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INTRODUCTION

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Handbook of Economic Development and Institutions

EDITED BY JEAN-MARIE BALAND, FRANCOIS BOURGUIGNON, JEAN-PHILIPPE PLATTEAU AND THIERRY VERDIER

This paper presents the introduction from the *Handbook of Economic Development and Institutions* published by Princeton University Press in January 2020. The book can be purchased online from Princeton University Press. Draft Working Paper versions of the book chapters are available by following the links below. All draft Working Papers can be found on the Economic Development and Institutions programme website.

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Economic Development and Institutions: An Introduction

BY JEAN-MARIE BALAND, FRANCOIS BOURGUIGNON, JEAN-PHILIPPE PLATTEAU AND THIERRY VERDIER

In the recent decades, economists have increasingly emphasized the importance of institutions as a fundamental factor for economic growth and development. Starting with the influential work of Acemoglu et al. (2001, 2005), an abundant literature in economic and political sciences has investigated theoretically and empirically the impact of institutions on some aggregate developmental outcomes (mostly GDP per capital or growth, but sometimes other outcomes such as health, education or political rights). The findings of this literature have been of crucial importance for development economists and policy practitioners in the fact that they suggest that institutional quality may be an important determinant of the persistence of poverty and low developmental outcomes in the world.

At the same time though, aggregate cross-country analyses have fundamental limits in properly identifying the causality link from institutions to development (Pande & Udry, 2005). This obviously calls for a need to provide precise descriptions of the mechanisms through which institutions play a role in determining various development outcomes as well as to move beyond aggregate studies to explore the heterogeneity of institutions in different settings. Moreover, we need to emphasize the importance of informal institutions in developing countries and their significant role in shaping socioeconomic outcomes. They are however much harder to 'measure'.[1] We also need to understand better their interactions with formal ones and how they jointly affect the actions and interactions of various members of the society.

These issues are not new and they have long drawn the attention of social scientists, including economists. A deep-rooted view among the latter is that changes in traditional values, attitudes and institutions were necessary for long run development (for an overview

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[1] As noted by many contributors to this Handbook (for instance Estache, Durlauf or Bourguignon and Gunning, this volume), our measurement of institutions remains rudimentary and approximate. More detailed research to define relevant measures of institutions in specific contexts is clearly needed.

of sociologists' contributions, see Yousfi, 2011). Arthur Lewis (1955) certainly shared this view when, commenting upon the historical failure of Spain to exploit the economic opportunities presented by the discovery of the New World, he concluded that "It is possible for a nation to stifle its economic growth by adopting passionately and intolerantly religious doctrines of a kind which are incompatible with growth" [Lewis, 1955: 107].

On the other hand, Arthur Lewis was inclined to think that religious beliefs, for example, may evolve and be re-interpreted depending on the economic environment confronting societies. In Lewis' framework, these two views can be reconciled: traditional values and attitudes, whenever they are hostile to economic advancement, will eventually adapt themselves to new economic opportunities, yet as this adaptation process may take time, traditional culture is likely to slow down the rate of change and also distort its effects [106].

Other authors also thought that institutions and the economy co-evolve: "Not only must economic organization be transformed, but social organization ... must also be modified so that the basic complex of values and motivations may be more favorable for development" [Meier and Baldwin, 1957: 356, 359]. "Generally, a slow but steady development is likely to create fewer political, social and economic tensions; and it is likely that an attempt to force the pace too strenuously may also be economically wasteful because the social and personal changes may not take place which are necessary to enable individuals or the society to profit from the development and to sustain it" [Bauer and Yamey, 1957: 71].

This raises the question as to what extent some institutions are themselves transformed by economic development. We need to understand better the process of institutional change and its interaction with the dynamics of economic development. In fact, it may well be the case that some institutions have to change or be changed rather significantly before economic growth can take place, as in the case of extractive institutions analyzed by Acemoglu et al (2001).[i2] Others need not and may be thought as 'spontaneously' evolving with economic development. One of the issues is then to determine which institutions belong to the former 'fundamental' category and which, to the latter 'adaptative' category. In addition, adaptive processes and their interactions with growth and development are presumably highly non

[2] Extractive institutions are defined by the authors as institutions allowing a "small" group of individuals to exploit the rest of the population , as opposed to "inclusive" institutions in which "many" people are included in the process of governing and sharing the benefits of development.

linear (see Durlauf, this volume). Thus, it may well be that very few institutions need to change before growth starts, yet until some critical institutions have sufficiently evolved, growth will remain rather slow.

This approach to the role of institution seems to us much more fruitful and relevant than the sort of grand approach that purports to discover the institutional determinants of growth and development conceived as fundamental prerequisites for growth. It echoes the 'adaptative' perspective suggested by Joseph Schumpeter in his critique of Max Weber Ideal Types: "So soon as we realize that pure Feudalism and pure Capitalism are equally unrealistic creations of our own mind, the problem of what it was that turned the one into the other vanishes completely. The society of the feudal ages contained all the germs of the society of the capitalist age. These germs developed by slow degrees, each step teaching its lesson and producing another increment of capitalist methods and of capitalist 'spirit'." (Schumpeter, 1954, pp. 80-82).

In the following, we will first propose some definitions of the key concepts, then present the various chapters of this handbook and their global focus, before discussing open research avenues that we feel are in need of further research.

1. Definition of key concepts

We conceive of institutions as rules, procedures or other human devices that constrain individual behaviour, either explicitly or implicitly, with a view to making individual expectations about others' behaviour converge and allowing individual actions to become coordinated (North, 1990). By definition, they are not exclusively determined by the technological environment but also depend upon the local culture, for instance, in the selection of a particular focal point in a multiplicity of possible equilibria (Aoki, 2001). These focal points can themselves get progressively 'institutionalized' as a norm of behaviour.

Contracts constitute a very good example of our conception of an institution. Indeed, a contract is a procedure that, properly implemented, constrains individual behaviours and consequently frames actors' expectations on the likely outcome. A contract involves the following features. First it specifies a set of actions to be implemented (how, where, when and by whom). Secondly, it involves the specification of the various consequences when these actions are not undertaken (conditional on the degree of verifiability and enforcement capacity of the parties involved). As such, these elements create constraints on actors' behaviours and expectations on outcomes within and outside the limits of the contract.

Contracts are typically incomplete. They may be therefore subject to culturally embedded local interpretations and converging expectations. For instance, standard incentive compatibility conditions would predict the observation of a considerable variety of contracts with terms varying according to the characteristics of the parties involved (e.g., their degree of risk aversion). The fact that some contract terms –for example, the shares in sharecropping contracts, or the interest rates in loan contracts– tend to be uniform in particular areas suggests that focal point representations may be present (Stiglitz, 1996).[3]

We conceive of an institution as formal when the rules that it embodies are made explicit, most typically when they are written, and when they are enforced through channels widely accepted as official (Helmke and Levistky 2004). Regarding the first feature, the requirement is that the rules are stated in a sufficiently clear and articulated manner that the people involved have little uncertainty about how they are expected to behave in given circumstances. Regarding the second feature, it is to the extent that the rules are effectively enforced that people also know the likely consequences of their actions.[4] If rule violation is imperfectly detected, enforcement is itself imperfect and these consequences are uncertain.

An important implication is that, because they are written, formal rules contain information that is perfectly transferable to an individual who does not belong to the community or group in which they have been laid down. They thus resemble blueprints in the field of technology: both are codified statements and prescriptions that can be understood by anyone who has learned the language in which they are written. Also, a well-functioning formal institution specifies not only the actions required in specific circumstances but also the sanctions that follow violations of the prescriptions. To put it in another way, it is a codified mechanism that determines the allocation of decision responsibilities (it thus delimits a domain of individual freedom) and its implementation inside a particular social group and in

[3] For another, more orthodox interpretation, however, see Allen and Lueck (2002: 88-92)

[4] For Aoki (2001), effective enforcement is an inherent attribute of an institution: a representation is an institution only if it deemed credible, and it is deemed credible only if it is properly enforced.

well-defined circumstances. To illustrate, a political constitution under a presidential regime states the conditions and frequency of presidential elections. The expectations of citizens and political actors are shaped by this constitution and they act accordingly. The very fact that a president tempted by authoritarian rule and unlimited mandate knows that he must first amend the constitution, and that there are rules organizing a constitutional change, is evidence that it is an institution in the formal sense. Many private contracts, such as a loan contract, share the same characteristics.

There are three important qualifying remarks that need to accompany the above way of defining a formal institution. First, it does not imply that the rule is mechanically followed. The most obvious reason is that the identification of the circumstances that apply leaves room for interpretation by the actors or the law enforcers. Hence the unavoidable subjectivity of the judges dealing with cases where a rule is invoked. In particular, whether attenuating circumstances can be called for is a matter for the judge or the jury (in a court of appeal) to decide. In addition, the prescriptions of the law themselves may be stated in rather vague or incomplete terms, thereby requiring the judge to exercise his own judgmental capacity. For example, in the divorce legislation of some advanced countries, the alimony to be regularly paid by a man to his ex-spouse may not exceed a certain proportion of his income (one-third in Belgium) while the precise amount should be calculated in such a way that the level of living of the ex-spouse does not fall. All judges nevertheless know that this requirement is impossible to meet because divorce has the general effect of impoverishing both parties (owing to the loss of scale economies). Even granting the maximum proportion to the ex-wife is typically insufficient to allow her to maintain her previous standard of living. The subjective appreciation of the law by the judges is again necessary to make a decision about the proportion eventually set by the court. There are thus numerous cases in which "even when institutions are formally codified, their guiding expectations often remain ambiguous and always are subject to interpretation, debate, and contestation" (Mahoney and Thelen, 2012: 10-11).

Second, the rules themselves may comprise ambiguous or contradictory statements about the appropriate behaviour. For example, it is well known that the Sharia, which is the written sacred foundation of Islam, comprises normative statements that are not easily compatible with each other (e.g., those defining the appropriate dressing code for women or the obligation of married women to go to the Mosque for praying).[5] To take another example, when laws are subject to innumerable amendments by the parliament, as is the case in present-day France, they are susceptible of containing inner contradictions that make the task of the enforcing agencies especially difficult.

The third qualifications relates to the nature of the enforcement mechanism. A formal institution has to be implemented through a channel widely accepted as official. In most cases it goes directly through the operation of the rule of the law with sanctions that are backed by a central authority. Formal institutions, however, may also involve self-imposed official rules that govern local organizations such as corporations, political parties, and interest groups. In such cases, the direct enforcer seems to be the organization itself (i.e., the Board of the corporation, the committee of the political party or the council of the association), and not necessarily the state. The state is still likely to be the last recourse and backing enforcement power, while the rules and the specifics of the implementation mechanism are decided by the organization itself. In any case, directly or indirectly, a well-functioning state seems to be necessary to make formal institutions credible.

It should be observed that even under an effective state, judges or bureaucrats may decide to refrain from implementing the law or the formal rules. For example, in West Africa, judges dealing with inheritance cases may opt for a settlement that rests on a compromise between the formal law and the custom. Thus, when one son and one daughter disagree about their entitled shares of the wealth of their deceased father, there are cases where the judge persuades the defendant (the son who asks for the enforcement of the custom according to which he should inherit the entire wealth of the father) and the claimant (the daughter who asks for the enforcement of the statutory law that has established the principle of gender equality in matters of inheritance) to accept a verdict based on the Islamic law (the daughter receives one-half of the brother's share). In this manner, the authority of Islam is invoked (the claimant and the defendant are both Muslims) with a view to avoiding a confrontational approach that is likely to disrupt family relations. The example attests that judges may be confronted with a trade-off between their preference for doing their duty, which is to apply the statutory law strictly, and their own intrinsic preference for the outcome

[5] The advice of the Prophet to the faithful is thus : « Do not prevent your wives from going to the mosque even though they are better off in their homes » (cited from Platteau, 2017, 95-6).

(Aldashev et al., 2012b). Incidentally, this example also shows that the stark opposition made between French colonial countries relying on written codes and British colonial countries relying on the common law, a distinction that is routinely used to identify the role of institutions behind long-term growth performances, may not be as relevant as initially thought.

It is tempting to consider informal rules as the strict complement of formal rules, that is, as unwritten rules that are enforced through non-official punishment mechanisms. Regarding the first aspect, they resemble routines, i.e., unwritten ways of doing things that are learned through direct concrete experience rather than through abstract knowledge acquisition (Nelson and Winter, 1981). As a result, they are genuinely understood only by members of the group that has generated them. An associated feature of informal rules is that they are typically loose and somewhat flexible. This is, in particular, because the circumstances under which they apply are not precisely spelt out. In fact, the way they apply may vary depending not only upon circumstances but also upon the social status or the bargaining strength of the parties involved.

Regarding the enforcement aspect, sanctions against violations may be of three kinds. First, they may correspond to a punishment (e.g., an indemnity to be paid to the aggrieved party by way of compensation for the damage inflicted) meted out by an informal authority in the sense of an authority that does not possess an official status or is not officially recognized (Wade, 1988; Putnam, 1993; Baland and Platteau, 1996, Ch. 8 and 12). Second, other members of the community or social group may impose sanctions in a decentralized manner, such as when ostracization or reputation mechanisms are brought into play (Ellickson, 1991; Ostrom, 1990; Greif, 1989). Finally sanctions can be internalized through a psychological mechanism (social learning and cultural transmission), anchoring the prescriptions in the agents' preferences (Weber, 1978; Frank, 1988; Coleman, 1990; Elster, 1989; Bisin and Verdier, 2000).

The first punishment method tends to dominate in vertically structured societies while the second one is more typical of relatively egalitarian and closed-knitted communities with dense social networks. As for the third mechanism, it is generally found in both types of societies. Moreover, where the first method is implemented, a “mini-state” must exist to enforce the informal rules. The difference between informal and formal institutions then follows from one of the aforementioned characteristics of the latter: formal rules are enacted and enforced by a central official state over a well-defined area (e.g. national) while informal rules are enforced by a local authority (typically of a traditional kind) recognized only over the restricted space of a community, clan, kinship network, or extended family.

The distinction matters because, when the environment changes, informal rules may be more difficult to enforce than formal rules, especially if their enforcement goes through decentralized punishment. This is because the former are less strictly encoded and more dependent upon expectations that tend to evolve as the environment changes. For example, an informal rule that guides the procedure to follow when starting a strike is more easily violated when the surrounding circumstances change than a formal rule to the same effect (Knight, 1992).

The third punishment mechanism associated to internalization differs from the other two for the following reasons. First, it does not require as much information (observation by others) to be effective. Second, it cheaply solves the problem of free rider of second degree (who punishes the failure to punish) and indirect reciprocity. Finally, it dynamically evolves differently through a cultural transmission based on different principles (conformism, paternalism, comparison with peers, social learning) that do not necessarily react the same way to environmental changes as the two other mechanisms (a “mini-state” authority for the first method, and a reputation mechanism associated with the repetition of the relationship for the second method). Note also that the various sanctioning mechanisms may interact with each other (positively or negatively).

As is often the case with typologies, there is nevertheless a grey zone in which the difference between formal and informal rules is not as clear-cut as suggested above, at least regarding the first feature. As a matter of fact, informal rules may sometimes be written in the form of written customs, for example. It is nevertheless noteworthy that, albeit written, they remain limited to local areas or communities. Thus, for instance, the English customals or the French ‘coutumes’ varied considerably from one region to another, whether written or not, hence the difficulty of codifying and uniformising them over a large territory. On the other hand, some customs spread in an evolutionary manner through vast territories so that they can no more be considered to be local. A striking example is the code of driving on the right side of the road that started as a formal prescription imposed by Napoleon in the French empire but later spread to contiguous areas in a gradual and informal way, as analysed by Peyton Young (1998). Another example that pertains to developing countries concerns the system of marriage payments: the widespread existence of bride prices in Sub-Saharan Africa and dowries in India.

The second ‘mirror’ feature of informal institutions is not subject to the ambiguity that the first feature potentially presents. In other words, it is always true that informal rules are not enforced through a modern legal system. We can therefore adopt two different definitions of informal institutions or rules: rules are informal stricto sensu (ss) when they share the two aforementioned features –they are unwritten rules applying to a restricted social group or community and enforceable through non-legal mechanisms at work inside that group or community–while rules are informal lato sensu(ls) when they only display the second feature –they are written rules applying to large populations yet enforceable through non-legal mechanisms at work inside small groups or communities.

To get substantive meaning, it is also important not to define informal institutions as a residual category, in the sense that it can be applied to virtually any behaviour that departs from, or is not accounted for by, the written-down rules. To avoid such problem, one must say more about what an informal institution is not. First, informal institutions are, of course, not synonymous to weak institutions. Empirically, a potential major asymmetry between formal and informal institutions is the degree of observability of the effective functioning of these institutions. It is easier to observe weak formal institutions and to treat informal institutions as a residual. However, observing formal institutions with some dis-functioning does not necessarily mean that there is an underlying informal institution that matters underneath. In other words, many formal institutions are ineffective, and yet such weakness does not necessarily imply the presence of (effective) informal institutions. Second, informal institutions must be distinguished from other informal behavioural regularities. Not all regular informal behaviour is rule-bound or rooted in shared expectations about others’ behaviour. For instance, removing one’s hat in a church is an informal institution or social norm, whereas removing one’s coat in a restaurant is simply a behavioural regularity (Brinks 2003). Third, informal institutions should be distinguished from informal organisations. Although blurred by the fact that informal rules are often embedded within organisations, the game theoretical distinction between “players” and rules of the game is analytically convenient. By the same token, one can make a distinction between informal institutions and the broader concept of culture (or shared values). Embedded in people, culture may help to shape informal institutions and facilitate the construction and maintenance of shared expectations. However, shared expectations may or may not be rooted in broader societal values.[6]

As is evident from the above discussion, there are many respects in which societies may institutionally differ. A first source of variation lies in the relative importance of formal versus informal institutions (as stressed by Polanyi, 1957). A second source lies in the type of dominant punishment mechanisms undergirding informal institutions. Third, from a dynamic perspective, there are societies, typically Anglo-Saxon societies, in which formal institutions emerge as the result of a codification of informal rules that have been implemented informally over a rather long period of time. In other societies, those influenced by the Roman tradition, for example, formalization often comes about as the expression of a hierarchical centralized power that decides to establish a clear rule defining appropriate behaviour.

2. Presentation of the contributions

The chapters composing the Handbook follow the above definition of institutions in an explicit or an implicit manner. In the latter instance, a particular institutional structure may be embedded or concealed behind the mechanism described. Changes in mechanisms typically entail institutional changes that are then explicitly addressed.

This Handbook is divided into five different sections. The first section deals with political institutions, clientelism and the role of inequality. The first chapter, written by Ernesto dal Bo and Fred Finan, presents a in depth survey of the experimental evidence available on political institutions and focusses on three main dimensions: (i) political accountability, which includes

[6] It should be mentioned that certain types of organizations such as corporations and firms are actually clusters of institutional interactions including both formalized aspects (internal governance structures and self-imposed rules of functioning) as well as informal dimensions (corporate culture). The may coexist together in complementary or substitutive ways. As such, although they are not stricto-sensu institutional rules in the sense of North, one may obviously consider them as important institutional clusters that in some analyses can be analysed as institutions.

electoral rules, information and political norms, (ii) state capacity, which includes taxation, bureaucratic incentives or the design of a monitoring system and (iii) the quality of enforcement, including the awareness of one's rights, the selection of judges or the design of the enforcement scheme. The second chapter, by Pranab Bardhan and Dilip Mookherjee, focusses on clientelism, and the mechanisms used by political actors to deliver benefits selectively to voters in return for their votes. As they argue, clientelistic practices are not specific to poor countries and persist along the process of development. Their nature however changes, as they move from pure clientelism, which involves discretionary allocation of benefits to particular individuals, to programmatic (pork-barrel) politics which covers a group of citizens with a designated characteristics. They review the literature and investigate the consequences of these two types of clientelism. They argue that programmatic politics arises with property right reforms and, in turn, by generating public goods, it fosters economic development. As a result, the relationship between clientelism and development should be viewed as a two-way dynamic interaction.

After investigating the 'institutional economy' of the natural resource curse, Ragnar Torvik, in the third chapter, reviews the literature relating resource endowment, political power and institutions, arguing that it is the initial interplay between these three components that determines the evolution of the economy and of its institutions. He then discusses the design of institutional reforms in a politically constrained context, so that the reform is politically feasible and acceptable. In Chapter 4, Rohini Somanathan, in chapter four, investigates the persistence of group inequality in democracies, where groups consist of citizens who are given a socially recognized marker, such as race, caste, color or language. In this context, she discusses the relative merits of affirmative action policies as compared to public policies which are not based on those group identifiers. The dearth of real evidence comparing the relative effectiveness of these different policies in the short and in the long run is unfortunate. She ends up questioning group classification on the grounds that it conceals large intra-group differences and, more fundamentally, shapes social identity. Finally, Joan Esteban and Debraj Ray present a panoramic view of the literature on social conflict and economic development, organised around three widely shared views: higher standards of living reduce the probability of conflict; inequality nurtures conflict; and most conflicts in developing countries are ethnic in nature. An important line for further research is based on the fact that a substantial share of social conflict can be attributed to economically similar groups. The dividing cleavage is then non-economic (though the conflict can still be over economic resources) and manifests itself along ethnic lines. For this reason, the interaction between ethnic identity and economic characteristics, and how such interaction might result in ethnic conflict, is a research topic of the highest importance. A related question raised by the review involves the role of institutions in framing economic divergence or competition into ethnic rivalry and stronger ethnic identities.

The second section of this Handbook reviews the literature on growth, economic development and institutions. Steven Durlauf introduces this Section by reviewing the empirical evidence relating 'institutions' and 'growth'. Cross-country evidence provides limited evidence, given their general inability to identify a particular mechanism as well as massive uncertainty about the appropriate 'model' (i.e., specification). The few existing structural approaches combining theory with data suffer from the multiplicity of the possible interpretations of the same empirical regularities. Historical analyses, based on a deep understanding of the context, probably provide strong, albeit specific, evidence on institutions. The most promising research strategy integrates knowledge emerging from those three different approaches into a consistent interpretational framework. Relatedly, while 'institutions matter', a key challenge is to translate broad institutional categories such as used to compare national experiences, into operational and, hence, context-specific institutional configurations. The author concludes in favour of more work on the policy implications of the institution and growth literature, with a focus on context-specific institutional portfolios. In chapter 7, Thorsten Beck takes stock of the literature on financial development and the role of institutions, and highlights the possible trade-offs between financial development, economic growth and stability. Given its intertemporal nature, the financial sector is one of the most intensive in institutions, and its outreach critically depends on governance and trust. Also, by increasing competition in the real sector, financial development fosters demands by the society for institutional change. Policy-wise, it is critical to identify the institutional and the political constraints on the development of the financial sector. The optimal sequencing of institutional change for financial development remains an open issue.

Section 3 investigates the role of institutions in international economic exchanges, in particular trade, aid and migration. In chapter 8, Jaime de Melo and Marcelo Olarreaga focus on the role played by trade agreements, trade promotion organizations and private labelling or trading platforms in shaping trade flows and their impact in developing economies. An important issue raised there is the gradual shift from an exchange of access rights to markets to deeper reforms which involve, typically, social, environmental and investment norms and policies, the consequences of which we need to assess and understand better, particularly in the South. Francois Bourguignon and Jan Willem Gunning, in chapter 9, investigate the two-way relationship between foreign aid and local institutions and the resulting trade-offs. Direct aid may encourage rent seeking and discourage the institutional reforms needed while conditionality may promote governance and institutional improvements. On the other hand, the quality of governance and institutions in a country plays a key role in attracting foreign aid and in making it more effective. They propose a simple model aimed at organizing the discussion around these issues, illustrating the major trade-offs and providing key analytical distinctions between different types of aid. The refined taxonomy proposed, combined with relevant measures of institutional quality, provides clear avenues for future empirical research. In chapter 10, Kaivan Munshi reviews the literature on migration, focussing on the role of community networks, which facilitate migration in the short run but can have detrimental consequences on the migrant in the long run, typically by restricting spatial or occupational mobility. The review raises two important questions: first, what are the circumstances under which such networks form and, second, what are the static and dynamic inefficiencies associated with these networks?

The fourth section of this Handbook focuses on the role of culture, gender and families, and more generally, on the role of informal institutions. In a thought-provoking chapter, Marcel Fafchamps, focusses on contract enforcement in market exchange, and rejects the widespread notion that formal institutions simply displace informal ones. On the basis of experimental and anthropologic evidence, he develops instead the central idea that formal institutions should be thought of as reinforcing informal arrangements, which are themselves based on norms, emotions and thought processes. He then explores the role of families and communities in the transmission and perpetuation of these norms, and how, in many instances, they fit market institutions well. In chapter 12, Gerard Roland provides an exhaustive survey of the economic literature on culture, institutions and economic development, and focusses on the different dimensions of culture. He also investigates the determinants of cultural change and the origins of cultural diversity. A central question in this chapter is the tension between a notion of cultural inertia, which may be related to its transmission mechanisms, and the numerous instances of fast moving cultural traits and attitudes. Relatedly, the sources of cultural diversity remain an open issue, and more research is needed to identify the fundamental pillars of different cultures as well as their commonalities, and to understand their determinants.

Catherine Guirkinger and Jean-Philippe Platteau, in chapter 13, discuss families as a fundamental informal institution. Drawing from scattered empirical works as well as historical studies, they focus on the dynamics of households and families in response to change in the economic environment: division of family land, household splits, inheritance rules,... The various roles played by families implies that adaptation to change in one dimension often imply increased inefficiencies in other dimensions. In this respect, some of the critical functions of families (for instance, judiciary or political) and the existence of authority structures within families are typically ignored in most economic approaches. The authors call for more work on the evolution of households and families, the determinants of household's organizational structure, as well as a better understanding of the impact of family laws on family structure and their members' welfare. Moreover, they illustrate and emphasize the possibility of non-monotonous transformations of family structures such as when collective forms give rise to more individualized forms that in turn can become re-collectivized under circumstances that they elucidate. Stephan Klasen, in chapter 14, investigates gender relations as resulting from formal and informal institutions, highlighting large differences in gender gaps and in their changes. After reviewing the large literature on the impact of gender gaps on economic development, he investigates the differential evolution of these gaps, for instance in comparing the rapidly changing access to education to the much more stable norms governing segregation and restrictions in occupation. He also discusses the possibility of backlash effects through which resistance to gender equalizing trends develops. He concludes by reviewing the scant literature on the determinants of gender gaps and their evolution, and calls for more research on this issue.

Section 5 investigates the inter-connections between institutions and economic development in a number of different sectors. In chapter 15, Imran Rasul presents what is known on the impact of institutions and the state on worker outcomes, firm behavior and the labor market in developing economies, bringing in new descriptive evidence from various surveys. His survey covers issues such as the institutional constraints on firm expansion, job matching, entrepreneurial skills or the role of unions, and suggests the need to better understand the effects of changes in institutional packages on labor market outcomes, instead of singling out particular reforms. Meghana Ayyagari, Asli Demirguc-Kunt and Vojislav Maksimovic review the literature on the role of institutions in the financing of firms. Firm financing in developing countries suffers from poor protection of the investors' rights as well as information barriers arising from poor accounting practices and inadequate public recordings of credit or bankruptcies. However, in their overview of firm's lifecycle at the micro-level, there is little evidence of a long term impact of institutions on firms. This may be due to the fact that institutions matter for the entry of new firms, or that institutions change frequently over a firm's life, so that one needs to better understand the short run effect of institutional changes on firms' evolutions at different points of their life-cycle. Little is known about those two issues.

In Chapter 17, Antonio Estache provides a comprehensive survey of the large literature on infrastructure services and discusses various institutional and policy alternatives. Poor project selection, poor maintenance and poor ability to improve access are all linked to institutional choices. In practice, the latter involve privatization and partnerships, deregulation, independent regulation, decentralization or shared mandates. The pro-market orientation of many recent reforms did not improve the situation. More research is needed to understand, both theoretically and empirically, the role institutions can play in improving the performance of the sector, taking into account the specificities of particular infrastructures as well as the structural characteristics of the economy. In their review of education, institutions and economic development, Tessa Bold and Jakob Svensson identify teacher's effort, knowledge and skills as the main bottlenecks in improving educational performance in developing countries. They then discuss the question of scaling up successful micro-interventions, focusing on local implementability and wider political economy constraints. Two key research issues, at the local level, are how to design appropriate performance contracts for teachers and how to improve the knowledge content and the pedagogical skills of the teachers. At a higher level, we need to understand better how to scale up interventions, given the political and institutional constraints in place, and the possible impact of private educational subsidies for the poor.

Chapter 19, by Eliana la Ferrara, investigates the role of the media as a tool for institutional change. She focusses on three main issues. The first one, which has been well explored by economists, is the role of media in providing information which impacts political accountability, typically through voter participation and voting outcomes. The second one deals with media bias and media capture, which relates to the degree of political control and ideological biases in the information released by the media. While the evidence comes in large part from high-income countries, the importance of media bias and capture in the weaker institutional setting of many developing countries clearly calls for more research in the latter context. The third issue is the role of media in inducing social change, through their impact on norms, preferences, beliefs and attitudes. An important gap there is how entertainment media can be used to foster civic values and political participation. In chapter 20, E. Somanathan surveys the role of institutions in addressing environmental issues. At the level of local resources, such as forests, we need to understand better the economic and political determinants of decentralization, given the overall success of local level management schemes compared to more centralized ones. At the national or subnational level, for issues such as waste disposal, traffic congestion or access to clean water, we still know very little about the performance of alternative regulatory institutions. (Estache (this volume) makes an essentially similar point when discussing the closely related theme of infrastructures.) The possibility of low level equilibrium traps and how to solve them also needs more investigation.

3. Broad Research Avenues

From the collection of surveys described above, it appears that two broad research avenues are of particular interest. The first one is the interaction between institutions, in particular those between formal and informal institutions. As discussed by Marcel Fafchamps or Somanathan (this volume), one of the questions is the extent to which these two types of institutions are complements or substitutes. Additionally, many contributors to this Handbook share the view that institutions are essentially changing and endogenous. The second research issue has to do with institutional change, and the necessity not to limit our attention to abrupt changes induced by ambitious policy reforms. Gradual changes may play a more important role and it is therefore essential that economists pay them much more attention than they have done in the past.

3.1. Substitution and complementarity effects between formal and informal institutions

Formal and informal institutions interact in a variety of ways. A useful starting point for a typology of interactions between formal and informal institutions is the two dimensional typology of Helmke and Levistky (2004) that was developed in the context of comparative politics, but can be extended to other socio-economic contexts as well. This is illustrated in the following table:

Outcomes	Effective Formal Institutions	Ineffective Formal Institutions
Convergent	Complementarity	Substitution
Divergent	Accommodation	Competition

The first dimension (on the vertical axis) concerns the degree to which formal and informal institutional outcomes converge. The distinction here is whether informal rules produce substantively similar or different results from those expected from a strict and exclusive adherence to formal rules. Where there exists substantial discrepancy or contradiction across outcomes emanating from informal and formal rules, formal and informal institutions diverge. Where outcomes are not substantively different, formal and informal institutions converge.

The second dimension refers to the effectiveness of the relevant formal institutions, that is, the extent to which formal rules and procedures are enforced and complied with in practice. Effective formal institutions actually constrain or enable individuals' choices and there is a high probability of official sanctions in case of violation of the rules. Where formal institutions are ineffective, agents expect a low probability of enforcement (and hence a low expected cost of violation).

According to the table, four different types of institutional interaction patterns can arise. The upper left corner combines effective formal rules and convergent outcomes, producing *complementarity* between informal and formal institutions. In such cases, informal institutions either address contingencies not dealt within the formal rules or facilitate the pursuit of individual goals within the formal institutional framework. They may also serve as pillars for the functioning of formal institutions, creating or strengthening incentives to comply with formal rules that might otherwise exist merely on paper. A typical example relates to the effectiveness of a political constitution such as the US constitution that clearly depends on a complementary set of shared beliefs and expectations among citizens or the efficiency of Singapore's postcolonial bureaucracy (the formal organization of which resembled those of Indonesia and the Philippines) which has been attributed to underlying norms of meritocracy and discipline. The discussion of 'embeddedness' by Marcel Fafchamps (this volume) is a clear example of powerful complementarity between formal contract institutions and social norms.

The lower left corner of the table combines effective formal institutions and divergent outcomes. This corresponds to a situation of *accommodation* between informal and formal institutions. In such a case, informal institutions create incentives to behave in ways that alter the substantive effects of formal rules, but without directly violating them. They contradict the spirit, but not the letter, of the formal rules. Accommodation occurs when a contradiction emerges between outcomes generated by the formal rules and prescriptions emanating from customary or informal rules. The effectiveness of formal rules however impedes an outright change or open violation of the rules. Accommodation helps to reconcile conflicting dimensions within the existing formal institutional arrangements and results from the implementation and interpretation of formal rules by actors subject to informal prescriptions (see the earlier example of succession laws in West Africa and the discussion and illustrations in Guirkinger and Platteau, this volume).

The cell in the lower right corner of the table combines ineffective formal rules and divergent outcomes, producing *competition* between informal and formal institutions. In such cases informal institutions structure incentives in ways that are incompatible with the formal rules: to follow one rule, actors must violate another. Typical examples of such situations occur, for instance, when particularistic informal institutions like clientelism and nepotism occur in various contexts of weak formal political or economic institutions (Hoff and Sen 2005, Mookherjee and Bardhan, this volume). Thus, competing informal institutions are often found in postcolonial contexts in which formal institutions were imposed on indigenous rules and authority structures. In postcolonial Ghana and India, for instance, civil servants were officially instructed to follow the rules of the public bureaucracy, but most believed they would pay a significant social cost (such as a loss of standing in the community) if they ignored kinship group norms that obliged them to provide jobs and other favours to their families and villages (Price, 1975; Kakar, 1978).

Finally, the upper right corner of the table considers the combination of ineffective formal institutions and converging outcomes, thus corresponding to a situation of *substitution* between formal and informal institutions. In such cases, informal institutions are employed by agents who seek outcomes compatible with formal rules and procedures but in environments where formal rules are not routinely enforced. Hence, in substitution situations, informal institutions achieve what formal institutions were designed, but failed, to achieve. For instance, traditional and informal norms of income sharing within communities substitute for formal insurance markets as they tend to achieve the same type of insurance mechanisms as these formal markets which remain incomplete because of lack of verifiability and/or asymmetric information between contracting parties.

The previous typology allows us to classify the nature of the interactions between informal and formal institutions at a given point of time. It should be clear that the sign of such links may evolve dynamically depending on the institutional path followed by society. In this respect, it should also be emphasized that informal and formal institutions influence each other along a dynamic two-way process. Specific formal rules and institutions may be inspired by (or simply formally reflect) already well diffused and practiced social norms of behaviors. In return, such formalization process may as well modify dynamically the structure of the informal interactions that inspired the design of these formal rules. The inclusion of informal practices into formal law, and in return the constraints effectively imposed by formal law rulings on informal codes of behaviors are clear examples of such two-way dynamic interactive process.

3.2. Gradual institutional change

We still know very little about institutional change. When institutions are conceptualized as Nash equilibria and are therefore considered as stable outcomes, the only manner in which they can possibly change is as a result of exogenous shocks that modify some key parameters of the game considered. The shocks can consist of technological or other changes that end up modifying the payoffs accruing to some or all the agents, changes that bring new actors onto the scene and/or remove old ones from it, changes that allow for new individual actions or alter the agents' expectations regarding others' actions. New Nash equilibria then emerge while old equilibria stopped displaying this property.

Just think of the distinction between inclusive and extractive political equilibria described by Acemoglu and Robinson (2012). Once a country has attained one or the other equilibrium, it gets trapped into it. Therefore, an exogenous shock or a chance event is required to move a country from the vicious (extractive) to the virtuous (inclusive) equilibrium. In the words of Greif and Laitin (2004, 633): "A self-enforcing institution is one in which each player's behaviour is a best response. The inescapable conclusion is that a change in self-enforcing institutions must have an exogenous origin." The same authors nevertheless stress indirect institutional effects (so-called feedback effects) that either expand or reduce the set of situations in which an institution is self-enforcing. By redefining some of the exogenous parameters as endogenous variables (that they call "quasi-parameters"), they are able to account for the stability or the breakdown of different institutional equilibria. As illustrations, they propose the decline versus the resiliency of social order in Venice and Genoa and the decline versus persistence of ethnic cleavages in Estonia and Nigeria.

On the other hand, it is evident that, in a static framework, we are not told anything about the pathway that leads from the old to the new equilibrium, and how the latter is influenced by the former (bear in mind that an equilibrium selection problem arises in the new situation created by the shock). Precisely because it is based on a dynamic framework, the evolutionary approach to institutions avoids the last aforementioned difficulty. None the less, the problem of explaining institutional change remains. According to a central theorem of evolutionary game theory, indeed, evolutionary equilibria have the properties of strategic equilibria: for a large class of evolutionary games, if the dynamics converge, they converge towards a steady state in which the limiting distributions are in equilibrium in the same sense as in classical game theory. The population seems to learn the rational equilibrium as its distribution evolves, and this is true despite the fact that limited rationality of the actors is assumed. An institution thus exists as a set of stable individual behaviours given what the other agents are doing. As a result, it answers the definition of a coordination mechanism of some sort (Montet and Serra, 2003: 8-9; Bowles, 2004).

In explaining institutional change, the attention of economists inspired by an equilibrium approach is naturally directed to major events deemed to be significant enough to disturb an existing equilibrium. Radically different is the approach proposed by a group of social scientists who are more interested in gradual and piecemeal changes based on endogenous developments that often unfold incrementally and only 'show up' or 'register' as change if a somewhat long time frame is considered (Mahoney and Thelen, 2010: 2). In this perspective, the sources of institutional change are not simply exogenous shocks or environmental shifts, and path-dependent lock-in effects are considered to be rare in real societies.

For the sake of illustration, we can cite the transformation of land tenure rules in Sub-Saharan Africa during the last century. This transformation can be described as an incremental individualization process whereby rules of corporate ownership of land gradually gave way to freehold rights. To identify the successive steps in the process, one must reckon that, far from being a monolithic concept, private property in land involves a continuum of attributes: the rights to use the land, to make decisions about its current exploitation and about its improvement through investment, to bequeath it, to lend it, to rent it out (against a cash payment), to donate it and, finally, to sell it. Even the latest right may not be availed of in a single move: in the beginning, the right to sell may thus be granted only on the condition that the sale has been approved by designated members of the family or community. On the other hand, the right of the purchaser to keep the land may be limited by the right of the seller to retake possession of it as soon as he has the required wherewithal.

Mahoney and Thelen distinguish between four modal types of institutional change: displacement, layering, drift, and conversion. *Displacement* means the removal of existing rules and the introduction of new ones. *Layering* refers to the introduction of new rules on top of or alongside existing ones. *Drift* is the changed impact of existing rules due to shifts in the environment. Finally, *Conversion* is the changed enactment of existing rules due to their strategic redeployment. Note that displacement can be a slow-moving process when new institutions are introduced and directly compete with an older set of institutions. Layering changes the ways in which the original rules structure behaviour. Drift occurs when rules remain formally the same but their impact changes as a result of shifts in external conditions: institutional change can then be said to grow out of the neglect of an institution or, more precisely, the failure to adapt and update it so as to maintain its traditional impact in a changed environment. By contrast, conversion occurs when rules remain formally the same but are interpreted and enacted in new ways thanks to the intervention of actors who exploit the inherent ambiguities of the existing institutions (pp. 15-17).

The authors then suggest that differences in the character of existing institutions as well as in the prevailing political context affect the likelihood of specific types of change. The role of these two key dimensions revolves around the two following questions:

- Does the political context afford defenders of the status quo strong or weak veto possibilities?
- Does the targeted institution afford actors opportunities for exercising discretion in interpretation or enforcement?

The table below provides a manner to think about how these two dimensions interact and determine the type of expected institutional change.

Characteristics of the targeted institution (Row) Characteristics of the political context (Column)	Low level of discretion in interpretation/enforcement	High level of discretion in interpretation/enforcement
Strong veto possibilities	Layering	Drift
Weak veto possibilities	Displacement	Conversion

Our example of gradual institutional change in land rights in Sub-Saharan Africa appears to belong to the case labelled “weak veto possibilities”, so that transformation has been incremental and rather smooth. What is less clear, however, is whether it falls under the high or the low level of discretion in interpretation/enforcement, that is, whether we are dealing with a case of displacement or a case of conversion. Evidence tends to indicate that conversion is probably the best way to describe the type of change involved, implying that customary rules are characterized by a rather high level of discretion in interpretation/enforcement.

Looked at from the lens of the economics profession, the gradual change approach suffers from a major disadvantage: it does not allow clear identification with the consequence that causal relationships cannot be established. On the contrary, the approach centred on exogenous changes in equilibria, because it uses the comparative-static method to study change, is able to solve the identification problem by exploiting exogenous shocks. The fact remains that, as the aforementioned example attests, it may be unreasonable to dismiss the gradual change approach and to thus deprive ourselves of the promising bridge that it puts up between the works of historians and the works of economic historians and development economists.

This being said, one would like to go beyond the broad characterizations of change types proposed by Mahoney and Thelen with a view to better understanding the way gradual change possibly articulates with abrupt change. More precisely, we would like to have a better theory in support of their claim that "gradually unfolding changes may be hugely consequential as causes of other outcomes" (p. 3).

To what extent and under which circumstances can an apparently discontinuous change be considered as the outcome of a slow-moving process of gradual institutional change that prepared the ground for the institutional break? An insightful example is the demise of serfdom in Tokugawa Japan as described by TC Smith (1959). This demise is depicted as the end outcome of a sustained process of gradual emancipation of the serfs (the *nago*) as a result of the development of rural (silk-producing) industries which created an acute competition for local labour. Despite the calls issued by the landlords (the *oyakata*), the state did not use its repressive force to bring running away serfs back to their masters. As a consequence, the implicit labour contracts ruling inside the feudal estates were progressively modified to allow more freedom and better terms for the tenants. The Japanese experience is in striking contrast to the experience of Russia, for instance, where serfs became emancipated (in 1861) as a result of a top-down, state-directed reform abolishing serfdom. Even here, however, some caution is required: in some estates, indeed, gradual reforms had been introduced before 1861 under the initiative of enlightened landlords (Zuravskaya and Markevich, 2015).[7]

Relatedly, institutional change although continuous in it essential dynamics may actually appear as fragmented and discrete from the point of view of an external observer. This is related to the idea of Timur Kuran (1995) of “private truth and public lies” inspired by the Iranian revolution, namely the fact that some latent institutional change may occur in a continuous way in the private or informal sphere of the society, and only appear publicly or formally once these hidden changes have crossed a specific threshold. Such processes may then be viewed as mechanisms of "neutral" institutional developments which up to certain threshold effects do not seem to matter much in terms of societal outcomes, but which in complement to other changes or shocks to the system, may trigger punctuated and discrete relevant institutional dynamics afterwards. Developing models of such institutional dynamics and identifying historical situations for such phenomena may help reconcile in an innovative way the two views describing institutional changes (discontinuous versus gradual) that have been discussed so far.

As emphasized by Ragnar Torvik (this volume), the analysis of endogenous change immediately raises the issue of the role of different actors with a stake in that change, calling for a political economy approach which features the relative power weights of the various actors, the negotiating arenas existing in the society, and the motives of the state. Why is it, for example, that the Tokugawa state refrained from meeting the landlords’ demand for strict enforcement of the feudal type of labour relations? In the case of land tenure in Africa, the relatively smooth process of incremental change that has been described can only occur if the central state does not interfere awkwardly, for example by appropriating valuable customary lands for the purpose of promoting the interests of the ruling elite, by imposing land titling measures ‘ex abrupto’ when the individualization process is still in its infancy, or by imposing private property rights when scale economies and externalities work in favour of traditional corporate ownership. On the other hand, the local customary authorities may have a vested

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[7] Interestingly, the main factor driving the change in Japan is market development in response to growing demand for silk. In the individualization of land tenure in Africa, the engine consists of both population growth and market integration, the latter force being itself influenced partly by the development of transport infrastructure.

interest in maintaining a traditional system of land tenure rules from which they derive ample benefits such as the right to adjudicate competing claims and to settle land conflicts. What are their motives for not resisting the ongoing changes?

A recent economic literature proposes a number of theories of gradual change that do not rely on evolutionary mechanisms and the associated assumptions of limited rationality, nor on discrete equilibrium shifts. For example, Acemoglu and Jackson (2015) have written a model of interactions between the law and prevailing social norms in which agents meet in pairwise encounters and are allowed to denounce violators of the law. They show that in this setup the law may gradually evolve to adapt to the social norm. In the converse way, Aldashev et al. (2012a) have developed a dynamic model that shows how the custom may gradually evolve in the direction of the law in a world where customary authorities pronounce judgements referring to the custom. Interestingly, expanding economic opportunities have the same effect as a statutory law when both circumstances afford weaker groups new exit possibilities and, hence, confer greater bargaining power upon them (see Guirkinger and Platteau, this volume). But these gradual changes may be disrupted and even overturned if political power changes hands and progressive laws are rescinded or cease to be enforced. Another application of economic theory of gradual change to institutions is the paper by Bidner and François (2013) on the emergence of political accountability. They focus on the role played by political norms –specifically, the extent to which leaders abuse office for personal gain and the extent to which citizens punish such transgressions. They show how qualitatively distinct political norms can coexist because of a dynamic complementarity in which citizens' willingness to punish transgressions is raised when they expect such punishments to be used in the future. Their analysis also highlights the role of leaders, offering an account of how their actions can instigate enduring change, within a fixed set of formal institutions, by disrupting prevailing political norms. A key finding is that such changes are asymmetric in effect –a series of good leaders can (and eventually will) improve norms, whereas bad leaders cannot damage them[8]. If there is a small yet growing amount of works

[8] Acemoglu and Jackson (2015) study also the emergence and dynamic evolution of social norms in response to individual behavior and actions by leaders. In their model leaders are agents endowed with visibility of acts whom are part of a sequence of players through time. This visibility allows leaders to play a coordinating role that can induce a sequence of good play from immediate followers. They also show that social norms can be shaped by a pattern of mean-reverting dynamics of expectations and behavior.

dedicated to the theory of gradual change applied to some institutional issues, empirical studies by economists remain very rare.

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