PART IV

Society

SOCIETAL FORCES SHAPE THE EFFECTIVENESS, GROWTH, AND LEGITimacy of market institutions, which in turn affect the rules and values of societal actors. The chapters in this part of the Report explore the range of interactions between society and market institutions. Chapter 9 on *Norms and Networks* discusses how the informal institutions used by societal groups influence transactions in the market. Finally, Chapter 10 on the *Media* looks at the institution that, in reflecting and disseminating the views of members of society, can improve the working of markets by greatly reducing the costs of information flows.

CHAPTER 9

Norms and Networks

In civilized society [man] stands at all times in need of the cooperation and assistance of great multitudes. In almost every other race of animals each individual, when it is grown up to maturity, is entirely independent, and in its natural state has occasion for the assistance of no other living creature. But man has almost constant occasion for the help of his brethren.

—Adam Smith, 1776

Immigrants in California raise credit through rotating credit associations rather than from banks. Small traders in Mexico use informal mechanisms rather than courts to resolve disputes. Bankers in Japan seal deals with a handshake rather than a legal contract.[1] All three groups rely on institutional arrangements far removed from the formal constructs of governments and modern organizations. In all societies systems based on social norms or networks—alternatively referred to as informal institutions and sometimes as "culture"—are a central means of facilitating market transactions.[2] Such norm-based institutions are especially critical for the poor, who often lack formal alternatives.

Transactions that rely on informal institutions are regulated by a set of expectations about other people's behavior. These expectations derive from a common understanding of the rules of the game and the penalties for deviation and are based on shared beliefs and shared identities of network members. Such norm-based behavior is not always confined to small groups but is also evident on a broader scale. One example is tax compliance, when individuals in society tend to act more honestly if they sense that other people's behavior is similar and when there is a social penalty for deviation.[3]

Individuals, when deciding to comply, either with taxes or with a contractual obligation, have three reasons to do so. First, because of an *individual* or "internalized" norm, such as honesty, which may be founded in a shared belief system, such as a religion or in a sense of obligation to one's peers. Second, because deviant action will be not be socially tolerated by others and this lack of acceptance will result in some form of *social* sanction. Third, because of an *economic* sanction associated with the deviation, such as a fine, imprisonment, or denial of future business, often with added social stigma attached to the economic punishment. Formal institutions focus on the third incentive and thus can be ineffective if this economic sanction is weak.

Norm-based institutions can supplement or supplant laws and formal rules. They may substitute for formal institutions where the latter do not exist or are not accessible or where they fail to facilitate business transactions. In these cases informal institutions allow those sharing norms or culture to behave predictably, lowering the risks in a transaction (chapter 1).[4] Corrupt environments, for example, are often the result of ineffective formal institutions that coexist with weak social deterrence, sometimes called a "culture of corruption" (chapter 5).[5] In such situations incentives for corruption rise as peers also become corrupt, leading to a vicious cycle of socially undesirable behavior.

For geographically isolated and poor market participants, formal institutions are not easily accessible. These groups are more likely to use informal mechanisms to improve information flows and enforce contractual arrangements. For much of the world's poor, informal institutions play a primary role in making business easier.[6]

But informal mechanisms are used not only by those in poorer environments. Social networks grounded in class, caste, tribe, and neighborhoods—as well as school background and membership in clubs—can be as important for cementing deals in corporate towers as in rural markets. Work is habitually helped by the use of conventions, personal relationships, and shortcuts that complement codified rules in large corporations as well as small firms.[7] In these markets informal institutions tend to *complement* formal ones.

For policymakers, building new formal institutions that complement existing informal institutions is a challenge. When inadequate attention has been paid to norms and culture, formal institutions have not delivered desired outcomes. But many successful institutional arrangements have flourished precisely because of their ability to harness, or adapt to, prevailing norms.

An important issue is that new laws or organizations can make some market participants worse off than they were under norm-based institutions. In extreme cases new institutions may not bring many benefits while destroying old norms that have benefited market activities. Thus, in some situations, replacing informal institutions with formal institutions may not be the preferred policy (as is the case with community-based land tenure in some regions, discussed in chapter 2). That is even more likely if, as in many poorer countries, the preconditions for effective and efficient formal institutions are not met.

Connecting communities through trade can bring about a demand for formal institutions to complement norm-based institutions. Norm-based institutions become less effective as the number of trading partners grows and they become more socioculturally diverse. Moreover, because informal institutions often function by restricting access to new members, they can be inaccessible for many market participants and may hinder competition in markets. Widespread income growth and poverty reduction require formal institutions that can serve as bridges between separate groups. These can help support more complex transactions and widen the set of opportunities and agents that can benefit from various market transactions.

Experimenting with innovative elements that recognize the presence and effect of norms creates more effective formal institutions. Policies that allow parallel operation of informal and formal institutions increase options for market participants. Examples are courts that operate in parallel with informal enforcement mechanisms, formal rural credit schemes that explicitly use elements of local norms of solidarity, and institutions such as affirmative action that try to reduce discrimination.

This chapter draws on established research and new analysis in the social sciences as well as studies of the development experience to elucidate the role of informal institutions and their interactions with formal institutions. Finally, it provides insights for policymakers building new institutions by addressing three questions: How do informal institutions aid market transactions? Why do informal institutions facilitate transactions for some and not for others? And how can the interaction of informal and formal institutions be used to ensure a dynamically supportive market environment?

Informal institutions in markets: their utility and shortcomings

This section first illustrates when and where norms lower transaction costs in markets and facilitate activity. It then discusses examples of situations where norms, though aiding transactions, can be exclusionary or less efficient than formal institutions. This includes cases where norms restrict entry and so reduce competition.

When norms and networks help market-based activity

Informal institutions develop to spread risk and to raise relative returns from market transactions. They do this by improving information flows, defining property rights and contracts, and managing competition.

Informal institutions for sharing information within groups. Well-established informal mechanisms for *information-sharing* have been used all over the world. Armenian traders in the 17th and 18th centuries, and Chinese immigrant trading communities until today, shared valuable trading information among themselves to ease transactions. Less sophisticated devices are used by members of small business and trading groups all over the world, from street vendors in Peru, to mutual aid groups in Benin, to wealthier members of clubs and business associations. In each case, an informal network communicates information about business opportunities, barriers, and potential partners to fellow group members.

The information networks in these groups can lower the riskiness of transactions, as members gain information about the quality of partners and the business environment. In developing countries formal alternatives—

credit-rating agencies or chambers of commerce, for example—do not exist or do not serve the small trader. Without informal knowledge channels, the costs of conducting business would be prohibitive. Informal networks lower these costs and enable smaller businesses to enter the market. Over time, groups coalesce to lower the costs of coordination.[8]

This type of informal information exchange is based on trust. Close familial bonds and friendships permit information sharing. Things are different when groups are larger. Trust among kinfolk and strongly bound ethnic groups is built through multiple or repeated interactions, which allow each group member to assess the other for reliability in adhering to contracts. Ghanaian fishmongers in Accra, for example, share business information even among competitors. This sharing of information is helped by multiple bonds: the women live in the same neighborhood and sell in the same market, they share a common ethnicity, and their husbands (the fishermen) are business partners as well.[9]

Different types of information may be exchanged within networks. Agents may have *specific information* about their counterparts, gained through previous interactions. In the absence of specific information, their only recourse is *generic information*, such as shared value systems (stemming from shared ethnicity, say, or common socioeconomic circles) or indirect "symbolic" denoters of quality or honesty (such as whether male or female, white or black, or the same or different ethnicity).[10]

The groups that have access to information may be formed in many different ways. For example, in markets in Africa, women market traders form close-knit groupings that offer mutual support, with even direct competitors selling for a member if she is sick. Their bond exists even though they may be of different tribal affiliations because their group is bound together by their common gender.[11] A second binding element is their repeated interactions that build up *specific* knowledge about one another. This helps cement the trust, letting the group know who among them can be relied on to use the information. Specific knowledge thus also helps determine the boundaries of the group sharing the information.

Informal institutions for dispute resolution or contract enforcement within groups. Some informal institutions also define property rights and enforce contracts. In modern-day rural Indonesia, for example, an informal system inhibits participants in business or credit transactions from defaulting on fellow members of the community. One of the key instruments is the knowledge that a reputation for untrustworthiness would exclude people from future transactions.[12] Informal contract enforcement mechanisms are *self-enforcing*—the costs of deviating are high even in the absence of formal contract enforcement mechanisms.[13] Such incentive structures may be devised in a variety of ways—some at an individual level, some at a community level, and some involving the informal use of outside mediators or enforcers. Broadly speaking these incentive mechanisms can be divided into six groups, summarized in table 9.1.[14]

Table 9.1
Types of informal sanctions in contract-enforcement mechanisms

Level	Short-run sanctions	Longer-term sanctions
Individual	Personal (for example, guilt) Retaliation by partner in transaction Sanctioned punishment by an outside mediator	Reputation loss and resulting exclusion from future transactions of the kind where cheating occurred.
Community	Direct sanction from community	Exclusion from other social transactions

In a world where information—about the other party in a transaction and about the transaction itself—is imperfect, there needs to be a way for the aggrieved parties to resolve their differences amicably. In developed markets participants can use formal institutions such as the justice system and the police. But the use of formal mechanisms for dispute resolution may be uncommon in many communities, where official dispensation of justice may be regarded as too costly or inefficient. It may also be unavailable, if, for example, the courts are too far away. In industrial countries efficient court systems also offer an incentive to develop privately negotiated solutions to disputes, whether through formal channels, such as trade associations, or informal (chapter 6). Studies of the United States, for example, have found that private solutions to dispute resolution predominate. In richer countries, formal institutions complement informal ones; informal rules can be very effective as they have formal laws as the backup. In developing countries market participants use informal mechanisms as substitutes.

In some instances, use of formal mechanisms is minimal. Among a sample of Malagasy traders, for example, a study found that a vast majority never used formal mechanisms at all.[15] In other situations informal enforcement mechanisms may explicitly reinforce formal ones. This, for example, is the case for the Grameen Bank in Bangladesh. Repayment rates are kept relatively high for small business loans to women not just through formal credit histories, but also through explicit social mechanisms. Group members are urged to select one another with an eye to as much homogeneity as possible. Then, loan eligibility of each member in a group is made subject to the credit history of the other members of the group, creating a strong element of peer pressure.[16]

The short-run mechanisms in table 9.1 have their direct counterparts in the formal sphere as well. There, the punitive act comes from the state, usually a fine, imprisonment, or both, imposed by a court of law. Mediation is also a common, and often effective, alternative to a drawn-out judicial process (chapter 6). For informal contracts, loss of reputation is especially important if the partner in the transaction is one of few in the particular line of business. This may be a village moneylender, or the sole supplier of inputs for a farmer in a remote area, or a community member. In more competitive markets, where business partners outside the group are available, informal mechanisms become less effective. They are also less useful during economic or political upheavals and similar situations, where the composition of communities is volatile.

Such multidimensional and long-term punishment structures are effective so long as the individual needs to remain part of the community. But their utility diminishes when the relevant group involved in transactions is large and is spread across different communities or regions, as when lower transport costs or changes in policies increase the range of trading partners.

When norm-based institutions may not be enough

Reliance on informal institutions alone is not enough for the growth of inclusive markets. Some groups may be excluded from the use of such institutions. Also, such institutions may limit the scale of operation, or they may have multiple objectives. In some cases the problems of, for instance, no access or multiple objectives are common to poorly designed formal institutions as well. But because policymakers have more discretion over the reform of formal institutions, these shortcomings can be more easily remedied.

Limits on entry and exclusion from informal institutions. A persistent problem in many poorly designed formal institutions, as discussed throughout this Report, is that they may not be available to all interested parties. Informal institutions, by their very nature, suffer from this problem as well. Information flows about business opportunities may be available only to members of a group, with outsiders excluded because of linguistic or cultural barriers (box 9.1). Also, because information is usually shared during the process of intracommunity *social* occasions, even among today's ethnic business communities, it may be difficult for outsiders to gain access.

Sociocultural barriers to using informal mechanisms can be costly in multicultural or multiethnic societies. In parts of Africa there are often scores—and sometimes hundreds—of societies that were institutionally autonomous until recently.[17] One example is The Gambia. Within its more than 4,000 square miles, main ethnic communities include groups such as the Madinko, Fula, Wolof, Jola, and Serahuli, each with endogamous profession-based "castes" among them. Other significant examples are the Mauritanian Moorish and Lebanese trading communities.[18] In such situations formal institutions may be the only way to lower the costs of doing business for all concerned. Similar conditions, among them barriers to using cultural traditions that build trust, exist for minority groups. A case in point is the Korean minority in Japan, which is excluded from the bonding *iemoto* groups that help build trust and ease transactions even in today's Japan.[19] The same is true for those indigenous people in many countries throughout the world who live culturally separate existences from the mainstream.

Issues of access can be important even for those who benefit from norm-based practices in some transactions. Reliance on their own networks alone can mean that other possible businesses and potentially high-yielding projects, governed by different institutional arrangements, are unavailable. The situation in box 9.2 illustrates how reliance on networks alone implies that more efficient producers may be denied access to credit.

Therefore, the very mechanisms that promote lower transaction costs for participants can discriminate against those denied access to the networks. In such cases there is a clear need for good formal institutions.

Box 9.1

Exclusion in trading in African history

An interesting example of exclusion because of lack of access to informal institutions comes from the cattle trade in Nigeria in the 18th and 19th centuries. The Hausa cattle traders who operated there shared a common set of values, based on Islam and the Hausa language, which generated trust in partners. When French traders tried to enter the market, they ran into barriers. Much of the problem arose because the French could not enter into credible contracts in credit transactions with the Hausa, because there was little trust among the transactors. The French were not part of the social sanction mechanisms used by the Hausa. Without formal institutions for dispute resolution, these contracts between the Hausa and the French could not be enforced.

Source: Austin 1993.

Otherwise, without shared heritage or even geographic proximity, many people can be excluded from the benefits of market-led growth in incomes. Even those in networks may not be able to engage in profitable business opportunities with outsiders.

Over time, a natural result of excluding people from higher-return economic activity is a widening in disparities of income and wealth and perhaps an increase in social unrest, crime, and violence. This is illustrated by historical examples, where small elite groups or colonizers used their own "clubs" and other informal networks to do business more efficiently than others in the economy, differences that have persisted. It is also true in today's world, where economic outcomes differ between ethnic groups that have strong norm-based business practices and those that do not.

Moreover, informal contract enforcement may rely on third-party mediators, such as the Mafia in Sicily, which historically developed to fill the void left by nonfunctioning formal institutions.[20] Similar phenomena are observed today in other parts of the world. The danger, as is obvious from the examples, is that the informal institutions that arise when formal alternatives do not exist may bring with them significant negative externalities. These can range from a worsening of the business climate (and thus the discouragement of legitimate and honest businesses) to the simultaneous operation of unrelated criminal activity. To avoid this outcome, effective formal institutions are needed.

Box 9.2

Tiripur in Tamil Nadu (India): insiders and outsiders in the use of informal institutions

Since 1985 Tiripur has become a hotbed of economic activity in the production of knitted garments. By the 1990s, with high growth rates of exports, Tiripur was a world leader in the knitted garment industry. The success of this industry is striking. This is particularly so as the production of knitted garments is capital-intensive, and the state banking monopoly had been ineffective at targeting capital funds to efficient entrepreneurs, especially at the levels necessary to sustain Tiripur's high growth rates.

What is behind this story of development? The needed capital was raised within the Gounder community, a caste relegated to land-based activities, relying on community and family networks. Those with capital in the Gounder community transfer it to others in the community through long-established informal credit institutions and rotating savings and credit associations. These networks were viewed as more reliable in transmitting information and enforcing contracts than the banking and legal systems that offered weak protection of creditor rights. The intense competition in the garment industry ensured that good money would not follow bad and that firms would pay attention to the needs of customers.

But there is more to this story. Outsiders (non-Gounders) have entered the industry. These participants do not have access to community funds. Yet outsiders, starting with around one-third as much capital as the Gounders, have outperformed them, developing larger-scale and better-integrated production capacity and making up more of the complicated export business.

Thus, the Gounders' networks have stimulated trade, but for those not part of the network, many opportunities for using better ideas remain unexploited because they do not have access to the same network of funding sources. Public institutions, such as collateral law (and enforcement), would allow stronger creditor protection and promote lending by formal institutions such as banks, allowing entrants not part of the network to better participate in the market.

Source: Banerjee, Besley, and Guinnane 1994.

Informal institutions and scale diseconomies. As the scale and breadth of transactions increase, there are two other problems with informal institutions: *coordination failures* and the possibility of *exit from institutional structures.*

In situations where there is asymmetric information, coordination failures arise from the inability to trust business partners to keep to bargains that may improve outcomes for both parties. For instance, as there are more ethnic groups in a given economy, each with its own set of customs and norms for doing business, the complexity of the coordination problem also mushrooms. As group size grows, information processing and enforcement *within* the group also become difficult. Again, a shared set of formal institutions may be the solution.

With more alternative trading opportunities outside the community, the number and diversity of potential trading partners grow, and the relative benefit from staying in the network declines. In this situation, a trader may find it less costly to violate a community norm because any sanctions (such as loss of shared information) that can be imposed by the group are less effective. With increased competition and other trading partners, the trader may find it feasible to exit the community and exist comfortably without dealing again with those the trader has cheated.

Norm-based mutual insurance networks are an example. Small communities use these to protect members from individual economic shocks by sharing excess resources such as food, labor, and land (where land is abundant). Such systems are extremely valuable as a means of protecting every member of the community against misfortune. But as communities grow larger, commitments become more difficult to coordinate and deviations harder to punish. Moreover, a feature of mutual insurance mechanisms is that they come with a built-in set of incentives that may inhibit the community from encouraging economic experimentation, entrepreneurship, and processes where individuals compete among themselves. This is usually because of concern that excessive riches will allow the individual to "opt out" of the mutual insurance systems essential for the community's survival.[21] In more complex economies, therefore, such mutual insurance systems have been formalized under often more efficient systems of explicit taxes and transfers.

Multiple objectives of informal institutions. Well-functioning formal institutions are designed to solve a focused economic problem in the most efficient way possible. But norm-based practices almost always have *multiple objectives.* Take the example of a credit transaction. Institutions that address, among other things, two key elements of uncertainty—the borrower's ability to repay the loan and his propensity to default—mitigate the riskiness of the deal. Different formal institutions would act separately to mitigate the two risks; for example, a formal record of the borrower's credit history decides his creditworthiness, while the lender has recourse to specialized courts of law to enforce the formal loan contract.

In contrast, credit transactions within the community are carried out through an institution—the community network—built to facilitate an array of economic activity. This includes information about a person's creditworthiness and possible social sanctions on default. But it also incorporates mutual insurance schemes where a borrower, at a different time, may lend to today's lender or help him with information or connections in a totally different business matter. So a bad credit history may be discounted, or the punishment for default may not be as strong, as when impersonal formal institutions operate.

One problem is that poorer borrowers may not feel obliged to repay richer lenders and instead may see default as part of an implicit mechanism to equalize wealth among the kin or community.[22] In a survey of 58 firms in Ghana, no credit sales were made to kin because the potential creditors worried that they would not be able to compel relatives to pay.[23]

Such concerns, reinforced by cultural values about egalitarianism and fairness, can also hinder the process of development, although they serve a social purpose. A study in Cameroon, for example, found that village development committees in the north worked inefficiently because of concerns that no single person should benefit from the development work more than others.[24] In a village in the Republic of Congo another study found that fishermen who got new technology because of a fishery development project gave up using the new nets because fellow community members were not able to share in the improved incomes.[25]

As policymakers set up formal and more specialized institutions, however, the equity-enhancing roles of the informal institutions they displace often cannot be re-created. In these cases the policy choice is made more difficult because the creation of a more efficient formal institution can undermine long established risk-mitigating or redistributive functions played by norm-based structures.

Building and adapting formal institutions

Formal institutions are either superfluous or counterproductive when transactions take place within small communities and in larger communities with a shared set of effective informal institutions. But as economies develop, formerly distant communities become more integrated. Changes in individual behavior and government policies create new rules of the game that affect, directly and indirectly, even the most isolated communities. These growing forces of urbanization and globalization undermine the long-standing rules traditionally used by communities (box 9.3).[26] With greater competition and more trading opportunities, the exit of individuals from communities and their idiosyncratic norm-based institutions weakens the effectiveness of these traditional mechanisms. In such cases market activity stimulates a demand for formal institutions, supplanting community norms or networks. The stories of the medieval Genovese traders and the 19th century Thai rice farmers in chapter 1 illustrate how trade and openness helped the historical building of formal institutions.

Where there is a strong and widespread demand for formal institutions, policymakers looking to build institutions that will improve the market environment have a relatively simple job. But in many situations the demand for new and modern institutions may not be evident. In these cases the first step is to diagnose how well existing informal institutions support transactions. The second step, when formal institutions already exist, is to decide whether these are effective in reaching their stated goals, and if not, to decide whether to dismantle or reform them.

Open discussion and debate with the relevant users of institutions in the economy can help identify how well existing norm-based institutions are addressing their needs. This debate should include the costs of building or changing formal institutions, which may be significant. It may be the case that informal institutions are operating adequately in helping the existing level of market transactions (as they do for property rights in land in parts of Africa).

Conversely, existing informal institutions may be inappropriate for two distinct groups:

- Those that want to expand their activity beyond the community and trade with those outside their neighborhood, kinship group, or country
- Those ill served by existing socioeconomic norms, either because the norms exclude certain groups (such as the poor, isolated groups, and minorities) or because use of the norms is bundled with features that these groups find objectionable (such as xenophobia, exclusion, or even overly zealous egalitarianism).

Box 9.3
The influence of formal institutions on norms: colonial Uganda

In colonial Uganda, on what were called Mailo lands, chiefs had traditional feudal rights under a community system of reciprocal obligation in which they acted as trustees on behalf of the people of the tribe or clan. When the colonial government turned this informal institution into Western-style proprietary tenure, this gave the chiefs personal property rights over the land—and community members cultivating the land became legal tenants. This, according to some historians, led some of these new landlords to exact exorbitant rents and evict those in the tribe who were unable to pay. Thus, the situation caused by the introduction of the new formal institutions had to be addressed, eventually, by new formal laws fixing rents and limiting evictions—laws that would not have been needed under the set of traditional norms of community obligations and reciprocity.

Source: Firth 1963.

When there needs to be a shared norm to help transactions across diverse communities, the solutions can be straightforward. In many parts of the developing world, the language of the colonists and occupiers—English in India and Uganda, Spanish in Latin America, Russian in Eastern Europe and Central Asia—served as a common language among disparate cultures. Today, English has emerged as the language of the Internet, offering a common platform for those using it to communicate and exchange information.

But where there are discriminatory practices, the relevant societal norms may have to be explicitly supplanted rather than amended. Most societies prohibit such practices—or formally institute affirmative action—in order to promote equity and access. Sometimes economic pressures such as a tightening labor market may overcome deeply rooted discriminatory practices. Women, for example, have gained access to high-productivity work in countries enjoying swift growth.[27] Still, removing discriminatory practices on a more permanent basis may call for the building of explicit formal institutions such as antidiscrimination laws.[28] For example, affirmative action programs in India, while not always promoting the greatest efficiency of labor use, have met an important objective—providing to members of the scheduled castes and tribes opportunities, including political representation and government jobs, that might not otherwise be available to them. Thus,

Box 9.4
Islamic banking: informal and formal approaches

The *Qur'an* explicitly forbids usury, or *riba*. As a result, various Islamic communities have tried to develop ways to conduct credit transactions while refraining from charging interest. In rural areas of The Gambia, for instance, transactions are kept as short as possible—most for no longer than seven months—so that interest on the loan does not add up to large "usurious" amounts. So, credit sales of large farm machines are usually impossible.

Although countries from Malaysia to Iran have tried to institute forms of Islamic banking, one of the most ambitious attempts to adopt a widespread system of formal Islamic finance is taking place in Pakistan. The government, by order of the Supreme Court in December 1999, was given until mid-2001 to announce measures for "Islamizing" the financial system in the country, though more time may be needed. This transition is a laboratory for the introduction of a whole set of formal institutions that need to be consistent with the socioreligious norms prevalent in much of Pakistani society. Initial efforts have been varied. One bank has introduced a deposit plan that does not ensure fixed interest but shares the bank's losses and profits with the depositor. Other practices include rotating saving-investment associations among businessmen. Leasing and hire-purchase arrangements, where the monthly payment by the lessee is seen as a fee rather than interest, are an additional option. As more such systems are introduced, the one that eventually emerges as the dominant way of dispensing norm-consistent credit is likely to be decided through competition among the alternative institutional arrangements.

Source: Bokhari 2000; Shipton 1994.

Box 9.5
Education among the Orma in Kenya: adapting well-established norms

Formal education was controversial among the Orma herders in Kenya when it was first introduced in the 1950s and remained so when primary education became compulsory in the 1970s. The reason was that it conflicted with long-standing norms and practices of the community, where male children were crucial to herding. Many elders were strongly opposed to the practice, believing that it would jeopardize their livelihood. The Kenyan government, rather than imposing compulsory education, used the chief to gradually exercise persuasive pressure on the households he knew could afford to send their children to school. This gradual process allowed the demonstration of the beneficial effects of education, while preventing the hardening of opposition against it from the elders. By the late 1980s enrollments had increased greatly, and opposition to formal education had become muted.

Source: Ensminger 1994.

these laws potentially offer minority groups both voice and participation in the building and reform of market institutions.

Integrating informal and formal institutions

Building bridges between existing formal and informal institutions is an effective means of enhancing the success of formal institutions. [29] One way is to use the contract enforcement and information-transfer mechanisms that exist in tightly knit communities. The development of credit mechanisms in various parts of the world offers good examples. Credit cooperatives in 19th century Germany were effective intermediaries between banks and farmers, supplementing the formal contractual arrangements with the banks with informal mechanisms of information gathering and enforcement among each cooperative's members.[30] Intervillage collectors of agricultural products provided similar bridging functions in rural Indonesia in the 1980s. These intermediaries raised capital in the formal credit market and then made loans to smaller collectors, relying on informal mechanisms to create and enforce the credit contracts.[31] In the 1990s successive rural credit projects in Albania, supported by the World Bank, made use of community norms that emphasized reputation within the village to encourage repayment.

Instituting product standards is another way to build bridges between informal systems and formal ones. Historical examples include regional craft associations in late imperial China, which set product standards and inspected product quality, to serve as a bridge to formal sector buyers. Today, similar standard setting is seen among Indian handicraft producers in Gujarat, where an NGO (SEWA) has helped the villagers devise a quality-rating system to ensure that products are of sufficient quality to be marketed outside the immediate locality. (Chapters 2 and 7 contain broader discussions of product standards.)

On a larger scale, some efforts are being made to align formal institutions with prevailing norms. In formerly colonial countries, for example, colonial institutions have been redesigned to make them consistent with local practices; a prime case is the spread of formal Islamic banks in Asia and Africa (box 9.4).

One thing to keep in mind is that many formal institutions that try to supplant or even coexist with informal institutions may not be valued by the user at first, meaning that it will take time for them to succeed. Socioeconomic norms develop through social learning and imitation and are slow to change (much slower than formal institutions, which can be altered by some combination of market demand, political will, and administrative capacity). It may be desirable to introduce formal alternatives gradually with some experimentation to identify the most effective institutional form (box 9.5 gives an example from Kenya).

Conclusions

Market activities are supported by a complex blend of informal and formal institutions. In many poor regions of the world, and particularly for many poor people, informal institutions such as community networks are the only ones that are relevant, because access to formal institutions is relatively scarce. Moreover, in many situations, even if governments could establish formal institutions, the costs of doing so, relative to the benefits, may be high. Informal institutions can be superior to formal alternatives, either because they are more efficient at achieving the objective or because they embody features that formal institutions are unable to provide. But in other cases, informal institutions may prevent further market development, as when closed networks restrict the scale and breadth of possible transactions. In developing markets, informal institutions tend to substitute for the lack of formal systems, whereas in developed markets informal and formal institutions tend to complement each other.

While informal institutions provide people with a way to access and benefit from market opportunities and to manage market risks, they may also exclude potential entrants and partners. Formal institutions are important because they can deal with a larger group of participants and because, if well designed, they can serve to include more people rather than exclude them.

Imposing a formal legal system on an environment where informal contract enforcement has been the norm can either raise the transaction costs of dispute resolution considerably (formal legal procedures are often costly) or weaken the implicit contracts that governed relations until that time (without significantly strengthening the effectiveness of alternatives). Such considerations need to be kept in mind when examining the development of formal systems. When formal institutions replace one of the functions provided by informal ones (such as efficiency in a particular transaction) but not others (such as risk sharing), policymakers need to be aware of the effect of their choices not just on economic outcomes, but also on political and social effects; they can then either modify the pace of change or design complementary institutions. Take, for example, any policy that serves to weaken community ties, such as those that support out-migration or the breaking up of communities in order to resettle them to otherwise better areas. These actions could weaken the informal enforcement mechanisms for contracts, and alternative formal institutions for contract enforcement may be needed.

Finally, the greater use of formal institutions requires the removal of overly onerous regulatory barriers that help foster informal economic activity (chapters 1 and 7). A second, and critical, set of policies relates to literacy and education—without which sophisticated formal institutions may be unusable.