What Makes Poor Countries Poor?

'Law and development is a difficult field. It is at once multi-disciplinary and comparative; historical and policy driven; theoretical and empirical; positive and normative. Here at long last is a book that provides a masterful overview and critical analysis that will make this field accessible to students and teachers alike.'

– Katharina Pistor, Columbia Law School, US

This important book focuses on the idea that institutions matter for development, asking what lessons we have learned from past reform efforts, and what role lawyers can play in this field.

What Makes Poor Countries Poor? provides a critical overview of different conceptions and theories of development, situating institutional theories within the larger academic debate on development. The book also discusses why, whether, and how institutions matter in different fields of development. In the domestic sphere, the authors answer these questions by analyzing institutional reforms in the public (rule of law, political regimes, and bureaucracy) and the private sectors (contracts, property rights, and privatization). In the international sphere, they discuss the importance of institutions for trade, foreign direct investment, and foreign aid.

This book will be essential reading for those interested in a concise introduction to the academic debates in this field, as well as for students, practitioners, and policymakers in law and development.

Michael J. Trebilcock is University Professor and Chair in Law and Economics and **Mariana Mota Prado** is Associate Professor in the Faculty of Law at the University of Toronto, Canada.

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The Lypiatts, 15 Lansdown Road
Cheltenham, Glos, GL50 2JA, UK
Tel: +44 (0) 1242 226934 Fax: +44 (0) 1242 262111
Email: info@e-elgar.co.uk

William Pratt House, 9 Dewey Court
Northampton, MA 01060, USA
Tel: +1 413 584 5551 Fax: +1 413 584 9933
Email: elgarinfo@e-elgar.com

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Michael J. Trebilcock
and Mariana Mota Prado

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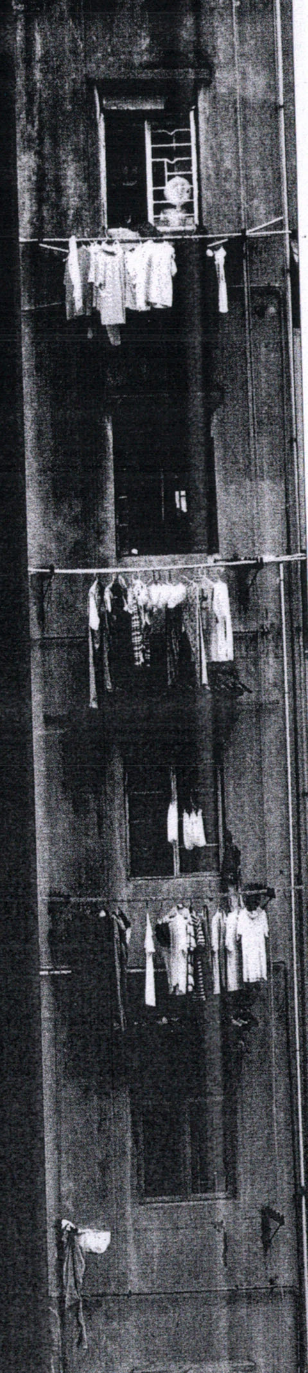

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Michael J. Trebilcock

University Professor and Chair in Law and Economics, University of Toronto, Canada

Mariana Mota Prado

Associate Professor, Faculty of Law, University of Toronto, Canada

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Preface

This book seeks to offer a concise overview of a field of studies that is often called 'law and development'. It focuses on the idea that institutions in general – and legal institutions in particular – matter for development, a topic that has generated a voluminous literature in the past ten years. This literature moves away from the assumption that development is primarily an economic problem, and one of its most relevant implications – as we argue in this book – is that lawyers have a very important role to play in this field of study. The central challenge faced by the field of law and development today is that we do not know how to reform dysfunctional institutions. While there is empirical evidence to support the argument that institutions matter for development,[1] a series of academic books that have assessed recent institutional reforms in developing countries come to the dismal conclusion that many – perhaps most – of these attempts have failed.[2] This book offers some insight into how lawyers and institution builders can best employ their skills to address some of the challenges of institutional reform.

The book starts with a brief overview of different concepts and theories of development, situating institutional theories within the larger academic debate on development. It then proceeds to discuss *why*, *whether* and *how* institutions matter in different fields of development. In the domestic sphere, we try to answer these questions by analysing institutional reforms in the public sector (rule of law, political regimes, bureaucracy) and the private sector (contracts, property rights and privatization). In the

[1] One example is the World Bank publication, *Governance Matters*, initially coordinated by Daniel Kauffman. More evidence has been provided in recent papers by other economists, such as Dani Rodrik from Harvard.

[2] Some examples include Thomas Carothers, *Promoting the Rule of Law Abroad: In Search of Knowledge* (Carnegie Endowment for International Peace, 2006); Kenneth Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development* (Brookings Institution Press, 2006); Michael Trebilcock and Ron Daniels, *Rule of Law and Development: Charting the Fragile Path of Progress* (Cheltenham, UK: Edward Elgar Publishing, 2008). A more recent publication by Paul Dragos Aligica and Peter Boettke, *Challenging Institutional Analysis and Development: The Bloomington School* (Mercatus Books, 2009) focuses on the philosophical foundations of the institutional discourse.

international sphere, we discuss the importance of institutions for trade, foreign direct investment and foreign aid. In each chapter, we briefly review the theoretical claim that explains *why* certain institutions matter for a particular aspect of development, then we briefly review the empirical evidence available to assess *whether* those institutions indeed matter, and we conclude by discussing *how* the details of institutional design are likely to affect the efficacy of attempts to promote institutional reforms. Our general conclusion is that lawyers indeed have a role to play in these reforms, but this role lies in taking seriously the intricacies of institutional design, and producing solutions that are best suited to different contexts and realities.

The book is intended for readers seeking an accessible overview of the area. By highlighting the important role that lawyers can play in this field, it should be of particular interest to a legal audience, but should also be useful to anyone interested in a concise introduction to broader academic debates in the development field.

This project grew out of our course entitled Law, Institutions and Development taught at the University of Toronto, Faculty of Law. The course has been modified over the years and the current structure of the book is largely based on central themes of the course today. The process of building, shaping and polishing this course started long before we started co-teaching it in 2007. About a decade ago, Michael Trebilcock first taught this course with Kevin Davis, and continued later with another colleague, Ron Daniels. A great deal of the materials and analyses canvassed in this book were contributions by Kevin and Ron to the course in its pre-2007 version. Thus, both Kevin and Ron were involved (albeit indirectly) in the conception of this book and have significantly enriched it.

We could not have undertaken the intensive research and writing process of transforming a course into a book without the help of five very talented and extremely dedicated research assistants: Tess Bridgman, Natasha Kanerva, Jee Yeon Lim, Joanna Noronha and Michelle Segal. In addition to our research assistants, the JD, LLM and non-law graduate students from many countries around the world who have taken our course over the years have contributed invaluable insights into many issues addressed in this book. One doctoral student, Theresa Miedema, deserves a special thank you. She provided insightful comments on an earlier draft of Chapter 4 and was extremely generous in sharing with us parts of her doctoral dissertation on this subject and other unpublished work on ethnic conflict.

Last but not least, we are deeply grateful to Nadia Gulezko, our administrative assistant, for incorporating multiple rounds of revisions, keeping track of the latest drafts and for taking care of everything that was not related to the book project with her usual expedition and competence so as to minimize distractions we would otherwise have faced.

1. The ends and means of development

I. INTRODUCTION

The field of development theory and practice, at least in the post-World War II years, has been dominated primarily by economists. The central thesis of this book is that much of value can be added by incorporating a legal perspective in the development discourse. Lawyers with a particular interest in the interface between law and economics and related issues of political economy may have a significant contribution to make to the development field on issues of institutional design. Law as a discipline has always been preoccupied with processes and institutions by which laws and related policies are enacted, implemented and enforced. Hence, our perspective throughout this book is a focus on the relationship between law, institutions and development, but more particularly on the challenges that developing countries face in reforming their legal institutions, given the institutional legacies of history and the problems of path dependency that these legacies engender.

While, in many respects, our perspective is primarily concerned with the means of development – that is, how a society organizes itself institutionally to achieve its development objectives – one cannot entirely set to one side long-standing debates over the ends of development. In some respects, these contemporary debates are related to philosophical debates of what constitutes the good life and date back at least to the ancient Greeks. Although it is not the purpose of this chapter to provide an intellectual history of moral and political philosophy from the ancients onwards, or to espouse and defend any fully elaborated conception of the good life, one can at least identify some prominent strands in contemporary debates over the ends of development.[1] Without some definition on what these ends might be, it would be logically impossible to engage with the central theme of this book: the most appropriate means or mechanisms for vindicating those ends.

1 See generally H.W. Arndt, *Economic Development: The History of an Idea* (Chicago: University of Chicago Press, 1989).

II. THE ENDS OF DEVELOPMENT

A number of classifications of countries – official and unofficial – exist, typically accompanied by various sub-classifications. One of the most conventional classifications identifies developing countries based on Gross Domestic Product (GDP) per capita. According to this classification, developing countries are all countries in the world except for the 40 or so members of the Organization for Economic Co-operation and Development (OECD) and other high income countries (such as some oil producing countries in the Middle East). This large universe of developing countries is typically sub-classified in various ways. For example, the World Bank distinguishes countries as low income; lower-middle income; upper-middle income; and high income countries. Low income countries are defined as having a per capita gross national income in 2010 of US$995 or less; lower-middle income countries have incomes between US$996 and US$3945; upper-middle income countries US US$3946 and US$12195; and high income countries have incomes of US$12196 or more.[2]

Implicit in such a classification of developing countries is the judgment that per capita income is what distinguishes developing countries from developed countries, and least developed from more developed countries. In such classification, the principal end of development might be inferred to be increasing per capita incomes. Indeed, in the early post-war decades, official multilateral development agencies such as the World Bank, many bilateral aid agencies, many governments in developing countries, and much scholarly discourse on development (especially in development economics) assumed that this was the primary end of development – that is, increasing per capita incomes and to that end maximizing rates of economic growth.[3]

In recent decades, dissatisfaction with such a narrow conception of development has been manifested in a number of quarters. For example, the United Nations Development Program (UNDP), in an annual series of Human Development Reports dating back to 1990,[4] has constructed a Human Development Index (HDI) based on three ends of development:

2 World Bank, 'Country Classification, Data and Statistics', available at http://data.worldbank.org/about/country-classifications (retrieved 13 April 2011).

3 Amartya Sen, 'Development, which way now?' (1983) 93:372 *The Economic Journal* at 745–62.

4 United Nations Development Programme, 'Origins of the human development approach' in *Human Development Reports*, available at http://hdr.undp.org/en/humandev/origins/ (retrieved 15 May 2009).

longevity, as measured by life expectancy at birth; knowledge, as measured by weighted average of adult literacy and mean years of schooling; and standard of living, as measured by per capita income.[5] While there is a strong positive correlation between per capita income and health and education status, this correlation is not perfect or tight. Rankings of developing countries often change significantly, either upwards or downwards, when health and education variables are incorporated along with a per capita income variable in this index.

In addition to the HDI, other indexes have been created. These indexes try to make visible various quantifiable indicators of development that are often overlooked in other indexes. They include social exclusion within OECD countries[6] and indicators of gender inequality,[7] for instance. More recently, the Oxford University's Oxford Poverty and Human Development Initiative (OPHI) joined the UNDP Human Development Report Office to create a new index to indicate the nature and quantify the extent of poverty. It is called the MPI, or Multidimensional Poverty Index.[8] The MPI examines a range of deprivations by using ten indicators at the household level (such as child mortality, years of schooling, and access to water, sanitation and electricity) to measure the same three critical dimensions of poverty as the HDI: education, health and living standard. This multidimensional approach to poverty reveals not only how many people are poor but also the nature and intensity of their poverty, which is relevant for policy design.[9] The percentage of people living in

5 United Nations Development Programme, 'The Human Development Index (HDI)' in *Human Development Reports*, available at http://hdr.undp.org/en/statistics/indices/hdi/ (retrieved May 15, 2009).

6 For example, the UNDP Human Poverty Index (HPI), introduced in the Human Development Report of 1997, is composed of the different features of deprivation in quality of life, such as a short life, lack of basic education and lack of access to resources. Within the HPI, the HPI-2 relates only to OECD countries, is derived separately from the Human Poverty Index for developing countries (HPI-1) and includes social exclusion as the fourth dimension of HPI-2 in order to better reflect socio-economic differences and the different measures of deprivation in the two groups. UNDP, ibid.

7 United Nations Development Programme, Human Development Reports, 'Gender-related Development Index (GDI) and Gender Empowerment Measure (GEM)' in *Human Development Reports*, available at http://hdr.undp.org/en/statistics/indices/.

8 This new index is featured in the 2010 UNDP Human Development Report, released in November 2010. Research findings are available online at http://www.ophi.org.uk.

9 Sabina Alkire and Maria Emma Santos, 'Acute Multidimensional Poverty: A New Index for Developing Countries' (2010) OPHI Working Paper No. 38 at 7.

poverty according to the MPI is higher than the percentage of people living on less than US$2 a day in 43 countries and lower than those living on less than US$1.25 a day in 25 countries. For example, in Ethiopia, 90 per cent of the population are MPI poor compared to 39 per cent classified as living in extreme poverty;[10] on the other hand, in Tanzania, 89 per cent of people live in extreme income poverty but only 65 per cent are MPI poor. This index captures access to key services such as sanitation and water in a more direct fashion, so the picture of deprivation seems to be a more accurate one: in some countries, services are available for free, while in others they are out of reach even for working people with an income.[11] Additionally, for the same reasons, the MPI can reveal the persistence of acute poverty in countries with strong economic growth, such as India.[12]

Another example of efforts to use more comprehensive measures to assess a country's level of development is exemplified by the eight Millenium Development Goals (MDGs) adopted in September 2000 by 189 members of the United Nations. In addition to defining these eight goals, the member countries of the UN also committed to a set of targets to be achieved by 2015 and defined indicators to monitor progress in achieving each of these goals:

1. Eradicate extreme poverty and hunger
   Target for 2015
   Halve the proportion of people living on less than $1 a day and those who suffer from hunger.
2. Achieve universal primary education
   Target for 2015
   Ensure that all boys and girls complete primary school.
3. Promote gender equality and empower women
   Target for 2005
   Eliminate gender disparities in primary and secondary education (preferred).
   Target for 2015
   Eliminate gender disparities at all levels.
4. Reduce child mortality
   Target for 2015

10 The World Bank classifies extreme income poverty as living on less than US$1.25 a day. Available at http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/0,,contentMDK:20153855~menuPK:373757~pagePK:148956~piPK:216618~theSitePK:336992,00.html.

11 Sabina Alkire and Maria Emma Santos, 'Multidimensional Poverty Index: 2010 Data. Research Brief' (July 2010) Oxford Poverty and Human Development Initiative. Available at http://www.ophi.org.uk/wp-content/uploads/OPHI-MPI-Brief.pdf, at 4.

12 Ibid.

   Reduce by two-thirds the mortality rate among children under five.
5. Improve maternal health
   Target for 2015
   Reduce by three-quarters the ratio of women dying in childbirth.
6. Combat HIV/AIDS, malaria and other diseases
   Target for 2015
   Halt and begin to reverse the spread of HIV/AIDS and the incidence of malaria and other major diseases.
7. Ensure environmental sustainability
   General target
   Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources.
   Target for 2015
   Reduce by half the proportion of people without access to safe drinking water.
   Target for 2020
   Achieve significant improvement in the lives of at least 100 million slum dwellers.
8. Develop a global partnership for development
   Targets
   - Develop further an open trading and financial system that includes a commitment to good governance, development and poverty reduction – nationally and internationally.
   - Address the special needs of the least developed countries and those of landlocked and small-island developing states.
   - Deal comprehensively with the debt problems of developing countries.
   - Develop decent and productive work for youth.
   - In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries.
   - In cooperation with the private sector, make available the benefits of new technologies – especially information and communication technologies.

Despite moving away from a strictly economic concept of development, both the HDI and the MDGs are mostly based on quantifiable variables, which can be measured periodically, and allow frequent comparison between different countries and their levels of development. In this respect, they are similar to income measures of GDP per capita.[13] The difference is that the multiplicity of variables in these two indexes makes it harder to draw clear-cut lines that distinguish developed from developing countries, such as the lines drawn by the World Bank between low, middle and high

13 For a critique of these measures as the basis for an agenda for public policy-making, see Kerry Rittich, 'Governing by measuring: the Millennium Development Goals in global governance' in Helene Ruiz-Fabri, Rudiger Wolfrum and Jana Gogolin (eds), *Select Proceedings of the European Society of International Law*, Vol. 2, 463 (Hart Publishing, 2010).

income countries. For example, Vietnam, Chile and Cuba fare better on health and education (and in the overall HDI ranking) than other countries with the same level of income, whereas Bahrain, Angola and the United States do worse on health and education rankings than other countries with the same level of income.[14] Thus, by adding two variables that are not necessarily correlated with income (health and education), the HDI challenges our ability to draw a clear line separating who is developed and who is not.

Like measures of GDP per capita, the HDI and the MDGs are also embedded within a concept of development – one that might be multi-faceted and less simplistic than GDP per capita, but still reveal a notion of what is development. At a conceptual level, the primacy of per capita income as an index of a country's state of development and maximization of rates of economic growth (and hence per capita income) as the primary end of development has been challenged by Amartya Sen, Nobel Laureate in Economics. In a widely celebrated book, *Development as Freedom*, Sen argues that the ends of development should be focused on promoting individual freedom, in the sense of enhancing the ability of individuals to choose to live lives that they have reason to value.[15] In Sen's view, to realize this objective various freedoms are important, including political freedoms, economic facilities, social opportunities, transparency guarantees and protective security. For Sen, freedom in these various dimensions constitutes both the means and ends of development in that they reflect a complementary and mutually reinforcing set of freedoms that promote more robust forms of individual agency and expand human capabilities, opportunities and functioning. The HDI partly reflects this concept of development. The MDGs, in turn, may not be easily associated with one particular author or concept of development, but it is clear that they have at least two novelties vis-à-vis other measures of development: a concern with gender equality, and a concern with environmental sustainability.

We accept that policies and institutions that increase per capita incomes

14 UNDP, *supra* note 5. These discrepancies have persisted since 1990. See also UNDP, 'Defining and measuring human development', *Human Development Report* (1990) at 14–16. Available at http://hdr.undp.org/en/media/hdr_1990_en_front.pdf

15 Amartya Sen, *Development as Freedom* (New York: Knopf, 1999). See also Martha C. Nussbaum, *Creating Capabilities: The Human Development Approach* (Cambridge, MA and London: Belknap-Harvard University Press, 2011); Martha Nussbaum, *Women and Human Development: The Capabilities Approach* (Cambridge University Press, 2000).

by increasing economic growth are instrumental in promoting development. But, following Sen, it cannot be the case that economic growth is the ultimate end of development or the exclusive means of promoting it. Economic growth is important for what it enables individuals, and the communities and societies of which they are members, to achieve in terms of their individual and collective conceptions of human well-being. In other words, focusing narrowly on economic growth as an end in and of itself – abstracting from what it enables members of a society, individually or collectively, to achieve (perhaps, as Sen would argue, in terms of enhanced human capabilities and functioning) – would be to accord economic growth a primacy in the conception of the ends of development that it cannot sustain. Nevertheless, it is important to recognize the opposing danger that the ends of development may become so diffuse that 'one sometimes wonders whether it now stands for anything more substantial than everyone's own utopia'.[16]

III. NON-INSTITUTIONAL THEORIES OF DEVELOPMENT

Debates about the means of achieving the ends of development have often reflected as much diversity of viewpoints as debates over the ends. In this section we provide a brief overview of a wide variety of theories regarding the means of development. The common feature among the theories described here is the fact that they ignore or reject the idea that institutions are important for development. Except for this common characteristic, these non-institutional theories of development differ radically from each other. At the risk of oversimplifying these differences, we have grouped a variety of non-institutional development theories under three major headings: (a) economic theories, (b) cultural theories, and (c) geographic theories. The following discussion will provide an overview of these theories and highlight their main policy implications.

Despite generally ignoring or rejecting the importance of institutions for development, most of these theories have an institutional connection. Some of them have institutional assumptions embedded in their models while others require functional institutions for their policy proposals to be effectuated. Thus, these so-called non-institutional theories have important institutional implications that are not always acknowledged or recognized.

16 Arndt, *supra* note 1 at 165.

A. Economic Theories of Development

Over the post-war period, various schools of thought concerned with economic growth have come into and out of favour, including: capital fundamentalism; *dirigiste* central planning; neo-Marxist dependency theory; the Washington Consensus (the neoclassical model or market fundamentalism); endogenous growth theories; and eclectic combinations of all of the foregoing. Most of these theories simply assumed the relevant institutional capacity to implement the (highly divergent) policies that each theory espoused.

According to a class of theories known as the 'linear stages approach' or 'capital fundamentalism', countries need to mobilize domestic savings and foreign investment in order to generate sufficient investment to accelerate GDP growth.[17] Linear stages of growth theory was a branch of modernization theory, which was based on the view of developing countries as simply backward societies which must be brought into modern civilization through the evolutionary process of industrialization and economic development. The dominant theory of development in the 1950s and 1960s, it was initially developed by the economic historian, Walt W. Rostow, shortly after World War II, and was formulated as a capitalist response to Marxist development theory. Rostow's basic assumption was that there were pre-defined stages through which every country must proceed in order to achieve economic development, and developing nations could be located at a particular stage based on national growth and investment rates.[18] According to Rostow the most crucial need of developing countries was capital. However, some developing countries had very low rates of new capital formation, and were not able to save the resources required (15 to 20 per cent of GDP) to promote economic development. In this context, foreign aid (and to some extent foreign direct investment) were proposed as a solution to the savings gap.[19] A central policy implication of this theory was a state-centred approach to promoting savings and investments in early post-war development through state-created tax incentives for both private savings and investment in production by private companies, and high levels of investment in state-owned companies.[20] Thus, the 'capital fundamentalists' assumed a functioning state, bureaucracy, tax system, and other institutional features of an operational economy, but they did not address the problem of how to acquire these institutions.[21]

The linear stages approach to development was replaced in the 1970s with two other competing categories of theories: structural change theories and international dependence theories. In contrast to linear stages theory, these two sets of theories went beyond economic policies, addressing the need for political and social change in order to foster development. However, similar to 'capital fundamentalism', these theories also had institutional implications that were not addressed directly by their theoretical models.

Structural change theories argued that economic growth required that 'underdeveloped economies transform their domestic economic structures from a heavy emphasis on traditional subsistence agriculture to a more modern, more urbanized, and more industrially diverse manufacturing and service economy'.[22] This transformation required the state to implement policies to foster industrialization and mechanization of the agricultural sector, to provide a strong educational system to train the work force and enable rural workers to move to industrial sectors, and to undertake urban planning and make infrastructure investments to accommodate the growth of urban centres. These assumptions largely ignored the complex institutional framework that is required to enable the state to perform all these functions.

Dependency theories were primarily conceived in developing nations (especially in Latin America), and emerged largely in response to modernization theory and the capital fundamentalists' overly simplistic understanding of economic development. Dependency theories looked to external and historical influences as central to the state of domestic economic development but, similar to other economic theories, they also had important institutional connections that were not addressed in their models. The basic claim of these theories was that the international economic order is polarized and entails a relationship of dependence between the industrial centre and an agrarian periphery.[23] This claim assumed that

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17 Michael Todaro and Stephen Smith, *Economic Development* (Boston, San Francisco, New York: Addison Wesley, 2012, 11th edn) at 110–111.

18 Rostow described the stages as follows: (a) traditional society; (b) preconditions for take-off into self-sustaining growth; (c) take-off; (d) the drive to modernity or maturity; (e) the age of high mass consumption.

19 Todaro and Smith, *supra* note 17 at 114.

20 Michael Trebilcock, 'What makes poor countries poor? The role of institutional capital in economic development' in Eduardo Buscaglia et al. (eds), *The Law and Economics of Development* (Connecticut: JAI Press, 1997) at 17.

21 Pranab Bardhan, 'Symposium on the state and economic development' (1990) 4 *Journal of Economic Perspectives* at 3–7.

22 Todaro and Smith, *supra* note 17 at 115.

23 Ibid., at 122. See also Dennis Conway and Nikolas Heynen, 'Classical

exploitation of former colonies had remained, and in some cases had been intensified, after independence.

Some *dependencistas* were also influenced by Marxist ideas that the division between rich and poor is required to support the global capitalist system.[24] To eliminate dependency, these theorists advocated aggressive economic nationalism[25] grounded on import substitution industrialization (ISI), with high levels of tariff protection to restrict the flow of imports and to promote the development of local industries.[26] ISI policies assume a major role for the state, especially in making investments in infrastructure (transportation, energy and telecommunications) and in fostering industrialization in capital-intensive industries (the commanding heights of the economy). These theories, however, did not explore the fact that heavy state intervention in the economy assumes at least an efficient and competent bureaucracy and a functional executive branch. Moreover, the policies prescribed required effective laws and regulations, such as the tariffs and exchange controls on which the ISI model depended. Despite being central to dependency theories, these institutional connections were largely unexplored in the academic literature.

The neoclassical (or neoliberal) counter-revolution replaced the structural change and dependency theories, becoming the dominant paradigm in development theory in the 1980s and 1990s. The neoclassical model assumed that free markets could promote an efficient allocation of economic resources by creating efficient pricing signals, thus being labelled 'market fundamentalism'. This contrasted with the state-centred view of development assumed by most preceding theories. This model assumed that the state was often the source of the problem rather than the solution to challenges of development. In the late 1980s, the neoliberal theory was embodied in a set of policy prescriptions that became known as the 'Washington Consensus'.[27] The central tenets of the Consensus were:

dependency theories: from ECLA to André Gunder Frank', in V. Desai and R. Potter (eds), *The Companion to Development Studies* (London: Arnold, 2002) at 97.

24 Todaro and Smith, *supra* note 17 at 123. See also Colin Clarke, 'The Latin American structuralists' in Desai and Potter, ibid., at 94.

25 Brian Tamanaha, 'The lessons of law-and-development studies' (1995) 89:2 *American Journal of International Law* at 478.

26 John Coatsworth, 'Structures, endowments and institutions in the economic history of Latin America' (2005) 40:3 *Latin America Research Review* at 126.

27 For a brief history of the term, see John Williamson, 'The Washington Consensus as policy prescription for development' in Timothy Besley and Roberto Zagha (eds), *Development Challenges in the 1990s: Leading Policymakers Speak from Experience* (New York: World Bank/Oxford University Press, 2005) at 33–61.

macro-economic stability (fiscal discipline, tax reforms and reductions in public expenditures), liberalization (open trade and market deregulation), privatization, and policies to attract foreign direct investment (FDI) and stimulate private entrepreneurship (reduction of tax burdens, availability of credit for private investors, and fostering of competition within sectors). The Washington Consensus was closely followed by many Latin American countries, and more cautiously by developing countries in other regions.[28]

In common with its counterparts, however, neoliberal theories largely ignored the central role of the state – not in directly promoting development, but instead in providing the pre-conditions for markets to operate. Markets depend on a functioning legal system and effective regulation of capital markets, banking sectors, competition policies, the trade system, tax collection, and investment in infrastructure, healthcare and education, etc. The lack of attention to these institutional connections has been perceived to be one of the central reasons why many of these policies failed.[29]

Endogenous growth theory developed in response to the inability of the neoclassical model to explain rates of technological change and productivity growth, as well as the variable long-term growth rates experienced by different countries.[30] In contrast with neoclassical theories, endogenous theories of growth emphasize that 'economic growth is an endogenous outcome of an economic system, not the result of forces that impinge from outside'.[31] Endogeneity, in economics, refers to the fact that variables in a certain model are not independent – that is, changes in one variable will produce changes in another variable, and vice versa. Endogenous theories of growth thus claim that these variables, such as technological change, are

28 V. Bulmer-Thomas, *The Economic History of Latin America since Independence (Vol.2)* (Cambridge: Cambridge University Press, 2003).

29 Dani Rodrik, 'Goodbye Washington Consensus, hello Washington Confusion? A review of the World Bank's economic growth in the 1990s: learning from a decade of reform' (2006) 44:4 *Journal of Economic Literature*, 973–87. Other critiques include that the Consensus was too focused on GDP growth, while ignoring other important factors that influence living standards, especially those related to economic inequalities, and that the policies have had a negative impact on poverty levels and living standards of the poor. See Robin Broad and John Cavanagh, 'The death of the Washington Consensus' in Walden F. Bello, Nicola Bullard and Kamal Malhotra (eds), *Global Finance: New Thinking on Regulating Speculative Capital Markets* (London: Zed Books, 2000).

30 Subrata Ghatak, *Introduction to Development Economics* (London, New York: Routledge, 2003, 4th edn) at 58.

31 Paul M. Romer, 'The origins of endogenous growth' (1994) 8 *Journal of Economic Perspectives* at 3–22.

not independent: they impact on growth, which in turn impacts on them. As a result, 'economic growth involves a two way interaction between technology and economic life: technological progress transforms the very economic system that creates it'.[32] Endogenous growth theories seek to understand this interplay and how such interplay results in economic growth.[33]

For endogenous growth theories, technological change is an outcome of public and private investments in education (human capital), infrastructure, and research and development in knowledge-intensive industries.[34] This focus on technology is based largely on Joseph Schumpeter's work on the innovative process and technological change, which has been elaborated on by Arrow.[35] This introduced an endogenous theory of knowledge production whereby engaging in problem-solving generates both specific experience and general knowledge. This knowledge is a public good that can be re-used by other producers, leading to knowledge spillovers, which generate growth because productivity increases as knowledge is accumulated and disseminated. Competition for profits leads to improved products and production processes, which can also be understood as technological change/innovation, and technological change/innovation leads to more competition, thus generating economic growth endogenously by increasing productivity and human capital.[36] This theory explains why developed countries continue to experience high or increasing levels of growth, as 'the more you learn, the faster you learn things'.[37]

This theory leads to an important policy implication: there is room for state intervention to create incentives for accumulation of knowledge (human capital) and technological progress. In contrast to neoliberal theories, endogenous growth theory 'is somewhat more sympathetic to a more activist policy role for the state in realizing the dynamic economies associated with the introduction and exploitation of modern technology and its accompanying externalities and spillovers'.[38] In this analysis,

32 Philippe Aghion and Peter Howitt, *Endogenous Growth Theory* (Cambridge, MA: MIT Press, 1998) at 1.
33 Ibid.
34 Todaro and Smith, *supra* note 17 at 150.
35 Kenneth Arrow, 'The economic implications of learning by doing' (1962) 29 *Review of Economic Studies*.
36 Ghatak, *supra* note 30.
37 James M. Cypher and James L. Dietz, *The Process of Economic Development* (Taylor and Francis, 2008, 3rd edn) at 249.
38 Trebilcock, *supra* note 20 at 18.

private organizations are likely to under-invest in human capital generation, as some of the benefits from this expenditure are externalities that benefit society at large while the private organizations bear all the costs. Therefore government is advised to subsidize this gap between private investment and the socially optimal level of investment in human capital formation, research and training.[39] However, if human capital is a major engine of economic growth, then a 'brain drain' where highly skilled individuals emigrate from developing to developed countries may be a serious impediment to growth in developing countries. This will limit the effectiveness of increased educational attainment as a government policy to drive growth. Among economic theories of development, endogenous growth theory is perhaps the one that has most explicitly acknowledged the role of institutions in promoting economic development. However, they do not provide any insight into how to improve them.

As a result of the deficiencies of neoliberal policies, and contrary to mainstream arguments for less state intervention in the economy, a consensus has emerged: it is the *quality* of state intervention that matters, not necessarily its quantity. The quality of intervention, in turn, is now recognized as a function of the quality of a state's institutions.[40] Indeed, over the past decade or so, an institutional perspective on development has become increasingly prominent in development thinking, captured in the mantra, 'institutions matter' or 'governance matters'. The focus of this perspective is on how a state should organize itself through its political, bureaucratic, administrative and legal institutions to advance its development goals (however defined). We describe this perspective in more detail and the challenges it raises in Part IV of this chapter.

B. Cultural Theories of Development

The word culture does not have a singular or universal meaning, and can be used to describe a wide array of societal forces, such as formal and informal norms of behaviour, religious beliefs, informal codes of conduct, social habits and attitudes, or the existing value, moral or ethical system that prevails in a particular society. Despite these ambiguities, or perhaps because of them, the term has often been used in development theory. This section provides a general map of some of the many ways in which culture is associated with development in the academic literature.

39 Cypher and Dietz, *supra* note 37 at 249.
40 See, e.g., Trebilcock, *supra* note 20.

As discussed in Part II, there are different conceptions of development that reflect different interpretations of what is required to achieve human well-being. Despite their divergences, these conceptions of development have one thing in common: they assume that there is a universal core to either the conception of what the good life is (the ends of development), or what is needed to enable individuals to pursue a good life (the means of development). In contrast, some authors argue that societies have diverse, culturally defined conceptions of 'the good life' and how one goes about achieving it. This perspective asserts that different societies have different values and these differences should be respected, and as such there are no grounds for judging that the values of some societies are better than others.

The most radical versions of this argument claim that everything is culturally defined.[41] This can lead to questioning the validity of the entire development enterprise. For example, the radical relativist Escobar argues for the preservation of indigenous culture and against the use of Western (or any) standards as a benchmark, and claims that the imperialistic nature of the development discourse makes it comparable to discourses of colonization.[42] The idea that there is an incompatibility between Western and other cultures may assume a static and perhaps immutable view of culture, which presupposes that we cannot intentionally and purposively change culture. A stronger version of this argument claims that 'culture is destiny', that with or without intentional attempts to do so, culture will not change.[43]

At the other extreme of this debate, there are theorists who believe that culture is at the very core of conceptions of development and, as a consequence, only cultural reforms can promote development. According to these theorists, universal conceptions of development cannot be realized unless the culture of developing societies mimics the culture of developed nations, which are more congenial to development objectives. Thus, promoting Western conceptions of development and trying to implement

41 For a discussion of this, see Jack Donnelly, *Universal Human Rights in Theory and Practice* (Ithaca, NY: Cornell University Press: 2003) at 89–107.

42 A. Escobar, 'Introduction: development and the anthropology of modernity' in *Encountering Development: The Making and Unmaking of the Third World* (Princeton, NJ: Princeton University Press, 1995) at 3–20. The label 'radical relativist' is explained in more detail in R.A. Shweder, 'Moral maps, "First World" conceits, and the New Evangelists' in L. Harrison and S. Huntington, *Culture Matters* (New York, NY: Basic Books, 2000) at 158–76.

43 Kim Dae Jung, 'Is culture destiny? The myth of Asia's anti-democratic values' (1994) 73 *Foreign Affairs* 6.

liberal democracies in developing countries will not work unless there is a substantive cultural change in these societies. Harrison argues, for instance, that some societies have a progress-resistant cultural outlook that will prevent development unless they change these cultural traits.[44] However, Harrison can be accused of formulating a revamped version of modernization theory as his theory similarly assumes that development is achieved through evolutionary progress (distinguishing backward from modern societies) and uses this notion to claim that developing cultures should improve by becoming similar to developed cultures. Other scholars, such as Sen, may also be vulnerable to the criticism of proposing a modified version of modernization theory. Any discourse that suggests that there is something universal that all societies should aspire to (rationalism, human rights, democracy, etc) assumes that there are societies that are at more advanced stages of their evolution, and that they should serve as models to laggard societies.

In contrast to those who use a concept of culture to challenge conceptions of development, there are theorists who question the notion of culture as defined in the development literature. Scholars such as Tatsuo seek to deconstruct Western representations of the First and Third Worlds, questioning conceptions that try to establish clear lines to separate them. Tatsuo claims, for instance, that most of the debate about development and culture is built upon false dichotomies that separate Western cultures from other cultures.[45] If we abandon these dichotomies, Tatsuo argues

44 Harrison argues that these cultures have the following outlook: they have religious beliefs that nurture irrationality, inhibit material progress, and are utopian; their views of destiny are informed by fatalism, resignation and sorcery; their members are focused on the present or on the past, not on the future, creating difficulty with planning and punctuality; wealth is conceived as a non-expandable resource and resource allocation is a zero sum game; knowledge is abstract, theoretical and cosmological, among other things. See Lawrence E. Harrison, *The Central Liberal Truth* (New York, NY: Oxford University Press, 2006); Harrison and Huntington, *supra* note 42.

45 Tatsuo challenges the depiction of Asia as a Confucian (or Confucian-Islamic) society in contrast to a Christian (or Judeo-Christian) West by showing that religious and cultural diversity are important characteristics of the Asian region. He also challenges characterizations of Asia as communitarian, arguing that individualism is not alien to Asia in general and to Confucianism and Buddhism in particular. Tatsuo concludes that the idea of an 'Asian culture' ignores the complex reality of the region (and its religious, cultural, and socio-economic diversity), and also presents an oversimplified portrait of religious and cultural traditions (assuming that Confucianism is incompatible with individualism): Inuoe Tatsuo, 'Liberal democracy and Asian Orientalism' in J. Bauer and D. Bells (eds), *The East Asian Challenge for Human Rights* (Cambridge: Cambridge University Press, 1999).

that the tension and incompatibility between liberal democracy and 'Asian culture' largely disappears. A similar argument is developed by Amartya Sen in his book *Identity and Violence*.[46] According to him, identities have been often defined by singling out one aspect of a person's life, such as religion, when in fact a person may identify more strongly with other aspects of his or her character. Sen claims that the miniaturization of identities has created polarization between different ethnic and religious groups, and has been a source of ethnic and religious conflict around the world.

Culture can also be understood in light of the distinction drawn by Amartya Sen between the ends and the means of development. Cultural freedom can be conceived as a goal of the development process if one believes that the opportunity to engage in cultural activities is part of the basic freedoms that constitute a developed country (conceiving development as freedom).[47] In turn, culture can be conceived as a means to an end, viewed as a necessary component of the process that generates economic gains or increased freedom of choice.[48]

In addition, culture can interact with the ends and means of development in more indirect ways, which have important policy implications. As to ends, culture strongly influences value systems,[49] affecting what a given society will consider to be 'a good life', therefore impacting upon what a society considers to be the ultimate end of the development process. As to means, culture may be a relevant consideration when designing effective strategies to reach development goals. Culture can influence economic, political and social behaviour in substantial ways.[50] In economic terms, culture can influence levels of entrepreneurship, willingness to take risks and business ethics. In political terms, culture can impact on the frequency and quality of public discussion, civic interaction and engagement in deliberative processes. In social terms, culture can determine levels of solidarity and trust, as well as educational attainment, marital patterns, or expectations about others' behaviour. Thus, on this view, reforms that try to influence economic behaviour should take into account specific cultural characteristics that guide economic behaviour in particular societies. Similarly, attempts to promote political reforms, such as implementing a liberal democracy, must acknowledge that political behaviour is

46 Amartya Sen, *Identity and Violence: The Illusion of Destiny* (New York: Norton, 2006).

47 Amartya Sen, 'How does culture matter?', in Vijayendra Rao and Michael Walton (eds), *Culture and Public Action* (Stanford University Press: 2004) at 39.

48 Ibid.

49 Ibid., at 42–3.

50 Ibid., at 39.

influenced by culture, and that the same political institutions might not function in the same way in different cultural contexts.

One of the conclusions that can be drawn from the influence of culture on human behaviour is that development policies need to be adjusted to divergent cultural contexts, and it is unlikely that one will be able to design a universal blueprint for all developing countries. This raises the question of whether it is possible to claim that there is a discipline or a field of study called law and development. The idea that development strategies and policies need to be tailored to particular contexts may suggest that the problem of development should be analysed on a case-by-case basis, with little or no room for generalizations.

However, culture is not the only factor that influences human behaviour.[51] Thus, there is room to develop some common strategies that transcend cultural divides. Despite cultural differences, many societies share important commonalities. Heterogeneous beliefs and practices will often exist within a given culture, and these dissenting voices can play an important role in questioning the maintenance and permanence of certain entrenched cultural traits.[52] Finally, culture is dynamic, making it difficult to draw conclusive distinctions between societies. Cultural change may occur endogenously, or may be linked to external forces arising from interaction with other cultures.[53] In other words, culture is not destiny. Policymakers should be mindful of cultural factors when designing development policies, but no society should be viewed as a prisoner of its existing cultural context.

In general, economists can be accused of not paying enough attention to culture as a relevant factor in human behaviour, and of not acknowledging its relevance for the development process.[54] There is, however, one important exception within this group: the new institutional economists,[55] who follow for the most part Douglass North's definition of institutions:

> Institutions are the rules of the game of a society, or, more formally, are the humanly devised constraints that structure human interactions. They are composed of formal rules (statute law, common law, regulation), informal constraints (conventions, norms of behaviour and self-imposed codes of conduct), and the enforcement characteristics of both.[56]

51 Ibid., at 43.

52 Ibid., at 43.

53 Ibid., at 43–44.

54 Ibid., at 37.

55 And, according to Sen, they are not the only ones. Adam Smith, John Stuart Mill and Alfred Marshall can also be cited as examples.

56 Douglass North, 'The new institutional economics and Third World

Most of what we refer to as culture is encompassed by what North calls 'informal institutions'. Thus, according to the new institutional economics, culture, together with formal institutions, influence human behaviour and structure social interactions.

However, institutional economists do not go much beyond acknowledging that culture influences human behaviour. It is not clear how, when and why it does so. The result is that culture is often treated as a black box in institutional analyses.[57] We do not know, for instance, to what extent the existence of formal institutions, such as the rule of law and democratic accountability depends on certain underlying cultural values, such as individualism and lack of hierarchical structures.[58] We also do not know if formal institutions can change culture and vice-versa.[59] And if these changes are possible, we do not know when and under which circumstances they are likely to take place.

This poses a major challenge for the advancement of our understanding of the problem of development. While institutional theories of development have become prominent in development discourse, without a thorough assessment of the role that culture plays in institutional stability and institutional change, reforms may have either limited success or unintended results. Culture is an important factor that is currently largely missing in the institutional reform puzzle.

C. Geographic Theories of Development

A third group of theories claims that development is largely dependent on the geographic location and condition of a country. These theories diverge, however, in their explanation of why geography matters, and whether it has a direct or indirect effect on development. This section will provide a brief overview of some of these geographic theories and discuss their policy implications.

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development' in J. Harris et al. (eds), *Economics and Third World Development* (London: Routledge, 1995).

57 D. Acemoğlu and S. Johnson, 'Unbundling institutions' (2005) 113 *Journal of Political Economy* 5.

58 For an analysis suggesting that there is empirical evidence to support the idea that there is significant influence of culture on governance, see Amir Licht, Chana Goldschmidt and Shalom Schwartz, 'Culture rules: the foundations of the rule of law and other norms of governance' (2007) 35 *Journal of Comparative Economics* at 659–88.

59 Harrison, for instance, argues that formal institutions do not change culture. It is necessary to modify culture before promoting institutional reforms. Harrison and Huntington, *supra* note 42.

Several basic claims are made to support the idea that geography can directly impact on a country's development, as well as a more recent approach – called economic geography – which attempts to show how geography interacts with a number of other factors, creating a dynamic in which economic activity is concentrated in certain areas despite the lack of relative geographic advantages. The first basic claim is based on climate: tropical countries are more likely to be underdeveloped. This might be so for a number of different reasons. Some scholars believe that tropical climates impact on productive economic activity, especially agriculture, because of the fragility and low fertility of tropical soils, high prevalence of crop pests and parasites, high evaporation and unstable supply of water, as well as ecological conditions favourable to infectious human diseases.[60] Others claim that tropical climates inhibit work because of hot weather and humidity,[61] or the abundance of easily obtainable, non-agriculturally produced food, which reduces the need to work hard and so creates a culture of idleness.[62]

The second claim is based on location: landlocked countries face significant barriers to engaging in trade, and therefore are significantly deprived of the economic benefits derived from international or inter-regional commercial activity.[63] According to Paul Collier, this can create a poverty trap whereby development prospects are limited because landlocked countries face impediments to integrating into the global economy, a problem which is particularly severe where the landlocked country's coastal neighbour has not invested sufficiently in the infrastructure necessary to allow its neighbour to transport goods to the coast where they can be traded intercontinentally. Collier describes these landlocked countries as 'hostages to their neighbours', especially where instability or violence restricts access to trade routes.[64] Further, impoverished neighbours are poor markets for

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60 David E. Bloom and Jeffrey D. Sachs, 'Geography, demography, and economic growth in Africa' (1998) 29 *Brookings Papers on Economic Activity* at 207–96; Jeffrey D. Sachs, 'Tropical underdevelopment' (2000) Centre for International Development at Harvard University, Working Paper # 57.

61 D. Landes, *The Wealth and Poverty of Nations: Why Are Some So Rich and Others So Poor?* (New York: W.W. Norton, 1998).

62 William Easterly and Ross Levine, 'Tropics, germs, and crops: how endowments influence economic development' (2003) 50 *Journal of Monetary Economics* 1, at 7 (citing Machiavelli).

63 J. Sachs and A. Warner, 'Economic reform and the process of global integration', in William C. Brainard and George L. Perry (eds), *Brookings Papers on Economic Activity* (Brookings Institution Press, 1990).

64 Paul Collier, *The Bottom Billion* (Oxford: Oxford University Press, 2007) at 55.

a neighbouring country's goods, preventing landlocked countries from leveraging on the growth of their coastal neighbours.

The third claim is based on natural endowments. It is intuitive to assume that natural resource abundance would be more conducive to growth, and indeed natural wealth can positively impact on a country's development outlook. However, this is not necessarily the case:[65] the phenomenon of the 'resource curse' has shown that under certain circumstances abundance of natural resources will not lead to growth,[66] will foster rent seeking and corruption,[67] and may lead to an increased likelihood of civil conflict resulting from disputed resource ownership.[68] There is a general consensus that what determines whether or not a country will be able to utilize resource wealth to become rich is largely determined by the quality of its institutions.[69]

Engerman and Sokoloff make an alternative geographic claim which

65 Jeffrey Sachs and Andrew Warner, 'Natural resource abundance and economic growth' (1995) NBER Working Paper Series 5398 at 1–47; Richard Auty, *Sustaining Development in Mineral Economies: The Resource Curse Thesis* (London and New York: Routledge, 1993). See also Thorvaldur Gysfason, 'The International Economics of Natural Resources and Growth' (2007) CESifo Working Paper Series No. 1994.

66 Studies have shown that the negative economic impacts were caused by a phenomenon called 'Dutch Disease': W. Max Corden and J. Peter Neary, 'Booming sector and de-industrialisation in a small open economy' (1982) 92 *Economic Journal* 368, Royal Economic Society, at 825–48. See also Migara de Silva, 'The political economy of windfalls, the "Dutch Disease" – theory and evidence' (1994) John M. Olin School of Business Discussion Paper (Saint Louis: John M. Olin School of Business). For an overview of economic and political causes and possible solutions to the problem of the resource curse, see Macartan Humphreys, Jeffrey Sachs and Joseph Stiglitz (eds), *Escaping the Resource Curse* (New York: Columbia University Press, 2007).

67 Richard M. Auty (ed.), *Resource Abundance and Economic Development* (Oxford and New York: Oxford University Press, 2001); Terry Lyn Karl, 'Oil-led development: social, political and economic consequences' (2007) *CDDRL Working Papers*, at 36; Carlos Leite and Jens Weidman, 'Does Mother Nature corrupt – natural resources, corruption and economic growth' (1999) IMF Working Paper No. 99/85.

68 Michael T. Klare, *Resource Wars: The New Landscape of Global Conflict*, (New York: A Metropolitan/Owl Book, 2002). On the correlation between natural resource dependence and civil conflict, see Paul Collier and Anke Hoeffler, 'Resource rents, governance and conflict' (2005) 49:4 *Journal of Conflict Resolution* at 625–33.

69 See Halvor Mehlum, Karl Moene and Ragnar Torvik, 'Institutions and the resource curse' (2006) 116 *The Economic Journal* at 1–20. See also Daron Acemoğlu, 'An African success story: Botswana' in Dani Rodrik (ed.), *In Search of Prosperity* (Princeton, NJ: Princeton University Press: 2003); Collier, *supra* note 64.

supports the idea that geography has an indirect effect on development by influencing the emergence of strong or weak institutions. This theory points to certain resource endowments as creating high levels of inequality of wealth, human capital and political power, which work against the development of strong institutions. Instead of fostering developmentally beneficial institutions, high levels of inequality allow the growth of 'institutional structures that greatly advantage members of elite classes'.[70]

Another argument based on natural resources focuses on germs and crops. Diamond, in his book *Guns, Germs and Steel: The Fates of Human Societies*, shows that some nations, including European nations, developed resistance to germs acquired from farm animals, whereas others, such as colonized nations, did not have farm animals and therefore did not develop such resistance.[71] The spread of these germs at the time of colonization negatively impacted on the development prospects of colonized nations. Also, regions such as Africa had germs that restricted the use of farm animals, undermining their productivity. Further, some regions had plant species that could be easily domesticated into high-yielding food crops, such as grains. In contrast, other regions did not have species that would lend themselves so easily to cultivation.

Economic geography is still another theory of development, which focuses on economic models of the geography of development, looking at why economic development takes place in a certain area rather than another, despite the lack of relative geographic advantages. This differs from the approaches explained above, which use the inherent geographic location of a country to explain a history of underdevelopment. Economic geography seeks to explain such phenomena as the 'division of the world into industrial and nonindustrial countries, the emergence of regional inequality within developing countries, and the emergence of giant urban centers'.[72] The theory focuses on a combination of the forces of chance and necessity producing one of many possible equilibria, which benefits

70 Stanley L. Engerman and Kenneth L. Sokoloff, 'Factor endowments, inequality, and paths of development among New World economies' (2000) 14:3 *Journal of Economic Perspectives* at 217–32. See also Michael Ross, 'Does oil hinder democracy?' (2001) 53:3 *World Politics* at 325–61; Nathan Jensen and Leonard Wantchekon, 'Resource wealth and political regimes in Africa' (2004) 37:9 *Comparative Political Studies* at 816–41.

71 Jared Diamond, *Guns, Germs, and Steel: The Fates of Human Societies* (New York: W.W. Norton and Co, 1997).

72 Paul Krugman, 'The role of geography in development' (1999) 22:2 *International Regional Science Review* at 147.

a particular place over another. The World Development Report (2009) produced by the World Bank examines geographic disparities in wealth by utilizing three explanatory concepts from economic geography:

- density (a local measure of human concentration);
- distance (a national measure of distance to hubs of economic activity, i.e. transport costs); and
- division (an international measure of economic integration and the impermeability of economic borders).[73]

The report concludes that three spatial transformations, 'higher densities, shorter distances, and lower divisions', are necessary for development to occur.[74]

One of the most prominent proponents of geographic theories of development is Jeffrey Sachs. He claims that barriers to development include three features that are intrinsically connected to a country's geography:

- transportation costs (which can be especially high for landlocked countries);
- diseases (an acute problem in the tropics, where infectious diseases may deter investment); and
- poor soil fertility (which can be caused partly by torrential rains, such as those that occur in equatorial regions).[75]

Sachs acknowledges the importance of economic policy and institutions – such as trade openness, fiscal rectitude, and the rule of law – for development, but he believes that 'for much of the world, bad climates, poor soils and physical isolation are likely to hinder growth whatever happens to policy'.[76] The result is that tropical countries cannot eliminate poverty by

[73] World Development Report 2009, 'Reshaping economic geography' (Washington: The World Bank, 2009). Available at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTWDRS/EXTWDR2009/0,,menuPK:4231145~pagePK:64167702~piPK:64167676~theSitePK:4231059,00.html.

[74] Ibid., at 57.

[75] Jeffrey Sachs, 'Institutions matter, but not for everything: the role of geography and resource endowments in development shouldn't be underestimated' (2003) *Finance and Development*. A similar argument is developed by Diamond, *supra* note 71.

[76] J. Sachs, 'The limits of convergence: nature, nurture and growth' (14 June 1997) *The Economist*. See also John Luke Gallup, Jeffrey D. Sachs and Andrew

simply promoting good economic policies or institutional reforms.

This does not mean that geographic theories of development are deterministic. Sachs, among others, believes that geography is not the sole cause of underdevelopment. Instead, geographic factors create barriers to development, which in turn generate a low-level growth equilibrium or a poverty trap.[77] According to Sachs, the poverty trap can be overcome by investing in infrastructure to reduce transportation costs, agricultural technology to increase productivity, and improved health care services and treatment to reduce the burden of tropical diseases. In order to enable these investments to be made in resource poor countries, he argues that the developed world should increase foreign aid to poor countries, especially in Africa, to assist these countries in breaking out of the poverty traps in which they are currently stuck.[78] Once geographical barriers to development are addressed, institutions then become relevant.[79] However, reformers must first deal with geographical barriers, lest these more fundamental problems undermine any positive effects of institutional reforms.

The idea that well-governed poor nations can be caught in a poverty trap has been influential since the 1950s, and has long justified large foreign aid programs (as discussed earlier with reference to Rostow and modernization theory). This claim, however, is much disputed in the contemporary development literature. Some claim that there is no empirical evidence to support the existence of poverty traps.[80] Others provide a great deal of evidence that poor institutions, rather than geography, are the fundamental cause of underdevelopment, as discussed below. Some of these institutionalists include geographic factors as a secondary cause of a country's level of development.

Daron Acemoğlu, Simon Johnson and James A. Robinson (AJR) are among the many authors who support the idea that geographic factors play only an indirect role in development by affecting a country's

D. Mellinger, 'Geography and economic development' (December 1998) NBER Working Paper No. W6849. Available at SSRN: http://ssrn.com/abstract=145013.

[77] Sachs, *supra* note 74; David E. Bloom, David Canning and Jaypee Sevilla, 'Geography and poverty traps' (2003) 8 *Journal of Economic Growth* at 355–78.

[78] Jeffrey Sachs, *The End of Poverty* (New York: The Penguin Press, 2005) at 208.

[79] Sachs, *supra* note 75.

[80] William Easterly, 'Reliving the 1950s: the big push, poverty traps, and takeoffs in economic development' (2006) 11 *Journal of Economic Growth* 289–318; Aart Kraay and Claudio Raddatz, 'Poverty traps, aid, and growth' (2007) 82 *Journal of Development Economics* at 315–47. But see Bloom et al., *supra* note 77 (showing that geography is not determinism, but it might influence poverty traps or low level equilibria).

institutions.[81] They argue that geographic factors affect the historical development of a country,[82] because the wealth that existed before colonizers arrived was influenced by geography, impacting on each country's overall development outcome. Geography influenced the types of institution that were implemented by colonizers: in regions with inhospitable climates, colonizers established extractive institutions to exploit natural resources (extractive societies); in regions with hospitable climates, colonizers created settler societies which developed strong institutions (neo-Europes). The institutional environment promoted at colonization had a dramatic impact on the development prospects of colonized countries. Well-functioning institutions encouraged investment in machinery, human capital and better technologies, fostering growth and development. AJR's argument differs from Sachs' argument, in that he concludes that geography has only an indirect effect on a country's level of development: development is determined by the institutional environment which is affected by geography.[83]

If institutions matter, countries should seek to create better institutions through institutional reforms in order to improve their development prospects. Sachs, however, criticizes this proposal as a convenient solution from a developed country perspective. Sachs points out that, according to institutional theories, 'the rich world has little, if any, financial responsibility for the poor because development failures are the result of institutional failures and not a lack of resources'.[84] Sachs claims that poor countries need money from developed countries in order to develop. However, this does not eliminate the institutional question. It is unlikely that a country can implement the ambitious policies Sachs calls for without

81 Another important paper in this literature is Sokoloff and Engerman, *supra*. note 70. See also Easterly and Levine, *supra* note 62; and Dani Rodrik, Arvind Subramanian and Francesco Trebbi, 'Institutions rule: the primacy of institutions over geography and integration in economic development' (2004) 9 *Journal of Economic Growth* at 131–65.

82 Daron Acemoğlu, S. Johnson and J. Robinson, 'The colonial origins of comparative development: an empirical investigation', 91 *American Economic Review* at 1369–401. For further evidence supporting AJR's hypothesis, see Easterly and Levine, 'Tropics, germs, and crops,' *supra* note 62 at 3–39.

83 To prove this point, Acemoğlu uses colonization as a natural experiment to compare the relative effect of geography and institutions in the level of development of different countries. According to him, colonization is a good experiment because it provoked an exogenous variation on institutions, eliminating problems of reverse causality and mere correlation without causation: Daron Acemoğlu, 'Root causes' (June 2003) 40 *Finance and Development* 2.

84 Sachs, *supra* note 75.

well-functioning institutions. Regardless of the specific policy arrangements, strong institutions are necessary for government policies to provide the necessary framework for effective development.

This Part has surveyed the major non-institutional development theories of the past 60 years, with a focus on their implications for institutional questions and institutional reform. There has been much controversy and criticism of development theory as it has evolved, which has spurred continuous debate in this field of study. However, there now seems to be a general consensus that institutions play an important role in promoting development (however conceived), as we discuss next.

IV. INSTITUTIONAL THEORIES OF DEVELOPMENT

As noted above, economic theories of development predominant in the past shared in common the characteristic of either disregarding the nature and quality of a developing country's domestic institutions or, alternatively, simply assuming that a country possessed the institutional capacity to implement the theories of development in question.[85] Pranab Bardhan has noted, 'in this [traditional development] literature the state was often left floating in some behavioral and organizational vacuum, making it easy to be used for a blanket endorsement of indiscriminate state intervention'. Cultural and geographic theories of development similarly tend to marginalize the importance of the character and quality of a country's institutions in advancing its development goals. Cultural theories tend to stress deeply embedded cultural beliefs and practices as a determinant of development (while being vague about whether or how these should be changed),[86] while geographic theories tend to emphasize natural endowments as a key determinant of development.[87] Both classes of theories have a deterministic quality that is much attenuated in institutional theories.

85 Pranab Bardhan, 'Symposium on the State and Economic Development' (1990) 4 *Journal of Economic Perspectives* 3, 3–7. In the case of endogenous growth theory, while acknowledging the importance of institutions to development, little guidance is offered on how institutions can be improved.

86 See e.g. Licht, Goldschmidt and Schwartz, *supra* note 58. But see Amy Cohen, 'Thinking with culture in law and development' (2009) 57 *Buffalo L. Rev.* 511.

87 See e.g. Bloom and Sachs, *supra* note 60 at 207–96; Sachs, 'Tropical underdevelopment,' *supra* note 60. See also Landes, *supra* note 61; and Easterly and Levine, *supra* note 62 at 7.

The idea that institutions matter for development has both a theoretical and an empirical pedigree. The theoretical pedigree of institutionally focused development theory is based on a number of assumptions and arguments developed by a school of thought called New Institutional Economics (NIE), which attempts to explain the reasons for the development of institutions and their effect on economies.[88] The basic assumption of NIE is that people are rational actors who respond to incentives and these incentives are influenced, if not determined, by institutions that induce individuals and organizations to engage in productive activities – or the converse.[89] The empirical pedigree is based on cross-country studies that show strong correlations between institutional quality and growth and development around the world, while some studies claim to find empirical evidence that also supports causation from institutional quality to development.

The institutional perspective is compelling because it appears to identify important determinants of a given country's development prospects that are within that country's control, suggesting that governments should no longer consider themselves captive to factors such as history, culture, climate, geography, natural resource endowments or the international economic system. If this perspective is adopted, lawyers – who often conceive of themselves as institutional designers – should become important contributors to the development enterprise.

The institutional perspective on development raises a number of key questions, which are briefly addressed in this section. These questions are the following:

1. What exactly do we mean by 'institutions'?
2. Does empirical evidence support the claim that the nature and quality of a country's institutions are a major determinant of its development prospects?
3. Why do institutions matter for development?
4. Which institutions matter, and with respect to which conceptions of development?
5. Why do some countries have chronically bad institutions?
6. How can these countries acquire good institutions?

88 Geoffrey M. Hodgson, 'The approach of institutional economics' (1998) XXXVI *Journal of Economic Literature* at 168.
89 North, *supra* note 56.

A. The Definition of 'Institutions'

What is an institution? The term, as used in both the theoretical and the empirical literature, exhibits significant ambiguity.[90] For example, Douglass North defines 'institutions' as follows:

> Institutions are the rules of the game of a society, or, more formally, are the humanly devised constraints that structure human interactions. They are composed of formal rules (statute law, common law, regulation), informal constraints (conventions, norms of behaviour and self-imposed codes of conduct), and the enforcement characteristics of both. Organizations are the players: groups of individuals bound by a common purpose to achieve objectives. They include political bodies (political parties, the senate, a city council, a regulatory agency); economic bodies (firms, trade unions, family farms, cooperatives); social bodies (churches, clubs, athletic associations); and educational bodies (schools, colleges, vocational training centres).[91]

This definition has been highly influential academically, and is widely used by development scholars. However, from a lawyer's perspective, it is an odd definition of institutions.[92] Beyond a country's constitution, lawyers do not tend to think of institutions as the rules of the game. For example, the legally prescribed speed limit on a given highway is not considered to be an institution but rather a legal rule promulgated by one set of institutions, enforced by another and, in the event of disputes, adjudicated by yet another. Also, the distinction between institutions and organizations that North draws is idiosyncratic in that many of his forms of organization, like political bodies (political parties, the senate, a city council, a regulatory agency), are typically conceived of by lawyers as institutions charged either with making, administering or enforcing laws. Finally, by including informal constraints (cultural conventions, norms of behaviour and self-imposed codes of conduct) in his definition of institutions, North's conception of institutions becomes so all-encompassing that it includes almost any factor that may influence human behaviour and hence risks losing any operational content. For our purposes, if only by stipulation, we understand institutions to mean those organizations (formal and informal) that are charged or entrusted by a

90 For an extensive survey of definitions of institutions, see Geoffrey M. Hodgson (2006) 'What are Institutions?' 40:1 *Journal of Economic Issues* at 1–25.
91 North, *supra* note 56.
92 Mariana M. Prado and Michael Trebilcock, 'Path dependence, development and the dynamics of institutional reform', (2009) 59 *University of Toronto Law Journal* 341.

society with making, administering, enforcing or adjudicating its laws or policies.

B. Do Institutions Matter?

At one level, this question invites an intuitive or axiomatic response. A central characteristic of 'failed states' is that few or none of the basic functions of the state are performed with even a minimal level of effectiveness, including such fundamental functions as maintaining some semblance of law and order, preventing mass starvation, and avoiding gross repression of or violence towards major segments of the population. 'Failed states' are characterized as such precisely because they lack functioning public institutions.[93]

At a somewhat less intuitive level, one can derive the importance of institutions to a country's development prospects by a process of elimination. This is the analytical strategy adopted by Mancur Olson in a widely cited paper.[94] In this paper, Olson evaluates access to the major factors of production by different countries and concludes that differential access to these factors cannot explain why some countries are rich and others poor. In terms of access to technology, Olson argues that most countries have roughly equivalent access to basic technological innovations and that their cost accounts for a tiny fraction of their GDP. With respect to access to land and natural resources, he argues that a high population-to-land ratio does not explain why some countries are rich and others poor – indeed, some of the richest countries in the world have some of the highest population densities and often lack major natural resources of their own. With respect to access to financial capital, capital in the contemporary world has become enormously mobile and will quickly gravitate to countries and activities where the marginal product of capital is highest. If one assumes that marginal returns to capital in capital-intensive developed countries are declining over time, capital would gravitate to countries with higher ratios of labour and lower ratios of capital where returns to capital would presumably be higher. Thus, according to Olson, none of these explanatory factors could adequately account for why some countries are rich and others are poor.

With respect to marketable human capital, it may be true that citizens

93 Robert Rotberg, 'Failed states, collapsed, weak states: causes and indicators' in Robert Rotberg, *State Failure and State Weakness in a Time of Terror* (Washington, DC: Brookings Institution Press, 2003) at 6.

94 Mancur Olson, 'Big bills left on the sidewalk: why some nations are rich and others poor' (1996) 10 *Journal of Economic Perspectives* 3.

of many developing countries possess less education and other forms of specialized human capital than citizens of developed countries, but Olson points out that most emigrants from these countries to developed countries typically increase their incomes substantially and immediately. If one assumes that employers in developed countries generally pay wages reflecting the marginal product of labour, this implies that these emigrants, even with their current stock of human capital, are much more productive in receiving countries than in their home countries. According to Olson, this is so presumably because of differences in the policy and institutional environments between these countries. In emphasizing the importance of differences in policies and institutions, Olson points to large differences in the growth record of countries during certain periods, despite the fact that these countries share common cultures and, for long periods of time, common histories: for example, North and South Korea, East and West Germany, China, Hong Kong and Taiwan.

More recently, led by the Governance Group at the World Bank, much more systematic cross-country econometric analyses of the impact of institutional quality on development outcomes have been undertaken.[95] The findings of this empirical perspective can be captured by examining one particularly influential study entitled 'Governance Matters', undertaken by Kaufmann, Kraay and Zoido-Lobaton, all of whom are affiliated with the World Bank. This regularly updated study is part of the World Bank's ongoing research on governance, which now covers about 200 countries.[96]

95 For a helpful review of the empirical literature on this issue, see Ashok Chakravarti, *Aid, Institutions and Development: New Approaches to Growth, Governance and Poverty* (Cheltenham, UK: Edward Elgar Publishing, 2006).

96 Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobaton, 'Governance Matters', World Bank Policy Research, Working Paper No. 2196 (Washington DC: World Bank, 1999) available at http://info.worldbank.org/governance/wgi/pdf/govmatters1.pdf; Daniel Kaufmann, 'Rethinking governance: empirical lessons challenge orthodoxy', Discussion Draft 11 March 2003 (Washington, DC: World Bank, 2002) available at http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/rethink_gov_stanford.pdf; see also Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 'Governance Matters IV: Governance Indicators for 1996–2004', World Bank Policy Research Group, Working Paper No. 3630, World Bank, 2005, available at http://www.worldbank.org/wbi/governance/pdf/GovMatters_IV_main.pdf; Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 'Governance Matters VII: Aggregate and Individual Governance Indicators, 1996–2007' World Bank Policy Research, Working Paper No. 4654 (Washington, DC, World Bank, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=718081; Daniel Kaufmann, 'Governance redux: the empirical challenge' in Xavier Sala-i-Martin (ed), *The Global Competitiveness Report 2003–2004*, (New York: Oxford University Press, 2004). See also World

The World Bank's Governance Project involves compiling a large number of subjective measures of institutional quality – meaning data obtained from either polls of country experts or surveys of residents – and grouping them into six clusters:

1. *Voice and accountability*: Measures the extent to which citizens of a country are able to participate in the selection of governments and combines indicators measuring 'various aspects of political process, civil liberties, political rights' and 'the independence of the media'.
2. *Political stability*: Measures 'perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means'.
3. *Government effectiveness*: Measures the inputs required for the government to be able to produce and implement good policies. Combines 'perceptions of the quality of public service provision, the quality of bureaucracy, the competence of civil servants, the independence of civil service from political pressures, and the credibility of the government's commitment to policies'.
4. *Regulatory quality*: Includes measures of 'the incidence of market-unfriendly policies such as price controls or inadequate bank supervision as well as perceptions of the burden imposed by excessive regulation in areas such as foreign trade and business development'.
5. *Rule of law*: Includes measures of 'the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of both violent and non-violent crime, effectiveness and predictability of the judiciary, and the enforceability of contracts.'
6. *Control of corruption*: Measures perceptions of corruption ranging from the frequency of 'additional payments to get things done' to the effects of corruption on the business environment. Corruption is defined as 'the exercise of public power for private gain'.

The authors of 'Governance Matters' created indexes that measure institutional quality along each of these six dimensions as well as a composite 'governance' index designed to measure the overall quality of governance in a society. They regressed three measures of development – per capita GDP, infant mortality and adult literacy – on these indices.[97] They found strong correlations (and asserted causal relationships) between each of their sub-indices of institutional quality, as well as a composite governance index, and their measures of development, hence their conclusion that 'governance matters'. In a more recent iteration of this work, Kaufmann reports:

> The effects of improved governance on income in the long run are found to be very large, with an estimated 400 percent improvement in per capita income associated with an improvement in governance by one standard deviation, and similar improvements in reducing child mortality and illiteracy. To illustrate, an improvement in the rule of law by one standard deviation from the current levels in Ukraine to those 'middling' levels prevailing in South Africa would lead to a fourfold increase in per capita income in the long run. A larger increase in the quality of the rule of law by two standard deviations in Ukraine (or in other countries in the former Soviet Union), to the much higher level in Slovenia or Spain, would further multiply this income per capita increase. Similar results emerge from other governance dimensions: a mere one standard deviation improvement in voice and accountability from the low level of Venezuela to that of South Korea, or in control of corruption from the low level of Indonesia to the middling level of Mexico, or from the level of Mexico to that of Costa Rica, would be associated with an estimated fourfold increase in per capita incomes, as well as similar improvements in reducing child mortality by 75 percent and major gains in literacy.[98]

Drawing on the Kaufmann et al. data, Rodrik, Subramanian and Trebbi estimate the respective contributions of institutions, geography and international trade (integration) in determining income levels around the world.[99] In their study the authors use a number of measures of institutional quality that capture the protection afforded to property rights as well as the strength of the rule of law. The authors find that the quality of institutions 'trumps' everything else. Conventional measures of geography are shown to have, at best, weak direct effects on income, although they have a strong indirect effect by influencing the quality of institutions. Similarly, in their analysis trade is almost always insignificant except for indirect effects on institutions. To convey a flavour of the striking nature of their findings, the authors conclude that 'an increase in institutional quality of one standard deviation, corresponding roughly to the difference between measured institutional quality in Bolivia and South Korea, produces a 2 log-points rise in per capita incomes, or a 6.4-fold difference

Bank, *Where is the Wealth of Nations? Measuring Capital for the 21st Century* (Washington, DC: World Bank, 2007).

97 For a critique of the variables employed in this and succeeding studies and their definitions, see Kevin Davis, 'What can the rule of law variable tell us about rule of law reforms?' (2004) 26 *Michigan Journal of International Law* 141.

98 Kaufmann, 'Governance redux: the empirical challenge', *supra* note 96.

99 Rodrik, Subramanian and Trebbi, *supra* note 81 at 141.

– which, not coincidentally, is also roughly the income difference between the two countries'.[100]

A major challenge confronting these empirical studies is the problem of causation. Correlation does not imply causation: showing that all rich countries have good institutions does not prove that they are rich *because* they have good institutions. For instance, one can show that civil law countries fare better on average than common law countries in international soccer tournaments, but this does not mean that the soccer players' performance is determined by that country's legal regime.[101]

In addition to the possibility that strong institutions and wealth are unrelated but coexisting variables, it is also possible that wealth causes the development of strong institutions, rather than the reverse. For example, Glaeser, La Porta, Silane and Schleifer argue,[102] based on cross-country econometric evidence, that (a) human capital is a more basic source of growth than institutions, and (b) growth causes good institutions, because poor countries escape from poverty through good policies, often pursued by dictators, and these countries only subsequently improve their political and related institutions. In other words, they claim that the causal arrow flows from human capital and good policies to well-functioning institutions. However Kaufmann et al., in subsequent iterations of their work, test for and reject the possibility of reverse causation, concluding instead that the econometric evidence supports causation running from strong institutions to improvements in development indicators (including growth).[103]

It is also possible that the two factors, wealth and good institutions, influence each other – both being endogenous to a single system of development – and therefore the causal arrow flows in both directions: strong institutions ⇔ wealth. Therefore, both conclusions – that good institutions create wealth and wealth creates good institutions – may be correct.

There is, however, a more important limitation in these studies: the cross-country econometric measures provide very little operational guidance to policy reformers because of the level of abstractness employed in defining institutional variables. As Mary Shirley states,

[100] Ibid., at 136.

[101] Mark West, 'Legal determinants of World Cup success' (2009), Michigan Law and Economics Research Paper No. 02-009. Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=318940 or DOI: 10.2139/ssrn.318940

[102] Edward L. Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Do institutions cause growth?' (2004) 9 *Journal of Economic Growth* 271.

[103] Daniel Kaufmann and Aart Kraay, 'Governance and growth, causality which way? Evidence for the world in brief', WBI. Washington, 2003, available at http://www.uoit.ca/sas/governeaceAndCorr/GovGrowth.pdf.

> [t]he measurement of institutions is still in its infancy. Although important regularities have been discovered, the current measures are not actionable. They are too crude to help aid agencies, policy-makers, and concerned citizens to design reforms and gauge their outcomes. The devil is truly in the detail, and the current set of measures may be seriously misleading about the micro-developments. Part of the fault for the weakness of the measures lies with researchers who have focused their attention and efforts on variables that can be used for cross-country growth regressions. Actionable variables are not likely to be useful for papers worthy of peer reviewed journals, but they are essential for a useful understanding of institutions.[104]

C. Why do Institutions Matter?

From an economic perspective focused on growth, the answer to this question turns on the nature of the economic incentives embodied in the institutional framework and whether they induce socially productive or unproductive activities. According to North, 'the institutional framework dictates the kinds of skills and knowledge perceived to have the maximum pay off . . . If the institutional matrix rewards piracy (or more generally redistributive activities) more than productive activity, then learning will take the form of learning to be better pirates'.[105] If one adopts more expansive conceptions of development (such as Sen's conception of development as freedom), certain institutions may matter not only because of consequentialist impacts on growth or other social indicators, but also for intrinsic or deontological reasons such as facilitating and ensuring various civil and political liberties – for example, freedom of expression, association and other democratic freedoms. Even if one adopts this perspective, however, empirical evaluation is still important in assessing whether institutions do in fact protect or advance the freedoms that are central to this perspective.

D. Which Institutions Matter?

Much of the recent scholarship espousing an institutional perspective on development is extraordinarily vague as to (a) which institutions matter to development, and (b) within classes of institutions, which institutional characteristics are conducive or antithetical to development. As we noted earlier, definitions of institutions are also often extraordinarily vague and ambiguous. Moreover, it is important to note that much of the recent institutional literature concludes that a host of context-specific factors

[104] Mary Shirley, *Institutions and Development* (Cheltenham, UK: Edward Elgar, 2008) at 98.

[105] North, *supra* note 56 at 17.

determine optimal institutional characteristics within classes of institutions. For example, although Francis Fukuyama has recently concluded that institutionalists have won the debate over the causes of underdevelopment 'hands down', and that institutions are the 'proximate causes of growth'.[106] He notes that public administration is not a science susceptible to formalization under a set of universal rules and principles[107] and that political institutions also are not susceptible to characterization in terms of optimal formal political arrangements.[108] According to Fukuyama, the full specification of a good set of institutions will be highly context-dependent, will change over time, and will interact with the informal norms, values and traditions of the society in which they are embedded.

Fukuyama is not alone in emphasizing the context-dependent nature of institutional design. Rodrik, Subramanian and Trebbi, in their paper 'Institutions rule', reach rather salutary, perhaps even sobering conclusions, despite the triumphalist title of the paper. For example, they find that while property rights may be an important determinant of development in all countries, the precise configuration of an optimal property rights regime is likely to be highly context-specific:

> Obviously, the presence of clear property rights for investors is a key, if not the key, element in the institutional environment that shapes economic performance. Our findings indicate that when investors believe their property rights are protected, the economy ends up richer. But nothing is implied about the actual form that property rights should take. We cannot even necessarily deduce that enacting a private property rights regime would produce superior results compared to alternative forms of property rights.
>
> . . . there is growing evidence that desirable institutional arrangements have a large element of context specificity, arising from differences in historical trajectories, geography, political economy, or other initial conditions.
>
> . . . there is much to be learned about what improving institutional quality means on the ground. This, we would like to suggest, is a wide open area of research. Cross-national studies are at present just a beginning that point us in the right direction.[109]

106 Francis Fukuyama, 'Development and the limits of institutional design' in Global Development Network, St. Petersburg, Russia, 20 January 2006, unpublished conference paper, available at http://depot.gdnet.org:6666/gdnshare/pdf2/gdn_library/annual_conferences/seventh_annual_conference/Fukuyama_plenary1.pdf., at 1.

107 Francis Fukuyama, *State-Building: Governance and World Order in the 21st Century*, (Ithaca, NY: Cornell University Press, 2004).

108 Fukuyama, *supra* note 106.

109 Rodrik, Subramanian and Trebbi, *supra* note 81. See more generally, Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions and Economic Growth* (Institutions for High-Quality Growth, 2007), Chapter 5.

In a similar vein, in a recent paper,[110] Rohini Pande and Christopher Udry state:

> Recent years have seen a remarkable and exciting revival of interest in the empirical analysis of how a broad set of institutions affects growth. The focus of the recent outpouring of research is on exploiting cross-country variation in 'institutional quality' to identify whether a causal effect runs from institutions to growth. These papers conclude that institutional quality is a significant determinant of a country's growth performance.
>
> These findings are of fundamental importance for development economists and policy practitioners in that they suggest that institutional quality may cause poor countries and people to stay poor. However, the economic interpretation and policy implications of these findings depends on understanding the specific channels through which institutions affect growth, and the reasons for institutional change or the lack thereof . . . We also conclude from our review that this literature has served its purpose and is essentially complete. The number of variables available as instrumental variables is limited, and their coarseness prevents close analysis of particular causal mechanisms from institutions to growth . . . This suggests that the research agenda identified by the institutions and growth literature is best furthered by the analysis of much more microdata than has typically been the norm in this literature.

Complementing her criticism that the current institutional measures are not useful to policymakers, Mary Shirley also makes a claim for more microdata in the form of case studies:

> Developing more useful measures of institutions will not be simple. Ultimately, consistent, comparative case studies will be crucial if we are to understand the complex nature of institutions and institutional change and develop more specific and accurate measures.[111]
>
> Comparative case studies are one way to discover the determinants of reform without sacrificing necessary institutional details . . . Unfortunately, case studies have a bad and not entirely undeserved reputation as *sui generis*, unscientific, devoid of theory and unworthy of publication in top academic journals . . . Even rigorous comparative cases will likely suffer from small sample problems, selection biases and the difficulty of constructing a counterfactual. Nevertheless, comparative case studies are worth the effort if we want to begin to unravel the determinants of institutional change. It seems unlikely that cross-country econometric studies can begin to develop more nuanced measures of institutions until they are informed by comparative case studies.[112]

110 Rohini Pande and Christopher Udry, 'Institutions and development: a view from below' (Yale University, 18 November 2005) in R. Blundell, W. Newey and T. Persson (eds), *Proceedings of the 9th World Congress of the Econometric Society* (Cambridge University Press).

111 Shirley, *supra* note 104 at 98.

112 Ibid., at 184.

In sum, while much empirical evidence supports the view that institutions matter for development, we know very little about which institutions matter, and what specific institutional characteristics within classes of institutions matter for development.

E. Why are Some Countries Afflicted with Persistently Bad Institutions?

According to most of the institutional literature reviewed above, countries that are afflicted with persistently bad institutions are (in Olson's words) leaving 'big bills on the sidewalk'. Why would societies engage in such myopic or self-destructive behaviour, particularly in an era where mass communications technologies make information highly accessible at low cost? Many members of these societies should be, and probably are, aware of the fact that alternative institutional arrangements in other countries appear to generate dramatically superior development outcomes. So why do bad institutions persist?

According to North, the reason is the phenomenon of 'path dependency', which describes how the reinforcement of a given set of arrangements over time raises the cost of changing them.[113] Most public institutions exhibit increasing returns to scale and network effects, making it very difficult for rival institutions that demonstrate superior qualities to emerge. Existing institutions also generate biased feedback loops that tend to confirm prior institutional expectations about existing institutional arrangements rather than providing exposure to and information about institutional alternatives. In addition, vested interests both within and outside existing institutional regimes often derive substantial benefits from these regimes, hence creating concentrated sources of resistance to institutional change. All of these factors, according to North, tend to create strong forms of institutional path dependency that often render radical institutional reform infeasible.[114] While occasionally revolutions occur or charismatic leaders emerge that may offer the prospects of a decisive break with the past, these contingencies are much more the exception rather than the rule. However, as Bardhan indicates, with the exception of North, the new institutional economists have not taken these issues very seriously.[115]

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113 For a helpful overview of path dependence theory and its applications, see Paul Pierson, 'Increasing returns, path dependence, and the study of politics' (2000) 94 *American Political Science Review* 251 at 252–7; our discussion below draws in part on Pierson's survey of the literature.

114 Douglass North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 1990).

115 Pranab Bardhan, *Scarcity, Conflicts, and Cooperation: Essays in the Political*

F. What can Countries with Bad Institutions do to Acquire Better Institutions?

To a large extent, responses to this question are constrained by responses to the previous question about the reasons for the persistence of bad institutions. Much advice that has been offered on this question borders on the banal. For example, Olson concludes: 'The best thing a society can do to increase its prosperity is to wise up.'[116] *The Economist*, in a survey article, suggests: 'Africa's people need to regain their self-confidence.'[117] These proposals do not offer much in the way of concrete, actionable reforms.

Serious thinking about this question needs to address the complexities of the path dependence dynamic described above. This is, however, a daunting endeavour and we still do not have a firm understanding of how to transform dysfunctional institutions. Indeed, Douglass North in a recent book states: 'To put it bluntly, we may know a lot about polities, but not how to fix them.'[118] This lack of knowledge on how to successfully promote institutional reforms is illustrated in a recent book on rule of law reform and development (co-authored by Michael Trebilcock), which describes the mixed to weak results of many rule of law reform initiatives in developing countries.[119] Recent faltering initiatives to install democratic regimes in many developing countries (such as Iraq and Afghanistan) provide further illustrations of these challenges.[120]

Thus, while economists have been influential recently in emphasizing the important role of institutions as a major determinant of development, they have made much more limited progress in illuminating strategies for overcoming these 'path dependency' obstacles. After a detailed recent review of the economic and political scholarly literature on path dependency,[121] we drew the following tentative implications that follow

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and Institutional Economics of Development (Cambridge, MA: MIT Press, 2005), chapter 2.

116 Olson, *supra* note 94 at 21.

117 'Africa: the heart of the matter', *The Economist*, 13 May 2000 at 22–4.

118 Douglass North, *Understanding the Process of Economic Change* (Princeton, NJ: Princeton University Press: 2005) at 67.

119 Michael J. Trebilcock and Ronald J. Daniels, *Rule of Law and Development: Charting the Fragile Path of Progress* (Cheltenham, UK: Edward Elgar Publishing, 2008).

120 Georg Sorenson, *Democracy and Democratization: Processes and Prospects in a Changing World* (Westview Press, 2007, 3rd edn); Larry Diamond, *The Spirit of Democracy: The Struggle to Build Free Societies Throughout the World* (New York: Henry Holt and Co., 2008).

121 Prado and Trebilcock, *supra* note 92.

from attention to path dependence in formulating institutional reform strategies.

First, because of context-specific factors that explain the evolution of existing institutions (and networks of institutions), no one-size-fits-all blueprint for legal reform or broader institutional reform in developing countries is likely to be optimal. Other developing countries which share many of the same historical experiences and institutional characteristics as the country whose institutions are the focus of reform efforts are likely to be a more useful source of information, experience and ideas as to what is likely to work than other countries which share few of these common characteristics.[122] Future research on reform options, to be effective, will often have to be led by scholars within the countries in question complemented by scholars with relevant comparative expertise pursued through collaborative research initiatives.

Second, as a result of switching costs and institutional interdependencies, ambitious or highly innovative across-the-board political, bureaucratic or legal reforms carry significantly greater risk of failure than more modest or incremental reforms. Disillusionment with progress with democratic and rule of law reforms in many developing countries may, in this respect, reflect unrealistic expectations.

Third, if more ambitious or innovative institutional reforms are to be pursued successfully, they should focus on institutions that can be more easily detached from mutually reinforcing mechanisms, and become relatively free-standing, although even in such cases complementary reinforcing institutional reforms over time are likely to be necessary.

Fourth, detached, free-standing institutions, pilot programs or decentralized initiatives enlisting enthusiastic participants are likely to be more successful than across-the-board centralized reforms of existing institutions that conscript unwilling participants by imposing significant switching costs on them. Demonstration effects from pilot projects may subsequently persuade sceptics on either the demand or supply sides of the institutional reform equation that switching costs are not as large as previously assumed or that the benefits of incurring these costs are larger than expected. Such pilot projects also have the virtue of reversibility in the event that they generate unintended consequences, and thus entail lower risks.

Fifth, in reforms that are sensitive to switching costs from the institutional status quo, it is important to identify the different kinds of switching

122 See Sharun Mukand and Dani Rodrik, 'In search of the Holy Grail: policy convergence, experimentation and economic performance' (2005) 95 *American Economic Review* 374.

costs that may be salient – whether they reflect political economy factors that have shaped and been reinforced by the initial choice of institutions; or reflect lack of financial or technical resources; or reflect learning effects; or reflect co-ordination or network effects; or reflect deeply entrenched cultural or religious beliefs or practices. While these factors can be conceived of as exogenous constraints on institutional reforms, one can equally view them as endogenous factors that have shaped the evolution of the institutional status quo. On either view, they will also significantly shape feasible margins of reforms, but in different ways.

Sixth, political and economic crises or catharses may provide opportunities for more radical institutional change, but also present risks of denial, deferral or repression, or precipitous adoption of ill-conceived policy or institutional choices in response to public consternation or disaffection. To mitigate these risks, the reform process must broaden the pool of policy ideas by enlisting previously marginalized constituencies and incorporating them into more enduring institutional reforms so as to create a new alignment of ideas, interests and institutions.

We are fully cognizant of the modesty of these conclusions. However, we take comfort from the fact that it reflects a similar modesty on the part of at least some of the more prominent New Institutionalists, such as Douglass North:

> Path dependence means that history matters. We cannot understand today's choices (and define them in the modelling of economic performance) without tracing the incremental evolution of institutions. But we are just beginning the serious task of exploring the implications of path dependence.[123]
>
> A major frontier of scholarly research is to do the empirical work necessary to identify the precise source of path dependence so that we can be more precise about its implications.[124]

V. CONCLUSION

Path dependence counsels attention to contextual and historical particularities in proposing institutional reforms. As with debates over the ends of development – which yield explicit or implicit divides between those who believe that there are certain core or universal elements in a normatively defensible conception of development and those who believe that such conceptions are highly culture- and context-specific – similarly with

123 North, *supra* note 56 at 100.
124 North, *supra* note 118 at 7.

respect to the means of development. Even if certain ends of development were thought to be universal, the different starting points or initial conditions of the large universe of developing countries may suggest that there will be very few universally effective blueprints with respect to substantive economic and social policies and the processes and institutions appropriate for implementing, administering and enforcing such policies. However, it may be argued that, at least amongst some groups of developing countries, some problems are sufficiently common that at least limited generalization is possible as to problem diagnoses and prescriptions. Espousing extreme forms of relativism as to the ends of development may lead to acceptance of or acquiescence in appalling abuses of power by tyrannical governments, including abuses of the most fundamental human rights by incumbent political regimes or rival factions vying for power, or traditional religious or cultural belief systems and practices that may be egregiously discriminatory towards major segments of the population, including women and ethnic and religious minorities.

As to the means of development, if one views differences as overwhelming any commonalities, then, as Arndt puts it, we are simply resigning ourselves to the proposition that each country should 'write its own history,'[125] and that nothing is to be learned through successes and failures of policies, processes and institutions in addressing similar problems in other developing countries, or at least other developing countries that share much in common in terms of economic, social, political, geographic and historical experience. Without some potential for at least cautious or qualified generalizations, the whole field of development as a scholarly or analytical enterprise is called into serious question.

125 Arndt, *supra* note 1 at 165.

2. The rule of law and development: in search of the Holy Grail

I. INTRODUCTION

Recent empirical research on the relationship between the nature and quality of a country's institutions and development outcomes purports to demonstrate, inter alia, that improvements in the rule of law are likely to have dramatic impacts on development outcomes. For example, as noted in Chapter 1, according to the World Bank, an improvement in the rule of law by one standard deviation from the current levels in the Ukraine to those middling levels prevailing in South Africa would lead to a fourfold increase in per capita income in the long run.[1]

Similarly, according to Rodrik et al., an 'increase in institutional quality' (measured largely in terms of the strength of private property rights and the rule of law) 'of one standard deviation, corresponding roughly to the difference between measured institutional quality in Bolivia and South Korea, produces a 2 log-points rise in per capita incomes, or a 6.4-fold difference'.[2]

Reflecting this view of the relationship between the rule of law and development, beginning in the 1990s there has been a massive surge in development assistance for law reform projects in developing and transition economies involving investments of many billions of dollars.[3] There has also been a major resurgence of scholarly interest in the relationship between law and development.

Proponents of an optimistic view of the relationship between the rule

1 Daniel Kaufmann, 'Governance redux: the empirical challenge', in Xavier Sala-i-Martin (ed.), *The Global Competitiveness Report 2003–2004* (New York: Oxford University Press, 2004).

2 Dani Rodrik, Arvind Subramanian and Francesco Trebbi, 'Institutions rule: the primacy of institutions over geography and integration in economic development' (2004) 9 *Journal of Economic Growth* 141.

3 See David Trubek, 'The rule of law and development assistance: past, present and future', in David Trubek and Alvaro Santos (eds), *The New Law and Economic Development: A Critical Appraisal* (Cambridge: Cambridge University Press, 2006) at 74.

of law, or law more generally, and development have made extremely bold claims about the potentially beneficial impact of legal reforms. For example, in his influential book, *The Other Path*, Hernando de Soto makes claims such as: 'The legal system may be the main explanation in the difference in development that exists between industrialized countries and those that are not industrialized.'[4] He also argues that 'development is possible only if efficient legal institutions are available to all citizens'[5] and that 'the law is the most useful and deliberate instrument of change available to people'.[6]

In contrast, various law sceptics doubt the ability of legal reformers to identify appropriate legal reforms; consider that legal reforms often face potentially insurmountable economic, political and cultural obstacles; or argue that legal reform is often irrelevant because informal alternatives to law are of overriding importance as mechanisms of social control in many developing countries.[7] In this respect, sceptics point to the failure of the first law and development movement in the late 1950s to early 1970s – which we discuss in more detail in Part III of this chapter – and argue that we may be condemning ourselves to repeating earlier mistakes by ignoring the lessons of history.

In examining the relationship of law to development, several broad questions need to be addressed:

1. What is embraced or connoted by terms such as 'law', 'legal institutions' and 'the rule of law'?
2. Do law and legal institutions in fact significantly determine a country's development prospects (given particular conceptions of the ends of development)?
3. To the extent that they do, what explains why many countries have chronically poor law, legal institutions, or the rule of law (or in Mancur Olson's terms, why are they 'leaving big bills on the sidewalk')?[8]
4. If a country has chronically poor laws, legal institutions or rule of law, what measures are both important and feasible in a law reform strategy?
5. What is the appropriate role for external actors in promoting rule of law reforms in developing countries?

[4] Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Basic Books, 1989) at 185.
[5] Ibid., at 186.
[6] Ibid., at 187.
[7] See Kevin Davis and Michael J. Trebilcock, 'The relationship between law and development: optimists versus skeptics' (2008) 56 *American Journal of Comparative Law* 895.
[8] Mancur Olson, 'Big bills left on the sidewalk' (1996) 10 *Journal of Economic Perspectives* 3.

II. THE DEFINITION OF LAW, LEGAL INSTITUTIONS AND THE RULE OF LAW

'Law' could connote an almost infinite number of areas of substantive law, from commercial and corporate law to tax law, family law, property law, contract law, administrative law, and so on. Nobody possesses the requisite expertise across all of these areas of substantive law to judge whether a country's substantive laws reveal deficiencies in one respect or another as evaluated against some conception of the ends of development. Instead, we will focus on the major classes of legal institutions which include courts, police, prosecutors, correctional institutions, specialized regulatory or law enforcement bodies, legal education institutions, professional regulatory bodies, and so on, and examine the characteristics of these institutions against various conceptions of the rule of law.

Problems of evaluation begin with widely divergent understandings of the content of the concept of the rule of law, which – despite the now fashionable pre-eminence accorded to it in many development circles – has in fact been the subject of long-standing normative debates and is highly contested terrain. According to Tamanaha, in a recent intellectual history of the rule of law, 'there are almost as many conceptions of the rule of law as there are people defending it'.[9] Michael Trebilcock and Ron Daniels have reviewed these debates in some detail in previous work.[10] For present purposes, it suffices to say that conceptions of the rule of law run the gamut from the deontological (protection of basic human rights) to the instrumental (protection of property rights and contracts to promote investment and growth), and from extremely 'thick' conceptions (that largely equate the rule of law with a just legal system, which in turn is largely elided with a just society), to very 'thin' or formalistic conceptions (that emphasize that laws should be publicly promulgated, be predictable in their application, apply to all citizens, including government officials, and be subject to some

[9] Brian Tamanaha, *On the Rule of Law: History, Politics, Theory* (Cambridge: Cambridge University Press, 2004) at 3.
[10] Michael J. Trebilcock and Ronald J. Daniels, *Rule of Law Reform and Development: Charting the Fragile Path of Progress* (Northampton, MA: Edward Elgar, 2008) Chapter 1.