

# *Limits of the New Institutional Economics Approach to African Development*

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**Abstract:** In the last two decades, there has been a marked shift in the research on sub-Saharan Africa (SSA) from standard neoclassical analysis to new institutional economics (NIE). The increasing emphasis on NIE is reflected in a wide range of work by international financial institutions and scholars. However, the NIE approach retains fundamental limitations due to its narrow interpretation of institutions, its over-reliance on analysis of transactions costs and property rights, and its ahistorical attachment to markets and private sector firms as major engines of development. Furthermore, NIE typically fails to look “inside institutions” to identify the complex cultural factors that shape the interests and behaviors of the members of institutions. This paper engages in a critique of NIE analysis of SSA economic development, and suggests the need for a nuanced analysis of property rights and culture, along with development programs to address inequality and poverty and to foster state-led development.

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## *Introduction*

In the last two decades there was a significant shift in mainstream economics research on development from standard neoclassical analysis to new institutional economics (NIE). We have seen the awarding of four Nobel Prizes to NIE scholars, a best-selling book introducing the NIE perspective on comparative development, and an increasing emphasis on NIE research by mainstream scholars and the international financial institutions (IFIs). This leads Tamanaha (2015, 89) to conclude, “NIE appears to be the new consensus view of development thinking, supplanting the neo-liberal Washington Consensus that dominated global development policy in the 1980s and 1990s.”<sup>1</sup> The effect of the NIE Consensus on development policy can be seen in the increasing emphasis on institutions, and especially governance, by the World Bank, International Monetary Fund (IMF) and Non-Governmental Organizations funding development projects in sub-Saharan Africa (SSA). In response, there has been a flurry of research by Original Institutional Economics (OIE) scholars criticizing the NIE approach (Tamanaha 2015; Castellano and Garcia-Quero 2012; Zein-Elabdin 2009). Ha-Joon Chang’s (2011) important critique of NIE formed the centerpiece of an issue of the *Journal of Institutional Economics* devoted to an assessment of NIE development theory.

The NIE Consensus represents an improvement in the study of economic development compared with previous mainstream neoclassical approaches. NIE has brought the importance of institutions to the development process to the fore in development policy circles. Nonetheless, there are some significant deficiencies in this approach, which become particularly glaring when applied to SSA. Also, NIE theories have been applied in a very narrow, market-oriented fashion by the IFIs, which has resulted in the continued application of inappropriate policies in SSA.

This paper draws on the NIE literature on comparative development, the policies implemented under the NIE Consensus by the IFIs, and the OIE critique to analyze the limitations of the NIE approach in the SSA context. Specifically, we discuss the limitations of the property rights approach to development, the lack of a sufficient analysis of culture in NIE work, and the inadequate attention to inequality, poverty and the role of the state that render the NIE Consensus largely ineffective in SSA.

### ***Property Rights as the Dominant Institution in Development***

In their seminal NIE article on comparative development, Acemoglu, Johnson and Robinson (2001) argue that the establishment of institutions protecting property rights, versus extractive and predatory institutions, explains much of the world's economic growth performance. According to Gérard Roland (2014, 108) this work "has quickly become the dominant [mainstream] view on explaining growth." Acemoglu, Johnson and Robinson (2001, 1387) argue that "the reason why African countries are poorer is not due to cultural or geographic factors, but mostly accounted for by the existence of worse institutions in Africa." The primary institution of concern within NIE is property rights, because NIE economists believe historical data "shows that countries with more secure property rights, i.e., better economic institutions, have higher average incomes" (Acemoglu, Johnson and Robinson 2005, 403). They attribute this to the colonization strategies of European countries. For example, "in the Congo or the Gold Coast, they set up extractive states with the intention of transferring resources rapidly to the metropole. These institutions were detrimental to investment and economic progress.... [T]hese early institutions persisted to the present" (Acemoglu, Johnson and Robinson 2001, 1395) because elites have no incentive to make changes (*ibid.*, 1376).

Property rights, along with the ability to enforce contracts, feature very heavily in the Worldwide Governance Indicators database and Governance Matters series produced by World Bank researchers.<sup>2</sup> These indicators lead Kaufmann and Kraay (2003, 1) to conclude that “better governance exerts a powerful effect on per capita incomes,” where governance is defined by “control of corruption, the protection of property rights or rule of law, and voice and accountability.”

The focus on property rights may be reasonable for some societies in certain historical periods, but the idea that property rights are the most important institution in the development process in contemporary SSA is questionable. This approach neglects the entire institutional configuration in particular places and is therefore prone to error. For example, in Kenya, Senegal, Gambia, and many other countries in SSA, efforts to establish secure rights to land undermined the well-being and productivity of many people, especially women, pastoralists, and others with traditional, subsidiary land rights (Platteau 1996, 40). Due to the complex nature of traditional land tenure and ownership systems that persist in SSA, governments are often unable to assign property rights fairly or effectively. Some of the most productive members of society, particularly women, tend to be excluded from government efforts to extend formal property rights to communal lands.<sup>3</sup> Women in rural Africa are incredibly productive farmers, and allocating property rights in a way that reduces their access to land is deeply problematic on many levels.<sup>4</sup>

Another vexing problem is the legitimacy of the existing distribution of property in SSA. In many countries the system of property rights is widely considered to be illegitimate. In South Africa, the fact that the distribution of property has changed little since the end of *Apartheid*, other than the benefits that have accrued to a very small black elite, means that any policies that

might freeze property rights in their current state could generate widespread unrest and destabilize the economy (Schneider and Nega 2015).

Also, the establishment of property rights is easily manipulated by the elites, especially in the presence of inadequate records.<sup>5</sup> During the allocation of public lands or private land tenure rights, “clever, well-informed or powerful (and usually educated) individuals often successfully jockey to have parcels not previously theirs registered in their own name, while the mass of rural people are generally unaware of the new land provisions or do not grasp the implications of registration” (Platteau 1996, 43-44), as was the experience in Uganda, Kenya, Somalia, Nigeria and many more. In Zimbabwe after independence very little land was redistributed (about 12 percent of the amount that had been promised) and the most valuable land was usually allocated to political insiders (Addison and Laakso 2003). These factors featured heavily in the subsequent land occupations that precipitated Zimbabwe’s economic crisis.

With 39 out of 48 SSA countries considered to be un-free or partially free (Nega and Schneider 2011, 424), and with centralized political power being used in most SSA countries to capture property rights, it is likely that the distribution of property in most of SSA is considered illegitimate by much of the population. Establishing property rights within existing power structures is likely to reify the current property distribution, which will continue to be a recipe for instability and conflict over the long term. In most SSA countries, the establishment of formal property rights is unlikely to be the panacea that NIE economists think it will be.<sup>6</sup> Another flaw in the NIE approach is the dismissal of culture as a major influence on development.

### *Towards a More Sophisticated Analysis of Culture*

The selection of an individualistic, rational-choice-based theoretical approach in NIE is a recipe for missteps when recommending development policies in SSA. As noted above, Acemoglu, Johnson and Robinson (2001) claim to have proven that culture is not a significant factor in determining economic growth. They dismiss culture as an important variable by discrediting a stereotype and by arguing for the primacy of institutions over culture.<sup>7</sup> The cultural analysis they criticize is the view “many people still maintain that Africans are poor because they lack a good work ethic, still believe in witchcraft and magic, or resist new Western technologies” (Acemoglu and Robinson 2012, 57). They argue that such broad, systemic differences in culture do not explain development differences. The aspects of culture that matter to them, “such as the extent to which people trust each other or are able to cooperate, are important but they are mostly an outcome of institutions, not an independent cause” (*ibid.*).

No OIE economists would disagree with the idea that racist cultural stereotypes of Africans are invalid. The argument that cultural factors are less important than other institutions, however, is a value judgment that stems largely from unsophisticated analysis of culture and its importance in shaping behaviors and institutions. To demonstrate this, we will focus briefly on the ongoing importance of kinship relations in post-colonial SSA.

The lack of political and economic security has reinforced rather than reduced the importance of kinship relations in post-colonial SSA. We see numerous examples of this. In Ghana, it is common for employees at firms to be selected from the same ethnic group (Berman 2010, 21). In Tanzania employing family members is the norm (Trulsson 1997), and we have found the same thing in many black-owned firms in South Africa. In NIE research on market institutions in SSA, Fafchamps (2004, 8-9) finds that “solidarity among relatives and kin

represents the dominant form of social insurance. Gift exchange thus constitutes a very important allocation mechanism....” Family relationships are used to generate capital and to provide business contacts, and trust stems more from personal relationships than formal contracts. However, patronage expectations from family relationships make African firms reluctant to engage in market transactions with family members (Fafchamps 2004, 305). Clearly, kinship relations in SSA are important in many economic decisions, affecting employment, investment and trade.

Cultural factors also have a strong influence on the allocation of land. Throughout most of SSA there are strong cultural beliefs that land should belong to the “sons of the village.” Land continues to be a source of identity and to confer status, as well as providing economic security and social insurance (Platteau 1996). Consequently, the cultural patterns in much of SSA preclude the functioning of an efficient (in the NIE sense) market for land. Due to established cultural practices, many SSA communities may not accept markets for land once formal property rights have been allocated, creating uncertainty and even conflict.<sup>8</sup> This further undermines the NIE argument that stability of land tenure will lead to greater productivity.

Thus, we have clear evidence that cultural factors have a strong influence on economic behavior and that family relationships have a direct bearing on market activity. In an uncertain environment, kinship provides financial and contract-like security and, in NIE parlance, it reduces transactions costs. These factors cannot, of course, be reflected in the blunt measures of institutions being used by Acemoglu, Johnson and Robinson (2001) or the IFIs. And, even the more sophisticated NIE analysis of culture by Trulsson (1997) and Fafchamps (2004) is limited because, “instead of trying to comprehend the complex imbrication of different cultural and economic phenomena on their own terms, they attempt to fit them within a model of an

individual choosing self in a knowable progressive historical journal” (Zein-Elabdin 2009, 1163). Theories utilizing a deductive methodology based on rational economic man will likely continue to result in policy missteps, especially where cultural factors trump “economic” calculations. Those missteps are apparent in development programs that have not successfully addressed inequality and poverty.

### *Inequality and Poverty*

When NIE analysis is operationalized in development projects by the IFIs, we tend to see insufficient attention paid to policies likely to improve inequality and poverty. Market-based development efforts in SSA largely ignore the inequitable distribution of income and resources. In order to participate willingly and fully in development efforts, societies need a common purpose and people must have a stake in the development process. This can be facilitated through democratic governance, robust civil society, and some method of insuring that the benefits of development are widely shared (Nega and Schneider 2011). In places characterized by a fractured ethnic landscape and the lack of a national interest, uniting society is extremely important for development. Yet, development plans rarely pay sufficient attention to this issue, despite research by Englebert (2000, 29) establishing that “the developmental capacity of African states is partly a function of their degree of legitimacy ....”

Also, a broad-based approach that provides income for the poor can be effective in stimulating development. Cash grants to the poor are usually spent locally, stimulating businesses and jobs. South Africa’s \$12 billion social grant system (3.4 percent of GDP), has stabilized real incomes for the poorest South Africans, and “social grants aid investment expenditure by poor households and aid job search behavior among the unemployed” (Bhorat



and Cassim 2014). Without such social grants, the South African economy would be less stable and there would be less money circulating through poor townships.

The Poverty Reduction Strategy Papers (PRSPs) that the IFIs negotiate with SSA countries target poverty explicitly, but the emphasis on fiscal austerity tends to undermine this focus. According to World Bank data, the rate of extreme poverty in SSA, defined as the percentage of the population living on less than \$1.90 a day, was 42.7 percent in 2012. With a poverty gap of 16.5 percent and 388.8 million people living below \$1.90 a day in SSA, it would cost about \$45 billion per year to move *everyone* in SSA above this poverty line. This would eliminate extreme poverty and stimulate job growth in poor communities. Cash grants yield immediate poverty reductions, and they could stimulate development if paired with other means of improving opportunities for the poor.<sup>9</sup> We could eliminate extreme poverty in SSA for a relatively low cost by utilizing programs that worked well in South Africa and Brazil.<sup>10</sup> The choice not to do so is evidence of the economic philosophy driving PRSPs. Unfortunately, the IFIs have focused on the narrowest, most neoliberal aspects of NIE. We can see this most glaringly in attitudes towards the state.

### ***The Role of the State***

Ultimately, NIE as employed by the IFIs is a supply-side approach, giving primacy to transactions costs and the private sector over demand considerations and the public sector. PRSPs draw on NIE research, incorporating governance and recognizing that each country contains an institutional environment that requires a unique policy mix. Nonetheless, PRSPs in SSA have emphasized strict monetary policy more than 80 percent of the time, fiscal austerity 95 percent of the time (Sumner 2006, 1407), and trade liberalization, privatization and

decentralization 100 percent of the time (Harvey 2008). The obsession with reducing the role of the state, while seemingly warranted by the level of corruption in many SSA countries, comes about in part because, “NIE focuses on the constraining aspects of institutions, while OIE also highlights the enabling aspects of institutions” (Tamanaha 2015, 97). Viewing the state primarily as an impediment to development is problematic. There are almost no instances of late-industrializing countries succeeding without substantial state intervention, so it makes little sense to continue de-emphasizing state-led development. Much better would be to assist SSA countries in improving their state institutions to develop a comparative institutional advantage in industries with growth potential (Schneider 2008). Improving governance, as emphasized in PRSPs, is important, but the establishment of a developmental state requires more intensive emphasis on improving state capacity.

Also problematic is the obsession with rent-seeking, which misunderstands the potential role of rents in development. Channeling rents into productive endeavors has been the hallmark of development in many instances. Rent-seeking is not always destructive, and some method of capturing capital for domestic purposes remains essential (Schneider 2008). Also, patrimonialism is endemic to most SSA countries, and it would be naïve to think that this will change any time soon given the cultural factors discussed above. A more useful approach would be to find ways to channel typical SSA behavior into productive rather than predatory outlets. For example, restricting capital flight (and regulating capital markets) while promoting domestic investment would help. The rapid rise of Chinese Town and Village Enterprises (TVEs) also provides an interesting example. TVEs were collectively owned and accounted for more than half of China’s industrial production in the 1990s (Angresano 1996, 538), demonstrating that groups previously excluded from markets can respond to market incentives in an adept fashion under the right

conditions. Creative organizational structures based on local relationships could be similarly effective in SSA.<sup>11</sup>

### *Conclusion*

It may well be the case that economic development improves institutions rather than vice versa (Chang 2011, 476). Investing in industrial development and job creation along with robust anti-poverty policies could stimulate exactly the kind of institutional change the IFIs have been unable to achieve. Such an approach would require an accountable state accompanied by substantial investments in developing state capacity, as opposed to austerity.

There are a number of NIE economists who are pushing the boundaries of their analysis beyond the transactions costs, property rights and contract enforcement focus that forms the core of the NIE approach. But these economists are not receiving the most attention from the profession, and they do not yet have significant influence in shaping development policies by the World Bank and IMF. Thus, the NIE Consensus is being used to justify market-oriented development programs that, although they represent an improvement over Structural Adjustment Programs, are still problematic when implemented in SSA.

What is needed is a more nuanced analysis of property rights and culture, along with development programs designed to address inequality and poverty, and foster state-led development. In other words, the IFIs would benefit from listening to their more broad-minded NIE colleagues and OIE economists.

### *Notes*

1. The Nobel Prize winners are Ronald Coase, Douglass North, Elinor Ostrom and Oliver Williamson. The best-selling book was *Why Nations Fail* (Acemoglu and Robinson 2012). NIE research has been published in the *American Economic Review* (Acemoglu, Johnson and Robinson 2001) and dominates many development journals and World Bank publications.
2. See [www.govindicators.org](http://www.govindicators.org) for information on governance and governance indicators.
3. In most SSA programs attempting to establish formal rights to land without an existing title, ownership is usually granted to the male person with the clearest claim to the land.
4. Reducing women's access to land is, of course, problematic in many more ways than just the impact on agricultural productivity. Gender equality and empowerment should form a key part of any development project.
5. Most SSA countries have incomplete records regarding land ownership.
6. Platteau (1996) calls for community-based solutions and pragmatic and gradualist efforts to re-institutionalize land tenure and promote adaptation to modern realities. This would be inexpensive, and it would have the potential to achieve widespread support in a way that IFI to date approaches have not.
7. Acemoglu, Johnson and Robinson (2001) imply here that culture is not an important institution. Specifically, they consider culture to be less important than property rights, transactions costs, and the enforcement of contracts. Thus, they establish a hierarchy of institutions without providing sufficient justification for this hierarchy. Meanwhile, OIE economists place the role of culture as central to economic analysis.
8. As long as control of land is associated with social status, it is unlikely to be bought and sold based on market calculations. The association between land and one's ancestors in SSA also promotes strong bonds to particular plots of land. Furthermore, even when land is sold in a market, traditional tenure access to land can trump formal land ownership in determining which persons have rights to use land. Given the importance of land to well-being and cultural practices,

land in SSA is indeed a “fictitious commodity” (Polanyi 2001), and the market for land cannot function effectively in the current institutional environment.

9. The poverty rate in SSA was 58 percent in 1999 and 42.7 percent in 2012 using the poverty line of \$1.90 per day (see <http://povertydata.worldbank.org/poverty/region/SSA>, accessed 12-13-2015, 12:17 P.M.). During the same time period, official disbursed foreign aid to SSA increased by 220 percent, from \$18.6 billion to \$59.5 billion (Nega and Schneider 2015). Meanwhile, African economies grew steadily at a rate of almost 2.6 percent per capita from 2001 to 2010 during Africa’s commodity boom (Nega and Schneider April 2015). Thus, a huge increase in aid and rapid economic growth resulted in a significant decline in poverty, but the decline was much smaller than it should have been given these favorable economic conditions. The PRSPs and other developed country aid programs that target poverty have, to date, had a limited impact.
10. Brazil’s program, the *Bolsa Familia*, was very effective in reducing poverty and inequality.
11. In the same way that the Grameen Bank tapped into existing cultural attitudes and values to improve micro-lending and investment, SSA communities could build on established relationships to construct informal and formal economic institutions.

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