Development Centre Studies

Informal Institutions

HOW SOCIAL NORMS HELP OR HINDER DEVELOPMENT

Edited by Johannes Jütting, Denis Drechsler, Sebastian Bartsch and Indra de Soysa

OECD

DEVELOPMENT CENTRE

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FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

This publication is part of the Development Centre's work on informal institutions and development, as defined under the 2005/06 work programme. It benefited from a generous financial contribution from the German Ministry of Economic Co-operation and Development for which the Centre expresses its gratitude.

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Preface

By now, most people agree that institutions matter for development. The debate has nevertheless not sufficiently taken into account the whole spectrum of institutional arrangements. In fact, too much emphasis has been put on the importance of formal state institutions. Undoubtedly, a sound legal system, a solid constitution and a functioning democratic framework are indispensable ingredients to achieve sustainable development. However, people often forget to acknowledge the crucial impact of norms and values that allow formal institutions to operate efficiently. Such informal institutions – traditions, customs and social norms – provide the underpinnings of social order and are thus pivotal to understanding human interaction and the performance of economies.

To contribute to this emerging debate, the OECD Development Centre — in co-operation with the OECD Development Assistance Committee's Network on Governance (DAC-GOVNET) — organised an international seminar on "Informal Institutions and Development: What Do We Know and What Can We Do?" in December 2006. The seminar brought together high-level policy makers, representatives of civil society and international experts. They discussed linkages and possible conflicts between formal and informal institutions, and looked at ways in which donors and partner countries can foster the contribution of informal institutions to a more enabling environment for development. The seminar (the proceedings of which are presented to you in this report) concluded with some important policy lessons that can improve development co-operation. It also highlighted areas that have so far not been understood sufficiently and require additional research in the future.

For the OECD Development Centre, the seminar marked the close of two consecutive Programmes of Work (2003-04 and 2005-06) that highlighted important linkages between informality and development. Many important

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results have been achieved in the last years: including the launch of the first comprehensive data base on gender equality, which presents information on discrimination in informal institutions (OECD Gender, Institutions and Development Data Base); an analysis of the crucial role of family structures for investment and savings behaviour; and an assessment of the potential to scale up risk management systems, based on reciprocity with more formalised insurance mechanisms.

Yet despite these achievements, more work still needs to be done. We do need a better understanding of why, in the process of globalisation, informality seems to increase rather than decrease, and why we have not yet witnessed a formation of universally shared values such as freedom, democracy and human rights. In fact, most peoples' lives are still grounded in local contexts and conditions. Better understanding of these multiple realities is urgently needed if we want to fulfil our objectives as set out in the United Nations Millennium Declaration. An improved handling of informal institutions will be crucial in this endeavour.

Louka T. Katseli

Director, OECD Development Centre

June 2007

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Opening Remarks by the Secretary General of the OECD

In order to promote development, it is indispensable to look at the institutional frameworks of countries. High-quality institutions enable a better economic and investment climate, foster better governance and accountability, encourage trust, reinforce property rights and avoid the exclusion of sections of the population.

In emerging and developing countries, *formal* institutions such as laws, regulations and legally enforced property rights are usually poorly established. *Informal* institutions based on trust, solidarity and social capital – such as family and kinship structures, traditions, civil and social norms – often substitute for, compete with or complement formal institutions. In fact, informal institutions are of high importance and can help or hinder the development process: ignoring them can be costly for partner and donor countries alike.

This collection of papers presented at the OECD conference on "Informal Institutions and Development: What Do We Know and What Can We Do" held in Paris, December 2006 examines the ways in which informal institutions matter, and how OECD and its partner countries could pay more attention to them.

The *Paris Declaration on Aid Effectiveness* calls for a significantly increased effectiveness of aid and support to partner countries in their efforts to strengthen governance and improve development performance. Informal institutions either in their existing state, or with the required changes, can help move in that direction.

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The OECD recently established an advisory unit to support the Partnership for Democratic Governance (PDG). PDG aims to support the efficient and transparent provision of certain services in developing countries.

Strengthening the capacity to respond to the legitimate desire of citizens for the delivery of adequate services is a major challenge; facing up to it requires careful assessment of existing formal and informal institutions. Initiatives such as the PDG and the "Heiligendamm Process", which is also hosted by the OECD, demonstrate that the Organisation is moving beyond the "institutions matter" stage, to helping member and partner countries implement policies that reinforce those institutions that contribute to progress, human security and growth.

Angel Gurría

Secretary General of the OECD

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Introduction and Overview

Informal Institutions: An Emerging Topic

Johannes Jütting, Denis Drechsler, Sebastian Bartsch and Indra de Soysa

This book collects the main deliberations of an international seminar on "Informal Institutions and Development: What Do We Know and What Can We Do?" that was held in Paris on 11-12 December 2006. The meeting was organised jointly by the OECD Development Centre and the OECD Development Assistance Committee's Network on Governance (DAC-GOVNET), bringing together more than 100 participants including policy makers, scholars, business people and representatives of civil society from around the world.

The specific aims of the seminar were threefold: First, to raise awareness by sharing experiences that illustrate how ignoring the role of informal institutions for development can be costly for developing and developed countries alike. Second, to provide examples of programmes and policies that have successfully integrated informal institutions to achieve growth and poverty reduction. And third, to start a policy dialogue among policy makers and senior civil servants, academics, and representatives from donor agencies and partner countries on how to improve policy design and implementation in the light of the findings of the seminar. By focussing on selected key areas in which informal institutions impact on development outcomes — notably gender, governance and private sector development — and by placing emphasis on practical examples from the field, this book bridges the important divide between the academic and policy maker communites.

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Participants of the seminar agreed that informal institutions have a key influence on development which is often unknown or ignored. Their impact on development can be positive or negative, depending on the specific country context. In fact, even within the same country context, the impact of informal institutions might change over time, as is illustrated in the following example that was presented at the seminar:

> *South Africa's booming mini-bus taxi industry developed in response to severe shortcomings in the country's public transport system — one which is plagued by high prices, low quality service and a chaotic operating network. Mini-bus taxis operate outside of formal laws and regulations. What makes the industry work is a commonly agreed, informal business "culture" that is flexible, innovative and keeps operating costs down. The results are undeniable: at peak times mini-bus taxis hold 65 per cent of the entire commuter market share. However, high accident rates due to insufficient security regulations, violent incidents over un-commissioned routes and fare levels, and tax evasion have imposed high costs on society, prompting South Africa's government into action to regulate the service. What once started as a welcome solution to South Africa's transport problems now requires significant reform.*

This book does not provide ultimate answers but raises important questions. The report deliberately does not present a strict definition of informal institutions. For some of the contributors, informal institutions are closely linked to the informal sector. Some include organisations such as saving clubs and self-help groups; others exclusively focus on institutions as "rules of the game". Although the authors of the chapters do not adopt a single definition, they all share the notion that informal institutions — such as family and kinship structures, traditional practices and social norms — are of great importance and can help or hinder development.

Informal institutions affect development processes in multiple ways. Mutual help, family assistance and social capital are examples of informally organised solidarity that often provides the cornerstone of informal social security systems. Credit and saving groups, community-based health insurance schemes and funeral associations further show the large variety of organisational set-ups that such assistance can take. In other cases, informal institutions — such as the moral authority of village chiefs — help to mediate disputes and constitute key informal accountability mechanisms. This is particularly important in countries where the power of formal government is limited.

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In many developing countries, the social order is predominantly shaped by informal agreements that are not written on paper, but exist outside of formal laws and regulations. As the South Africa example shows, such situations must not be disadvantageous and can sometimes even promote a country's development. Village associations that are solely based on trust and peer pressure provide access to credit and insurance, help in times of distress, and facilitate the construction of public roads and sewage systems. The rapid expansion of community-based health insurance schemes all over Africa provides a good example.

Unfortunately, while informal institutions can increase the well-being of people, they sometimes also prove detrimental to development. The very institutions that are the basis of informal security systems can have perverse effects and become a "tax on success". For instance, forced solidarity will oblige any hard-working farmer in Benin who has accumulated some wealth over the years to share the fruit of his labour with his enlarged family, including distant relatives. In economic terms, the informal institution of "sharing" potentially becomes a disincentive to invest and may result in opportunistic behaviour as there is no obligation to reciprocate.

Other informal institutions lead to discrimination, of which women are most often the victims. Women might be excluded from participating in informal networks, or have no voice and limited influence in appropriating the accrued benefits of collective action.

These few examples show the difficulty in grouping and labelling informal institutions, as well as, analysing their short-term consequences and long-term impact on development outcomes. This book aims to awaken understanding that — despite the complexity and sensitivity of the issue — clear understanding and positive interaction with informal institutions are a pre-condition for achieving long-term sustainable development and poverty reduction.

Structure of the Book

The three parts of this book follow the course of the seminar. Part I sets the stage with two introductory chapters: one from a policy angle provided by South Africa's Deputy Minister of Foreign Affairs, Susan van der Merwe; and the second from a research perspective, written by Indra de Soysa and

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Johannes Jütting. Both chapters are complementary in nature. Van der Merwe reflects on South Africa's recent history and economic development before giving two telling examples (the mini-bus industry described above and community saving clubs) of how informal institutions have played – and continue to play – a crucial role in South Africa. She concludes by highlighting the role of social relations that influence the dynamics of informal institutions. De Soysa and Jütting start from a different angle, reviewing the literature on institutions in general and on informal institutions in particular. Following Douglass North, they opt for a narrow definition of informal institutions as the "rules of the game". They argue that the same informal institution might lead to different institutional and development outcomes, depending on the specific country context. To summarise the different definitions of informal institutions used in this book, an "In Focus" box at the end of Part I gives an overview of the conceptual variety of informal institutions.

Part II is composed of three main chapters that each introduces a field of development in which informal institutions are key: gender, governance and private sector development. The seminar organisers called for discussion of practical examples of day-to-day life by focusing on particular (mostly cross-cutting) areas in development. The contributions by Gita Sen, Nils Boesen, and Stephen Nicholas and Elizabeth Maitland served as input papers for the conference and were followed by discussions in separate parallel sessions (also documented). To illustrate specific examples, Part II also features three "In Focus" boxes: one on the OECD Gender, Institutions and Development Data Base; one on governance indicators and informal institutions; and one on the role of informal institutions for the business climate in Tanzania.

Gita Sen explores the importance of informal institutions for gender equality. She provides theoretical background of the interaction between informal and formal institutions, and describes many real-life examples to support her analysis. Sen highlights the importance of offering formal institutions to counter traditions and other informal institutions that may harm gender equality. Such formal institutions need to gather support from local groups to obtain the necessary legitimacy to compete successfully with existing informal institutions.

Nils Boesen looks closely at the interplay between formal and informal institutions, making a distinction between rule-based and relation-based governance systems. In particular, he points to the competition that can arise between diverging formal and informal institutions when the former are only weakly enforced. Boesen discusses the political conflicts that result from

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such a situation, and the clamour for institutional change that follows. He calls for realistic policy objectives in transforming (negative) informal institutions that need to respect the existing power balance in order to gain maximum support of different political actors.

Stephen Nicholas and Elizabeth Maitland focus on alternative institutional arrangements to foster trade and economic growth in their anylsis of private sector development. The authors discuss how relationship-based informal institutions can provide cheap contractual mechanisms to enforce "good behaviour". They contrast the success of Hong Kong investors in the Guangdong Province, who rely on informal relation-based contractual enforcement mechanisms, with less successful Australian investors in that same area, who were obliged to use less efficient formal enforcement mechanisms. The authors explain how policy makers give support for such pro-business informal governance mechanisms while, at the same time, transforming such mechanisms into more formal ones. In this context, Nicholas and Matiland acknowledge the importance of democratic political structures that minimise elite resistance to institutional change.

Finally, Part III discusses emerging policy conclusions. The Chair of the DAC Richard Manning and GOVNET Chair Eduard Westreicher share their views on what has been learned at this seminar and outline policy implications for international development assistance. The authors also explore how the emerging agenda of informal institutions could be taken forward in the context of the OECD work on development. In a concluding chapter, the editors of this book summarise the current status of the debate on the role of informal institutions in development and highlight questions for future research.

Part I

Informal Institutions: Friend or Foe of Development?

Chapter 1

A Policy Perspective from South Africa[1]

Susan van der Merwe

Summary

Informal institutions are very prevalent in South Africa, especially in the second economy in which formal institutions often do not exist. The informal mini-bus taxi industry, for example, accounts for up to 65 per cent of the entire commuter market share. Community saving groups provide credit to those who do not have access to formal credit. Government programmes need to integrate informal institutions into policy making in order to maximise potential benefits and eliminate negative side effects.

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Like many developing countries, South Africa has a colonial history. Colonial rule was followed by the apartheid regime, which was plagued by policies of racial discrimination and exclusion. The apartheid government deliberately marginalised the majority of the people through a comprehensive web of discriminatory legislation and practices. Segregation, marginalisation and discrimination permeated every aspect of life.

Hilda Bernstein, a stalwart anti-apartheid activist, captures the physical separation and marginalisation of women in South Africa in her book, *For their Triumphs and their Tears: Women in Apartheid South Africa*:

> *"Every person, black or white, has to live in an area designated as their 'own area'. For the white minority, this means most of the country including the areas where almost all economic activity is based. For the black majority, it means living either in a Bantustan [a tribal reserve for black inhabitants of South Africa; editors remark], or a white-owned farm, or in a 'black' township near a 'white' town. For many black women in domestic work, it means living on the white employer's property in separate accommodation. The townships are segregated dormitory areas with virtually no commercial or industrial activity and few opportunities for employment outside what is sometimes called the informal sector. Most of those who live in the townships must, if they are employed, travel each day to work in the 'white' areas."*

This polarisation of the society along racial lines was mirrored in the structure of the economy. So, when South Africa won her democracy 12 years ago, the country's government was faced with the daunting task of not only dismantling the apartheid legislative framework and creating democratic institutions, but also reversing apartheid's social architecture, while simultaneously reviving an economy in crisis. In these past 12 years, South Africa has come some distance towards transforming her society. Amongst other things:

— a progressive constitution was adopted;

— all discriminatory laws were eliminated and replaced with democratic ones;

— a comprehensive social security system has been put in place, targeted at the most vulnerable people in society: the elderly, children and the disabled;

— a vibrant civil society and a free media have evolved; and

— macro-economic stability has been achieved.

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South Africa's economy has grown steadily for the past 12 years, the longest period of consistent growth in the country's history. South Africa experienced 5 per cent growth in 2006 and expects a slightly lower rate in 2007 at around 4.8 per cent. The budget deficit has been reduced to less than 1 per cent and the prospects for the economy for the next few years are positive.

However, South Africa continues to face serious challenges. The levels of unemployment and poverty are unacceptably high and the country is divided still, in some respects, along racial lines. President Mbeki has described this situation as a dual economy — i.e. two economies in one country.

The first economy is characterised as:

— modern;

— integrated in the global economy; and

— producing the bulk of the country's wealth.

The second economy, in which informal institutions are the most prevalent as formal institutions often do not exist, is characterised as:

— underdeveloped;

— isolated from the first and global economies;

— home to a large percentage of people including the urban and rural poor; and

— contributing little to the country's wealth.

South African informal institutions need to be examined in the context of the country's history and how this history has drawn current development challenges. It is still very evident, for example, in the distance between where the majority of the people live, and where businesses (hence work opportunities) exist. This makes searching for employment difficult and expensive.

Also, after decades of institutionalised racial discrimination, remnants of discrimination still persist and many factors impacting employment opportunities continue to be directly related to race: e.g. the historically low investment in education for African people.

Institutionalised discrimination has many facets. It shows in the mismatch between where people live and where work opportunities exist; in historically poor education offered for black people under apartheid, not matched with the skills needed in the modern South African society; or in

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fewer social networks amongst black people that could lead to employment. It is the combined effects of these factors that contribute to the present challenges South Africa faces with high unemployment and related poverty.

Significant informal institutions exist in South Africa, despite the fact that under apartheid, entrepreneurship was actively discouraged. (However, compared with our neighbours on the African continent, South Africa has a relatively small informal sector.) Over the years, South African people have responded to their predicament and devised institutions to control their environment. To illustrate this, I will describe two such institutions in our society.

The first can be found in the mini-bus taxi industry, in which privately owned mini-buses carry about 16 passengers at full capacity. It developed spontaneously in response to non-provision of rail and bus services to certain sectors of the community. It has grown over the past 20 years, and today is a multi-million dollar industry. It has grown into a strong economic contender with traditional modes of transport, namely buses and passenger rail: at peak times, this industry holds 65 per cent of the commuter market share.

Until recently, the industry was completely unregulated, without safety standards and regulated route allocation. Naturally, it was outside the income tax net. The industry's huge growth, compounded by the lack of regulation, led to high accident rates — primarily due to overloading and poorly maintained vehicles. Sometimes, violent conflicts have erupted over contested routes. Also, as it is a cash industry, the opportunity cost of uncollected tax revenues for the government is significant.

After a lengthy and inclusive consultation process, the government has taken the first steps in regulating the industry through a taxi recapitalisation programme. Start-up capital is provided through a scrapping allowance for all existing taxis. These will be replaced with new vehicles, which will have to comply with safety standards. Their operations will be included into integrated transport planning, taking into account all modes of transport.

The potential benefits for the government — in terms of direct tax revenue as well as the human safety spin-off (by reducing accidents associated with the condition of the vehicles) — are anticipated to be far above the cost of the scrapping incentive. The formalisation of the taxi industry will produce

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significant development gains, in terms of safety for commuters and tax revenues, thereby enabling more to be spent on road infrastructure, for example.

A second and very significant informal institution that was originally started in the 19th century is what is known as *stokvels*. These community savings clubs exist throughout South Africa. Members club together in their own neighbourhoods and contribute a specific amount each month to the club. The system operates on a rotational basis: each member receives all the contributions when their turn in the rotation arrives. Some work simply as savings clubs (in which the payout helps with Christmas or holiday expenses), but many are funeral clubs that pay only on the death of the registered member. As funerals are expensive in South Africa, this informal insurance scheme allows for a decent burial and relieves the family from financial burden.

These clubs emerged as an alternative to traditional banking, which was previously unavailable to the poor, but also provide very important community networks as social clubs. The *stokvel* system in South Africa has grown into an important industry, worth an estimated $ 800 million per year with membership of around 3.5 million people. In recent years, some *stokvel* societies have become big investors in the bond market. There is now a National Stokvel Association of South Africa, forming its own regulation mechanism. This savings system also emerged as a response to exclusion from the mainstream, and remains one of the most vibrant savings systems in the country.

These examples show the response of marginalised communities to the conditions of exclusion produced by apartheid in South Africa, and the need for a means of survival. The question then is this: to the extent that these and other informal institutions exist in the second economy, what has been government's response?

The democratic government was faced with the task of having to bring a large percentage of the population into the mainstream economy — without upsetting the traditional community-based informal institutions that are still critical in providing services from which such groups were excluded under apartheid.

In order to address the second-economy challenges, the South African government has examined the "structural funds" instituted by the European Union (EU) in respect of its regional policy. This policy promotes financial solidarity by transferring a portion of the EU's budget to the less prosperous regions and social groups within the EU. The EU programme is premised on the reality that the market cannot be relied on to meet the development needs of the less-favoured regions within the EU. Nor can it guarantee the achievement of the centrally important objective of social cohesion and provide the means for the implementation of "strategies for catching up".

The same is true for the organisation that is hosting today's event. The OECD was set up in 1948 to co-ordinate the Marshall Plan for the reconstruction of Europe after the Second World War, supported by significant funds from the United States and Canada.

In the same spirit, the South African government therefore resolved that the development of the marginalised economy required the infusion of capital and other resources by the democratic state to ensure the integration of this economy within the formal sector.

This involves, in South Africa's case, an active partnership between all levels of government and other social partners in society, including trade unions, political parties and religious organisations. Some key strategies have been developed to meet the development challenges, including:

— an integrated and sustainable rural development programme;

— an urban renewal programme;

— an extended public works programme with an emphasis on infrastructure development;

— the development of small, medium and micro-enterprises with special emphasis on black economic empowerment;

— special programmes for the empowerment of women; and

— restructuring the education system to provide necessary skills in our society.

In other words, the South African government decided that in order to bring people into the first-economy world, with all its benefits, many players needed to be mobilised, including but not restricted to the State.

Appreciation of the dynamic interplay between the informal and formal institutions has been described in the recently published government document, *A Nation in the Making: A Discussion Document on Macro-Social Trends in South Africa*. According to this study:

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"The fact that some macro-social developments play themselves out irrespective of public policy does emphasise the need to understand both the capacities and limitations of the State. In part, this underlines the importance of partnerships across all sectors of society. But it can also reflect omissions on the part of public policy, or unintended consequences of a particular programme or a combination of programmes."

In 2005, the government took a further step to speed up the implementation of the strategies to meet the country's development challenges by initiating the Accelerated and Shared Growth Initiative for South Africa (AsgiSA), whose objectives include eliminating the second economy. This initiative emphasises the shared nature of the approach, and that growth of the economy is not, in itself, sufficient to address the country's unemployment problems. The government recognises that "without interventions directly addressed at reducing South Africa's historical inequalities, growth is unsustainable. Conversely, successful measures to reduce inequalities will add impetus to growth."

It should be emphasised that the AsgiSA initiative is not a new set of policies, but rather a co-ordinated and targeted approach to identifying key areas of growth and potential growth. It intends to leverage the mainstream economy resources to address the second-economy issues.

There are numerous examples of how informal institutions have been regularised and brought into the mainstream economy with positive results. For example, several informal institutions have been integrated into a regulative regime within the financial sector including community funeral schemes, money pooling, and informal saving and loan schemes.

One initiative is providing the poorest members of society access to financial services. Through the Financial Services Empowerment Charter (an agreement among business, civil society, labour and government), business has agreed to make financial services within reach of the previously "unbankable" sectors of the population. This undertaking is already delivering positive results as it offers opportunities for basic savings for individuals.

There are now opportunities for earning returns on investment for micro-investors and access to credit at realistic rates, for individuals who were once at the mercy of unscrupulous money lenders. There is room to do more in this sector, as the government realises that access to financial services

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is one necessary step to alleviating poverty. South Africa needs a comprehensive set of undertakings that ensures the economically marginalised population is brought into the mainstream.

Access to finance is important – even vital. Alongside this, we also need to consider the efficacy of fair and equitable tax regimes in developing economies, and the building of effective institutions that contribute to the broader development agenda of the country. This is, of course, a reciprocal process. Government alone cannot create effective institutions if the citizenry do not co-operate with government by contributing to revenue-generation by paying their taxes.

According to the *2006 World Development Report*:

> *"It follows that the same institutions that influence the quality and breadth of service delivery also affect the overall tax effort. Revenues, like spending, increase with a country's level of income, but the quality of institutions — notably voice and accountability — can strengthen the tax effort, as the services provided become a reflection of the desires of the broader electorate rather than a privileged few."*

We must recognise that the better the revenue collection (and thus the increase of resources available for public spending), the less countries will be reliant on foreign aid. However, for this to happen, there needs to be confidence in the governance structures and in democratic political processes.

In recognition of the huge potential that the collective energies of people can contribute towards the economic agenda of the post-apartheid era, the South African government has sought to regularise this informal sector and bring those people who are still in the second economy into the mainstream economy. This project has attempted to run parallel to the dismantling of the apartheid state machinery and legislation, to create the right conditions so that the informal sector can be brought from the margins to improve economic efficiency and support inclusion.

I have attempted here to give a South African perspective on the challenges that the country faces, many of which are shared with other developing countries. Various informal institutions have played a key role in creating the new South Africa. I have described two here, the *stokvels* or savings clubs and the taxi industry, which have become significant economic players.

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I would like to conclude with a reference to an argument by Karl Polanyi, an exponent of economic sociology. He argues that economic transactions cannot be understood outside of their social relations. Thus, key components of social relations that influence the dynamics of informal institutions range from relations of kinship to religion and gender. As economies evolve, these informal institutions underpinning social arrangements and constituting informal institutions reach a point at which they become part of the mainstream — i.e. they become regulated, part of the tax base and part of the democratic process.

Notes

1. This chapter is based on a speech given by Ms. van der Merwe during the international seminar on "Informal Institutions and Development: What Do We Know and What Can We Do?".

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Chapter 2

Informal Institutions and Development: How They Matter and What Makes Them Change

Indra de Soysa and Johannes Jütting

Summary

This chapter discusses two important questions: First, how and through which channels do informal institutions impact on development? Second, what makes informal institutions change? To address both questions, the authors develop a complex analytical framework that links informal institutions to development outcomes. Based on this framework, the authors look at determinants of institutional change and provide various examples. Finally, the chapter briefly outlines which players could initiate and promote institutional change.

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Informal Institutions: An Emerging Topic

When Mohammed Yunus won the Nobel Peace Prize (2006) in recognition of the success of the Grameen Bank, it drew public attention to a case in which informal and formal rules co-exist harmoniously to shape important development outcomes. Grameen's performance tells a story about how trust, solidarity and informal social pressure among the very poor could be combined successfully with formal banking regulations and procedures. Conversely, there are numerous examples in which formal and informal institutions work against each other, with less favourable outcomes. For example, current governance reforms in many developing countries that try to introduce new public management may, in fact, upset entrenched forms of informal power sharing — with the risk of threatening social stability.

This chapter maps out an analytical framework linking institutions (formal and informal) to development outcomes, and discusses main factors of institutional change. It aims at identifying major channels and transmission mechanisms to disentangle institutional outcomes from an institution itself as the same institution might have a different impact in another socioeconomic or political setting.

The notion that *institutions matter* for economic growth and development has been widely accepted. However, there is far less agreement as to what exactly constitutes a "good" or "bad" institution. It is furthermore uncertain how institutions differ from institutional outcomes and what determines institutional change. In addition, while the literature has addressed the role of formal institutions in depth, institutions outside formal rules have only recently begun attracting more attention (Helmke and Levitsky, 2004). Consensus is gradually emerging that formal institutions alone do not shape human behaviour, but that much of what goes on can be explained by informal institutions that are grounded in — and emanate from — a society's culture. This recent increase in attention for informal institutions has not yet been accompanied by systematic studies. Informal institutions are difficult to identify, measure and quantify. Moreover, they often relate to dimensions of a society's culture that economists and other social scientists prefer to avoid.

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Channels and Mechanisms

What are Institutions?

Institutions are generally defined as the "rules of the game", or "humanly-devised constraints that shape human interaction" (North, 1990). Since human beings live in an uncertain world, they devise institutions to control their environment so as to bring about some certainty and to minimise transaction costs — i.e. those cost that arise while doing business, from finding a partner/clients to enforcing contracts. The rules of the game can be either formally or informally determined. Formal institutions are normally understood as rules encapsulated in formal structures such as constitutions, political institutions, formal legal and property rights systems. Formal institutions are enforced by official entities (courts, judges, police officers, bureaucrats, etc.). By contrast, informal institutions are largely self-enforcing through mechanisms of obligation, such as in patron-client relationships or clan networks, or simply because following the rules is in the best interests of individuals who may find themselves in a situation in which everyone is better off through co-operation (Box 2.1). While informal institutions are generally not codified, they are widely accepted as legitimate and are, therefore, rules in use rather than just rules on the books, or what Ostrom terms "rules in force" (Ostrom, 2005).

Box 2.1. **Informal Institutions and Their Enforcement**

Informal institutions are:

— socially sanctioned norms of behaviour (attitudes, customs, taboos, conventions and traditions);

— extensions, elaborations and modifications of formal rules outside the official framework.

Enforcement characteristics are:

— self-enforcement mechanisms of obligation, expectations of reciprocity, internalised norm adherence (standard operating procedures), gossip, shunning, ostracism, boycotting, shaming, threats and the use of violence.

Source: Authors.

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According to North (1990), institutions include any form of constraint that human beings devise to shape human interaction. These constraints include both what individuals are prohibited from doing and the conditions under which individuals are permitted to undertake certain activities. In other words, they are the "incentive framework" for human action. In fact, some scholars view rules as tools that allow individuals to solve problems of collective action. "Institutions are among the tools that fallible humans use to change incentives to enable fallible humans to overcome social dilemmas" (Ostrom, 2005). Thus, understanding how institutions shape outcomes is particularly useful for policy makers.

How Do Institutions Affect Economic Development?

Institutions facilitate economic development in two broad ways: reducing transaction costs and ensuring competitive processes (Islam, 2001). In the first instance, development is promoted by the expansion of economic activity (markets). If the costs of transacting are high, then economic activity is constrained. Institutions smooth the path of transactions, minimising the costs of doing business. As Greif (2006) has shown, Genovese traders were able to expand successfully their economic activity because their individualist ethos permitted them to build institutions that facilitated the expansion of anonymous transactions. By contrast, Muslim traders were constrained by a closed, communal ethos that relied on inter-communal, face-to-face dealings based on collectivistic modes of sanctioning. This demonstrates how culturally determined norms and attitudes, and the rules of the game they prescribe, determine the nature of economic activity.

In the second instance, institutions that advance competitive processes drive development by ensuring efficiency. Since institutions determine the incentive structure for individual and group behaviour, the rules governing the market affect how competitive that market will be. The degree to which industries are regulated, the enforcement of tax laws and the degree of rent-seeking are shaped by the nature of formal and informal institutions — and their interplay. Most countries, for example, have laws governing bribery and corruption. Yet norms and attitudes about what corruption is and how one deals with it determine the extent to which formal rules on corruption will be effective. Giving expensive gifts to government officials in China in the course of transacting is a norm that would fit very uncomfortably in

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most Western, developed states, in which free and fair competition requires impartial conduct. The system of *Amakudari* in Japan, through which high-level public servants retire as top corporate executives is another example that would not be well viewed by Western countries. Yet even in Western democracies, lobbying and other forms of rent-seeking exist to different degrees among informal channels.

An Analytical Framework

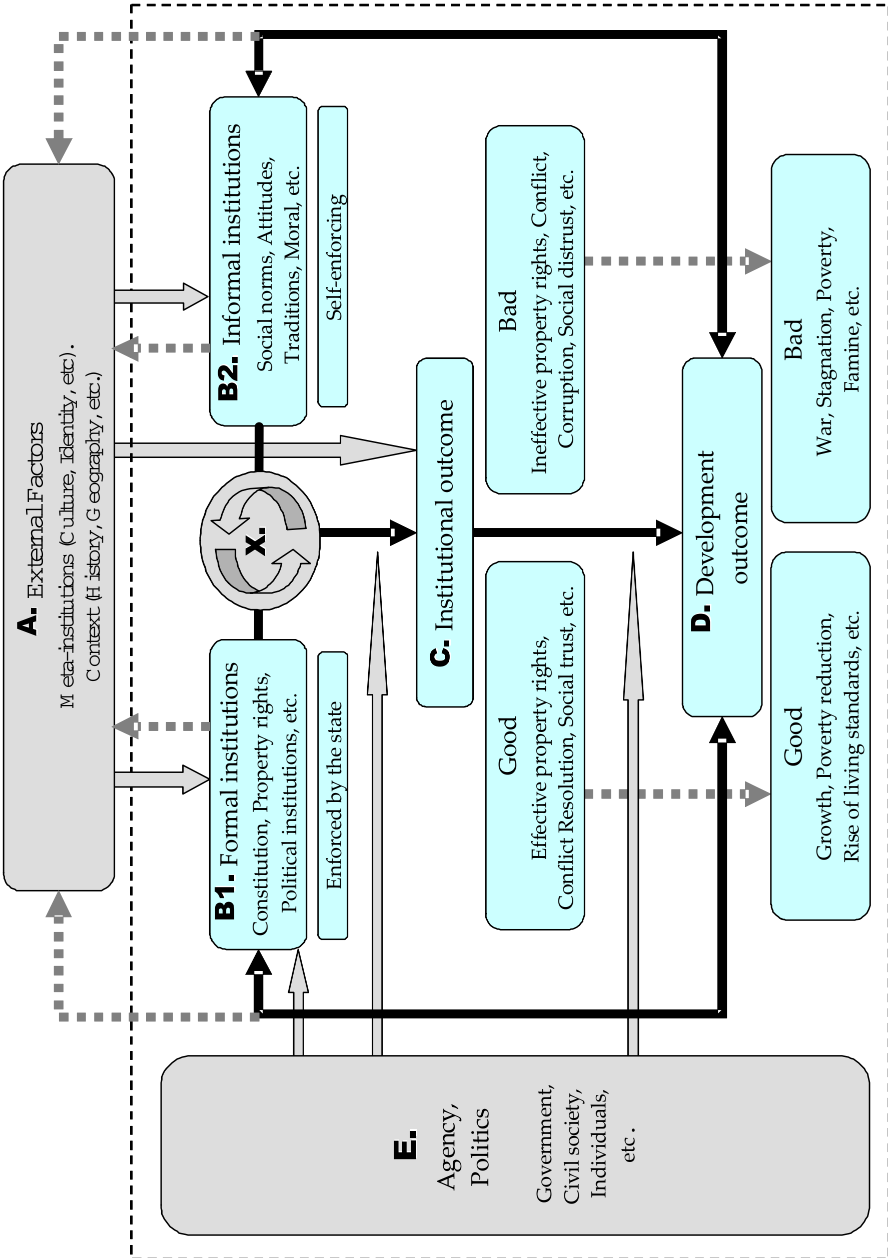
Figure 2.1 illustrates how institutions affect development outcomes. According to this analytical framework, development outcomes (D) cannot be attributed to a single institution but rather depend on several factors: external factors (meta-institutions and context) (A); formal (B1) and informal institutions (B2) and their interaction (X); and the action by political players, other powerful groups or individuals which is labelled agency (E). These linkages are explored in the following paragraphs.

External Factors: Meta-Institutions and Context (A)

The impact of institutions on development outcomes is influenced by several external factors. In particular, meta-institutions need to be distinguished from contextual variables. Meta-institutions such as identity and culture change very slowly. Obviously, they have an impact on all institutions, both formal and informal. Contextual variables, such as history and geography, also help shape social norms that affect human behaviour. For example, some scholars see formal institutions as shaped by civic traditions that have their roots in a society's history (Putnam, 1993).

Indeed, it is impossible to address issues of norms, attitudes and values in the context of institutions without addressing issues of culture and history. Ostrom (2005) and others conceptually separate rules that govern a particular collective endeavour from norms and attitudes thought to emanate from deep, historically determined cultural forces. Rules can be devised by individuals to solve social dilemmas, such as governing common property resources, or fighting neighbourhood crime. Similarly, norms do not necessarily emanate from deep historical sources but could be thought of as shared expectation about behaviour (Helmke and Levitsky, 2004). In contrast to history and culture, norms can change rather rapidly, as witnessed by the end of duelling practices or lighting up a cigarette at a dinner party without asking others whether they minde.

Figure 2.1. **A Framework for Analysing Institutions and Development**



Source: Authors

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Thus, while it is obvious that meta-institutions and context variables are an important element to be included, they are treated as exogenous (in box A above) and outside of the general framework of reference (depicted by the dotted quadrant).

Interaction between Formal and Informal Institutions (X)

Figure 2.1 illustrates that it is not just formal and informal institutions themselves, but also their interaction that matters (Cell X). According to Helmke and Levitsky (2004), informal institutions can be thought to interact with formal institutions in four ways: complementary, accommodating, competing and substitutive.

As to the first, informal institutions are *complementary* to (effectively enforced) formal institutions when both types of rules contain similar incentives and enforcement characteristics. Suppose that a state decides to adopt stronger anti-corruption laws. The content of the specific laws may matter very little if, in fact, pre-existing norms already form informal checks and balances on public officials. In this scenario, knowing what is important to the public about anti-corruption law requires that one understands how the norms and law interact to produce a more beneficial outcome. Both might reinforce the checks on corruption, or the formal laws (due to some quirk) may hinder the informal checks in place. Yet again, the formal law may evolve to be an even better check than previously existed, since the informal norm might have evolved only as a second-best solution.

Second, informal institutions may *accommodate* (effectively enforced) formal institutions when both types of institutions diverge. Informal institutions, in this case, do not violate the letter of the law but violate its spirit. In other words, they co-exist with the formal institution and aim for an outcome that is not entirely intended by the formal rules. The hiring practices of many universities are a good example of accommodating institutions. Even though there are formal search committees that interview a selection of candidates, in practice departments tend to hire each others' students. The letter of the law is followed; committees are set up, they meet, they review applicants, etc. But the spirit of the law is violated because the committee has already agreed informally on the outcome. In fact, the outcome of such informal selection processes might even be more efficient as hiring committees run the risk of being hamstrung by veto players, delaying the process and perhaps souring good relations within departments. Formal committees might also spend time and money debating candidates, which does not necessarily ensure the highest quality of the candidate selected. Thus, even if the informal institution may be identified as violating the letter of the law, it might be more efficient in terms of time and resources spent.

Third, informal institutions *compete* with formal ones when formal institutions are ineffective and the two diverge. This is true if formal law is poorly enforced or simply ignored by authorities. The literature on legal pluralism shows how people resort to multiple sources of justice where competing laws and norms operate at various levels, particularly in cases in which inherited legal systems following colonial rule operate side by side with customary law. This situation exists because states do not feel the need to enforce the laws (they ignore them) or they do not have the capacity for effective enforcement (costs are too high). Thus, not accounting for state capacity to enforce formal institutions in any analysis of any relevant outcome potentially yields highly biased views. Here again, the criteria used to judge the outcomes are crucial. While many laws protecting women and human rights in poor countries may exist in the books, customary laws contravene these rights in practice.

Finally, informal institutions can *substitute* for the lack of effectiveness of formal institutions. Like complementary institutions, these informal institutions are designed to achieve what formal institutions aim to do, but are ineffective or ignored by official sources. Informal credit markets and insurance schemes might very well be thought of as substitutes for formalised market or state agencies that usually provide such services. Informal neighbourhood associations that gather to prevent crime or collect garbage off streets may be substituting for a city government's function. Since many of these voluntary associations pose little threat to formal institutions, they are usually encouraged by state authorities. However, such voluntary groups may also form vigilante groups, such as the Minutemen in the United States who have taken upon themselves the task of policing the US-Mexican border.

Institutions and Institutional Outcomes (C)

The framework presented in Figure 1 is built on the idea that one should differentiate between an "institution" and an "institutional outcome". Formal institutions — such as constitutions, legal systems, property rights systems and regime types — influence institutional outcomes (Persson and Tabellini, 2003; Barro, 2000; Clague, 1997). Political scientists find that some formal

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institutions generate predictable outcomes. For example, a two-party system is more likely under plurality electoral rules, whereas proportional electoral systems generate multi-party systems. The implications of these rules are important for understanding why some small parties, such as the Greens in Germany, are able to influence politics relatively well compared to small parties in the United Kingdom and the United States. Formal rules, thus, generate some institutional outcomes that are more accountable and representative compared to others (Powell, 2000; Przeworski *et al.*, 1999; Lijphart, 1984).

However, formal rules do not generate the same institutional outcome in all situations to similar degrees. As Rodrik *et al.* (2002) conclude on the question of formal institutions and development, "desirable institutional arrangements have a large element of context specificity, arising from differences in historical trajectories, geography and political economy or other initial conditions…". In the figure, context variables are placed in box A and the arrow depicts their impact on institutional outcomes.

As the framework shows, a given institution can lead to an institutional outcome that may be conducive or harmful for development. Take the example of property rights: a desirable institutional outcome conducive for development is "effective" property rights that are enforced and accepted by the population. This does not mean, though, that property rights have to be formal to become effective. On the contrary, ample evidence of land titling programmes show that formally legalised property rights are often not accepted by the local population. Reforms sometimes rather led to an ineffective system in which both formal and informal rules operate side by side, causing "bad" development outcomes such as over-use or an under-utilisation of resources.

The Role of Agency (E)

Agency is involved in various stages in the processes described. First of all, political action helps determine the exact design of formal institutions through shaping legislation, etc. Politics can also be involved in shaping informal institutions, perhaps to a somewhat lesser extent. For example, a certain social group may benefit from a specific social norm, and will, thus, try to maintain or manipulate this norm. Formal politics as represented by government action could also influence informal institutions. For example, formal legislation to ban corruption could be unsuccessful if there was a large group of people in the public arena benefiting from rent-seeking behaviour and have no interest in an effective change.

Development Outcomes (D)

Do high-quality institutions lead to better economic and investment climates, expand trade, encourage technological development, foster better governance and accountability, encourage trust, reinforce property rights, ensure competition and avoid the exclusion of sections of the population from the fruits of development? Most likely, yes, though the difficult questions are to determine what are “good” or “high quality" institutions and can they at all be identified? The presented framework shows the complexity and difficulty in linking a specific institution – formal or informal — to desirable development outcomes. There are various context-specific factors that matter. From this, it follows that blueprints and guidelines for institutional reform have to be taken very cautiously as they have to be adapted to the local context.

Where Do Informal Institutions Come from and What Makes Them Change?

Two broad approaches can be identified to understand the origin of institutions and their impact – the *calculus* approach and the *cultural* approach (Hall and Taylor, 1998). The calculus approach, from which the New Institutional Economics gathers much of its inspiration, views institutions as “purposive” devices that reflect preferences and expectations of actors. Institutions are consciously devised by individuals to reduce transaction costs and increase efficiency. Informal rule-making by groups of individuals is part of everyday life. However, while some rules can be changed relatively easily, others change more slowly — even if they are inefficient. The persistence of inefficient institutions depends on power structures, political economy and the distributional aspects of institutions (Lal, 1999; Stiglitz, 2001; Ensminger, 1992; Knight, 1992). If institutions work badly, those ill-served by the rules may have high costs to change institutions; or a narrowly established group with power benefits from maintaining existing rules (Ostrom, 2005). In many developing countries, in which state elites have enormous access to resources and power, informal institutions may consequently persist because the elites draw an advantage from preserving the *status quo*.

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The cultural approach sees institutions as far less purposive or rationally devised. Social relations are not simply "atomistic" and rational individuals are engaged in behaviour within the constraints of functional (or dysfunctional) rules. Some ways of doing things might be thought of as the "natural state" of things. Thus, women can come to believe that girls are inferior to boys, etc. (Douglas, 1986). The cultural view is that people engage in satisfying behaviour within social milieus made up of networks of association (Granovetter, 1985).

When it comes to changing informal institutions, one has to acknowledge that this is a tedious process that involves changing power relations and overcoming path dependency. Patron-client relations that exist in many developing countries are a telling example. In many situations, the clients vote for political platforms and proposals inimical to their long-term interests, largely because they obtain more immediate benefits from the patrons, whose wishes they follow. Thus, knowing the exact nature of the short-term benefits of the individuals who are part of these clientelistic arrangements is a first step to altering the way in which politics might reflect better outcomes for the poor. Wealth, access to careers and secure employment are three reasons feudal social relations dissipate, as ordinary people become less beholden to powerful elites.

The case of genital mutilation among societies in many parts of North and Sub-Saharan Africa (Sudan, Egypt, Kenya, etc.) provides another example. Genital mutilation is carried out to discourage sexual activity by females because it makes sexual intercourse uncomfortable. *Yao* girls in Malawi, however, are encouraged to have sex and are initiated into the practice as young girls. Why would adults (men and women) encourage two different norms? Can one factor explain both outcomes? Apparently, the mechanism that explains the difference is that men, in matrilineal and matrilocal societies, are confident that their offspring will be brought up and supported by the mother's village and households. In patrilineal societies, men are concerned that they will have to support children they themselves have not fathered (Horne, 2001). Thus, men in patrilineal society strongly prefer the norms of curtailing sexual activity of women. If, in fact, this explanation is true, changing this norm from outside is bound to be difficult and slow. A starting point might be to pay attention to educating men in patrilineal societies, particularly regarding child-rearing practices. Social insurance schemes and public action targeting children may also help.

Not all change of informal institutions is as difficult to initiate as in the previous examples. At very micro levels, informal institutions (or simple informal rule-making) occurs all the time among individuals who organise collectively for mutually beneficial activities (Ostrom, 2005; Fine, 2001). For example, a groups of women with little access to formal credit markets may come together to create a micro-credit association governed by a set of rules that prescribe the terms of lending and borrowing, and how those rules will be enforced. The women may devise the rules, but they may also imitate others for whom these rules have worked well for this specific purpose. Imitation and borrowing best practices has been a feature that explains the development of human beings from time immemorial (Soltan *et al.*, 1998).

Changing Informal Institutions: By Whom?

Governments can have a major impact on informal institutions based on the capacity and willingness of a government to enforce its will. States, in most cases, set the larger rules of the game. Norms that need changing can be affected by governments by outlawing a particular pattern of behaviour (e.g. smoking in public spaces). Governments have the ability to reach mass audiences through campaigns and by deciding the educational content of school books, for example. Governments can furthermore induce particular types of behaviour by offering tax breaks and subsidies for particular types of behavioural changes, such as recycling practices for garbage disposal, conservation issues, or civil activism for providing collective goods.

But there are also strong limitations to the role that a government can play in changing informal institutions. The crucial question concerns a government's legitimacy when it tries to change customs, religious practices, and traditions, all of which form an important part of the private sphere of citizens. One could argue that a democratically elected government has a legitimate mandate to change informal institutions. Even in OECD countries, however, some religious minorities such as Jehovah's Witnesses still contest laws that are not in agreement with their beliefs. Democratic procedures can positively influence the chances of success for a reform of informal institutions — yet it is not a cure-all. Discrimination against women, for example, still exists in many poor countries with democratic structures because

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governments' influence on family life remains limited or does not exist. This is particularly true in rural areas that are less accessible for formal state mechanisms.

Civil society groups have been instrumental in changing particular types of behaviour, which are now part of agreed social norms. Activists across borders, such as Amnesty International, were central to spreading and advancing the norms of human rights, not to mention various environmental groups, such as Greenpeace, that campaigned to change norms in order to end the nuclear arms race (Keck and Sikkink, 1998). Thus, civil society can have a crucial impact on existing norms. The promotion of gender equality in Western countries is another good example in which lobby and pressure groups have played an important role in overcoming long-established traditions.

Key personalities can also change behaviour. Historical examples of authoritative leaders who brought about substantive changes in behaviour and traditions include Kemal Ataturk in Turkey (in the 1920s after a war and a revolution) and Habib Bourguiba (in Tunisia in the 1950s and 1960s after the country's struggle for independence). Many non-governmental organisations have used celebrities to champion their causes. For example, the anti land-mine campaign (which was actively supported by the late Princess Diana) clearly led to regularised ways in which governments approach land-mine use and challenged the very norm of national defence policy making.

Conclusions

People in both rich and poor countries rely on informal institutions to varying degrees to facilitate transactions. However, informal institutions are much more important in poor countries and small, traditional communities in which formal institutions are less developed and the reach of formal law and state power is relatively weak. This chapter argues that the same informal institution might lead to different institutional and development outcomes, depending on context. Besides having a direct impact, informal institutions interact with formal ones in various ways that can lead to converging or diverging development outcomes. Hence, searching for the Holy Grail of *good* institutions is likely to be misleading.

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In Focus

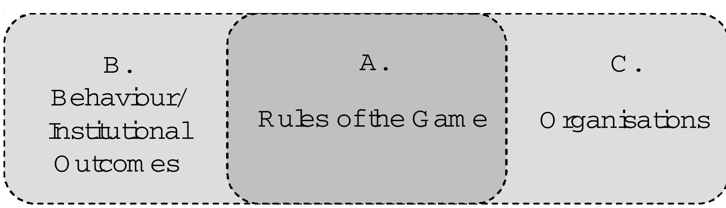
Defining (Informal) Institutions

Jante Parlevliet

In the literature and in the policy debates, no commonly accepted definition of the term “institution” can be identified. This is not surprising as institutions constitute a topic of research in very different disciplines such as economics, sociology, political science, and anthropology — all with their own sub-disciplines and schools of thought. Thus, institution means different things to different people.

As mentioned in the introductory chapter, this book does not follow one particular definition of institution; it lets the authors decide which view to follow. In a very stylised and simplified way, three broad concepts of institutions are reflected in the chapters of this volume, as Figure 1 illustrates.

Figure 1. **Different Concepts of Institutions**



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Institutions as Rules (A)

The most rigorous and narrow understanding of institutions, followed by some authors, is inspired by the work of Douglass North who defines institutions as "humanly devised constraints that structure political, economic and social interaction"; in short "the rules of the game". These rules can be *formal*, as encapsulated in constitutions, laws and legally recognised property rights; or they can be *informal*, as rules that can be found in taboos, customs, traditions and social norms. In this book, a narrow understanding of institutions as "rules of the game" is particularly followed by de Soysa and Jütting, who also distinguish institutions from institutional outcomes (e.g. behavioural practices) and organisations (i.e. the actors of the game).

Institutions as Rules and Behavioural Practices (A+B)

For some contributors, concrete institutions encompass the rules of the game and behavioural practices. For example, in his chapter on governance, Boesen refers to illicit rent-seeking and nepotism as informal governance institutions. Similarly, in their contribution on institutions and private sector development, Nicholas and Maitland consider corruption, rent-seeking and black market activity as informal institutions.

Institutions as Rules and Organisations (A+C)

In every day language, institutions are often equated with organisations. For example, a university might be called an institution of higher education or the OECD an institution dealing with economic policy issues. In fact, some economists, such as Oliver Williamson, claim that firms and other organisations are institutions themselves. This overlap between institutions and organisation is sometimes also apparent in this book. Both van der Merwe and Sen mention organisations for saving and lending services as examples of institutions. In the same vein, van der Merwe refers to the informal mini-bus industry in South Africa as an institution. At first sight, it might seem difficult to fit such understanding of institutions with the notion of institutions as mere "rules of the game". At the same time, organisations can clearly be seen as an expression of these rules. Again, it remains to be debated to what extent and in what instances it is useful to distinguish between the two.

Part II

Informal Institutions in Three Key Areas of Development:

Gender Equality, Governance, and Private Sector Development

Chapter 3

Informal Institutions and Gender Equality

Gita Sen

Summary

Informal institutions are particularly relevant in the context of gender equality. This chapter presents a comprehensive framework that distinguishes several different types of interaction between formal and informal institutions, which either favour or oppose gender equality. It also discusses the troubling evidence that sometimes women support informal norms that seem to work against them. Decision makers need to be aware of the specific institutional set-up and adapt their policies to be effective. Engaging women's organisations and other local initiatives is crucial to enhance gender equality, but there is also room for government and donor initiatives. In order to gradually replace hierarchical patterns that oppose gender equality, aid agencies can help change norms and attitudes by designing appropriate formal institutions.

Introduction

Ever since the work of Boserup (1970) over three decades ago, research and policy evidence has accumulated showing that both informal and formal institutions may sometimes be supportive of, but can often be inimical to, gender equality. Research has detailed the varieties of women-unfriendly norms, practices and customs in different communities and societies (Behar and Gordon, 1995; Bell *et al.*, 1993; Leonardo, 1991; Etienne and Leacock, 1980; Reiter, 1975; Rosaldo and Lamphere, 1974). While there is considerable variation across different regions, such norms and practices cover a range that includes: unequal access to and control over property, economic assets and inheritance; strongly defined gender-based divisions of labour within and outside the home; unequal participation in political institutions from village to international levels; unequal restrictions on physical mobility, reproduction and sexuality; sanctioned violation of women's and girls' bodily integrity; and accepted codes of social conduct that condone and even reward violence against women.

It is important to note that these norms and resulting practices reflect underlying gendered relations of power, and that is fundamentally what makes them difficult to alter[1]. Gendered informal institutions cover the entire gamut of human interaction, from the most private sphere of sexuality to the public arenas of economic and political life. Consequently, they form a web of beliefs and practices comprising different strands that mutually reinforce each other. Cutting through these strands to replace them with norms that are more conducive to gender equality can be time-consuming and often frustrating. Policy change is more than a matter of rational choice and good information/education/communication, as changes may be opposed by power holders in subtle and creative ways.

As the power of informal gender institutions has come to be recognised, society has also become more aware that gender blindness or gender discrimination in policy aims — and in the creation of formal economic, political, legal and social institutions — can lead to gender inequalities and serious inequities in policy outcomes. Such outcomes are usually, but not exclusively, detrimental to the well-being and human rights of women and girls (Agarwal, 1994; Bruce and Dwyer, 1988; Buvinic *et al.*, 1983; Elson, 1991; Jahan, 1995; Tinker, 1990; Kabeer, 1994; Moser, 1993; Sen, Germain and Chen, 1994; Sen and Grown, 1987).

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Gender *blindness* refers to non-recognition of the ways in which control over productive assets, division of labour, decision making and physical mobility (among other factors) are biased against women. For example, requiring formal land titles as a precondition for obtaining agricultural credit or technological support can be gender-blind. It can effectively shut women out if (as happens all too often) they do not possess land titles regardless of how much farm work they may do. Other examples are policies that attempt to increase secondary-school enrolment in areas where parents are reluctant to send girls long distances to school once they have reached menarche, or health programmes that expect significant unpaid labour from women carers at home without recognising the competing demands on their time or the burden of over-work from which they already suffer.

Gender *discrimination* refers to formal institutions that actively discriminate against women, e.g. differential minimum wages for women and men, or requiring the permission/signature of a father or husband before a woman (even if she is a legal adult) can apply for a loan for a development programme, pursue education, or access a range of public services including health services (especially contraception or abortion).

The possibility that formal institutions may be gender-blind or gender-discriminatory means that, from the standpoint of gender equality, the interactions between formal and informal institutions may be more complex than is usually assumed by modernisation theories. Not all formal institutions are beneficial and not all informal ones are harmful[2]. Furthermore, in addition to the types of examples given above, formal institutional support through gender-sensitive laws and changes in civil and criminal codes, and organisational mechanisms for their implementation (such as governmental machinery, public campaigns and leadership for gender equality) may be weak or ineffective even when they exist on paper.

Although the broader literature on informal institutions in development recognises that they can be both constraining and supportive, when it comes to gender equality, policy makers (and sometimes researchers) tend to view them largely as constraints. This is especially true for those norms that are associated with longstanding cultural and social traditions[3]. This chapter presents a different view, while affirming the universality of women's human rights and rejecting a culturally relativist position. Acknowledging that informal institutions (like formal ones) can have both positive and negative elements when viewed from the standpoint of gender equality and women's rights will be instrumental in a better understanding of how women attempt to adapt informal institutions to their needs whenever possible.

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Such understanding could be valuable for two reasons. First, because women often have greater presence in spaces in which informal institutions abound, they may be able to use and even shape some informal institutions to meet those needs. This can mean that women may ,themselves, have a stake in the continuance of certain institutions and therefore be unwilling to give them up. There may also be trade-offs that women have to make between institutions that meet different kinds of needs, which may translate into trade-offs between informal versus formal institutions. If women themselves are to become agents of change towards greater gender equality, recognising costs and benefits and the stakes they may have in retaining or changing the *status quo* is essential. Second, for policy makers and programme implementers, a more variegated understanding of the relationships between informal institutions and gender equality may provide firmer analytical underpinnings. Such an analysis could help in developing nuanced and more effective approaches to social change and its sequencing — what can be done easily, what can be done early, what will have to be tackled more slowly and carefully, and what prerequisites will have to be met in which cases.

Formal and Informal Institutions and their Interactions

Informal institutions are defined here as social norms that represent evolved practices with stable rules of behaviour that are outside the formal system. Acceptable behaviour may be governed through a set of known sanctions or through powerful processes of internalisation without recourse to sanctions. When considering norms that apply to gender, such processes of internalisation may be as strong as actual sanctions, and can serve to recruit women themselves into norms of gender inequality, as discussed in the next section[4].

Formal institutions, on the other hand, are those in which norms, rules and sanctions are guaranteed through formal processes that are usually (but not always) official. Formal institutions are written and enforceable (possibly through legal recourse or arbitration). They can be associated, therefore, with organisations of the state, market or civil society. They include economic and political institutions, legal systems, and cultural and social institutions with formal rules and procedures. As stated earlier, the growth of gender sensitivity in formal institutions in many developing countries has been slow and uneven. The role of women in nationalist movements has brought them the vote in many countries. However, many of the other political, economic

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and social institutions of the post-colonial state have remained gender-blind, if not actively discriminating against women, as even official reviews report (UNIFEM, 2000; UNIFEM, 2003; UNRISD, 2005; World Bank, 2001). Universal norms of citizenship, accountability, equality of opportunity and equality of access may not be recognised, and the practices of formal institutions are often significantly wanting.

Legal redress for this situation has also been partial and far from adequate to change the environment within which both formal and informal institutions exist and interact. Since norms evolve through the actual practices of the members of organisations, formal institutions have to favour gender equality before they can hope to influence informal institutions effectively. Policy makers charged with the responsibility for ushering informal institutions towards greater gender equality are hardly likely to approach the task in effective ways if the formal institutions that shape their own behaviour are not gender-sensitive.

In such a context, the relationships between formal and informal institutions in different situations present a very mixed picture. Helmke and Levitsky (2004) distinguish among situations in which formal institutional support for gender equality is strong, weak or does not exist. This provides a framework for classifying informal institutions in terms of their relationship to formal institutions, and sets out a range of examples taken from economics, politics, human development and civil codes (Table 3.1). In relation to formal institutions, informal institutions may be *complementary, accommodating, substitutive, competing* or *dominant*.

Table 3.1. **Interactions between Formal Institutions (FIs) and Informal Institutions (IIs) in Gender Equality**

	FIs favouring gender equality do not exist	FIs favouring gender equality exist Weak FIs	 Strong FIs
IIs oppose gender equality	1. Dominant e.g. Female Genital Mutilation, treatment of widows, unsafe abortion	2. Competing e.g. dowry demands, unequal educational access for girls vs. boys	3. Accommodating e.g. HIV peer education programmes, gendered division of labour
IIs favour gender equality	4. Dominant e.g. tontines or chit funds	5. Substitutive e.g. tontines, women's co-operatives, women's courts	6. Complementary e.g. pregnancy ceremonies and maternal health

Note: The examples given in this table do not inherently belong in a particular cell; the entries in particular cells represent actual cases from specific contexts.
Source: Author.

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When Informal Institutions Oppose Gender Equality

Informal institutions oppose gender equality (Cells 1, 2 and 3 along the upper row of Table 3.1) according to whether formal institutions exist at all, and if they do, whether they are weak or strong.

Dominant (Negative) Institutions — Cell 1:

When formal institutions favouring gender equality have not even been created, informal institutions will be dominant, whether or not they favour gender equality. Many such informal institutions strongly oppose gender equality (Cell 1) and cover a range of practices that control women's physical mobility and autonomy, and limit their rights to bodily integrity (especially in matters related to sexuality and reproduction), as well as inheritance and property rights, and rigid divisions of labour by sex. They can include practices such as female genital mutilation (FGM), violence against women (often by close family members), restrictions over women's reproductive and sexual rights, abusive treatment of widows, and honour killings. They may also include limits to women's property ownership, customary and unequal inheritance, and greater work burdens for girls and women.

In many countries, such informal institutions are still dominant. Very little has been done to legislate against them. In fact, the formal system may, due to political exigencies and the power of forces opposed to gender equality, even reinforce them. An example of the latter was the passing by President Zia ul Haq in Pakistan of the *Hudood* ordinance in 1979. This rule requires four adult male eye-witnesses for a woman to bring a charge of rape, and if she fails to bring these witnesses, she risks punishment for adultery by stoning or lashing (Internet Source 1). Another is the recent action by the Senate in Nicaragua to ban all abortion, including in cases of rape or when the mother's life is in danger (Internet Source 2). Action for gender equality in such cases requires changing laws, rules and procedures so that the formal norms can change. This may need considerable preparatory work and, even so, it will not be sufficient to bring about substantive change unless there is effective enforcement.

Competing Institutions — Cell 2:

When formal institutions exist but are weakly enforced, informal institutions that oppose gender equality compete with them for influence. Examples include: norms of civil codes around marriage; the abolition of

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dowry; child marriage; sex selection biased against females; access to education, nutrition, or health care; and unequal wage rates. In many (though not all) developing countries, formal institutions exist in many of these areas in the form of laws banning bigamy, early marriage, dowry and discrimination in schools, health facilities, nutrition centres or labour markets. Yet, poor formulation or ineffective implementation of laws, lack of leadership or incentives to ensure that the formal institutions actually begin to take hold, sustain informal norms and even make them stronger. An example is the anti-dowry Act in India, which has never been effectively enforced; in the meantime, the phenomenon of dowry has been expanding even into communities in which it did not exist previously (Oldenburg, 2002).

Another example is the 73rd Amendment to the Indian Constitution, which reserves one-third of the seats in *panchayats* (village councils) for women (Box 3.1). However, this process has been subverted where the Act has been weakly enforced. From the beginning, cases were documented in which husbands or other male kin blatantly substituted for elected women in the functioning of some of the councils. Elected women have also been forced, in some instances, to resign and make way for the appointment of male representatives. More recently, stories have begun to emerge about creative forms of subversion in which the entire village plays a role. In the Madurai district of the state of Tamilnadu, control over the office of the *panchayat* president is auctioned off to the highest bidder, usually a wealthy, higher caste man. The money goes to the village council, and the elected woman president is expected from then on to do the bidding of the winner. The village as a whole sanctions the entire process, which is justified on the grounds of "efficiency". The winning bidder will "help" the elected president, who may be ignorant of procedures and may not have links to key officials and politicians, and the village council gains by way of funds! Even worse are reports from the state of Gujarat where the state government has been giving monetary incentives to villages that agreed to single candidates for the president's seat, thereby doing away with elections altogether. This is justified on grounds of saving funds, which can be used for village development. Non-governmental organisations argue that it is a political ploy by the governing Hindu fundamentalist party to ensure that its candidates capture a large number of the local seats. Apparently this was already done in the 2001 elections (INTERNET SOURCE 3).

Box 3.1. **India's 73rd Constitutional Amendment: Quotas for Women**

The 73rd Amendment to the Indian Constitution reserves one-third of village council seats for women. Where this has been weakly implemented, the intent of the process has been subverted. However, where it has been strongly implemented, and where civil society engagement has been active, this measure has been rightly lauded as one of the strongest reform measures to change the pre-existing norm whereby women were not expected to exercise political power, and, therefore, had very little representation in political bodies. Women's organisations have been training elected women to play their roles more effectively. Over 1 million elected women representatives have been learning to run village councils, exercise authority over budgets and set priorities.

Source: Vyasulu and Vyasulu, 1999.

Accommodating Informal Institutions — Cell 3:

Informal institutions that oppose gender equality may be forced to accommodate formal institutions when the latter are strong. One example is the success of peer-education programmes, as well as empowerment and sensitisation programmes in dealing with adolescent sexuality in the context of HIV/Aids. Many such programmes are part of new formal institutions that challenge the traditional beliefs and practices around sexuality and norms of femininity and masculinity. An example is the Girls' Power Initiative (GPI) in Calabar, Nigeria that equips adolescent girls with human rights, sexuality and reproductive health information, thereby empowering them for leadership, healthy sexuality and social justice (Internet Source 4). Using an innovative approach, GPI draws on parents and teachers in its programmes, ensuring that their fears and concerns are openly addressed. The informal norms around adolescent sexuality, femininity and masculinity are changing. But equally important, informal norms around parent-child and teacher-student communication (that typically excluded explicit discussion about sexuality) have been forced to accommodate the presence of a strong programme.

Violence against women is central to the peer-education programme of ProFamilia, a non-governmental organisation in the Dominican Republic. Challenging traditional attitudes that violence and submission to it are natural attributes of masculinity and femininity, respectively, the organisation has

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brought the issue to the heart of a major public debate. It has thereby forced latent anti-women attitudes into the open, promoted legal change and strengthened support services for women victims (Goldberg, 2006).

A different example is a project to reduce the burden of fuel collection in Mali, jointly supported by the United Nations Industrial Development Organization (UNIDO) and the International Fund for Agricultural Development (IFAD). The project specifically empowers women by involving them in the design and management of multifunctional energy platforms using diesel engines that can meet not only women's energy needs but also benefit men. Traditional norms, which usually give control over such projects to village men, have been challenged and forced to conform to the realities of the project that give voice and power to women.

Another example concerns the practice of early marriage in the Indian state of Karnataka. Formal legal requirements had been introduced stating that a girl's marriage cannot be arranged before she is at least 18 years old (Personal Communication, 2006a). However, as the traditional practice of early marriage was still dominant, parents were concerned that their daughters would become too old to be acceptable in marriage if they waited until the legal age. Parents came up with the idea of creating their own marriage bureau through which all their children could find partners among each other. Thus the informal institution of early marriage was made to accommodate the formal norm, without doing away with the practice of arranging marriages.

When Informal Institutions Favour Gender Equality

Dominant (Positive) Institutions — Cell 4:

While many informal institutions may be harmful, not all are. In the absence of formal support, women have to make do with their own resources, but these resources are often pooled to help each other to tide over risk and uncertainty, as well as unanticipated crises. The best examples are institutions for mutual lending in the absence of formal credit institutions, which can increase women's access to and control over economic resources. Less well-known are other informal pooling mechanisms among women that involve sharing of labour resources, mutual help with care of children and the sick and elderly, and mutual help with essential activities such as water and fuel collection[5]. Such support is usually cemented through informal ties of reciprocity and mutual obligations.

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Substitutive Informal Institutions — Cell 5:

There are also positive examples of informal institutions that substitute for weak formal institutions in economic and legal areas. *Tontines* operate on the basis of well-known informal norms to ensure access to credit and savings for women who are excluded by gender-blind or biased formal credit norms. A different example is the case of women in the state of Gujarat, India who, when they found themselves treated as second-class citizens by the textile trade unions, formed their own co-operative, the Self Employed Women's Association (SEWA). Started in 1972, SEWA is a membership organisation for women who work in the informal sector, and currently has close to 1 million members. It provides collective bargaining services, health care, child care, banking, insurance and training to its members. It is arguable that, at this point, with its clearly specified rules and large membership, SEWA's methods of functioning and the rules by which it operates are no longer informal. However, the organisation has had a major impact in gaining recognition for women's informal work, their need for child care, the possibility of lending to poor women, and providing them with health and life insurance (Internet Source 5).

Yet another example is the *nari adalats* or women's courts in different states in India. When they found that they could not get justice from the male-dominated village *panchayats* (councils), village women created these courts — with their own rules, procedures for investigation and evidence in order to provide justice to women — in cases of domestic violence, land disputes, dowry, rape and murder. These have become a respected and powerful way by which poor rural women are able to obtain recourse to justice that was otherwise out of their reach (Internet Source 6).

Complementary Informal Institutions — Cell 6:

While finding examples for this scenario is not easy, they do exist. A recent example is the use of a traditional norm by a gender and health equity programme to improve maternal health in the state of Karnataka in India (Personal Communication, 2006b). The traditional norm requires that a special social ceremony be performed for pregnant women at the start of the third trimester. Generally viewed as a positive cultural practice, it neatly complements formal maternal health programmes that attempt to raise families' and the communities' concern for the health of pregnant women. In the programme, the traditional ceremony, usually viewed as a women's ceremony,

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has been modified so that men are included and take part in honouring their pregnant wives. This has become a way by which men publicly acknowledge their responsibility for the health of the pregnant woman.

Strong formal institutions are those in which norms are well formulated and clearly specified. They are backed up by effective organisational mechanisms for implementation, strong leadership and a favourable structure of incentives to support behavioural change. Real change may also require creative public and media campaigns, and space for women's advocates to play a role.

Women's own informal economic and mutual support institutions — and their creativity in developing new institutions — generate situations in which informal institutions can complement or substitute for formal ones. Policies towards informal institutions must clearly take this variability into account and devise methods that will build on the best, while challenging the harmful. But, in this process, an important prior question that must be answered is why women themselves support informal institutions.

Women's Attitudes to Informal Institutions

It is easy enough to understand why women may be strongly supportive of informal institutions that actually meet some of their needs, especially when formal institutions fail to do so, or do so weakly. But why do women support informal norms that appear to work against them? Women sometimes do so even when such institutions limit their mobility, reduce their health and life expectancy, stigmatise and violate them, and subordinate them within power relations. Several reasons have been identified:

— Women may simply give in if they have no choice because sanctions are too strong; submission may buy peace or even survival. This may be especially true in areas involving physical mobility, sexuality or reproduction.

— Women may themselves reproduce informal institutions because this gives them status despite being painful or dangerous. Danger and even degradation may be in the eyes of the beholder. This has been discovered to be true for female genital mutilation as women's beliefs are around cleanliness and purity rather than mutilation and disfigurement.

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— Women may tolerate loss of control and agency because they trade this off against economic support, especially if their fallback position is weak (Sen, 1990).

— Women submit to negative norms because it assures their integration into social networks that may be crucial to their own survival and that of their children.

— Some informal institutions, such as segregation during menstruation or post-partum, may actually give them much needed rest, although to outside observers they may appear to be stigmatising.

— Women may themselves internalise and believe in the norms that relegate them to secondary and subordinate status; especially if su ch norms hold a promise of improvement in status with age.

— Women may support negative norms as an expression of defiance against the larger society or in solidarity with the community, as in the case of women wearing veils (e.g. *hijab* or *niqab*) in Europe today.

This range of reasons why women themselves may support negative informal institutions emphasises the need for caution in designing policies to bring about change. Nuanced policies that acknowledge and work around these reasons are more likely to be effective.

Toward More Effective Policies

Different types of policies to support gender equality may be needed, depending on the particular context. If informal institutions are inimical to gender equality, strong formal institutions will be needed to counter them. If formal institutions do not exist, they have to be created; if they exist but are weak, they need to be strengthened. Where informal institutions are not inimical to gender equality, a set of complementary processes should be considered. In all cases, women's own perceptions and needs should be kept in focus; it is important that outsiders not intrude into women's lives without checking what women themselves want and why.

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Creating Alternative Formal Institutions[6]

When informal institutions are harmful to gender equality and women's human rights, the first requirement is to create alternative norms through laws, along with international and regional agreements. This may be easier said than done, especially if there is powerful, organised opposition to gender equality.

Through a combination of rising labour market participation, the contraceptive technology revolution and growing democratisation, coupled with advocacy by women's organisations, strong global norms to protect and promote women's rights have been created in recent decades. The UN conferences of the 1990s (in particular the Vienna conference on human rights, the Cairo conference on population and development, and the Beijing conference on women) led to the recognition of women's human rights. In some key instances (such as violence against women), these conferences went beyond the articles of the Convention on the Elimination of All Forms of Discrimination Against Women (Antrobus and Sen, 2006).

At the same time, a backlash against these advances has also emerged in the form of powerful alliances at global and national levels (Sen, 2005). The strongest and most committed forces countering such a backlash are women's movements alone or in alliance with others (Sen, 2006). However, the challenges they face include having to negotiate complex trade-offs when making alliances. Those countries in the North that support most vociferously women's human rights (in the sense of personal freedoms) at the international level do not equally support women's economic and social rights. Nevertheless, advances can be made, provided women's movements have the strength and capacity to do so, and are supported by their governments.

What can policy makers do in such complex situations, characterised by cultural and religious beliefs, and multiple actors, and compounded by difficult economic and political circumstances? The cardinal rule is that there must be local groups of advocates who can play a strong role. In many situations, women's organisations or human rights groups can do so. Others, especially external actors and agencies, can only follow their lead by providing support (financial, technological and moral). Usually, reform will take a long period of preparation, especially if there is an organised conservative opposition that can use the threat of reform as a way to mobilise atavistic fears on cultural, religious or masculinist grounds. Capacity building among government officials, judges and parliamentarians can be valuable for the day when change can be realised.

In each of the successful examples in Boxes 3.2 and 3.3, there was virulent opposition to the change in the norms. Women's organisations and their allies had to prepare the ground over many years; even then, the results were not certain and there were many setbacks. In each case, the government had to step in on the side of reforms, either through a powerful leader or through action by a superior court. The motivation of leaders may be ambivalent, but this may be inevitable since a politician will always have to consider the political benefits and costs of any action. What is critical, given such contexts, is the tenacity of women's organisations and their ability to build alliances. The policy lesson in such cases is to create the space for women's organisations to play this role, and to support them to be able to function effectively. Sensitisation and training of government personnel (including judges and politicians) can also be essential.

Box 3.2. **Change in Pakistan's Hudood Ordinance**

According to the Human Rights Commission of Pakistan, a rape is committed every two hours and a gang rape every eight hours in the country. The promulgation of the Hudood Ordinance in 1979 has to be seen in this context, and is generally recognised as a political ploy by former President Zia ul Haq to win the favour of the fast-growing conservative political parties.

The small but articulate women's movement, together with the human rights movement in Pakistan, has been struggling for change in a political situation made increasingly complicated by the wars in Afghanistan and Iraq. Their efforts have recently borne fruit with the passing, by the National Assembly and the Upper House, of the 2006 Protection of Women Bill, which transfers the jurisdiction over rape cases from sharia to civil courts. It also makes it easier for a woman to prove a rape allegation without being charged for adultery.

Although consideration of the Bill had to be postponed earlier because of Islamist opposition, spearheaded by the Muttahida Majlis-e-Amal (MMA), it is now expected that President Musharraf will sign it into law. It is not clear how far the government is genuinely committed to reform, and how much it is bending to American pressure to reduce the role of Islam in government. However, the government itself sees this as only a beginning and there is hope for women's groups that demand full repeal of the Hudood laws. The story is far from over with a number of clerics denouncing the new Bill as "un-Islamic, immoral and unconstitutional".

Source: Internet Source 1.

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Box 3.3. **Female Genital Mutilation (FGM) in Egypt**

According to the 1995 Egyptian Demographic and Health Survey, 97 per cent of married Egyptian women had been circumcised and 82 per cent supported the practice. How to make even an inadequate law work effectively in the face of such a pervasive social norm? Anti-FGM activists have attempted to mobilise as many allies as possible and have received support from different quarters.

> In 2005, *"in a symbolic attack on the widespread practice of female genital mutilation (FGM) in Egypt, religious leaders and gender activists … signed a public declaration calling for an end to FGM, in the hamlet of Abou Shawareb, near Aswan in southern Egypt…UNDP was a sponsor of the signing ceremony…*
>
> *The anti-FGM declaration was part of a programme called 'The FGM Free Village Model.' The campaign was established in 2003 by the National Council for Childhood and Motherhood (NCCM), UNDP and various other donors. The purpose was to counteract community and cultural pressures that led to FGM and to eliminate the practice in 60 villages within the six governorates of Assuit, Aswan, Beni Suef, Minya, Quena and Sohag in Upper Egypt.*
>
> *After two years, the project's use of various education and training approaches reaching out to families, health workers and religious leaders, has made inroads. According to UNDP, the community of Abou Shawareb was able to overcome cultural pressure and convince families not to circumcise their girls and symbolically declare themselves an FGM-free village…*
>
> *Since the mid 1990s, the government has actively campaigned to end the practice of FGM with information and education campaigns and the incorporation of the topic into school curricula. In 2003, the Egyptian First Lady, Suzanne Mubarak, threw her weight behind the issue by launching the 'Egyptian Girl' campaign, which sought to end all forms of violence and abuse, including FGM, aimed at young girls. On a larger scale, the FGM free village model project has established a mechanism to coordinate a national movement against the practice under the umbrella of the NCCM and to incorporate hundreds of Egyptian volunteers working to end FGM."*

Source: Internet Sources 7 and 8.

Making Existing Formal Institutions More Effective[7]

While creating alternative formal norms may be the necessary first step, this may not be sufficient in a number of circumstances. Many of the cases cited in the discussion of Cell 2 of Table 3.1 belong to this category. Formal norms exist but they are either poorly framed or badly implemented. Indeed, in many contexts, passing formal laws may be easier than ensuring that they are implemented effectively. In democratic environments, political parties and public actors sometimes need to take progressive positions on gender equality and women's rights for historical/political reasons, but they may do so without real commitment or the participation of civil society organisations. At other times, the formal passing of laws is a way for the government to appear to be doing something without taking any real action. India has a number of examples of such laws favouring women and gender equality. The first gap is usually one of poor formulation of the law itself, such that it becomes difficult to implement in a meaningful way, as illustrated in Box 3.4.

In addition to poor formulation, there can also be other reasons for poor implementation. Kabeer and Subrahmanian (1999) argue that:

> *"…a particular source of failure results from the ways in which policies are often perceived, both in the communities in which they are implemented as well as by those responsible for designing and implementing them…(A) major source of 'misbehaviour' …is linked to the gender dynamics within the implementing agency itself… There are (similar) examples…of implementation failure from the experience of international agencies as well…(F)ailure to carry out the realignment between goals, on the one hand, and rules and practices, on the other, considerably slowed down the ability of these organisations to implement their commitment to integrating gender concerns into their activities….However, even where appropriate rules and adequate resources are in place, this will not necessarily guarantee the success of gender-related policy. What is critical is also the beliefs and values of the people responsible for implementation."*

Any organisation can be peopled by what Lotherington *et al.* (1991) call "innovators, loyal bureaucrats, hesitators and hardliners". The direction of implementation may well depend on the numbers and strengths of each group. Resistance to gender-equal policies may take the form of trivialisation, dilution, subversion or outright resistance. An important counter to this can be strong monitoring indicators that include women's own assessment of the impact on their well-being. This can help foster better understanding by outsiders of how women themselves view the process of change, and

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Box 3.4. **Domestic Violence Bill in India**

An example of poor formulation of a formal norm was the early draft in 2002 of India's Domestic Violence Bill, which left many loopholes — including lack of recourse for a woman who may be thrown out onto the streets by a violent husband if she dares to challenge him using the law. As a result of strong lobbying by women's groups, and effective re-drafting by feminist lawyers, the draft was changed: a considerably improved Act has recently come into force as the Protection of Women from Domestic Violence Act 2005. Both physical and verbal abuse can lead to charges, and the rules also ban husbands from harassing their wives for larger dowry payments. The Act uses a broad definition of violence to include beating, slapping, punching, forced sex, insults or name-calling. Preventing wives from taking up a job or forcing them to leave are also covered.

The Act allows abused women to complain directly to judges instead of to police, who usually side with men and rarely act on complaints. Now, when a woman files a complaint, the onus is on the man to prove that he did not abuse his wife. The law also ensures the woman's right to stay in the family home, regardless of whether or not she has any title in the household. The Act covers not only wives and live-in partners, but sisters, mothers, mothers-in-law or any other female relation living with a violent man. As such, it is one of the most progressive pieces of legislation on this subject to date.

Source: Internet Source 9.

allow women to become agents of that process. In doing so, women can begin to shape the speed and direction of change. Well-crafted, gender-aware indicators can fulfil multiple functions, as "a *signal* to all actors involved in the intervention, as *constant reminder* during the life of the intervention, as *measure of performance* in the achievement of gender-aware goals and objectives, and as a *tool* for analysing shortfalls" (Kabeer and Subrahmanian, 1999).

The resistance identified above means that the task of awareness-raising needs to focus as much (if not more) on policy implementers and male power holders as on women. At least one view of the resistance to reform on FGM in Egypt argues that — contrary to a popular perception that women are the ones who perpetrate, value and sanction the practice — greater attention should be paid to the role of men[8].

Complementary or Substitutive Informal Institutions[9]

As discussed earlier, informal institutions sometimes favour women even though formal institutions do not yet foster gender equality. In particular, this possibility is relevant when norms that hinder women still exist, but competing norms arise that are more in favour of gender equality — often through the conscious action of civil society groups. If successful, these new norms can then be supported by formal institutions.

At least two important cases can be identified in which discriminative norms have been challenged and new norms have become increasingly institutionalised. The most well-known of these is the micro-credit revolution that arose from the work of organisations such as the Grameen Bank in Bangladesh. These efforts challenged the existing norms that held women as unworthy of credit and embraced the idea of group-guaranteed credit to create new norms. The other example is less well-known but led to the formulation of an ILO Convention, as discussed in Box 3.5.

The examples given above suggests that giving policy support to the formalisation of norms that enhance gender equality that originate in the non-governmental organisation sector[10]. But this can be a slow and uncertain process. Might it be appropriate to support substitutive informal institutions in situations in which formal institutions for gender equality are unlikely to develop in the short or even medium term? This raises additional questions. *Might support for substitutive informal institutions delay or even prevent the development of formal ones? Will such policies let the state and policy makers off the hook? What risks might this entail? Could such accommodation result in enshrining informal norms and practices that have only limited potential for gender equality? Where should the line be drawn?* These questions are still open and need to be debated more intensively.

Conclusions

Many of the examples here illustrate how policy actions can be taken. The broad lines include challenging negative informal institutions by creating alternative formal norms, and making their implementation effective, as well as supporting the transformation of positive informal institutions into formal ones. The core requirements for policy effectiveness remain the same as in other situations: change the public discourse, support through incentives

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and sanctions, appropriate funding, institutional placement and enforcement of accountability. Without these, no policy action can be effective. At the same time, caution must be exercised in remembering that gender norms are very closely woven into women's own lives and their needs. Thus, the response of women must be central in whatever actions are taken.

Box 3.5. **ILO Convention 177 on Home (Based) Work**

The Convention obliges

"...any ratifying member State to 'adopt, implement and periodically review a national policy on home work aimed at improving the situation of homeworkers.' The policy is to be developed in consultation with employers and worker organizations and other organizations concerned with homeworkers. The national policy on home work shall seek to 'promote equality of treatment between homeworkers and other wage earners' in such areas as the right to organize, protection against discrimination, remuneration, occupational safety and health, social security and maternity protection, and training.

However, home work is an activity that largely escapes administrative control. The ranks of the low-paid and frequently clandestine force of homeworkers are growing in developing and industrialized countries alike. Women account for the vast majority of homeworkers (as much as 95 per cent) and child labour is often associated with home work. The ILO Convention also calls on governments to include homeworkers in labour statistics and labour inspection systems. An ILO Convention, once ratified by a member State, creates a binding international obligation.

The provisions in the proposed Recommendation call for equal treatment and registration of homeworkers. Collection of data on homeworkers and employers of homeworkers, are mainly intended to provide a basis for the national policy on home work. Finally, member States are called upon to promote and support programmes, which provide direct assistance to homeworkers. A whole range of such programmes are enumerated and they cover a wide range of means to improve the social and economic situation of homeworkers."

Sadly, the Convention, which came into force in 2000, has only been ratified by five countries to date — Albania, Argentina, Finland, Ireland and the Netherlands. This is in many ways a classic case in which governments have not followed up on their promises.

Source: Internet Source 10.

Notes

1. An illustration for this point is the ease with which male dress codes change in most societies, while codes for proper female attire continue to be enforced, and can be fought over bitterly. The former are simply a form of social behaviour; the latter include sanctions that serve to define dress codes as an informal institution. For further discussion of the distinction between informal institutions and informal behavioural regularities, see Helmke and Levitsky (2004).
2. For instance, informal credit institutions such as *chit-funds* and *tontines* serve women well in that they give women access to group savings and credit that are often out of their reach in the formal sector.
3. This has not always been so. The history of colonial rule in different countries provides evidence that those in power supported or opposed gendered traditions and customs depending on what suited their own economic or political interests (Oldenburg, 2002).
4. The definition here differs in this respect from Helmke and Levitsky's (2004) definition: "…socially shared rules, usually unwritten, that are created, communicated, and **enforced** [author's emphasis] outside of officially sanctioned channels."
5. This insight has been obtained from field activists in various development programmes over the years.
6. This discussion applies especially to the kind of situations in Cell 1 of Table 3.1.
7. This discussion applies to the situations in Cells 2 and 3 of Table 3.1.
8. The Egyptian FGM Task Force conducted a set of interviews to explore "male involvement, knowledge and attitudes towards the practice" of female genital mutilation. "Investigating men's understandings of

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masculinity, feminity, sexuality, marriage, and human relationships revealed profound miscommunication between men and women…Men possess limited knowledge about FGM but hold strong opinions about whether or not their social dependents (sister, wife, or daughter) should be circumcised. *Men are the principal decision-makers in the question of whether or not to circumcise their children* [author's emphasis]; most respondents favoured circumcision… men's main reason for supporting circumcision was that it would diminish women's overwhelming sexual desire which threatens male status." WIN News, 2001.

9. This addresses the issues relevant to Cells 4 and 5 in Table 3.1.

10. Although the definition of formal norms earlier had indicated that formality has to do with formal rules and procedures rather than the locus of the organisation (state, market or civil society), it is nonetheless true that there exist degrees of formalisation. Ultimately, recognition by the nation state or official international bodies provides the final stamp for formalisation.

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In FOCUS

The OECD Gender, Institutions and Development Data Base

Denis Drechsler

Informal institutions are particularly relevant in the context of gender equality. In many countries existing norms, traditions and cultural practices prevent women from fully participating in social and economic life. Policies to improve gender equality need to take into consideration the importance of social institutions through coherent, culturally sensitive and inclusive strategies.

The GID Data Base — A Quality Resource for Better Policies

Against this background, the OECD Gender, Institutions and Development Data Base (GID-DB) is a new tool for researchers and policy makers to determine and analyse obstacles to women's social and economic development (accessible at www.oecd.org/dev/gender). It provides 60 indicators on gender discrimination in 161 countries, compiled from various sources. In a systematic and coherent fashion, it brings together the current empirical evidence on the socio-economic status of women.

The true innovation of the data base is the inclusion of institutional variables that range from intra-household behaviour to social norms. Information on cultural and traditional practices that affect women's economic development is coded so as to measure the level of discrimination. Such a comprehensive overview of gender-related variables, along with the data base's specific focus on social institutions make the GID-DB a unique tool for a wide range of analytical queries and for case-by-case adaptation to specific research or policy questions.

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What Distinguishes the GID-DB from Existing Compilations?

Discrimination against women has multiple facets. It is becoming increasingly evident that social institutions comprising informal laws, customs and traditions are an important factor determining the extent to which women can participate in social and economic life. Accordingly, the GID-DB introduces a set of innovative indicators that can be grouped into four categories:

— *Family code,* including information on marriage customs and decision-making power within a household.

— *Physical integrity,* capturing the prevalence of female genital mutilation, the phenomenon of "missing women" (e.g. as a result of sex-selective abortions) and other types of violence against women.

— *Civil liberties,* measuring the extent to which women can participate in social life (e.g. by moving freely in public without being obliged to wear a veil or be escorted by male relatives).

— *Ownership rights,* indicating the quality of women's most basic economic right – to hold property, either in the form of bank loans, land or other material assets.

Application and Use of the GID-DB

Preliminary analyses using the GID-DB clearly indicate the relevance of social institutions to understand the economic role of women. Specifically, higher values of discriminatory social institutions seem to be associated with lower rates of women's participation in the labour market.

Discriminatory social institutions have a direct impact on women's economic development. A low level of ownership rights stalls entrepreneurial behaviour. Discriminatory social institutions also exert an indirect influence by affecting women's access to resources; violence against women, for example, damages health and, thus, women's chances in the labour market. Indeed, these negative relationships are more pronounced than the positive correlation between a country's level of income and women's participation in the economy.

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Looking Ahead

The Gender, Institutions and Development Data Base makes an important contribution to the gender debate, in particular because it encompasses institutional obstacles to women's economic development. Initial econometric analyses suggest that the quantitative significance of institutional factors overrides more commonly used variables such as income per capita. This finding supports the view that an improvement of the economic role of women will not necessarily follow an increase in the level of income. Rather, policy measures – such as the recent reforms to the family code in Morocco – need to be implemented that directly address institutional bottlenecks. The GID-DB helps to identify policies that address the roots, rather than the symptoms, of gender discrimination.

Further Reading

JÜTTING, J., Ch. MORRISSON, J. DAYTON-JOHNSON and D. DRECHSLER (2006), *Measuring Gender (In)Equality*. OECD Development Centre Working Paper, Paris.

Discussion Report

Gender Equality

Laila Abdallah

Lead Questions

— What kind of informal institutions prevent progress towards gender equality?

— What are appropriate policies or approaches for dealing with gender discriminating institutions? (Country examples of successes and failures)

— Which actors are well placed to initiate and support changes? (Country examples of success and failures)

Composition of the Panel

The working group on gender was chaired by Sebastian Bartsch, OECD Development Co-operation Directorate. Based on the background paper of this session, the introductory remarks were given by Gita Sen, Indian Institute of Management (India). Additional views were provided by Neema Mgana, African Regional Youth Initiative (Tanzania) and Denis Drechsler, OECD Development Centre.

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Introductory Presentation

Gita Sen shared experiences from her scientific and practical work with formal and informal institutions in India, especially in the field of gender and health. She highlighted several points related to the issue of informal institutions and gender equality.

First, Sen emphasised the difficulty of examining both informal and formal institutions without a vantage point. According to Sen, there is always a "we" embedded in all institutions, which underpins existing power relations. Second, development practice and practitioners are not immune to informal institutions and have their own interpretations. Finally, gender equality can mean various things; it sometimes also refers to gender equity or women's human rights. It is, therefore, crucial to use a clear terminology.

Sen also highlighted the difference between *gender discrimination* and *gender blindness*. Gender discrimination refers to institutions that actively discriminate against women; for example, rights that can only be obtained through a man's permission. Gender blindness is the non-recognition of the ways in which power relations are biased against women.

Formal institutions need to be clearly distinguished from informal institutions. Formal institutions comprise all norms, rules and sanctions that can be enforced through formal processes, and are generally associated with organisations of the state, the market or civil society. Informal institutions refer to all social norms and common practices that have stable rules of behaviours and are outside any formal system. Both formal and informal institutions can oppose or favour gender equality. When informal institutions oppose gender equality and play a dominant (negative) role (e.g. due to the absence of formal institutions), laws and procedures need to be adapted to improve gender equality. However, formal institutions are sometimes weakly enforced and compete with informal institutions that oppose gender equality. Poorly formulated laws, ineffective implementation and lack of leadership or incentives to ensure that formal institutions are effectively implemented can be the cause of this.

The asymmetry between the formal and the informal is less prevalent in the case of what Sen calls *accommodating* informal institutions. In such cases, informal institutions are forced to comply with formal institutions if the latter are strong enough. However, Sen explained why the transformation from informal to formal institutions is not necessarily beneficial. It can even worsen a situation if the enforced formal institution is gender blind in relation to local conditions.

In other situations, informal institutions can play a dominant role and promote gender equality. Reciprocal ties and mutual obligations, in particular, are examples of positive informal institutions that can replace a weak formal institutional framework. *Tontines* in India, for example, offer credit programmes for women who are otherwise excluded due to gender-blind formal institutions. In general, such substitutive informal institutions struggle to be integrated into a formal system.

Finally, there are rare cases in which informal institutions complement formal institutions in support of gender equality. Social ceremonies for pregnant women in the Indian state of Karnataka, for example, have promoted maternal health programmes and strengthened the responsibility of men for the health of their wives.

Sen described the varying relationships between formal and informal institutions that depend on the existence and relative strength of formal institutions. Strong formal institutions are those in which norms are clearly formulated and backed up through effective organisational mechanisms that ensure successful implementation. Above all, however, the relative strength of formal institutions depends on whether informal institutions complement or oppose them. It is, consequently, of great importance that policies be nuanced so they take these variations into account. Sen stressed three policy directions in particular:

— *Create alternative formal institutions when informal institutions are harmful to gender equality and women's human rights*. This requires political initiatives and support. Sen pointed out that women's organisations at the local level are the most suitable actors for this work. However, they could encounter problems of backlash and should, therefore, be accompanied by capacity building among officials (governmental representatives, judges and parliamentarians). Media could also give incentives to improve gender equality.

— *Make existing formal institutions more effective.* Important gaps preventing gender equality include poorly formulated legislative texts and gender bias on the side of the implementers. Sen explained that the resistance to gender-friendly policies manifests itself by trivialisation, dilution, subversion or outright resistance to issues of gender equality. She suggested the use of well-designed monitoring indicators as signals, constant reminders or measures of performance.

— *Support complementary or substitutive informal institutions.* Many examples already show the feasibility and potential merits of such initiatives, including the Grameen Bank micro-credit schemes and International Labour Organisation

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Convention 177 of home-based work. However, experience also illustrates some risks related to this strategy. On the one hand, formal institutions might distort or completely eliminate the gender sensitivity of informal institutions. On the other hand, support for substitutive informal institutions might delay or even prevent the development of formal ones, letting the state and policy makers off the hook. What is more, by focusing on informal institutions, the norms and practices they entail might become enshrined, despite the fact that they only have limited potential to improve gender equality.

Sen emphasised the importance of local engagement of women and women's organisations to avoid policies that act like a "bull in the gender china shop". She nevertheless highlighted the need for capacity building in gender equality among those administrators who implement development policies.

Sen's presentation stimulated a lively discussion. Questions that were raised include: How can quick wins to improve gender equality be realised without losing sight of the long-term objectives? How clear is the division between formal and informal institutions, considering their close interdependence? Can harmful informal institutions, such as female genital mutilation, simply be replaced by formal institutions? How can the perpetual power struggle between supporters and opponents of gender equality be replaced with a win-win situation?

Informal Institutions in Rural Tanzania

Neema Mgana presented experiences from the agricultural sector in Tanzania. As women in rural Tanzania are generally not able to obtain bank loans, they created an organisation that provides saving and lending services to their members. In Sen's methodology, this organisation thus describes the application of a substitutive informal institution.

Women often have to balance reproductive and productive activities. Recent studies indicate that reducing women's time constraints from reproductive activities can increase significantly overall household income. Further research is needed to understand the potential impact of informal institutions on development outcomes, especially the link between formal and informal institutions. By not providing financial services to women, policy makers in Tanzania have not responded to the needs of women and society in general. This gender blindness clearly illustrates the importance of engaging and empowering women in the process of policy development. Mgana presented four strategies to better link formal and informal institutions:

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— work with women's groups at household and community levels to better identify and measure the impact of informal institutions;

— provide women's groups with tools to develop local approaches to linking informal and formal institutions;

— conduct social capital and time use studies to generate gender-disaggregated data; and

— monitor and evaluate policy implementation on reducing gender inequality.

Social Institutions and Gender Equality

Denis Drechsler presented the Gender, Institutions and Development Data Base (GID-DB), a new tool for researchers and policy makers to measure and analyse gender equality around the world (see "In Focus" box). With its comprehensive set of 60 indicators for 161 economies, the GID-DB can be used to compare the status of women across countries, to construct indicators of gender equality and to analyse obstacles to women's social and economic development.

The data base focuses, in particular, on social (mostly informal) institutions that are key to understanding gender discrimination. Building new schools for girls will not be effective, Drechsler explained, if families do not allow their daughters to leave the house or continue to arrange their marriages at a young age. In addition to aspects of family law, the GID-DB features information on informal institutions concerning the physical integrity of women, their civil liberties and their ownership rights.

Results indicate that informal institutions are the least discriminatory towards women in OECD countries. However, disaggregating the findings according to income groups reveals that even in high-income countries, inequalities in social institutions can be pervasive. Drechsler underlined the importance of addressing social institutions in order to improve gender equality as a key for development, and of approaching regions differently according to local specificities. While OECD countries need to focus on balancing women's careers and family life, developing countries need to tackle social obstacles that prevent women from fully participating in economic activities.

Participants of this session agreed that compiling information on informal institutions is a welcome new approach that fills a gap in the gender debate. However, the variables presented in such a data base need to be carefully selected

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so as to avoid bias from exogenous factors. Drechsler explained that the future work programme of the GID-DB will include a revision of indicators to improve data quality and selection.

General Discussion

Several interventions explored the definition of gender equality in development assistance, especially considering the diversity of discrimination against women through formal and informal institutions. Sen's discussion of formal and informal institutions that address gender equality (and the interactive linkages between them) revealed some cultural and social factors that should be considered in development policy work. Mgana gave an illustrative example of an informal institution that is beneficial to rural women in Tanzania. Nevertheless, she called for further research and development strategies to improve the transformation of such informal institutions into formal institutions. Finally, Drechsler suggested a methodological framework to measure gender (in)equality in both formal and informal institutions.

Engaging women's organisations and other local initiatives was seen as crucial to enhancing gender equality through development assistance. In the context of the Paris Declaration on Aid Effectiveness, participants recognised the importance of building capacity among those actors who can promote gender equality in development work (e.g. judges, members of parliament and governmental officials). Education and public debate raise awareness and can open discussion on the underlying power relations that currently block gender equality.

Participants suggested a number of strategies to integrate gender equality into policy making, including: creating awareness through capacity building in order to understand who "we" are in development work; making policy work more effective by strengthening or replacing informal institutions through supportive, complementary or alternative formal institutions; and improving measures of gender equality in development assistance.

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Chapter 4

Governance and Accountability: How Do the Formal and Informal Interplay and Change?

Nils Boesen

Summary

This chapter describes the interplay between formal and informal institutions, making a distinction between rule-based and relation-based governance systems. Different forms of interaction are highlighted, ranging from complementary to competitive. A pragmatic approach to dealing with informal institutions is called for: hastily introducing formal mechanisms might sometimes even do more harm than good. Policy makers, thus, need to carefully select which institutions to change and which ones to keep. Realistic policy objectives for transforming (negative) informal institutions need to respect the existing power balance in order to gain maximum support of different political actors.

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The Rules of the Game: How are they Managed, and Does it Matter?

In most Central Asian republics, political life is dominated by informal, clan-based networks that undermine the formal legal and electoral framework (Collins, 2002). In South-East Asian countries, informal, personal relations between big business and government have been instrumental for growth (Hamilton-Hart, 2002). By contrast, the same kind of relations have stifled growth in Sub-Saharan Africa (Walle, 2001). In Tanzania, creating a formal association of business tax-payers forced district tax authorities to greater formal accountability in what had hitherto been an informal system (Lerise, 1999).

So, it matters whether governance, accountability and institutions are more or less formal. This chapter moves the discussion beyond this observation and addresses three issues in the following sections:

— How do formal and informal aspects of governance interplay in the development process, and how do they relate to the wider rules of the game in a society?

— How does governance change, and how can partners and donors harness informal governance structures and institutions for capacity development that delivers pro-growth and pro-poor regulations and services?

— Which preliminary policy lessons can be drawn on to illustrate how partners and donors can improve governance and accountability in settings in which informal institutions and informal governance mechanisms are strong?

Institutions are, in this chapter, defined as "the rules of the game in a society or, more formally ... the humanly devised constraints that shape human interaction" (North, 1990). They are resilient social structures within an institution (Scott, 2001) of which some are informal. This means that they are rules based on implicit understandings and not accessible through written document or necessarily sanctioned through formal position (Zenger et al., 2001).

Governance refers broadly to how the formal and informal rules are managed and enforced or how power and authority are exercised (Scott, 2001; Hyden, 2004). Governance can be formal and/or informal – indeed,

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governance mechanisms are themselves institutions. *Accountability* is an element of governance, denoting how those who govern account for their actions to those with power or authority[1].

Discussing formal and informal governance across levels of society and over time is a risky endeavour. Sweeping generalisations may easily be based on inconclusive evidence. This review has not found basis for such generalisations, except one: nothing seems to indicate that there is any "right mix" or "proper way" to deal with the balance between formal and informal governance mechanisms. However, by understanding the formal and informal governance interplay and how it is shaped by structures, norms, interests and power, partners and donors can promote long-term capacity development for pro-poor outcomes.

How Do Informal and Formal Governance Relate?

The Long Journey from Informal towards Formal Governance

It is worth recalling that governance – which is, in this chapter, used as a purely descriptive term for how authority and power is exercised – was originally informal. During history, governance has been gradually codified into formal rules, from the first written laws of King Hammurabi some 3 700 years ago, to the tight web of laws, rules and regulations directing behaviour in today's OECD countries, in relation to the political, economic and civil society.

Arguably, history could be viewed as a process of ever-increasing formalisation of the informal rules and governance mechanisms, made necessary by the growing complexity of specialisation and division of labour (Jütting, 2003). From this viewpoint, formalisation of rules and governance would be expected to accompany economic growth and diversification.

However, while the perception that laws underpin development is very old,[2] formalisation of many governance aspects have appeared much later than industrialisation and urbanisation. Male suffrage was only adopted at the beginning of the 20th century and universal suffrage only after the Second World War. Modern bureaucracy only arose early in the 19th century, with central banking and patent laws following in the 1830-40s (Grindle, 2004).

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Industrialisation may seem to have been driven as much by informal personal relations as by formal rules. The informal relations were often closely linked to patronage, corruption and the strong connection between big business and political power. In the United States in the late 19th century, a few powerful individuals controlled virtually all major industries, and had close relation to banking and politics. Bribery was part of the game: one railroad baron boasted that "if he wanted state legislation, he could buy it and if necessary he could buy Congress and the judiciary as well" (Li et al., 2004). This was not unique to the land of opportunities: around the same time, the leading industrialist in Denmark also used bribes, falsified accounts, established monopolies and influenced politics and legislation. Still, few, if any, would doubt his positive significance for the country (Lange, 2006).

Informal relations seem based on deep-rooted institutions that do not succumb easily or automatically to the functional demands of the economy. Singapore's record of sound government rests on informal governing institutions as well as attributes of the formal government sector (Hamilton-Hart, 2000). In South Korea, it has been convincingly argued that a century-old system of informal patron-client relations — rather than formal rules — was behind the country's push for high growth (Srivastava, 2004).

Summing up, these examples suggest that elements of informal and relation-based governance can be important parts of successful development trajectories. However, a closer look at the difference between formal and informal governance is warranted.

Trust in People or Trust in Rules: The Difference between Rule-based and Relation-based Governance

Informal governance can be rule-based: that is, based on informal — but nevertheless effective — rules for how authority can and cannot be exercised. However, an important subset of informal governance mechanisms is based on trust in persons, rather than on formal contracts. This is an essential feature of what has been labelled *relation-based governance*, which, by its very nature, is informal. In economic society, it compares to formal rules-based governance as shown in Table 4.1 (Li et al., 2003):

When relation-based governance dominates, there is no strong formal state authority effectively regulating the market, enforcing contracts and ensuring property rights. The state may, by the very absence of a strong capacity to regulate, have a high degree of autonomy from economic and

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civil society. The non-state actors have not developed effective broader, formalised governance mechanisms that can discipline the state and make it accountable — as, for example, elections or enforceable charges of unconstitutionality. Governance will instead take place mainly by personal relations. Politics, both at national and sub-national level, will be dominated by bargaining of power and interests organised along patron-client systems in clans, ethnic groups, extended families, etc. This can be congruent with governance in civil society dominated by strong enforcement of social norms and values that are linked to family, age or gender roles, as well as, to common cultural beliefs (Scott, 2001).

Table 4.1. **Differences between Rule-based and Relation-based Governance**

Relation-based Governance	Rule-based Governance
• Relying on private and local information	• Relying on public information
• Complete enforcement possible	• Enforcing a subset of observable agreements
• Implicit and non-verifiable agreements	• Explicit and third-party verifiable agreements
• Person-specific and non-transferable contracts	• Public and transferable contracts
• High entry and exit barriers	• Low entry and exit barriers
• Requiring minimum social order	• Requiring well-developed legal infrastructure
• Low fixed costs to set up the system	• High fixed costs to set up the system
• High and increasing marginal costs to maintain	• Low and decreasing marginal costs to maintain
• Effective in small and emerging economies	• Effective in large and advanced economies

Source: Author.

In developed countries, formal rules clearly dominate both the economy and the state. This has been the case for the public sector to such a degree that rule- and procedure-based public administration has been challenged by more modern variants, particularly "new public management". However, both old public administration and new public management are building on the application of uniform norms, processes, criteria and tools to make governance transparent and explicit.

All countries display a blend of relation- and rule-based governance mechanisms. However, in developing countries informal mechanisms (particularly relation-based governance) will tend to be relatively stronger than in developed countries.

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The Relations between Formal and Informal Governance

How does the introduction of different rule-based governance mechanisms fit with the environment of informal, relational governance? What happens when rules are introduced in a setting in which relations – and other informal governance mechanisms – are strong?

In Singapore and South Korea, it can be argued that informal governance has complemented, or even substituted for, formal governance. Leaders have used formal and informal governance to press for one fairly consistent set of developmental goals. Illicit rent-seeking, nepotism and other variants of informal governance may have accompanied these processes, but they were never the dominant goal. The situation has been different in other circumstances, as evidenced in Box 4.1, in which informal institutions have come to substitute for formal ones with less positive outcomes.

Box 4.1. **Undermining the Effectiveness of Formal Governance Mechanisms in Uganda**

In 1990, the Uganda Revenue Authority (URA) was established and given operational autonomy in return for meeting agreed targets. It was exempt from civil service rules concerning recruitment, retention, pay and conditions; instead, it operated on business principles. Expatriates filled most top positions, with the expectation that they would be relatively inured to political pressure and patronage. A relatively independent board of directors was supposed to give policy directions and oversee operations; in practicek this board has remained involved in day-to-day operations.

Initially, the URA was a resounding success: Revenues increased from 7 per cent of GDP in 1991 to 12 per cent in 1996. However, the initial highest level political support for the URA faded, the autonomy of senior management eroded, and the building of a merit-based cadre of staff failed as appointments based on patronage came to dominate. As a consequence, a decade later, corruption — which the very establishment of the URA was intended to redress — was perceived to be chronic, pervasive and well organised.

Governance reforms with elements of both old and new public management were, thus, in this case not effective in a political context shaped by informal institutional imperatives of retaining power through patronage and personal rule.

Source: Robinson, 2006

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As indicated in this example, the formal governance was initially fairly effective, but may have accommodated informal interests that were not compatible with official goals. As informal goals changed to put more emphasis on power preservation, the informal governance became a directly competing system, with capacity to undermine the effectiveness of formal governance.

The complex interplay between the formal and informal is also visible at local level, in the relation between indigenous, mostly informal organisations and the formal modern public sector organisations, as illustrated in Box 4.2.

Box 4.2. **Two Faces of Informal Local Government Institutions in Karnataka**

Informal local government institutions in Karnataka (India) draw their legitimacy from custom and tradition, and are largely rooted in the system of caste. Though still very patriarchal as custodians of traditional norms and rules, these institutions have been able to adapt to changing circumstances, and to perform a wide range of useful, collective activities. These include organising social activities, dispensing informal justice, providing financial and moral support to those in need, and maintaining local law and order.

The informal institutions exercise public authority at the local level through mechanisms distinctly different from those employed by formal state institutions. Though their decisions are not absolutely enforceable, they manage to enforce most of their decisions through social pressure. The institutions carry with them the social tensions and gender bias inherent in rural societies. Social conflicts and tensions within the villages are constantly negotiated and managed, sometimes in an oppressive manner, by the informal institutions. However, they are neither wholly benign nor totally oppressive institutions.

Despite Karnataka's long history and impressive record of democratic decentralisation, the local informal institutions are not shrinking as elected local government institutions (Grama Panchayat) become more institutionalised and influential.

There are several types of interactions between the informal and the formal system: The informal institutions influence formal elections; there is overlap of leadership; they intervene in selection of beneficiaries for government anti-poverty projects; and they perform supplementary informal resource mobilisation. As such, they are complementary to, rather than competing with, the formal governance system.

Source: AnanthPur, 2004.

The preceding examples fit the Helmke and Levitsky (2004) typology for assessing how the formal and informal may relate, according to four types of relationships: complementary, substitutive, accommodating and competing (also explored in other chapters in this report).

When objectives are converging, informal governance can complement formal governance, or indeed act as a substitute for ineffective formal governance. By contrast, informal mechanisms pursuing divergent objectives would typically accommodate to effective formal governance, but compete for primacy when formal governance is weak.

These contrasting examples lead to the proposition that informal and formal governance elements interplay dynamically. Informal governance may, at different points in time, enhance and/or undermine aspects of formal governance, respectively. Understanding the interplay requires a specific empirical analysis.

Changing How the Rules of the Game are Managed

Though much can be gained by an understanding of the delicate balances between formal and informal governance, this is only half of the challenge. Ultimately, we are also interested in the questions of how informal governance changes, and of how donors and partners can contribute to changes that will increase capacity for poverty reduction.

The Good News: Many Sources of Change

Informal institutions and governance mechanisms are often considered to be highly resistant to change, changing only slowly and incrementally. Yet, informal institutions and governance *do* change – and may change quite rapidly. The centuries-old practice of women's foot-binding, which was practiced in China for alleged beauty purposes and resulted in deformed and dysfunctional feet, disappeared within a generation. In politics, apparently solidly rooted institutions may also disappear quickly. In Mexico, the *Partido Revolutionario Institucional* (PRI) governed from 1929 to 2000; the incumbent president traditionally selected his successor from the ranks of the party through a practice known as the *dedazo*, or finger-pointing. The practice was abandoned thanks to an increasingly competitive and fair electoral

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environment, in which other parties threatened the power monopoly of the PRI. This threat allowed local PRI leaders to contest the practice (Helmke and Levitsky, 2004).

Social norms related to authority also change through actions taken by individual action — not necessarily with the intent of changing informal governance institutions, but with the effect of change, as evidenced in Box 4.3.

Box 4.3. **Youth Migration Undermining Traditional Authorities in Bolivia**

In the Bolivian Andes, indigenous people have over the last 20 years struggled to obtain formal government recognition of their traditional ayullu authorities. These authorities have governed social and economic life in the villages in accordance with century-old customs and practices, including administering justice according to old customs. As part of the Popular Participation reform introduced in 1994, the traditional authorities gained official recognition, which has since been strengthened by Bolivia's ratification of international resolutions about the rights of indigenous peoples.

Paradoxically, at the same time as the ayullus have become at last formally recognised and gained a voice before the formal state, their effective authority in the villages has been undermined by the effects of migration. Youth seeking their fortune in El Alto, a poor but vibrant city close to the capital La Paz, lose respect for the traditional rural authority structures when they are exposed to urban life. Socio-economic and demographic pressures — in this case, rural-urban migration — thus change informal governance mechanisms. The ayullu leaders may well have a stronger voice with the government, but they have a weaker one with their sons and daughters.

Source: Danida, 2000.

Some of the short-term drivers of change in formal and informal governance are the power and interests behind governance mechanisms. Persons and groups take deliberate political action with the very intent of changing or preserving the rules of the game and how these rules are managed (Scott, 2001). They do so to pursue a mixture of narrower interests (of the individual, group or clan) and wider interests in promoting the provision of public goods. Donors are, in this sense, also political actors, pursuing a mixture of altruistic and narrower foreign policy interests.

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The success of deliberate action to change governance mechanisms depends not only on whether the powers supportive of the change are stronger than those whose interests would be negatively affected. Boxes 4.4 and 4.5 illustrate that it also depends critically on the design of new governance mechanisms. Table 4.2 shows sources of change of informal governance, exempting violent change (*e.g.* war, social upheavals, major natural catastrophes) from the discussion.

Box 4.4. **Failure of Popular Justice in Uganda**

In 1987, as part of a decentralisation scheme, Local Councils (LC) in Uganda were granted judicial authority as tribunals of popular justice. They were intended to provide expedient, inexpensive and culturally appropriate justice for the less powerful, who would not have capacity to use the weak, state-sponsored formal legal system.

However, the intended benefits of community justice did not materialise. Particularly, the new system failed to protect women's customary land rights, and unofficial payments to LC officials often exceeded costs paid in magistrates' court. LC courts were male dominated, and a woman taking a marital land dispute case to court would confront a council filled with her husband's relatives.

Disgruntled with the informal "rule of persons" that operates in the LCs, that sought out magistrates or legal aid clinics whom they perceived to be autonomous from local society and that would operate according to a "rule of law". Women needed to borrow power from outside the local arena to go against local elites using informal institutions for purposes of social control. This desire for social control is also the reason that LC officials often act as gatekeepers trying to prevent women seeking external litigation.

Exploiting informal mechanisms, in this case, allowed local might to impose itself, questioning the common belief that informal community-based governance mechanisms are per se better than centralised state mechanisms.

Source: Khadiagala, 2001.

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Box 4.5. **Reducing Corruption in Community Development Projects in Indonesia**

Can corruption be reduced by changing the rules of the game? Which mechanisms provide the best results? These questions were tested when 600 villages built a village road as part of a nationwide village-level infrastructure project in Indonesia. Two different mechanisms were applied in the villages. In some villages, the normal likelihood of a formal audit by national authorities of 4 per cent was increased to 100 per cent, so the villages knew that an audit would take place. In other villages, grassroots participation in monitoring the projects was strengthened A third group of villages acted as the control group.

In the control group, missing expenditures were around 30 per cent of project costs, with the key leakage occurring through delivery of smaller quantities of materials than invoiced. This waste was reduced to around 22 per cent where formal audits were announced and implemented. Strengthening the more informal grassroots participation reduced missing expenditures somewhat, but had little overall effect.

In this case, changes in formal top-down accountability were, at least in the short run, more effective than strengthening of more informal bottom-up accountability.

Source: Olken, 2005.

Mixed News

The framework presented in Table 4.2 allows a more nuanced analysis of whether there are converging pressures for change at different levels, or whether change in governance mechanisms is sought against all odds. Given the multiple, related layers that foster or constrain change, the process of change in governance is not the passage from one order (informal governance) to another. It may be better viewed as a rearrangement in the patterns of multiple governance mechanisms, through which changes in one layer produce multiple effects that, in the end, may feed back.

The less good news is that the framework does not identify which deliberate political actions — by domestic or international actors — will be effective for pro-poor outcomes in a given environment shaped by structures, norms and interests.

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Table 4.2. **Sources of Change of Informal Governance Mechanisms**

Source of Change	Mechanism and Pace of Change	Examples and Outcomes
Exogenous factors reducing functional appropriateness of informal mechanisms	Changing actors' cost-benefit calculus and outlook can be relatively rapid	Need to comply with international quality standards for export has pushed formal environmental regulation in Central America. Economic growth in China pushes enforcement of commercial regulations.
Cultural evolution	Change in societal values can be very slow	Gradual erosion of kinship-based norms of responsibilities for extended family.
Social pressures	Differentiation of groups, discordant beliefs and conflicting institutions can be relatively rapid	Urbanisation, strong demographic but weak economic growth fosters political contenders who exploit traditional and religious values.
Technological change	Change in access to information and communication over distance can be rapid	The Internet and mobile cell phone technology changes marketplaces, social/political mobilisation processes and parameters for public control
Change in social distribution of power and resources	New rounds of bargaining are often incremental	Erosion of clientelism through growth of relatively autonomous middle class.
Intentional political action to change formal governance	Change in design or effectiveness of formal mechanisms can be rapid	Reduction of corruption through audits in Indonesia; increased revenue collection through tax authority agency in Rwanda and Uganda.
Intentional political action to change informal governance mechanisms	Formalisation, change in design or effectiveness of informal mechanisms can be rapid	Taxpayer association enforcing accountability of local government in Tanzania; media scrutiny of wrongdoing in Kenya.

Source: Author.

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Does this mean that there are no pointers at all to areas of action and related broader socio-economic developments that seem particularly promising for enhancing formal or informal governance? Extreme cautiousness is warranted: correlation may easily be mistaken for causality, and the scope for changing complex systems by altering a few variables assumed to be independent may be grossly overestimated.

With all these caveats, there are four interlinked issues in literature:

— First, growth linked to economic diversification, technological development and competitive domestic and international trade can advance significantly without strong formal governance in place. But such growth still seems to be a dynamic factor, eventually pushing rule-based governance forward. Governance may matter for growth, but the opposite is also the case. Interestingly, where sheer geographical distance was earlier a barrier to how far personal relations could reach out, modern communication technology actually removes this barrier. For example, purely informal, relation-based criminal networks can now operate globally.

— Second, at the societal level, some processes must gradually break the vicious circle of strong, informal social governance mechanisms weakening or crowding out a stronger state, which reinforce informal, vertical-social control mechanisms and eventually leave the state as prey for capture, rather than as vehicle for development. External military threats have historically disciplined state and society to develop bonds that have changed the relative autonomy of the state in some parts of the world, notably in Europe. This no longer being an acceptable change factor in the international order, the focus is mostly on domestic factors. The emergence of a broader *urban economic and professional middle class*, which is able to hold the state accountable for delivering basic public goods (security, urban infrastructure, urban property rights), is often singled out for holding promise (Migdal, 1988). Evidently, such a middle-class development would be linked to economic growth, though not necessarily pro-poor growth – and heavy losses of members of this group. Moreover — due to migration to OECD countries or the HIV/Aids pandemic — would weaken it significantly.

— Third, and linked to the above, a relatively *independent bureaucracy*, recruited based on merit, may appear a necessary (though not sufficient) condition for developing an efficient state bureaucracy (Migdal, 1988; Rauch and Evans, 2000). Many observe the difference between more successful Asian states and less successful African ones, in which the civil service lost independence in the first decades after decolonisation. Unfortunately, recognising that a merit-based civil service is eventually necessary does not provide clues on how to arm the service against the informal pressures of patronage politics.

— Finally, the cost of *transparency* in making competing informal systems work has been singled out as an overlooked element in attempts to reform governance (Kaufmann, 2005). Donors should, nevertheless, insist on increased transparency (particularly as a means of strengthening accountability between government and citizens) and include support to independent media and investigative think tanks in their governance portfolios.

Governance mechanisms do change, and they can be changed by deliberate action. As with other change processes, successful efforts must be adapted to societal, institutional and political pressures as well as to incentives for change. While the long-term direction of change may be towards formal governance at the expense of informal governance mechanisms, most deliberate change efforts should expect to result in a new balance of formal and informal governance elements. The greater the divergence between formal goals (e.g. poverty reduction) and informal goals (e.g. rent-seeking and power preservation), the more informal governance mechanisms will compete with and seek to subvert formal mechanisms.

Within this vast range of options and constraints, it is likely that a very broad set of simultaneous movements and activities is required. This would include, but not be limited to: economic growth and diversification; strengthening the accountability ties between an emerging urban middle class and the state; making merit count more in the civil service; and increased transparency and disclosure of public affairs and public-private relations.

Policy Lessons

What preliminary policy lessons can be drawn from the discussion above? Five lessons are offered as the conclusion of this chapter.

1. *Understanding informal and formal governance is a sine qua non for effective action*. This is no small lesson: there is a lot of knowledge demonstrating how informal and formal governance and institutions interplay; how

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informality is not necessarily the enemy of development; how the specific configuration of norms, interests and formal/informal mechanisms can be analysed; how this analysis can inform decision making; and the difference between old and new public management approaches.

2. *Governance is about norms, power and politics.* Informal governance mechanisms are, in many countries, rooted in rather narrow power structures, bargaining between interests, and patterns of coalitions and conflicts between patronage systems. This may play out in arenas of shared and conflicting norms and values, many of which are radically different from those of donor staff and small urban intellectual elites. Dealing with these issues to enhance capacity for pro-poor outcomes is not free of conflict: poverty reduction objectives often sharply conflict with the power preservation prerogatives of the informal system. There are limits to what external actors such as donors can do in these settings, but being aware of the nature of the game they are part of is likely to enhance performance.

3. *Eliminating bad governance may not be the first priority.* "Zero-tolerance" policies vis-à-vis corruption and semi-authoritarianism may ride the moral high ground and exhibit firmness and idealism to tax-payers in donor countries. Should they prove effective, such policies might well undermine patronage-based power systems without offering any alternative but chaos. "Good enough governance" (Grindle, 2004) can give room for considerable positive development, as the lessons of history demonstrate. This is not complacency, nor does it imply giving up values and long-term goals. It is simply necessary for achieving practical results on the ground. It does not make life easier for donors, and it does create uncomfortable dilemmas. There is, unfortunately, no way around such dilemmas.

4. *Adopt a systems approach to governance.* Searching for the ultimate formula — claiming first that the state has a primordial role, then assigning primacy of the economy, then focusing on institutions, and then on the privileged role of civil society and its alleged capacity to exert accountability — is doing more harm than good. In governance, there are factors that should definitely not be overlooked – but they are never the only ones to focus on. Different country realities will result in different combinations of promising options for action.

5. *Develop networks and tools to enhance donor and partner capacity to deal with informality, governance and political issues*. The knowledge required to move forward in this area is found in universities and think tanks: the weak link between academia and development practitioners needs to be strengthened. More practical tools and approaches, based on sound concepts, are also needed to assist donor and partner staff in dealing with the sensitivities and complexities of the governance theme.

The lessons above may need to be nuanced and complemented. Pursuing them will not provide simple answers. Indeed, simplicity is not effective when dealing with complex societal systems and processes. But going in this direction can push the boundaries and broaden the scope of what must be discussed to deal with the challenges of governance. It is both timely and vital to deal with these challenges in a carefully considered manner.

Notes

1. Author's definition, departing from principal-agent concepts. It captures how those given power (agents) account or should account to those empowering them (principals), e.g. to voters if *de facto* power really grew out of elections; or to military, business or clan/ethnic groups, if they are the real principals sustaining the executive agents.
2. In the Danish "Jutlandic Law" from 1241, it was solemnly stated "With law shall country be built".

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In Focus

Governance Indicators and Informal Institutions

Charles Oman

The use of governance indicators is booming. Already, some 140 sets of indicators can be accessed publicly. Among the most widely used are the World Bank Institute's *Worldwide Governance Indicators*, the *International Country Risk Guide* produced by Political Risk Services, Transparency International's *Corruption Perceptions Index* and Freedom House's *Political Rights* and *Civil Liberties* indicators.

Governance indicators seek to quantify the quality of a country's governance institutions by considering, for example, the extent of corruption in the economy, the quality of public and private regulatory systems, the prevalence of the "rule of law", the level of political stability, and the effectiveness of government. Most of the widely used governance indicators are composite, perceptions-based indicators, which combine a large amount of perceptions data into a single numerical score for a given country in a given year.

Governance indicators are used primarily by international investors, official national and multilateral donors of aid, journalists and academics. Investors, who currently channel more than $ 650 billion per year into emerging markets, increasingly base their investment-location decisions on the perceived quality of a country's governance. Donors of aid use governance indicators for two reasons: to pressure potential recipient countries to improve local governance, by rewarding good and punishing weak performers; and to make their own allocation decisions as transparent and objective as possible. The US Millennium Challenge Corporation provides an important example.

The Downside of Governance Indicators

Users of governance indicators face several problems: the construction of composite indicators generally lacks transparency; the scoring criteria are opaque because of the diversity and large number of underlying indicators they embody; and the substantive meaning of *good* governance remains conceptually undefined. Indicators can, thus, not give guidance as to what specifically needs to be changed in order to improve a country's governance: they are not "actionable".

Similar weaknesses are associated with so-called facts-based measures, such as some of the World Bank's "Doing Business" indicators. Not only does their construction generally entail as much or more subjective interpretation of the governance significance of the observed facts as do perceptions-based indicators. By focusing on the measurable features of governance outcomes (e.g. the length of time required to register a new enterprise), they fail to incorporate the role of informal — and therefore often un-measurable — institutions whose influence can nevertheless be, and often is, decisive for governance outcomes (e.g. a social norm that tolerates and promotes rent-seeking behaviour in administrative processes).

A clear separation of institutional outcomes and the underlying institutions that produce them is crucial to identifying what is (mal-) functioning and why, as highlighted by Jütting and de Soysa in this volume. Otherwise, people who seek to improve governance outcomes can easily aggravate the status quo instead. As illustrated by Boesen, implementing anti-corruption mechanisms as a response to weak governance scores, without sufficient understanding of underlying informal power systems, can lead to civil unrest.

Moreover, developing countries often, understandably, resent being pressured to raise their standards of governance by foreign suppliers of funds that base their judgment on what are, in fact, non-transparent indicators. The uncritical use of governance indicators by external stakeholders, such as aid agencies and international investors, can also easily lead to herd behaviour by these important suppliers of funds. Such herd behaviour can thus severely deprive a country of funds precisely when they are most urgently needed.

Analysing the Broader Institutional Context

Users of governance indicators need to clearly understand the limitations of these tools. The producers of governance indicators need to be much more transparent about those limitations, while working to overcome them. Users will

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often need to rely on country-specific governance indicators and analysis, which do not allow for a simple cross-country comparison of scores. Users must also look carefully beyond quantitative governance indicators in order to identify the formal and informal institutions that developing countries need for better governance and development.

Further Reading

ARNDT, Ch. and Ch. OMAN (2006), *Uses and Abuses of Governance Indicators*, OECD Development Centre Study, Paris. www.oecd.org/dev/publications/governanceindicators

Discussion Report

Governance, Accountability and Capacity Development

Nicolas Meisel

Lead Questions

— Does informal governance matter in the development process?

— How do formal and informal aspects of governance interplay?

— Which preliminary policy lessons can be drawn on how partners and donors can improve governance and accountability, particularly in settings in which informal institutions and informal governance dominate?

Composition of the Panel

The working group on Governance, Accountability and Capacity Development was chaired by Andreas Proksch, Head of Department, German Agency for Technical Co-operation (GTZ). The introduction and background paper was given by Nils Boesen, Process and Change Consultancy, Denmark. Additional presentations were given by S.S. Meenakshisundaram, Visiting Professor, India; Upala D. Banerjee, Asia-Pacific Regional Coordinator, UN Inter-Agency Lessons Learned Project on Human Rights-Based Approaches; and Mark Nelson, Senior Operations Officer for Capacity Development, World Bank Institute.

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Introductory Presentation

In his introductory remarks, Nils Boesen explained how the formal and informal spheres interplay and change. Boesen called for a pragmatic approach to dealing with informal institutions, recognising that they are not always the enemy of development. Much to the contrary, informal institutions need to be brought into the development process. In fact, introducing formal mechanisms might sometimes do more harm than good. Thus, carefully selecting which institutions to change and which ones to keep is highly important.

The primary difference between most advanced countries and developing countries lies in the fact that relationship-based governance – i.e. governance based on interpersonal trust and social pressure – is generally much more cost-effective in developing countries. Informal institutions frequently replace formal regulations that are inefficient due to a lack of good governance or insufficient capacity of the authorities. Thus, the pressure put on the state to provide formal governance mechanisms is weaker; consequently, formal state-controlled mechanisms are not easy to introduce because other actors substitute for the state.

The good news is that informal institutions do change, but it is a complex and multidimensional process. The best lever for change might be economic growth and diversification: as economies open, actors become confronted by the limits of informal relationships and, thus, ask for some formality in their governance system.

In his conclusion, Boesen insisted that local political powers should be taken seriously. Donors should strategically choose whether (and how) to engage with them.

Informal Institutions in India

S.S. Meenakshisundaram described his professional experience in India. He explained the five levels of formal institutions in India (from state to village) and provided numerous examples of how informal institutions shape development outcomes in that they are the basis of forest management committees, water-users associations and other self-help groups. He outlined the advantages of promoting development through informal institutions that include all members as stakeholders, ensure direct accountability and provide a built-in transparency.

However, such an approach also has negative implications: interests can be conflicting, groups might not be homogenous and long-term planning can be very difficult. Development through informal institutions, therefore, warrants a careful analysis of the specific advantages it might entail. As both formal and informal institutions are necessary to reach sustainable development, both types of institutions should be linked at the operational (local) level in order to find areas of complementarity. In India, informal institutions have often acted as a cost-effective checks-and-balances mechanism in relation to formal institutions. To this end, forums have been set up in villages to allow informal organisations to easily engage in local politics.

Informal Institutions and Human Rights

Upala Devi Banerjee explored informal institutions and the linkages to human rights-based approaches. While experts currently recommend working towards an "acceptable reconciliation" between traditions and human rights, Banerjee pointed out that not all informal institutions are acceptable from a human rights perspective. For example, gender rights are massively weakened by customs such as genital mutilation or honour killings. Informal institutions may be compatible with a human rights perspective under three conditions: if they effectively provide redress of grievance; if they are consistent with basic principles of justice and access to justice (e.g. independent and non-discriminatory); and, finally, if the state has the will and the means to enforce a basic human rights paradigm.

Building on the local country context, Banerjee suggested a mid-point to make institutions compatible with a human rights-based approach. Such a strategy would include an identification of all elements in informal institutions that corresponded to human rights laws. These elements could then be used as a basis for building a universal framework.

Demand-Driven Institutional Change

Mark Nelson discussed demand-driven institutional change through the power of data and information. According to Douglass North, human evolution involves the intentions of the players. Coming to a common view of those intentions, and finding ways of influencing the intentions of development partners, is not easy. Data and information are powerful tools in this endeavour. They provide a mechanism for advocacy, priority setting and the generation of

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consensus. Development co-operation should, thus, pay particular attention to increasing the flow of data and information, and to stimulating the demand side as a force for positive change.

Nelson discussed how the work on capacity development provided lessons for the World Bank's more extensive work on governance. He reported that an analysis of capacity development approaches in World Bank projects had revealed several shortcomings, including a lack of attention to the higher-level, demand-side factors and informal institutions that we know have a huge impact on success. Instead, many projects rely on technocratic reforms and conditionalities that have a decidedly mixed record. In order to move from technocratic to dynamic approaches for capacity development, Nelson suggested demand-driven programmes that emphasise local leadership and consider the critical political dimensions of change.

General Discussion

During the discussion that followed these four presentations, participants agreed on a number of ideas. First, the importance of acknowledging power and politics was emphasised. Second, formal and informal institutions should no longer be treated as opposites, but as complements or substitutes. When traditional systems function well, there is no point in trying to fix them and even less to replace them. The important thing is to integrate them in a stimulating environment. The regulatory power of the state remains central in this respect, as it has a direct bearing on the institutional framework and the rules of the game. But in many developing countries, the government can only govern and implement policies if it relies sufficiently on informal institutions. Third, for centuries the norms of the West have been more or less explicitly imposed in most developing countries. Thus, "informality" tends to be seen as "illegality", which will not help donors to devise good programmes for the informal sector. The time is now ripe for questioning Western values and reviving the primacy of the local actors' point of view.

Remaining Questions for Future Research

— What is the incentive to change institutions? Research should focus more on the demand for change and describe it more precisely.

— Are donors in the weakest countries not, themselves, a powerful interest group favouring or hampering change? How can donors be held accountable as local political actors? Does improvement of local governance in these countries not imply, first and foremost, a reform of donors' governance?

— What do we really know about the distinction between the formal and the informal? What do we do with this knowledge? Have we spent enough time defining concepts?

— How do the norms of donors interact with local norms when they are transferred locally? How can we distinguish between between norms of donors, local norms, and universally accepted norms?

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Chapter 5

Private Sector Development: How Business Interacts with Informal Institutions

Stephen Nicholas and Elizabeth Maitland[1]

Summary

This chapter explores the impact of informal institutions on private sector development. Informal institutions are critical in countries with weak formal economic institutions, such as inadequate bankruptcy and contract laws. In these countries, kinship systems, which are usually restricted to members of the same ethnicity or religion, offer a more reliable mechanism to enforce agreements. Based on experiences from Hong Kong, China and India, this chapter illustrates how different access to formal institutions influences the design of contractual arrangements. Depending on a manager's understanding of the country's formal and informal institutions, the quality of contracts for business exchange varies significantly. In order to support the gradual development of open business networks, development agencies should foster informal economic institutions that support private business. In this context, it is vital to improve the flow of information about the availability, reliability and skill levels of suppliers, distributors and partner firms. Access to such information will reduce the costs of designing and managing contracts.

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Formal and Informal Institutions for Economic Development

After two centuries of economic expansion, the technical requirements of combining capital, labour and inputs to secure economic growth are well understood. Why, then, does nearly half the world's population (roughly 3 billion people) currently live on less than $ 2 per day? Why, in the last decade, have some parts of Asia, sub-Saharan Africa and South America experienced negative growth, including Indonesia, where per capita income was lower in 2004 than in 1997 (van der Eng, 2004)?

As a result of increasing attention to the role of institutions in the development process, it is now clear that today's development challenge lies not in technological solutions to production and distribution, but in structuring institutions to promote economic exchange and growth (North, 2005, 1990). Without the ability to engage in economic exchange – the trade of goods for services, labour for goods, and of goods for goods – a society's growth is limited. To permit economic exchange, a society needs to develop institutions as the "rules of the game" by which private business plays. Such rules are needed to reduce uncertainty, facilitate information exchange and provide enforcement mechanisms. These rules can be both formal institutions (including legal rules, regulations and policies) and informal institutions (comprising the web of social, cultural and, often, religious norms of behaviour). Thus, institutions can decrease the costs of economic exchange and activity by providing standardised terms of interaction.

The important role of formal institutions in this regard is broadly accepted. Informal institutions, on the other hand, are often overlooked as mechanisms that reduce uncertainty, provide information and enforce contracts for private business. However, informal institutions are powerful mechanisms that can contribute to economic efficiency or distort resource allocation. In Asia, for example, some informal institutions, such as bowing when exchanging business cards, may seem relatively trivial. They nevertheless retain their importance to business by signalling a willingness to co-operate (Ellickson, 1994; Landa, 1994). Corruption practices that are sustained by insider knowledge of who, when and how much to bribe to win government contracts, constitute another example. Many informal institutions emerge within business communities to reduce the costs of searching for reliable partners, writing business agreements and enforcing mutually beneficial exchange. The rules devised by business communities are frequently complex and multidimensional ,and aim to maintain profitable

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relationships and standing among peers (Macauley, 1963; Charny, 1990; Landa, 1994; McMillan and Woodruff, 1999). By identifying and ostracising poorly behaving firms and individuals, business networks reduce the costs of doing business for all members (Williamson, 1993; Grief, 1993). As a result, business communities are often not open to all players. The extent to which they are open to players, or whether they are kinship based (e.g. familial, religious or ethnic bonds tie group members together), thus constitutes a key distinction among different business networks.

To understand how an economy grows, stagnates or declines, a first challenge is to identify institutions, and differences in institutions among countries. A second step is to understand how businesses match specific contracts for exchange and trade to particular institutional environments. This is a distinct challenge for multinational firms that operate simultaneously in different countries with different formal and informal institutions. Managers, thus, face two challenges: how to understand the host country's institutions; and how to design contracts with local firms, consumers and governments in each location. Furthermore, managers' cognitive limitations play a central role in designing contracts. Faced with uncertainty and incomplete information in a foreign environment, how do managers know what is and what is not optimal? For example, choices have to be made between selecting a partner or doing it alone; relying on host country courts or depending on trust for dispute resolution; and writing detailed contracts or relying on verbal/implicit agreements.

The following questions are explored:

— How do open and kinship informal institutions facilitate or impede economic growth within a country's formal institutional environment?

— How do managers write specific contracts, given the informal and informal institutions in a host country?

— How do the cognitive limitations of managers shape the design of contracts in different institutional environments?

To illustrate the influence of informal norms and codes of behaviour on firms, this chapter looks at historical examples and case studies. The case studies include the experiences of Hong Kong firms in their cultural homeland of Guangdong Province and Australian multinational enterprises (MNEs) in China, India, Indonesia and Viet Nam.

Open and Kinship Business Communities

Reputation mechanisms are an important tool for businesses to create private ordering through open and kinship systems. Poor behaviour tarnishes the offending firm's or individual's reputation, resulting in blacklisting by other businesses. For a reputation mechanism to work well, three conditions are central: the prospect of repeat interaction; a system for transmitting relevant information to participants; and punishment for cheaters. Reputation systems are path dependent and evolve over time in response to the weakness or absence of formal law-based systems to protect trade. Kinship systems, such as the 11th century Mediterranean Maghribi traders, are exclusionary, based on ethnicity, language, familial ties and/or religion, as described in Box 5.1.

Box 5.1. **11th Century Mediterranean Maghribi Traders: A Kinship System for Information and Enforcement of Trade**

The 11th century Mediterranean merchants, the Maghribi traders, developed a kinship-based business network, in which ties of family, religion and ethnicity supported complex business relationships over considerable geographic distances. The Maghribi traders were Jewish merchants who operated in the Western basin of the Mediterranean, using agents to supply services such as information on trading conditions and prices, loading and unloading of ships, paying duties, storing and selling goods, providing credit and remitting funds. Each service was subject to potential opportunism: inaccurate information, delays in loading and unloading, spoilage of stored goods, under-pricing of products and the extension of finance to un-creditworthy buyers could impose high costs on merchants.

Source: Greif, 1993.

Greif (1993) has shown that the Maghribi merchants had contracts with many Maghribi agents in different trade centres. Maghribi merchants only traded with Maghribi agents; and Maghribi agents only traded with Maghribi merchants. The merchants rewarded agents with a wage or commission high enough to encourage honest behaviour, coupled with the punishment of contract termination for cheating. But, termination or the threat of termination from one merchant was not sufficient to deter cheating. Merchants entered into repeat contracts with each agent, contracted numerous agents, and shared the same agents, thereby creating an extensive information network. By

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sharing their information on agents, merchants undertook collective punishment: an agent cheating one merchant would be ostracised by all merchants. A reputation for honesty by an agent ensured trade with all merchants. During a period of slow communications, in the presence of uneven knowledge sets and the absence of formal legal systems, the informal social network of the Maghribi traders created the information flows that identified dishonest agents and a punishment system that excluded opportunistic agents, thereby enabling trade across large geographic distances.

In contrast, open systems, which may be based on membership in an association or residence in a particular city or country, are more inclusive. However, these may be weaker in enforcing agreements and provide poorer quality information flows than are available through kinship systems. Examples of open systems are the merchant courts of the 12th and 13th century Champagne fairs and manufacturers in the 1990s in Viet Nam. Both provide examples of open systems that created informal community systems for identifying both reliable and unreliable suppliers and buyers, as illustrated in Boxes 5.2 and 5.3.

Box 5.2. **Enforcement of Trade by Medieval Merchant Courts**

The emergence of developed countries' formal and informal institutions to support private economic exchange was a long-term, path-dependent, historical process. In the 12th and 13th centuries, merchant courts at the Champagne fairs were economic organisations that established "rules of the game" for economic exchange. They operated in a context of weak formal institutions supporting trade. The rules served three purposes: they permitted only merchants in good standing to trade at fairs; disciplined and excluded untrustworthy merchants from trading; and they encouraged western European rulers to ensure safety and fair treatment for foreign traders.

In the absence of comprehensive formal laws and regulations, the merchant courts were privately ordered organisations that developed informal rules that reduced the costs of economic exchange. The merchant courts were a step between personal trade and state-regulated market systems of impersonal exchange. They offered information on traders, sanctions for non-performance and restitution of losses from bad deals with trading partners who cheated.

Source: Greif, Milgrom and Weingast, 1994.

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It is a mistake to assume that informal institutions to facilitate economic exchange arise only in the absence of formal institutions. The impact of informal institutions is especially important when formal institutions exist but are not efficient. For example, under Viet Nam's system of central planning, formal laws and regulations did not allow private entrepreneurial activity (see Box 5.3).

Box 5.3. **Informal Institutions and the Dead Hand of the Past**

Without a credible legal system, access to financial markets or protection from corrupt bureaucrats, the private sector in Viet Nam still accounted for 29 per cent of the country's industrial output and was responsible for much of the 8-9.5 per cent annual GNP growth between 1992 and 1997.

In the absence of courts and unbiased regulators, economic exchange in Viet Nam rested largely on informal rules. Manufacturers structured written incentive contracts with suppliers and buyers to limit cheating by either party; such written contracts added clarity, if no legal benefit, to the exchange. Since non-debt repayment was not enforceable in court, community sanctions were used instead. Manufacturers developed information systems, trading information on poorly performing and opportunistic suppliers and buyers to identify those most likely to cause contracts to fail. Manufacturers also used business contacts to create information on potential buyers and suppliers. Finally, repeat contracts with previous buyers and suppliers were types of repeat economic exchange games, which provided increasing levels of information on supplier and buyer behaviour and performance.

Thus, in the absence of appropriate formal institutions for a market-based economy, informal institutions or rules for sharing information developed through private ordering to reduce the costs of exchange. The business system was open to all and not restricted to traders from a particular clan, family or ethnic group (such as Chinese, Hmong or local Vietnamese).

Source: McMillan and Woodruff, 1999.

From 1986, a series of economic (*doi moi*) reforms were introduced in Viet Nam to encourage the growth of private enterprise. But these changes were hampered by a lack of reform to existing political and legal structures, which functioned to directly control and undertake economic activity.

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Correspondingly, new legislation was subject to differing interpretations, applications and significant administrative discretion (Chi, 1996). Enforcing contracts for private business was hampered by lack of precedence, judicial inexperience, and police discretion when enforcing court and arbitral awards. As one local entrepreneur observed, "[t]he courts normally just create more problems….in Vietnam no one believes we have a good legal system" and that "…the local authorities just create problems for us rather than supporting us" (McMillan and Woodruff, 1999). Given the failure of formal institutions, businesses, thus, created a system of private ordering to promote trade.

The interplay between formal and informal institutions is important when designing institutional change. Because the reform of formal institutions will not automatically lead to the desired outcome, the risks of economic reform are great, and governments are cautious about implementing new formal institutions. Box 5.4 discusses the problems of formal institutional change in the Soviet Union, where informal systems of power and privilege have impeded the emergence of new formal institutions to support private sector development.

Box 5.4. **Political Lessons from Institutional Change**

Russia's post-Imperial and post-Soviet experiences starkly illustrate the impact of formal institutions on existing informal institutions and economic structures. The 1917 Russian Revolution triggered the development of new formal and informal economic, political and social institutions. These emerged over 50 years of civil war, purges, public ownership and dictatorship. The "command economy", state planning bureaux, investment in heavy industry (as opposed to consumer goods), and collectivisation of agriculture created a concentration of political and economic power in individuals, the state bureaucracy and the Communist Party.

Finally *Perestroika*, Gorbachev's economic liberalisation reforms, unhinged Russia's existing institutional arrangements with their embedded power structures. Gorbachev's reforms were met by much resistance from Party officials. When new formal institutions were introduced, existing political and economic arrangements eroded, upsetting existing economic, social and political balances, and resulting in disorder. In the process, informal institutions arose that gave party leaders and economic managers privileges and responsibilities different from ordinary people.

Source: North, 2005; McFaul, 2001.

One challenge for developing country governments that are undertaking economic reform is how to manage the introduction of new formal institutions — without undermining the delicate balances within a society, which could potentially lead to disorder and economic decline. Governments also need to recognise the important role of informal institutions in promoting economic exchange, and facilitate informal institutions that promote growth.

Writing Contracts: The Role of Informal Institutions

Institutions create the conditions for writing firm-to-firm and firm-to-customer contracts. To understand a society's economic trajectory, one needs to analyse the institutional environment, first by identifying the mix of formal and informal institutions and the operation of business communities. The next step is to discern how managers respond to the prevailing institutional environment, which is typically by writing and operating specific contracts with partners, suppliers, distributors and employees.

In this respect, China's transition from the system of central planning to new formal and informal institutions that aim to encourage private sector development offers an interesting case study. In this case, MNEs had to design specific contracts in an environment of rapid institutional change. As depicted in Table 5.1, foreign firms use a range of equity and non-equity arrangements for investing in China. In this section, two very different groups of foreign investors in China are studied in relation to how they structured contracts: Hong Kong firms, which relied on kinship systems; and Australian firms, which depended on open systems.

Hong Kong Manufacturers in Guangdong Province

Contractual joint ventures were the most commonly used type of contract for Hong Kong investors in China. They are non-equity strategic alliances between Hong Kong firms and Chinese enterprises that are formed by the government at the township and village levels to further China's economic transformation. Before 1985, joint ventures accounted for almost twice the realised foreign direct investment (FDI) of equity joint ventures and wholly foreign-owed enterprises combined ($ 465 million vs. $ 270 million). In the province of Guangdong, which adjoins Hong Kong,

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Table 5.1. **Contractual Arrangements for Investing in China**

	Equity	Description
Wholly owned subsidiary	Yes	Foreign owned and controlled entity
Joint venture	Yes	Limited liability firm between one Chinese and one or more foreign firms
Contractual joint venture	No	Long-term agreement between a Chinese and foreign firm; no separate legal entity established
Strategic alliance	No	Alliance formed to achieve a set objective, such as developing a new technology
License	No	Contract designed for technology, brand and trademark transfers between a licensor (company that owns the assets) to a licensee; the contract specifies a period of use by the licensee, in return for a set fee (royalty) to the licensor on every unit sold
Franchise	No	Special type of licensing agreement specifically for retail activities
Build-operate-transfer	No	Contract to build infrastructure and operate for a set period, before ownership reverts to the state
Processing and assembly	No	Contracts specifying subcontracting activities related to production of basic products

Source: Authors.

contractual joint ventures remained the dominant form of FDI until 1998, when they were finally overtaken by equity joint ventures and wholly foreign-owned enterprises (Wang and Nicholas, 2005). Until the late 1980s, contractual joint ventures operated under the formal legal institutions of central planning. Specific equity joint venture laws (1979 and 1984) and wholly foreign-owned enterprise laws (1986) were implemented before contractual joint venture laws (1988 and amendments in 1995). Given the institutional environment in China, how did Hong Kong managers design contractual joint ventures for day-to-day control of economic exchange?

Contractual joint ventures were concentrated in China's Pearl River delta area of Guangdong, a province that has maintained its unique spoken language (Cantonese) and a distinctive *Yue* culture. Hong Kong and Guangdong are characterised by historically strong ethnic, cultural and language links. The majority of Hong Kong people are either born or descended from counties and villages in Guangdong, approximately 80 per cent of Hong Kong's Chinese population have relatives in the province, and around 95 per cent of Hong Kong's 6 million residents speak Cantonese (Child and Mollering, 2003). These strong kinship ties made Guangdong's township and village enterprises attractive partners for Hong Kong's labour-intensive manufacturers looking to outsource production activities. The ties between the two groups facilitated the development of informal institutions based on reputation and the sharing of information within business and social networks. Through these networks poor behaviour by a Guangdong or Hong Kong firm would be publicly revealed and punished through exclusion by other firms.

Both sides also carefully structured their incentive contracts to control day-to-day economic exchange. Drawing on interviews with 73 contractual joint venture managers (43 from Hong Kong and 30 from Guangdong), Wang and Nicholas (2005) detailed the operation of these contracts. Direct monitoring by the Hong Kong side was relatively inexpensive, since geographic proximity made it possible for Hong Kong managers to cross to Guangdong every day to oversee their production activities. The Hong Kong side usually provided the chair of the board and the CEO of the contractual joint ventures, and Hong Kong managers were in charge of key positions in finance and production.

Repeat contracting provided the Hong Kong firms with information about their Guangdong partners that allowed contracts to be fine-tuned. Contractual joint ventures had up to four amendatory contracts and many attached supplementary terms and remarks, to cover profit distribution and production rates with their Guangdong partners. The flexibility of contractual joint ventures was reflected in the continuous negotiation and re-negotiation of the contracts to fit changing conditions, rather than being bound by the original terms and conditions typical of equity joint ventures and wholly foreign-owned firms. The 1995 Implementation Regulations of the Contractual Joint Venture Law restricted some of the flexibility, by detailing regulatory guidance on some operational matters (for example, spelling out more clearly the methods and proportions for profit distribution). Despite this law, the Guangdong partners co-operated with the Hong Kong side to by-pass the local agencies and bureaucracies implementing the new provisions.

Without a formal legal framework prior to 1988, contractual joint ventures were structured to ensure investments by both the Hong Kong managers (in the form of long-term orders, high rent, knowledge about final markets and consumer tastes, and managerial assistance) and the Guangdong

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side (labour, factories, plant and equipment facilities, and bureaucratic connections). The two partners were mutually dependent on each other. Such mutual "hostage" imposed high costs of contract termination on both parties, encouraging co-operative behaviour.

Finally, path-dependency was important. Many contractual joint ventures evolved out of previous business relationships, such as process and assembly contracts between the same Hong Kong and Guangdong partners. Repeat interaction between the partners built trust and co-operation.

Contractual joint ventures were dynamic, adjusting to changes in China's formal institutions. Over time, a shift could be noted from negotiated to more legalistic approaches in dispute resolution. At the formation stage of the contractual joint ventures in the 1980s, interviews revealed no case in which disputes were solved by legalistic approaches, such as referring to the letter of contract, third-party arbitration, resorting to courts or termination. In 1999, however, six contractual joint ventures were terminated. Similarly, disputes were increasingly resolved by reference to the letter of contract. These changes reflected the development of China's formal legal institutions. According to many interviewees, the 1995 contractual joint venture implementation law significantly reduced the costs associated with using courts or other third-party enforcement.

The development of China's formal institutions also explains the decline in the use of contractual joint ventures for new investments, and the rise in equity joint ventures and wholly foreign owned enterprises by Hong Kong managers. While fewer Hong Kong managers opted for new contractual joint ventures (selecting joint ventures and wholly foreign owned enterprises instead), few also exited their existing contractual joint ventures. Among the six contractual joint ventures that terminated, only one became an equity joint venture and only one a wholly foreign owned enterprise. In spite of changes in the formal legal environment, existing contractual joint ventures continued as efficient economic organisations, with low costs of economic exchange, as they were supported by informal institutions (social networks, etc.) accessible by the Hong Kong managers.

Australian MNEs in China

Operating in the same institutional setting as the Hong Kong investors, Australian managers were denied this access to informal institutions that supported Hong Kong-Guangdong contractual joint ventures. A survey of

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171 Australian MNEs in China before 2000 illustrates how Australian managers structured specific contracts, given China's institutional environment.

Before entering China, Australian investors relied on their existing commercial networks for information on business opportunities and operational challenges. While these were not the deep networks open to Hong Kong investors, many Australian firms also learned about their China business opportunity, or were introduced to the China market, through informal business links. However, Australian investors experienced more problems in communicating and negotiating in China than Hong Kong investors. Some 50 per cent of Australian MNEs encountered moderate levels of difficulty communicating and negotiating in China; 20 per cent were subject to high levels of difficulty. Australian firms found the responsiveness of Chinese government agencies slow, fairly difficult and less open than desired, though not hostile. This was a different experience from that of Hong Kong investors, who collaborated with their Guangdong partners to by-pass government officials.

Uncertainty and incomplete information meant Australian investors sought a range of entry forms in China, including wholly foreign owned enterprises (8 per cent), equity joint ventures (29 per cent), representative office or agents (22 per cent), management contracts (17 per cent), export (12 per cent), and licences, franchises and build-operate-transfer contracts (12 per cent). The most important entry form, equity joint ventures (JVs), were formed mainly with state-owed enterprises (68 per cent), drawing on their Chinese partners' strengths in interpreting the surrounding environment and providing downstream distribution connections. Through their joint venture partners, Australian managers gained knowledge of local markets, government and commercial contacts, cultural and social contexts, and marketing and distribution networks.

In contrast to contractual joint ventures, the Australian partners exercised on-site and day-to-day operational control, reflecting the skills of Chinese partners in communicating with local suppliers, logistics providers and the workforce. To counter immediate operational control by their Chinese partners, Australian firms received formal monthly reports and informal reporting on a daily or weekly basis, supplemented by numerous written and verbal communiqués, and frequent visits by Australian executives. Australian partners had equal or dominant control at the board level and most board meetings (63 per cent) were held in China, providing a further

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opportunity to directly monitor operations. Approval from Australian headquarters or the equity joint venture board was required for all decisions affecting financial and growth strategies for the venture.

Besides monitoring their partners, Australian managers had to resolve disputes. The leading sources of disharmony were cultural and linguistic differences, different short-term expectations and general misunderstandings. Serious problems, related to benefiting at the expense of the other party, were not major issues for most Australian firms. Although 81 per cent of JVs had disputes, most were solved by negotiation, based on the written contract. Recourse to legal and third-party enforcement was rare, reflecting the reality of a deficient formal court system. The dominant factor in negotiated equity joint venture conflict resolution was the desire to maintain an ongoing partnership.

Australian investors in China were aware that formal institutions to reduce the costs of exchange were weak or non-existent and that many of the informal institutions utilised by Hong Kong investors were closed to them by culture, family and language. While Australian managers negotiated with their Chinese counterparts when disputes arose, these negotiations were not in Cantonese or supported by ethnic and familial connections. This meant the negotiations were not comparable to those between Hong Kong and Guangdong managers. In the end, only half the Australian firms made a profit.

Cognitive Limitations and Contract Design: How Australian Managers Structured “Good” and “Bad” Contracts

The cognitive limitations of managers, coupled with unfamiliar and uncertain informal and formal institutions in the host country, constrain the design of contracts. Good contracts further the involvement of international firms in a country’s economic development. Inappropriate contracts result in the termination of foreign firms’ involvement or sub-optimal transfers of knowledge and skills, to the detriment of the developing country. A case study presents how Australian-based managers’ perceptions of institutional proximity between Australia and different host locations affected the design of their investment contracts. Managers’ assessments of these differences resulted in sub-optimal outcomes in India, but efficient outcomes

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in Indonesia and Viet Nam. Two elements were critical to these outcomes: the impact of experience in emerging markets and the decision to seek local partners for their rich, context-specific knowledge and relations.

When determining new foreign strategies, managers engage in a two-stage process of decision making. Scanning a range of countries, they first select a non-equity (strategic alliances, licenses, R&D agreements) or equity (joint ventures and wholly owned subsidiaries) economic organisation (see Table 5.1). Managers then design control and incentive mechanisms appropriate to the economic arrangement selected to safeguard exchange, as described in the China case study.

To simplify decision making on country choice and the design of contracts, managers look for common elements between the institutional environments in the home and host country. Focusing on the common characteristics of the formal institutions of two countries (such as legal system or political structure) may disguise the divergence between informal norms, and how informal institutions distort the operation of formal institutions. This may lead managers to select and design inappropriate contracts. Outward signs of the wrong choice of contract design include dissatisfaction with the performance of a new venture against unrealistic or inappropriately specified performance targets, or reliance on law-based mechanisms to resolve disputes with partners in countries subject to corruption in the judiciary. Finally, prior (or lack of prior) multinational experience will increase (decrease) the probability of managers selecting and designing effective contractual forms.

These propositions were tested using data on 64 Australian companies operating long-term contractual arrangements in Indonesia, 33 in India, and 19 in Viet Nam. Using the surveys and other data, Table 5.2 outlines the institutional similarities and differences between each host country and Australia. With respect to formal institutions, India clearly shares a number of common elements with Australia, including a common commercial language, legal system and parliamentary governance. All three host locations, including India, were characterised by informal norms associated with strong business-government-bureaucracy ties and entrenched rent-seeking.

Yet, Australian firms entering India chose not to align themselves with local firms that were familiar with and embedded in these informal norms and practices. The types of economic organisations varied significantly across the three countries: 50 per cent of all firms selected equity joint ventures in Viet Nam and Indonesia, but only 22 per cent did so in India (where licenses,

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Table 5.2. **Comparative Institutional Environments: Viet Nam, Indonesia, India and Australia**

			Viet Nam	Indonesia	India	Australia
Formal Institutions						
	Form of legal system (Origin)		Socialist (French)	Civil (Dutch)	Common (British)	Common (British)
	Form of political governance		Socialist	Nominal Democracy	Democracy	Democracy
	Official language		Vietnamese	Bhasa Indonesian	Hindi	English
	Tariff and non-tariff barriers[a]		Very high (5.0)	Low (2.0)	Very high (5.0)	Low (2.0)
	Foreign investment restrictions[a]		High (4.0)	Low (2.0)	Moderate (3.0)	Low (2.0)
	Property Rights enforcement[a]		Very low (5.0)	Moderate (3.0)	Moderate (3.0)	Very high (1.0)
	Rule of law[b]		34.9 (-0.47)	39.8 (-0.34)	56.6 (-0.01)	93.4 (+1.79)
	Control of corruption[b]		30.7 (-0.60)	35.3 (-0.44)	43.3 (-0.29)	93.3 (+1.73)
	Religion (% of population)[c]:	Protestant	0.2	4.8	1.1	23.5
		Catholic	3.9	2.7	1.3	29.6
		Muslim	1.0	43.4	11.6	0.2
		Other	94.9	49.1	86.0	46.7
Informal Institutions						
	Corruption ranking (out of 52 countries)	1995	-	41	35	7
		1996	-	45	46	10
	Black-market activity[a]		Very high	Very high	Very high	Low
	Regulatory discretion[a]		Very high	High	High	Moderate
	Language of commerce		Vietnamese	Bhasa Indonesia	English	English
	Voice and accountability[b]		11.5 (-1.24)	16.2 (-1.08)	60.7 (+0.27)	99.0 (+1.65)
Overall Institutional Environment						
	Gastil Index (freedom status)[d]	1995/96	Not free (7,7)	Not free (7,6)	Partially free (4,4)	Free (1,1)
		1996/97	Not free (7,7)	Not free (7,5)	Partially free (2,4)	Free (1,1)
	Economic freedom[a]		Repressed	Mostly unfree	Mostly unfree	Mostly free
	GDP per capita (US$)[e]	1995	273	1024	370	20,333
	(figures in current prices)	1996	312	1135	379	22,281
	Political stability[b]		60.4 (+0.38)	30.5 (-0.34)	23.8 (-0.55)	91.5 (+1.08)
	Government effectiveness[b]		55.9 (-0.18)	66.5 (+0.08)	56.4 (-0.16)	94.4 (+1.58)
	Regulatory quality[b]		25.4 (-0.54)	65.7 (+0.19)	44.2 (-0.13)	89.5 (+1.15)

Notes

a. Index of Economic Freedom , The Heritage Foundation (www.heritage.org)

b. Governance indicators for 1996 by GRICS, World Bank (www.worldbank.org). *Source:* Kaufmann, Kraay and Mastruzzi (2003). Figures depict the percentile rank on each governance indicator, each ranging from (0-100); figures in parenthesis are the margin of error estimates, ranging from (-2.5 to + 2.5).

c. Religious affiliations: percentage of population belonging to major world religions in 1980. *Source:* La Porta *et al.*. (1999).

d. Freedom House Gastil Index: Combined average for rating of political rights and civil liberties, each from 1 = highest degree of freedom, 7 = lowest (www.freedomhouse.org).

e. United Nations Statistical Yearbook, 1997, Issue 45.

Source: Authors.

wholly owned and non-equity contracts were common). Compared to Australian firms in India, companies investing in Indonesia and Viet Nam sought partners specifically to tap into local information sources through their partner's web of intertwining relations between the corporate, social and political spheres.

Further, Australian firms investing in Indonesia and Viet Nam had pre-existing Southeast Asian subsidiary networks. By contrast, investors in India had dispersed networks, with only one or two investments in any one region. The experience of investors in Indonesia and Viet Nam proxied information and expertise in operating in the institutional environments of emerging economies, which are characterised by compromised and weak legal systems, long histories of state ambivalence towards FDI, and deep connections between local firms, the bureaucracy and government (Wade, 1990; Lassere and Schq´tte, 1999). Regionally experienced firms ranked the absence of strong commercial experience and networks, particularly in Viet Nam, as a high risk factor, compared to a significantly lower risk assessment by regionally inexperienced firms. Not surprisingly, Viet Nam and Indonesia investors designed contracts that demonstrated their awareness of the influence of informal norms.

In India, contract design and operation reflected over-estimation of institutional proximity and lack of prior multinational experience. Despite India's weak intellectual property rights regime and history of barring foreign licensors from setting procurement, pricing and export restrictions on transferred technology (Shun, 1994), 52 per cent of the managers in India placed legal limits on their agents, such as territorial limits on exporting, domestic sales, and production locations; and restrictions on the purchase or supply of managerial services, and on research and development. Only two firms in Indonesia sought such constraints. The heavier reliance on legal devices in India coincided with higher levels of disharmony: 82 per cent of firms had disputes with their agents, with 27 per cent experiencing difficulties monitoring contractual compliance. One-third of these disputes were resolved by reference to the legal contract and one firm sought recourse to arbitration. No monitoring problems or disputes were reported with Indonesian agents.

Cognitive limitations and uncertainty about the informal institutions in India led Australian managers to select and design the "wrong" contracts. Based on the parent managers' satisfaction with the profitability and success of their overseas operations, India clearly underperformed relative to Viet

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Nam and Indonesia. These "wrong" choices may reflect a similar situation in many MNEs operating in India, helping to explain India's slower economic development relative to China.

Using the Lessons of the Past and Present to Understand the Future

Informal and formal institutions, by setting the "rules of the game", shape the economic, political and social organisations that create economic growth, or lead to stagnation or decline. However, the context-specificity of experience in operating contracts in developing countries makes it difficult to draw universal lessons.

Institutions are dynamic and, as illustrated in the case studies, strongly path-dependent. Private businesses are always embedded in formal institutions, whether those of the feudal system in Charlemagne's 12th-century Europe or Viet Nam's 20th-century state planning system. In many developing countries, prevailing formal institutions hinder private business development. Generally, institutional change is slow, and formal institutional change must be consistent with informal institutions, as *Perestroika* showed in the Soviet Union. Informal institutions co-exist with formal institutions in all economies, either impeding economic reform, as in post-Soviet Russia, or facilitating private business, as in Viet Nam, China and 12th-century Europe. Even when informal institutions facilitate economic growth, kinship systems (Maghribi traders) may be inferior to open systems (Viet Nam and the merchant courts). Several lessons can be drawn from these examples:

— *Lesson One:* Development agencies and developing country governments should foster informal economic institutions that support private business, especially open business networks over kinship networks. Informal institutions that support private economic exchange are also likely to support formal institutional change, such as impartial court systems for settling disputes. However, this is probably not an easy task. Informal institutions that impede private business are also likely to hinder formal institutional reform and delay economic growth and development.

— *Lesson Two:* Development agencies should promote the replacement of those informal economic institutions inimical to growth, a task likely to be beyond the capacity or willingness of developing country

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governments. When encouraging such changes, development agencies must understand that the new rules will compete with a developing country's existing institutions. The successful introduction of new institutions will depend particularly on their fit with the existing matrix of political and social institutions. The new institution may not facilitate economic growth, even when designed to support private economic exchange.

— *Lesson Three:* For informal economic institutional reform to be successful, political institutional change may be necessary. Authoritarian governments can foster formal and informal economic institutional reform, but political elites frequently resist efficient formal and informal economic institutions. Development agencies and foreign and domestic governments need to determine what is feasible, given a country's cultural heritage and prevailing power structures. Can economic development be sustainable without incentive structures embedded in Western democratic institutions?

— *Lesson Four:* Transplanting institutions into a developing country is unlikely to be successful and, where successful, is unlikely to be rapid. New institutions need to evolve from existing institutions. For example, a transparent legal system for developing countries should be designed using the informal institutions of the developing country, as opposed to importing Western models. There may be a convergence in black-letter law (basic standard elements of law) across countries, but the operation of legal systems is society-specific.

— *Lesson Five:* Enhancing the flow of information about the availability, reliability and skill levels of suppliers, distributors and partner firms reduces the costs of designing and managing contracts. Development agencies' support for programmes aiming for richer, deeper and more transparent information flows within business communities facilitates contract choices conducive to economic development. In particular, information on informal institutions will reduce the cognitive limitations of managers: Australian managers thought (correctly) that China's legal system would not support contract dispute resolution, but their misreading of India led them to the opposite (and false) conclusion for India.

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In Focus

Growth of the Tanzanian Firm Sector: The Role of Formal and Informal Institutions

Marion J. Eeckhout[1]

Tanzania offers an interesting case to study the role of formal and informal institutions in spurring or hindering the private sector. While, on paper, the government seems committed to private sector development, in practice entrepreneurs complain about the inadequate and unpredictable application of government rules. As a consequence, informal institutions have often come to substitute for formal ones to render business relations more predictable. However, the scope of informal institutions is limited and the failure of formal institutions needs to be addressed more carefully.

Tanzania's macroeconomic performance in recent years is promising. Over the last decade, the country has seen annual growth rates of 4 per cent and 5 per cent in real terms, whereas annual growth rates in the early 1990s were a meagre 2 per cent. Yet, the rapid growth rate is mostly due to a limited number of sectors such as tourism, mining and services. Many small firms in the manufacturing sector did not benefit from improved macroeconomic conditions: productivity growth is limited; innovation often lacking; and few manufacturing firms succeed in exporting their products.

Explaining Tanzania's Poor Business Growth

What can explain this poor performance? Firm development often results from a stable macroeconomic and policy environment. Clearly, Tanzania's macroeconomic environment has improved. The volatility in exchange rates has

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been stabilised and inflation rates have come down considerably. Furthermore, in recent years, the Tanzanian government has launched a number of private sector promotion programmes. The present government has recognised private sector growth as a priority area for Tanzania's development and poverty reduction, as expressed for example in the *Tanzania's Poverty Reduction Strategy Paper* of 2005.

Nonetheless, it appears that the government's formal policy statements are not always met in practice. Survey data show that firms often do not trust the government in implementing its formal policies. Firms complain about the way services are provided, specifically about the unpredictability and unreliability of services. For example, in a recent World Bank Investment Climate Assessment, firms complain about the level of taxation and the unpredictability of the implementation of taxation rules. Respondents (who were dealing with tax officials on average seven days per year) indicated that inspectors often required gifts or payments.

Informal Institutions as a Substitute

The lack of trust in government policies — and the resulting malfunctioning or lack of formal institutions — has induced small firms to create their own informal governance arrangements. Kahkonen, Lee and Semboja (2001) provide an example of legal institutions in economic development. Faced with a lack of well-functioning formal institutions, such as property rights and contract enforcement mechanisms, firms have established their own mechanisms to overcome risk and uncertainty in their relations with other businesses. Most firms prefer to maintain good relationships with well-known and long-term suppliers and consumers. They rely on their social network, which is often built on trust among ethnic or religious groups.

The case study also shows, however, that the scope of these informal institutions is unsatisfactory. Informal contracts are very simple and thus very limited in their reach. In addition, small firms often see the continuation of trustworthy relations as more important than timely payment. Therefore, half of all trade credits are delayed. Furthermore, only entrepreneurs with a broad and deep network can benefit from enforcement mechanisms based on informal institutions, leaving many entrepreneurs aside.

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What Next?

The key requirements for an appropriate investment climate, such as stable macroeconomic policies and a committed government, are by now in place. Other important elements, however, have not yet been established, and the growth of the private sector is still disappointing. To overcome the obstacles small firms face, it is thus of crucial importance for the government to improve its attitude towards the private sector and to respect the rule of law. It is clear that governance and reliability will take time, but only then will a government committed to private sector growth see its formal policies matched by results.

Notes

1. Marion J.Eeckhout wrote this article as a contribution to the research exchange arrangement between the ISS and The Netherlands Ministry of Foreign Affairs.

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Discussion Report

Private Sector Development

Felicity Proctor

Lead Questions

— How do informal institutions promote or hinder private sector development (i.e. the creation of markets/firms/jobs)?

— How do multinationals deal with the local informal institutional environment? Do they adapt to it or change it?

— How can the investment climate be improved in an environment with strong informal institutions?

Composition of the Panel

The working group on Private Sector Development was chaired by Robert Peccoud, Director of Research Department, Agence Française de Développement, France. Based on the background paper of this session, the introduction was given by Stephen Nicholas, University of Newcastle, Australia. Responses were provided by Elena Panaritis, Director, The Panel Group LLC, USA; Marion Eeckhout, Ministry of Foreign Affairs, Netherlands; Kithinji Kiragu, Chairman of Solid Investment Securities, Kenya; and Juan de Laiglesia and Christian Morrisson, OECD Development Centre, France.

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Introductory Presentation

Both formal and informal institutions are important for private sector development. Formal institutions provide the constitutional framework in which organisations and individuals interact. Informal institutions comprise the norms and conventions that govern the ways of doing business. Informal institutions can reduce the costs of undertaking economic, political and social initiatives by providing information to firms. Stephen Nicholas explained that today's development challenges do not lie in finding technological solutions to production and distribution constraints, but rather in structuring institutions to promote economic exchange and growth.

As informal institutions are more prominent in environments with weak formal institutions, their effect on business outcomes is particularly pronounced in developing countries. Though informal institutions can reduce transaction costs, they frequently fail to reduce uncertainty, provide sufficient information or effectively enforce economic exchange. This situation becomes particularly problematic when markets are growing and informal businesses can no longer rely solely on the reputation of members. Finding adequate contractual arrangements that consider the country's formal and informal institutions is, therefore, a prerequisite for high performance and development. Nicholas encouraged development agencies to focus on informal institutions that support private business, especially those that can replace kinship structures with open business networks. In order to reduce the cost of designing and managing contracts, development agencies should support programmes that enhance the flow of information about the availability, reliability and skill levels of suppliers, distributors and partner firms.

Informal Institutions and Effective Property Rights in Peru

Giving a private sector perspective, Elena Panaritis shared a success story of bridging private sector development and informal institutions. Drawing on the experience of property rights reform in Peru, she explained how social and economic benefits can be achieved by aligning the incentives of all key players: the private sector, citizens and the State.

In order to construct functioning formal institutions, it is crucial to understand the history and current set-up of the informal institutional framework. Given the high importance of informal property assets in developing countries, transforming them into tradable assets offers an important entry point for

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institutional reform, explained Panaritis. The 1990 reforms in Peru created a new property rights system that facilitated the titling and official registration of land parcels, which had previously only been recognised by community members. Such formal property assets drastically increased in value and could now be used as collateral in the financial markets.

Informal Institutions and the Tanzanian Business Sector

Marion Eeckhout discussed the disconnect between formal and informal institutions in the Tanzanian business sector (see "In Focus" box). She explained that Tanzanian firms are not held back by the lack of markets and finance, but by inappropriate formal institutions. In order to cope with this situation, firms have created a self-sustaining system of small-scale networks. As such networks rely solely on cash payments that do not allow credit relationships, the business sector in Tanzania is plagued by stagnating productivity growth, little scaling up of networks and insufficient access to financial services. Bridging formal and informal institutions would require the strengthening of formal institutions, through trust-building processes at the national and local level. There was, she explained, "no shortcut to improve the investment climate with stroke-of-the-pen measures".

Informal Institutions and Private Sector Development in Kenya

Kithinji Kiragu explained how informal institutions can have positive and negative effects on private sector development. On the positive side, Kiragu illustrated how informal institutions helped in managing community land use, ownership and lease. He described the instrumental role of informal institutions in promoting savings and credit practices among women's groups. However, informal institutions also block the development of the private sector in Kenya. Community-based resistance, for example, has prevented foreign direct investment in the mining industry.

Kiragu discussed the apparent confusion among multinationals on how to bring informal institutions into their strategies: he explained that they relied too strongly on their home and/or host country to resolve existing problems and challenges. A successful strategy would, nevertheless, require an active engagement of local initiatives and more inclusive democratic practices.

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Culture, Family Ties and Saving Behaviour in Sub-Saharan Africa

Juan R. de Laiglesia and Christian Morrisson presented their work on culture, family ties and saving behaviour. They described the remarkable diversity in family structures around the world, with varying household sizes and dependency ratios. These result from family institutions (both formal and informal) such as polygamy, marriage practices and child fostering.

Saving patterns and investment behaviour vary across household structures and compositions. Specifically, polygamy is associated with lower savings and investment. Indeed, polygamous households have, on average, lower net wealth per capita than monogamous households. This assessment emerged from a statistical analysis of household data from Côte d'Ivoire and Ghana, and underlines the finding that high frequency of polygamy is associated with lower investment rates across countries. Family institutions should, thus, be taken into account in policy making (as they create incentives for investment decisions) and in designing regulatory changes.

General Discussion

In the subsequent discussion, the working group debated wider contextual issues relevant to the topic before turning to the overall questions of this session. Although not shared by everybody, the group expressed concern over the terms "formal institutions" and "informal institutions". Participants preferred to distinguish between "formal rules" (e.g. regulations, laws) and "informal rules" (e.g. codes of behaviour, traditions and culture). Given the major changes that are taking place in economic activity and private sector development, it is difficult to distil the elements of the informal sector; this is particularly true concerning the differentiation between "institutions" and "organisations". The validity of separating the formal from the informal was also subject to debate. Some people argued that formal structures are often embedded in informal rules, which highlights the close connection between formal and informal institutions. The group called for a clear terminology and a glossary of key concepts.

Participants recognised that each country is characterised by its unique history, culture, asset base, level of urbanisation and pace of development. All these factors influence (and are influenced by) formal and informal rules, and the interactions between them. In order to foster private sector development, donors and other development practitioners need a deeper understanding of these

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interactions at national and sub-national levels. Donors should avoid generalisations and should realise that their policies might not be easily transferable.

Of deeper concern was the view that the international development agenda — especially the delivery of the Millennium Development Goals (MDGs) — may not be a shared agenda. Despite international efforts to halve extreme poverty by 2015 (MDG 1), the political elite in many countries continues to reap the wider economic gains of development, with little regard for re-enforcing opportunities of broad-based equitable growth. Concern was also expressed about the unintended consequences of current development policies. For example, privatisation and liberalisation efforts, as well as high and increasing levels of aid, produce winners and losers.

Such factors influence private sector development and the manner in which the informal and formal structures interact and respond. In addressing economic development and the engagement of the poor in the market, the group identified a weak understanding of household structures. In particular, there is insufficient understanding of multi-locational economic activities of the extended family (i.e. networks of households), and the associated informal and formal rules and structures that govern a family member's effective inclusion or exclusion in a given economic activity.

More generally, the group questioned whether enough information existed on how formal and informal rules and structures support economic development, including pro-poor economic development. In order to improve policies, the type of information that is currently available needs to be assessed, as well as the information requirements of particular groups such as foreign investors. Existing reports on investment climate and a country's governance (such as those supported by the World Bank) inadequately capture informal rules.

How Do Informal Institutions Promote or Hinder Private Sector Development?

The debate focused on the level of access of the poor to productive assets, which seems to depend on a country's specific local context. Evidence from Peru suggests that positive economic and investment outcomes might be attained by strengthening formal legal entitlements, particularly in cases in which the initial informal system had not delivered such benefits. In the case of Kenya, on the other hand, economic assets might be gained by the poor through fostering and reinforcing customary systems at the local level.

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How Do Multinationals Deal with the Local Informal Institutional Environment? Do they Adapt to it or Change it?

The debate followed two key threads. First, foreign investors form different types of ventures, (including various contractual obligations) in the country of investment based on existing formal and informal rules, their own networks and knowledge. Second, — and particularly important from a development perspective – these contractual structures and business relationships entail potentially different development outcomes. Beyond the immediate and measurable commercial gain, these factors also determine the type and level of knowledge shared, the level of capital invested and the payment systems adopted (as described by Nicholas in comparing Australian and Hong Kong based firms, and their strategy and investment approach in China).

Uncertainty and asymmetry of information create opportunities to either cheat or to be trustworthy, thus contracts are structured within this framework. In India, for example, a strong tendency for business to operate within the framework of informal rules potentially lowers the level or pace of innovation and, thus, of development. As is illustrated by the case of Viet Nam, the strengthening of formal rules enticed multinationals to rely less on informal conventions and more on formal rules and structures, without negative consequences.

How Can the Investment Climate be Improved in an Environment with Strong Informal Institutions?

The group felt the need for a broader and deeper understanding of the interaction between informal conventions and formal rules, as well as the interaction between the informal private sector (often operating largely through informal rules) and the formal private sector. It was suggested that the wider voice of the private sector (i.e. formal and informal private sectors, small and large businesses, as well as organisations of civil society) should be taken into account in the preparation of a country's Poverty Reduction Strategy Paper and/ or national private sector development strategy.

Given a potential disconnect between the formal and the informal, donors and development partners might solely recognise and relate to formal rules and structures. This omission of the informal will further widen the gap between the formal and the informal. It will also reduce opportunities for an effectively managed transition and/or enabled linkages, with potentially negative development

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consequences. Supply-side measures for private sector development (e.g. technology, finance) were identified as less effective when a low equilibrium prevails in the effective transition between informal and formal structures.

Conclusion and Outlook

Overall, it was felt that there are no quick fixes. Time and resources should be given to support the transition from informal to formal rules. In order to secure positive development outcomes and economic growth, this strategy, nevertheless, reinforces and sustains those informal rules and structures that currently provide critical support for the poor. Societies are changing very rapidly, especially due to the forces of globalisation. The group called upon national governments and donors to tackle the development challenge of informal rules and structures as a priority. This should include fostering debate at sub-national (local) as well as national levels. Countries need the capacity to analyse their own experiences. Finally, a need was identified to understand sequencing, build trust and start with those transitions that are likely to have successful outcomes, in particular those that include an engineered change from informal to formal rules and structures.

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Part III

What Have We Learned and What Can We Do? Implications for Policy

Chapter 6

Policy Implications: A DAC Perspective on Donor Policy and Practice

Richard Manning and Eduard Westreicher

Summary

Given their importance for development, informal institutions matter for the international donor community. This chapter summarises lessons learned in exploiting the multiple linkages between informal institutions and development outcomes. It also highlights current and future work streams of the OECD Development Assistance Committee – Network on Governance, which aims to further our knowledge on the various facets of informal institutions.

Institutions are necessary to get things done in every country and every society. As structures and mechanisms of social order and co-operation, institutions are needed to allocate duties and responsibilities, and to overcome collective action problems. They shape and constrain human behaviour through rules, norms and other frameworks. They can influence individuals: to maximise benefits, to act out of duty or an awareness of what is socially acceptable behaviour, or simply to follow routines because a "certain way we do these things" is taken for granted and alternatives are inconceivable.

Thus, in order to foster development, it is indispensable for policy makers to look at countries' and societies' institutional environments, and to understand how these environments shape outcomes and constrain viable policy choices. This institutional environment consists not only of formal institutions, in the sense of the rules that are encapsulated in formal structures (such as constitutions and government) and enforced by official entities (such as courts, police and bureaucracies). It includes also the "behavioural regularities based on socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels" (Helmke and Levitsky, 2004). These informal institutions matter everywhere, but they can be of particular importance in developing countries in which formal institutions are often poorly established.

Adequately addressing informal institutions is a difficult task. They impinge on development in various ways, ranging from positive to harmful. Many aspects of informal institutions that are also often referred to as "social capital" are, themselves, indispensable for development: e.g. basic features of social organisation such as trust, co-operative norms and associations between individuals that can improve the efficiency of society. In this respect, informal institutions can be powerful complements to formal institutions, as underlined by the success of the Grameen Bank, which uses peer pressure to ensure the payback of micro-credits. In other cases, informal institutions hamper desirable processes of formalisation, such as transitions to judicial independence and the emergence of the rule of law more broadly. Finally, some informal institutions are inimical to development, such as norms and customs that exclude and discriminate against certain groups.

To complicate matters further, a given informal institution can lead to different development outcomes, depending on the interaction with formal institutions and the specific country context. Risk-sharing rules in rural communities protect community members against shocks in one setting and potentially act as a "tax on success" for the more affluent members of society

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in another. Similarly, personal relations between big business and government that are instrumental to growth in one case may stifle economic development in another.

The implications of this context dependence for donor policy and practice are complex and require flexible responses. However, several general recommendations might prove useful.

1. Include Informal Institutions into Development Strategies

Informal institutions need to be taken into account in policy making. They matter greatly for development and not necessarily in negative ways. Neglecting the impact of informal institutions in the design of policies is likely to hamper, rather than foster, development.

Development policy and practice must not rely on a dichotomy between formal and informal institutions. Stressing the difference tends to imply an oversimplified judgement, namely that informal institutions are "of the past" whereas formal ones are "of the future". Effectively integrating informal institutions into development strategies requires less normative thinking, but an increased awareness of the historical and political realities. It is important to look at the way in which institutions of all kinds persist or change, are re-invented, interact or create alliances among themselves.

2. Design Effective Policies to Gradually Adapt the Institutional Framework

Based on a careful analysis of the institutional system, a pragmatic mix of nuanced policies should be developed. The variability of informal institutions needs to be taken into account and be followed by flexible policy responses. Policies should build on the best informal institutions and challenge the harmful. Where informal institutions are inimical to development goals, strong formal institutions need to counter them. Where such formal institutions do not exist, they need to be created. If such formal institutions exist but are weak, their implementation should be made more effective. Where informal institutions are not inimical to development goals, a set of complementary processes should be considered. In many cases, smart policies will be those that promote convergence of formal and informal institutions.

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Policies of zero tolerance are not enough to overcome harmful informal institutions. As in the case of anti-corruption campaigns, policies that try to undermine patronage-based power systems need to do more than just weaken the influence of informal institutions. Policies must offer viable alternatives. Otherwise situations are likely to worsen and might even result in an institutional vacuum or chaos.

Policies to promote institutional change that work in one country are not necessarily optimal elsewhere. A simple transfer of models is likely to create ineffective parallel structures that are bound to fail because they do not link to deep-rooted values and customs that hold societies together. Different country realities require different combinations of promising options for action. Effectively changing institutions will not happen overnight. Institutional changes are always incremental and include changes in both the formal and the informal spheres. They require considerable time and support to address underlying structural conditions.

3. Be Aware of the Political Realities that Back up the Institutional Framework

Institutions are politics; being aware of the "nature of the game" is likely to enhance performance. Institutions are not technical tools, free of values. They are the substance of which politics is constructed and – by underpinning power structures, patterns of interests and patronage systems – a vehicle through which the practice of politics is transmitted. Changing institutions to advance development, reduce inequalities and enhance capacity for pro-poor outcomes will rarely be free of tensions. Poverty reduction objectives often oppose and threaten power structures that are established by the informal system.

Understanding the institutional landscape of countries and societies, and the wider context in which the landscape is situated, requires an investment in assessments and analyses. Power relations — and the need for change that is necessary to advance development — must be brought to light.

4. Create Effective Partnerships

Institutional change cannot happen without the active involvement of partner countries. Successful institutional reform requires their genuine ownership, and local actors need to play a leading role. External actors and

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agencies should follow their lead and provide support in order to attain the long-term objectives. With patience, changes are possible even in the most difficult circumstances, as many examples have shown.

More practical tools and approaches based on sound concepts are needed to assist donor and partner staff in dealing with the sensitivities and complexities of informal institutions. Essential knowledge in this area is found in think tanks and universities, including those in the South. Links between academia and development practitioners should be strengthened, and multi-disciplinary approaches pursued.

While the role of informal institutions in and for development is increasingly recognised, more needs to be done to shed light on their interplay with formal institutions in the wider development process. Part of the answers must come from the research community. As the seminar on informal institutions has shown, the OECD Development Centre is particularly well placed to play an important role in this regard. The OECD Development Assistance Committee (DAC), for its part, is a good place for reviewing and sharing donor experience and for developing policy guidance. Subsidiary bodies of the DAC are dealing with various facets of the complex reality of informal institutions, as is reflected, *inter alia*, in the following work streams.

Political Economy Analysis

The imperative of illuminating the power relations, the political and institutional factors that drive or impede pro-poor change, and the underlying interests and incentives that affect the environment for reform has been echoed in the DAC Network on Governance (GOVNET) work on political economy analysis (OECD, 2006a; OECD, 2005a). A comparison of donor approaches to political economy and institutional analysis illustrated a strong groundswell of interest and support for better understanding of the political and institutional context of development among bilateral and multilateral donors. Although donor agencies take different analytical approaches, some common starting points can be identified. One of these is the need to take account of informal institutions to better understand underlying causes (not just symptoms) of poor governance. Studies by various donors have helped to structure existing knowledge, provided a shared language and understanding of the impact of political and institutional context, and stimulated thinking about processes of change. These studies are also beginning to influence donor policy in two ways: by emphasising the importance of political factors in shaping development outcomes; and in highlighting political and institutional issues in programme design across sectors. Opportunities to further disseminate the insights from political economy and institutional analysis will be arising in connection with new GOVNET work on assessing governance, corruption and capacity.

Anti-Corruption

A particularly problematic dimension of the importance of informal institutions has been highlighted by the GOVNET's work on anti-corruption. Anti-corruption assessments show that formal institutional reforms are sometimes encountering significant implementation problems. Some have limited penetration and traction because they are circumvented, if not subverted, by the informal "rules of the game" (OECD, 2006b). There are cases, for example, in which the independent audit of Heavily Indebted Poor Countries funds noted non-compliance with financial management and procurement procedures, despite significant safeguards and international monitoring. In other cases, potential contractors were eliminated from tender lists, despite new procurement rules. Broad political-economy dynamics of corruption cannot be addressed by focusing attention exclusively on formal institutions and channels. More exposure concerning informal institutions and processes is needed. This includes the role of clientelism, patronage, religion, tribe and traditional leaders. The GOVNET remains committed to shed more light on these issues.

Capacity Development

New DAC guidance on capacity development has underlined that informal institutions need to be taken into account as part of the enabling environment (OECD, 2006c). Understood as the ability of people, organisations and society to manage their affairs successfully, capacity depends on more than the experience, knowledge and technical skills of individuals. Capacity development at the individual level, although important, depends crucially on the organisations in which people work. In turn, the functioning of particular organisations and the behaviour of individuals is shaped and

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constrained by the enabling environment – including the structures of power and institutions, both formal and informal. The DAC sees further need for an institutionalisation of a common mindset of what capacity development should mean. This could be achieved through a process of horizontal learning across the Committee's various streams of capacity development work.

Conflict, Peace and Development Co-operation

The importance and the complexity of the interplay between formal and informal institutions has also been highlighted in the work of the DAC's Network on Conflict, Peace and Development Co-operation (CPDC). CPDC guidance has gone a long way towards taking account of the fact that informal institutions and traditional authorities often have a significant influence on communities, and can be essential mechanisms for effective peace-building and reconciliation (OECD, 2001). Likewise, the majority of people (particularly the poor) in many places rely on informal institutions of justice for safety and the resolution of disputes concerning their personal security, and protection of their land, property and livestock, as well as family and community disputes (OECD, 2005b). Informal institutions are widely used in cases when no access to formal state justice exists or when state systems are more expensive, less rapid, less culturally relevant, and less responsive to people's needs. In some cases, they supplement or complement state institutions; in other cases, they operate in lieu of formal institutions. However, it is important to also note the shortcomings and risks that can be associated with informal institutions of justice. It may be, for instance, that they do not equally serve all segments of society; they may marginale and discriminate against an ethnic group, women or the poor. Some may coerce conciliation, coerce confessions and serve the interests of unelected individuals and powerful groups. In such cases, it is key to carry out sound analysis and contextualisation of the role formal and informal justice institutions and actors play in a given setting.

Outlook

The international seminar on "Informal Institutions and Development: What Do We Know and What Can We Do?" clearly illustrated the importance of considering informal institutions in development theory and practice. Based on existing areas of work, the OECD-DAC will continue its analysis of informal institutions and address more clearly the ways in which they matter for development. The seminar, which drew the attention of many high-level policy makers from OECD and partner countries, and was opened by the Secretary General of the OECD Angel Gurría, created an important momentum that will be used to continue the work on this crucial issue. Together with our colleagues from the OECD Development Centre, the OECD-DAC will further study the implications of informal institutions on development and provide policy advice to better serve the needs of donor and recipient countries.

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Chapter 7

Conclusions and Outlook

Johannes Jütting, Denis Drechsler,
Sebastian Bartsch and Indra de Soysa

Referring to the two lead questions of the seminar: "Informal Institutions and Development: What Do We Know and What Can We Do?", this book provides ample evidence of the various roles that informal institutions play in the development process. During the seminar, a consensus emerged that it would be useful to classify informal institutions into those that promote, those that harm and those that blatantly oppose development objectives. This could be a first useful step to categorise their impact on development and provide entry points for the design of better policies. However, it would be naïve to rely on this classification only: more research is needed to truly understand the functioning of informal institutions. Two critical issues need to be kept in mind. First, some well-functioning "good" informal institutions can turn into "bad" ones during the process of modernisation. Second, any given informal institution can have a different development impact depending on the specific country context in which it is applied.

It is, thus, not entirely clear how best to deal with informal institutions. "What can we do?", therefore, remains an open question. However, the contributions in this book provide some guidance as to what policies might work and which ones are likely to fail. Neither the "romantic preservationist" approach (arguing for preserving existing informal institutions as being part of the local culture) nor the "bulldozing moderniser" approach (seeking a radical change in one single stroke) promises an adequate solution.

Institutional reform is a delicate affair that needs to be undertaken with caution — and sometimes against conventional reform dogma. In some cases, good intentions may even aggravate the *status quo*. Reforms need to acknowledge the mindsets of people and their readiness for change, as well as the incentive structures that govern people's behaviour. Thus, winners of the reform may champion the process, but losers need to be adequately compensated so that they do not block the transformation process.

Changing laws alone, without building public support and providing proper enforcement mechanisms, is bound to be ineffective. Sometimes it might even pose high costs for the alleged beneficiaries. Given the complexity of institutional reform, striving for the first-best options might not always be the right approach. Reforms have to be adapted to the specific country context and applied within the boundaries of what is possible. Institutional change requires a long, tedious and modest implementation of thousands of small steps in which the correct sequencing of reforms plays a crucial role. More research is needed to better understand the exact functioning of informal institutions. Only then will policy makers be able to design better policies which truly deliver the positive development impact of informal institutions. This publication offers an interesting first overview which will inspire more work in the future.

As the discussions in Paris have shown, improving knowledge on informal institutions and their multiple interactions with policy could become a key to achieving development objectives. A lot is already known… much more still needs to be done.

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Programme

Monday, 11 December 2006

Opening Session

Chair	Louka T. Katseli, Director, OECD Development Centre
Opening Address	Angel Gurría, Secretary-General, OECD
Keynote Speakers	Gonzalo Arenas Valverde, Vice Minister of Planning, Chile Susan van der Merwe, Deputy Minister of Foreign Affairs, Republic of South Africa

Roundtable 1 Informal Institutions: Friend or Foe of Development?

— How do informal institutions positively or negatively shape development outcomes?

— Is there a dynamic evolution from informal to formal institutions?

— Can informal institutions be influenced and, if so, how? How can stakeholders support improvements in institutional frameworks?

Chair	Richard Carey, Deputy-Director, OECD Development Co-operation Directorate
Introduction	Indra de Soysa, Professor, Norwegian University of Science and Technology Johannes Jütting, Senior Economist, OECD Development Centre
Panelists	Mona Makram-Ebeid, Professor, American University in Cairo Jean-Philippe Platteau, Professor, University of Namur Anne-Marie Goetz, Chief Advisor, UNIFEM

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Tuesday, 12 December 2006

Parallel Sessions: Experiences from the Field in Three Main Areas

Session A Gender Equality

— What kind of informal institutions prevent progress towards gender equality?

— What are appropriate policies or approaches to deal with gender-discriminating institutions?

— Which actors are well placed to initiate and support changes?

Chair	Sebastian Bartsch, Administrator, OECD Development Co-operation Directorate
Presentations	Gita Sen, Professor, Indian Institute of Management, India
	Neema Mgana, Director, African Regional Youth Initiative, Tanzania
	Denis Drechsler, Policy Analyst, OECD Development Centre
Rapporteur	Laila Abdallah, Doctoral Student, Stockholm Center for Organizational Research, Sweden

Session B Governance, Accountability and Capacity Development

— Does informal governance matter in the development process?

— How do formal and informal aspects of governance interplay?

— Which preliminary policy lessons can be drawn on how partners and donors can improve governance and accountability in settings in which informal institutions and informal governance dominate?

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Chair	Andreas Proksch, Head of Department, GTZ, Germany
Presentations	Nils Boesen, Consultant, Process and Change Consultancy, Denmark
	S.S. Meenakshisundaram, Visiting Professor, National Institute of Advanced Studies, India
	Upala D. Banerjee, Coordinator, Lessons Learned Project on Human Rights-Based Approaches, Thailand
	Mark Nelson, Senior Operations Officer, World Bank Institute
Rapporteur	Nicolas Meisel, Economist, Agence française de développement, France

Session C Private Sector Development

— How do informal institutions promote or hinder private sector development, i.e. the creation of markets/firms/jobs?

— How do multinationals deal with the local informal institutional environment? Do they adapt to it or change it?

— How can the investment climate be improved in an environment with strong informal institutions?

Chair	Robert Peccoud, Director of Research Department, Agence française de développement, France
Presentations	Stephen Nicholas, Professor, University of Newcastle, Australia
	Elena Panaritis, Director, Panel Group LLC, United States
	Marion Eeckhout, Ministry of Foreign Affairs, Netherlands
	Kithinji Kiragu, Chairman, Solid Investment Securities, Kenya

	Juan de Laiglesia and Christian Morrisson, Economists, OECD Development Centre
Rapporteur	Felicity Proctor, Director of Programme Development, Natural Resources Institute, United Kingdom

Plenary Session

Reporting back from Working Groups: Summary of lessons learned in the field.

Chair	Johannes Jütting, Senior Economist, OECD Development Centre

Roundtable 2 Informal Institutions: Implications for Policies

— What are the main lessons for different stakeholders (partner countries, donors, civil society, private sector etc.) for policy design and implementation?

— Is the expected scaling up of aid an opportunity or a risk for changing formal and informal institutions?

— What are the most suitable instruments or approaches for better understanding and dealing with informal institutions?

Chair	Richard Manning, Chair, OECD Development Assistance Committee
Panelists	Ginette-Ursule Yoman, Secretary of State for Good Governance, Côte d'Ivoire
	Shahrbanou Tadjbakhsh, Director, Center for Peace and Human Security, Science Po Paris, France
	Subir Lall, Deputy Division Chief, Research Department, IMF
	Naresh Singh, Executive Director of the Commission on Legal Empowerment of the Poor, UNDP

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Closing Remarks and Follow Up

Speakers	Johannes Jütting, Senior Economist, OECD Development Centre
	Sebastian Bartsch, Administrator, OECD Development Co-operation Directorate
	Eduard Westreicher, GOVNET Chair, Federal Ministry for Economic Co-operation and Development, Germany

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Informal Institutions

HOW SOCIAL NORMS HELP OR HINDER DEVELOPMENT

Informal institutions – family and kinship structures, traditions, and social norms – not only matter for development, but they are often decisive factors in shaping policy outcomes in environments of weak states and poor governance structures. Based on concrete examples in the areas of gender equality, governance and private sector development, this book advocates a pragmatic way of dealing with informal institutions. Neither the "romantic preservationist" nor the "bulldozing moderniser" approach promises an adequate solution. Incorporating informal institutions in development strategies – whether by taking advantage of them in their existing state, by seeking to optimise their impact or by providing incentives to change them – will be instrumental in improving development outcomes, including achieving the Millennium Development Goals.

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