Interactions between Formal and Informal Institutions

The reliability of the production process is a physical channel through which development can influence institutions

In many developing and transition economies informational and contracting constraints make it more difficult for enterprises to do business. These constraints are perceived to stem mainly from dysfunctional formal enforcement institutions, such as courts. To deal with these constraints, enterprises use informal mechanisms of contract enforcement based on reputation, networks, and relationships. There is ample evidence of this from around the developing and developed world. Existing studies consider formal and informal institutions to be full substitutes. But this is unrealistic, since these two modes of governance are extremes. How formal and informal institutions interact remains a central question.

A recent paper by Dhillon and Rigolini addresses this open question by developing a new theory of institutional interactions in which formal and informal institutions coexist and influence one another. The authors develop a theoretical framework in which unobserved firm-level shocks, related to the level of development, imply the production of poor-quality goods. Such shocks generate a moral hazard problem because consumers cannot determine whether poor quality stems from a shock or from firms cheating and intentionally producing goods of low quality. To cope with this problem, consumers rely on two enforcement mechanisms: an informal one, based on reputation and networks, which is enhanced through consumers’ investment in being “connected”, and a formal mechanism, which acts through legal enforcement (but can be weakened by firms through bribes).

This theory makes two contributions. First, it highlights the importance of market prices as a channel of institutional interaction. High equilibrium prices affect both the incentives of firms to bribe because of the higher rents involved and the incentives of consumers to connect with one another to identify poorly performing firms. At the same time, however, unobserved productivity shocks keep the equilibrium price higher than marginal costs, to encourage firms to foster high quality. In particular, the higher the frequency of productivity shocks (a typical feature of low- and middle-income countries), the higher the price must be relative to the actual costs of production. This provides a new explanation of why some goods, even in a competitive setting, may be priced higher in low- and middle-income countries.

Second, the theory suggests a physical channel through which development can influence institutions: the reliability of the production process. An unreliable production process affects institutions and the welfare of consumers in several ways. Beyond leading to higher equilibrium prices, it provides firms with greater incentives to bribe if a case is brought to court because higher rents are involved. In addition, it directs consumers toward informal networks and personal connections in order to identify poorly performing firms.

Preliminary evidence suggests that such a channel could play a significant role. The authors use World Bank Investment Climate Survey data from six regions to study the determinants of firms’ membership in business associations (a proxy for informal connectedness) and of their perception of corruption. A firm is considered a member of a business association only if it belongs to the association and recognizes its ability to resolve disputes and provide information on domestic product markets. The authors create a corruption variable that accounts for all the firms that identify corruption as an important constraint to business. In addition, using the principal components method, they construct a reliability index based on whether firms identify electricity shortages, transport, and skills as important constraints.

Once country and sector characteristics are taken into account (through fixed effects), the authors observe that in all regions the reliability index has a statistically significant relationship with both membership in business associations and corruption. This confirms what the theory predicts: lower reliability of a market is associated with a higher likelihood that a firm is a member of a business association and with higher corruption.


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Too Big to Fail or Too Big to Save?

There is an obvious policy interest in reducing bank size to below the point where banks’ national contingent liabilities are so large that there are doubts about governments’ ability to stabilize the banking system. This also at least partially explains the current proposals to limit bank size or tax systematically large banks. But that the percentage of systematically large banks had already declined in 2008 even without additional regulation and taxation may reflect private incentives to downsize in the face of a too-big-to-save effect in fiscally constrained countries. Additional regulation or taxation aimed at very large banks may strengthen this trend.