

# **Markets and the Diffusion of Institutional Innovations**

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**Marcel Fafchamps  
Department of Economics  
Oxford University**

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## Introduction

- **Institutions are important for development**
- **Africa has weak market institutions and unsophisticated market practices**
- **This raises two questions:**
  - Is this the result of an inherently market-unfriendly culture?
  - What can be done to remedy the current situation?
- **The purpose of this presentation is to offer elements of answer to both questions.**

## Market institutions: Laws and courts

- **Much policy attention to market institutions directed towards laws and courts**
- **Yet little evidence that firms in Africa rely on laws and courts to enforce contracts**

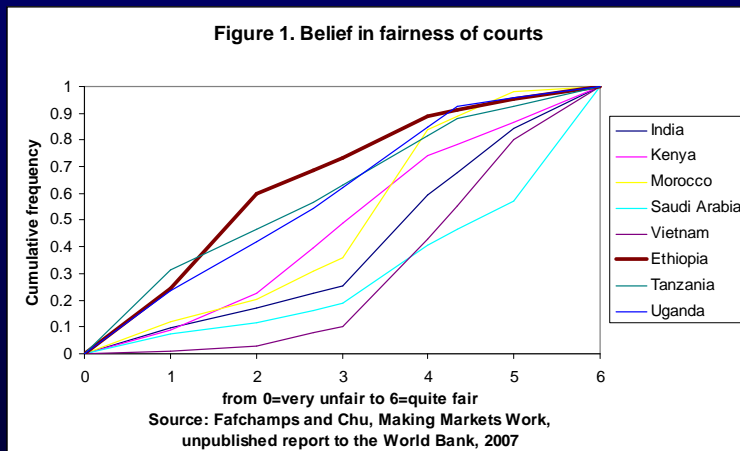


Table 1. Recourse to legal institutions	Ghana	Kenya
Following a dispute with a supplier		
Ever saw a lawyer	13%	6%
Ever went to court	2%	0%
Ever used arbitration	4%	0%
Threatened to call the police	5%	2%
Ever called the police	5%	0%
Following a dispute with a client		
Ever saw a lawyer	8%	38%
Ever went to court	6%	21%
Ever used arbitration	4%	6%
Threatened to call the police	14%	4%
Ever called the police	5%	4%

Source: Fafchamps, Market Institutions in Africa, Table 4.5

## **Market institutions: Relationships**

- **Laws can only affect market efficiency if they are internalized in social norms and expectations of behavior.**
- **Can work as a deterrent only if threat of court action is credible**
- **For many transactions, the fear of losing a valuable relationship serves as deterrent to opportunistic behavior**
- **It follows that dealing with an unknown firm or person is risky**

## **Market institutions: Reputation**

- **Possible solution: reputation mechanisms**
- **What distinguishes modern economies is the widespread use of a multiplicity of reputation mechanisms:**
  - Publication of names of defaulters on bill of exchange
  - Credit rating agencies
  - Specialized press
  - Customer report
  - ISO certification
  - Ebay feedback
- **These reputation mechanisms ultimately rely on laws and courts to punish misreporting and other malfeasance**

## **Market institutions: Reputation**

- **For reputation mechanisms to work, economic agents must be unambiguously identifiable**
  - Brand recognition
  - Name recognition
- **For a name to unambiguously identify a person, it needs to be protected**
  - Business registration
  - Trademark and brand name protection
  - Copyright
  - Protection against identity theft
- **The fear of losing the reputation associated with a name or brand becomes a deterrent against breach of contract**
- **The most important role of courts is indirect: to support private and public institutions that activate reputation mechanisms**
- **If laws and courts do not serve this supporting role, must rely on informal reputation mechanisms along social networks**

## **Market institutions: Multiple equilibria**

- **Enforcement mechanisms are vulnerable to massive defection**
  - If economic agents fulfill contracts in a reliable fashion, breach is interpreted as a sign of fraud or impending bankruptcy and hence triggers punishment
  - If economic agents do not fulfill contracts reliably, breach of contract is not a useful predictor about future behaviour and hence does not trigger punishment
- **Possibility of multiple equilibria: different patterns of behavior generate expectations of behavior**
- **These patterns over time become enshrined in social norms or 'business culture'**
- **What is normal in one location or sector may not be normal elsewhere**

## Market institutions: Embedded markets

- **Norms and expectations are embedded within a social structure consisting of associations and overlapping social networks**
- **This is true everywhere but especially so when formal market institutions are weak and the enforcement of contracts relies on informal enforcement mechanisms**
- **Social contacts assist the functioning of markets in many different ways**

Table 2. Main Source of Information on Market Conditions by firm size:

	Small	Medium	Large	Total
A. Prices:				
Other traders	81%	61%	40%	60%
Suppliers and clients	15%	31%	37%	28%
Messengers	4%	8%	23%	12%
Public sources	0%	0%	0%	0%
B. Supply conditions:				
Other traders	32%	20%	19%	23%
Suppliers and clients	65%	76%	68%	70%
Messengers	2%	4%	12%	6%
Public sources	1%	0%	0%	1%
C. Demand conditions:				
Other traders	30%	11%	10%	16%
Suppliers and clients	68%	86%	79%	78%
Messengers	1%	2%	9%	4%
Public sources	1%	2%	2%	2%
Number of observations	227	254	243	729

Size categories are based on total sales.

## Market institutions: Ethnicity and social networks

- **Business patterns of socialization partly reproduce private ones**
- **Social context matters: ethnicity, religion, gender**
- **Hence business communities are often segmented along ethnic, religious, and social lines**
- **Segmentation along ethnic or religious lines is often reinforced by other processes – e.g., discrimination, signaling – but can exist even without reinforcement**

Table 4. Ethnic Composition of the Ownership of African Manufacturing Firms

	African	Asian	European	Mid-Eastern	Other
Burundi	81.7%	3.3%	5.8%	0.0%	0.8%
Cameroon	80.8%	2.1%	13.8%	1.3%	2.5%
Cote d'Ivoire	60.3%	0.0%	22.5%	6.5%	10.3%
Ethiopia	83.2%	0.5%	0.9%	0.0%	15.4%
Ghana	91.3%	0.0%	0.8%	7.9%	0.0%
Kenya	42.2%	50.7%	3.6%	1.8%	1.8%
Tanzania	72.9%	24.3%	0.0%	1.7%	1.1%
Zambia	59.5%	25.9%	13.0%	1.6%	0.0%
Zimbabwe	32.9%	12.7%	47.4%	0.0%	6.9%

Source: Fafchamps, Market Institutions in Africa, MIT Press, 2004

## **Institutions and development: Growth and innovations**

- **Long-term improvements in standards of living are ultimately driven by technological innovations**
- **The dramatic acceleration in growth since the industrial revolution results from the application of science to technology**
  - To machinery and equipment
  - But also to institutions
- **Economics and other social sciences are an effort to apply scientific methods (e.g., statistical inference, experimental methods, inductive reasoning) to institutional and organizational design**

## Institutions and development: Improving market institutions

- **Informal market institutions are:**
  - Inefficient: the reach of the market is limited, changing trading partners is difficult
  - Inequitable: better connected individuals are at an advantage
- **The solution is better market institutions. This means formal institutions:**
  - Laws and courts, but also...
  - Many specialized institutions, some private, some public
  - The purpose of many of these institutions is to reinforce reputation mechanisms
- **Formal institutions facilitate the emergence of organizations that specialize in information and intermediation services**
  - Stock markets and commodity exchanges
  - Auction floors
  - Financial institutions

## **Institutions and development: Business practices**

- **To survive in business, familiarity with local practices is essential**
- **Familiarity normally comes from upbringing and imitation**
- **Most African entrepreneurs are unfamiliar with conditions prevailing elsewhere, and particularly with modern institutions for economic exchange**
- **This puts them at a disadvantage when faced with competition from entrepreneurs from other parts of the world**
  - Poor export performance of Africa
  - Displacement of domestic firms by foreign firms in African domestic markets
- **To survive in the 'global village' African entrepreneurs must learn about modern business practices**
- **Who will they learn from?**

## **Institutions and development: Diffusion of institutional innovations**

- **Familiarity with technological innovations can spread along business networks through imitation**
- **Analogy with epidemics: the structure of the social network matters for how far and how fast a disease spreads**
- **The same is true for the diffusion of technological innovation**
- **But institutional innovations present an additional challenge: several people around you must switch to a new institution for you to switch as well**
- **We therefore expect the *density* of the network to affect the spread of institutional innovation**
- **Segmentation in the business network – e.g., between different ethnic communities – is expected to complicate the spread of institutional innovations across ethnic boundaries**

## **Institutions and development: Foreign investors**

- **Foreign investors can be a powerful source of knowledge about modern technology and institutions – much easier than trying to reinvent the wheel**
- **Hence welcoming foreign investors is essential for the transfer of knowledge about modern market institutions**
- **If the technology and institutional gap between foreign investors and domestic entrepreneurs is too large (e.g., informal sector), business networks are likely to remain segmented**
- **In that case usage of modern technology and business practices do not spread beyond a foreign enclave**
- **Foreign investors reap large returns from their more productive technology and institutions, returns from which local elites feel excluded**
- **This generates political resentment**
- **Political resentment fuels attitudes that serves as a disincentive to investment – e.g., corruption and other forms of expropriation, exclusion of the business class from political affairs**
- **Hence the modern private sector remains stunted – often a hostage to autocrats**

## Conclusion

- **A sustained improvement in standards of living ultimately comes from the application of science to technology and institutions**
- **Modern market institutions are a complex mix of formal rules and social norms**
- **When they are absent, business networks serve as an imperfect substitute**
- **Private patterns of socialization influence the formation of business networks**
- **This fuels political tension and inhibits the spread of institutional innovations**
- **The end result is a low equilibrium trap in which countries discourage foreign investors for fear of losing control**

## Conclusion

- **The solution is to promote social integration, especially in business circles**
- **Integrating socially with foreign investors is the best short-term strategy for getting Africa out of a vicious circle:**
  - its entrepreneurs are not sufficiently familiar with up-to-date institutional practices to form an attractive business environment for modern production
  - but local elites are reluctant to let foreign entrepreneurs fill this need for fear of losing political control
- **Not so long ago India and China faced the same dilemma – and long resisted foreign investment**
- **But they eventually gained the confidence to gradually open up**
- **What Africa needs are strong confident governments and educated elites capable of imitating foreign investors**
- **Once this is in place, I expect Africa to follow the same path as India and China**