PART I

Introduction

CHAPTER 1

Building Institutions: Complement, Innovate, Connect, and Compete

How do we account for the persistence of poverty in the midst of plenty? If we knew the sources of plenty, why don't poor countries simply adopt policies that make for plenty? . . . We must create incentives for people to invest in more efficient technology, increase their skills, and organize efficient markets. Such incentives are embodied in institutions.

—Douglass C. North, 2000

In the 11th century the Maghribi traders of North Africa wanted to expand business across borders, all around the Mediterranean. Trade in each center was free of formal regulations and restrictions, and competitive, with many buyers and sellers negotiating prices through brokers, open-bid auctions, and direct dealings. Cross-border trade also was generally free of formal regulations and restrictions. But it was fraught with uncertainty about selling prices, the quality on arrival, and the possibility of theft. Only if merchants traveled with their goods to distant markets could they ensure the safe arrival and sale of their merchandise. Such risks and costs naturally limited trade.

So in all major trading centers around the Mediterranean, the Maghribis set up overseas agents to represent their interests and exchange information about markets. Being from the same community, these agents were seen as trustworthy. And with fewer contractual problems, Maghribi merchants no longer needed to travel to ensure that they would not be cheated. Information flowed freely in this network bound by social ties. And the rules of the organization, although not written, were self-enforcing. Remaining in the coalition of traders best served each member's interests. Social ties cemented mutually beneficial business relationships, and cross-border trade flourished.

Today, a millennium later, people everywhere face similar problems in striving to improve their well-being through market activity. African entrepreneurs lack information about potential business partners. Poor farmers in Latin America lacking formal title to their land cannot use it as collateral to secure access to credit. Budding entrepreneurs in Central Asia, trying to start new businesses, run into political obstacles from established firms and the state.

Despite the problems, many people in rich countries and poor are engaged in productive—and rewarding—market activity. As *World Development Report 2000/2001* argued, income from participating in the market is the key to boosting economic growth for nations and to reducing poverty for individuals. This Report is about enhancing opportunities for poor people in markets, and about empowering them. What makes market activity rewarding and possible for some, and not others? Why are some market systems inclusive and integrated, allowing benefits to flow to the poor as well as the rich, the rural people as well as the urban? And why are other markets localized and segmented?

The Maghribi example illustrates some of the reasons. Markets allow people to use their skills and resources and to engage in higher-productivity activities if there are institutions to support those markets. What

are these institutions? Rules, enforcement mechanisms, and organizations supporting market transactions. Extremely diverse across rich and poor communities and nations, they help transmit information, enforce property rights and contracts, and manage competition in markets. All market-supporting institutions do one or more of these things. And in so doing, they give people opportunity and incentives to engage in fruitful market activity.

This Report is about people building institutions that support the development of markets. The 2000/2001 Report underscores the importance of institutions in affecting poor people's participation in markets. This Report discusses both institutions that support growth and those that directly affect access of people left out of many market activities. It considers those institutions that provide opportunities for people and that empower them. It goes beyond the 2000/2001 Report by analyzing what institutions *do* to promote growth and facilitate access and by suggesting *how* to build effective institutions. And it emphasizes how institutions can help people make better use of the assets they own and how to accumulate more. In focusing on institution building, it does not devalue the importance of policy. But good policies are not enough. The details of institution building matter for growth and poverty reduction.

The Report contributes to existing work on institutions and markets in several novel ways. It provides a diagnostic framework for understanding how institutions support market activity. Bridging the gap between theory and evidence across disciplines, it also builds on existing evidence on the role of institutions and institutional change. It extends previous empirical work on institutional change to developing countries and presents a framework for institutional change. It confirms that one size does not fit all in considering institutional design. But it does more than that. It illustrates *how* to proceed in building more effective institutions. It provides policy guidance by taking a pragmatic approach. The aim is not to define what should be done in an ideal world, but what can be done in today's world.

In understanding what drives institutional change, the Report emphasizes the importance of history. Many developing countries have been nation-states for a short time compared with industrial countries. The evolution of nations teaches that building institutions takes time and that the process within each country may stall or reverse because of political conflicts or economic and social conditions. It offers lessons about the process of change and the importance of norms and culture in particular countries. Institution building is generally a cumulative process, with several changes in different areas building up to complement and support each other. This Report identifies elements of such a strategy. Even small changes can build momentum for future changes. The whole is greater than the parts, and even moderate progress in the parts can contribute to a better system to promote growth and reduce poverty.

Four main lessons emerge for institution building. The first two are about supplying effective market-supporting institutions. But supplying institutions is not enough. People must want to use them too. Thus, the second two lessons are also about creating the demand for such institutions, and about the forces for change within countries.

To ensure effective institutions:

- *Design them to complement what exists—in terms of other supporting institutions, human capabilities, and available technologies.* The reason? The availability and cost of supporting institutions, existing levels of corruption, human capacity and technology determine the impact of a particular institution. That is why institutions that achieve their goals in industrial countries may not do so in developing ones. Much of the important work in building institutions lies in modifying those that already exist to complement better other institutions and in recognizing what not to build in a particular context, as much as what to build. "Best practice" in institutional design is a flawed concept.
- *Innovate to design institutions that work—and drop those initiatives that do not.* Even in countries with similar incomes and capacities, innovation can create stronger institutions because of differences in local conditions—differences ranging from social norms to geography. Experimentation, which has some costs that must be recognized, can nevertheless help identify new and more effective structures. Countries can gain from expanding successful public innovations and adopting private innovations. But they must also have the courage to drop failing experiments.
- *Connect communities of market players through open information flows and open trade.* Exchanging goods and services outside existing networks and communities creates demand for market-supporting institutions. Exchanging information through open debate creates demand for institutional change by holding people to account, by changing behavior, and by supplying ideas for change from outside the community. Linking communities of people in networks of infor-

mation and trade is thus a priority for policymakers building market-supporting institutions.

- *Promote competition among jurisdictions, firms, and individuals.* Greater competition modifies the effectiveness of existing institutions, changes people's incentives and behavior, and creates demand for new institutions. Developing country actors may face too little competition, often because of current institutional structures. Changing this will improve the quality of other institutions. Competition among jurisdictions—for example, among different states within a country or between countries—highlights successful institutions and promotes demand for them. Competition among firms and individuals does the same.

This chapter first provides a framework for evaluating the role of institutions in supporting market transactions, growth, and poverty reduction. It then focuses on the four main lessons on institution building, followed by a discussion of the impact of political and social forces on institutional evolution.

How do institutions support markets?

Small vendors engage in simple spot-market transactions, with buyers and sellers dealing face to face in fairly standard products whose quality is easy to verify. A rural vegetable market in a poor country is such a market. Large multinational firms exchange more differentiated products, facing greater difficulties in verifying quality and bigger separations in time and space between the *quid* and the *quo.* International exchange of food products is an example of such a market. Most economies have both types of markets—the first more common in developing countries, the second in industrial economies.

Developed markets, more global, inclusive, and integrated, offer more opportunity choice. Underdeveloped markets, more likely in poor countries, are more likely to be local and segmented. So, compared with farmers in Canada, poor farmers in Bangladesh have fewer opportunities—and far fewer formal institutions (such as banks and formal courts) to reduce their risks and increase their opportunities.

What limits market opportunities? Transaction costs from inadequate information, incomplete definition and enforcement of property rights, and barriers to entry for new participants.[1] What increases them? Institutions that help manage risks from market exchange, increase efficiency, and raise returns (boxes 1.1, 1.2, and 1.3).

Box 1.1
A poem on the problems of trade

If I knew you and you knew me
'Tis seldom we would disagree;
But never having yet clasped hands
Both often fail to understand
That each intends to do what's right
And treat each other "honor bright"
How little to complain there'd be

If I knew you and you knew me.
When'er we ship you by mistake ,
Or in your bill some error make
From irritation you'd be free
If I knew you and you knew me.
Or when the checks don't come on time
And customers send nary a line,
We'd wait without anxiety,

If I knew you and you knew me.

Source: Who's Who in the Grain Trade 35 (June 20, 1922–23); cited in Bernstein 2001, *World Development Report 2002* background paper.

Yet not all institutions promote inclusive markets. The Maghribis lowered transaction costs among themselves, but in so doing excluded other communities. Institutional designs that evolve through either historical circumstances or directed action by policymakers are not necessarily the best institutions for all society—or for economic growth and poverty reduction. Moreover, institutions that once supported market transactions can outlive their usefulness—for example, privatization agencies and bank restructuring agencies. The challenge for policymakers is to shape policies and institutional development in ways that enhance economic development. The Maghribis operated under a policy of free trade that enhanced their opportunities. It was to take advantage of these opportunities that they developed their institutions.

Clearly there is no unique institutional structure guaranteed to lead to economic growth and poverty reduction. Large firms in the United States and the United Kingdom are often publicly held, with dispersed ownership, and are widely traded. But that is not the case in other high-income countries such as France or Canada, where ownership structures are highly concentrated (figure 1.1). And to promote competition, policymakers can use quite different guidelines. In East Asia competition authorities consider a market share of 50 to 75 percent to be evidence of possible monopoly

Box 1.2
What are institutions?

Institutions are *rules, enforcement mechanisms, and organizations.* This Report considers those institutions that support market transactions.[2] Distinct from policies, which are the goals and desired outcomes, institutions are the rules, including behavioral norms, by which agents interact—and the organizations that implement rules and codes of conduct to achieve desired outcomes. Policies affect which institutions evolve—but institutions too affect which policies are adopted. Institutional structure affects behavior. But behavior may also change within existing institutional structures.

Institution builders can be diverse—such as policymakers, businesspeople, or community members. Corporate, collateral, and bankruptcy laws are *public institutions*, as are the judiciary, tax collection agencies, and regulatory agencies. Banks, reciprocity between community members, and land inheritance norms are *private institutions.* Many private institutions exist under the aegis of public institutions. Private banks, for example, operate within the framework of public law. Social norms exist within (or without) formal laws.

The enforcement of rules can be internal, implemented by the parties affected by the rules, or external, implemented by a third party. Informal institutions and private formal mechanisms generally rely on their own members for enforcement. Individual agents organize themselves into informal groups, such as business associations (chapter 3) or mutual insurance systems (chapter 9) when the cost of collective action is low and the rules can be easily monitored. In these groups, expulsion from the community is a form of punishment.

External enforcement mechanisms, such as judicial systems or third-party arbitration, are critical mechanisms for the development of integrated markets. They allow access to market opportunities for a broader group of market participants. For external enforcement mechanisms to be effective, the legitimacy of the enforcer is vital. When the state acts as an agent that shares the objectives and beliefs of its citizens—and implements rules consistent with them—it is more likely to build effective formal institutions to support market development.[3]

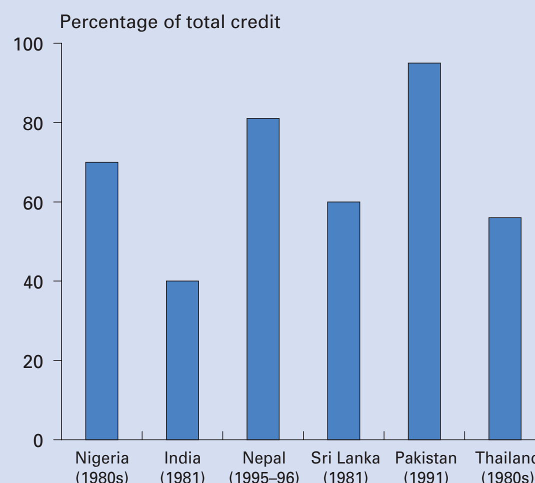
Effective institutions are those that are *incentive-compatible.* Institutions with internal enforcement mechanisms are effective because there is a mutually recognized system of rewards and penalties. An important issue in the design of public institutions is ensuring that the incentives that are created actually lead to desired behavior. Take the example of deposit insurance, which is designed to protect depositors from the risks inherent in financial institutions (chapter 3). Experience has shown that deposit insurance can weaken the incentives of financial managers to lend depositors' funds prudently and can lead to excessive risk-taking. In circumstances like this, complementary regulations are required to realign incentives, such as regulations to ensure that bank managers have a significant financial stake in bank performance.

Informal and formal institutions

Formal institutions include rules written into the law by government, rules codified and adopted by private institutions, and public and private organizations operating under public law. For example, organizations include firms operating under corporate law. Informal institutions, often operating outside the formal legal system, reflect unwritten codes of social conduct. Examples include land inheritance norms and moneylenders using social networks to determine creditworthiness based on the reputation of the agents involved.

People in both rich and poor countries rely on informal institutions to facilitate transactions, but these institutions are relatively more important in poor countries where formal institutions are less developed. Moreover, poor people in poor countries are often ill served by the limited formal institutions available. In poor countries, and poor regions in particular, informal institutions substitute for formal institutions (box figure). Countries and communities can go a long way toward resolving information and enforcement problems without using their formal public legal systems.

Informal rural credit in selected developing countries, 1980s and 1990s



Source: Kochar 1997; Besley and others 2001; Ijere 1986, cited in Adegbite 1997; Mansuri 1998; Desai and Mellor 1993.

Networks, such as those of the Maghribis, that are based on common ethnic, religious, and other common ties, are closed groups; that is, entry into the group is limited. In such groups, costs of information processing and definition and enforcement of property rights are lowered by mutual ties or trust. Although these transaction costs are lower in closed groups, the informal and norm-based institutions that such groups rely on tend to support a less diverse set of activities than do formal legal institutions. As countries develop, the number and range of partners that market participants deal with increases and market transactions become more complicated, demanding more formal institutions. Conversely, public or private agents may build formal institutions to enable a more diverse set of activities.

Box 1.2 *(continued)*

Legislators may purposefully base formal law and judicial practice on social norms. In some cases this may consist of simply codifying and modifying existing practices and writing them into law (Bernstein 1999). But this is not simple, particularly in heterogeneous societies. Choosing how to weigh each group's norms and standards is critical in determining not just the efficiency impacts, but also legitimacy and distributional implications.[4] For example, in multiethnic Uganda, English was adopted as a neutral common language for the formal functions of the state. Such concerns extend to standards or rules in international markets as well.

Ideally, informal and formal institutions should complement each other. Together, they can reduce transaction costs more than either can alone. Formal courts, for example, deter litigation and facilitate informal settlement simply by providing the threat of enforcement (chapter 6). Far more disputes arise in business transactions than go through a formal dispute resolution process (Bernstein 1999).

Public versus private roles

Governments have an important role in providing public goods, such as laws that delineate property rights and the judicial institutions that enforce these rights and establish the rule of law. But governments have been known to impede the development of markets through arbitrary exercise of state power, overtaxation, corruption, short time horizons, cronyism, and the inability to uphold public order. For example, governments may establish restrictive trading rules in response to lobbying by business monopolies intent on safeguarding their monopoly interests. The balance between markets and state power, and between business and social interests, is a delicate one in the course of institutional development. Historically, the government's role in the protection of property rights and the provision of other public goods has been closely linked to its role in ensuring peace or law and order. Conflicts over property between private agents, and between the state and private agents, are some of the most important issues that governments have had to deal with, because they often lead to a breakdown of law and order.

Market development and private business flourish when the behavior of those who govern is not arbitrary (see box 1.3). For example, detailed analyses of the evolution of corporate law in several countries show that in the early stages of development, private business was typically subject to the arbitrary whims of those in power. The state, with primary control rights, granted the permission to incorporate case by case (Pistor and others 2000). At later stages, the right to incorporate was no longer a personal favor but was granted to any entrepreneur that met a set of predetermined conditions.

Box 1.3
Institutional evolution and economic development: private traders and public rulers

In medieval Europe, the political power of local rulers was extensive. Local rulers could confiscate the property of individual traders from other regions without incurring penalties. In response, private mercantile guilds evolved to promote trade and to guard against the arbitrary action of local rulers. These guilds established agreements with merchants in foreign cities and with local authorities themselves. Arbitrary confiscation was punished by the withdrawal of large amounts of business by the guild, and so local rulers were forced to respect the rights of its members. This change in the balance of power helped to promote the security of foreign traders.

In the 12th century, traders in Europe established community-based mechanisms to facilitate the exchange of credit and trade across borders. These mechanisms were based on the community accepting responsibility for the performance of its members vis-à-vis other communities. For example, when a Genoese merchant defaulted on a loan from a merchant in London, community leaders in Genoa were responsible for enforcing the contract by imposing sanctions on the defaulter. Community origin was easily established, meaning that reputation within the community was important, and agents could be trusted not to renege on their contracts.

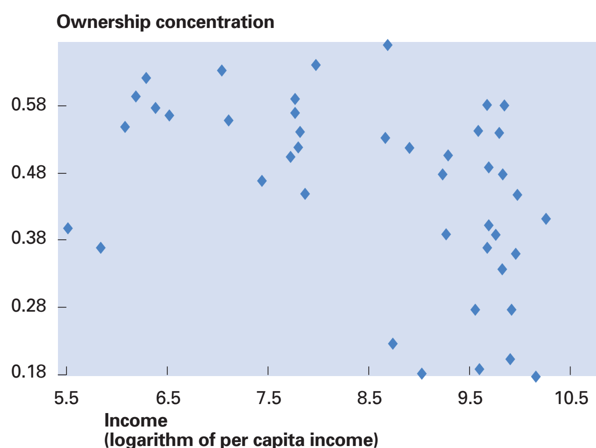
As cities grew in size and number, so did the communities of merchants and traders, making collective action more difficult. Unrestricted entry into trading led to more competition among traders, and increased problems of information and enforcement. Growth meant trading with members from other social and ethnic backgrounds, which meant that social connections could not easily be used as a basis for information or enforcement.

Members no longer wanted to be collectively responsible for individual breaches of contract. So leaders pushed for an enforcement and sanctioning system based on individual responsibility rather than community responsibility. To the extent that community growth implied more intracommunity social and economic diversity, it also reduced the political viability of the community. But the extent to which communities could abolish community-based mechanisms depended on a reliable third party to enforce contracts. In England, the monarch performed this role, and in 1275 King Edward I issued a statute outlawing community responsibility for debts.

The example illustrates a general principle: as economies grow and develop, different types of institutions are needed to facilitate transactions. Many different actors can push for new institutions. But the role that the state plays depends on its capacity and political viability: a strong state that respects the law itself and refrains from arbitrary action is a critical factor.

Source: Greif 1997a.

Figure 1.1
The concentration of ownership varies tremendously across countries



Note: Ownership concentration is measured by the combined stakes of the three largest shareholders in the 10 largest privately controlled firms.
Source: La Porta, Lopez-de-Silanes, and Shleifer 1999.

power, whereas in Africa the range is 20 to 45 percent. Within South Asia some farmers rely on cooperatives to market their goods; others use informal contracts with private traders.

This Report provides a framework that applies across the range of market-supporting institutions. It cuts through the complexity and diversity of institutional structures by focusing on what institutions do. Understanding what they do is the first step in building effective institutions. Institutions do three main things:[5]

- *They channel information about market conditions, goods, and participants.* Good information flows help businesses identify partners and high-return activities—and assess their creditworthiness. Information about businesses helps governments regulate effectively. Institutions can affect the production, collection, analysis, verification, and dissemination—or the withholding—of information and knowledge. They do this for participants in, and between, communities and markets. Examples include accounting firms and credit registries, which facilitate information processing, or government regulations on the media, which restrict the dissemination of information.[6]
- *They define and enforce property rights and contracts, determining who gets what and when.* Knowing one's rights to assets and income and being able to protect those rights are critical for market development. These include the rights of the private sector in relation to the state. Institutions can reduce the potential for disputes and help enforce contracts. Examples include a country's constitution, its judicial system, and the full array of social networks.
- *They increase competition in markets—or decrease it.* Competition gives people incentives to do better and promotes equal opportunity. In competitive markets resources are more likely to follow the merits of a project than the social or political connections of an entrepreneur. The degree of competition also affects innovation and economic growth (chapters 2 and 7). But while some institutions facilitate competition, others impede it. For example, by overregulating the entry of new business, governments can constrain competition. And by organizing market activities around a closed group of participants—recall the Maghribis—outsiders will find it harder to compete even while opportunities for those in the group may increase (chapters 3 and 9).

The transaction costs of acquiring information, enforcing property rights, and restraining competition can prevent the emergence of inclusive markets. But effective institutions can reduce those costs. Consider the following example. If the quality and value of the grain that traders buy from a farmer cannot be easily determined, and if traders have little information about a farmer, they have to inspect each bag of grain to assess quality. Traders also provide credit to farmers. But if traders have little information on the ability of farmers to repay the debt—or if farmers cannot use the assets they own as security—providing credit is risky. These problems are magnified for smaller and poorer farmers. The trader may impose higher interest rates on poorer farmers, and the farmers may be more likely to default than if they were exposed to competition.[7]

Through these three functions, all institutional structures affect the *distribution* of assets, incomes, and costs as well as the incentives of market participants and the efficiency of market transactions. By distributing rights to the most efficient agent, institutions can enhance productivity and growth. By affecting the incentives to invest—for example, through strengthening property rights—they can affect investment levels and adoption of new technology. By delineating market rights, such

Box 1.4
Courts and the expansion of trade

Studies of manufacturing firms in eight African countries demonstrate the supporting role institutions play in market development. These country studies show that the absence of effective public dispute resolution mechanisms in cases of breach of contract has limited the expansion of trade and market development. Courts tend to be slow and inefficient. The absence of formal contract enforcement mechanisms has limited the growth of firms and the development of financial institutions. The small scale of the formal productive sector has, in turn, prevented the development of complementary institutions.

Another study analyzing six countries in Africa (Burundi, Cameroon, Côte d'Ivoire, Kenya, Zambia, and Zimbabwe) shows that among these countries, the presence of a more developed legal system encouraged firms to undertake riskier activities because well-functioning legal systems helped to adjudicate and settle disputes that arose from such market activities.

Source: Bigsten and others 2000; Collier and Gunning 1999.

Box 1.5
Weak institutions hurt poor people

Mounting evidence shows that the poor bear the greatest burden of institutional failure. Take corruption, a highly regressive tax. Demands for bribes and unofficial fees for services hit poor people hardest. In far too many cases legal systems and the judiciary fail to serve poor people. Their illiteracy and inability to pay for legal representation put formal legal institutions beyond reach. The failure of the state to protect property also hurts the poorest disproportionately, because they cannot afford to protect themselves from crime. And badly designed regulatory institutions reduce the provision of infrastructure to the poorest in society.

World Development Report 2000/2001 stressed that poor people are often more vulnerable than others to macroeconomic crises and natural disasters. Market institutions that support growth of overall incomes can reduce their vulnerabilities to shocks and help them insure against bad times. Some of the institutions discussed in this Report have an important and direct role in this. For example, financial institutions help mitigate their risks, allowing individuals to diversify their savings and risks and allowing them to smooth their consumption over good times and bad.

Source: World Bank 2000d.

as through competition law, they limit producer rents and protect consumers from high prices. And by clarifying rights for the disadvantaged in markets, institutions can directly affect the lives of poor people. For example, giving formal titles to poor people whose occupancy rights were not recognized by lenders allows them to borrow and invest.

How do institutions support growth and poverty reduction?

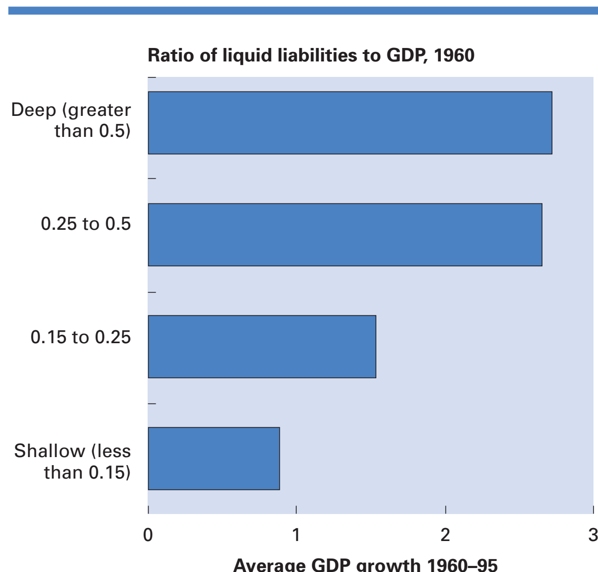
Institutions that support market transactions can thus affect poor farmers in Latin America as much as they affect wealthy businessmen in Canada. Country case studies, as well as cross-country empirical work, provide important insights into institutional development and market development (box 1.4). They confirm how market-supporting institutions affect people's lives by influencing growth, determining people's access to markets, and enabling poor and rich people to make the best use of their assets. Moreover, weak market-supporting institutions can hurt the poor disproportionately (box 1.5).

A growing body of research links institutional success (and failure) to economic growth and market development over time and across countries. A wide range of indicators captures the performance of different, often overlapping sets of institutions. For example, the success of the state in providing laws and the performance of the judiciary and police reflect whether citizens and investors perceive the state as respecting property rights. Access to financial services and the sophistication of financial markets reflect how successfully institutions protect the property rights of borrowers and lenders. High levels of public corruption reflect how the behavior of public agents in state institutions responds to the types of incentives that exist for politicians and civil servants to pursue the public good over their self-interest.

Positive relationships between economic development and these indicators of institutional success have been widely documented. But most studies do not establish links between *specific* institutions and specific outcomes. Instead, they highlight the wide variety of institutions that support markets. For example, income and the rule of law—encompassing the collective importance of property rights, respect for legal institutions, and the judiciary—are highly correlated. For another example, the development of financial institutions predicts growth (figure 1.2).

On institutional development and economic growth, important differences have been found between coun-

Figure 1.2
Financial depth generates growth



Note: Figure based on partial scatter from the instrumented cross-sectional regressions in Beck, Levine and Loayza 2000.

tries that once were colonies and are now industrialized and former colonies that are still developing. Both groups trace key features of their institutions to former settlers. A big part of the difference in later institutional development—and its impact on growth—is the effort of settlers in establishing well-functioning legal institutions.[8]

In the United States and New Zealand, colonizers settled in large numbers and transplanted institutions common to, and understood by, the general populace, mostly new immigrants. In such countries the transplanted legal institutions were widely used, adapted to local circumstances, and changed with economic development. Developing countries on every continent also received formal legal systems, transplanted by colonizers. But their indigenous populations had little access to or understanding of these legal systems. So the institutions were not adapted to local circumstances. Cross-country evidence suggests that the quality of institutions that support growth and poverty reduction through market development is lower in these countries than in the former group and has therefore not supported economic growth and poverty reduction to the same extent.

Institutions also affect how countries deal with conflict. A recent study found that growth and poverty outcomes in Asia, Latin America, and Sub-Saharan Africa since the mid-1970s have depended on the quality of institutions for conflict management.[9] In divided societies, such as those with ethnic fragmentation or high inequality, low-quality institutions for managing conflict—including low-quality government institutions and inadequate social safety nets—magnify external shocks, triggering distributional conflicts and delaying policy responses. Prolonged uncertainty in the economic environment and delayed policy adjustments curtail subsequent economic growth.

How do you build effective institutions?

Recalling the framework of information, enforcement, and competition, policymakers building institutions first need to assess what is inhibiting market development or leading to certain market outcomes (box 1.6). Rather than focusing first on specific structures, they need to focus on the functions that are missing and determine why. Policymakers need to ask:

- *Who needs information on what?* For example, do bankers lack information on the creditworthiness of potential borrowers?
- *Are everybody's property rights and contracts clearly defined and enforced?* For example, do farmers have enforceable rights to land they use?
- *Is there too little competition—or too much?* For example, is an infrastructure monopoly inhibiting entry or are firms not undertaking high-return research because they lack safeguards on intellectual property?

Once the institutional gap is identified, the next step is to design the appropriate institution. Both supply and demand factors are important. Moreover, as countries change and develop, so will the appropriate institution. To be effective, such an institution must be designed so that the incentives of market actors are aligned to achieve the desired outcome. Four key approaches toward institution building hold across all sectors and countries: complement what exists, innovate to identify institutions that work, connect communities through information flows and trade, and promote competition.

Complement what exists

Developed market economies have institutional structures that depend heavily on a capable state—a provider of public goods, a regulator, and an adjudicator. But the involvement of the state in markets must be consistent with its capacity. *World Development Report 1997* emphasized matching the capability of the state with the tasks that government organizations take on.

Box 1.6
Who builds institutions?

Institutional reform is not just the preserve of national governments. Individuals and communities, local entrepreneurs, multinational companies, and multilateral organizations can build institutions, often in partnership with each other. National governments may initiate reform or may simply respond to pressures from the private sector or from external actors.

In some cases of systemic institution building, governments have been effective in successfully transplanting laws, organizations, and agencies. In other cases systemic reforms did not have the desired outcomes. The contrast between Poland and Russia is instructive in this regard. Poland had a more recent history of a market system, and Polish policymakers and business people had a better understanding of the requisite institutional framework. Polish reforms focused on clarifying property rights between the state and private actors—for example, by imposing hard budget constraints on public firms. Russia did not have a recent history of market development, and reforms did not initially have the desired effects, partly because there was no clear delineation between private and public institutions. Firms were not immediately exposed to hard budget constraints, as shown by widespread arrears in taxes and other payments (Recanatini and Ryterman 2000).

Institution building at the sectoral level has also met with varying success. In Tanzania and Zambia the public sector intervened in agricultural marketing with the stated aim of stabilizing farmer incomes. In most cases these reforms failed—leading to lower marketable output and often corruption. Worse, the experiences affected perceptions of the overall integrity of public institutions. Successes include the reform of business registration in Bulgaria, now conducted online and taking around two days, not three weeks as in the past.

Local business interests, the foreign business community, nonprofit organizations, the media, and international organizations have all been involved in direct institution-building efforts in developing countries. For example, membership in the North American Free Trade Association has hastened the pace of domestic reform in Mexico. Some countries in Eastern Europe are implementing wide-ranging institutional reforms as they strive to become members of the European Union.

Recent developments surrounding the AIDS crisis illustrate how different groups may affect the process of institutional change.

Many agents of change: health crises and patents

More than 95 percent of HIV/AIDS cases are in developing countries. But the average cost of the antiretroviral treatments, which have reduced AIDS mortality by 70 percent in industrial countries, is still more than $10,000 a year, far beyond the reach of most people in poor countries.

Some developing countries—Brazil, India, South Africa, and Thailand—have taken steps to reduce the cost of AIDS treatment through the design and application of their intellectual property rights laws—an international institution—to allow compulsory licenses permitting the production of generic drugs and the import of cheaper generic drugs. In Thailand generic drugs became available at just 10 percent of the price of the patented product.

These measures led to threats of trade sanctions and law suits from the drug manufacturers. But collective action, initiated by international agencies and NGOs, helped increase access to AIDS drugs by enforcing existing public health safeguards, permitted under the Trade-Related Aspects of Intellectual Property Rights agreement but not previously implemented. The news media were instrumental in publicizing the disparities in the availability of AIDS treatment and promoting public debate on the issue. As a result, the U.S. government retracted its trade sanction threats. And pharmaceutical companies agreed to reduce prices—and more recently to drop a lawsuit on intellectual property rights against the South African government.

Source: Perez-Casas and others 2000.

This Report builds on that analysis by examining how existing information, enforcement costs, and the cost of building and maintaining institutions affect the way governments support private transactions in markets. It also examines how market development is affected by the extent to which government actors themselves respond to the institutions they build. As countries develop, the types of institutions they need and demand also change.

One of this Report's messages is that institutions that work in industrial countries may not produce similar results in poorer countries because of differences in:

- Complementary institutions, such as those promoting transparency and the enforcement of laws
- Existing levels and perceptions of corruption
- Costs, relative to per capita income, of establishing and maintaining institutions
- Administrative capacity, including human capabilities
- Technology.

Both existing and newly transplanted institutions can be more effective in poor countries if they are systematically modified to take these differences into account.[10] This may sometimes mean changing priorities in terms of which types of institutions to build first, and whether to build at all at a given time.

Complementary institutions. Government interventions can reduce many market failures, but governments may also fail in trying to support market transactions. For example, governments may impose regulations to try to compensate for market failures or as a way of re-

stricting private activity. Choosing between market failures and potential government failures is not easy, but measures can be taken to limit both. However, the limited capacity of developing country governments to implement regulations means that many activities in poorer countries are overregulated.

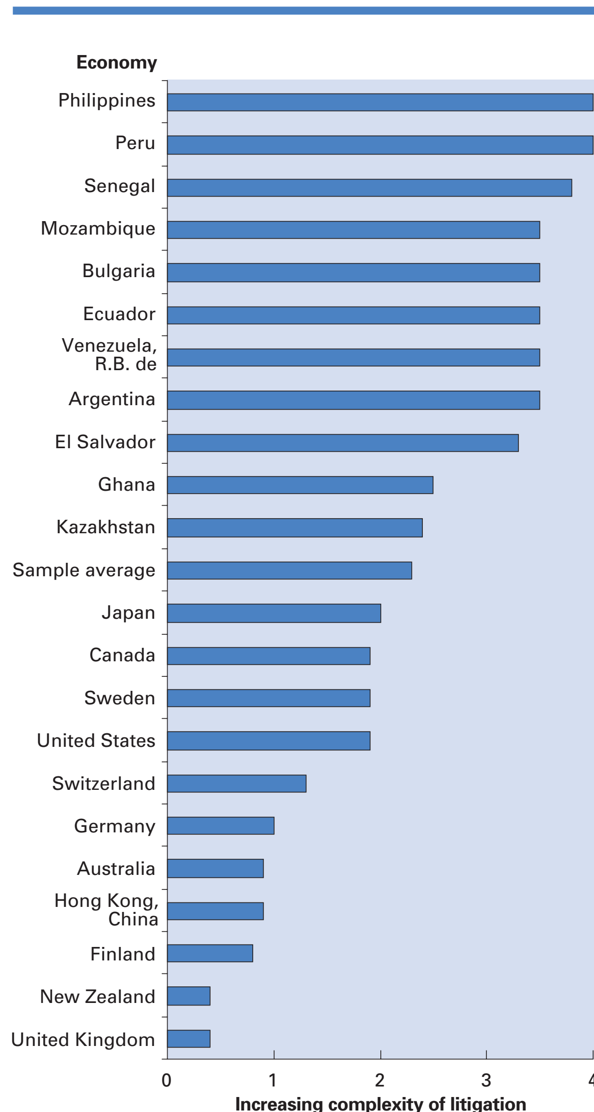
For regulatory systems in developing countries to have a realistic chance of success, they need to be simpler, often less information-intensive, and less burdensome on the courts. Many developing countries, however, despite their weaker judicial systems, tend to have very complex debt collection procedures (figure 1.3).

Regulations in industrial countries can also be very complex, but they do not impose as many additional costs as they do in poorer countries—for several reasons. Enforcement capacity in richer countries is stronger, and judges may face other incentives that affect their performance and judicial efficiency (chapter 6). Regulators are more accountable, and complementary institutions (such as those affecting judges' wages or careers, or those which promote transparency) provide checks and balances to protect market participants. In developing countries, where there are fewer supporting institutions (for example, where courts are weak or lack credibility), one solution is to write simple rules and have fewer of them.

Where informal institutions operate effectively, and when formal institutions require supporting institutions, building new formal institutions may not be a priority for policymakers.

- Studies of land titling in various countries show that formal titles may not have the desired effects when input, output, and credit markets and institutions are underdeveloped and the demand for agricultural goods is low (chapter 2). In such cases traditional community-based mechanisms are more effective in delineating property rights.
- Corporate governance is difficult in poorer countries because of weak legal systems and the lack of private information intermediaries. In this situation concentrated ownership structures—and business groups and associations—may provide more effective corporate oversight than dispersed ownership structures.

Figure 1.3
Complexity of procedures in debt collection



Note: For the definition of complexity see chapter 6. The sample average is based on 96 countries.
Source: Survey done for *World Development Report 2002* in conjunction with Lex Mundi, an international association of law firms.

Costs, capacity, and corruption. The cost of government regulation, whether in financial or other terms, needs to be consistent with a country's per capita income to be effective. For example, a recent study covering 85 countries found that in many developing countries, the financial cost of complying with regulations for registering a business is very high relative to per capita gross national product (GNP) (figure 1.4a) and higher than industrial country averages.[11] Surprisingly, developing countries that have less administrative capacity also require more procedures to register a business (figure 1.4b). The high cost, whether in complexity or resources, deters entry into the formal sector, potentially reducing competition and incurring ad-

Figure 1.4a
Cost of business registration (as percentage of GNP per capita) is higher for lower-income countries

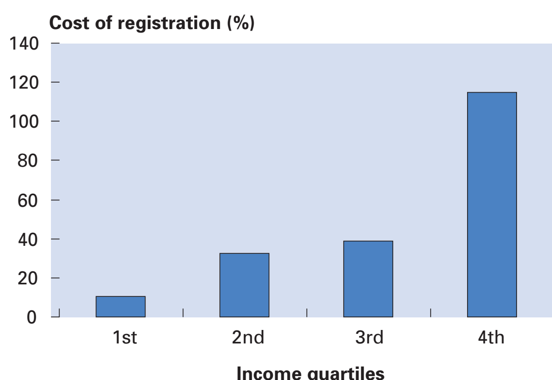


Figure 1.4b
Lower-income countries have more procedures

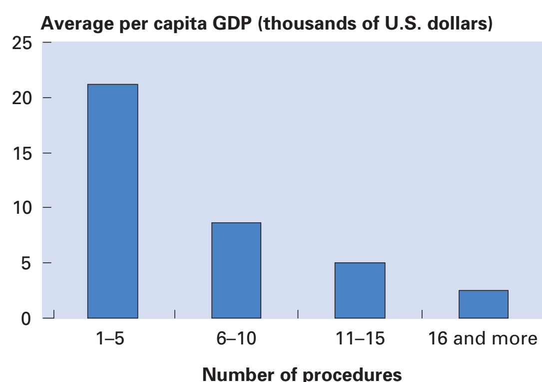
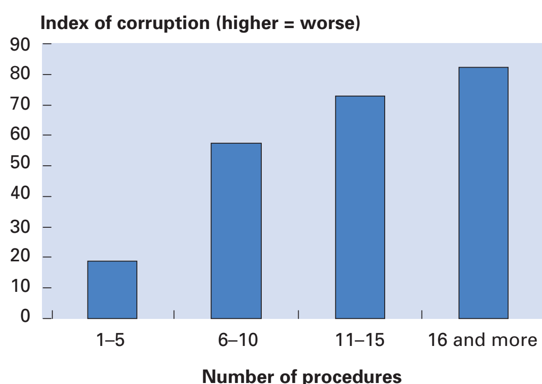


Figure 1.4c
More procedures are associated with higher corruption



Note: Costs are defined as official fees as a percentage of 1999 GNP per capita.
Source: Djankov and others 2001, *World Development Report 2002* background paper.

Box 1.7
Human capital and institutional design

Human capital affects the quality of the rules that govern market transactions and the enforcement of these rules. Literacy levels and technical skills vary greatly across and within countries. The poorest economies of the former Soviet Union have income levels lower than many countries in Asia and Africa but nearly universal primary education. So literacy is less of a barrier for Armenians using formal institutions than it may be for some Angolans—and it is less of a problem for today's Malaysians than it was for those of a generation ago. The rules and organizations that govern markets have to allow relevant market actors to use them easily. This argument holds within countries as well—for example, across poorer rural and richer urban areas.

The usefulness of institutions also depends on the capability of their administrators. Judges untrained in corporate law and accountancy, for instance, may not be the best arbiters of bankruptcy cases. Successful institution builders have had either to tailor institutions to prevailing administrative capacity (using, for example, simpler bankruptcy rules) or to complement institution building with a strong focus on concurrently developing technical expertise for administrators (from accountancy skills to regulatory economics).

ditional costs in the form of increasing corruption (figure 1.4c).[12] A World Bank study also finds that in many African countries, restrictive regulations and practices are often aimed at generating rents for officials and favored private agents or groups, constraining business activity in both agriculture and industry.[13]

Since building institutions is costly, requiring a minimum threshold demand before they can operate efficiently, small countries can face problems. Small countries and those countries wishing to expedite access to institutions may wish to rely on foreign institutions—such as foreign banks or foreign stock market listings—rather than build supervisory and regulatory capacity at home (chapter 4). Hungary and Estonia, for example, encouraged the entry of foreign banks, supervised and regulated in their country of domicile.

Human capability. More human capital may be needed to use some market institutions—such as formal judicial methods to resolve disputes—and to administer regulations or develop standards (box 1.7). For example, competition authorities need people who understand the complex details of competition cases. As countries build human capabilities, they need to consider where to focus their attention. Human capital and the array of market institutions in an economy have a dynamic relationship. Agents need human capital to

benefit from certain institutions. And over time, as agents learn, institutions need to be adapted. As can be seen from the experience of East Asia, actively promoting literacy and primary education can have a big payoff in the eventual quality and success of formal institutions, as both users and administrators are more able to work with market institutions.

Technology. Infrastructure regulation shows that technical standards used in industrial countries may be inappropriate for developing countries (chapter 8). In poor countries service providers using low-cost technology often operate in the informal sector for parts of society not reached by formal operators. Regulators are typically hostile to informal providers. But some developing countries recognize the benefits of allowing those providers to operate. In Paraguay about 400 private water suppliers operate their own wells and provide piped water to households unserved by the public sector. Imposing strict standards on providers using simple technology would immediately drive these private suppliers out of business. A more gradual evolution in regulation is needed.[14]

Countries do not have to go through a long learning-by-doing process in all aspects of institutional development. They can transplant and modify some institutional forms from other countries and shorten the development process by learning from other countries. They can also use Internet technology to reduce institutional constraints and improve the effectiveness of institutions. In many developing countries the Internet is already providing the means for accelerated learning, improved information flows, reduced enforcement costs, and enhanced competition in markets (box 1.8). But to leapfrog stages in development through technology, policymakers need to increase access to technology for market agents. Market rules affect access.

International rules and standards. Standardizing laws and regulations generally reduces the information and enforcement costs of transactions across borders and can enhance trade efficiency. International standards also have the potential to provide benefits much larger than those under bilaterally agreed standards between countries for both poor and rich countries. But depending on which standards are chosen, international standards can also be costly for poor countries and can have significant distributional consequences *between* countries.

International trading rules and principles, enshrined in the World Trade Organization (WTO), promote trade (chapters 5 and 7). But some standards, through their distributional effects, can discriminate systematically against poor countries. For example, the Trade-Related Aspects of Intellectual Property Rights Agreement (TRIPS) can impose significant costs on poor countries, because strong patent protection is not as appropriate for them as it is for rich countries. Many industrial countries themselves only recently adopted laws safeguarding intellectual property, and the nature of these laws has evolved over time in response to changing domestic economic and political factors. Developing countries also lack the supporting institutions to implement TRIPS effectively—these will take time and resources to build.

Another example is the adoption of international accounting rules by companies in many developing countries. This has enhanced their access to credit in inter-

Box 1.8
Computerization and land registration in Andhra Pradesh, India

Buying property in Andhra Pradesh used to be complex and take a long time. After the purchase the buyer visited the local office of the Sub-Registrar of Assurances in person, had the property valued and stamp duty calculated, purchased stamp paper, and had a writer draft the deed in the requisite legal language. The purchaser also had to provide additional documents related to income and other properties owned. All these documents were then scrutinized by the registrar, and recorded, before an exact copy of the final deed was copied by hand and certified.

In Andhra Pradesh, 387 subregistrar offices registered about 1.2 million documents a year, 60 percent of them for agricultural land. A yearly manual update of property information was carried out, since hundreds of thousands of property files were updated with the new sales from the year.

Land registration offices throughout the state are now equipped with computerized counters under the Computer-aided Administration of Registration Department (CARD) project, initiated and financed by the state government to improve efficiency and increase duty collections. Starting with a pilot project in 214 locations over 15 months, the entire database was transferred to computers, the copying and filing system was replaced with imaging, and all back-office functions were automated. Standardization and greater transparency in property valuation procedures boosted stamp duty revenues. Registration processing time was cut from 10 days to 1 hour.

Source: Case study by Dr. Subhash Chandra Bhatnagar, University of Delhi. World Bank 2000, as part of the E-Government Focus Group, available at http://www1.worldbank.org/publicsector/egov.

national markets. Voluntary adoption of standards by firms wanting to obtain credit in international markets is likely to be beneficial. But these standards are not appropriate for smaller firms (chapter 3). And forcing small firms in developing countries to adopt them would raise their costs and possibly push them into the informal sector.

For international standards to truly benefit all countries by facilitating trade—and to avoid systematic biases against developing countries—the standards need to reflect realities in developing countries. These include the costs of adhering to standards as well as the benefits, and particularly important are the costs imposed on the poor. Important questions are: Whose standards should be adopted and why, and what is the process under which these standards are negotiated? The process of reforming international rules needs to be transparent, and developing countries need to be active participants to influence outcomes in their favor. But human capital constraints may prevent developing countries from representing their interests. In such circumstances international donors could help enhance their representation, or developing countries could pool their scarce technical skills and have common representation at international negotiations or hire private specialists to represent them.

Variation within countries. Some variation in institutions may be desirable for both efficiency and distributional reasons, even between regions within countries. Even industrial countries do not standardize all laws and regulations within the country. For example, Australia and Canada have different laws in different states for secured transactions. Different states in the United States have different corporate laws. The differences exist because of variations in economic and social structures—variations that can be particularly instructive for large countries such as Brazil, China, India, and the Russian Federation. Of course the costs of standardization versus diversity will vary depending on the institution and the relative distribution of gains and losses. Where spillover effects across jurisdictions are large and not sustainable at the macroeconomic level, variation may be less desirable.

Innovate to identify institutions that work

Even at similar levels of development, countries differ in many ways—in their norms, geography, and endowments. Innovation, often through experimentation, can help accommodate those differences and produce more effective institutions. Experimentation also has costs, however, and these need to be balanced against potential benefits.

Policymakers can replicate successful local innovations. But they also need to be flexible enough to drop unsuccessful experiments. Because innovation can come from many sources, collaboration by the different actors in society is vital, as shown by the development of microfinance institutions in Bangladesh, where the government adapted its formal legal structure to accommodate private innovation, and the process of land titling followed in Peru (box 1.9).

In some cases, greater local autonomy and participation may foster institutional experiments that lead to in-

Box 1.9
Private innovation supported by formal institutional change

In Bangladesh an economics professor had an idea—to help poor people help themselves by giving them small loans to start businesses despite their lack of collateral or credit histories. He started the Grameen Bank in 1976 using his social connections in government to manage a village branch of a government bank. The success of this endeavor, followed by expansion to other bank branches, led the government to eventually change the laws governing the Grameen Bank. It was established first as an independent entity with government control, then as an effectively private bank run by a public official, and finally as an effectively private bank run by a private individual and an independent board of directors. Today, Grameen Bank has branches in more than half the villages in Bangladesh and more than 2 million borrowers.

In Peru another innovative individual began with an experiment. He found that in Lima it took 728 bureaucratic steps for a person with an informal right to housing to get legal title. He followed up with a 10-year public information campaign, proving to politicians that there was a "hidden consensus for reform" for simplifying the procedures for formalization. Faced with overwhelming public support for simplification, the Peruvian congress unanimously passed legislation to formalize titles. Today, a simple legal procedure for establishing land titles for poorer people works in parallel with the formal system.

These two stories show how the state can work with private actors to promote institutional innovation by directly supporting experiments—or at least by allowing them to proceed and be tested and then, if they are successful, by encouraging their growth. The stories also show the importance of other factors in promoting innovation. Social connections and networks can reduce barriers to experimentation. Openness in information sharing provides the impetus to adopt and expand successful experiments.

Source: De Soto 2000; Yunus 1997.

novation. For example, Aguas Argentina, a privatized monopoly that provides water and sanitation services in Buenos Aires, worked under a novel institutional arrangement to design new ways to organize service delivery. The monopoly worked with local government, a low-income community, and a nongovernmental organization (NGO) to create a new organizational form to improve service delivery. The community was experimenting with two systems: a low-cost sewerage system and a double water system (with one connection to the network for small volumes of potable water and another drawing on groundwater sources too salty for drinking but good for washing and bathing). The double water system was dropped at the experimental stage because it was too expensive to develop, while the sewerage system was maintained. To expand its water network, Aguas Argentinas took over those systems built at lower cost by the community, giving customers a discount on the price in exchange. In effect, it had contracted out construction to the community.[15]

Innovation through experimentation can happen at different levels. Experimentation and innovation occur on at least three levels: national public policymaking, private commercial practices, and local action by communities and civil society leaders (see box 1.16). Local experimentation has the advantage of allowing many innovations to be tried simultaneously—with the successful ones replicated and the failures contained. But not all innovations can be left to local or decentralized communities—since local actions may have consequences across communities and too much experimentation can lead to each community having different rules. Local innovation can also open institutions to capture by local elites, inviting corruption. When effective innovations are identified, policymakers can help expand such institutions by replicating them in other areas (for example, through adopting a law) or by sharing information on the innovation.

Who innovates determines institutional evolution. Depending on who innovates, institutions can evolve in quite different ways (and with quite different distributional consequences), as shown by the evolution of bankruptcy law in the United Kingdom and the United States (box 1.10). As history shows, during the development process the institutions adopted favor those who control the process.

Debates among people who formulate policy, those who implement it, and those outside government can help in disseminating information on institutional innovation.[16] The tension between experimenting and standardizing public institutions within countries will be settled in favor of the latter when effective institutional forms are found. Policymakers have to ensure that successful local innovations can be scaled up. They must also be willing to drop outdated institutional forms. Hungary, in the early years of its transition, for example, experimented with a particular form of bankruptcy law, which was later dropped when conditions changed and a more effective alternative emerged (box 1.11).

Box 1.10
Distributional effects of innovation depend on who innovates: bankruptcy law in two countries

The United Kingdom created its bankruptcy regime through explicit legislation that recognized the importance of decentralized contracting: legislation stated that corporations were free to make the rules under which they would transact. Lenders and borrowers in the United Kingdom had the power to innovate through contracts, and over time commercial practice was incorporated into law. In the United States judges and legislators held that power.

The U.K. system, designed by private agents engaged in borrowing and lending, is today characterized by a great concentration of rights in favor of the principal lender. The principal claimant appoints a receiver who uses his powers for the sole purpose of repaying this principal's debt. The court's role is much less significant than it is in the United States, and the judgment is not subject to court review.

In the United States, Chapter 11 bankruptcy law is characterized by a partial dispersion of rights away from secured claims (priority lenders). U.S. legislation was amended several times at moments of economic crisis at the instigation of the judiciary. At these times preservation of companies rather than their dissolution was uppermost in the minds of legislators and judges—leading to a debtor-friendly bankruptcy law. Upon default a company in the United States may seek protection from its creditors, usually retaining control over the business.

Source: Franks and Sussman 2000.

Connect communities through information flows and trade

Open information exchange and open trade promote institution building by creating demand for market-supporting institutions.

Open trade. Going beyond allocative efficiency, open trade does more.

- It exposes market participants to a larger, more diverse, group of trading partners, increasing the de-

Box 1.11
Experimentation and adaptation: bankruptcy institutions in Hungary

In 1992 the Hungarian government adopted a bankruptcy code giving creditors very strong rights to file for bankruptcy. The intention was to impose a hard budget constraint on firms, particularly on large enterprises. The law therefore stated that the creditor could file for bankruptcy if a company was three months or more overdue on any debt (known as an automatic trigger). Since accounting systems were underdeveloped, information on the true performance of firms was not readily available, and the available information was not always reliable. The solvency or insolvency of a firm was therefore hard to measure.

The short time frame and the establishment of such a strong trigger for bankruptcy proceedings led more than 5,000 firms to file for bankruptcy. The government had not expected such a large number of bankruptcies, particularly of small firms. The automatic trigger allowed the government to assess quickly the true condition of firms. But because the courts dealt with so many cases, they quickly developed experience in handling bankruptcies. The result: the authorities abolished the trigger in 1998. Not only were courts better able to adjudicate bankruptcies, but better information systems had developed to allow creditors to monitor companies. Market dynamics and supporting institutions had evolved enough so that the law was no longer needed.

Source: Gray and others 1996.

mand for formal institutions to provide information and enforce contracts.[17]

- It helps firms learn about technology and about organizational and managerial forms.
- It exposes markets to greater competition and changes in relative returns, which induce institutional change (see below).
- It exposes countries to a different set of risks, possibly supporting the creation of additional institutions to manage the new risks.
- It brings new market participants from other countries or regions who also demand more effective institutions to support market transactions.

The case of Thailand illustrates how liberalization of trading rules led to a shift in agricultural returns—and to institutional change in the market for land (box 1.12).[18] Similar patterns are observed in other countries and sectors. The development of standards for rice within Japan was spurred after markets within Japan were connected (box 1.13). The demand for formal

Box 1.12
Trade and institutional change in Thailand

In the early 19th century, with labor scarce and land abundant, land had little value in Thailand. Slaves rather than land were taken as collateral in financial markets. Correspondingly, land markets were underdeveloped. There was little demand or need for the development of formal institutions. But there was a well-developed legal system to govern transactions in labor commitments. In theory, all land belonged to the king. In practice, individuals could use and sell the land, as long as they paid taxes and did not let it lie fallow for more than three consecutive years.

In the latter part of the century, international trade opened up, and transport costs declined. A rice export boom led to a rapid expansion of production and use of land. Land became more valuable, land disputes more common. The demand for formal institutions, such as registries, to convey information and enforce property rights increased.

The government responded by implementing a series of procedural and administrative changes, beginning in 1892. The first initiative, to document land rights, was modified and improved several times; the final legislation was passed in 1954. The current legislation is a compromise between traditional practice, which allowed citizens to bring unoccupied forestland under cultivation as private property, and the more formal requirement of land titling based on detailed land surveys.

Such institutional evolution is not unique to Thailand, for industrial countries have also shown that trade, by changing the terms of trade, gives rise to the demand for clear property rights and a need for the state to define them.

Source: Siamwalla and others 1993; Stifel 1976.

land titles in many countries (chapter 2) developed once markets for goods produced on the land were accessible or when new members entered the community.

Empirical work spanning over 110 countries shows that measures of institutional effectiveness (such as the quality of institutions for public service delivery, or perceptions of the rule of law) are significantly related to openness in international trade. This is so even after accounting for differences in size, per capita income, legal heritage, years the country has been independent, and other factors (figure 1.5).[19]

Greater openness in trade and capital markets has been associated with the development of financial systems, as historical and cross-country analyses clearly show. Large incumbent firms that have access to finance—through either retained earnings or established links with financial institutions—do not always have an

Box 1.13
Institutional evolution of rice markets and standardization in Japan, 1600–1920s

In Japan's Tokugawa period (1600–1868), local private traders collected and marketed the rice shares of both the *daimyo* (feudal lord) and the peasant. The traders had to be big, since poor inland transport meant that rice was shipped in large sailing vessels and later steamships—a costly and risky venture. When the network of railroads was extended to local areas, locally segmented markets began to form a nationwide market. And with the economies of scale in transport and related risks, small traders could market their rice, using small shipments from many local centers.

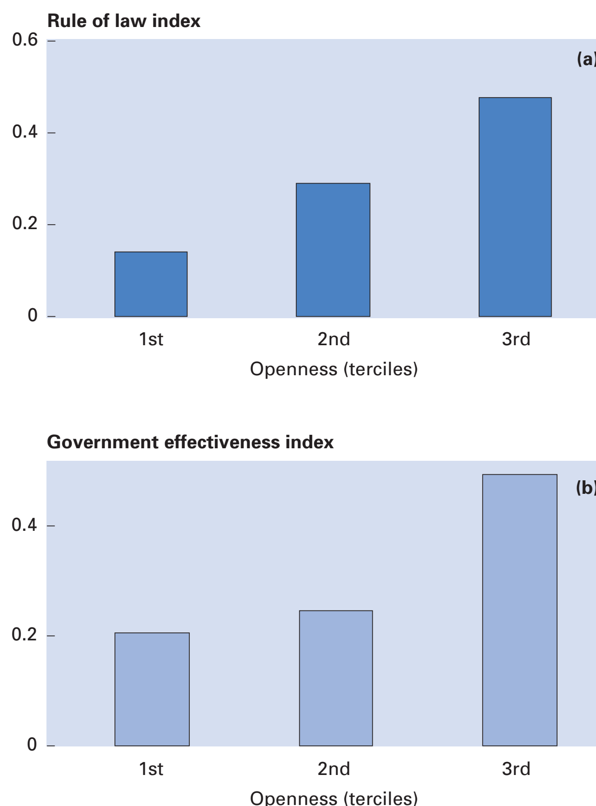
The competition among small traders from different rice-producing regions increased the pressure to standardize rice grades. Better and more stable quality and standards ensured higher prices in urban markets. Groups of farmers and traders began taking the initiative by labeling the quality of rice in various regions. By 1900 these voluntary efforts were transformed into official regulations by local government agencies, which began to set standards for the packaging of rice shipped to other regions. By 1910 there were 33 rice-grading warehouses (*beiken soko*), managed by private companies or cooperatives, serving several purposes—inspecting, grading, repackaging, and storing.

Innovations in finance followed. As farmers and traders brought ungraded rice to the warehouse, it issued a "rice exchange note." The precursor to today's inventory credit, these notes were also used as collateral for loans from banks and pawnshops, easing capital constraints for farmers and traders.

More trade among different communities led to the developments of standards, first adopted by private traders and later by government. These early institutional changes promoted new institutions to support market exchange.

Source: Kawagoe 1998.

Figure 1.5
Greater openness and quality of institutions



Note: The figures show the partial relationship (after accounting for the effect of differences in the legal systems, ethnic diversity, GNP per capita, years that the country in question has been independent, country size, and inequality of income) between an indicator of rule of law/ government effectiveness and openness for over 100 countries in 1997–98. The countries have been divided into three groups of equal size.
Source: Islam and Montenegro forthcoming, *World Development Report 2002* background paper.

incentive to promote financial systems that would facilitate new entry into their markets. Opening the economy to trade and financial flows can automatically reduce rents that incumbents receive from preferential access to financial institutions. And over time the lower rents can reduce opposition to financial sector reform.[20]

Rather than improve their own systems, policymakers in open economies can import whole aspects of the institutional system: laws, regulations, and enforcement systems. Because of the political problems and costs of importing foreign agencies, including foreign human capital, there are not many examples. Many countries have allowed foreign banks to operate in the domestic financial sector, helping financial services grow even with underdeveloped supervisory and regulatory systems. To get around weak judicial systems, poor countries can export the enforcement of contracts. For infrastructure deals in which private investors from rich countries invest in poor countries, for example, international arbitration clauses can be used in cases of dispute.

Open information flows. Open information exchange, a driver of institutional development, can both improve the quality of other existing institutions and create a demand for new ones. Better information makes monitoring peoples' behavior easier. This ability to monitor behavior changes behavior and institutional quality even when institutional structure does not change. Better information can also change social norms and so change

people's incentives to participate in different institutions. And it can inform policymakers and other market participants about the benefits of institutional reform and about the constraints on institutional reform.

Information from the media and low-cost information on the Internet can enhance the functioning of public institutions. Evidence indicates that corruption, for example, is lower in countries with a free press (box 1.14). There is also evidence that free media, by providing a check on political actions, can raise policymakers' awareness of the social effects of policies, improving the provision of social services. A study in India found that the media affected how the government responded to floods and famines: the distribution of relief was greater in states with higher newspaper circulations. The more information the local media provided, the more effectively citizens could develop a collective voice and put pressure on the government.[21]

Recent research for this Report shows that competition in the provision of information can significantly increase the impact of the media on the quality of institutions. For example, where the state does not control information through monopoly or concentrated ownership of the media industry, the media can do much in checking corruption (figure 1.6). The effect of private monopolies on information flow can be expected to be similar.

Information about the potential benefits and costs of particular institutional arrangements can change the incentives for those who engage in market transactions and the demand for institutions. In Nepal the publication of simple facts about the costs of business licensing—both in time spent and in bribes paid—led the government to undertake reforms that reduced licensing time from years to days.[22] With poor information flow in an economy, regulatory rules and policies are unclear. So regulated firms and customers do not know, or cannot find out, what regulations apply to them or how to comply with them.[23]

Promote competition—among jurisdictions, firms, and individuals

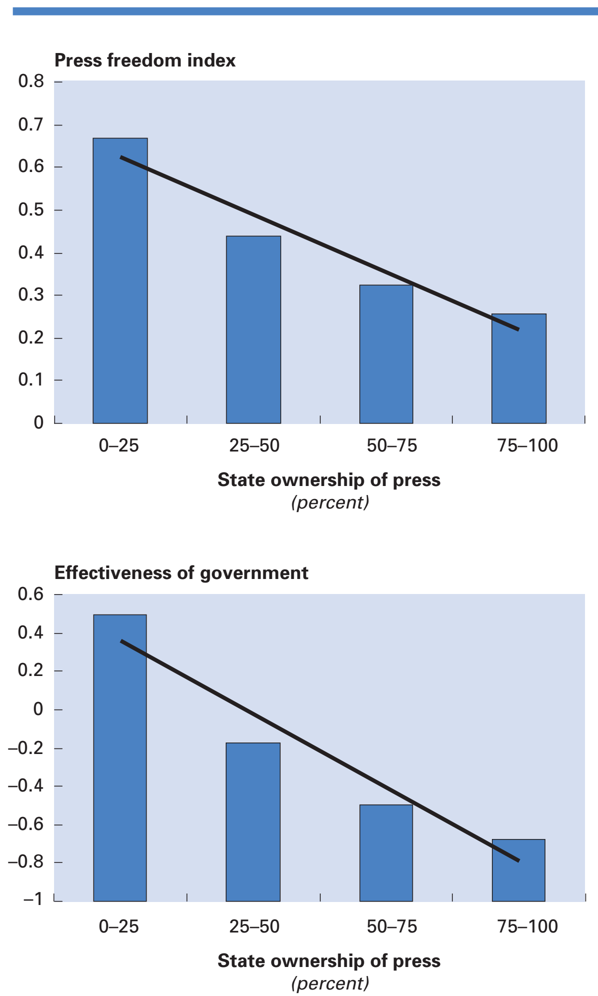
Competition among jurisdictions, among firms in product markets, and among individuals does much for institutional change.[24] Often, current institutional

Box 1.14
Role of the news media in fighting corruption in Kenya

In 1996 investigative journalists from a privately owned newspaper uncovered evidence of corruption in Kenya's ministry of health. A purchase of unapproved malaria chemicals was planned through a foreign firm at a substantially higher price than local firms were charging. It was also reported that the health minister paid the foreign firm 400 million Kenya shillings, even though no goods were received in return for this payment. The press revealed these findings and made daily reports on the scandal. Eventually, under unrelenting pressure from the media, the minister was dismissed.

Source: Githongo 1997; Stapenhurst 2000.

Figure 1.6
Diversity of information providers and quality of institutions



Source: Djankov and others 2001, *World Development Report 2002* background paper.

structures may inhibit competition. Competition makes institutions more or less effective by affecting relative returns and changing the incentives of agents. For example, as competition in markets increases, traditional norm-based institutions may become inadequate or obsolete.[25] Competition can reduce the effectiveness of closed groups, such as guilds or business networks, whose existence and effectiveness depend on superior access to such inputs as information. This can create the demand for new institutions or improve the quality of existing institutions by changing behavior. In places as varied as Thailand and Uganda, greater competition for land increased land disputes and created the demand for more formal procedures for recording transactions. Competition in product markets has led to institutional change in labor markets (chapter 7). And there is some evidence that competition between firms can be a partial substitute for strong shareholder rights in inducing managers to act in the interest of owners.

Firms competing in product markets, forced to increase efficiency, have the incentive to lobby policymakers to implement institutional changes that lower their costs. Competition also affects the distribution of gains among market players, and so increases the demand for institutional change among those who want to maintain their gains in the light of changing economic factors. But sometimes institutions, such as rules governing intellectual property, may be needed to limit the degree of competition in markets and to foster innovation.

For firms in international capital markets, competition can produce demand for better institutions, such as accounting standards (chapter 5). In turn, domestic banks, to compete with foreign banks outside their home markets, may pressure their regulators to improve prudential regulations. This happened in Mexico after it signed the North American Free Trade Agreement. A World Bank study looking at institutional performance cites competition as a key factor affecting institutional performance, since it changes the incentives for individuals to succeed.[26]

Jurisdictional competition also fosters institutional evolution. A study of corporate law evolution shows that competition between countries—and between foreign firms operating in a country—has created pressure for change in corporate laws (box 1.15). In the United States competition between states to attract business has led to institutional evolution of different forms in the various states. For example, personal bankruptcy and corporate laws vary across the states. Education systems vary across districts.

Markets with more competition may require fewer formal institutions, since competition can substitute for regulation. Take infrastructure: greater competition, possible with technological changes, has allowed regulators to lower the frequency of price reviews (chapter 8). Sectors previously considered natural monopolies became potentially competitive, so governments now rely more on competition to deliver desired outcomes, such as affordable prices for consumers.

But the competition from new infrastructure providers can also complicate regulation. Before the privatization of state monopolies in many countries, state infrastructure monopolies cross-subsidized some customers—in many cases lowering costs for poorer households by charging higher prices to business users. After privatization, governments aiming to protect poorer customers have found it difficult to regulate the privatized firms in a way that provided adequate profits for

Box 1.15
Competition and the evolution of corporate law

A study investigating legal change in 10 jurisdictions, including both industrial and developing countries over more than 100 years, found competition among firms operating within countries and across borders to be important in promoting changes in the corporate law. The changes were often enacted in response to crises, owing to competitive pressures, or as a conscious effort to standardize corporate law across countries.

Studies of Europe in the late 19th century highlight jurisdictional competition in the development of corporate law. There was a shift from concession systems, in which rulers granted the right to incorporate case by case and often as a special favor, to a system of registration in which any company meeting certain minimum requirements could incorporate. For example, in France in 1867, the shift was induced by the expansion of English companies on the continent. Once France allowed companies incorporated in England to operate as a corporation in France, without special approval by parliament, it faced pressure from domestic companies to drop the concession requirement at home.

Israel in 1999, Japan in the 1990s, Chile in 1981, and Delaware in the United States (where there have been continuous changes) provide examples of jurisdictions that changed their corporate laws in response to competitive pressures in the 20th century.

Source: Pistor and others 2000, *World Development Report 2002* background paper.

firms while providing adequate services to the poor (chapter 8).

There are times when institutions restricting competition are desirable. Some market rents may need to be tolerated to fund the adoption of new technology, and institutions restricting competition may be needed to promote market development. And regulating the degree of competition among banks can enhance financial stability by reducing the incentives for risk taking.

How do political forces, social pressures, and shocks affect the pace of change?

Political forces and social pressures can either accelerate or retard the development of new institutions. Shifting social, political, and economic balances are in turn affected by a government's institutional reform efforts. In industrial markets, however, the state is constrained from arbitrarily changing rules and laws, and there tend to be more checks and balances on various actors, public and private.

Political forces. An institution exists in part because some constituencies gain from its existence and so have the incentives and influence to support it. This distributional aspect is particularly important when institutions benefit a small group or minority in society for whom the costs of collective action are low and benefits are large. Checks and balances on political power, from firms and interest groups, can support the interests of the majority. But minority interests may in some cases oppose the modification of institutions.

So policymakers wishing to embark on reforms may have to create new institutions rather than modify existing ones. According to some, this was important in the recent establishment of a regulatory authority for telecommunications in Morocco. But even though building new institutions may be desirable, the costs of collective action—including those of information collection, enforcement, and competition—may be so great relative to perceived benefits that they would frustrate the formation of a new political coalition that would push for institutional change.

Institutions often change when the power of those who directly benefit from the existing structures is undermined or when they no longer reap any benefits so that they no longer have the incentive to oppose change. One way to accelerate institutional change is to co-opt the opponents of reform. In China after 1978, local governments were encouraged to collect federal taxes since they could keep any collections above a certain level. Local governments were also able to raise additional taxes, not shared with the national government.

But all reforms are not equally difficult politically. Some ineffective institutions may exist in part because there are no interest groups pressing for change—not because some interest groups oppose change. Or it may be that those who would oppose change do not have much political sway. Whatever the reason, reforms in these areas could be accelerated. And as these reforms breed new constituencies and forces, they can lead to a demand for greater change. The key is to find the opportunities and to work in these areas.

Although indigenous institutional development responds to changing economic and social conditions, a central issue for transplants is managing distributional conflicts. Institutional change creates winners and losers. For example, bankruptcy law designates the rights to income and assets for creditors. Corporate law distributes rights among owners, managers, and the government. Regulation covering service provision to the poor transfers economic gains from producers to poor consumers and between levels of government (chapter 8).

The distribution of power among different levels of government largely determines the type of regulatory structure likely to be effective. A study of the evolution of regulation in infrastructure conducted for this Report argues that the allocation of regulatory authority in the now industrial countries closely followed the political structures of those countries.[27] The degree of political and administrative centralization in a country significantly affects the intervention by the upper level of government in regulation. In the United States—where the states are large and there is a great deal of autonomy—local regulation of concessions for water and electricity was gradually overtaken by state-level regulation. The greater centralization was hastened by corrupt municipalities or complex regulatory issues between local jurisdictions. Traditionally, regulation of natural monopoly infrastructure firms evolved in response to political pressure from firms or communities. In response to high prices and high profits, the public demanded government intervention. By contrast, France has a very centralized political system and has generally adopted a much more centralized regulatory structure.

When transplanting regulatory agencies from industrial countries, the domestic political structure and balance of power must be considered along with the qual-

Box 1.16

The interplay of social, political, and economic forces in the reform of land institutions in China

Before the 1960s rural land in China was the responsibility of communes. In the early 1960s farmers in Anhui Province began calling for a restructuring of communes, so that earnings could be linked to work. Local leaders began experimenting, allowing some households to contract for individual plots. The demonstration led others to push for plots, and the resulting productivity increases led to formal sanctioning by local leaders of this system. At that time the central government was not involved. Later, the system was partially reversed because of central government disapproval. Then in 1978 a severe drought in Anhui led to a food crisis, and provincial leaders allowed households to cultivate any land the collective farms were unable to work. Nearby villages emulated the practice.

The central government began accepting local institutional innovation after almost 20 years, when faced with an economic crisis. Central government officials formally adopted the Household Responsibility System, under which households could contract with local leaders to produce on their "own" land. Initial distributions, although different from village to village, were essentially the same within the village. In other words, both social and productivity considerations determined land allocations in the transition to individual and more formal rights. But the contracts with households did not assure them of very stable land use rights. Although such rights were supposed to be allocated for a period of years, most villages in China adopted the practice of periodically readjusting landholdings in accord with changes in household makeup. Chinese farmers and officials have not been of one mind regarding social versus efficiency considerations. Surveys of farmers in the 1990s indicated that they wanted more secure land rights, but many also favored readjustments. Chinese farmers indicated that they would overwhelmingly support a no-readjustment policy if their welfare concerns could be addressed by other means (such as preferential allocation of wasteland or taxes). Lack of consensus on the institutional structures to protect farmer welfare probably slowed the effective implementation of land contracts.

In some cases land readjustments also reflected the desire of local cadres to maintain influence. Control over land remains one of the main sources of economic and political power for local officials. Perhaps as a result, land system rules regarding tenure—both formal and informal—and practices have varied widely around the country. Although the central government approved 15- and then 30-year tenures, this was not implemented. Field research indicates that *county-* and *provincial-*level officials from jurisdictions that rely heavily on agriculture are more likely to have interests that are similar to those of farmers than local officials.

China's story reveals some important lessons for institutional reform.

- Experimentation has been key for institutional reform, in this case at local levels. The central government was important in validating a successful experiment and thus in accelerating its acceptance around the country.
- Institutional reform takes time. Chinese land policies will continue to be modified as several important issues are resolved and as other supporting institutions evolve.
- At different stages in the process of institutional reform, the role of local versus other leaders varied significantly.
- When changing established norms, governments need to be aware of dual role played by institutions—in this case formal, but in many others informal—in affecting both efficiency and equity. Social concerns affect the pace of reform. Explicit considerations of these issues can help policymakers undertake institutional reform.

Source: Prosterman, Schwarzwalder, and Hanstad 2001; *World Development Report 2002* background paper.

ity of information that is available to different levels of government. Such issues are particularly important in large countries such as Brazil, India, and Russia. Information problems at the national level tend to be more severe, but so could be the risk of regulatory capture at local levels. While economic analysis may argue for a certain design, for effective institution building, political and social realities and their dynamics will need to be considered.

History shows that politics influence the development of financial systems.[28] Financial institutions, particularly banks, provide an easy way for governments to channel the economy's resources in directions they deem politically desirable.[29] The effective functioning of government agencies, such as tax collection agencies and financial supervisory authorities, depend critically on politics and checks and balances on political power. Many developing countries have recently tried to establish autonomous revenue agencies to free tax collection from political influence. What determines the success of these reforms? The authority granted to these institutions, and the political commitment to support their greater autonomy (chapter 5).

Political instability also affects investment within countries, as cross-country empirical studies show. In countries more polarized and less politically stable, policymakers are less committed to strengthening the legal system and protecting private property rights.[30] Weak property rights in politically unstable countries lead to lower investment.

Social pressures. Social structures such as inequalities in income distribution and in the influence of different ethnic groups also affect the demand for institutional reforms and their sustainability (box 1.16).

More inequality sometimes means lower institutional quality. Empirical work across countries—using indicators of institutional development that measure the rule of law, corruption, enforcement of property rights, and an overall index of these indicators—suggests that there is some association between the distribution of income and institutional quality, with very unequal distributions of income being associated with a lower quality of institutional development.

Why might this be? Perhaps more unequal societies are more polarized or less likely to engage in social or economic transactions with each other. More polarized societies also may be less likely to agree on institutional reform, much as they may find it more difficult to agree on policy reforms.[31] Or perhaps when a few players, such as large business groups, dominate economic transactions, they have little incentive to support formal institutions that would enhance competition in their activities. Those players, often part of well-knit networks, can conduct most of their business through reputational mechanisms.

The differences in the development paths of North and South America are often cited as examples of how social factors—such as equality in the distribution of human capital and other resources, differences in ethnic diversity, and the economic power of the dominant group in these economies—can affect institutional development and growth.[32] Countries in both regions imported institutions from Europe. A more equal initial distribution of income and a less polarized society in the United States is cited as an important factor promoting institutional reform. There was more participation by broad segments of the population in a competitive market economy. More egalitarian societies may also be less polarized. This factor is probably more important for ethnically diverse countries, particularly during economic downturns when conflicts tend to be magnified.

Other forces may be at work. True, the history of the industrial countries is full of examples of periods and countries of high inequality. Consider the prevalence of sweatshops, unhealthy working conditions, and extensive child labor in much of the United Kingdom during industrialization. But this inequality did not keep the United Kingdom from the forefront of industrial development. So it is not clear that initially high income inequalities will always prevent later broad-based market development. There may be countervailing forces at work, such as the open exchange of information, open trade and competition, and innovation, all promoting institutional development.

The recent experience of the East Asian economies suggests that policies to promote equality, through investments in education, can yield high returns. People who are literate and educated are more likely to participate in and demand formal market-supporting institutions. This Report provides some guidance for institution building in the social sectors (box 1.17). Promoting opportunity in this way can promote social cohesion, important for consensus-building on reforms.

Large initial inequalities in wealth in closed markets can also engender situations where strong economic interests may "capture" the state, leading to regulatory structures that favor their narrow interests and prevent broad-based markets. Market participants can have a key role in the design of institutions that affect their transactions. Creating inclusive institutions with more social legitimacy—systems in which business interests and government can work together in an open and transparent fashion in establishing institutions—can lead to faster progress than in closed systems.

Shocks. Large shocks to economic and political systems change the balance of economic, social, and political power—and thus the effectiveness of institutions. Sometimes shocks forestall reform and at other times they can accelerate it. During economic depressions, for example, business and financial groups often come under greater scrutiny. It is claimed that periods of economic depression in Europe reduced political and social support for financial development, particularly for the development of equity markets.[33] But country experience also shows that since market-supporting institutions need some stability to be effective, large economic or political shocks may be needed for all but gradual change. And sometimes several large shocks are needed.[34] For policymakers and politicians, periods of crisis can sometimes provide opportunities, at least in some sectors, to undertake bolder institutional reforms—and these are opportunities to be seized.

A detailed analysis of the evolution of corporate law in industrial and developing countries shows that economic crises create demand for reform. For example, the recent financial crises affected reform in Malaysia (box 1.18).[35]

Shocks in technology also create demand for new institutions. Regulators need to develop new institutions to deal with such technological breakthroughs as the Internet. For example, the spread of e-banking and the provision of financial and other information over the Internet offers lower transaction costs—and new opportunities for fraud.

Box 1.17
Applying the lessons to the social sectors

Some of the key problems institutions face in the delivery of social services are information, enforcement, and competition.

Limited *information* about the beneficiary is available to the provider of services, complicating the targeting of income transfers to those truly in need. In Moldova, for example, before recent changes in transfer systems, a 1997 survey found that the richest 10 percent of the population enjoyed almost a fifth of all social assistance payments, while 38 percent of poor households got no form of social assistance at all.

Enforcement by public officials of good quality is difficult. In relatively poor areas of most countries, there are difficulties in maintaining staff and providing services, especially for public providers. Evidence from Canada (Anderson and Rosenberg 1990) to Indonesia (World Bank 1994b), and from India (The Probe Team 1999, p. 44) to Zambia (World Bank 2001f) shows substantial differences in vacancy rates in health posts between urban and rural areas.

Then there are the issues of *competition*. For example, competition by the government in providing social transfers may drive out private institutional arrangements—such as family networks, which can be targeted more effectively to the poor than more arm's length (public) social assistance.[36] A study from the Philippines, simulating the results of introducing an unemployment insurance scheme, found that net private transfers to the unemployed would fall by 92 pesos for every 100 given by the government (Cox and Jiminez 1995).

Complementing what exists. The demand for modern *public* institutions to deliver universal social services and widespread social assistance is fairly recent. In health the large national systems of the United Kingdom and Canada date from 1948 and the 1970s, respectively. and in education, the achievement of universal primary education, requiring public funding, occurred late in the 19th century. The origins of national social assistance schemes are also fairly recent.

In each case, extensive reliance on the private sector preceded the participation of governments. In fact, as today's richer countries grew more advanced, they could provide more *formal* social services at a price-quality mix demanded by the population. They could ensure adequate training of public providers. And they had the complementary institutions (such as more reliable income and asset ownership records) to better target social assistance to the neediest and that were free from corruption.

For developing countries, public involvement in these areas has accelerated. With poor complementary institutions—inadequate monitoring capacity, poor communication networks—providing universal coverage immediately may be too ambitious. Public financial constraints, including low fiscal resources, may also worsen quality of services. So recognizing the need to be flexible in price-quality goals is important.

Innovating to identify what works. Despite the lack of complementary institutions, developing countries can use innovative methods to ease many of the information and enforcement problems in these areas. The use of providers closer to the community—such as NGOs, whose motivations are different from both private sectors and civil servants—can be a solution for both service delivery and the provision of social assistance. What many NGOs bring to the table is a credible promise not to exploit weaknesses in the monitoring systems of government.

In many sparsely populated and poor areas, such as one might find in rural Africa, it is unusual to find private, modern medical facilities unless provided by NGOs, particularly faith-based NGOs. In delivering social assistance, NGOs based in the community may be better able than formal agencies to discover who is most in need of aid and may be organizationally more flexible in delivering appropriate assistance to the neediest. The community may also serve as the arbiter of who has the most needs—as in the *mahalla* system in Uzbekistan.

For many of the poorest countries, the best option for targeting social transfers effectively may be to experiment with different self-targeting mechanisms to find the system that best ensures that few other than the poor use the transfers. Innovative approaches using less desirable consumption goods for the poorest (as in Bangladesh in the 1970s and Tunisia in the early 1990s) have proved useful (for Tunisia, see Tuck and Lindert 1996). Well-designed public works programs that pay below-market wages are also a good self-targeting way to ensure that resources get to those who need them.

Connecting communities. Promoting open information exchange has been very important in building successful service delivery institutions. In the state of Ceara in Brazil, one factor in the dramatic improvement of health service delivery was an innovative monitoring approach. But also critical was a substantial public relations campaign that preceded the program, increasing its visibility, enthusiasm, and prestige. In this way, the program recruited a cadre of interested local monitors (Tendler and Freedheim 1994).

Sometimes, simply providing information to local communities is enough to stimulate improvements in quality in service delivery. Recent technological advances, including the Internet, allow government and private agents to provide information cheaply. The rate of sharing information is dramatically enhanced. Take Uganda. In 1995 a study to track expenditure from the central government to individual schools found that as little as 30 percent of nonsalary recurrent budget allocations meant to reach schools actually did. The results of this study were publicized in newspapers and posted at local facilities. A follow-up survey in 1999 showed an increase in actual disbursements, averaging very close to 100 percent (Ablo and Reinikka 1998). Another variation that does not depend on technological improvements is sharing information through the use of traveling teachers.

Promoting competition. Competition between public and private providers improves institutional quality. In Malaysia a reliable system of public clinics has maintained pressure on the private sector to keep prices reasonable (van de Walle and Nead 1995; World Bank 1992). But competition is possible only in areas densely populated enough to support multiple providers. This leaves unaddressed the problem of remote areas with many poor people. In the United States, for example, voucher systems are almost always advocated only for urban areas.

Box 1.18
Crises and institutional change in Malaysia

Malaysia had one of the most developed capital markets in East Asia in the early 1970s. At first, securities market regulation followed mostly the English system of market self-regulation. Although a comprehensive securities act was enacted in 1973, jurisdiction over market supervision was divided among several state agencies—including the ministry of finance, the registrar of the companies, and the capital issues committee.

In 1993, after a decade of rapid market development, controls were unified in a new securities commission. Before the financial crisis in 1997, the commission had determined to replace the detailed merit regulations system with a liberalized system based primarily on disclosure. But in the wake of the crisis and with the aim of reducing capital outflows, policymakers adopted selective capital controls.

After an evaluation of the crisis, a series of more substantial institutional changes were introduced in preparation for continued liberalization. Focused on transparency and governance, these changes included new accounting standards, merger and acquisition rules, capital adequacy rules for stock brokering companies, and broker commission liberalization.

The implication for policymakers is clear: if crises expose real vulnerabilities in markets, policymakers should take advantage of these times to fix the vulnerabilities.

Source: World Bank staff.

Organization and scope of the Report

The second part of this year's Report concentrates on firms. It addresses institutional issues that affect productivity and risk management in agriculture: the rights to land, the credit in rural areas, and the institutions that support innovation and dissemination of ideas in agriculture. It also concentrates on the problems of governance for firms, looking at institutions, internal and external to the firm, that enhance investment in firms and ensure good management—especially the interaction between ownership structures and legal frameworks and between private institutions (such as business associations) and public ones. And it explores the critical role of financial institutions, the necessary supporting institutions for their development, and the role of the supervisory and regulatory system in ensuring a healthy financial system. It draws on new research done for the Report on the role of politics in financial development, institutions to secure access for new borrowers, and the effects of foreign bank entry and privatization.

Part III of the Report concentrates on government. It examines how political institutions support good governance, focusing on the policymaking process, the incentives for corruption, and the institutions of taxation. It next explores issues of judicial efficiency, and the experience with reforms aimed at improving efficiency, and examines the causes and consequences of cross-country differences in judicial procedures from a new survey covering over 100 countries. It then discusses the main impediments to competition in markets, gathering new data on business entry regulations around the world and on competition authorities and legislation. Last, it assesses the regulation of monopolies in developing countries and the consequences for service delivery to poor people.

Part IV of the Report concentrates on society. It discusses how norms and codes of conduct in societies influence markets and public institutions and in turn are influenced by market developments. It also explores the role of the media in expressing and disseminating the concerns and values of society—and the effects such information flows have on institutional quality and thus on economic and social outcomes. It draws on a new study of media ownership around the world written for the Report.

Market-supporting institutions are a big topic, for these institutions are everywhere and varied. So much remains to be learned about them. This Report offers policymakers some guidance that has been distilled both from the history of institutional evolution and from the lessons of recent experience—the varied experiences of the transition economies in the 1990s, the continuing struggles in many poor countries around the world, and the successes of some of the emerging economies in the past decades.

At the same time, the Report does not address all possible institutional problems in all possible fields. Rather, it focuses on a subset of these institutions from many fields to illustrate that the framework (inform, enforce, compete) and messages (complement, innovate, connect, and—again—compete) can be applied regardless of the specific sector studied. It does not cover in detail institutions that previous *World Devel-*

opment Reports have covered. This Report, one in a series looking at critical development issues, is a natural continuation of *World Development Report 2000/2001,* which discusses the central role of markets in the lives of poor people. It leaves some important issues for *World Development Report 2003,* which will focus on issues related to the environment as well as on social cohesion and stability.

Conclusions

Development experience shows that markets can provide the means to attain sustained increases in living standards for people around the world. *World Development Report 2000/2001* argued that markets are central to the lives of poor people. By providing opportunities to engage in productive activities, and by empowering citizens, they can promote growth and reduce poverty. But for markets to provide widespread benefits, they need to be inclusive and integrated. Policies that promote growth and reduce poverty are important, but the details of institutional design matter as well.

Improvements in living standards, and overall improvements in the lives of poor people, depend on institutions that support growth as well as those that directly enhance the access of poor people to markets. That is, poor people are affected by what other market actors do.

Building effective institutions is a complex task. Experience indicates that one size does not fit all. But notwithstanding the uniqueness of countries, analysis of country experience does hold important lessons for institutional development.

This Report provides a framework for institutional development. It builds on the work of several disciplines, combining theory and evidence. It extends empirical evidence on the details of institutional design across a wide range of countries, and within countries over time, to understand the process of institutional change. And it provides guidance on how to build new institutions, modify existing ones, and create the forces for change.

Most times institutional change is a step-by-step process. The Report acknowledges as well that many reforms are difficult because there are constituencies which benefit from existing institutions and often interest groups which would promote change do not do so. But it is also true that some institutions continue to exist not because there is concerted support for them, but because forces that would press for change are not adequately organized to do so. Reforms to such institutions are not as difficult to implement politically and, once implemented, could not only improve the way markets work but can help build momentum for further change. Both the supply of institutions and the demand for them matter. Development experience does not provide a universal guide as to which particular institutions should always be created first. However, within each sector, the Report does identify areas where the introduction of a particular institutional structure may need to wait for the development of other supporting or complementary institutions or conditions. In other words, some priorities can be identified.

This Report also considers the interaction between informal or norm-based institutions and formal institutions. Many poor people, particularly those in poor countries, do not have access to formal institutions. Innovative designs may help bridge the gap between informal and formal institutions and gradually increase the access of those left out. Simplifying formal institutions, providing more information about them to users, strengthening human capital, and accepting informal institutions when formal institutions would not have their desired impact are some of the ways in which institutional designs can be modified to suit the needs of poorer countries and of poor people.

Local, national, and international actors, public or private, affect how institutions evolve over time. The balance of power between private and public actors, and the state's recognition of both its strengths and limitations, is an important factor in market development. A strong and capable state is necessary to support markets, and an arbitrary and corrupt state can impede their development. But it is not only the balance between private and public actors that matters. The design of institutions and the pace of reform are affected by how local and national leaders and national and international leaders interact. All of these interactions are affected by the nature of information flows and the capabilities of the various parties.

The four main lessons of this chapter are that for effective institution building policymakers need to complement what exists, innovate to suit local conditions, foster open trade and open information exchange, and foster competition among regions, firms, and individuals. The incentives provided to people depend on the whole set of institutions and affect their performance. So when building an institution or modifying one, the

key thing to consider is whether supporting institutions—without which the institution would not be effective—exist. If not, perhaps it would be better to work on the supporting institutions first or to modify design so that the planned institution can work without the supporting institution. Also important are the levels of human capital needed, the extent of corruption, and costs relative to per capita income. With scarce human capital, complex regulations cannot be enforced as they are in countries with highly skilled personnel. These factors argue for simplification of institutional design. Higher costs relative to per capita income of accessing formal institutions will mean that the disadvantaged and poorer members of society will be unable to access these institutions. Corruption is facilitated by complexity of regulation in nontransparent markets and where other incentives for bureaucratic efficiency (such as wages or promotion) are weak. In these countries, to complement existing conditions, regulation needs to be streamlined. Technological differences are also relevant. To accommodate country-specific differences in culture and endowments, innovation should be encouraged and accepted. Finally, providing opportunities for trade will develop markets and the demand for institutions that support transactions in markets. Open information sharing will do the same. Competition among regions and among firms, often limited by current institutional structures, will help identify new institutional forms and create the demand for new institutions.