The role of institutions for human development

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1. Introduction

The objective of this paper is to explore the interconnections between institutions and human development. These links are very complex and intricate, because human development is a multidimensional concept and because there is a variety of relevant institutions for any development dimension. Therefore, this paper could not — and would not — explore the whole network of connections and related issues, but only focus and review some critical aspects, pointing at issues that deserve further research.

The paper is divided in two parts. In the first (§2 to §4), the old and new institutional economics (ONIE) are reviewed in order to understand how they approach development, and in particular if they are concerned also with human development. In the second part (§5 and §6), some aspects of the human development and capability approach (HDCA)[3] to institutions are considered and compared to ONIE in order to summarize the (un)compatibilities and communalities between the two approaches.

Recently, a massive amount of articles is dealing with institutions and economic growth (Jones and Hall, 1999; Rodrik 1999; Sokoloff and Engerman 2000; Acemouglu et al., 2001; Glaeser et al., 2004; Acemouglu 2006), trying to find the main connections and causalities between the two. In the capability approach, both institutions and growth are considered just as *means* towards an *end*, which is human development. However, it seems that in the HDCA the theoretical linkages between institutions and human development have been not yet sufficiently and systematically explored. Starting from an overview of the connection between institutions, both formal and informal, and economic development, we could say that the literature has already shown the role of institutions in fostering economic efficiency (Williamson, 1985), better organisation (Aoki, 2001), education (Bardhan, 2005), social capital (Kornai et. al., 2004), trust (Raiser 1999) and economic growth (Olson et al., 1998). Most of these aspects are instrumental to human development, while

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[3] We are aware of the difference between the human development concept (created by Mahub ul Haq and UNDP) and the capability approach (developed by Sen, Nussbaum and others), being the latter the main theoretical underpinning of the former. However, for our discussion we will consider the two together, as a development paradigm.

others are constitutive of human development. However, in order to establish a more consistent connection between institutions and human development we should first reconsider the concept of institutions. They are defined as “a set of social rules that structure social interactions” (Knight 1992: 2). Following this definition, a selected review of the ONIE literature, from Myrdal (1974) to Hodgson (2006) and others, will show that not all the institutions are equally good for development, and that economic growth has to be differentiated from development (Brinkman, 1995; Cypher and Dietz 2004). The latter would bring about improvements in health, education and other collective goods, and it is boosted mainly by a process of institutional change, social dynamics and cultural change (Myrdal, 1974). This will allow us to find a connection also with the American Institutional School of Veblen, Mitchell and Commons. Given that, human development would be closely related with the holistic approach of development *à la* Myrdal. Hence, a parallel analysis between institutions/human development and institutions/economic growth will show coherence between the holistic institutional approach and the human capability approach. Institutional policies and development policies will come together to make development less uneven, and to create development opportunities for all, in order to improve living standards of people. Likewise, the capability approach has always attached much relevance and attention to the role of institutions for human development (Sen, 1999). In the capability approach, institutions are particularly relevant as mediators between economic growth and human development. Only appropriate formal and informal institutions can convert effectively and efficiently the resources generated by economic growth into sustainable human development. Although in the long run human development is generally associated to economic growth, the conversion is not automatic (UNDP, 1996). A special attention should be given to the interconnections between different types of substantial freedoms and the relative institutions involved. Among the diverse freedoms, especially relevant to development are the five types of instrumental freedom that Sen (1999: 38) suggests: (1) political freedoms, (2) economic facilities, (3) social opportunities, (4) transparency guarantees and (5) protective security. Each type of instrumental freedom refers to main institutional arrangements. The final part of the paper is devoted to analyse the communalities between the capability approach to institutions -as means for human development- and the holistic institutional approach to development. A cross-fertilisation of the two approaches could be reciprocally beneficial.

2. Institutions: general definitions among old and new institutional economists

Institutional economists argue whether institutions have any effect on the economic growth (North 1990). This contentious exerts a considerable impact. A definition of an institution is contested. Numerous definitions were proposed across the different economic theories. However, as a starting point one can assume that economic institutions, in a broad sense, can involve informal institutions such as behavioural rules, social customs, faith reports between economic agents, habits among the agents, etc. Besides, there are formal institutions: organisations, law, and economic agents themselves. Consequently, theoretical approaches to institutional economics vary consistently. In general, two approaches can be distinguished.

The first approach is the Old Institutional Economics (OIE)[4]. The OIE rejects the concept of *methodological individualism* and the concept of a rational individual who simply maximises his own utility. Instead OIE emphasises the role of habits, behavioural rules and social rules as the basis of the human action. The OIE develops an alternative concept of economic behaviour that finds its own origins in the institutions. The institutions are the rules according to which the enterprises and the consumers respectively "satisfy" and not "maximise" their own return and utility. In this approach of institutional economics, "*institution matters*". The institutions are not necessarily created to be socially and economically efficient; conversely they are created to serve and to preserve the interests of some social groups and to create new rules. Institutions, therefore, can be said to be efficient as long as they are committed to their original aims.

The second approach is the New Institutional Economics (NIE). Libecap (1998) claims that "the new institutional economics retains its general attachment to neoclassical economics with its emphasis on individual maximization and marginal analysis, but with attention to transaction costs, information problems, and bounded rationality". According to Douglass C. North (1990, p.6), one of the representatives of this school, "the institutions (...) represent the way through which the several economics face the market failures". Nevertheless, North rejects the assumption of efficient institution and he highlights the vital role of power clusters and lobbies upon the institutional agreements. However, North considers *efficient* the institutions that minimise the transaction costs. The most important role of institutions is that of reducing the uncertainty in order to determine a steady framework of social relations.

Although there are strong differences between these two schools, a theoretical bridge can be made using the North's approach (Hodgson, 2006). In fact, North is sometimes considered to be a *bridge* between Old Institutionalism and New Institutional Economist theory (Groenewegen et al., 1995). North (1990, p. 3) provided an alternative definition of institutions - they were considered as "*...the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction*". Here, institutions are means by which to reduce uncertainty in economic

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[4] Here we refer to Thorstein Veblen, John Commons and Wesley Mitchel, and more recently to Geoffrey Hodgson.

relations; and again, institutions remedy market failures. North's institutional theory is in fact close to the Old Institutionalists' thought when he states that institutions should not be necessarily efficient: "*[i]nstitutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to devise new rules*" (North 1990, p. 16).

Following this bridging approach, we argue that a consistent economic institutional framework is a necessary pre-condition (but not sufficient) for sustainable economic growth which produces at the same time human development. However, an institutional analysis has to consider also the informal dimension of an economic system. Such an informal dimension would be characterised first of all by *social norms*, conventions, moral values, religious beliefs, traditions and other *behavioural norms* that have passed the test of the historical time and that determine the individual's behaviour as well as organisations in pursuit of their aims. These norms are institutions if become "standard of appropriate behaviour for actors with given identity" (Finnemore and Sikkink, 1998, p.891).

The informal institutions can be called *Old Ethos or the Carriers of History* (Pejovich, 1999). These informal institutions are part of the dynamic evolution of a community and its cultural heritage. In addition, these institutions are self-reinforcing in course of time through mechanisms such as imitations, traditions and other forms of teaching. They also serve as sanctions that facilitate the self-reinforcing process such as: community membership, fear of expulsion, reputation and fear to be the only one not to respect the rules. There is an inbuilt threat in this Hobbesian type of competition[5] that allows the rules to be respected since otherwise the social relationships will become violent.

3. Institutions and growth

Many studies showed that institutions and good governance, in some ways, matter in economic organization and rising productivity (i.e., Knack and Keefer, 1995; Olson et al 1998; Jones and Hall 1999; Acemouglu et. al., 2001; etc). Institutions, in these researches are often defined broadly as "the rules of the game".

The relationship from institutions to economic growth has been increasingly investigated both from a theoretical and empirical point of view (e.g., North, 1981; Jones 1981; Knack and Keefer, 1995; Rodrik 1999). Olson *et al.* (1998) show that better governance and quality of

[5] Similarly, Robert Solow (1990, p. 27) speaks about that.

institutions are the main sources of economic growth and determine the differences between the output of the various countries. Along the same lines, Jones and Hall (1999) find that "social infrastructure" and governmental policies explain the different levels among countries of the residual productivity, which in turn, is the basis of the GDP level of the countries. However, very often the main problem with this analysis is a reliable estimate of the impact of institutions on economic performance. Usually, rich countries have better institutions. The difficulty is to obtain an instrumental and exogenous variable to compare with income. Acemouglu *et al.* (2001) estimate in a cross-country section that institutions, expressed instrumentally by settler mortality rates, have a significant effect on economic growth.

In their widely quoted *Economics of Development* book, Perkins et al. (2007) stress the difference between "economic growth" (understood as the rate of growth in goods and services produced) and "development" (which involves economic growth together with change in some human development variables, such as life expectancy, infant mortality, education, and other goals such as environment sustainability, political democracy, income distribution, participation, access to resources, etc). Cypher and Dietz (2004) also make such a differentiation between economic growth and "development". The latter "…encompasses a wide range of social and human goals that, while including the level of income and economic growth, goes well beyond this as well" (Cypher and Dietz, 2004: 29). Another interesting differentiation is the one discussed among institutional economists[6] who perceive economic growth as a static phenomenon and economic development as a wider perspective of development that includes structural and institutional change, social dynamics and cultural change (Myrdal, 1974). These two perspectives of development, the one put forward by Perkins *et al.* (2007) and Cypher and Dietz (2004) and the other put forward by Myrdal (1974), would easily converge in the end because, as Myrdal (1974: 729) himself states, economic development would bring about improvements in health, education and other collective goods.

In addition, in the terminology of the International Monetary Fund (IMF) and of the World Bank (WB), development is not just about economic growth in general but a particular kind of economic growth, identified by the words "high-quality growth" (HQG), which both the IMF and the WB claim to promote (IMF, 1995). In particular, IMF defines HQG as "…growth that is sustainable, brings lasting gains in employment and living standards and reduce poverty. HQG should promote greater equity and equality of opportunity. It should respect human freedom and protect the environment"; and it should "…bear the primary responsibility for the care, nutrition, and education. Achieving HQG depends, therefore, not only on pursuing sound economic policies,

[6] Cf. Brinkman (1995) for a review on this perspective.

but also on implementing a broad range of social policies" (IMF, 1995: 286). Hence, great emphasis is put on reduction in levels of poverty and inequality, together with the pursuit of social goals, such as improved health and education, which should increase accordingly during the process of economic growth.

Although in the long run economic growth may generate human development, the conversion is not automatic (UNDP, 1996), and empirically, the relation between human development and growth is very controversial. There is in some countries, such as Cuba and other Latina American countries, evidence of a stable or improved level of human development together with economic decline. There is evidence of human development in a reverse direction with respect to economic growth such as in the case of Botswana in the 1990s, which experienced good economic growth with a reduction in human development level, due to worsening of life expectancy and health levels. Mainstream economists argue that GDP is the best proxy for development (Anand and Harris, 1994; Srinivasan, 1994), arguing that human development index (HDI) does not add much additional information beyond that contained in GDP. However, they cannot deny the substantial evidence of growth without development.

Conversely, Desai (1991), Naqvi (1995), Boozer *et al.*, (2003), found out that HDI is able to capture, much more than GDP, people's real condition of life. Other economists such as Ranis *et al*., (2000), recognise that both GDP and HDI are consistently correlated in both directions. However they conclude that, in terms of policies, sequencing priority should be given to human development.

Hence institutions which aim only at economic growth would not bring automatically a process of development neither in the sense of Myrdal nor in the sense of Sen. They would instead bring about capital accumulation and, in the best case, skilled labour forces, employment and income.

4. Institutions and human development

One of the crucial purposes of this paper is to differentiate between economic growth and human development. Human development is defined as a process enlarging people's choices, achieved by expanding human capabilities and functionings (UNDP, 1990). Human development is strongly linked with institutions, first of all because in order to expand human capabilities institutions are needed. Moreover, institutions need to be rightly oriented, providing opportunities to poor and to people in general. Values and social norms such as equality, solidarity and co-operation shape formal institutions and choices. In turn, capabilities are enlarged by institutions (Sen, 1985).

In fact, institutional policies, consequence of prevalent norms and institutions, would allow for improving basic capabilities for human development, such as leading long and healthy life, being knowledgeable and having a decent standard of living. If basic capabilities are not achieved, many choices are simply not available and many opportunities remain inaccessible (UNDP, 1999).

In order to explain the link between institutions and human development, we need first of all a comprehensive, consistent and social oriented definition for institutions. A rather sophisticate definition of institutions is "a set of social rules that structure social interactions" (Knight 1992, p. 2). If we consider this definition of institutions, then the explanation of development should be consistent with that of Kuznets (1965, p. 30): "the transformation of an underdeveloped in to a developed country is not merely the mechanical addition of a stock of physical capital: it is a thoroughgoing revolution in the patterns of life and a cardinal change in the relative powers and position of various groups in the population". Consequently, in order to change institutions, the prevalent social rules need to be changed. In developing countries, for instance, informal economic institutions (i.e. uncodified and prevalent social rules[7]) can be very resistant towards change and inertia may occur. This is one of the most important problems which inhibit development. Institutional policies and an active State role are therefore needed in order to favour cultural change and foster development.

To characterize institutions and institutional reforms is a very difficult task and institutional economists are well aware of this. Recently, Bardhan (2005) suggested that some non-income dimensions of development are better explained by a particular institutional index such as participatory rights and democratic accountability than property right institutions, while according to Rodrik and Rigobon (2005) –who explain income gaps among countries– democracy and the rule of law are both good for economic performance. However, that is not necessarily "development" in the meaning of our approach.

Since 1996, the World Bank has regularly published governance indicators that focus on political institutions and informal institutions.[8] Some research using these indicators (Tridico, 2007) shows that Voice and Accountability along with Government effectiveness and Political Stability seem to be important for performance in terms of HDI.

[7] Cf. Hodgson (2006).

[8] World Bank indicators, elaborated by Kaufmann, Kraay and Mastruzzi (2006), reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. Indexes are estimated between -2,5 and +2,5. They concern five fundamental governance dimensions: Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption.

The point is that if government is ineffective or the State is politically unstable, the formal economic institutions are weaker and informal institutions and processes of spontaneous forces prevail. This informal institutionalization may also be *parastatal* or illegal. Examples include the mafia, organized crime, corrupt bureaucracy and an informal economic network among agents, lobbies, etc. These forces fill the *vacuum power*. These kinds of informal institutions will generate an informal and illegal economy, underdevelopment forces such as inequality and poverty will prevail and human development will be lowered.

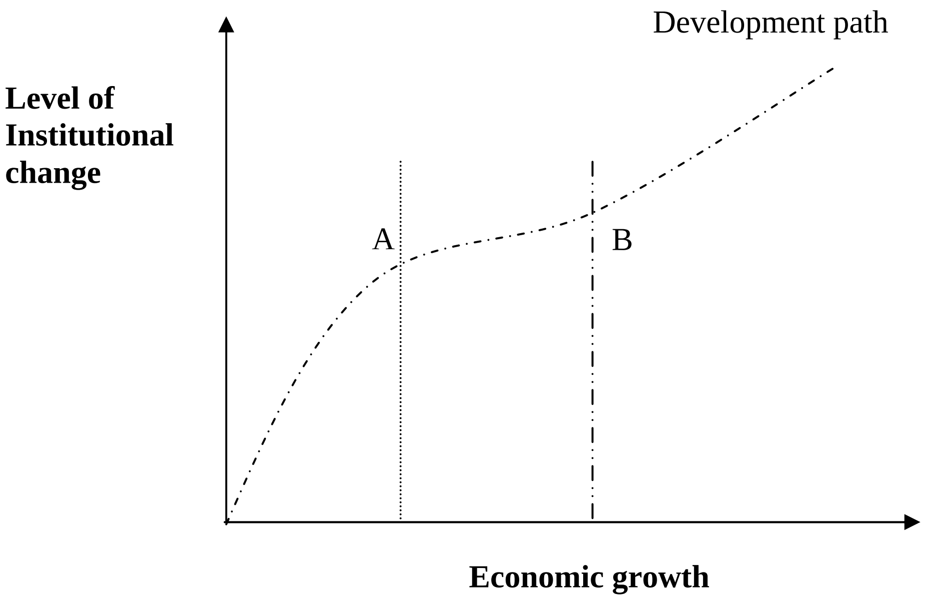
Sound institutions provide the right tools in order to accumulate and to distribute resources generated by GDP growth. Human development will simultaneously emerge if the interaction between institutions and growth is appropriately managed.

If institutions matter, then changing institutions is a crucial policy issues. However, in order to be socially sustainable and macro-economically stable, the incumbent process of institutional change has to be consistent; the change occurring in the formal sphere of the institutional framework should move coherently with that in informal institutions. Moreover, and most importantly, the change has to guarantee equal gains to people who otherwise would resist the transformation. Inertia towards a new institutional framework occurs when the social benefits of transformation are not universal and where many people, during the transformation, become losers in terms of unemployment, purchasing power, education, etc. A stable and sustainable development process needs a radical transformation which involves, coherently, social norms and formal rules, as well as relationships between the various powers, values and lobbies (Mabogunje, 1989).

The process of institutional change has to guarantee two important factors: first, breaking with previous institutions, routines and norms and overcoming "…the resistance of a whole complex of established interests and values" that previously impeded economic growth (Kuznets 1965, p.30). Secondly, it has to guarantee the distribution of growth and of the social benefits of development. It is crucial therefore to know how to change institutions and how to enforce a new institutional deal which will bring about economic development i.e. improving both living condition, in terms of income and distribution, and quality of life, in terms of health and education. Hence, institutional policies and an active role of the State are needed during such a transformation in order to guarantee a stable and sustainable economic development.

Such a definition of change, strictly linked with the process of development, can be summarised by a graph where, on the vertical axis is the level of institutional change, which involves social, cultural and structural change; on the horizontal axis is economic growth. These two variables, institutional change and economic growth, identify the path of the development process which, if the speed of change of the two variables is appropriate and coherent, will be positively inclined, as shown approximately in the graph below:

Figure 1.



Most importantly, during the first period, from the origin to the point A, the speed of institutional change is faster than the speed of economic growth. In the second period, from point A to B, the economic growth is faster than the speed of the institutional change. In other words, economic growth follows the institutional change.

5. Human development, capability approach and institutions

The objective of this section is to discuss briefly the extent and the relevance given to institutions in the HDCA literature and compare it with the ONIE. The capability approach has always given much attention to the role of institutions for human development. As Sen emphasised, "a broad approach of this kind permits simultaneous appreciation of the vital roles, in the process of development, of many different institutions, including markets and market-related organizations, governments and local authorities, political parties and other civic institutions, educational arrangements and opportunities of open dialogue and debate (including the role of the media and other means of communication)" (1999: 9).

From a certain point of view, the HDCA could be considered as an "institutionalist" approach, but it is much broader of any "institutionalism" because it goes well beyond the analysis of institutions. In fact, while HDCA is focused on the "human capabilities —the range of things that people can do or be in life" (UNDP, 2008), which are the *ends* of development, ONIE is focused on institutions, that are *means* of development. However, we will try to show that beyond a number of convergences between HDCA and ONIE –especially old institutionalism–, there are some divergences.

In the capability approach, institutions have many "vital roles" in the process of development. There are at least two broad types of roles. First, institutions have a vital role in promoting and enhancing *directly* capabilities of people. For instance, if for brevity we focus on the above mentioned five "instrumental freedoms" emphasized by Sen (1999), it is self-evident that institutions such as democracy and human rights are directly relevant to the fundamental human capability of "being able to participate effectively in political choices that govern one's life"; and institutions such as social safety net are directly relevant to vulnerable groups' fundamental capabilities of "being able to have good health, being adequately nourished and being able to have adequate shelter". In other words, such institutions "are directly important on their own, and do not have to be justified *indirectly* in terms of their effects on the economy" (Sen, 1999, p. 16, italics added).

Second, institutions have also a vital role in promoting and enhancing *indirectly* capabilities of people. One of the five instrumental freedoms – "economic facilities" – depends on institutions such as conditions of exchange and the working of markets. In the capability approach those economic institutions have only an indirect – although vital – role, because they could promote and enhance capabilities only through possible increased access to income and commodities. As the conversion of income and commodities into capabilities is neither automatic nor direct – because it depends "on a number of contingent circumstances, both personal and social" (Sen, 1999, p. 70) – economic institutions generally can, at best, promote and enhance only indirectly capabilities. An important exception is the labour market, because to be able to have a decent work has direct implications on human well-being.

The distinction between direct and indirect role of institutions in promoting and enhancing capabilities becomes very important when we reconsider the ambiguous, yet crucial, relations between economic growth and human development, which we have already discussed in previous sections from institutionalists' points of view.

In the HDCA, like in certain above-mentioned ONIE approaches, institutions are particularly relevant as mediators between economic growth and human development. In other words, their indirect role is vital: only appropriate formal and informal institutions (see previous sections) can convert effectively and efficiently the resources generated by economic growth into sustainable human development. Although in the long run human development is generally associated to economic growth, the conversion is not automatic (UNDP, 1996). On this argument there is convergence between HDCA and some institutionalists.

However, from previous sections emerges that, even if the institutionalist field is divided about the definition, the nature and the roles of institutions, all ONIE pays attention almost exclusively to the influence of institutions – even non-economic[9] – and institutional changes on economic performance (efficiency, optimal resource allocation, growth, modernisation, structural change, productivity, etc.), i.e. on the capacity of the economic system to produce and accumulate efficiently more and more and better commodities. This is because a good economic performance is considered eventually the main determinant of living stantards and quality of life. Some (minor) attention is also paid to distributional issues, i.e. which institutional arrangements could mitigate the unequal distribution of incomes and commodities that (inevitably?) derives from the production and exchange process.

In other words, the interest of ONIE is for institutions and institutional changes as main determinants of "the wealth of nations" in the long run. Hence, a common feature of ONIE is the scarce attention to institutions and institutional changes that do not appear to have influence on economic performance, but do have influence on human capabilities. An example is human rights. If a systematic violation of human rights does not hinder economic growth, ONIE will not be particularly disturbed. The harsh reality suggests that this violation can often be consistent with a sustained (and worldwide lauded) economic growth, like the case of China nowadays.

Therefore, a significant difference between ONIE and HDCA is about the value assigned to institutions. For ONIE institutions are merely instrumental to guarantee a stable and sustainable economic development, that can also be possibly translated into better quality of life: institutions are valued in terms of their capacity to support economic performance. For HDCA institutions have both an instrumental and a constitutive role. The instrumental role is the same as for ONIE, but there is also a constitutive role given to those institutions that foster human capabilities without having any necessary economic justification: their value is straightforward, not mediated by income or wealth. An example is the laws and organisations that protect endangered species (Sen, 2004): "being able to live with concern for and in relation to animals, plants, and the world of nature" (Nussbaum, 2000, p. 80) is a valuable capability that does not need any economic justification.

Another relevant difference between ONIE and HDCA is about people's agency and social change. In the ONIE prevails a "structuralist" approach that leads to a top-down institutional design, often based on mainstream/orthodox economics, or on conventional wisdom, or on modernisation

[9] There is a wide literature on the role of non-economic institutions – such as religion (Weber, 1905), ethos (Morishima, 1982), trust (Gambetta, 1988) – for economic performance.

theories. According the NIE, for instance, there are “sound” or “modern” institutions to introduce (such as property rights) through “institutional reforms” (such as Structural Adjustment) in order to replace “traditional” institutions (such as the commons) that hinder economic performance. According other institutionalists, older social rules that prevail in “developing” or “transition” countries need to be changed because economic development requires also a cultural change.

In those views there is little room for a pro-active role of people. The need for structural/institutional change is prescribed by external experts. Quoting Sen (1999), people are considered as *patients* rather than as *agents*. On the contrary, in the HDCA agency plays a central role in the development process: people are the main actors of social change. Changing institutions, i.e. older or traditional rules, social norms or culture, should be eventually decided through public discussion and people’s participation to collective choices.

6. Conclusions

We have briefly presented and compared the Old and the New Institutional Economics and their broad approach to economic growth and development. We have also tried to understand if this literature pays attention also to human development. The answer is positive: there is indeed in some institutionalists the awareness of difference between modern economic growth and improvement of living conditions, and the fact that there is no automatic translation from the former to the latter. Only appropriate institutional arrangements can sustain this process.

We have also briefly presented the general role of institutions within the Human Development and Capability approach. Both the ONIE and the HDCA attach a vital role to institutions, especially as mediators between wealth creation and human development. However, beyond this important convergence, the paper has also emphasized some significant divergences between institutionalist approaches and the capability approach. The contrast concerns the role assigned to certain institutions – those that influence human capabilities but not necessarily economic performance – and the role assigned to people’s agency. In both cases, the root of divergence lies in different values assigned to substantial freedoms that do not have any necessary economic justification.

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