

# Understanding the Relationship between Institutions and Economic Development – Some Key Theoretical Issues

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# Definitional Problems

1. No agreement on the necessary functions.
2. No agreement on the exact forms.
  - a. Most institutions serve multiple functions.
  - b. Many institutions (partially) serve the same function.
  - c. Functional equivalents exist.

# Forms vs. Functions

1. Confusion between forms and functions.  
= Virtually all “governance” indexes mix up variables that capture the differences in the *forms* of institutions (such as democracy, independent judiciary, absence of state ownership) and the *functions* that they perform (such as rule of law, respect for private property, enforceability of contracts, maintenance of price stability, the restraint on corruption).

# Forms vs. Functions

2. Functions are in the end more important than forms (functional equivalents).
3. However, forms cannot be totally ignored.
4. Having said that, the orthodox discourse, as seen in the Global Standard Institutions discourse, is too much biased towards forms (another “one-size-fits-all” approach).

# Over-Emphasis on Property Rights

## 1. The Measurement Problem

- Impossible to aggregate the composite institutions that make up the “property rights system”.

## 2. The Coverage Problem

- Tend to ignore communal and hybrid (e.g., Chinese TVEs) forms of ownership.

# Over-Emphasis on Property Rights

3. Assumption of the Superiority of Private Property Rights (many counter-examples).
  
4. Desirability of Strong Protection of Property Rights.
  - The relationship is not linear (more protection is not necessarily better).
  - Growth effect of a particular property right changes over time (historical examples).

# Theories of Institutional Change I – Institutional Persistence

1. A country's institutional complex contains various elements, which often work against each other.  
= Thus, explanations that rely on culture and institutions (as the embodiments of cultural values) can easily degenerate into *ex post* justifications (e.g., Confucianism).

# Theories of Institutional Change I – Institutional Persistence

2. There are almost always more than one “tradition” in a country’s culture and institutions (e.g., France).

= If there is more than one “tradition”, deliberate political choices (and the ideologies that influence such choices) become important in determining its developmental path.

# **Theories of Institutional Change I – Institutional Persistence**

- 3. Cultures and institutions are not immutable, sometimes changing rather quickly (e.g., Confucianism).
  - 3.1. Cultural/institutional changes and economic developments influence each other.
  - 3.2. The importance of human agency.

# Theories of Institutional Change II – Imitation, Adaptation, and Innovation in Institutional Development

1. Thanks to institutional imitation, developing countries today are enjoying higher standards of political democracy, human rights, and social development than what today's developed countries had enjoyed at similar levels of *economic* development.

# Theories of Institutional Change II – Imitation, Adaptation, and Innovation in Institutional Development

2. Of course, institutional imitation is rarely enough, and there is a need for adapting the imported institutions to local conditions.
3. The really successful countries are the ones that have been able to add their own innovations to an array of well-adapted imported institutions (e.g., Japan).

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