WORLD DEVELOPMENT REPORT 2002

Building Institutions for Markets

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Foreword

This *World Development Report* is about building market institutions that promote growth and reduce poverty, addressing how institutions support markets, what makes institutions work, and how to build them.

This theme is a natural continuation of last year's Report, which demonstrated that markets are central to the lives of poor people, that institutions play an important role in how markets affect people's standards of living and help protect their rights. This Report identifies how institutions can promote inclusive and integrated markets, and ensure stable growth and thus dramatically improve people's incomes and reduce poverty. It is about equal opportunity and empowerment for people, especially the poor.

Some countries have successfully harnessed market-oriented reforms to improve the welfare of all their people. But in other countries, markets have not given people as much incentive to engage in wider trade, the ability to use fully their skills and resources, and opportunities to increase their income.

Effective institutions can make the difference in the success of market reforms. Without land-titling institutions that ensure property rights, poor people are unable to use valuable assets for investment and income growth. Without strong judicial institutions that enforce contracts, entrepreneurs find many business activities too risky. Without effective corporate governance institutions that check managers' behavior, firms waste the resources of stakeholders. And weak institutions hurt the poor especially. For example, estimates show that corruption can cost the poor three times as much as it does the wealthy.

Addressing the challenge of building effective institutions is critical to the Bank's mission of fighting poverty. We recognize the central importance of institutions in the development process through the Comprehensive Development Framework, which stresses the interdependence of institutions with the human, physical, and macroeconomic sides of development.

The Report emphasizes the importance of historical context: where countries are today affects where they can go. It also takes a pragmatic approach to institution building, focusing on what can be done practically rather than on what should be done in an ideal world. Social and political factors affect the pace of change, and sweeping reforms are not always possible. It is important to work on the areas where opportunities present themselves; each step can take countries forward—if correctly designed. And smaller reforms can build constituencies for larger ones.

This Report recognizes that one size does not fit all in institution building and provides policy guidance on how to develop appropriate institutions. Building on the successes of countries, and learning from the failures, the Report provides a deeper understanding of market-supporting institutions and a better appreciation of how people may build such institutions. In identifying how to promote institutional change, it looks at the roles of private and public, and national, local, and international, actors. It draws on a wealth of research and practical experience from inside and outside the Bank, as well as on insights from many disciplines, presenting new research and data on institutions.

From these diverse sources, the Report distills four lessons on building effective institutions:

- Design them to **complement** what exists—in terms of other supporting institutions, human capabilities, and available technologies. The availability and costs of supporting institutions and capacity determine the impact of any particular institution. By understanding how institutions interact, we can identify priorities.

- **Innovate** to identify institutions that work—and those that do not. Sometimes this requires experimentation. Even in countries with similar incomes and capacities, innovation can create stronger institutions because of differences in local conditions, differences that range from social norms to geography. 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 information changes behavior. It creates demand for institutional change by holding people to account and by supplying ideas for change from outside the community. Linking communities of people in networks of information and trade is thus a priority for those building market-supporting institutions.
- Promote **competition** among jurisdictions, firms, and individuals. Developing country market actors often face too little competition, and changing this will significantly improve institutional quality. Greater competition modifies the effectiveness of existing institutions, creates demand for new ones, and increases choice for consumers. Competition among jurisdictions highlights successful institutions and promotes demand for them. Competition among firms and individuals does the same.

These broad lessons, as well as the detailed analysis and many examples throughout this Report, will help us and policymakers build institutions that ensure stable and inclusive growth and thus improve people's incomes and reduce poverty.

James D. Wolfensohn

This Report has been prepared by a team led by Roumeen Islam and comprising Arup Banerji, Robert Cull, Asli Demirgüc-Kunt, Simeon Djankov, Alexander Dyck, Aart Kraay, Caralee McLiesh, Russell Pittman, and Helena Tang. Nazmul Chaudhury, Jeffrey Hammer, Richard Messick, and Tatiana Nenova made additional contributions. The team was assisted by Theodora Galabova, Paramjit Gill, Yifan Hu, Olga Ioffe, Claudio Montenegro, Stefka Slavova, Mahesh Surendran, and LiHong Wang. Andrei Shleifer and Joseph E. Stiglitz provided valuable suggestions during the writing of the Report. Bruce Ross-Larson is the editor of the overview, chapter 1, and chapter 10. Andrew Balls provided editorial assistance. The work was carried out under the general direction of Nicholas Stern.

The team was advised by a panel of experts comprising Carl Anduri, Abhijit Banerjee, Kaushik Basu, Timothy Besley, François Bourguignon, Antonio Estache, Cheryl Gray, Avner Greif, Nurul Islam, Emmanuel Jimenez, Daniel Kaufmann, Michael Klein, Yingyi Qian, and Kenneth Sokoloff.

Many others inside and outside the World Bank provided helpful comments and wrote background papers and other contributions, and their names are listed in the bibliographical note. Much of the background research was supported by a generous grant from the Dutch government. Research was also supported by the Swiss Trust Fund. The World Bank Development Data Group contributed to the data appendix and was responsible for the Selected World Development Indicators.

The team undertook a wide range of consultations for this Report, from the initial outline to the final draft. During the Report's planning stage in 2000, a February workshop in Berlin and a July workshop in Washington, D.C. provided an exchange of ideas among academics and policymakers from around the world. During the drafting stage in 2001, a consultative meeting on the media was held in April, and a consultative meeting on judicial systems was held in May. In addition, the authors held consultations with a wider community that included nongovernmental organizations, holding meetings in Paris (with representatives from the French Conseil d' État, the Organisation for Economic Co-operation and Development, the French Development Agency, and the Competition Council); in London (Department for International Development, Overseas Development Institute, and nongovernmental organizations); and in Amsterdam (Amsterdam Institute for International Development). The team also conducted a series of videoconferences with audiences in Bangladesh, Brazil, Egypt, Japan, Mexico, Morocco, South Africa, and Thailand. A consultation with the International Confederation of Free Trade Unions was also held.

Rebecca Sugui served as executive assistant to the team; Leila Search as program assistant and technical support; and Shannon Hendrickson, Joanna Kata-Blackman, Mei-Ling Lavecchia, and Rudeewan Laohakittikul as team assistants. Maria Ameal and later Eva Santo Domingo served as resource management assistant.

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The countries included in regional and income groupings in this report are listed in the Classification of Economies table at the end of the Selected World Development Indicators. Income classifications are based on GNP per capita; thresholds for income classifications in this edition may be found in the Introduction to Selected World Development Indicators. Group averages reported in the figures and tables are unweighted averages of the countries in the group unless noted to the contrary.

The use of the word *countries* to refer to economies implies no judgment by the World Bank about the legal or other status of a territory. The term *developing countries* includes low- and middle-income economies and thus may include economies in trasition from central planning, as a matter of convenience. The term *developed* or *industrial countries* may be used as matter of convenience to denote the high-income economies.

Dollar figures are current U.S. dollars, unless otherwise specified. *Billion* means 1,000 million; *trillion* means 1,000 billion.

The following abbreviations are used:

EU	European Union
FDI	Foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
HIV/AIDS	Human immunodeficiency virus/ acquired immune deficiency syndrome
IPR	Intellectual property rights
NGO	Nongovernmental organization
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
R&D	Research and development
SMEs	Small and medium-size enterprises
TRIPS	Trade-Related Aspects of Intellectual Property Rights
WTO	World Trade Organization