ECONOMIC DEVELOPMENT & INSTITUTIONS

Appraising institutional challenges in the early stages of development

Chapter 1: Institutions and institutional change: concepts and theories

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Chapter 1: Institutions and institutional change: concepts and theories

The ‘institutions matter’ slogan appears today as a fundamental truth about development. Widely shared by the development community, including international organisations, it goes with the idea that the benefits of both market operations and state interventions are significantly conditioned by the presence of effective institutions. An abundant literature in economic and political sciences, both theoretical and empirical, has recently suggested that the poor quality of institutions is an important determinant of low development outcomes and the persistence of poverty in the world. In many cases, existing institutions are not well adapted to the challenge of modern economic growth and development. This raises the issue as to how existing institutions can be reformed, which is especially thorny because they are often the embodiment of local cultures and historical legacies.

This chapter is organised into three main sections. First, we provide a simple definition of institutions and comment upon their main aspects. Second, bearing in mind the pervasive presence of informal institutional arrangements in all developing countries, we highlight various ways in which these arrangements can interact with formal institutions, ending with a brief discussion of conflicts between formal institutions themselves. In the process we touch on the issue of institutional change, since an important question is how the dynamic of change is affected when formal and informal institutions enter into conflict with each other – say, following the creation of a new formal institution. Third, we address the issue of institutional change by looking at the various theories proposed by economists to explain why institutions may evolve or may alternatively persist in spite of a changing environment. Finally, by way of conclusion, we examine various arguments in the debate about radical versus gradual institutional reforms.

1.1 A simple definition of institutions

Many and diverse definitions of institutions have been proposed in books and papers written by economists and other social scientists. It is definitely not our intention to review all of them here. What we need to do is to provide a clear definition which the reader can expect to see being consistently applied in the following chapters. This definition, it must be noted, is not original or novel but it intends to emphasise the most critical features that will come up for discussion in the whole book, whether explicitly or implicitly. *By institutions, we mean rules, procedures, or organisations, formal or informal, that constrain individual behaviour in such a way that human actions become coordinated. Individual actions are influenced through adhesion or coercion; it is only in the former case that an institution can claim a high degree of legitimacy.*

A first implication of this definition is that in our understanding institutions cover a wide variety of humanly devised coordinating mechanisms, running from state administrations, the judiciary, and the police to religious bodies, tribal chiefdoms, and patronage relationships, passing through social norms, customs, contract arrangements, mutual aid groups, and neighbourhood associations.

A second implication, as underlined in North (1990), is that individual expectations play a pivotal role in the formation and maintenance of institutions. This is true whether the shaping of behaviours takes place through adhesion or coercion. This is most evident in the case of adhesion. People adhere to an institutional arrangement when they trust it in the sense that they believe that not only themselves but also other individuals support it. The arrangement is then considered legitimate by a large number of its users, and this legitimacy means that individuals expect many others to comply with the prescriptions involved. It should be noted that compliance does not necessarily imply that everybody is happy about the institution, or thinks it is the best that can be achieved. What it does imply is that everybody is confident that other people are likely to behave in the way prescribed because this is the normal thing to do or the established manner of behaving in the particular society and context in which they live. Striking illustrations are provided by many social norms and customs, but also by manifestations of voluntary compliance with laws or regulations.

For obvious reasons, adhesion is especially forthcoming when, through some form of collective action, people have themselves decided to set up rules that will constrain them in a way that is ultimately beneficial for all. For example, villagers may realise that, when left free to act according to their best private interests, they have a tendency to overexploit a local natural resource (a fishing ground, a pasture, a forest, underground water, etc). They may then vote for establishing regulations that will limit their freedom to exploit this resource – say through the imposition of quotas, harvesting seasons, and rules regarding the characteristics of the produce they are allowed to get hold of (for example, the size of fish that may be caught or the height of trees that may be felled).

In the case of coercion, expectations formed by individuals are equally important. Indeed, there can be no coercion without the possible use of sanctions meted out by an authority. And coercion will not be effective if people are not convinced that the rule will be more or less strictly enforced. Just think of tax laws or driving regulations in a democratic country: if citizens do not expect that the rules will be enforced, either because detection of fraud or rule violation is deficient or sanctions are small or easy to circumvent, they will not take them seriously. At least this is true unless they are imbued with a strong sense of civicness, which is understood as an inclination to follow a law just because it has been enacted by a legitimate authority (the state, in this instance).

A third implication, related to the first one, is that both formal and informal arrangements can be institutions. Institutions are formal when they rest on explicit, written rules which are enforced through official channels. As explained in more detail in Baland *et al*. (2019), the first requirement (explicitness) means that the rules are stated in a clear and articulate manner so that they are understandable by anyone possessing sufficient knowledge of the language in which they are written, and people are left with little uncertainty about the circumstances to which they apply. By contrast, informal institutions are generally made up of non-written rules or, if they are written, the rules are specific to a particular human community in the sense that their meaning is not easily accessible by outsiders. One important reason for this is that the circumstances and the social groups to which they apply may not be clear for those who are not members of the rule-setting community. They may thus appear to the external observer to be somehow arbitrary. In addition, informal rules are often somewhat loose or flexible. This is because they tend to allow for the consideration of individual circumstances and, relatedly, they involve *ex post* sharing, redistribution, or insurance. Reciprocity is therefore undefined *ex ante*, and rewards for performing a task are unspecified and are contingent on future shocks. This is especially true in the realm of the family (narrow or extended), where the dominant form of (economic) relationships is gift exchange in which reciprocity is typically delayed and combined with insurance (Fafchamps, 2019). Finally, the rules behind informal arrangements are typically enforced through non-official sanctioning mechanisms.

Non-official sanctioning mechanisms, like official ones, may consist of punishments meted out by an authority. In this case, the authority is informal, such as a tribal chief, a clan leader, a landlord-patron. Yet other types of sanctions are also found in the universe of informal institutions (for more details, see Colson, 1947; Sahlins, 1965; Hayami and Kikuchi, 1982; Greif, 1989, 1992, 1993, 1994, 1998, 2002, 2006; Platteau, 1991, 1994a, 1994b, 2000, 2006; Fafchamps, 1992, 1996, 2020; Aoki, 2001; Dixit, 2004). First is the fear of reprisal by a partner or a group that is outraged by the behaviour of a rule-violator, or by an organisation established for that purpose. The latter may be a thuggish or criminal organisation that specialises in the job of intimidating and threatening individuals or families with a view to obtaining redress for a fraudulent or deviant act. Second is the fear of losing a valuable relationship with the cheated or disappointed partner in a so-called ‘relational contracting’ based on repeated interactions between two agents. The punishment thus involves what Greif has called a bilateral mechanism of reputation and punishment. Third is the fear of losing reputation inside the whole group, community, sector, or location to which the cheated partner belongs. In this instance, a multilateral mechanism of reputation and punishment is set in motion. It operates in a decentralised manner and in an extreme case can take the form of ostracisation. Fourth, sanctions can be internalised through a psychological process, such as social learning and cultural transmission. In the latter case, social norms instilled in members of a community, a group, a brotherhood, or a sect, for example, may drive them to feel guilty whenever they deviate from their prescribed behaviour. Such guilt feelings are often anchored in the idea that deviation amounts to a betrayal of the collective. Internalisation mechanisms of this kind are the functional equivalent of civicness in the sphere of formal institutions. In both cases, individual preferences are shaped through a mental process whereby collective interests are given primacy over the private interests of an individual member.

Before turning to an examination of key issues raised by institutions, two remarks should be made. To begin with, there is an interesting parallel between the above idea that modernisation is reflected in the growing importance of formal institutions relative to informal ones and Greif’s idea that development entails a shift from ‘collectivist’ to ‘individualist’ societies (Greif, 1989, 1992, 1994). This is because order in collectivist societies is largely based on multilateral reputation and punishment mechanisms, which are essentially informal, while individualist societies cannot function effectively if their bilateral reputation and punishment mechanisms are not backed by formal institutions. In Greif’s reading of the history of Western Europe, it was the need to compensate for the lack of multilateral arrangements, itself caused by unstable social networks, that caused the gradual emergence (in cities in northern Italy during the thirteenth century and later) of legal and political enforcement organisations as well as a legal code.

Our second remark is that institutions are not all situated on the same level. There actually exists an institutional hierarchy that is made up of a set of institutions that are vertically entwined with each other. At the top of the ladder are fundamental or constitutional institutions that set the rules around which inferior institutions are grafted. An example of a fundamental institution is a political constitution: it defines a political regime and sets the rules regarding the frequency and mode of elections, the pattern of representation, and the like. It also spells out which liberties and individual rights should be upheld in the country. Within the framework of that constitutive law, other laws and regulations specify how the political system and the fundamental rights of the citizens are to be implemented in more operational terms.

To provide an illustration from the informal domain, let us refer back to the aforementioned example of collective action to ensure the efficient management of local natural resources. In rather egalitarian societies, the principle of equal contributions is considered important, and a convenient way to implement it is by sharing collective duties in a sequential manner among all the (adult) members. When a new initiative is decided, the corresponding rules will typically be inspired by this fundamental rotating principle applied at the highest level of the social and political order. Thus, the burden of monitoring the proper use of a resource – for example, guarding a village forest or fishing ground during periods of prohibited harvest, or ensuring that rights of access to irrigation water are duly respected – will be shared among the resource users according to some form of rotation. In fact, even rights of access to the resource may be organised following the same principle (Ostrom, 1990; Baland and Platteau, 1996).

As the last example indicates, it is impossible to talk about institutions and institutional change in developing countries without giving pride of place to informal arrangements, rules, norms, and modes of behaviour, which regulate essential aspects of everyday life. And since we are primarily interested in institutional change (or stagnation), which will be the central focus of our attention in Section 1.4, we need to first take stock of the various ways in which informal institutions can interact with formal ones. The most straightforward case of institutional change arises when a new formal institution is established in a context where informal arrangements exist. The question as to how both will coexist, adapt to each other, or enter into mutual conflict is therefore of great importance, hence our discussion in the next section.

1.2 Interactions between formal and informal institutions

A typology

Any social order is built upon a mix of formal and informal institutions, yet the proportion of either type can vary considerably from country to country for complex reasons that have to do with the political system, administrative traditions (centralised versus decentralised), and cultural influences, in particular. Along the modernisation path of a given country, formal institutions are predicted to grow in importance relative to informal ones. This is not only or necessarily because the former may displace the latter as the result of their being more effective in providing the same service – as witnessed by the replacement of informal insurance or mutual help mechanisms by formal social security systems in advanced West European countries – but also because they fulfil new functions for which informal arrangements are ill-suited. It is therefore useful to get a better understanding of the way these two types of institutions or rules interact with each other. To help us in this effort, we use a typology proposed by two social scientists, Helme and Levitsky (2004), and we discuss it in a way that extends the presentation made in Baland *et al*. (2020), a paper to which we directly contributed. Here, we make a special effort to illustrate the different cases highlighted in this typology, which is constructed along two dimensions and provides a static picture (the situation obtained at a given point of time).

The first dimension (represented on the vertical axis of Table 1) is the degree to which the outcomes of formal and informal institutions rules converge or diverge, depending upon whether the latter produce substantively similar or different results from those expected from a strict and exclusive adherence to the former. Divergence points to a substantial discrepancy or contradiction across these outcomes, whereas convergence is obtained when the outcomes are not substantively different. The second dimension (on the horizontal axis) indicates the effectiveness of the formal institutions, understood as the extent to which formal rules and procedures are enforced and complied with in practice. A high level of effectiveness thus means that individuals' choices are actually constrained or enabled, and there is a high probability of official sanctions in the case of a violation of the rules. Conversely, people expect a low probability of enforcement (and hence a low expected cost of violation) when institutional effectiveness is small.

Table 1: Typology of interactions between formal and informal institutions according to Helme and Levitsky (2004)

Institutional outcomes	Formal institutions Effective	Formal institutions Ineffective
Convergent	Complementarity	Substitution
Divergent	Accommodation	Competition

According to the table, four different types of institutional interaction patterns can arise: complementarity, accommodation, competition, and substitution. Let us consider them in turn.

Complementarity

A combination of effective formal rules and convergent outcomes produces complementarity between informal and formal institutions. In such cases, informal institutions may cover contingencies that are not properly allowed for by formal rules, or they may facilitate the pursuit of individual goals within the formal institutional framework, or else they may serve as pillars that support the functioning of formal institutions. In the latter instance, their role is to create or strengthen incentives to comply with formal rules that might otherwise exist merely on paper.

Fafchamps (2020) puts much stress on complementarity when he writes that formal institutions are best regarded as enabling informal ones to perform better. His focus is on the enforcement of market transactions and his central point is that, since interpersonal relationships are not eliminated by formal institutions (and contracts in particular), the role of good formal institutions is 'to reinforce the forms of social interactions that lead to a more efficient, more inclusive outcome, and to discourage those interactions that reduce efficiency and ostracize certain groups and individuals' (p. 376). Thus, formal institutions promote markets less by enforcing contracts directly than by seeking to reinforce informal contract enforcement mechanisms, especially those based on reputation. More precisely, they contribute to more active and more efficient markets by: (i) providing uniform measurement rules and quality standards; (ii) minimising conflicts stemming from fraudulent information or any form of misrepresentation by one party to a transaction; (iii) regulating fraud, bankruptcy, and the conditions under which a relational contract (e.g. an employment contract, a rental or a land lease contract) may end; (iv) curbing violent forms of informal contract enforcement (the reliance on thugs and criminal organisations, in particular); and (v) offering a strictly organised process for the adjudication of contractual disputes which agents may optionally use (pp. 380–1). This view of mutually supporting formal and informal institutions, long held by social scientists (Polanyi, 1957; Granovetter, 1985; Ensminger, 1992), is anchored in the idea that economic exchanges take place between individuals who are necessarily embedded within a social context that does not disappear with the introduction of formal institutions.

Accommodation

When effective formal institutions are combined with divergent outcomes we have a situation of accommodation between informal and formal institutions. This situation arises because informal institutions create incentives that prompt people to behave in ways that alter the substantive effects of formal rules, yet without directly violating them. In other words, the effect of informal institutions is to 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. What impedes an outright change or open violation of the formal rules is their very effectiveness. There exist conflicting dimensions within the existing formal institutional arrangement, and what accommodation does is to somehow reconcile them through the implementation and interpretation of formal rules by actors that are subject to informal prescriptions.

As an illustration, consider the following example, collected from fieldwork in West Africa. In Mali, judges in the formal court system often deal with inheritance cases involving rural people in ways that rest on a compromise between the formal law and custom. Thus, when one son and one daughter disagree about their entitled share of the wealth of their deceased father, the judge may choose to persuade 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 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. This is a typical instance in which an actor, the modern judge, plays upon several legal registers to find a solution that is acceptable to the different parties involved in a case. The formal law is not ignored since it serves as a reference point with respect to which the compromise with other types of laws is devised. Incidentally, the example shows that the stark opposition often drawn between French colonial countries, which rely on written codes, and British colonial countries, which rely on the common law, may be easily exaggerated.

Competition

The next possibility combines ineffective formal rules and divergent outcomes, giving rise to competition between informal and formal institutions. Here, informal institutions structure incentives in ways that are incompatible with the formal rules: to follow one rule, actors must blatantly violate another. Examples of such situations occur, for instance, when particularistic informal institutions, such as clientelistic relations and clan-based nepotism, arise in various contexts of weak formal political or economic institutions (Hoff and Sen, 2005, 2006; Mookherjee and Bardhan, 2020). Not surprisingly, competing informal institutions are often found in postcolonial contexts in which formal institutions that were imposed on indigenous rules and authority structures dominate, and have been retained by the new independent states. In postcolonial Ghana, 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 obligations that made it a duty for them to provide jobs and other favours to their families and villages (Price, 1975). The same attitude of favouritism may be found in non-tribal societies: for example, in India where loyalty is due to the *jati* (subcaste) rather than the kin group (Kakar, 1978).[1] In the worst cases, the officials' main goal is to extort revenue to distribute to their families and patronage networks. This temptation is increased when official posts are on sale, generally within a limited circle of people and groups. The winners are then forced to extort kickbacks to recoup their investment, such as is observed in parts of Pakistan and in Afghanistan (prior to the seizure of power by the Taliban in August 2021).

In some countries – African countries in particular – the problem of kin-based favouritism plagues not only the public sector but also, potentially, the private world of business firms (Kennedy, 1988). A series of studies of indigenous and non-indigenous (immigrant) firms located in certain African countries, and based on detailed interviews with a sample of trading and manufacturing firms, reveals interesting evidence (see Fafchamps (2004) for an extended synthesis, and Platteau (2014) for a short summary). Not only is trade with relatives and friends extremely rare in Africa but, whenever it happens, it harms firm performance. This suggests that, as much as possible, businesspeople want to avoid involving their kin networks in their business, for fear of the costs that are likely to follow. Such involvement is considered to be 'the surest way to go out of business', while selling on credit to relatives and neighbours amounts to 'signing the death warrant of the firm' and is therefore carefully avoided (p. 173). Entrepreneurs thus complain that it is difficult to keep business with relatives within the confines of an economic transaction. For example, it is

[1] We cannot resist the temptation to cite the following long excerpt from Kakar's insightful book:

'Among those Indians closely identified with the process of modernization, the well-educated urban elite who hold positions of power in modern institutions, the psycho-historical fact of the primacy of relationships, of family loyalties, of *jati* connections, is often a source of considerable emotional stress. For although intellectually the Indian professional or bureaucrat may agree with his western counterpart that, for example, the criterion for appointment or promotion to a particular job must be objective, decisions based solely on the demands of the task and 'merits of the case', he cannot root out the cultural conviction that his relationship to the individual under consideration is the single most important factor in his decision. This conflict between the rational criteria of specific tasks and institutional goals rooted in western societal values, and his own deeply held belief (however ambivalent) in the importance of honouring family and *jati* bonds is typical among highly educated and prominently employed Indians. And among the vast majority of tradition-minded countrymen – whether it be a *bania* bending the law to facilitate the business transaction of a fellow *jati* member, or a *marwari* industrialist employing an insufficiently qualified but distantly related job applicant as a manager, or the clerk accepting bribes in order to put an orphaned niece through school–, dishonesty, nepotism and corruption as they are understood in the West are merely abstract concepts. These negative constructions are irrelevant to Indian psycho-social experience, which, from childhood on, nurtures one standard of responsible adult action, and one only, namely, an individual's lifelong obligation to his kith and kin. Allegiance to impersonal institutions and abstract moral concepts is without precedent in individual developmental experience, an adventitious growth in the Indian inner world. Guilt and its attendant inner anxiety are aroused only when individual actions go against the principle of the primacy of relationships, not when foreign ethical standards of justice and efficiency are breached' (Kakar, 1978, pp. 125–26).

hard to collect payments from relatives, whether in relation to a loan or the delivery of a good. More generally, payment problems are frequent because friendship and family ties get in the way of exerting pressures on clients. In addition, firms buying from family and friends encounter more late delivery problems.

A second relevant finding is the absence of evidence of systematic mechanisms whereby information about clients' trustworthiness is shared among African manufacturing firms, other than direct recommendation by common acquaintances (Fafchamps, 2004: 173, 256–7, 295). Among agricultural traders, too, trust-based relationships constitute the dominant contract enforcement mechanism, implying that trust is established primarily through repeated interactions, with little role for referral by other traders. Information on bad clients does not circulate widely, which severely limits collective punishments for opportunistic breaches of contract (such as non-payment). African-managed firms face more cases of non-payment than other firms, and they also complain more frequently about deficient quality (Fafchamps, 2004: 92, 109, 117, 135). Their transaction costs are consequently higher. By contrast, within alien communities, information circulates rather freely and client referral is a common practice. As a result, non-indigenous firms operating in Africa are at an advantage. In Kenya, for example, it is only within the Indian community that first-time customers are able to obtain trade credit from the date of their first purchase. Moreover, indigenous firms (in Kenya and Zimbabwe) are less likely to socialise with suppliers, and they have more restricted knowledge about them and their supplies, compared to immigrant firms, suggesting that ethnic barriers are more limiting for the former. Since better business contacts allow firms to enforce contracts and economise on screening costs, immigrant firms tend to be more profitable (Fafchamps 2004: 252–3, 258, 300).

Finally, foreign firms hesitate to enter into business relations with indigenous firms, which they generally deem to be unreliable. In particular, they find fault with African managers for continuously trying to renegotiate delivery and payment terms *ex post* (Fafchamps, 2004: 110). Clearly, the multilateral reputation mechanism which, according to Avner Greif (1994), characterises so-called 'collectivist cultures' is conspicuously absent in sub-Saharan Africa. What we find, instead, is the bilateral reputation mechanism that is typical of 'individualistic cultures'. This is a rather paradoxical conclusion, yet it is perfectly congruent with the idea that in this region kinship/ethnic ties and their associated obligations are more an impediment to private capital accumulation than a social capital that can reduce transaction costs (Kennedy, 1988). Note that inefficiencies arising from kin-based relations are not only caused by non-contract performance: they are also caused by powerful redistributive pressures exerted on economically successful kin people. In fact, the two problems are often related since if African businesspeople do not estrange themselves from the realm of the family, they will typically be compelled to sell on credit to their relatives and friends, and the risk will be high that the loans will never be returned. The problem is that borrowers do not feel morally obliged to repay debts incurred from a prosperous relative. Refusing to return a loan is an accepted way to preserve a rough egalitarianism among kin people, or to maintain the prior state of status inequality within the kin group (when a clan leader claims a higher economic position). Insofar as the credit has been granted under this informal pressure, the gift involved results not from a spontaneous but from a forced transaction (Platteau, 2014).

Substitution

The last type of interaction between formal and informal institutions emerging from the table combines ineffective formal institutions and converging outcomes, and it involves substitution between the two types of institutions. Informal institutions are then employed by agents who seek outcomes that are compatible with formal rules and procedures but in environments where formal rules are not effectively enforced. In short, informal institutions achieve what formal institutions were designed, but failed, to achieve. It is easy to find illustrations of such situations in which informal arrangements are called for in order to compensate for deficient formal institutions. A well-known example is the persistence of traditional and informal forms of intra-community income sharing and mutual help in the face of absent or highly imperfect (formal) insurance markets, due to a lack of verifiability and/or asymmetric information between contracting parties (Scott, 1976; Platteau, 1991, 1997, 2021; Dercon, 2005). A second illustration concerns the problem of public order and public goods provision. The most glaring signal of a state's weak capacity is its failure to provide key public goods, including physical security and protection for its citizens. When this happens, there is a tendency for informal groups, networks, or organisations to fill the gap. There is thus abundant evidence of such groups emerging or extending their role to provide emergency help to people hit by a natural disaster (a flood, a forest fire, an epidemic), to build and maintain rural roads or water control infrastructure, or to supply basic education and health services. When it comes to public order, what springs to mind is the situation of failed states in which, by definition, the state is unable to fulfil its minimal function of guaranteeing law and order to all its people. In such contexts, law and order is generally established on fragmented portions of the national territory, at the level of regions or sub-regions, tribal and ethnic entities, religious communities, etc. It is implemented by warlords, clan militia, sectarian movements based on religion or a millenarian ideology, some forms of 'village republic', military groups backed and directed by a foreign government, or criminal organisations.

There is a serious risk that the substitution of these informal law and order agencies for state power entail what Chabal and Daloz (1999) have called a 're-traditionalization of society'. But this may be a misleading diagnosis. Indeed, compromises of the state system with traditional agencies may have been at the heart of this system, thereby contributing to its precariousness (Bayart, 1993; Reno, 1995; Jones, 2009). In Liberia, for example, we learn that 'tribalism is not an ancient form of organisation which pre-dates the nation-state, but an essentially modern concept which is inherently connected to that of the nation-state… It is a political resource which enables individuals and factions to pursue their interests in a national state…' (Ellis, 1999: 198). Therefore, 'the apparent uniformity of the formal system of government which has its centre in Monrovia was in reality a patchwork structure in which local communities and their leaders reached a variety of accommodations with the centre, in the process of which old institutions of government, such as chieftaincies and religious sodalities, acquired new characteristics…' (p. 207). Replace Monrovia with Kabul and you gain an important insight into the present predicament of Afghanistan. As the last example shows, interactions between informal and formal institutions may evolve dynamically depending on the institutional path followed by society: the two types of institutions influence each other in a dynamic two-way process.

Conflicts between formal institutions

When a state is the outcome of the sort of arrangements mentioned above, the problem of possible conflicts between its various components is especially likely to materialise. More specifically, if it is viewed as a source of exclusive privileges or economic rents, and as a domain in which particular interests can be more or less freely expressed, state resources come to be considered as spoils that are available for appropriation by those who have access to them. Thus, when ministerial posts are allocated between different factions contending for power, and the notion of a nation state created for the purpose of serving the common good is absent or weak, each minister has a tendency to look at his/her department as a private ground whose prerogatives must be defended against any intrusion – and even expanded if the possibility exists. In such a context, imposing governmental discipline upon the incumbent ministers, and creating the necessary coordination between the government's different arms, may be an almost unachievable task. The consequence is a state whose capacity is seriously impaired by continuous tensions and conflicts of competence, and by pervasive centrifugal tendencies threatening to break its coherence. Only the strong personal power of the president and his clique is then capable of preventing the awkward outcomes resulting from an internal tug of war: anarchy and confusion in decision-making and rule-setting. But there arises the attendant risk that the regime will slide into authoritarianism and arbitrariness.

What is true at the level of ministries can also be observed at lower levels. This is because the official representative of a faction is typically accountable to its leading members, as well as to the key politicians and business interests who made his promotion possible. As a consequence, he may have contrary appetites to satisfy, and the resulting decisions or laws may contain so many irreconcilable demands that it is impossible to implement them. A lack of internal consistency of rules and policies is most likely when powerful traditional informal interests clash with modernising reforms, as typically happens where there are competitive interactions between formal and informal institutions (see above). The problem of imperfect coordination between various levels of the administrative machinery is not specific to developing countries: it has also been discussed with respect to advanced democracies as well. What bears emphasis here is that the problem is especially acute in countries that do not possess an effective nation state, understood as an agency transcending particular interests and with which people primarily identify. Only when this concept of nation state is sufficiently anchored in the country's political tradition is there any hope of an effective or capable system of government (for inspiring readings on the problem of state capacity, see: Levy, 2007; Besley and Persson, 2009, 2010; Bourguignon and Verdier, 2012; Dincecco, 2017; Dincecco and Katz, 2016; Khemani, 2019; Wilson, 2019).

1.3 Economic theories of institutional change and stagnation

In the following paragraphs, we address the issue of institutional change by discussing four different strands of economic literature: the induced institutional innovation theory, the evolutionary theory, the theory of external shocks to self-enforcing institutional equilibria, and the political economy approach.

Smooth adaptation of institutions: price-induced institutional change

One approach to institutional change is to view institutions as more or less smoothly adapting to changing circumstances or a changing environment. This adaptation can be conceptualised either as the outcome of the changing behaviour of rational agents or as an evolutionary process driven by agents with only limited rationality. The former view, which we discuss in the present subsection, is well reflected in the so-called induced institutional innovation theory advanced by Hayami and Ruttan (1985) and Hayami and Kikuchi (1981). The basic idea is that changes in the environment are translated into the price realm and agents respond to changes in relative prices by modifying not only the technology they use but also the institutions that regulate their lives.[2] The explanation is thus based on an important simplification: institutions are treated analogously to ordinary goods and services, and market forces are conceived as exerting their influence upon them in the same way as they do for goods and production factors. In short, the market is the driver of institutional change.

As Hayami later admitted (1997), this is a quite naïve model, especially because institutional change typically requires collective action and it is simplistic to assume that it is automatically organised whenever the aggregate social benefit resulting from such a change exceeds the social cost. In his words, 'if such a naïve mechanism of induced institutional innovation always operated, all the economies would have grown smoothly and no great income gap would ever have emerged between developed and developing economies' (p. 20). Still, 'the naïve model could well be valid in broad terms of progress in human history', which seems to suggest that, with enough time, people eventually find solutions to overcome the incentive problems that stand in the way of collective action.

It is therefore no coincidence that the work of Boserup (1965, 1981) has been a major source of inspiration for development economists seeking to explain institutional change as a price-induced mechanism. In her detailed account of the evolution of agricultural systems and patterns of land use under pre-industrial conditions in both temperate and tropical regions she persuasively argued that food has been produced in increasingly complicated and labour-consuming processes. The dynamic changes involved, which entailed the reshuffling of land rights, the redefinition of gender roles, and other social and institutional changes, had the effect of increasing land productivity while simultaneously maintaining labour productivity and standards of living in the presence of growing population pressure.

Binswanger and co-authors have followed up on the idea that changes in endowments propelled by population growth are an important source of institutional change. They thus proposed a theory in which agrarian institutions and their evolution are largely explained as a function of population density (Binswanger and Rosenzweig, 1986; Binswanger and McIntire, 1987; Binswanger *et al.,* 1989). More precisely, relative scarcities of key production factors, jointly with material characteristics of agricultural activities and the pervasive information problems associated with them, play a major role in explaining changes in contract forms, the intensification of agriculture, and the emergence of small family farms in areas of high population density. Furthermore, they help to spell out the conditions in which plantations can exist. The idea that, under the influence of population growth and market

[2] When applied to technological choices, the theory is known as the induced technological innovation hypothesis, initially propounded by John Hicks (1932). See Hayami (1997, pp. 16–19) for a short presentation.

integration, informal land tenure rights are gradually transformed into forms that get increasingly closer to freehold rights has been studied in detail by Platteau (2000: Chap. 4; 2004). More recently, Guirkinger and Platteau (2015, 2017, 2020; Guirkinger *et al*., 2015) have further developed this line of explanation and supported it with first-hand empirical evidence about the nuclearisation of farm households in West Africa.

Following the same sort of theoretical framework, scholars have also explored important institutional transformations in the modern histories of Europe and Japan, in particular. Two works illustrate their efforts. To begin with, Smith (1959) offered us a detailed and fascinating account of the transformation of agrarian contracts and the demise of serfdom in Tokugawa Japan. This demise is depicted as the end outcome of a sustained process of gradual emancipation of the serfs (the *nago*) caused by the development of rural (silk-producing) industries. This expansion of new employment opportunities outside the purview of feudal estates created an acute competition for local labour and, despite the calls issued by the landlords (the *oyakata*), the state did not use its repressive force to bring runaway serfs back to their masters. To retain their labour force as much as they could, the landlords were compelled to accept a progressive relaxation of the implicit labour contracts to the effect that more freedom and better terms were granted to their tenants. The Japanese experience seems to be in striking contrast to the experience of Russia, for instance, where serfs were emancipated (in 1861) as a result of a top-down, state-directed reform abolishing serfdom. However, things may have been more complex than previously thought: for instance, Markevich and Zuravskaya (2018) have recently argued that there were estates where, under the initiative of enlightened landlords, gradual reforms were introduced before 1861.

The second work we want to cite is Voigtländer and Voth (2013), who traced the origin of late marriage in Europe to the Black Plague period. The mechanism behind their explanation is grounded in the idea that the key explanatory factor behind women's marriage patterns is the opportunity cost of women's involvement in husbandry production rather than in grain production and having children. In their words:

> 'By killing between a third and half of the European population, it [the Black Plague] raised land-labor ratios. Land abundance favored the land-intensive sector –animal husbandry. Because plow agriculture requires physical strength, women have a comparative advantage in livestock farming. Hence, after the Black Death, female employment opportunities improved. Working in husbandry mainly took the form of farm service –a contract that required year-round labor services in exchange for money, room, and board. As a condition of employment, all servants had to remain celibate –pregnancy and marriage resulted in termination of employment. Because many more women began to work in the booming pastoral sector after 1350, marriage ages increased. This lowered fertility in the aggregate. In a Malthusian world, there were second-round effects: lower fertility reduced population pressure, ensuring that per capita output never returned to pre-plague levels.' (p. 2228)

The authors also account for the varying evolution of marriage patterns between north-western Europe, on the one hand, and Mediterranean and Eastern Europe, and even China, on the other hand. The proposed explanation is based on the relative importance of grain and husbandry in the prevailing agricultural system, and the specific characteristics of the husbandry technology. In the Mediterranean regions, large herds could not be sustained throughout the whole year without resorting to transhumance. As a result, so they argue, there was no regular demand for women's labour services. As for Eastern Europe (and China), the point is that husbandry remained uncompetitive vis-à-vis grain production, with the result that the need for women's labour was therefore reduced. Another finding deserves attention: inside societies with late marriage, the change in the age of marriage for women was reversible, but only to some extent. As the comparative advantage of animal husbandry declined vis-à-vis grain production, demand for women's labour declined and earlier marriages became more frequent. The decline, however, was never so strong as to mark a return to the preceding system of early marriage.

At this final stage of our discussion of the first approach, two remarks are in order. First, in many post-Hayami studies the analytical framework actually departs from the original and crude idea of price-adjusting behaviours by agents endowed with so-called parametric rationality (agents take prices as a given which they cannot influence). The preferred theoretical approach has been the principal–agent model, in which a principal wants a task to be performed by an agent whose actions or characteristics s/he cannot directly observe. Since the agent is then incited to opportunistically exploit this information gap, the principal needs to design a contract or a scheme that will induce the agent to behave spontaneously in accordance with his/her interests as principal. In this type of model, individuals are assumed to possess strategic rationality, meaning that they are able to anticipate how others will respond to their own decisions. Instead of adjusting to relative prices, they make constrained optimal decisions in which the constraint is often set by relative factor scarcities (in land, labour, or capital) or by the importance of external opportunities (as reflected in the agent's reservation utility).[3]

Second, it is not coincidental that in the above-cited examples, institutional change is largely the outcome of individual decisions acting in a decentralised manner. In such instances the induced institutional innovation model does not appear to be too naïve, although it is based on a comparative-static reasoning rather than on a genuinely dynamic argument. When a change occurs in some parameters of the social, technical, and economic environment, the optimal institution, rule, or contract is modified and rational individuals are somehow able to recognise this and to bring about the new arrangement. If that does not happen, the persistence of the inefficient institution is typically attributed to an undue intervention by the government or another authority. By contrast to the above approach, the one to which we now turn is truly dynamic in the sense that it depicts the path that leads from one institution to another.

Smooth adaptation of institutions: the evolutionary view

An alternative view about how institutional change can come about when the environment changes – say because of population growth, the emergence of new economic opportunities, or an external threat or challenge – is anchored in the evolutionary theory. According to this view, the emergence, diffusion, and demise of rules or institutions are the outcome of an organic process of Darwinian natural selection which epitomises the competitive pressures of the market and the invisible hand. Institutions or rules are thus seen as evolving unconsciously and gradually as a result of the pursuit of individual interests as agents repeatedly face the same types of social problems or situations. In the simplest

[3] Optima are constrained because in the presence of private information first-best solutions cannot be achieved. What is sought is the best possible contract or scheme from the principal's standpoint.

version, inefficient institutions are expected to have a low evolutionary fitness, and therefore they tend to be displaced in the long run by more efficient institutions (see, e.g., Schotter, 1981; Axelrod, 1984; Sugden, 1986, 1989).

Looked at in this way, institutions emerge not as a result of rational, purposeful design by any individual or organisation of individuals, but as the result of spontaneous evolution. This means, for example, that people learn from experience that following a given constraint or custom can actually serve their own individual interests (Aoki, 2001: 40). Possessing a limited (or bounded) rationality, they follow trial-and-error behaviours: what works well for an individual is more likely to be used again, whereas what turns out poorly is more likely to be discarded. They look around them, gather information, and ground their decisions on the basis of fragmentary information. Because they have only an incomplete idea of the way the world in which they operate works, they do not fully understand the strategic implications of their choices, and may not be especially forward-looking (Young, 1998: 5–6). Thanks to imitation, trials and errors, and takeovers, however, effective strategies are more likely than ineffective ones to be retained (Axelrod, 1997: 47–48).

The key mechanism driving change in the evolutionary setup is the so-called replicator mechanism. Whereas in biology the inheritance of parental genes is the replication mechanism (called natural selection) that ensures the survival of the fittest over successive generations (the more effective individuals are more likely to survive and reproduce), in economics replication is often assumed to be effected through the types of behaviour just discussed: imitation and takeover of unsuccessful agents or firms by successful ones, trial-and-error experimentation, and learning.[4] In such ‘reinforcement’ mechanisms, it is one’s own past payoffs that matter, not those of other agents. The principle is that ‘the probability of taking an action in the present increases with the payoff that resulted from taking that action in the past’ (Young, 1998: 28). It should be noted that, in line with the assumption of limited rationality, the diffusion of more effective strategies does not require that the agents fully understand the strategic implications of their choices (that is, they are not assumed to have a perfect ability to reason inductively about a feedback mechanism between their own choices and the choices of the other players). Rather than explaining how they would rationally pick actions in a given situation, evolutionary theorising is concerned with understanding how behaviour evolves or persists over time (Rasmusen, 1989: 121).

Interestingly, many pioneers of the development economics discipline implicitly held a sort of (co-)evolutionary view of institutional and cultural change. Thus, Arthur Lewis (1955) thought that religious beliefs, for example, may evolve and be reinterpreted depending on the economic environment confronting societies. In other words, traditional values and attitudes, whenever they are hostile to economic advancement, will eventually adapt themselves to new economic opportunities (p. 106). And Alfred Hirschman (1958) pointed out that traditional images of change will remain a critical bottleneck for constructive action for

[4] Since in most standard evolutionary models pairs of players are selected randomly from a ‘large’ population to play the given game once, and are thereafter returned to the population, imitative and learning behaviours that involve strategy changes during the life of an agent are precluded. Recently, however, economists have paid increasing attention to learning models where the strategy revisions of a given player generate substantial feedback effects by affecting the other players’ payoffs, thereby inducing the latter also to revise their strategies subsequently. In all cases, limited rationality is assumed.

economic development until experience modifies them in the appropriate direction (see also Bauer and Yamey, 1957; Meier and Baldwin, 1957; and the discussion in Platteau, 2011).

A more rigorous application of the evolutionary theory of institutional change is Young's (1996) explanation of why in Western Europe vehicles drive on the right. He shows that this is the result of two distinct processes: an historical and contingent event (the French Revolution) that led to a legal intervention, and a contagion process that unfolded in a largely decentralised way. It is the latter process that Young analyses with the help of the theory, which highlights how people gradually adapt their behaviour to what others do, and continue to do so when they realise that their adaptation was in the right direction. As far as the historical event is concerned, economists have nothing to say: the fact that French Revolutionaries chose to impose driving on the right (rather than the left) in order to symbolise the reversal of the old order was no more rational than keeping on driving on the left and thereby continuing a convention that was efficient when it was created but had long ceased to be so.

Unlike what immediate intuition might suggest, and defeating the excessive hopes placed in them by the economists who first used them, evolutionary models do not unambiguously point to efficient adaptation of human institutions: there is absolutely no certainty that optimal rules or institutions will emerge from evolutionary processes. Furthermore, the idea that the competitive selection of group-level institutions might yield efficient arrangements raises problems that are even more severe than those confronting invisible hand arguments applied to individual traits. Several factors account for this (partial) failure (see Bowles, 2004: 90–91).

First, the repertoire of institutions and behaviours among which selection operates may be highly restricted. As emphasised by biologists, natural selection works on existing genetic material, which need not include the optimal genetic 'programme', and, if it does not, optimal adaptation is hampered. Moreover, the fact that gene mutations are blind (their occurrence is assumed to be independent of the needs of organisms) and can represent only gradual variations of existing genotypes precludes them from introducing optimal types in the population (Vromen, 1995: 95–96). The same conclusion applies, *mutatis mutandis*, to institutions: being absent from the available repertoire, many institutions remain unknown or untried. Moreover, 'the creation of novel institutions is akin to the emergence of new species: it requires the confluence of a large number of improbable variations in the status quo' (Bowles, 2004: 91).[5] Binmore (1992) makes essentially the same point when he stresses that in many evolutionary models attention has been artificially restricted to a few strategies, often arbitrarily chosen. No clue is given as to why particular strategies are there while innumerable other conceivable strategies are ignored (p. 434). If such an approach allows the evolutionary modeller to derive efficient institutions, it does so without really explaining their emergence, since the appearance of the beneficial strategies that lead to them is itself unaccounted for.

Second, the existence and efficiency of an institution often depend on the fraction of the population that is governed by it (a characteristic sometimes called strategic

[5] An immediate implication of the above point is that it may be impossible to measure inefficiency owing to the lack of a counterfactual. As a matter of fact, it is difficult to compare the efficiency of a selected institution against another because the latter has not been selected (Platteau, 2008: 460).

complementarity) and on the set of co-existing institutions.[6] Thus, 'some institutions may be complementary, each enhancing the functioning of the other, while some institutions may reduce the effectiveness of other institutions' (Bowles, 2004: 90). As a consequence, there may exist multiple stable configurations of institutions, and some of these configurations may be very inefficient and still persist over long periods of time. Because strategic complementarities or other sources of increasing returns – more particularly, setup or fixed costs which must be incurred to create an institution, or learning effects which raise the effectiveness of an institution which acquires growing influence – may thus give rise to multiple (equilibrium) outcomes, institutions may be path-dependent. When institutional evolution is path-dependent, small initial differences may cause distinct societal histories to emerge. Instead of institutional convergence, what is obtained is then the long-term coexistence of distinct evolutionarily stable institutions (Bowles, 2004: 403–4). The evolutionary process follows paths that have different long-run characteristics depending on where they start and on the order in which agents happen to meet, thus leading to different equilibrium configurations (Young, 1998: 8; see also North, 1990: 92–104).

Third, the analysis of evolutionary processes that select among group-level institutions, which involves a *coevolution* of preferences and institutions (each exerting an influence on the development of the other), may not support the emergence of efficient solutions. For example, success in inter-group conflicts may be caused by a group's military strength rather than by its efficient performance on any other account. Finally, it is entirely plausible that the rates of change induced by selection processes may be very slow relative to the pace of changes induced by chance events, or exogenous changes in certain key elements in the environment (e.g. knowledge, external influences). If that is the case, and if the outcome of a competitive selection process eventually materialises, it will have become inefficient.

The above conclusions, it must be noted, are not altered when evolutionary models are made more complex by bringing multi-level selection into the picture and by introducing players who intentionally pursue conflicting interests through collective action. The conclusion continues to hold that inefficient (and unequal) institutions can persist over very long periods of time (Bowles, 2004: Chaps. 11–13). It bears emphasis that such a possibility places the evolutionary theory of institutional change in clear opposition to the induced institutional innovation approach. The former is therefore better able than the latter to explain diverging institutional trajectories across countries. And since diverging paths are often encountered, the interest of the evolutionary approach ought not to be underestimated. This is particularly evident in the case of cultural norms and habits, modes of social interaction, and political regimes. There are thus notable variations in institutional details between the French and British democracies, or between the German federally structured state and the Italian republic.

We now turn our attention to two remaining approaches which, unlike the above two, are essentially static.

[6] Strategic complementarity thus applies to conventions, such as measurement standards or traffic rules: the incentive to adopt these standards or to abide by these rules increases with the number of other people taking the same action. These are typically the sorts of institutions that lend themselves to adaptive expectations 'where increased prevalence enhances beliefs of further prevalence' (North, 1990: 94).

Institutions as self-enforcing arrangements

This approach, in common with the principal–agent approach, conceives of institutions as self-enforcing (equilibrium) arrangements. However, rather than considering contracts or deals that are entered into in the context of bilateral relationships or multilateral relationships based on pairwise relationships inside a network, it analyses situations in which numerous actors interact simultaneously. Institutions are conceptualised as Nash equilibria because they ensure that beliefs have converged and actions are coordinated between individuals. More precisely, all agents form their own action-choice rules in response to their subjective perceptions (beliefs) of others' action-choice rules, and it is only when these perceptions are confirmed by the observation of the others' action-choices that an institution or rule is well-established (Aoki, 2001: 10–11). Institutions are therefore self-enforcing by virtue of the fact that at equilibrium the actors' expectations about each other's behaviour in a particular situation turn out to be consistent with the experience generated by the resulting actions. When this is the case, agents have no incentive to deviate from their own action-choice rule and institutions represent stable outcomes.

A number of important implications follow from the above characterisation. First, there are multiple possible institutions that can satisfy the requirements of a Nash equilibrium: that is, institutions for which beliefs converge and actions are coordinated. Furthermore, there is absolutely no assurance that they all correspond to socially efficient outcomes. Put in another way, it is only in particular situations, namely in pure coordination problems, that people are indifferent between possible stable solutions: for example, they do not care whether to stop at the traffic light when the colour is red, green, blue, or orange, the only thing that matters to them is that everybody follows the same rule or convention. Since individual beliefs or expectations play such an important role in many problems of institutional choice, it is highly plausible that people end up coordinating on a rule that is not optimal (in the sense intended by Pareto, that no other rule is available that could improve the situation of one individual without causing a loss of welfare for some other individuals). By definition, if a rule or institution is a Nash equilibrium, people do not deviate from the outcome to which their expectations have led them; cultural inertia appears to be the factor behind this stability (Basu *et al*., 1987). In the words of Stiglitz (1989), 'individuals know more about the institutions and conventions with which they have lived in the recent past than they know of others by which they might live' (p. 26).

Owing to the critical role of beliefs, it is even possible to come across paradoxical situations in which individuals choose to support rules or other institutional arrangements which they do not like, or even find repugnant (such as the caste system in India). As shown by Georges Akerlof (1976) and Timur Kuran (1995 : Chaps. 6–8), it may thus be rational for an individual to comply with unpleasant rules or to obey a totalitarian regime if there exists an effective network of mutually reinforcing social sanctions against disobedience and a system of converging expectations that sustain the existing arrangement. The underlying intuition is that a bad institution or a harmful rule persists due to mutual suspicion between people, and the immediate implication of the existence of a web of self-reinforcing sanctions is that everyone is both a victim and a supporter of a system in which there need not even exist a power-wielding central authority. For these sorts of effective sanctions to prevail, meta-punishment must be applied: that is, a person is considered disloyal to a regime or a rule if either s/he does not cooperate or s/he maintains relations with someone who is disloyal. (Kuran, 1995: 118–36 ; Basu, 2000: 136–47).

Raising the question of institutional change in this new framework amounts to asking how people can possibly extract themselves from the present arrangement. Logically, they can succeed in this only as a result of exogenous shocks that modify some key parameters of the situation produced by their history and culture. As pointed out by 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 shocks can have different sources: 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, or changes that enlarge the repertoire of available actions or alter the expectations of agents regarding others’ actions. In such cases, new equilibrium outcomes become possible while old ones may no longer be accessible.

A well-known example contrasts inclusive and extractive political equilibria, as described by Acemoglu and Robinson (2012) and by Sokoloff and Engerman (2000). While the latter are based on highly oppressive economic and political institutions, the former are characterised by participatory politics, checks and balances on politicians, and effective property rights for a broad cross-section of society. Once a country has attained either equilibrium, it gets trapped in it. For precisely this reason, an exogenous shock or a chance event is required to move a country from the vicious (extractive) to the virtuous (inclusive) equilibrium. As in the case of the first approach (induced institutional innovation), though, the theory is essentially static and therefore does not provide clues about the pathway leading from one equilibrium arrangement to the other. Since many agents are now involved, the issue of how they succeed in establishing the best institution following the occurrence of a beneficial shock is even more complicated than in the first approach.

To take another example, consider the aforementioned example of collectivist societies described by Greif: those societies were embedded in an institution that was dominated by the mechanism of multilateral reputations and sanctioning. Grounded in continuous relationships between members of a network, this arrangement enabled merchants to build trust, enforce contracts, and expand their activities in Europe and the Mediterranean during early modern times, and it is not coincidental that similar trade networks, or trading diasporas, have been equally successful in Africa as well (Platteau, 2000: 261–2). As trade opportunities expand, however, the limited size of a network may become a constraint on further capital accumulation and growth. What is needed, then, is a shift of the society from the collectivist institutional setup to a more individualistic setup in which political enforcement organisations operate.

Call ‘relation-based governance’ the informal mode of contract enforcement documented by Greif (that is, contracts involving reputational effects arising from repeated transactions), and ‘rule-based governance’ the system that relies on formal contracts and their enforcement by the courts or the police (Dixit, 2007: 141–2). Li (2003) has aptly clarified the analytical conditions under which each system is preferable to the other, and when the latter should replace the former (see also Dixit, 2004). Relation-based governance has small fixed costs since it can operate on the basis of existing networks of relatives and friends. But its marginal costs are large and they increase substantially as the scope of trade expands and requires the enlargement of the merchant network beyond close acquaintances who are generally trustworthy. In contrast, rule-based governance entails high fixed costs in the form of laws, regulations, regulatory agencies, and courts. Yet, once these formal institutions are in place, business deals with strangers can be struck at low marginal cost. The conclusion is rather straightforward: the relation-based system is scale-limited, being better at small scales of transactions but inferior to the rule-based system at large scales. But that leaves entirely open the question as to how, starting from an informal relation-based system, a society succeeds in moving to a formal rule-based system when such a shift becomes necessary.

What bears emphasis is that in most cases countries do not switch entirely to purely formal institutions: a lot of economic activity, even in the most advanced countries, continues to be governed by relational and private ordering 'under the shadow of the law' (Dixit, 2007: 143–4). To the extent that formal and informal rules are complementary, this feature does not create problems but actually helps promote growth in a rather smooth manner (see Section 1.2).

Let us now make another, but related, point: the problem of institutional change is especially knotty when the new institution has not previously been tried in the country in question. Thus, the transition from a planned economy to a market economy was easier in countries in Central Europe which had some experience of market economics not long before, such as the Czech Republic, Slovakia, Slovenia, and Poland, compared to Russia, Serbia, Bulgaria, and Romania, where capitalism had not put down deep roots in the past.[7] In Russia, for instance, failures of the planning system caused the emergence of networks of personalised relationships, the so-called *blat* relationships, which were no doubt useful in Soviet times. Their persistence beyond the collapse of the Soviet system has nevertheless been damaging, especially at the level of the bureaucracy and the old elite, which have taken on the habit of trading their favours by either demanding money in exchange for favourable decisions or launching their own businesses (Ledeneva, 1998: 188). It was impossible to be a successful manager in a Soviet-type economy without continually breaking the law and relying on personal contacts, and it continues to be so in post-communist times. What we have here is a clear syndrome of path dependence, which has been well described by Ledeneva (for a more detailed discussion, see Platteau, 2000: 330–4):

> '…*blat* … softened the rigid constraints of the command economy and the Soviet political system. It was well adapted to as well as restricted by Soviet morality. … Now, with the expansion of the *market* and the concomitant decline of Soviet norms and values, …*blat* practices stretched beyond their Soviet limits tend to be destructive to the national economy. These patterns which were organically connected to and functional for the Soviet social and political system have been carried over into the post-Soviet era with no control of their negative aspects and no attention to their advantageous sides. ... The "old guard", the nomenclatura – directors of the enterprises and of regional, city, local administration – kept their power and positions in the post-Soviet period. This power and position is now used for private deals. The nomenclatura used to be well connected and they still are. They know each other and are always in touch… It is no wonder that many firms established by the nomenclatura are flourishing. … The dissolution of the Communist party and attempts to reduce the influence of the former nomenclatura do not mean that such a strong and well connected apparatus has disappeared… All large-scale operations – financial swindles, non-paid loans,

[7] Our argument is actually in line with a finding of Heybey and Murrell (1999) that a country's initial conditions are more important than (radical) policy changes in determining its economic performance during the first few years of the transition from a planned to a market economy. They also find negative feedback in reform, implying that higher levels of initial liberalisation are likely to slow the subsequent reforms.

> investment projects, in which millions vanished in unknown directions – are mostly based on former connections.' (Ledeneva, 1998: 182, 187, 211)

Note that the *guanxi* informal exchanges in China resemble the Russian *blat* relationships. Although they have also been encouraged by the pressures of a (communist) shortage economy, in China they are even more resilient than in Russia, and their horizontal components have been much better preserved, thanks to their having deeper roots in kinship structures and traditions (Ledeneva, 2008; see also Greif and Tabellini, 2010, 2017).[8] A fundamental difference between the two countries, however, is that unlike in Russia, the central Chinese authorities have remained quite autonomous and therefore able to exert control over the private sector of the economy. In the post-reform period (since 1978), this meant imposing strictures on this sector so as to make its expansion compatible with the long-term development strategy of the government. Such a move is inscribed in a long tradition where in order to survive, central rulers had to tightly control clan heads and simultaneously rely on their support. This probably explains why the 'Chinese way', which combines a strong state with the clan acting as a powerful locus of cooperation, has been an effective pathway to development even compared to Western Europe, where the corporation rather than the clan was the springboard of collective action (Greif and Tabellini, 2010, 2017).[9] There is thus not one but several pathways to modern economic growth and development, and the emphasis on this feature is clearly a major achievement of both the evolutionary and the self-enforcing views of institutional change. In addition, not only does the comparison between China and Russia illustrate Acemoglu and Robinson's distinction between inclusive and extractive political systems, it also highlights the need to bring the state into the picture. This is precisely the objective pursued by the last approach.

The political economy approach: why are institutions and policies inefficient?

The discussion of this last approach proceeds in two steps. To begin with, we examine the many obstacles that can block the decentralised mechanisms whereby losers from socially beneficial institutional change are appropriately compensated. The need for an effective state emerges from this failure of a decentralised functioning of the society. Unfortunately, as argued in the second step of our analysis, the state may also fail for reasons that the political economy approach can help us to understand.

[8] Horizontal *blat* relationships are reciprocal relationships of assistance between people in rather equal positions. In the Soviet Union, most ordinary problems were thus solved by having recourse to the assistance of personal friends and acquaintances, without paying much attention to whether the manner of solving them was legal or caused harm to other persons situated outside the circle of the *blat* relationship (Ledeneva, 1998, 2008). The idea here is that vertical *blat* relationships have more effectively survived into the post-Soviet times than their horizontal counterparts.

[9] The whole history of unified China can actually be seen as an endless struggle between the Confucian and the Legalist traditions, the former tradition serving to justify a family-based socio-political structure and the latter serving to advocate the establishment of a strong centralised state. Confucianism is a philosophy in which family obligations carry more legitimacy than political ones: according to its broad moral doctrine of the state, the state must be modeled on the family and, if a conflict of interest arises between duty to one's father and duty to the state, the former should always trump the latter. By contrast, the Legalists saw Confucianism and its glorification of the family as a serious obstacle to the consolidation of political power. Their central concern was to make subjects obey a strong central authority, even if this meant inflicting the harshest punishments on them (Fukuyama, 2012: 119–21).

The Coase theorem

Consider the frequent situation in which the aggregate benefits of an institutional change exceed the costs but some individuals or groups are going to lose from the shift to the new institution. The efficiency principle that underpins the well-known Coase theorem indicates that this should not be an obstacle to the change: under certain assumptions, through decentralised bargaining and transfer payments, agents should be able to reach an agreement that ensures that the losers are duly compensated by the winners and therefore agree to depart from the status quo. In these conditions, moreover, the choice of the efficient institution, which is supposed to be unique, does not depend on the ***a priori*** distribution of power between the parties involved. The latter will only affect the distribution of the costs and benefits of the change concerned. In short, the issues of efficiency (selecting the efficient institution) and distribution (how the gains from institutional change are shared among all the participants) are separable (see Milgrom and Roberts (1992: 35–8), for a detailed argument).

The problem is that, whether explicit or implicit, the assumptions required for effective decentralised bargaining and the absence of power considerations in institutional choices are very restrictive. We review them because their limitations point to important barriers to institutional change. The efficiency principle simply states that, if people are able to bargain together effectively and can effectively implement and enforce any agreements they reach, they should be able to realise the gains resulting from a shift from an inefficient situation to an alternative that everyone would prefer (Milgrom and Roberts, 1992: 24). Two explicit assumptions are that negotiating costs are nil and no wealth effect is at play. The former assumption is clearly violated when many people are involved or they have heterogeneous characteristics. It is true that bargaining can be entrusted to groups' representatives, but then all sorts of collective action problems arise, including the delicate issue of leadership (see Baland and Platteau, 1996: Chaps. 5–7, and 1997, 1998, for an extensive treatment). Moreover, if one party can more easily solve these problems than the other (think of the old Smithian problem of a well-organised group of colluding producers facing a large group of consumers), the resulting institutional choice will favour the former and not necessarily coincide with the optimal solution. As for the second assumption, it is realistic only when the sizes of the cash transfers are small relative to the agents' financial resources: that is, when the stakes of institutional change are not too high. If that is not the case, the very payment transfer process is going to affect the wealth of the negotiating parties, who will then modify their transfer demands (for the losers) or their willingness to satisfy them (for the winners).

But there is another bargaining-related assumption that is often ignored: the reasoning is typically based on a two-agent framework where the outcome of bargaining is rather straightforward. As Shapley and Shubik (1969) have shown, however, when there are more than two agents, a bargaining solution may not exist. More precisely, an efficient solution may exist, yet the parties will not be able to reach it through decentralised bargaining. Moreover, whether a bargaining solution is attainable or not may ultimately depend on the initial assignment of rights to the parties: that is, on the initial distribution of bargaining powers. In this instance, the separability between efficiency and distributive issues is clearly broken (Baland and Platteau, 1996: 51–52).

To these major difficulties a number of other snags must be added. Three of them deserve particular attention (see Platteau, 2008: 447–9). First, people may not behave rationally, implying that they may seem to act against their interests. This is the case not only when they stick to a particular cultural prescription (a social norm may even prohibit compensatory cash transfers, at least when they involve certain categories of people), but also when they are imbued with a strong sense of justice that takes precedence over cold calculus. As an example of the latter possibility, common people may oppose awarding compensation to an erstwhile elite (say, big landowners) who will lose from a land reform that is socially beneficial. Their opposition may be justified by the excessively large benefits that this elite has drawn from the existing arrangement in the past. Ideology then trumps rational bargaining based on present and future gains. Second, uncertainty may complicate negotiations if winners and losers have a different assessment of the costs and benefits of institutional change. Such information asymmetries may originate in particular worldviews or ideologies. An apt illustration is provided by the resistance of national producers to an opening of the economy to external trade on account of an excessively pessimistic evaluation of the costs that such a change will entail for them. This kind of resistance is especially strong in countries with a protectionist tradition. And, finally, there is the double commitment problem that makes the outcome of decentralised bargaining hard to implement and enforce. Potential losers may typically not trust the potential winners' promise to compensate them once the institutional change has occurred. Realising the transfers before the advent of the change is of no help: the inverse problem will arise since the potential winners may now fear that the incumbents will opportunistically collect the payment and then oppose the agreed change.

For all of these reasons, efficiency and distributive issues are generally not separable and institutional choices tend to reflect the distribution of power in the society, rather than efficiency considerations. To increase efficiency, the intervention of the state is required. However, as soon as one drops the naïve assumption of a benevolent state or social planner which maximises the aggregate welfare of the population, the problem of power resurfaces. This problem is at the heart of the political economy approach: its main novelty consists of positing the state as a full-fledged actor pursuing its own (selfish) objectives, featuring the relative power weights of the various actors and the negotiating arenas existing in a society (see Acemoglu and Robinson, 2000, 2006a). In the new framework, an efficiency-improving institutional change will not occur if the interests of the state elite are aligned with those of a group of people who are opposed to that change. This is especially likely if organisations and interest groups which benefit from the current (inefficient) arrangements are able to shape the polity according to their wishes, thus making it still more difficult for change to come in the future. Ideology can also play a role, such as when agents or groups construct rationalisations with the aim of vindicating their society's rules and structures, and thereby account for their poor performance (North, 1990: 99).

The political Coase theorem

It is useful to lay stress on the analogy between some of the aforementioned problems undermining the applicability of the Coase theorem in a decentralised context, on the one hand, and the problems that arise when a centralised state exists and performs important tasks, on the other hand. As argued by Acemoglu (2003), an extension of the reasoning underpinning the Coase theorem to the political sphere would mean that political and economic transactions should push towards efficient policies and institutions (i.e. those that achieve the best outcomes for the society), regardless of who, or which social group, holds political power (p. 621).[10] In actual practice, however, politicians and powerful social groups do not typically strike deals with the rest of society for the purpose of adopting policies and establishing institutions that maximise aggregate production or social welfare while ensuring the redistribution of part of the gains to themselves. In short, they do not 'predate efficiently'. At the root of this recurrent state failure or political failure are 'inherent commitment problems associated with political power' (p. 622; see also Besley and Coate, 1998).

More precisely, while the validity of the so-called political Coase theorem rests on the ability of the state to write enforceable contracts, the state, or the social groups controlling the state, cannot actually commit to not using their power to renege on their promises or to not modifying the terms of the contract if their selfish interests dictate that they should do so. Because contracts written by the state are by definition unenforceable – there is no state above the state – an inherent commitment problem thus arises that prevents efficient outcomes from materialising. On the other hand, if the rulers relinquish their power, the citizens cannot commit to making side payments to them in the future since the former rulers no longer possess the political power to enforce such promises. This is the political form of the double commitment problem mentioned above. In this view, problems of credible commitment ultimately appear as problems about the future exercise of political power.

Because the relationship between the state and the citizens is repeated, it is possible to conceive some commitment based on reputation and supported by the threat of future punishment (Acemoglu, 2003: 623). This is the function of political constitutions and other institutions (for example, the delegation of monetary policy to a politically independent central bank) that are intended to provide checks and balances on the power of the rulers. The commitment problem cannot be completely overcome, however, and observation of the reality in many developing countries, in particular, confirms that states often choose inefficient and even disastrous policies and institutions because these choices 'are not made for the benefit of society as a whole, but for the benefit of those who control political power' (p. 648). A powerful ruler can thus flout a constitution that prescribes political mandates of a finite duration or that violate the independence of the central bank.

A general conclusion of the political economy literature addressing the problem of credible commitment is that the degree of inequality in the distribution of the costs of reforms, or of the benefits from the status quo, plays a critical role in determining whether reforms will be feasible or not. More precisely, when the inequality of power, or of benefits from status quo policies and institutions, is quite large, elites are prompted to oppose reforms in order to be able to hold on to their power and the associated rents in the future. Because the initial inequality in wealth and power is high, it is then difficult to commit in future to making everyone better off without making the elites worse off (Khemani, 2020: 5). Only through

[10] The distinction between policies and institutions proposed by Acemoglu is the following: while policies are choices made within a given political and social structure, institutions can be viewed as 'determinants of the political and social structure that are more durable and, as such, constrain future choices and policies' (p. 621, ftn. 2). Although institutions are often predetermined at the time when certain policy choices are made, they are also chosen by the society. Institutions thus correspond to the rules of the game that a society is playing, and these rules have been chosen by its citizens to constrain their future actions.

revolution or through a change in the composition of the elites and their preferences can key reforms become possible.[11]

Other reasons than unequal initial endowments can explain political opposition to reforms. These have already been mentioned in our discussion of possible causes of the failure of the Coase theorem. Thus, divergences about costs and benefits between key actors may be reinforced by ideological resistance to available evidence. It may actually be the case that the propagation of ideological prejudices against a reform is being driven by powerful groups whose interests would be harmed by its implementation. Moreover, uncertainty may exist over the distribution of the costs and benefits from reforms, perhaps due to a lack of solid technical evidence. In such cases, commitment problems will necessarily emerge and will block change (Majumdar and Mukand, 2004). In particular, a bias towards the status quo may exist whenever some of the individual winners and losers from reform cannot be identified beforehand. For instance, it may be difficult to predict *ex ante* precisely which sectors and which firms would benefit from trade liberalisation reforms. The important point is that when individuals ignore how they will fare under a reform, aggregate support for it can be lower than it would have been under complete information. This is true even when individuals are rational, forward-looking, and risk-neutral, and when there is no aggregate uncertainty. Under these conditions it may happen that, once adopted, reforms will receive adequate political support, but they would nevertheless fail to carry the day *ex ante* (Fernandez and Rodrick, 1991).

Norms and preferences for public goods

More recent strands of the political economy literature have turned their attention to problems beyond the credible commitment issue. One of them approaches resistance to reforms through the angle of norms, while the other refers to preference for public goods. The starting point of the norm approach is the idea that, if a contract among rival interest groups is not enforceable or justiciable, it has to be self-enforcing. Here lies a prisoner's dilemma, since each group can extract a private gain by reneging. Consider the case where several competing powerful interest groups, acting as multiple principals, attempt to control a government institution or department (the common agency). Each of these groups has an interest in offering the agency a little bit more than what others are offering in order to advance its interest at their expense (Dixit, 1996, 2003). Thus, Dixit (2018) argues that persistent and endemic corruption should be seen as a prisoner's dilemma in which, say, business groups are 'givers' of bribes. Although all of these groups would benefit from reduced bribes when taken as a whole, they stick to their current practice because they believe that this is the best they can do given the behaviour of the others. Absent some coordination mechanism or norm to regulate corruption, the high-level corruption equilibrium will persist.

That such mechanisms or norms are hard to come by is attested to by the general failure of anti-corruption policies, such as those embedded in the creation of the anti-corruption agencies that are so much favoured by the donor community (Olken and Pande, 2012; Khemani, 2020: 7–8). Such failures tend to be attributed to the lack of legitimacy of political leaders. A leadership's legitimacy, if one follows Akerlof (2017), is functionally equivalent to

[11] Lizzeri and Persico (2004) thus argue that the main factor that allowed for deep institutional reforms in the history of nations was significant shifts among elites in their demand for more public goods. This shift made them ready to give up private rents in exchange for these public goods.

agents monitoring each other with a view to ensuring compliance, implying the existence of some norm among peers regarding performing duties that are prescribed by a (legitimate) leader. The problem, however, is that in many instances political leaders are themselves corrupt – they extract rents from public office, indulge in vote buying and the like – or they are perceived as such by the population. They are therefore not in a position to implement reforms aimed at combatting not only big cases of embezzlement but also more ordinary forms of petty corruption. Clearly, to break the vicious cycle of corruption, there is a need for exceptional and strong leaders, such as Kemal Atatürk in Turkey or Habib Bourguiba in Tunisia (Platteau, 2021). Such leaders can serve as role models capable of starting a 'clean politics' virtuous mechanism.

When addressing the problem of resistance to beneficial reforms from the standpoint of preference, stress is laid on the fact that citizens may vote in ways that do not properly account for negative consequences. In particular, Stuti Khemani (2020) writes that 'Citizens' preferences for emphasizing private benefits over public goods when evaluating leaders, either delivered by co-ethnic leaders, or through vote buying at the time of elections, appears to be a significant factor explaining the persistence of clientelistic politics in democracies in the poor world and its negative consequences for political incentives to pursue reforms' (p. 11). Citizens actually appear to be cognitively constrained such that they demand policies that confer short-term benefits at the expense of long-term costs (Dal Bo *et al*., 2017). Clientelistic politics may thus cause public goods or services to be under-provided even when they seem to favour the poor disproportionately, like in the case of primary healthcare and anti-poverty programmes or policies (Khemani, 2015; Anderson *et al*., 2015; Bardhan and Mookherjee, 2020; Bardhan *et al*., 2020; Malik *et al*., 2020).

Moreover, because the poor often place a high value upon their ethnic affiliation, leaders and their political parties often find it a more effective strategy to supply targeted private benefits to a special clientele than to supply public goods from which many people will benefit (Banerjee and Pande, 2007). Following this interpretation, political corruption partly stems from the fact that citizens value honesty in their leaders less than they value their ability to supply public resources on the basis of shared ethnic or caste identity. Stark evidence of this possibility has been adduced by Prakask and co-authors (2019): in India people may not hesitate to cast their votes in favour of politicians accused of criminal actions, even though these politicians generate bad economic outcomes (Prakash *et al*. 2019). In sum, 'vote buying could be a form of political responsiveness to the demands or needs of voters' (Khemani, 2020, p. 12).

The problem of reforms is therefore immensely complex, especially when powerful interests derive enormous advantages from the status quo. It is also true that lack of information about the value of reforms constitutes an impediment to them. Yet even well-informed citizens may still oppose a reform if, as often seems to be the case, they are reluctant to change their beliefs and preferences when confronted by evidence. In the end, the credibility and legitimacy of the reforming leadership is a crucial factor for success but this is not a very reassuring conclusion given that we do not know where credibility and legitimacy come from (Khemani, 2020: 16).

The political economy approach: illustrating state capture and state failures

We can now briefly discuss a few interesting applications and illustrations of the argument according to which political elites may drive their societies away from efficient or development-enhancing institutions and policies, as well as of the role of beliefs and preferences. To begin with, we wish to refer to the political theory of economic backwardness, through which Acemoglu and Robinson (2006b) show how and in which conditions state elites may deliberately thwart development. Their basic intuition is that political elites face a trade-off between economic gains and power. All else being equal, they prefer technological progress and prosperity-inducing reforms that might increase their economic rents in the future. Yet all else is not equal because such changes can potentially erode their political advantages relative to other groups. They will thus decide to ‘block beneficial economic and institutional change when they are afraid that these changes will destabilize the existing system and make it more likely that they will lose political power and future rents’ (pp. 115–6). The theory predicts a non-monotonic impact of political competition on resistance to development: while political elites that are either subject to intense competition or do not face any competition due to their complete domination of the electoral landscape adopt new technologies, elites occupying an intermediate position between these two extremes will adopt the opposite attitude. This is because, with intense political competition, elites prefer to innovate lest they should risk being replaced, whereas strongly entrenched elites do not fear losing political power so that for them there is no trade-off between economic gains and power. By contrast, elites that are ‘somewhat entrenched’ but are still afraid of being replaced are tempted to block innovation to prevent such replacement from happening (p. 116). Interestingly, this theory has recently received empirical support in the particular case of Pakistan (Malik *et al*., 2021).

Along the same line, within a framework in which education is both the engine of growth and a determinant of political participation, Bourguignon and Verdier (2000) have looked for the conditions under which an educated oligarchy may have an incentive to subsidise the poor's education and to initiate a democratic transition, thereby promoting the endogenous emergence of a middle class. When these conditions are violated, the oligarchy will undermine universal education. There is evidence that, indeed, the education of ordinary people may be blocked by the elite. For example, Martin (2016) has observed a tendency among traditional landlords to oppose the (secular) education of their dependents lest they should seek emancipation and develop ‘unrealistic expectations’, and thereby cause a shortage of cheap agricultural labour (p. 87). Also, assuming a regime of autocracy, Auriol and Platteau (2017a, 2017b) have shown that a ruler may deliberately sacrifice institutional reforms in order to placate the opposition coming from traditional leaders (including religious authorities) who resent that their erstwhile prerogatives will be encroached upon (see also Auriol *et al*. (2021), where the army is added as a strategic actor). This raises the serious issue of how a modern state can manage the divergent interests of popular masses under the influence of traditional authorities which want to preserve the old order based on the community, on the one hand, and urban elites which have been exposed to Western values centred upon the improvement of the individual, on the other hand.[12]

Turning to the role of beliefs and preferences, Chinese history supplies us with an interesting example of the role of ideology. Since the early fifteenth century, the Chinese authorities

[12] This subject is at the centre of Platteau (2017).

have developed the idea that China does not need to develop its external trade links to become or remain a major economic and political power. Under the influence of the mandarins, who scorned and distrusted commerce, and unlike the eunuchs, who had the opposite interests and beliefs, the new worldview led the Chinese into believing that their country is better off when it relies on its own forces. Carried over well into the nineteenth century, ‘this deliberate introversion’, a major turning point in Chinese history, proved to be a disaster for the country that was leading the world in many respects several centuries earlier. It could not have come at a worse time, since it disarmed China just as European power was rising (Landes, 1998: 96; see also Jones, 1981: 168–69).

It bears emphasis that in the above discussion the state has been treated as a single actor. This is an obvious simplification, not only because it ignores the distinction between the executive, the legislative, and the judiciary, but also because it bypasses possible conflicts existing inside each of these branches. Thus, serious dysfunction of the state apparatus may arise from tensions or contradictions that may come from a variety of different sources: between a government and its administration, between various departments or levels of the bureaucracy, between various political interest groups, or between appointed and elected leaders (say, between district officers and elected councillors). Note that the latter tensions may actually be ignited and nurtured by holders of central power who are eager to ‘divide to rule’ (for a vivid application of this argument to Pakistan, see Cheema *et al*., 2005). Technically, whichever the source of misalignment, the problem can often be framed as one of multiple principals with conflicting interests (Dixit, 1996, 2002; Martimort, 1996; Bolton and Dewatripont, 2005: Chap. 13). Among the solutions to this problem that can be derived from this literature are exclusive deals aimed at making a common agent depend on a single principal, a greater role for the autonomy of the agent, a reduced role for top-down hierarchical monitoring, and an increased role for peer-to-peer professional norms (for a few illustrations, see Khemani, 2019: 8–15).

Another important source of efficiency losses lies in the fact that the administration is often undermined by the corrupt behaviour of selfish officers and politicians. Consider the following example of the rise and decline of the effectiveness of land documentation and titling in Kenya (see Onoma, 2010). Although this was embraced by the postcolonial government after independence in 1963 (the system was initiated by the British in the early 1900s), the associated practices were gradually eroded so that by the early 2000s they had fallen into disrepute. Ominous signs of this institutional degradation were visible before, as attested by the cancellation of hundreds of title deeds by Kenya’s High Court in May 1991, a dramatic move which led one commentator to wonder ‘whether the assumption that a title gives one indefeasible rights to property was still true’ (p. 65). Onoma’s explanation is that the administration, by exchanging fake land documents for money, largely contributed to the erosion and drift, causing a marked fall in the efficacy of land documentation. At the same time, it appears that civil servants acted under the corrosive influence of well-connected politicians who used land documents to obtain political support. For these politicians, ‘issuing and selling land documents became an excellent way of raising cash for electoral campaigns, for buying the support of various individuals and groups, and for dissuading would-be opponents’ (p. 66).

Onoma sums up his diagnosis by stressing that the problem was not just one of weak state capacity, nor was it that the system of land documentation was not well-established in the first place. The problem was rather that state agencies became increasingly less willing to use their powers to stop the fraudulent exploitation of land documentation by people close to the state (p. 66). Herein lies a prisoner's dilemma: an institution serving the common good (an efficient institution) has been created or confirmed, yet key participants find it in their own selfish interests to break the rules and thereby undermine it. At the root of the problem lies a system of political patronage that prompts key political actors to instrumentalise the administration for their own immediate benefit, rather treating it as a vehicle for advancing the national interest.

Other problems have plagued land titling in Kenya, including the usual problem of a lack of proper updating of land records. One of these problems in particular deserves our attention because it vividly illustrates the role of ideology and the political influence of the common farmers rather than the Big Men. In Kenya, lenders have usually faced great difficulty foreclosing on land mortgages in the face of determined opposition from family and community. The fact of the matter is that 'the presence of many kin around mortgaged land makes it politically unfeasible to auction the holdings of defaulters' (Shipton, 1988: 120; see also Migot-Adholla *et al.*, 1991: 170; Ensminger, 1997; Platteau, 2000: 145–7, 153–6). One important politico-ideological reason behind the government's reluctance to strictly enforce the law after independence was its fear of breaking the fragile political consensus on which national policies rested. In the words of Bates (1989): 'The cry of land hunger had fed the nationalist rebellion that had brought the government to power. To turn people off the lands that they had fought to capture would be to risk the wrath of the true believers in the nationalist revolution' (p. 74). The pressure on the government was all the stronger as the official opposition, represented by a radical party (the Kenya African Democratic Union (KADU)) lobbied intensively on the land issue (pp. 67–68).

The stylised approach of the political economy approach has the advantage of supplying us with structured treatments of well-defined issues involving politics, as well as useful predictions of the effects of changing components in the environment. However, because the inter-relationships between institutions, politics, and development, and the dynamics of institutional change, are so complex, the approach needs to be complemented by contributions from other disciplines: political science, history, and socio-anthropology in particular. As attested by the above example about Kenya, these contributions are expected to provide a lot of details on the concrete processes of institutional change, as well as the specific problems they raise in particular contexts.

1.4 By way of conclusion: radical versus gradual institutional reforms[13]

The radical approach to institutional reforms views cultures and informal arrangements as powerful and persistent dragging forces that are unsuited to market-oriented growth and social development (Harrison and Huntington, 2000). In this perspective, the discrepancy between people's traditional behaviour, beliefs, social norms, and collective rules and modernity can only be overcome by radically changing cultural traits. This can be done only

[13] This section is largely inspired by a note written by Jean-Philippe Platteau and Thierry Verdier in 2022: 'Formal and informal institutions in development: Contexts, resistance, and leverage', Economic Development and Institutions (EDI) Project, Oxford Policy Management, Oxford.

by imposing new institutions by force, thereby creating an unavoidable tension and conflict between modern elites and traditional power structures.

Under certain circumstances, reformers with enough power and legitimacy may succeed in drastically modifying people's expectations and bringing about radical changes. For instance, Mustapha Kemal Atatürk undertook radical reforms to modernise Turkey, which had the effect of erasing a legacy of dominance by religion and tradition. A comprehensive set of policies was implemented, ranging from compulsory secular education, restrictions on wearing religious symbols in school, and the closure of religious orders, to the extension of women's voting rights, their right to be elected to public office, and separation between governmental and religious affairs in the country. In general, however, state policies directly aimed at top-down institutional change fail to produce effective and long-standing changes to existing traditional institutions. Even the Turkish experience has revealed that bold measures that ignore the deep values and norms of a large number of people have the effect of polarising the society between a modern urban elite residing in big cities and traditional masses inhabiting the countryside and towns. As the rise of an Islamist party testifies, and even though some important achievements were left untouched, some backtracking on previous reforms took place as soon as the left-aside masses were given a voice (Platteau, 2022). This is the cultural backlash effect which radical institutional reforms are likely to generate.

One of the factors explaining the strong resilience of traditional structures in the presence of a forced top-down imposition of formal institutions is the internalisation of informal norms and cultural values within individual preferences (Bisin and Verdier 2001, 2010). This internalisation allows for the persistence of traditional values and their transmission to future generations even in the absence of an explicit policy or will to perpetuate them. Another factor relates to the fact that the choice of a non-traditional option may require anticipation of the long-run effects of the policy reform. These effects themselves depend on the way people's expectations converge, and the way their actions, based on these expectations, are coordinated. When a reform implies a departure from traditional ways of doing things, changing behaviour is individually harmful if undertaken alone. Resistance to radical reforms may be all the stronger as these reforms involve radical changes which destabilise the status quo, and therefore entail uncertain consequences.

Yet not all reforms are aimed at modifying the traditional order of things and at questioning deep-rooted social norms. Trade liberalisation reforms, for example, have no straightforward effect on a country's culture. This is the example chosen by Fernandez and Rodrik (1991) to illustrate their argument in favour of radical reforms. They make the critical but sensible assumption that there is initial uncertainty about the distribution of the costs and benefits of a reform. They show that a radical reform that is initially opposed by important sections of the population may eventually come to receive their support once uncertainty has vanished. Thus, in Taiwan, South Korea, and Turkey, where trade liberalisation was authoritatively imposed by an autocratic ruler against the wishes of the business community, the reform was gradually accepted by important group coalitions once they realised that the net benefits were greater than initially expected.

When cultural rules and social norms are at stake, like in the domains of family law and land tenure rules, however, a stronger case can be made for a more gradualist approach to institutional reforms. A first argument in favour of gradualism is that it avoids the large redistributive effects, both economically and culturally, which are typically produced by radical changes. It may also avoid head-on confrontation with the established power structures. More gradual or stepwise policies, which only marginally affect established interests at a given point in time, may be easier to implement with popular support (Gulesci *et al*., 2021; see also Aldashev *et al*., 2012). In their analyses of the policy trade-off between big-bang and gradualist reforms in the transition economies of the 1990s, Dewatripont and Roland (1992a, 1992b, 1995) argue that a gradualist strategy significantly relaxes the political economy constraints of reforms, and may sequentially exploit the fluidity of stepwise reform-supporting coalitions in the process of institutional change. In other words, because they are stretched over a rather long period, gradualist reforms allow political groups which were not initially in favour of changing the status quo to gradually emerge and join other groups which were initially supportive.

Relatedly, reforms that have few distributional consequences are arguably easier to carry out, in contrast with those that call into question established hierarchies. Moreover, from a social psychology standpoint, a gradualist approach also keeps socially determined goals and outcomes within the 'window' of the conceivable aspirations of individuals affected by the reform, which helps maintain their motivation and support (see Genicot and Ray, 2020). In this respect, public policies which radically promote Western values may be too distant from local norms, thereby generating frustration, conservatism, or backlash, especially when a large share of the population feels disenfranchised. Interestingly, Islamic fundamentalism was born as a movement of cultural reaction against attempts by colonial powers to annihilate local cultures (Platteau, 2017, Chap. 7).

An institutional gradualist approach has some drawbacks, though. A first issue stems from the existence of complementarities between different institutional dimensions. Introducing some institutional change along one dimension may fail to produce any effective outcome if there is a strong complementarity with another dimension that is not reformed at the same time. A second issue with gradual reforms relates to their credibility: because marginal changes may appear too hesitant and riddled with too many exemptions, the proposed policies do not credibly support a viable alternative. Essentially, the same argument stresses that a reformist government must engage in excessive signalling to distinguish itself from a less purposeful one. In this way, indeed, policy actions will convey useful signals about their intentions to financial markets and investors (Dixit, 2007: 145). More generally, formal institutional reforms that are designed to preserve certain traditional norms and practices may fail to change beliefs about what is the socially appropriate behaviour. Given the resilience of traditional institutions in shaping beliefs and constraining individual behaviour, gregarious practices that are in line with tradition may have a high degree of persistence in the face of such institutional reforms. In these cases, a more comprehensive approach may prove more effective.

In the sensitive domains of personal and community life, however, the best way to think of institutional change is in terms of leveraging informal arrangements to the extent that they can effectively promote development, possibly in tandem with formal institutions. Particularly useful are informal structures, including support networks relating to reciprocity and mutual help, and traditional common pool management institutions. In addition to being able to fill gaps that are left vacant by market and state failures, these horizontal institutional arrangements based on castes or kinship groups may be better able to adapt to new opportunities and changing conditions. By fulfilling new roles and adapting successfully, they may become stronger and they may persist, even though their original function has vanished. This is the approach actually followed by many non-governmental organisations operating in rural areas of poor countries. Conversely, there is scope to leverage formal institutional structures with a view to indirectly promoting changes in informal arrangements within communities. Thus, within the framework of rural development projects, external supporting agencies often demand that local communities set up organisations that obey certain rules: regarding the creation of a general assembly of members and a management committee, the appointment of a treasurer, the regular convening of the assembly, the laying down of precise accounts about the use of money received, etc. These rules aim at imparting financial discipline, accountability, delineation of responsibilities, and clear separation between the sphere of interpersonal relations and the sphere of professional activities.

The discrepancy between formal and informal institutions may also be reduced by openly allowing their joint functioning in the same domains. An interesting example is the approach of legal pluralism, where formal law coexists with customary law. Once specific dimensions are fixed by the formal structure, individuals may be left free to choose between various legal systems of arbitration and dispute settlement (formal and informal) in order to resolve their conflicts. This type of mechanism allows for a flexible implementation of the law that is compatible with traditional beliefs and social structures, eventually leading to a convergence of the two systems (Aldashev *et al*., 2012; Platteau and Wahhaj, 2013). The experiences of legal pluralism in the Ottoman empire, or presently in Indonesia, offer vivid illustrations of the beneficial effects which such an approach may engender (Bowen, 2003; Kuran, 2004a, 2004b).

To sum up, when compared to a gradual approach, a radical institutional approach enjoys the benefits of signalling policy commitment as well as the gains of complementarities across institutional dimensions which are tackled at the same time. On the other hand, it encounters more stringent political economy constraints, and may induce strong cultural resistance from significant parts of the population, especially in domains where reforms hurt deep-rooted social norms and may be viewed as an attack on local cultures.

Several implications can be drawn for policymakers and foreign donors. First, when political constraints are particularly strong, a radical approach may not be feasible. In such a case, aid policy should preferably stimulate gradual and marginal changes in endowments and resources so that over time coalitions can be formed along the reform process. Similarly, in domains where cultural resistance is a serious issue, aid policy can favour the implementation of a gradualist approach, with support for mixed institutional reform systems, whereby specific dimensions are fixed by the formal structure while other dimensions are left to the functioning of traditional structures. Finally, individuals may often appear to oppose progressive social changes because they fail to anticipate their consequences and focus therefore on their individual, short-run costs. One way out of this dilemma is to ensure that resources and endowments can be provided to reduce these short-run costs. In such instances, donors can make a useful contribution by stimulating complementary institutional structures that implement transfers of resources through various channels, such as insurance systems, money transfers, information diffusion, and coordination mechanisms.