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DESIGN AND REFORM OF INSTITUTIONS IN LDCS AND TRANSITION ECONOMIES[†]

Institutions: Top Down or Bottom Up?

By William Easterly*

A large research program in economics has established a persuasive link between institutions and economic development. But what does this imply for development policymaking? Can a political leader or aid agency seeking to promote development readily change institutions? This article starts off wildly general, and then moves to specifics.

I. The Intellectual History of the World, Part I

Every once in a while, it is worthwhile for economists to look up from the details of their specialized research projects to the broader worldview that their research results fit or do not fit. Nowhere is this truer than in the field of institutional economics, which can hardly avoid the big picture as it seeks to understand the determinants of institutions and make policy recommendations about changing them.

Two contrasting worldviews coexist in institutional economics, which go all the way back to the eighteenth-century Enlightenment. Let us label these views "top down" versus "bottom up." The top down view of institutions sees them as determined by laws written by political leaders (the view of most Enlightenment intellectuals like Rousseau and Condorcet). The bottom up view sees institutions instead as emerging spontaneously from the social norms, customs, traditions, beliefs, and values of individuals within a society, with the written law only formalizing what is already mainly shaped by the attitudes of individuals (the view of the leading critic of the top-down French Revolution, Edmund Burke).

The two worldviews have very different implications for institutional change. In the top down view, the political leadership can start with a blank slate, tearing up the old laws and making new laws at any time (as was attempted in the French Revolution). The bottom up view sees current institutions as heavily constrained by previous institutions. Institutional change in the bottom up view is always gradual, evolutionary rather than revolutionary.

The two views also have very different implications for the role of economists or other "experts." In the top down view, there is a heavy burden on economists to determine the optimal institutions to recommend to political leaders, using theory and empirics to design new institutions from scratch. In the bottom up view, there is a much more specialized role for economists, who at best can recommend desirable incremental changes, subject to the constraint that institutional reforms cannot attempt "too much" without disrupting the functioning of the economy by much more than is justified by the benefits of the "desirable change."

In the top down view, economists recommend institutions through pure reason. In the bottom up view, economists express reluctance to make drastic changes to institutions whose rationale they cannot fully comprehend, showing respect for the historical evolution that has somehow yielded today's institutions. This is not to advocate the extreme view that "what is, is right,"

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This session is dedicated to the memory of John McMillan, who passed away on March 13, 2007, after many years of brave struggle against cancer. He was one of the foremost researchers on institutions and markets in less-developed countries and transition economies, and he was a lucid expositor of these issues for professional and general readers alike. He was to have been one of the authors in this session. The economics profession will miss his insights and his personality. An obituary is posted at http://www.gsb.stanford.edu/news/headlines/obit_mcmillan.shtml.

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only the more modest view that "what is, is for a reason." The reason a particular institution has emerged (even if it is a bad reason) will certainly affect the consequences of attempts to change that institution.

Even if the bottom up economists can think of NO reason why a particular institution exists, they are still cautious about changing existing institutions abruptly (assuming such institutions are not too obviously destructive) with the knowledge that there is SOME reason, not yet understood and perhaps never to be understood, for their existence. As Richard Dawkins said about the analogous exercise in evolutionary biology of trying to understand the rationale for the anatomy of each species, "evolution is smarter than you are."

The top down view also tends to go together with the view that there is one globally unique best set of institutions, toward which all societies are hopefully thought to be "developing." The development economist acts as a cross-country communicator of the institutions of the "advanced" society to the less informed in the "backward" society. The bottom up view of institutions is more open to the possibility that societies evolve different institutions even in the long run.

This absurdly grand and brief tour of intellectual history has painted these two worldviews as opposing extremes, which is a caricature—most views lie somewhere in between. The top down view is seldom advocated explicitly, but is implicit in the traditional analysis in aid agencies that sees institutions as something the central government must create to make possible the functioning of a market economy. The aid agencies' agenda for "second generation" institutional reforms (following the "first generation" of policy reforms) is an example of such a top down view. Nor is the most extreme bottom up view tenable, or we would not need formal states and laws at all, whereas in fact they are ubiquitous.

Yet the apparent effectiveness of top down formal institutions in rich societies may still depend on these institutions having evolved from the bottom up. If so, then attempting to introduce formal institutions into poor societies where bottom up factors are lacking will not replicate the institutional successes of rich countries.

The top down view is thrown into sharpest relief by the criticisms of its opponents, a long list including Edmund Burke, Karl Popper, Isaiah Berlin, Friedrich Hayek, P. T. Bauer, and Thomas Sowell. Another economist who enriched our view of the shortcomings of the top down approach is the late John McMillan, to whose memory this session is dedicated.

II. Institutional Economics and Development Policy

Economists have provided partial insights into how institutions can emerge spontaneously from the bottom up, albeit not a general theory. Avinash Dixit (2004) summarized a number of models of bottom up institutions that are feasible even in a lawless society (the mafia being a classic example, but not the only one). Avner Greif's pioneering research (summarized in Greif 2006) suggested how networks of merchants can enforce contracts in the absence of any formal institutions. Marcel Fafchamps (2004) has demonstrated the pervasive importance of such networks in Africa.

Dixit's (2004) insights on institutional change are an example of how useful insights from partial models can be, even without a comprehensive theory of institutions. Suppose contract enforcement depends in part on an informal system where one does not cheat one's business partners for fear of losing one's reputation and opportunity to do repeat business with the network of business partners. When an alternative formal system is introduced alongside the informal network all at once, this allows opportunistic individuals to cheat their partners in the informal network, then exit the network for the new system. The old network can break down more rapidly than the new system starts functioning, leading to a net decline in contracts executed and economic activity. This is a nice cautionary tale for the proponents of abrupt top-down changes to institutions.

Aid policy shows little awareness of such subtleties. One of the most notorious failures of top down reform was "shock therapy" in the former Soviet Union, an attempt to shift instantaneously to the institutions of capitalism from those of Communism. The drop in output was one of the worst on record, in contrast to the rapid growth of China that followed a more gradualist, evolutionary approach to changing from Communism to capitalism.

The increased emphasis on fighting corruption in poor nations beginning about the mid-1990s in the aid agencies has yet to show discernible payoff in lessening corruption (or redirecting aid to corruption-free channels). The share of aid going to corrupt countries actually increased in the late 1990s and early twenty-first century, to 80 percent (where "corrupt" is defined as a score of 2 or less on the ICRG index that goes from 0—most corrupt—to 6—least corrupt). The share of aid going to corrupt countries increased not because of changing composition of aid recipients, but because the same aid recipients became more corrupt (William Easterly and Tobias Pfutze, forthcoming). Similarly, there is little sign of payoff to aid agencies' efforts at about the same time to promote democracy from the top down. Only about 20 percent of aid goes to countries classified by Freedom House as "free," a proportion that has not changed over time despite much rhetoric to the contrary.

III. Land Titles in Africa

Finally, to get as concrete as possible, let us examine one very specific kind of top down institutional reform—the attempt to introduce land titles to resolve uncertainty over property rights in land in Africa.

The theme of land titles improving incentives is an old one in Africa. For example, a colonial research commission in 1938 concluded about land registration: "all discussions on the subject agree as to the value of giving security to the occupier of land....legal security against attack or disturbance can most effectively be guaranteed by registration (Lord Hailey 1938, 868, 876)."

The World Bank in 2003 expressed pretty much the same viewpoint, as if very little had changed in 65 years: "{Land} arrangements found in many countries are often not optimal from either an economic or a social perspective. For example, in Africa, the vast majority of the land area is operated under customary tenure arrangements that, until very recently, were not even recognized by the state and therefore remained outside the realm of the law" (xviii).

Despite decades of attempts to register land titles, during both the colonial and independence eras, today only about 1 percent of land in Africa is registered under the formal system (Commission for Africa 2005, 231). Clearly, something about the top down registration of land titles is not working.

In Africa, there has been a long historical evolution of customary rights to land, which are often quite complex in giving different parts of the "bundle of rights" implied by land ownership to different parties at different times during the harvest cycle. Issuing a land title to yet another party can increase rather than decrease uncertainty about who has what rights to the land.

Indeed, a number of empirical studies show little effect of land titles on the incentive to invest. In Kenya, an ambitious plan to introduce land titles was introduced even before independence (the Swynnerton Plan of 1954). However, much subsequent research showed little constructive effect of land titling. For example, Shem E. Migot-Adholla and Frank Place (1998) showed a weak effect of land titles in Kenya on perceived land rights of farmers, credit use, and land yields (a measure of investment in the land).

The anthropologist Parker Shipton (1988) looked at the consequences of land titling for the Luo tribe in western Kenya in the early 1980s. The traditional system among the Luo was a complicated maze of swapping plots between kin and seasonal exchanges of land for labor and livestock. Each household's claims to land included many plots of different soils and terrains, on which many different crops grew, not a bad system with which to diversify risk in an uncertain climate. The traditional land patrons (*weg lowo*) would often give temporary land rights to clients (*jodak*).

Land titling brought new uncertainties into this complex system. Would the government give the titles to the *weg lowo* or to the *jodak*? The system inclined toward the latter, fostering bitter conflict between the two groups. Sometimes the former *weg lowo* would wind up as the *jodak* of his former *jodak*. Other times, claimants would not bother with adjudication, as the costs exceeded the value of the property. Although land sales increased after formal registration, neither the buyers nor sellers wanted the high fees or red tape to register sales. The system of formal titles thus gradually lost correspondence with whom the locals knew owned the land.

Moreover, land titling may have increased rather than decreased the scope for the kind of opportunistic behavior that institutions are supposed to prevent. Sellers who pledged their land as collateral for a loan would fail to inform the buyer of this claim on the land. Banks found it politically difficult to auction off the collateral land after default, since land owned by kin of the defaulter surrounded it. Some sellers sold to several buyers at once, using different elders as witnesses.

In an illustrative anecdote from Shipton, Ocholla Ogweng of Kanyamkago got a loan of 30,000 Kenyan shillings from Barclay's Bank in 1979. To raise collateral, he asked the help of his wife's father, Ogwok Nyayal. Mr. Nyayal arranged with his sister's husband, Mr. Alloyce Ohero, to pledge his land as collateral for Mr. Ogweng's loan. Alloyce Ohero then sold part of his land to two strangers, without informing them of the Barclay's Bank lien, and they settled on the land. Mr. Ohero died in 1981 and Mr. Ogweng defaulted on his loan. The two sons of Alloyce Ohero expected to inherit the unsold part of his land, equally unaware of the Barclay's Bank claim. By 1982, a court broker prepared to auction off all of Mr. Ohero's former land on behalf of Barclay's, to the consternation of everyone involved. The two strangers blamed Mr. Ohero's sons, who blamed their uncle Ogwok Nyayal, who blamed Alloyce Ohero, who if he were alive would blame Ocholla Ogweng.

Other studies throughout Africa bear out the picture of ineffective land titling. A study of land titles in Burkina Faso (Anne-Sophie Brasselle, Frederic Gaspart, and Jean-Philippe Platteau 2002) found no effect of land titles on incentives to invest in the land. Kathryn Firmin-Sellers and Patrick Sellers (1999) found that a land titling program in Cameroon was not successful in consolidating individual property rights, although it had some other benefits. Hanan G. Jacoby and Bart Minten (2007) found no effect of land titles on plot-specific investment in rice fields in Madagascar. Klaus Deininger and Songqing Jin (2006) have recently summarized the literature on land titles in Africa as showing little or no effect of titles on investment or access to credit, although they found evidence that a more general measure of "tenure security" in Ethiopia (not dependent on titles, which did not exist) fostered land investments.

Shem E. Migot-Adholla et al. (1991) long ago presented evidence that indigenous property systems in Africa, far from being static, have themselves spontaneously evolved toward more individualized land rights in response to increased population pressure. They argued therefore that the indigenous systems do not constrain investments in increased land productivity. Jean-Philippe Platteau 1996 also argued that there is little evidence of any benefit of formal land rights compared to indigenous systems. Lorenzo Cotulla (2007) and Karol Boudreaux and Paul Dragos Alicia (2007) provide more recent statements of this same view, albeit with some variations and cautionary notes that indigenous evolution is not a panacea for optimal outcomes.

After all this research and experience, the aid donors today remain stuck on some kind of idealized comprehensive (top down) government reform that would somehow make formal registration of land titles "optimal." The United Nations Millennium Project (2005) said, for example: "The rule of law involves security in private property and tenure rights.... upholding the rule of law requires institutions for government accountability.... this requires a well functioning and adequately paid civil service and judiciary, proper information technology (for registration of property....)" (31, 111). Here, the donors' answer is more computers to register formal land titles!

The World Bank (2003) *Land Policies for Growth and Poverty Reduction* concedes many of the problems with government land registration discussed above, but still concludes the answer is even more intensive and comprehensive top-down government planning:

> The establishment of a land policy framework to guide the sequencing of specific interventions in the sector can have multiple benefits in generating consensus, helping to prioritize actions, and (by ensuring participation in the implementation and monitoring of these interventions) avoiding costly errors. Given the long-term nature of interventions in the area of land policy... integration into the broader development strategy is particularly relevant to provide a basis for relating land policy to other interventions (179).

IV. Conclusion

Is the bottom up view of institutions hopelessly pessimistic? It certainly undermines the naïve optimism implied by aid agency recommendations that institutions can be rapidly changed from the top by political leaders. Even without a comprehensive theory of institutions, historical evidence, contemporary research, and common sense suggest that institutional change is gradual in the large majority of cases. Attempts at rapid, top down change can even have negative consequences. If that is reality, then an agenda of gradual reform that recognizes the constraints of bottom up evolution will lead to more hopeful results than a delusory top down attempt to leap to institutional perfection.

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