Institutional Development in Third World Countries: The Role of the World Bank

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Abstract

Institutional development is becoming a dominant theme for development assistance as a result of an increasing appreciation of the complex interrelations that link institutions, organizations and the process of economic growth. The lack of an adequate conceptual framework for institutional development, however, has often resulted in inadequate integration between institutional development work and other forms of the World Bank's development assistance, and in less than satisfactory developmental impacts of many institutional development interventions. This paper argues that while no dynamic theory of institutions is as yet available, the New Institutional Economics (NIE) has made important progress in this direction and that the insights provided by the NIE have important implications for the way in which we conceptualize development processes and organize Bank work. The paper also argues that as we integrate institutional development more closely into our models of economic development and our operational activities, we shall need new approaches to and, possibly, new instruments of development assistance.
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I. Introduction

A review of economic trends in Third World countries during the last 50 years shows vast and still largely unexplained differences in economic development performance (World Bank, 1991). Similarly, after more than a decade of structural adjustment lending we are at a loss to explain large differences in the outcomes of virtually identical structural adjustment policies. It is clear that something is missing in the body of economic theory and the economic models that we currently employ.

In an attempt to address these anomalies, increasing attention has been paid in recent years by both development theorists and development practitioners to the crucial role that institutions play in influencing the rate and pattern of economic development. Whereas important contributions have been made by organizational theory, political science and sociology, the New Institutional Economics (NIE), in particular, has provided fresh insights into the interactions between institutional development and economic growth, and is expanding the frontiers of development thinking to include such areas as political "markets," cultural factors and organizational learning.

This paper argues that institutional development is becoming a dominant theme for development assistance and that the insights provided by the NIE have important implications for the way in which we will conceptualize development processes and organize World Bank work in the years ahead. The paper also argues that as we integrate institutional development more closely into our models of economic development and our operational activities, we shall need new approaches to development assistance, e.g., increased flexibility in the project cycle, more reliance on participation and dialogue with the beneficiaries, more emphasis on implementation issues and sustainability, etc. The paper shows that these requirements are consistent with the changing context of development assistance and are convergent with a number of trends that have emerged since the end of the Cold War era.
II. The Changing Institutional Context of Development Assistance

Although we do not have yet a full-fledged theory of institutional development\(^1\) a stylized account of some of the basic processes can be derived from historical evidence (North, 1990).

In traditional subsistence economies, the small-scale village trade exists within a dense social network of informal constraints that are sufficient to facilitate (and regulate) local exchange. Given the limited amount of specialization and the tendency to self-sufficiency, informal constraints are all the institutionalization that is needed. Transaction costs are low and the organizational structure of the village is congruent with (and therefore tends to perpetuate) the institutional setting. As the market extends to broader areas, regional trade results in sharply higher transaction costs because the dense social network of the village is replaced by more infrequent clientization of the players (who are now much more numerous). Hence, more resources must be devoted to measurement and enforcement. Yet institutions are still mainly informal and, in the absence of any unified political structure or formal rules, cultural norms and religious precepts usually play a key role in setting standards of conduct for the players. In the next stage, the creation of capital markets and the development of manufacturing firms with large amounts of fixed capital entail the need for some form of coercive political order because as more complex and impersonal forms of exchange evolve, personal ties, voluntaristic constraints and ostracism are no longer sufficient to deal with the problems of agency and opportunistic behavior. In the "final" stage, specialization entails that increasing percentages of the resources of the society be engaged in transacting so that the service sector now accounts for a large percentage of gross national product.

To realize the gains from trade inherent in successively more impersonal markets requires institutions that will make possible such impersonal exchanges — not only economic exchanges but also political as well. Throughout history most economies have become "stuck" somewhere along the path. Two critical junctures, for example, where economies have become stuck are:

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\(^1\) The word "Institutional Development," as currently used in the World Bank, refers to both institutions in a strict sense (i.e. the "rules of the game") and organizations (i.e. the "players"). As discussed below, although institutions and organizations constantly interact among themselves and may be mutually reinforcing, conceptually it is preferable to maintain a clear distinction between the two.
(1) during the creation of economic institutions that would make possible impersonal markets, particularly markets that involve long distance trade or capital markets that involve contracting over space and time; and

(2) during the development of political institutions that would specify and enforce property rights in ways that encourage productive contracting.

Schematic as these stages are, they nevertheless provide some clues to explain global trends that have affected the institutional environment and economic development in Third World countries during the last 50 years:

(a) The globalization of trade, production and finance has put great pressure on the institutional environment of virtually all Third World countries and elicited a great variety of institutional and organizational responses (not always in the sense of increasing the efficiency of the economy, as shown by the mixed experience with structural adjustment).

(b) Differences in the initial conditions and, especially, a great disparity in the adaptive efficiency of poor countries have produced an increased economic diversification of the Third World, from the rapidly growing economies of East Asia to the stagnating or declining societies of Sub-Saharan Africa (in some cases, e.g., Brazil, this pattern has manifested itself within a single economy). In turn, this has triggered very different dynamics of institutional and organizational change. The political changes in the formal socialist countries and the difficult process of transition to market economies have introduced a new dimension and further complexities in this already highly diversified panorama of institutional development (Schiavo-Campo, 1994).

(c) The debt crisis and the painful adjustment processes of the 1980s have contributed to produce a significant weakening of public organizations (in particular, civil services) in many Third World countries, which in turn has weakened or even caused retrogression in the institutional environment of these countries (witness, for instance, the emergence of the "patrimonial state" in Africa).
(d) The rapid decline of the ideology of the state as the main engine of economic and social development (which was accelerated by the collapse of communism) has created in virtually all developing countries political pressures to redefine the role of the state and "reinvent the government" (a catchy phrase to mean institutional reforms and the creation of an enabling environment for more effective public sector management).

(e) The social demand for decentralization, increased participation, and larger use of democratic processes have created in many Third World countries a new emphasis on civil and political rights (as well as economic, social and cultural rights) as key elements of a reformed institutional environment.

III. The World Bank’s Contribution to Institutional and Organizational Development

Partly in response to these trends, the World Bank’s role in the institutional and organizational development (ID) of Third World countries has been growing over the years in both volume and complexity. From an initial emphasis on project-related technical assistance (mainly in the form of training), the Bank’s support in this area has gradually expanded in the context of structural and sectoral adjustment lending to include sector-wide or economy-wide organizational and institutional reforms considered necessary to implement policy changes. In addition, the Bank has financed a growing number of free-standing, ID-related technical assistance loans, in areas such as civil service reform, public enterprise restructuring/privatization and other aspects of public sector management. ID-related Bank lending typically includes components aimed at strengthening one or more of the following aspects:

- internal organizational structures of government agencies and ministries;
- strategic planning and policy design systems, including monitoring and evaluation;
- financial management (budgeting, accounting, auditing);
- human resource management (including civil service reforms);
• interorganizational relationships;

• organizational and institutional structure of sectors or subsectors;

• various aspects of the overall legal framework (including tax laws, investment codes, banking laws, capital market regulations, corporate laws, bankruptcy laws as well as judiciary systems).

It is estimated that the average annual commitments for ID-related technical assistance was about $1.6 billion in FY88-92 to which one should add the substantial volume of ID-related non-lending activities (training, research, economic and sector work, informal technical assistance provided by Bank staff, etc.).

Although many of these activities have never been evaluated, available evaluations done by the Operations Evaluation Department World Bank, 1993a) and by others (Paul, 1989 and 1990; Israel, 1990; Buyck, 1991; Berg, 1993) suggest that: (i) a strong correlation exists between project/program outcomes, the success of institutional development components and the expected sustainability of project/program benefits; and (ii) the overall performance of ID-related projects or components leaves much to be desired. For instance, of the 1,170 projects evaluated by OED during 1989-1992, 48 percent showed only "partial" ID achievements and 23 percent had "negligible" ID achievements.

A common theme in these evaluations is that while some progress has been made by the Bank in recent years (better definition of work programs, greater use of local consultants, more innovative delivery modes, larger role of resident missions), serious problems persist; in particular:

• the absence of systematic analyses of government’s commitment to institutional reform;

• the uneven quality of institutional analyses;

• a lack of country-specific institutional development strategies, leading to lack of integration of ID-related activities with "mainstream" development assistance and ad-hoc treatment of ID activities;
• deficiencies in program/project design (inadequate recognition of borrowers’ limited absorptive capacity leading to excessively complex ID designs; excessive reliance on traditional delivery modes of technical assistance despite their recognized flaws; lack of specific indicators to assess progress; unresolved tensions between capacity building and operational support objectives of project-related technical assistance; little or no participation of beneficiaries in project identification and design);

• the supply-driven nature of ID-related technical assistance leading to the perception among recipients that its opportunity cost is at or near zero, which in turn leads to excessive use, inefficient allocation, and weak local ownership/commitment;

• poor incentives and working conditions in recipient countries resulting in weak motivation of local staff and limited receptivity to capacity-building efforts;

• wrong incentives in the Bank ("approval culture" resulting in inadequate attention to implementation issues and sustainability of reform efforts; priority given to capital lending with ID often treated as an afterthought; inadequate resource allocated to the design and/or supervision of ID-related activities);

• inadequate organizational learning in the Bank (skill mix issues, insufficient dissemination of best practices across regions, poor institutional memory).

IV. Institutions Matter: Fresh Insights from the NIE

Two conclusions flow from the above analysis:

(1) institutional development matters, and we know that it does; and
(2) we have not yet quite learned how to deal with it.

It seems evident that successful implementation of development policies and programs entails an understanding of the dynamics of economic change if the policies and programs pursued are to have the desired consequences on a sustainable basis. But a dynamic model of
economic change entails, as an integral part of that model, analysis of the polity since it is the polity that specifies and enforces the formal rules.

While we are still some distance from having such a model, the structure that is evolving in the New Institutional Economics, (North, 1990 and 1993), even though incomplete, suggests radically different development policies than those of either traditional development economists or orthodox neo-classical economists. Development economists have typically treated the state as either exogenous or as a benign actor in the development process. Neo-classical economists have implicitly assumed that institutions (economic as well as political) don't matter and that the static analysis embodied in allocative-efficiency models can be a sufficient guide to policy; that is, "getting the prices right" by eliminating exchange and price controls. In fact, the state can never be treated as an exogenous actor in development policy and getting the prices right only has the desired consequences when you already have in place a set of property rights and enforcement systems that will then produce the competitive conditions that will result in efficient markets.

Transaction Costs and Market Efficiency

The key to efficient markets are low costs of transacting. Transaction costs are the costs involved in measuring what is being exchanged and in enforcing agreements. Goods and services or the performance of agents have multiple valuable attributes and the ability to measure those attributes at low cost is a necessary condition for capturing the gains from trade that were the keys to Adam Smith's Wealth of Nations. But a sufficient condition requires in addition that the contracts embodying the exchange process can be enforced at low cost. Those conditions are not met in many Third World countries and in consequence markets often either do not exist or are beset by very high costs of transacting. Because transaction costs will influence the technology employed, both transaction and transformation costs will be higher in the factor and product markets of such economies.

The inability to have low cost specification of the attributes being exchanged and effective enforcement of agreements in economic markets is ultimately a function of the political markets of such economies because it is the polity that specifies the property rights and provides the instruments and resources to enforce contracts.
Institutions and Organizations

It is one thing to define the characteristics of efficient markets at a moment in time; it is quite another to model the way markets evolve through time. To do so we must explore the interaction between institutions and organizations over time. Before going further it is essential to distinguish clearly institutions from organizations. Institutions are the rules of the game of a society or, more formally, the humanly-devised constraints that structure human interaction. They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both.

Organizations, too, specify the constraints that structure human interaction inside the organization but in addition they are action groups. They are composed of groups of individuals bound by a common purpose to achieve objectives. They include political bodies (political parties, the senate, a city council, a regulatory agency); economic bodies (firms, trade unions, family farms, cooperatives); social bodies (churches, clubs, athletic associations); and educational bodies (schools, colleges, vocational training centers). Organizations in pursuit of their objectives are the primary source of institutional change. These definitions undergird five propositions that define the essential characteristics of institutional change:

1. The continuous interaction of institutions and organizations in the economic setting of scarcity and hence competition is the key to institutional change.

2. Competition forces organizations to continually invest in skills and knowledge to survive. The kinds of skills and knowledge individuals and their organizations acquire will shape evolving perceptions about opportunities and hence choices that will incrementally alter institutions.

3. The institutional framework dictates the kinds of skills and knowledge perceived to have the maximum pay-off.

4. Perceptions are derived from the mental constructs of the players.

5. The economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent.
These propositions require some elaboration. Economic change is a ubiquitous, ongoing, incremental process that is a consequence of the choices individuals and entrepreneurs of organizations are making every day. While the vast majority of these decisions are routine (Nelson and Winter, 1982), some involve altering existing "contracts" between individuals and organizations. Sometimes that recontracting can be accomplished within the existing structure of property rights and political rules; but sometimes new contracting forms require an alteration in the rules. Usually existing informal norms of behavior will guide exchanges, but sometimes such norms will be disregarded and will wither away. In both instances institutions are gradually being modified. Modifications thus occur because individuals perceive that they could do better by restructuring exchanges (political or economic). The source of the changed perceptions may be exogenous to the economy — for instance a change in the price or quality of a competitive product in another economy that alters the perceptions of entrepreneurs in the given economy about profitable opportunities. But the fundamental source of change is learning by leaders of organizations.

While some learning is a result of idle curiosity, the rate of learning will reflect the intensity of competition amongst organizations. Competition is a ubiquitous consequence of scarcity and hence organizations in an economy will engage in learning to survive. But the degree of learning can and does vary. If competition is muted as a result of monopoly power the incentive to learn will be reduced.

Whereas the rate of learning influences the speed of economic change, the kind of learning affects the direction of economic change. The kind of learning is a function of the expected pay-offs of different kinds of knowledge and, therefore, will reflect the mental models of the players and, most immediately at the margin, the incentive structure embodied in the institutional matrix (which consists of the framework of interconnected institutions that together make up the formal rules of an economy). If the institutional matrix rewards piracy (or more generally redistributive activities) more than productive activity, then learning will take the form of learning to be better pirates.

Change is typically incremental, reflecting ongoing, ubiquitous, evolving perceptions of the entrepreneurs of organizations in the context of an institutional matrix that is characterized by network externalities, complementarities and economies of scope among the existing
organizations. Moreover, since the organizations owe their existence to the institutional matrix, they will be one or more ongoing interest groups that will strive to assure the perpetuation of that institutional structure — thus assuring path dependence. Revolutions do occur, however, when organizations with different interests emerge (typically as a result of dissatisfaction with the performance of existing organizations) and the fundamental conflict between organizations over institutional change cannot be mediated within the existing institutional framework.

Some Policy Implications

It is one thing to describe the characteristics of economic change; it is something else to prescribe the correct medicine to improve the performance of economies. We simply don't know how to transform ailing economies into successful ones, but the fundamental characteristics of institutions suggest some clues.

Institutions are made up of formal rules, informal norms and the enforcement characteristics of both. It is the admixture of rules, norms, and enforcement characteristics that determines economic performance. While the formal rules can be changed overnight, the informal norms change only gradually. Since it is the informal norms that provide the essential "legitimacy" to any set of formal rules, revolutionary change is never as revolutionary as its supporters desire and performance will be different than anticipated. More than that, societies that adopt the formal rules of another society (such as Latin American countries’ adoption of constitutions like that of the United States in the 19th century) will have very different performance characteristics than the original country because both the informal norms and the enforcement characteristics will be different. The implication is that transferring the formal political and economic rules of successful western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance. Privatization is not a panacea for solving poor economic performance.

It is polities that shape economic performance because they define and enforce the economic rules of the game. Therefore the heart of development policy must be the creation of polities that will create and enforce efficient property rights. Unfortunately, however, research in the new political economy (the New Institutional Economics applied to polities) has been largely focussed on the United States and other developed countries. While we know a lot about the characteristics of the polities of Third World countries, we have very little theory about such polities. We know even less about the consequences of radically altering the
in institutional framework of central and eastern European societies. However, the characteristics of institutions described in the foregoing sections of this paper suggest some implications:

(a) Political institutions (rules that specify the structure and decision making framework of the polity) will be stable only if they are supported by organizations with an interest in their perpetuation. Therefore an essential part of political/economic reform is the creation of such organizations. Such political organizations will have the coercive power to specify and enforce the economic rules.

(b) It is essential to change both the institutions and the belief systems for successful reform since it is the mental models of the actors that will shape choices. Therefore belief systems and the way they evolve will be the ultimate determinants of the institutional matrix.

(c) Evolving norms of behavior that will support and legitimize new rules is a lengthy process and in the absence of such reinforcing norms polities will tend to be unstable.

(d) While economic growth can occur in the short run with autocratic regimes, long-run economic growth entails the development of the rule of law and (probably) some level of protection of civil and political freedoms.

(e) Informal rules — norms of behavior, conventions, and codes of conduct — are a necessary (but not sufficient) condition for good economic performance. Societies with norms favorable to economic growth can sometimes prosper even with unstable or adverse political rules. The key is the degree to which there is enforcement of the adverse political rules. We know very little about the evolution of belief systems and consequent informal constraints, although religions have clearly been a basic component of belief and value systems.

Understanding the interaction between changing institutions, the consequences for the welfare of the diverse groups of participants in a society, the resultant perceptions of the diverse groups, the degree of access of diverse groups to political expression, and in consequence, the political repercussions of the changed institutions which will lead to subsequent institutional
change requires a dynamic modeling of these changes through time. It is thinking in these dynamic terms rather than static "one shot analysis" that is essential for good policy. Until we explicitly evolve such models in the context of intimate knowledge of the (path dependent) characteristics of individual economies we will fail to achieve the desired results.

Path dependence means that the degrees of freedom that policy makers possess to alter the direction of economies is constrained by the institutional matrix and the belief systems of the players. Of all the implications of institutional analysis for policy, this is the most important. It is essential to have an intimate knowledge of the institutional structure and the way it is evolving to understand what is possible. The implicit assumption of neo-classical theory that institutions don't matter and can be ignored in policy prescription is itself a prescription for disaster.

It is adaptive rather than allocative efficiency which should be the guide to policy. Allocative efficiency is a static concept with a given set of institutions; the key to continuing good economic performance is a flexible institutional matrix that will adjust in the context of evolving technological and demographic changes as well as shocks to the system. It is the creation of a stable polity with complementary norms that is the essential characteristic. Successful political/economic systems have evolved such characteristics over long periods of time. The western world, for example, evolved stable political and economic institutions over hundreds of years. We know very little about how to create such systems in the short run or indeed, whether it is even possible to create them in short periods of time. However, it is doubtful that the policies that will produce allocative efficiency are always the proper medicine for ailing economies. Experience has shown that efficient policies that are perceived to be inequitable will engender political reactions which can stall or reverse their implementation.

V. The World Bank’s Future Role in Institutional and Organizational Development

As indicated above (section III), the World Bank’s role in the field of institutional and organizational development has continued to grow over the years. In addition to the increasing volume of ID-related free-standing technical assistance projects, it is estimated that over 90 percent of all projects and programs currently under supervision contain components directly or indirectly related to institutional and organizational development. Despite the persisting doubts about the overall effectiveness of these activities, it is likely that the growth trend will continue
in the years ahead, for a number of reasons. First, this is a field which experience has shown to be crucial for the effectiveness of the Bank's overall lending. Second, there is strong demand for the Bank to remain involved, from both the borrowing countries and, as recently discussed in the governance paper (World Bank, 1993b), from Part I countries as well. Finally, it is not clear that any other development organization has a comparative advantage over the Bank in this area.

It is imperative, however, that the Bank's effectiveness in institutional development be significantly improved. As argued in Section IV above, a necessary condition for this to happen is that we develop a better understanding of the political, social and cultural factors that affect economic development via the institutions and the organizations. A new analytical framework needs to be developed that will extend and enrich the economic models we currently use. The very notion of "development" needs to be revisited to clarify that development is really economic growth plus "appropriate" institutional change, i.e., change that facilitates further economic growth (Toye, 1993). As discussed above, the New Institutional Economics can provide some of the building blocks for this learning process.

A new model of development assistance will gradually emerge as the new analytical framework and new models of development processes take root in the World Bank. Although no blueprint can be provided at this stage on how to do a better job in support of institutional development, some broad implications can already be drawn. At a micro-level, since the key to efficient markets is low transaction costs, increased emphasis will need to be placed in our project work on the analysis of the determinants of transaction costs and the design of institutional/organizational interventions to address the problems thus identified. This is likely to require increased Bank involvement in the reform of legal and regulatory frameworks as well as the various mechanisms to enforce contracts and property rights. At the sector and macro levels, policy design requires greater awareness that incentive systems result from the interaction of formal rules, informal constraints (including belief systems and other cultural variables) and the enforcement characteristics of both, and that unpredictable outcomes may result if this interaction is disregarded. At both micro- and macro-level, more attention will need to be paid to the political economy of reform and to the path dependent nature of institutional (and technological) change. As the degree of freedom that policy makers possess to alter the direction of economies is constrained by the historically determined institutional matrix and the belief systems of the players, choosing the appropriate point of intervention will be for the Bank a major determinant of development effectiveness. In any case, institutional development will
continue to be a slow, gradual process, with learning and, possibly, political/social leadership as the two most influential agents of cultural change.

VI. Some Operational Implications

As part of the process of transition toward a deeper and, hopefully, more effective World Bank involvement in institutional development, it seems that we need to:

1. pay more attention to institutional development and its interrelations with political institutions and economic growth in our research programs (for some suggestions, see Appendix A). This would be instrumental to developing a better analytical framework to capture the dynamic interactions between political and economic institutions/organizations in the process of economic growth;

2. integrate the institutional development perspective into the design of country assistance strategies;

3. systematically identify the principal constituencies and stakeholders when designing institutional reforms, and ensure their involvement at the appropriate stages of the program/project cycle;

4. carefully relate institutional development objectives to the degree of institutional development of the intended beneficiaries (this implies a need to eschew overly ambitious designs, to sequence ID activities in relation to their political as well as technical feasibility, and, in general, to pay much more attention than in the past to the problems of change management — see Tobelem, 1992);

5. as institutional development is a slow and gradual process, recognize the limitations implicit in the use of the existing Bank lending instruments (e.g., whereas institutional reforms are often necessary to ensure the successful implementation of adjustment programs, it is unrealistic to expect that the quick disbursing SALs and SECALs can be an effective vehicle to implement complex institutional changes, especially in countries with limited institutional capacities);
(6) develop new operating procedures — and, possibly, new lending instruments — which are more compatible with the requirements of institutional development assistance such as increased flexibility in the project cycle, more reliance on the "process approach" (as opposed to the blueprint approach which is typical of most Bank projects), and more emphasis on participation and dialogue with the beneficiaries (Israel, 1990). One could think, for instance, of multi-year framework agreements for institutional development, subject to annual specification of detailed targets and work programs. Some modified version of the Training and Visit approach to know-how transfer could be used in this context, as an alternative to more traditional delivery modes (such as the very common, quite costly, and very discredited model of expatriate resident experts and local counterparts);

(7) support the increased flexibility to adjust or redesign institutional development components after project approval with more adequate performance monitoring indicators (this would also require a willingness on the part of the Bank to allocate the resources needed to what is likely to be, in many cases, a very staff-intensive process);

(8) revisit skill mix, training requirements and organizational implications in the Bank (including possible changes in management approaches and incentive systems);

(9) tap local expertise on institutional issues by establishing cooperative arrangements with local universities, particularly for economic and sector work, and by making greater use of local consultants on management and organizational development;

(10) consider options to increase the perceived opportunity cost of ID-related technical assistance among the intended beneficiaries (including some form of "marketizing" of technical assistance — see Berg, 1993).

None of these changes in approach or processes is absolutely new. Indeed, many of them are already occurring in the Bank, in one form or another — a testimony to the fact that ID is as incremental and path dependent in the Bank as it is for our member countries. What is new — and what makes the progress slower than many would wish — is that these changes seem to postulate a new, and not yet completely articulated, model of the project cycle, i.e., an alternative way of applying development knowledge and organizing development assistance. Whereas the traditional project cycle assumes "hard" technologies, predictability of key parameters, and relative invariance of project design to cultural differences, the new model of
project cycle, which is currently being debated in the Bank, assumes a complex and uncertain environment not amenable to precise long-term planning and a type of development assistance which is highly sensitive to the institutional matrix of the receiving country. As a consequence, institutional development can no longer be treated as an "add-on" component, but becomes an integral part and a central aspect of the project/program itself. By the same token, instead of the traditional fairly rigid sequence of identification, preparation, appraisal and supervision, the new project cycle needs to rely on cycles of experimentation, evaluation, learning and redesign prior to "mainstreaming." The differences are not merely procedural, for the new project cycles seems to be based on a different cultural model where development knowledge is not simply transferred from those who have it to those who don't, but is created together (Bank and borrowers) in a continuous process of "action learning" (Argyris, Putnam and McLain Smith, 1990).

VII. Conclusions

Virtually since its inception the World Bank has been actively promoting institutional development in Third World countries, and its involvements have been growing in volume and complexity in recent years. It is also clear that there is an increasing appreciation in the Bank of the importance of the complex interrelations that link institutions, organizations and the process of economic growth. After all, one of our goals has always been to develop efficient markets, and we have learned that the market is itself an institution — or to be more precise, the point of intersection of a large number of formal and informal "rules of the game." Similarly, our work on policy reform in Third World countries has been, in fact, an attempt to redefine or reorient some of the basic "rules of the game" of those societies.

Is it then possible that, like the character in Moliere, we have been speaking prose without knowing it? As shown in this paper, the problem has been not so much a lack of appreciation of the importance of institutional development, but rather a lack of an adequate conceptual framework and an overall Bank strategy to link institutions, organizations and economic growth in Third World countries. Perhaps not surprising, at the country level this has resulted in inadequate integration between ID work and other forms of the Bank's development assistance, and in less than satisfactory developmental impacts of many ID interventions.
This paper has argued that while no dynamic theory of institutions is as yet available, we know what the main characteristics of this theory should be. Moreover, the New Institutional Economics has made important progress in this direction by developing an analytical framework which recognizes the critical role of economic and political institutions and social learning in the process of economic change. In due course, these theoretical advances may drastically change both the way in which we think of economic development and the way in which we organize and manage development assistance. Much more work needs to be done, some of which the Bank can either do itself or, at least, promote and facilitate. However, a number of operational implications can be drawn already, as this paper has attempted to show. Perhaps the most important among these is that the NIE can give us a better understanding of the conditions under which development assistance can be effective or, alternatively, is unlikely to work, because the institutional structure provides no underlying framework within which policy reforms can be absorbed and produce the intended results. As we internalize these lessons, we should be able both to increase the development effectiveness of the programs/projects that we finance, and to improve our ability to avoid wasting money on projects that will not work.
References


Appendix A. Institutional Change and Economic Development: Suggestions for a Research Agenda.

The Bank is in an ideal position to advance the understanding of the interrelationships between institutional change and economic development because of the immense potential of empirical evidence it can command. Four areas seem to hold the promise of generating useful dynamic hypotheses that could serve as a guide to informed policy:

(a) What are the specific sources of variation in performance with the same formal rules? Is it a question of differences in enforcement or in informal (cultural) norms of behavior or both? Can we predict when rules will have the desired result and when they won’t? What is the impact of the institutional matrix on entrepreneurship?

(b) What kind of political institutions and organizations will provide the best incentives for productive activity and improved adaptive efficiency in various contexts? How do you get them? This research would need to look in detail at how public enterprises work, how regulatory systems work in different contexts, and how various kinds of political institutions that structure the game have evolved, and how they work. It would also consider the conditions under which some degree of isolation from political pressures "of the wrong kind" can be a positive condition for the promotion of effective institutions.

(c) Modeling dynamic change entails accumulating studies of the interaction between institutions (political and economic), organizations (political and economic), and learning through time. This requires thinking about policy reform not just in terms of one or two stages in comparative statics, but as a dynamic process in which the overall political-economic system in a country is continually evolving. An adequate framework to assess a proposed policy reform would first identify the immediate economic consequences of the institutional change (e.g., in terms of their impact on relative prices, employment levels, income distribution, etc.), then look at the political repercussions of these changes. These are likely to engender new institutional changes downstream, which in turn will alter the way in which the economy and polity are going to evolve. This is the most important (and the most difficult) item on the research agenda because unless one consciously analyzes policy changes in a dynamic context, one will always be getting results at variance with objectives.
(d) The hallmark of sustained growth (historically, a very unusual phenomenon) is the long-term flexibility of the institutional framework which enables it to adjust to technological and demographic changes as well as exogenous shocks to the system. Doing research on what produces institutional flexibility is focusing on the polity, on norms of behavior, on social learning, and on the interactions among these factors. While the Bank may not have a comparative advantage in this specific area, it could support the research efforts of individual scholars who could build on the accumulated empirical knowledge of the Bank in an attempt to distill the essence of adaptive efficiency.
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