

**The Institutional Foundations of a Market Economy: What Makes Markets Work Well? (Opening Remarks by Roumeen Islam)**

Let me first thank you all for being here today. I look forward to two days of stimulating discussions on the complex topic of institutional development and market processes. In order to start off the discussions of the next two days, I would just like to make some short comments, mostly in the form of questions, related to the subjects on the agenda

First, let me begin by addressing the general issue of markets and institutional change and why the World Development Report, 2001 is focusing on this topic. As is well known, before the late 1970s economists thought very differently from the way they do today about the role of the public sector. The government was involved, often quite extensively, in production in many developing countries. And whenever markets failed to provide what were considered welfare enhancing outcomes, direct controls on private activity, or provision by government were often the preferred solutions. But subsequent periods were characterised by waves of liberalisation. As economic thinking changed, developing countries turned their economies to the private sector and to market forces, specifically the reduction of price distortions and the privatisation of production. In some countries in the developing world these efforts have been comprehensive, while in others, much less so.

However, in this ensuing period, worldwide growth rates in fact did worse than they had done in the 1960s and early 1970s. The decline in growth rates in the developing countries was probably to a large extent, due to lower growth in developed countries. Much of the recent cross country empirical work on growth demonstrates that lower policy distortions and stable policies (as reflected for example in lower black market premia, and adjusted exchange rates, lower inflation) are positively correlated with growth, so we may assume perhaps that, had growth in developed countries not fallen, reduction of policy distortions would have led to higher growth rates worldwide because of improved policies in developing countries.

During these decades, although there was trend in **inequality** levels, in some countries such as those in Eastern Europe and Central Asia, inequality increased quite a bit. Also, the short run effects of policy changes (sometimes leading to output declines), in many cases have been to make the poor within countries poorer. One of the issues that came to the fore was that in the presence of fundamental differences in economic and social characteristics such as the initial distribution of income and assets (including human capital) and technology across countries, similar policies have different impacts on production and distribution in the short and long run.

As growth continued to lag behind expectations, and in the wake of the East European and East Asian crises, the overriding policy concern became that of boosting the positive effects of “market reforms” by building institutions. A question was, are countries poor (and markets underdeveloped) because they have weak institutions or do

they have underdeveloped (formal) institutions because they are poor? Much of the recent empirical literature implies that if countries could construct better institutions at their per capita GDP levels, then this would improve growth.

When we talk about institutions for well functioning markets we are really focussing on two main functions that institutions may perform: lowering transaction costs and enhancing competition. The WDR will focus on these two themes. As we think about how markets grow – we need to think about the ability to do arms length transactions with business partners and the ability to undertake large investments which often carry high risk. In poor countries the costs of doing business are high mainly because of the presence of significant asymmetries in information and because of the inability to enforce commercial contracts or resolve disputes with business partners.

The second theme: that of competitive markets is important because not only can competitive markets generate more innovation and greater increases in productivity, but also because of the role competition plays in enhancing equity in some sense, by providing equal opportunity to economic agents.

These themes will be explored under the specific topics of the WDR 2001/2002. Basically the report will look at how firms grow in markets, how they interact with each other and with their financiers (corporate governance), how economies finance productive activities in a risky world (financial system development), and how social structures and government institutions (political institutions, social institutions, judicial systems) affect

production and distribution under particular market conditions and structure (competition policy and regulation). There are some issues that this WDR will not focus on which one might think would normally enter a report on institutions. These topics include civil service reform, the role of the police in establishing the rule of law, the mechanics of decentralisation of government, budgetary processes, the delivery of certain public services, and the details of the labour market. The reasons are that first, it is necessary to limit the already broad scope of the report. And second, these topics have been examined extensively in other World Bank reports.

As development practitioners we feel it is important to **study** institutions because we think we can learn something that will help us advise developing countries and help us to formulate better policies. We are increasingly recognising the importance of initial conditions, of natural endowments and history and that institutions are shaped by economics, political and social dynamics. But we also know and believe that we can affect change by bringing in factors from outside the system. For example, We know that by changing formal laws, and even transporting laws across countries we can affect behavioral change. And we also know that this has often failed. The question is what are the conditions under which these types of changes be effected successfully?

In the writing of this report I had intended to focus some attention on history. While we know that the world is different today in some key aspects (such as the internationalisation of markets, speed and openness of communication and the state of technology), history can still provide us with some important lessons. One of the

questions I raise is how does looking at the historical development of rich nations help us in understanding the problems of poor countries despite the diversity of initial conditions (including culture) that exists and how does it help us in shaping advice to policymakers? Take the issue of resolving commercial disputes. In pre-modern Europe for example, at a time when the state's public finances and administrative capacity were not well developed, commercial disputes were often resolved by state hired and privately paid judges. This system worked because these judges had an incentive to be impartial and efficient, since their reputations, and future income were at stake. Clan leaders in some parts of the world would presumably have performed similar functions.

When developing countries design laws and enforcement mechanisms and seek guidance on what works, should they look for example, at what worked in Europe when it was much poorer rather than at what works now in Europe when it is much richer? In order to answer this we need to think about how rich and poor countries differ.

During the first session of the conference, I have asked you to think about what we mean by *institutions*. Do we mean just rules/ laws, or also how they are enforced. What about organisations- such as for example statistical agencies of government-- where do they fall in this definition? And how are policies different from institutions?

But let me put aside these important distinctions for now. One distinction that I *would* like to make at this juncture is between formal and informal institutions. By informal institutions, I mean those that represent accepted norms or standards in society,

generally useful for exchange between partners within a community but which are not codified or written. Informal institutions serving business tends only to be relevant for smaller groups rather than encompassing similar transactions done with those outside the group. By formalising institutions we create acceptable norms of behaviour for large groups or for interaction between groups. In poor countries the relative mix tends to favour informal institutions and these tend to substitute for formal ones. In rich countries formal private and public institutions generally tend to *complement* informal ones. In other words, they do not displace informal ones. For example, when an economic agent in the United States seeks to hire an individual or seeks a business partner, the first step is often an informal telephone call to other business associates or university friends- a social network. But it does not end there. The credentials of the business partner or potential hire are substantiated by audited financial statements, or degrees from accredited educational institutions. It is also more likely to be the case that in developed market economies, the social networks relevant for business transactions differ in an important way: the first recourse is not based on family ties but more on business ties or social connections established during schooling.

As an illustration of some of the problems that both informal and formal business related institutions have been trying to resolve, I would like to read you a poem. It is not one I wrote, but one that was published in the newsletter of the proper name National Grain & Feed Association of the United States ("*Who is who in the grain trade*") in 1922:

If I knew you and you knew me  
'Tis seldom we would disagree;  
But never having yet clasped hands,  
Both often fail to understand  
That each intends to do what's right  
And treat each other "honor bright."  
How little to complain there'd be  
If I knew you and you knew me.  
When'er we ship you by mistake,  
Or in your bill some error make,  
From irritation you'd be free  
If I knew you and you knew me.  
Or when the checks don't come on time  
And customers send nary a line,  
We'd wait without anxiety,  
If I knew you and you knew me.

The grain trade association, a private enterprise was formed in order to disseminate information, resolve disputes and penalise non-conformers.

So one of the key questions is how do formal institutions come about that serve similar purposes to informal ones and can replace or coexist with informal ones? And what can policymakers do to support this type of development?

Our second session is on *competition policy and regulation*. The issue that we would like to focus on in this conference is how to get competitive markets in practice in developing countries where the economic environment, including the capacity of the enforcement agencies is so different. For example, what is a small and poor country which has privatised its public monopoly, to do in order to enhance competition? We need to think about the particular types of situations that hinder entry and growth in developing countries. In this context it will be important to understand the relative importance of macroeconomic versus microeconomic factors and those that impede the exit of firms and the reallocation of resources, for example labour market and bankruptcy policies. In developing countries anti-competitive acts of government, whether intended to favour incumbents, or just the result of bureaucratic inefficiency (such as difficult business registration procedures) may be even more important than anti-competitive acts of the private sector (such as predatory pricing behaviour). We would like to revisit issues such as the relative importance of trade liberalisation as a measure to enhance competition in the presence of other distortions; foreign investment or company laws and the differential treatment of domestic firms and foreign firms. The nature of these restrictions may differ substantially across countries: from government restrictions on new business entry, to lack of access to finance, or to restrictions on distribution or marketing channels. The question is which types of problems are big in developing countries (and there may be systematic differences between countries at different stages of development or similar historical evolutions). And what sort of regulatory structures and principles work.

On the issue of *corporate governance*, there seems to be a diversity of opinion as to what constitutes good corporate governance. And also which are the principal corporate governance problems in countries at different stages of development. Put another way, which are the main contract enforcement and informational issues for poor countries and how should we deal with them. What is the role of labour in defining the corporate governance framework? I expect countries in Africa might look very different from countries in East Asia for example. In these sessions I would ask you to reflect on the links between industrial structure, on ownership patterns, and the relationships between creditors and debtors and how these affect the nature of competition and the contract enforcement problem. For example were close links between financial institutions and firms in East Asia a response to the lack of more impersonal third party enforcement mechanisms? And will severing these links result in more competition or better corporate governance when the absence of third party contract enforcement mechanisms prevails?

On the issue of *financial system development* : we know that there is not a unique relationship between structure and function though a great deal of debate has been centered around market based versus bank based systems. Rich countries have done well with widely varying structures. But there seem to be certain historical regularities in terms of the types of financial institutions that developed first, say in Europe or the United States and what we observe today in many developing countries. For example, during the beginning stages of the industrial revolution in England for example, banks were more likely to finance consumption of the landowning class and trade than industry.

This is something that we may observe in many LDCs today. The question is, why did these tendencies change? Of course we have to remember that developing countries operate in a more sophisticated world today-so how does this change the options available to them? How does foreign entry change the allocation of resources?

Then the question of regulation: If poor countries are different because of the much greater informational asymmetries, scarce human capital and lack of formal contract enforcement mechanisms, then how can we believe that methods of supervision and regulation used in developed countries which do not have these problems will work in poor countries?

On the issue of *political institutions and governance*, a key question will be: what changes as the government goes from being an owner of productive capacity to a regulator of markets? For example, the nature of corruption may change - public officials cannot steal directly from public firms but instead impose unofficial taxes on private markets ). Under what conditions do governments tend to act more benevolent rather than predatory? And how might the nature of political institutions (for example, how many checks and balances there are in government) be related to the stability of policy or even the design of regulatory institutions? How does lack of development of public finances affect the role that the state can play? Are there areas which may be left to the private sector- however imperfect this solution may be since market failures may be less costly than government failures for certain types of countries?

And finally what is the impact of *social structure* on institutional development, on private and public institutions? How do ethnic and income differences affect the nature of bonding, and the ability to participate in formal market institutions? For example, banks do not lend readily to the rural poor nor in some cases to certain ethnic groups. What determines whether different segments of society are able to participate in formal production and distribution activities in the marketplace and what is the role for government? In many developing countries, policy initiatives such as those which improve communications, information flow, education, and encourage labour market participation, have changed the nature of social interactions in the sense of making them more “market friendly”. Market participation in turn changes the nature of social interactions.

I think that I have raised a lot of questions. And while we cannot hope to answer them all, what I do hope to get from you during the next two days is some guidance. What should be the areas of focus for this report and are the question I have raised even the most relevant ones? Let me conclude here and say that I look forward to hearing from you over the next two days.