



# Law, Institutions, Social Capital and Economic Development

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## Outline of Presentation

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Institutions and social capital

The role of international economic law: a law and economic perspective

Economic development and legal reform

## Institutions and growth

The are short-run and long-run factors that have propelled institutions to the top of economic growth studies since North.

The “short-run” reasons are the failures of even successful developing countries (even those that have managed to enter the OECD, namely, South Korea) to escape from macroeconomic crises associated with fragile institutional foundations in their economies (see Krugman).

The “long-run” reasons derive from a near exhaustion of many of factors from standard economic growth models that can explain why some countries are rich and others remain poor. The move to consider that “good government,” i.e., one that protects its citizens against arbitrary expropriation, safeguards the rights of its citizens, freedom from corruption, is a key element of long-run growth (Acemoglu et al.). The experience of Africa comes to mind vs. Australia.

## Social capital and development

The emphasis on formal institutions in some ways hampers the ways in which informal institutions can operate, particularly in developing countries where a complete legal system is unlikely to exist and transplantation of rule of law are problematic (see e.g., Pistor et al. regarding transition economies).

The study of social capital reflects the fact that most developing countries, and also developed countries at their start of industrialisation, were not equipped with a complete set of laws, regulations, enforcement mechanisms, etc., but developed them over time in ways that are suitable to their local context, particularly with respect to enforcement (see e.g., Carlin and Mayer for the UK).

Crucially, this interplay between formal and informal institutions where enforcement may be through informal means enacting formal rules is often overlooked when countries are assessed on their governance (see Greif for the existence of such practices in Medieval Europe). China's development is a prime example.

## Institutions and social capital

The case of China:

Often perceived as an outlier for having experienced strong economic growth, but within a highly imperfect formal institutional framework, e.g., poor rule of law, risk of expropriation, lagging enforcement, badly defined property rights.

However, the incentives generated by China's gradualist reform come from "institutional innovations," which gave profit motives to households and firms. For those used to operating within such a context, the "innovations" were sufficient to rely upon. Different for foreign firms, so the early laws protected joint ventures and thus foreign investors.

For enforcement and manoeuvring in such a system (e.g., licenses, suppliers), the reliance on informal, trust-based relationships supplanted the imperfect formal system. However, there are limits, as seen in recent legal reforms.

## A law and economics perspective

What this and other studies suggest is that most countries will have an evolutionary legal/regulatory system, but with informal institutions that often supplement (well or badly) the formal system (e.g., Chinese *guanxi* vs. Russian *blat*).

Where economic development meets the boundary of international economic laws is here.

Globally, the trend is toward harmonisation of economic laws, changing the old principles of autonomy. For instance, this is seen in the World Trade Organisation which has created global standards for intellectual property rights (TRIPs), among others.

The conflicts, and carve outs, in the globalisation debate are now found in this arena, e.g., generic pharmaceuticals for developing countries such as India.



## Economic development and legal reform

There are several advantages, but also challenges, for development as a result.

First, it is true that there is no need to reinvent the legal wheel. Just as countries can leapfrog technological steps, they should be able to adapt international best practices to reform their legal systems and regulatory practices at a much quicker pace than developed countries.

Second, international economic law has as its premise a level playing field so that countries can negotiate on the basis of promulgated rules, such that Brazil can bring the U.S. before the WTO and win.

Third, harmonisation tends to increase market access as there are fewer trade and investment frictions, so that scale and learning is more available to developing countries.

## The challenges of economic development and legal reform

But, there are also challenges... among which are the following:

Uniform standards and rules tend to be those of the developed countries such that the lagging systems in developing countries cannot cope with wholesale adoption but are subject to criticism for their lagging enforcement, e.g., TRIPs.

Although formal laws may become more similar, informal institutions remain as disparate as ever. Judging development on the basis of institutional reform can overlook the informal workings of developing countries' markets to the detriment of receiving aid or technical assistance.

The playing field is not level because countries are at different stages of development, such that the most competitive firms are from the rich countries while poor countries still want to foster their own domestic firms.

## Conclusion

The growing body of international economic laws and rules alongside the rapid advance of globalisation has thrown up challenges for economic development.

Although institutional foundations for any economy are essential, the form, nature and speed of creating the appropriate institutions are unclear.

The force of harmonisation in an unequal global economy adds a further dimension of difficulty for developing countries, while at the same time, providing the know-how to permit more rapid legal reform.

Studies of social capital emphasise the importance of trust and social norms in explaining disparate economic performance. An analysis of international laws and rules alongside such contextual studies would be warranted to determine the overall effect of formal and informal institutions on long-run growth.