

Chapter 10

Construction of the development strategy versus informal constraints*

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Introduction

In the modern economy, there is a growing recognition of the thesis about the importance of institutions for socio-economic development of societies.¹ Many empirical studies, both those of a nature of a case study, and cross-sectional analyses on large samples of countries, showed that the rules deciding about social life determine the achieved level of prosperity (Easterly & Levine, 2003; Acemoglu, Johnson, & Robinson, 2005; North, 2006). Therefore, in order to program development, those in power should devote much attention to the institutions regulating economic activity in the country, and the quality of institutions should occupy an important place in the development strategy.

Under the influence of politicians there are mainly institutions *de iure*, or formal regulations, laid down in the legislative process. However, in the social reality there are also informal constraints, of an unofficial nature, with their source in the culture and in the history of society. As a result of various interrelationships between formal and informal regulations, *de facto* results of the former may be different from those predicted by legislators and, therefore, the whole body of institutions is important for socio-economic results (Acemoglu, Johnson, & Robinson, 2005; Voigt, 2013).

Therefore, one might raise the question of the role played by informal constraints in the socio-economic life and the nature of their impact on the effectiveness of formal institutions. The answer to this question will indicate the appropriate approach to the construction of the development strategy, in particular, whether

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¹ This was proven for instance by a debate which was held in the *Journal of Institutional Economics* (December 2011), dedicated to interrelations between institutions and development.

and how social factors should be taken into account. The aim of the chapter is to present the mechanisms of informal institutions from the point of view of socio-economic development. It presents the hypothesis that informal constraints are the basis for daily activities of individuals and as such must be taken into account in planning the development of a country. What seems especially important is the informational aspect of all institutions, which means that they allow economic actors to build expectations and plan their own activities.

The chapter is a theoretical reflection on issues of programming development and institutional change. It presents the views of representatives of contemporary institutionalism, and attempts to critically respond to the experiences of the development policy.

10.1. Conceptualization of the notions of development and development strategy

Socio-economic development can be treated in two ways – in terms of positive categories, as a phenomenon occurring objectively, or normatively, as a goal, which societies should pursue and which in varying degrees can be achieved. When adopting an objective approach (e.g. Hausner, 2012), to define “development” one can use the formulation of Thirlwall (2006, p. 17) who treated it as “the process of economic and social transformation of countries.” It is, therefore, a phenomenon occurring all the time, consisting in constant changes of living conditions and social provisioning. Schumpeter (1960) looked at development in a similar way and emphasized the multidimensionality and discontinuity of these changes. Thus, with the development strategy in mind, one should remember that it leads not only to the quantitative increase of production capacities, but also to the changes of the economic and social structure.

The normative aspect of development is equally important. It is a process, as a result of which, simply put, people should live better lives. Evaluating the occurrence of development, what is observed is not only the material standard of living, but also two other dimensions of human existence: the sense of dignity, and freedom (Thirlwall, 2006). Improving people’s living standards and higher satisfaction of their needs are of course important,² but preserving the dignity of an individual and increasing the range of freedom is a necessary condition for achieving development in this sense. Alternatively, referring to Sen (2000, p. 295) development is “(...) the expansion of human capability to lead more worthwhile and more free lives.” Freedom is not only a goal to which we aspire, but also a means, an instrument of development – without which the improvement of economic performance is in the

² Particularly in relation to developing countries – economic growth is the best means to eradicate poverty as GDP growth serves poverty eradication (Thirlwall, 2006, pp. 34–35).

long run impossible. Hausner, among others, writes that the two aspects of development – social and economic – mutually condition each other, and increasing material prosperity must be accompanied by the dissemination of ethical standards.

Assuming at this stage the above broad understanding of development, one can agree with the statement that the socio-economic development is a goal which society should pursue. In this way, it becomes the goal for those in power and the basis for the legitimacy of their actions. As noted by Kozak (2012), in recent decades in business practice, a strategic approach to development has gained significance and popularity. Strategy – the concept derived from military terminology, and brought to public policies from the business sector (Gorzela & Kozak, 2012) – means “an instrument of conscious and systematic actions aimed at achieving concrete long-term development goals” (Kozak, 2012, p. 32). The fact that many countries create and pursue development strategies is not only a conceptual change, but has a much more significant meaning. In the practice of governance of the country, a systematic approach, which is characterized by, or at least should be characterized by the following features, is gaining popularity (Kozak, 2012):

- long-term planning based on a vision – a desirable state of society in the future,
- carrying out an accurate diagnosis of the initial situation, identifying barriers and opportunities for development,
- broad, multi-dimensional approach, taking into account non-economic goals,
- systematic execution and, possible, revision of the planned activities.

In addition to typically practical purposes, the development strategy plays important informational functions. First of all, one should see in it as an expression of the desire to reduce the complexity and uncertainty of the environment. Thanks to an accurate diagnosis, the strategy makes it easier to understand the nature of socio-economic processes, points to the barriers and development opportunities, and becomes a source of information for economic actors, by setting objectives and implementation tools. This way, one can achieve consistency between the actions of various actors – both public and private – and mobilize them to take the desired action (Kozak, 2012).

Development objectives have to be met in everyday business practice. Therefore, the primary mechanism of pursuing them will be to influence the decisions of economic actors, by increasing their potential, or supporting proper patterns of behaviour. Therefore, a special function of development strategy is to create a framework for business activity, that is, institutions. Market activities are always embedded in wider institutional order, which should be the focus of those in power (Hodgson, 1998; Polanyi, 1957).

This results in two general requirements for the authors of the development strategy. Firstly, it must be effective in improving the material well-being of socie-

ties, which underlies the positive freedom of individuals. Secondly, it must comply with ethical standards, that is, meet the requirement of fairness, in particular accordingly to the understanding of community, which is to be covered by the strategy. Whether the two presented conditions of a good strategy are complementary to each other or may be in conflict will be considered later in the text.

10.2. Informal restrictions

In accordance with the approach of modern institutionalism, the starting point for the analyses conducted is to adopt the vision of limited rationality of an individual (Chmielowski, 2011). One of its hallmarks are the processes of acculturation, thanks to which people internalize certain common behaviour patterns within the environment (Goldschmidt, 2006) in order to use them later when making decisions. Among the internalized elements one can distinguish: customs, norms and rules. Although between these three categories there are significant differences (Ostrom, 1998), for the purposes of this article they will be understood in a way North (2006) understood them, that is, as informal constraints.³ Their common distinguishing feature is that they are “produced, communicated and enforced outside of the officially sanctioned channels” (Helmke & Levitsky, 2004, p. 725). On the other hand, formal institutions are those that “are produced, communicated and enforced through the channels generally accepted as official,” i.e. primarily by state authorities (Helmke & Levitsky, 2004, p. 725).

What is significant from the point of view of the analysis are the following distinguishing features of informal constraints (also referred to as restrictions):

- they constitute a restriction for decision-making, as they indicate which actions are permitted, advisable or prohibited, and certain choices involve sanctions,
- the enforcement mechanism of sanctions can rely on social control or internal control, based on conscience (Voigt, 2013),
- because they are anchored in the culture and history of societies, they are based on ideologies, mental models, and are also very durable and less susceptible to changes (North, 2006),
- they do not necessarily lead to economically efficient results, because they can in fact pursue other social functions: guarantee stability, maintenance of power or preservation of tradition,
- they often take the form of tacit knowledge. Because they are treated by individuals as natural, their exact content may often be difficult to observe and communicate (Couyoumdjian, 2012).

³ The chapter interchangeably uses terms “informal limitations,” “informal institutions” and “informal regulations.”

Informal constraints influence the actions of individuals and, more broadly, social and economic life in different ways. They affect both the preferences of individuals as well as the situation of choice, shaping possible alternatives, the sequence of actions or information resources. Firstly, through mechanisms of rewards and punishments they create incentives to take specific actions. Secondly, the role of restrictions is to reduce uncertainty by increasing the mutual predictability of actions. If in a given community there are strong rules of action that are effectively enforced, it increases confidence regarding the specific behaviour of partners in the interaction. This makes it easier to formulate expectations, and build long-term plans. Thirdly, due to its durability, they help workers and entrepreneurs form specific ways of solving economic problems, i.e. routines. Routinization of economic activity in turn allows for significant savings of resources and better evolutionary adaptation to the environment (Nelson & Sampat, 2001).

Because usually informal rules coexist with formal ones, the analysis focused on the nature of the relationship between these two types of restrictions.

When constructing new or trying to change the existing formal institutions, one should keep in mind that their impact on individuals does not completely exclude the impact of informal limitations. If we accept the model of a socialized individual with limited rationality, there appears uncertainty regarding the results of actions of the designed rules. One reason for this uncertainty is acculturation of the norms and conventions of conduct (Voigt, 2013). According to Helmke and Levitsky (2004), there may be four basic types of interactions between formal and informal restrictions: complementarity, substitution, accommodation and competition (Table 10.1).

Table 10.1 *Typology of informal rules*

	Effective formal rules	Ineffective formal rules
Compatibility	Complementary	Substitutional
Incompatibility	Accommodative	Competitive

Source: Helmke & Levitsky, 2004, p. 728.

The first two types of dependencies occur when formal regulations introduced are consistent with existing in the community informal rules. Then the rules of both types reinforce each other, which increases the likelihood of achieving the results intended by the legislator and is beneficial from the point of view of social stability. If formal institutions for various reasons fail, they will be replaced by the activity of informal norms and rules (Voigt, 2013).

One can also treat formal institutions as a complement to previous limitations of an informal nature. North (2006) draws attention to it indicating that it is a natural mechanism of institutionalization in conditions of increasing complexity of

social reality. Together with the increasing scale of economic relations and escalation of the anonymity of transactions, informal institutions are no longer enough and require top-down official reinforcement. Then, the proposed institutions will somehow grow out of the existing social conventions. This situation is very advantageous because it can reduce the uncertainty and the development of generalized trust in the macro-scale.

What is more complicated is the case of discrepancies between the content of formal and informal restrictions. To illustrate this situation, one can use the reasoning presented by North (2006, pp. 36–45). Assume that in the conditions of the institutional balance and the match between institutions a formal institutional change was introduced. It will precipitate the whole system out of balance and will create tension, because social conventions suited to old institutions *de jure* will not match the new ones. The results *de facto* observed at the level of society are likely to be for some time different from the expectations of those in power, because some people will adhere to strongly internalized norms and rules. North (2006) predicts that, over time there will occur adaptation of informal restrictions to formal requirements of institutional order, but it seems that this scenario is overly optimistic. It assumes the effectiveness and efficiency of new institutions and the government in enforcing them. What is better suited to reality is the distinction made by Helmke and Levitsky (2004) of two scenarios: adaptation and competition. In the first of them, with a gradual, non-radical reform, due to the plasticity of culture, it is possible to adapt informal restrictions to new formal requirements. Such adjustment, however, will require the passage of time. From the point of view of authorities, the most adverse scenario is clearly a conflict between formal and informal rules. The risk of its occurrence increases especially in the case of radical reforms. The society may not agree on a new institutional order and continue to act in accordance with the informal regulations. This means the failure of reforms and high uncertainty about the final social results (Spranz, Lenger, & Goldschmidt, 2012).

The risk associated with the conflictual scenario becomes visible when one pays attention to the informational role of institutions. In the case of the two conflicting systems of conduct uncertainty among economic actors increases significantly. There is then no certainty as to how the other party of the transaction or a joint action will behave – and whether they will act according to the rule of law or social norms. What is more, it decreases the ability to sanction rules, both from the state and society, and the resulting institutional dualism is a significant barrier to development. Thus, the introduction of the institution, which often aims to reduce complexity and lower transaction costs, may lead to an exactly opposite effect and paralyse economic activity (Grzymala-Busse, 2010).

Finally, the dominance of formal rules in the institutional environment may have an adverse effect on social capital. The mere fact of external coercion appears to negatively influence trust and cooperation. There is a phenomenon of “moral hazard”: if public institutions care about reciprocity and trust, then we, as private

citizens, no longer have to worry about it. Meanwhile, standards and rules developed in the activity of the community are its social capital and strengthen confidence and ability to work (Ostrom, 1998).

One should also pay attention to the ethical aspect of institutional change, highlighted earlier as a prerequisite of development. It seems that radical reforms that are in opposition to informal rules can have, together with the inefficiency described above, dubious ethical quality. Of course, there are cases in which informal rules do not meet the ethical standards. However, the mere introduction of solutions to conflict in relation to the existing social order should each time be subject to scrutiny.

10.3. Critical analysis of development policy

As shown by Easterly (2008), the theory of social sciences has nearly always included two opposing approaches regarding the origin of institutions, or more broadly – sources of social order. According to the supporters of the “top-down” vision, social order is imposed from above by the government, and it is based on statutory law. In this approach, in its extreme representation, those in power and experts are virtually unrestricted in the construction of institutions and may propose solutions deemed optimal on the basis of their theory.

Conversely, representatives of the “bottom-up” approach perceive the source of rules governing society in everyday interactions at the local level – out of them there emerge orders at higher levels. Because they are anchored in local structures they cannot be altered in any way, but only carefully and gradually. A similar distinction is found in the North’s thoughts (2006) – a radical and incremental institutional change. Description of the properties of these two approaches, in its ideal-type forms, are shown in Table 10.2.

Many contemporary authors of economic development indicate the dominance of the top-down approach in thought and in the economic policy practice of the twentieth century, seeing in this fact the source of many failures of the development policy (Ostrom, 1998; Rodrik, 2003; Easterly, 2008). In postwar decades, with the collapse of colonialism, a fight against poverty and the improvement of the economic situation of underdeveloped countries became one of major global challenges. Through the activities of international organizations and the direct influence of Western governments, economic policy in many countries in Africa and Latin America was conducted according to the standards imposed from the outside. Rodrik (2003) describes the attempts to transplant ready-made recipes from Europe or the United States – first in the paradigm of development based on import substitution, and since the 80s by the so-called Washington Consensus. Development strategies proposed to poor countries were, therefore, first, imposed from above, and, second, came from another historical-cultural order.

Table 10.2 *Two visions of the origin of social order*

	Top-down	Bottom-up
Determination of order	Emergence from interactions, culture	Statutory law
Government action, possibility of institutional change	Limited, evolutionary	Freedom, radicalism
Role of experts, economists	Advising incremental changes (2 nd -best)	Construction of optimal institutions (1 st -best)
Basis of search	Respect for existing solutions	Pure reason
Balance	Many	One

Source: based on Easterly, 2008.

The vision of the order imposed from above has its roots in the utilitarianism of Bentham. Bentham believed that societies are substantially similar to each other in terms of needs and, therefore, institutions – the mechanisms of rewards and punishments – can be fairly easily transplanted between countries. Such “transplants” will require some adjustments, but according to Bentham they will not be a problem for the government, thanks to easy access to the information needed about the local community and its preferences (Couyoumdjian, 2012). However, this attitude turns out to be too optimistic for several reasons. Excessive universalism of institutional recommendations and top-down nature of the rules lead to conflicts with informal rules, according to the theory presented earlier. North (1994, p. 366) wrote that “economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy, because of different informal norms and enforcement.”

Easterly (2008) draws attention to the fact that the formal institutional order of rich countries, which enabled them to develop in recent centuries, has its origins in earlier informal institutions, and is their natural continuation. Easy transfer of ready institutions to poor countries is burdened with a very high risk because they do not have centuries of evolution of informal rules and norms behind them.

It turns out that the Bentham’s approach to the possibility of knowing local preferences is unjustified. The tacit nature of knowledge results in the fact that its communication, accurate understanding and modifying is very difficult for external actors (Couyoumdjian, 2012). If the authors of public policies fail to reach local structures of knowledge and information, any attempt to regulate will be burdened with the aforementioned risk of increasing complexity. The example of such an event could be the transformation of the CIS countries, where the elements of free market capitalism were quickly introduced into the post-Soviet socio-economic reality (Chavance, 2008). The weakness of both institutional arrangements, formal

and informal, as well as the competition between them made it impossible to create reliable economic expectations and paralysed economic activity.

Aldashev, Chaara, Platteau, and Wahhaj (2010, p. 29) mention other factors that reduce the efficiency of the top-down approach to programming development: ignorance of society about the law, the lack of confidence on the part of citizens regarding formal rules and state institutions, and the risk of manipulation of the rules and regulations by the political elite to seize economic rents. Ostrom (1998), in her observations on the development programs carried out by international organizations in developing countries, goes a step further and states that they may even be counter-productive, causing perverse effects. The introduction of strong formal rules displaces trust between citizens and strikes at the foundations of social capital. Treating people as passive recipients of policies repeatedly led to negative results, whereas the public institutions created to strengthen the existing private rules led to their disintegration (Ostrom, 1998).

According to some authors, the source of failure lies in the incorrect identification of good institutions with the institutions of Western countries, or even more narrowly – Anglo-Saxon ones. Relying the development strategy of the country on Western institutional patterns, including strong protection of private property and increasing the scope of economic freedom, often led to fatal results. Dogmatic free-market approach disregarded ownership and management rules existing in the recipient societies (Rodrik, 2003; Chang, 2011).

Conclusions

Since the top-down construction of development-oriented institutions is at a high risk of failure, then how should authors of public policies proceed with them? Rodrik (2003) indicates pragmatism in the first place. The recommendations resulting from the theory of economics, even in its neoclassical edition, are fairly general and do not indicate precise institutional forms. The basic requirement for starting and maintaining dynamic development is to ensure that economic actors ensure the returns of the labour or capital resources involved.⁴ In order for the economic activity to occur, an employee must be sure to receive remuneration for the work performed, and the entrepreneur must be able to keep profits from the company he directs. The ability to create reliable expectations requires clear – formal and informal – rules enforced in practice.

Whether this will be done within the framework of private, community or state property, and the extent to which the activities will be regulated by the state is a sec-

⁴ Thirlwall (2006, pp. 74–75) mentions two subsequent, also very general, properties of good institutional order – the quality of governance and limitations imposed on politicians.

ondary issue. Observing the institutional order of the richest countries in the world today, one can see a high diversity of institutions, which reflects cultural differences between societies. Only in Europe, one can identify diverse socio-economic models, and even greater differences occur when the comparison also includes countries of Southeast Asia. Thus, one comes to the conclusion that universalism is not the right approach in the construction of development, and introduction of Anglo-Saxon models of management is not its *sine qua non* condition.

Institutions should be specific, tailored to the local context, which includes, among others, market structures, structures of power and political constraints, local administration and informal restrictions. Quoting Rodrik (2003, p. 10): “The pre-existing institutional landscape will typically offer both constraints and opportunities, requiring creative shortcuts or bold experiments. From this perspective, the ‘art’ of reform consists of selecting appropriately from a potentially infinite menu of institutional designs.”

Effective reform will require a thorough diagnosis of local constraints and opportunities, and the possibility of building on local knowledge. Bearing in mind the possible negative consequences of the conflict with informal rules, the authors of public policies should in the first place as far as possible meet the social context and cultural background (Spranz, Lenger, & Goldschmidt, 2012). The process of institutional change should involve the representatives of the community, and the implementation of rules should be preceded by deliberation and appropriate informing of citizens. If economic subjects understand formal rules and trust in their actions, this will translate into beneficial realization of informal constraints, to the benefit of economic activity (Aldashev et al., 2010). Because these are usually informal rules that are the primary source of trust, formal institutions should be the support for their implementation. They can do this, for example by providing: information on the specific economic problem and the sides of the interaction; tools for monitoring implementation of the provisions and efficient judicial system to settle disputes and execute sanctions imposed on participants (Ostrom, 1998; Boettke & Fink, 2011). As Aligica and Boettke (2011) write, systems of formal and informal rules, instead of imposing one specific procedure should transmit knowledge and thus enable social learning, through lessons learned from successes and failures.

Zweynert (2006) notes that often informal existing rules are identified as barriers to development. Then the intermediate goal of the development strategy will be to change informal rules. In this case, the authors of the development strategy may face a significant dilemma – respect for informal rules or own recommendations to promote development. To some extent, this is also a dilemma between efficiency and ethics of solutions. The trade-off between these two options, however, is limited – the effectiveness of the strategy is to some extent dependent on the adaptation to the local context. Since the change of informal rules may take a very long time, one should ensure that in the meantime discrepancies between informal constraints and official institutions are not too large because it can lead to undesir-

able results, as described earlier. These are the arguments for a gradual institutional change, based on the existing social structures.

The observations lead us to the basic conclusion – informal limitations must be taken into account during the construction of development strategy if the ethics and high efficiency of actions is to be achieved. Summarising the analysis conducted, one should mention once more recommendations on how this can be done:

- respect for local, informal constraints; where possible, basing on them the formal institutions,
- making incremental rather than radical changes,
- pragmatism instead of universal recommendations,
- the role of information and deliberation during the construction and implementation of strategies.

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