1. Introduction

Our first evening in Bogotá, Colombia, my husband and I happened upon two small, dirty little boys on the hard cement stoop of a shop, asleep. Very concerned for these poor little boys, we rushed home and asked our landlady to alert the police and social services. She was amazed by our attitude. "It's useless to call." she said, "They will just laugh. Over 50,000 such gamines live on Bogotá's streets, robbing and begging."

Poverty is the rule, not the exception. Most of humanity lives in underdeveloped countries, vast numbers in appalling circumstances. This misery continues despite a fall in extreme poverty from one-third of the world's population in 1981 to 18 percent in 2001 (Chen and Ravallion 2004, p. 14). This drop is welcome indeed, but it does not mean that poor countries are developed now, or will be developed any time soon. Extreme poverty is just that, extreme. The extremely poor live on less than about $1 a day adjusted for difference in the purchasing power of the dollar. If, instead of extreme poverty, we measure poverty as most middle-income countries do – incomes below about $2 a day – then the number of poor increased between 1981 and 2001 and is still 45 percent of the world's population. China does well even on this measure. Poverty in China fell from 85 percent of the population in 1981 to 47 percent in 2001. That is an extraordinary achievement – but not the same as development. Very few people in developed countries live as poorly as the bottom 45 percent of China's population. Moreover, development means more than just fewer poor people. Citizens of developed countries enjoy freer access to political and economic markets, and to ideas, information, and knowledge. They can start businesses, form civil organizations, or create political movements with much greater ease and lower cost. They also benefit from stability and order and from laws that are enforced for most residents, not just for the privileged few.

Why are poor countries poor? At one time development experts believed poverty was caused by too little investment – a problem that could be solved with foreign aid. Yet when investment went up in some poor countries, it did not trigger sustained growth. As Chapter 2 describes, new investment did not spur growth in countries with high transaction costs, powerful business groups, and large informal sectors. When investment did not work, bad macroeconomic policies were blamed. Macroeconomic policies in poor countries were often bad, and development economists preached to poor countries: "Get your prices right." But this advice begged the question: why were governments able to sustain such blatantly damaging policies? Even when countries reformed their macroeconomic policies, they still did not always grow. A new explanation was needed, and education became the development mantra. Yet when workers in poor countries increased their average years in school, labor force productivity did not improve. The benefits of increased education were undermined by poor quality and low returns. Underinvestment, bad policies, and lack of education are proximate, not ultimate, causes of poverty. Ultimately development rests on choices made by societies' members, and those choices are constrained by institutions, the rules and norms that structure human interaction (North 1990).

Every society has a set of fundamental institutions that provide the basic scaffolding for human interactions, what North calls an institutional framework (ibid.). In modern developed societies, institutional frameworks nurture market exchange by lowering the cost of transacting, encouraging trust, and motivating the powerful to protect the property and individual rights of the weak. Institutional frameworks that encourage modern markets only developed in the last 300 years. For millennia people relied on eyeball-to-eyeball barter, and used family ties, religious affiliations, business networks, or social groups to learn the reputations of their trading partners. Traders enforced their bargains by threatening to ostracize cheats. In the late Middle Ages new, more impersonal institutions began to emerge in Europe. Traders began to write bills of lading and contracts and to codify merchants' rules; they began to enforce their agreements through laws, courts, police, and similar third-party mechanisms. Thanks to these new institutions traders were able to contract with people they did not know, who were outside their networks, even outside their country.

How did these impersonal institutions emerge in Europe? Why are such market-supportive institutions weak or absent in many poor countries? Chapter 3 addresses these questions, drawing on recent research by institutional economists and historians. Despite this research, our understanding is incomplete. Academics debate the relative importance of Enlightenment ideas, nation-states, limits on government powers, border conflicts, and other explanations for the industrial revolution. Similar debates rage over the causes of poverty today. Some scholars emphasize the institutions inherited from colonialism. Settlers from England, with its limited state and more competitive economy, brought very different rules and traditions compared to colonists from Spain, with its powerful, centralized state serving a narrow elite. Other scholars emphasize factor endowments, land and labor. Regions such as South America had rich lands suited for plantations or large native populations suited to be a cheap source of labor. Small numbers of colonizers settled in these regions and designed institutions to extract wealth and to suppress the native population or imported slaves. Large numbers of settlers immigrated to places like the US and Canada that had lands ill-suited for plantations and few or hostile native occupants. Where colonists settled in large numbers they behaved differently, expanding the franchise, investing in schooling, encouraging immigration, promoting secure land rights, protecting intellectual property, and generally establishing rules that favored equality.

Colonialism is not the only explanation for underdevelopment; some scholars focus instead on how poor countries today differ from Europe in the late Middle Ages. Border wars raged in medieval Europe, and kings needed nobles to provide armies, and merchants and creditors to provide the funds to pay the armies. Leaders of poor countries today rely far less on their citizens for self-defense. Instead they depend on great power détente to protect their borders and outside aid to fund their military. They use their armed forces predominantly to suppress internal rebellion. Such states are less responsive to citizens' demands and less concerned about growth; they impede institutions that might increase access to markets or politics because greater access threatens their survival.

Another group of scholars stresses beliefs and norms. In their view, societies whose beliefs and norms centered on individualism were quick to develop organizations, such as corporations, that exploit mutual interests. Societies dominated by collectivist beliefs and norms retained social structures based on family, clan, religion, or ethnic ties, group-based social structures that were less conducive to modern, impersonal markets.

North et al. (forthcoming) have a different explanation. They argue that underdeveloped institutions are a "natural" state, the dominant social order for most of human history. Natural states arose from primitive societies when powerful groups formed coalitions to reduce costly violence. In the natural state an elite group controls the military, the political system, and the economy, and creates institutions that make entry by non-elites prohibitively costly. Laws are enforced only for elites; non-elites must seek elite protection and patronage. Natural states evolved into modern democracies in Europe through incremental changes that slowly opened access to markets and trade. Freer economic access was sustained by freer access to politics and civil society more generally. Open access states are the exception, however. Most states today are natural states; even in those that appear to be democracies, access has remained largely limited to elites. Over time the personalities of these elites may change and new groups, such as leaders of labor unions or ethnic minorities, may become elites, but the exclusionary power structure persists.

All of these explanations for underdevelopment have one thing in common: they are bad news for foreign aid, something I explore in detail in Chapter 4. The amount of aid and the size of the aid community are burgeoning, yet there is *no* evidence that aid promotes development and *no* evidence that aid can improve institutions. Foreign aid can play a vital humanitarian role and improve the lives of direct beneficiaries by, for example, vaccinating children against dangerous diseases. But aid has been ineffective in fostering the market-supportive institutions that distinguish today's developed countries from the rest of the world. Indeed the nature of aid makes it impossible for aid-givers to improve damaging rules and norms. Institutional frameworks usually endure for centuries; aid is focused on the short term. Institutional frameworks endure because they are congruent with society's underlying power structure; aid-givers necessarily work within this power structure. Changes in power structures, rules, and norms do occur, but they occur through heterodox experiments adapted to local conditions; aid agencies seldom support these experiments. Aid-givers focus their support on what their staff and consultants know best, what they can best defend to sponsoring governments, and this usually turns out to be Western best practice. Aid cannot repair broken institutions; it has tried to bypass them by creating special units to implement projects, by operating through non-governmental organizations (NGOs), or by working directly with groups of beneficiaries. These efforts leave harmful institutions intact, so they do little to promote development, and they sometimes hurt the sustainability of aid projects.

If aid cannot improve or avoid damaging institutions, it makes sense to assist only those countries that are already improving their institutional frameworks. This is theoretically possible, but unlikely. How will we identify institutional progress? An institutional framework is a large and intricate network of interrelated rules and habits embedded in a broad social order. Institutional frameworks are self-enforcing because they fit with people's beliefs about proper behavior, their expectations of how others will behave, and their assumptions about how others expect them to behave. Current measures of institutions were designed for cross-country statistical analysis and reflect little of this complexity. These measures serve econometrics well since they aggregate a multitude of rules, norms, and enforcement characteristics into a single variable, such as rule of law or democracy. But an aggregate measure like rule of law does not give local reformers or foreign aid-givers the precision they need to determine progress or aid effectiveness. I analyze common measures of institutions in Chapter 5, looking specifically at measures used: (1) to describe democracy, (2) to qualify countries to receive US aid money, and (3) to qualify countries to receive World Bank soft loans. These measures have many weaknesses typical of most institutional indicators, yet in some ways they represent progress. Previously, economists used to assume away institutions entirely. Adding institutions adds realism to economic models, but it also necessarily adds complexity, because reality is messily complex.

Reform in water and sanitation (Chapter 6) illustrates this complexity and also shows how critical it is to improve our understanding of institutions. Many countries reformed their urban water and sanitation systems in the 1990s, and we have a woefully inadequate understanding of the outcomes of these experiments. Most cross-country analyses of water system reforms fail to account adequately for local circumstances, politics, and beliefs. Beliefs and institutions affect the demand for and design of water system reforms as well as the willingness of investors to supply the requisite capital and skills. Water and sanitation reform is a politically charged issue subject to powerful competing interests. People without connections will favor reforms that add connections, so too will developers, builders, contractors, and property owners seeking lucrative business opportunities or higher property values. Often overlooked, however, are people who are already connected to the system who often oppose expansion for fear that their water tariffs will increase and farmers who fear urban expansion will reduce their water supply. These different interest groups influence the design of reforms differently depending on how well they can act collectively and on how much political institutions encourage politicians and bureaucrats to respond to their demands. The motives of private investors matter if the reform privatizes operation of the water and sanitation system. Private investors will only be willing to bid on water contracts if they can earn reasonable returns, and then only if they believe government will honor its bargain. Such credible commitment is demanding because it depends on how well institutions bind future politicians, regulators, and judges.

To illustrate how such institutions work in practice, Chapter 6 analyzes water reform in Buenos Aires and Santiago. These two cities experienced notionally similar reforms with very different outcomes. These differences were largely determined by the countries' different economic and political institutions, some specific to the water sector, others fundamental to the governance of the country. Their networks of institutions are themselves the outcome of long histories of jockeying between powerful elite groups.

This book argues that progress in a sector such as water or in the broader economy is determined by durable institutions and deeply-rooted power structures. This argument does not mean that development is impossibly difficult. Development is rare, but progress does occur and deeply-rooted institutions do change, sometimes dramatically. This happens when new ideas profoundly alter a society's assumptions about the world, opening the way for incremental reforms that ultimately transform its institutions. We have only a very partial understanding of how this happens, which I summarize in Chapter 7.

Based on work with Jessica Soto, Chapter 7 explores some hypotheses about when local scholars act as institutional entrepreneurs devising and disseminating a new economic paradigm, a new conceptual model of how the world works. When elites feel their present policies and paradigms cannot cope with an economic shock or an external threat, they are ready to consider new policies and even a new set of economic assumptions. Policymakers and the wider public will be influenced by local scholars only if they are organized and persuasive and if they are believed to be credible, disinterested, and truthful experts. Change follows if the elites accept the new policies and paradigm and are powerful enough to overcome or ignore opposition. Under the right circumstances, the new policies cause beneficial changes, triggering incremental transformations that gradually move societies well beyond the elites' original intentions. In this way, intellectuals promoted new ideas and institutional change in Enlightenment Europe and in today's newly developed countries.

Chapter 7 explores these hypotheses in six case studies. Two of the cases, Taiwan and, to a lesser extent, South Korea, were transformed into open access societies, both politically and economically. Chile may be on a similar path, although there is a worrying level of public skepticism about Chile's development model. The fourth case, China, is harder to assess. China has increasingly opened access to the economy, generating great growth, but its open markets are out of equilibrium with its closed political system. Argentina is a counterfactual case: reforms were not sustained despite the influence of prominent scholars. Indonesia is another counterfactual case: scholarly influence was limited to devising macroeconomic policies in response to economic downturns; despite two decades of growth, the Indonesian economy and polity remained closed.

Although there is much we do not understand about institutional change, these preliminary case studies suggest that damaging institutions are not destiny. Since the Second World War, a few countries have transformed themselves into developed market economies and open access societies, despite the challenge of an increasingly competitive global market. Although fortuitous circumstances played a part, foreign aid was usually not important; except for the impetus it gave South Korea and Taiwan to reduce their dependence on US aid. Local intellectual capital was important. Local scholars devised new paradigms, argued the case for their ideas, advised and directed economic policy. Local scholars are not sufficient to promote institutional transformations, but they are beneficial and quite possibly necessary. Yet there are few efforts to foster this sort of scholarship. Most large-scale support tends to stifle self-directed research by offering funds for topics favored by donors or by hiring local scholars as consultants or staff. What is needed is scholar-by-scholar support and mentoring, such as that provided by the Ronald Coase Institute, which nurtures local researchers without stifling them.