the knowledge base that informs the search for alternatives. In short, market forces, shaped by an institutional policy environment represented by the "constitutional" order, drive institutional innovation.

Institutions and Development in Less Developed Countries

Institutional changes foster economic development at the local level. It is important to clarify the relationship between participation and development, because it has remained murky in the literature. It seems evident, for example, that technological change or a sound structural adjustment program can produce significant economic development without increasing democratization. Nevertheless, there is a broad variety of literature that argues that development projects frequently fail without provision for "real" local participation.

The first point stressed by this literature is that local (or "traditional") communities have not survived for generations without evolving mechanisms for solving the social and economic problems that commonly confront them. Not surprisingly, therefore, these communities evince remarkable energy, ingenuity, and effectiveness in dealing with the collective challenges of development, when given an opportunity to do so. This adaptive capacity has been attributed to several sources.

One source of adaptation commonly referred to is the indigenous culture. In generations of adapting to the local environment, perhaps through trial and error, communities have evolved effective techniques of dealing with common problems. Knowledge of these techniques is social "capital," which is available to assist development if the opportunity arises.

There is, however, a second level of explanation that forms a recurring pattern in the "decentralization" literature, namely, that community organizations—being inherently simpler, less hierarchical, and "closer" to the problem—are more dynamic than centralized, large-scale hierarchies. This represents a direct rejection of the Weberian assumption that bureaucracy should be the epitome of efficient and rational organization in human society.

A third argument has been made from time to time that cuts across those above. One might argue with Ralf Dahrendorf that there are certain ecological and cultural requisites for "group formation." Where these are missing—in ethnically diverse and poorly integrated economies, for example—the most effective organizations are likely to be small ones located at the community level.

At the operational level the distinctions among these arguments are probably not important, as they tend to converge on fairly common prescriptions for project design. However, for those interested in the analysis of institutional change, the distinctions are significant. An example of the vitality and utility of "traditional" institutions for development involves Hindu society. The institutions referred to are not community-level organizations but the principles of caste that constitute the very structure of Hindu society. What is seen in caste is the cultural capacity for large-scale organization that could rival class as the foundation for political and economic action. It is also advisable to recall the argument that not all adaptations of "traditional" community institutions prove to be viable development tools. Some, indeed, are pathological. Nevertheless, the overall point is well taken: human communities are indeed generally highly adaptive in the right environment.

There has been a tendency to view institutional innovation and change at the local level as "adaptive." Cultures have evolved their institutional capital as they have responded to environmental challenges in order to survive. There is little in most of the "participation" literature to suggest that human institutions may evolve in order to pursue human definitions of the "good, the advantageous, and the just." But if participation is not a process of choice, then it is simply good management to be evaluated on efficiency grounds. This study, then, is important since it puts local participation in the constitutional context of expanding human choice, to which project design and implementation are secondary.

The arguments presented here make a strong case for building on "traditional" organizational forms. This is good advice for the project officer, who has limited control over his environment. It is also good advice at the constitutional level of institutional change. For example, in the Bhagavad Gita, Mohandas Gandhi found a vital part of traditional Hindu culture: a formula for selfless nonviolence that fired a nationalist movement. His predecessors had found in the same text an equally powerful formula for communal violence. In both cases, the culture had provided a recognizable metaphor for action and change. Much of the anthropological literature has tended to view institutional change as an exceedingly slow process and culture as the source of continuity rather than a source of innovation. But this is not necessarily the case. Institutional and cultural change may be rapid, for example, if conditions change rapidly and dramatically, if incentives for innovation are strong, and if opportunities for learning new organizational and cognitive forms are afforded. It is important to view culture as a basis for expanding choice, not limiting it.

As we search local communities for evidence of community initiative, it is not surprising that we find institutional arrangements that exploit both hierarchy and reciprocity. Nor is it unusual for larger-scale institutions to be built on these community-level building blocks. For example, many national-level political organizations are simply an aggregate of local factional traditions. What is uncommon in simpler rural communities, Karl Polanyi argued, is the presence of market institutions governing such basic economic interactions as contract and property. In fact, the disruptive impact of market forces on traditional communities has fascinated Western observers of economic change since the nineteenth century. It is clear that national elites throughout the Third World have attempted to reduce the impact of market forces on local institutions, frequently with disastrous economic consequences.

We find, then, contrasting explanations for the erosion of local institutions. Karl Polanyi, much of the anthropological tradition, and many nationalist leaders in the Third World have found the "collapse" of local institutions engendered in the spread of the market economy. This study, in contrast, finds much of the explanation in a hierarchical constitutional tradition exploited by "predatory elites." In fact, the two explanations are not mutually exclusive. Both the market and a centralized political order permit "predatory elites" to create private opportunities for profit that are beyond the control of local communities and existing institutions. Nor are "traditional" institutions immune from corruption. In fact, as Susan Wynne suggests, many of these local institutions were merely older versions of similarly predatory strategies. Thus the character and contribution of local institutions depends to a great extent on the character of the broader regime within which they exist. The role of local institutions will depend on such factors as the strength of market forces, the vertical distribution of authority, the character of intermediate institutions, and the broad constitutional norms that govern the formation of associations.

James Roumasset and Sumner J. La Croix make an important contribution to institutional analysis by arguing forcefully that the performance of institutions cannot be deduced a priori from their structure or, one might add, from their consistency with the historical traditions and culture of the society. Rather, institutions—old and new—must be evaluated in the context of the "political economy" environment in which they appear and by whether, within that environment, they serve to increase or decrease efficiency and promote growth.

Susan Wynne reviews the "stock of cognitive resources" upon which African nations can draw to fashion development institutions. Exploring the traditions of the Kgalagadi of Botswana, she finds a fairly recent evolution of more "consensual" relationships within certain groups, replacing the hierarchy of the past. She attributes this institutional innovation to the migration of some communities into the arid desert of western Kweneng, where coping with the harsh environment engendered a more flexible set of social arrangements. Another contributing factor was the appearance of employment opportunities in South Africa for the young men, giving them greater independence. There are undoubtedly tensions in these local communities. Wynne stresses autonomy and the concomitant freedom of experimentation that it affords the community as major contributors to successful community problem solving.

Amos Sawyer illustrates the close relationship existing between participation and development within local communities in Liberia, with participation serving both as a goal and as a means of development. Citing the experience of the Putu Development Association, he demonstrates the importance of local self-organization in achieving development objectives. The Putu Development Association rested on the adaptation of recognized indigenous organizational principles that had been used in the past to manage communal land and settle disputes. Successful as a local initiative, the association nevertheless foundered because of government opposition. Both the "constitutional" environment and the lack of effective intermediate institutions for the settlement of external disputes proved the undoing of the organization. The author concludes: "The survival of local units of collective action depends upon their being nested in a larger system of federated authority relationships." The chapter also touches on the importance of political exchange, such as community support for national elites in exchange for local autonomy, in establishing local autonomy.

Sawyer also examines the Liberian movement toward autocracy, and finds it to be characteristic of postcolonial Africa. The origins of this tendency lie in the precolonial traditions, the centralized character of colonial authority, the decolonialization process itself, and the integrative strategies of the nationalist regimes. Curiously, although these experiences differ greatly among African regimes, the political consequences appear to be similar.

Before the establishment of Liberia, the indigenous population was organized into diverse ethnic communities, in an environment into which the slave trade had introduced a high level of conflict and instability. With the repatriation of American slaves and the establishment of the new constitution, a strongly centralized political order was superimposed. Within this constitutional order, power steadily gravitated toward the presidency, a development that culminated in the personal rule of President Tubman (1944–1971). What has resulted is a predatory regime in which personal power is unrestrained by law.

The story of Liberia raises challenging questions about the sources of such autocratic tendencies in Africa. Does it simply reconfirm an argument that ethnic diversity does not necessarily replicate the preconditions of the American pluralist political tradition? Did the repatriated slaves simply replicate an exploitative colonial political order? Did halting economic growth inhibit the economic and political integration of the country, leaving the national leadership unchecked by countervailing political forces? In any case, the emergence of national political power in Liberia, as is frequently the case elsewhere, has been fundamentally destructive of local autonomy and initiative.

Roumasset and La Croix make their analysis based on an exploration of current conceptual problems concerning institutional change in the context of nineteenth-century Hawaii. At the most general level, the authors challenge current thinking in economics, which argues that institutional change—in this case the intervention of public authority to establish political rights in property—is a direct consequence of changing market conditions. Rather, they assert that political change must be viewed as an autonomous process, although it may well respond to the same forces that are acting on the market.

They make a second, equally important argument that the efficiency of alternative institutional arrangements cannot be deduced a priori from their structure. Rather, the performance of any such arrangements is an empirical question that will depend on a variety of factors, including both their structure and their interaction with their political and market environments. Specifically, they argue that private property cannot automatically be assumed to be more efficient than common property; it depends upon the particular environment. Further, because political and economic change are related but autonomous, it cannot be taken for granted that rent-seeking behavior is always contrary to increased efficiency and growth. It may well be the case that, in the right circumstances, the efforts of the powerful to alter institutional arrangements to permit themselves to capture more rents may move institutions in more efficient directions.

Their argument complements Feeny's above-mentioned discussion. In effect, Roumasset and La Croix assert that political and institutional changes are not an automatic consequence of changes in factor prices. Political and institutional changes, as Feeny argues, have costs and risks associated with the shifts in power, income shares, and institutional rights engendered by the changes. One must understand why political entrepreneurs would take those risks and pay the costs. There is a tradition in political science that posits that political entrepreneurs are driven by the desire for "power" in the same way that economic entrepreneurs are driven by the desire for wealth. In certain circumstances this may be sufficient to explain the emergence of a centralized state, increased tax demands, and other autonomous changes in the political economy, as Roumasset and La Croix suggest. It is equally plausible however, that the economic gains from rent seeking will be sufficient to induce economic entrepreneurs to become political entrepreneurs.

Market Institutions and Contingent Considerations

At the most basic level, the market system is considered to rest on society's fundamental values, namely, the ones that define property rights, the right to associate and organize for economic gain, and the limits placed on individual choice. The market is perceived as an institutional arrangement that maximizes the individual's ability to order his consumption preferences and to pursue them freely. Consequently, market institutions rest on a fundamental conviction regarding the individual's capacity for instrumental rationality. In addition, with the exception of problems that center on a variety of "market failures," the market will provide the most efficient means of allocating consumption and the factors of production in order to assure that the society's resources are used to maximize the aggregate satisfaction.

In economics, much of the discussion of "public choice" has centered on public interventions that compensate for instances of "market failure." Market failure may rest in information asymmetries, or gaps, that inhibit rational choice on the individual's part. Failure may also rest on the character of the goods in question; "public goods," for example, are difficult to price and supply through market mechanisms. Goods that are characterized by large "externalities" also present difficulties.

But the discussion in this study goes beyond this traditional focus of "public choice." In doing so, it invites an exploration of the institutional foundations of the market economy itself. What are the factors that permit and encourage institutional change within the market economy? How do various definitions of institutional rules (or rights) influence the performance and outcomes of market institutions?

In a brief essay he prepared for the Agency for International Development, Lowi listed the "institutional requisites" of a market economy. Among them were: (1) law and order, (2) a stable currency, (3) property law and property rights, (4) contract law, (5) laws governing exchange, (6) regulations for the conveyance of public domain to private hands, (7) provision of public goods, (8) provision and regulation of human capital (labor), and (9) pooling of risk. Several of these are discussed in greater depth in this book. There is a growing recognition in the development literature of the contribution of improved market institutions to the efficient use of development resources. The variety and complexity of the institutional underpinnings of an effective market economy are less frequently recognized, however. But as John Taylor indicates, an understanding is needed of how the foundations of the political community interact with the foundations of a market economy.

Furthermore, neither the economy nor market institutions are stagnant. Markets are not simply established for all time. As the economy grows in complexity and sophistication, the evolution of market institutions must follow. Economic forces themselves "induce" institutional change through the increasing costs associated with increasingly inefficient and outdated institutional arrangements. In such circumstances, the potential gains to both individuals and society from such innovation become very large. These concerns predominantly involve the process of technological change, but also touch on such fundamental economic institutions as property and contract. Hartmut Picht's search for alternatives to public monopolies in the supply of currency, bears directly on this question.

Louis De Alessi explores the implications of Adam Smith's observations that individuals respond in predictable ways to opportunities for gain, and that the process of economic exchange is fundamental to society. Starting with certain basic principles of economic exchange, De Alessi then explores how, for example, different systems of property rights may alter the character of those exchanges.

Among many possible systems of exchange, the market system is deemed efficient because it permits individuals maximum freedom to pursue individualized preferences. In fact, De Alessi comments, in a market system the welfare of individuals is closely related to the consequences of their own decisions. The market then allocates resources and production according to those principles. The function of government is to define rights (such as rights to property) and protect them. The market system also performs a second order of functions in that, beyond the regulation of production and consumption, it also determines the future of the economy by directing investment—that is, by allocating capital and risk. De Alessi also discusses "market failure" and the role of government in alleviating it. The problem of "getting prices right" in an economy is not a regulatory problem but an institutional one, namely, establishing the set of rules and rights that governs the process of individual choice.

John Taylor further explores the market as a social institution. Whereas De Alessi argued that market institutions depend on a publicly determined set of rules and rights, Taylor suggests that these rights must have their basis in the bonds and values of the political community. The key to a system of exchange lies not in the ability of the government to enforce institutionalized rights but in the community's recognition and acceptance of those rights. Ultimately, he suggests, economic exchange is not an exchange of goods but of rights over those goods. The key community values that support market exchange are reciprocity and voluntarism in the exchange.

Vincent Ostrom discusses the interrelationship between markets and public authority. He discusses economic institutions—or any other kind of institution—as a form of "public good" that facilitates exchange. In consequence, the constitutional order, which regulates the application of public authority and creates the normative context for the establishment of economic institutions, determines in large measure the character of the market economy. Although Ostrom criticizes Polanyi's concept of an autonomous market as a logical impossibility, there is much in common between Ostrom's and Polanyi's views. Polanyi describes an environment in which rapid demographic and economic change has destroyed the foundations of "community." The scale and complexity of the emerging nation-state and the emerging national economy effectively remove these processes from community control, Polanyi argues. The processes and the consequences that Polanyi describes in Europe resemble the conditions Ostrom describes in the modern developing world. Furthermore, Polanyi argues, market forces themselves are poorly understood by the same elites that benefit from them—hence the appearance of the Poor Laws in England. Europe was forced, Polanyi implies, to correct this situation by reintegrating its populace into the political community—presumably, as Reinhard Bendix suggested, by the concept of "citizenship" and, as Karl Deutsch has argued, through the force of nationalism. Britain and America effected this change through liberal political and economic institutions; continental Europe effected it through other constitutional traditions.

Ostrom suggests that the institutions of political control in the Third World have permitted political elites to exploit market forces for their benefit. In addition, these political economies have not been able to find effective institutional alternatives to the market nor to counteract the effects of bad policy environments on their growth rates. Ostrom makes a powerful case that regimes designed to maximize political control and rent seeking by the few are unlikely to afford opportunities for institutional experimentation by individuals striving to resolve their own economic problems and to capture personal opportunities for increased efficiencies and growth. In short, the constitutional order may greatly inhibit the "institutional innovation" that Ruttan seeks.

Hartmut Picht explores institutional solutions to a common problem of economic policy: unstable currency. The origins of Picht's inquiry lie in the critical role that a stable currency plays in social exchange generally, and in a market economy in particular. Picht explores suggestions that have been made in recent years to "privatize" currency, that is, to eliminate the governmental monopoly on currency systems, and to introduce a competitive system of privately supplied currencies as a way to reduce the scope for bad government policy. In a careful institutional analysis, Picht argues that the institutional requirements for a successful competitive market in currencies are unlikely to appear in the current international setting.

Picht also suggests (as Milton Friedman has) that a "constitutional" provision for automatic adjustment of the money supply, based on the impact of productivity advances on prices, will produce analogous effects at lower institutional cost. He suggests that it may be possible to establish effective property rights in specialized "units of account" that would permit privatization and differentiation of this key function of currency.

Picht's discussion of institutional options for managing currency systems is interesting as a way of addressing currency problems. Conceptually, however, it has a broader significance. First, his analysis suggests the necessity, as economies grow in size and complexity, for greater differentiation, specialization, and sophistication in key economic institutions. Second, it demonstrates how rigorous institutional analysis can suggest changes in rules and rights, perhaps at the constitutional level, that can encourage this process of differentiation. This suggests an important relationship between economic change and institutional change. Economic forces and economic analysis may reveal growing inefficiencies in an economy and, in consequence, there are opportunities for economic gains from institutional "innovation." The analytic tools for exploring and understanding such institutional innovation, however, demand the capacity to deal effectively with the interaction of rules (even at the constitutional level) and the performance of markets.

The Continuing Challenge

The key problems facing the developing world today are sustainability and efficiency. Sustainability refers to the inability of developing countries to maintain the investments that have been made. This can be seen in virtually every sector. The Green Revolution (development of high-yield hybrid cereals and other improvements) represented a remarkable breakthrough in Asian agriculture. But there is now serious concern about the ability of Asian research systems to stay ahead of pests and diseases and to sustain the growth rates that have occurred over the past two decades. Rural road systems, irrigation canals, and other infrastructure deteriorate for lack of maintenance. Malaria, thought to be near eradication in South Asia, is resurgent again in the Himalayan foothills. The sustainability problem cannot be blamed on a preoccupation with artifacts rather than human capital, institutions, and systems. Training and management systems have been a continual focus of development efforts. U.S. development efforts, for example, have stressed long-term commitments to institution building in universities, local governments, and the key development ministries.

Efficiency is the other major concern. In Asia, for example, economies have continued to grow, except when interrupted by human disasters. However, the return on resources invested is unfortunately low in comparison with the needs. Children start school, but do not stay long enough to emerge literate. Bad policy directs capital into inefficient uses. Water is carried through irrigation systems at enormous cost and then much is lost through leakage or wasted through improper cultivation techniques—often resulting in growing salination.

This is not to suggest that there is neither growth nor good news. For example, world-class science has emerged in Asia. Also, most Asian economies have weathered the vagaries of shifting oil prices and maintained steady, if modest, growth rates without falling into debt traps. Nevertheless, it is reasonable to conclude that neither the public nor the private sector in much of the developing world has developed institutional arrangements that allocate resources efficiently. Furthermore, the growing national wealth and the expanding choices are both concentrated in relatively few hands.

What do the approaches presented in this volume have to offer in the context of these problems? The principal findings are:

1. Much development effort is misdirected because of misdiagnosis. For example, many of the efforts directed toward institutional development focus on training and internal management systems. Yet this is likely to be ineffective if rent seeking drives incentives in detrimental directions. We need to understand and undertake management improvements in the context of changing incentives.

2. While there are remarkable exceptions, the environment for institutional experimentation and innovation is poor throughout the developing world. Attempts by the communities to provide their own public goods frequently falter from the opposition of national elites or the lack of a legal environment that permits initiative. It is vital to understand that sovereignty is not a zero-sum game, and that variety in the organization of public authority is both possible and productive.

3. Although the public sector in developing countries is not large by the standards of developed ones, it is clear that the government sector has grown very rapidly in a context of considerable concentration of political power. Consequently, the institutions of representation and control are frequently unable to keep pace with the capacity of political and military elites to affect economic choices at both the macro and micro levels. Furthermore, the influence of the elites is not illegal in any sense of the term. Without any expectation of major constitutional changes, it may nevertheless be possible to suggest incremental changes that will shift power in the direction of greater, rather than less, growth and economic efficiency.

4. In the face of momentous changes in the Asian economies over the past twenty years, markets have been very slow to react for a variety of reasons. For example, there has

> been a shift from subsistence to predominantly commercial agriculture within this period. Yet the marketing structures for key inputs and for intermediate-term capital have frequently not responded. In the face of rising budget deficits and foreign exchange shortages, several countries in Asia are engaged actively in the privatization of public sector enterprises and in trade liberalization. Yet there is real concern that the indigenous capital market will be unable to keep up with this structural change in the economy. It is reasonable to argue that, in many of these countries, public authority has not been directed toward improving market institutions and market efficiency. Even more recently, the development goal has been stated as one of expanding the private sector, rather than of developing market institutions. We need to understand clearly the character of the public functions and policies that encourage expansion and innovation in a market economy.

This book represents a self-conscious attempt to look at the process of development as the interaction of public and private choice. It attempts to demonstrate how the process of public choice can expand or diminish private choice. It contends, furthermore, that in all circumstances the political process will structure private choices through its influence on key economic institutions. The methodologies presented in this volume can illuminate these interactions. Through this improved knowledge, we can aspire to improved policy and improved institutional innovation.

About the Contributors

LOUIS DE ALESSI is professor of economics with a joint appointment in the Department of Economics and the Law and Economics Center, University of Miami, Coral Gables, Florida. His teaching and research interests are price theory and its application, with special focus on the economic consequences of using alternative institutions to control economic activity.

SOMBAT CHANTORNVONG is professor of political science at Thammasat University in Bangkok, Thailand. His research interests are concerned with democracy and development in Southeast Asia.

DAVID FEENY is professor in the Department of Economics and the Department of Clinical Epidemiology and Biostatistics at McMaster University, Hamilton, Ontario. He has published studies in economic history and development, institutional change, and health technology assessment, including *The Political Economy of Productivity* (University of British Columbia Press, 1982) as well as numerous articles in various development economics, economic history, and health science journals.

SUMNER J. LA CROIX is an associate professor in the Department of Economics and in the Social Science Research Institute at the University of Hawaii, Honolulu. He has published numerous papers concerning the economic history of Hawaii and various topics in law and economics.

NORMAN NICHOLSON is chief, Plans and Analysis Division, Office of Development Planning, Bureau for Asia and the Near East, U.S. Agency for International Development. His research interests are economic policy and institutional development.

RONALD OAKERSON is currently senior analyst and assistant director of research at the U.S. Advisory Commission on Intergovernmental Relations, Washington, D.C. He is on leave of absence as associate profes-

---

These individuals contributed chapters to the volume *Rethinking Institutional Analysis and Development*, from which this executive summary is taken.

sor of political science at Marshall University, West Virginia. His major research interests are American local government and public policy.

ELINOR OSTROM is codirector of the Workshop in Political Theory and Policy Analysis and professor of political science at Indiana University, Bloomington. Her research interests have focused on the effects of institutional arrangements on citizens and public officials in various settings, including urban areas and diverse common-property resources.

VINCENT OSTROM is Arthur F. Bentley Professor of Government and codirector of the Workshop in Political Theory and Policy Analysis at Indiana University, Bloomington. His research interests are the nature and constitution of order in human societies, with emphasis upon the constitutional level of analysis.

HARTMUT PICHT, senior fellow at the Institute of World Economics, University of Kiel, West Germany, is currently visiting associate professor of economics at Indiana University, Bloomington. His research and teaching have focused on monetary economics, international finance, and economic development.

JAMES ROUMASSET is a professor of economics at the University of Hawaii, Manoa. He specializes in applications of neoclassical institutional analysis to peasant and industrialized economies, and collaborates on interpreting the economic history of Hawaii.

AMOS SAWYER, former dean of social science, University of Liberia, is currently a research scientist at the Workshop in Political Theory and Policy Analysis, Indiana University, Bloomington. His research interests include investigation of problems associated with the constitution of order and institutional development in African societies.

JOHN F. A. TAYLOR is professor emeritus of the Department of Philosophy at Michigan State University, East Lansing, Michigan. His chapter, "The Ethical Foundations of the Market," is an abridged version of the argument set forth in his Guggenheim study, which has appeared in two works, *The Masks of Society* (New York: Appleton-Century-Crofts, 1966), and *The Public Commission of the University* (New York: New York University Press, 1981).

SUSAN WYNNE is a research associate at the Workshop in Political Theory and Policy Analysis, Indiana University, Bloomington. Her research has focused on the relationship between institutional design and economic development.

- 33 '

ICEG Academic Advisory Board