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I'd like to thank the organizers of this fantastic conference for the opportunity to come and to speak to you about an issue quite close to my heart as an economist and a lawyer.

There's probably two aspects of this talk that I hope will appeal to the scientists which I know are gathered here today. The first one is an economist's attempt to produce a system. So the four concepts I'm going to discuss: law, institution, social capital, and economic development, I'm actually going to weave those together in my talk to try and get at some of the connections and the implications of the changing global legal system as well as indigenous social capital developments that we've seen to try and see if we can gain a slightly better understand of what challenges this new system, both external and internal to developing countries, might mean for their economic development and the second aspect which I hope will appeal to the scientists among us is I will focus a bit on technology as a driver of growth.

So in my talk I'm going to as I say, ambitiously try and bring out some of the interconnections. And the first thing I could say is I want Manfred Max-Neef to know, there is not a single equation in my presentation, so hopefully that will serve me well and then the other thing I want to do before I go to the gist of the talk is just sort of briefly define each of the terms and highlight why these connections are important. I've already said social capital tends to be indigenous, laws increasingly are international, why are institutions important? I'll go through a bit of the economic literature but just to motivate it a bit, we heard this morning from Lidia Brito that the big gap – and I thought her diagram was so notable – the big gap between what economic development strategies have been in theory and in reality if you recall on the left part of her slide she had things like markets and exchange and specialization, all the things that economists always talk about, and at the end there was this chart, very optimistically with an upward growth trend with dollars behind that, and there was a whole big missing middle section which she began to fill out with things like institutional development in various guises. And actually that's probably the best motivation for why I'm trying to draw these things together, which is, this has been a big gap and why it is that after so many decades of really huge attempts to try and address the question of development and poverty, it's still the case today as you heard yesterday and this morning that there is abject poverty in the world still. A billion people live below one US dollar a day, how can this be? Africa has had a negative 0.6% average annual growth rate since 1972. In a world of prosperity how is it that our theories and models don't work? I'm going to try for you to try and fill in a bit of the institutional an element of it and try to introduce social capital as a way of bridging the gap between formal law and institutional development. So the outline of the presentation: we will look at institutions and growth, social capital and development, institutions and social capital, and then give you a bit of a law and economic perspective on what the sort of international rules in economics now mean and then conclude with some challenges for economic development and legal reform. Now if anybody points out that I haven't actually connected all of these factors back and forth, I have to remind you, I only have 18 minutes.

So the first thing to start with is, why do we look at institutions and growth? By giving you the big picture element, let me sort of go into the economic literature a bit on this. There's both short-run and long-run factors that have propelled institutions to the top of the economic growth studies. The short-run reasons are that there are the failures on the part of even successful developing countries such as those that have managed to join the OECD which is the club of rich countries, like South Korea, to escape from macroeconomic crises like the Asian financial crisis which hit around 1998 for that country. And these crises are associated with having fragile institutional foundations. So for short-run macroeconomic stability reasons it has taken the Asian region nearly a decade, it took about 5 years for capital flows to become positive, but it has taken nearly a decade to redirect [?] the cash for many of those countries, and there are important short-run reasons for thinking about what actually underpins the market. Now the long-run reason I've already given you in the big picture. The long-run reasons are there's been a near exhaustion of the factors that can explain the differential growth rates of rich and poor countries in the world. So the move to consider: could government, so institutions, such as the rule of law, a government that protects its citizens against arbitrary power, safeguards the rights of its citizens, freedom from corruption, is now viewed as a key to long-run growth. And in many ways the experience of Africa which indeed has been ridden by conflict versus say, Australia, which inherited a fairly good set of institutions and maintained them was able to grow at a much better rate. So the focus on the institutions in the economic growth models, to summarize what I've said in layman's terms is because we ran out of other things to look at.

So in terms of social capital and development. The emphasis, and I'm going to give you an example of this by focusing on the case of China, the emphasis on formal institutions in some ways could hamper the way in which informal institutions operate, particularly in developing countries, where having a complete legal system is quite unlikely and transplantation of legal norms just doesn't work. It is very difficult to superimpose the laws which have evolved in another country into a country, and the studies of Katherine Pistor [?] for transition economies attest to this. So the study of social capital, by which I mean informal institutional arrangements, trust-based relationships, social norms, cultural-based relationship, kinship-based relationships, networking, reflects the fact that most developing countries, but I also want to emphasize also developed countries at the start of their industrialization, who are not equipped with a fully fledged form—a set of formal institutions of laws, of regulations, of enforcement mechanisms, but they actually develop them over time to suit their local context. And this has particularly been the case with respect to enforcement and the work that I've cited here is by Wendy Carlin and Colin Mayer for the UK which is quite well admired for having a very strong regulatory system. Except for recently with the credit crisis at Northern Rock [a troubled UK mortgage lender] but aside from that up until this point, you know, the UK was admired for this sort of light touch regulation and a very, very solid legal framework. But if you look to the turn of the last century, this wasn't the case. In the UK the laws evolved in a common law sort of way so when corporations first started, they were really just owned by a family, and then eventually the shares were sold to the friends of your friends so you knew everybody that you were actually dealing with – relational-based contracting. But with the development of stock markets and dispersed ownership it became the case that

you needed laws and regulations to safeguard your interest in selling the shares of your company and also the interests of minority shareholders. So in many ways a common law system developed in response to the changes in the UK at the start of industrialization, and I would argue that that's quite similar to what a lot of developing countries are also experiencing. Now, crucially, this interplay between formal and informal institutions, where enforcement is through informal means, can be overlooked when countries are assessed just on governments. And as I said, I'll give you China as the example; but the other example here is Abner Greif's [?] work on Medieval Europe where he found that traders then relied on rabbis to act as enforcement, so there was no legal system to turn to, but if you were not honest in your dealings, you would have to deal with the local rabbi.

So I want to focus a bit on the case of China because China tends to be viewed as an outlier for having experienced extremely strong economic growth. So these are growth rates of 9–10%. China is, along with India, responsible for global poverty levels halving and reaching the millennium development goals. It's been an extraordinary growth story but India's often criticized for having very poor property rights and institutional framework, rule of law, there's a high risk of expropriations, enforcement is particularly poor, and I think not just a litany. But the fact that China didn't recognize private property until it incorporated it into the Constitution in October 2004 probably tells you quite a bit about the kind of property right system, that perhaps economists expect, which is a well-defined one where you actually own the piece of land that you build your house on, that you own the company for which you are the notional owner, these kinds of notions just didn't exist. So the big puzzle for why it is that China has grown so well has always centered on – how did China manage to create an increasingly marketized economy with none of the foundations of a marketized economy? This could probably be quite a long example but I'll sort of home in on what I think are sort of the main elements which go to why it is that social capital and informal institutions matter so much and institutions particularly in the case of institutional innovations.

What China experienced are the incentives which are generated by gradual marketization. If you give a profit motive by allowing farmers to retain their output, this was known as the household responsibility system and it's called an institutional innovation because it essentially gave residual ownership rights to the farmers without giving them outright ownership of the land. But it was enough of an incentive to move productivity, and even though it may not be legally recognized as what they own, implicitly people know what they own and people respect that. So the institutional innovations were extended everywhere, the contract responsibility system, the budgetary responsibility system. And what this suggests is that in this context, the creation of any partial right was sufficient for actors to know how their rights were delineated. And this is not anything formal like they privatize all of state-owned enterprises. No. This was the gradual creation of incentives through institutional reform to give the impetus for growth. Now, is this enough for foreign firms? No, this is clearly not enough because they're coming from a different context. So multinationals investing in China expected more clearly delineated laws. And indeed the earliest corporate lawsuit in China wasn't actually its own corporate lawsuit. China's company law came into existence in 1995. The joint venture

laws which gave corporate law-type rights to foreign investors were implemented in the mid-1980s, at the start of the open-door policy. So it does very much depend on the institutional context. Now, the final highlight of this example is that when you're dealing with such a developing country, within such an imperfect institutional system, maneuvering and enforcement is actually one of the major challenges. So, getting licenses, finding suppliers, and relying on an important mechanism that doesn't take you into the very imperfect court system means that lots of businesses in China rely on informal trust-based relationships to supplement the imperfect formal system. There are limits to this, as I will get to, with the changes international law and as the markets get more decentralized. But for the three decades in which China has grown, this supplementation has worked well. So that you can have trust-based relationships, particularly in terms of enforcement, helping to supplement a formal legal system. So, in other words, if you run off with my contract, I know your mother and she will come after you. So, that's the kind of social capital perhaps we're talking about, slightly simplified. So a legal and economic perspective on this.

And I want to bring in the international side now. What this and other studies, many other studies, in social capital and development, suggest is actually lots of countries have an evolutionary type of system, and informal institutions often supplement well or badly because it's not always the case, of course, that the relationship-based contracting is positive. I've given two major transition economies as examples with their varied experiences: Chinese *guanxi* versus a Russian *blat*. But for many countries it is this combination of adapting informal to informal means that has allowed them to grow. Now, where I think it becomes more challenging is when globalization takes hold and so in about 1995, even though international economic laws have always existed, the WTO formalized many of the international economic norms which were already in existence under the previous system, the GATT (the Generalized Agreement on Tariffs and Trade). So, globally since 1995, the trend is toward harmonization of economic laws and what it's done is that it's changed the old principles of autonomy. So you see this in the World Trade Organization, for instance in the TRIPs Agreement (the Technology Related Intellectual Property Rights Agreement) which harmonized intellectual property rights for all of its members, which cover 95% of world trade as one example, giving them a standard as high as in United States. So the conflicts and the carve-outs in the globalization debate are now found in this area, and we've seen it with pharmaceuticals in India for instance.

So what I want to do now is to sort of draw out what this means given the context that I've given about social capital in formal institutions and the lack of formal laws. What we're looking at is of course the advent of increasing legal reforms in the international arena and I would posit that it poses advantages but also challenges for economic development in developing countries. There's several advantages which I'll do first even though if I wasn't thinking about it, now I should have done it the other way. I should do the bad side first and then do the good points but you'll just have to bear with me. There are several advantages for development. The first is that there is no need to reinvent the legal wheel. So, countries can leapfrog technological advancement and there's no reason why they can't do that with international best practice to reform their legal systems and to

adopt regulatory practices at a much faster pace than what developed countries underwent. Second, international economic law has its premise of equal playing fields so that countries can negotiate on the basis of promulgated rules so that, for instance, Brazil can bring the United States before the World Trade Organization and win rather than relying on bargaining power when many developing countries are the recipients of aid. Third, harmonization tends to increase market access because there are fewer trade and investment frictions, so that it's possible to have scale and learning and it's more likely for multinationals to be willing to share their knowledge when there is harmonization of the rules.

But, of course, there are challenges, among which are uniform standards and the rules tend to be those of developed countries so that lagging systems in developing countries find it very difficult to cope with wholesale adoption, but they are increasingly criticized for their lagging enforcement. And actually, the TRIPS agreement is a classic example of this. It was delayed and is delayed for many developing countries, but many of them find it difficult to move from having virtually no legal system to having an intellectual property rights protection system as sophisticated as that of the United States. Second, although formal laws may become more similar, informal institutions are disparate as ever. So if you judge development on the basis of just formal institutional reform, you can overlook the informal workings that develop in country markets to the detriment perhaps of them receiving aid or technical assistance. And then finally, the reality is the playing field is not level because countries are at different stages of development so that the most competitive firms are from rich countries while poor countries, despite this open borders and globalization, still want to promote their own industries and there is inherently a sense of friction and therefore conflict in that arena.

So to conclude, as my time is over, there is a growing body of international law and rules alongside globalization and has thrown up many challenges for economic development. Although I don't think anybody would disagree that institutional foundations for any market economy are essential, the form, nature, and speed of creating those institutions are not so clear. The forced harmonization in an unequal global economy I think adds a further dimension of difficulty for developing countries, but at the same time it does help them adopt international best practice at a much faster pace. So, finally, studies of social capital emphasize the importance of trust and social norms in explaining disparate economic performance, and I would posit that an analysis of international laws and rules has to take into account these contextual studies to determine the overall effect of the very important concept of institutions on long-run growth prospects and economic development especially for the poorest countries of the world. Thank you very much for your attention.