single, united body, the free trade area would be able to carry more weight in negotiations with the EU and, as EFTA has done in the past, it would be able to guide its members in concluding bilateral free trade agreements with the EU for commercial and industrial goods.

The external tariffs differing from one country, and one sector, to another could assist by protecting still relatively uncompetitive areas of an economy against foreign competition, particularly from nearby Western countries, while the Central and Eastern European countries are undergoing the necessary modernization. On this basis, two European economic zones would be able to cooperate on equal terms, thus allowing the interests of the transition countries to be more fully considered than they have been in relations to date.

This proposal is not implying that East-West interaction ought to be reduced. On the contrary, the West ought to continue offering its assistance, but ought to take more steps to allow local labour to benefit from the measures taken.

In trade agreements concluded on a similar basis to their EFTA-EU counterparts, the countries joining together in CEFTA could be granted free access to the EU's markets for all of their manufacturing industry. "Sensitive areas" would no longer enjoy protection, and the Eastern Europeans would be able to play out their comparative advantage in labour costs to the full.

The countries might then be able to adapt to the Community *acquis* and develop a long-term option to join the Union in parallel to the process of developing their economic strength. The advantage of this approach would be that rules would evolve over time instead of having a set of standards imposed which have not grown organically within a country's own system, as envisaged by the current accession strategy. Countries would be able to make a gradual approach to the standards of the European Economic Area, in which all Single Market rules apply, and which has served in the past as a preparatory stage on the way to EU accession.

In the short and medium terms, then, a free trade area would be a suitable institutional arrangement to act as a counterweight to the EU in Eastern Europe, promoting economic cooperation there, facilitating the common transition to a market economy,[29] and paving the way for EU entry in the long term by way of confidence-building trading activity.

[29] Patricia Bauer: Probleme der ökonomischen Transformation Gesamteuropas, in: Berthold Meyer, Bernhard Moltmann (eds.): Neuer Osten – Alter Westen. Die europäischen Staaten zwischen Annäherung und Distanz, Frankfurt am Main 1996, pp. 76-107.

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The Explanatory Value of Neo-Institutionalism: Some Examples from Development Financing

Proponents of New Institutional Economics claim, among other things, that NIE forms the basis for a new theory of development financing. This article explains the differences between neo-institutional approaches and other theories of development financing. It shows that there is a link between the modelling assumptions of neo-classicism in general and NIE in particular and a correspondence between the two in their understanding of institutions and their recommendations of institutional reforms. A number of conclusions are drawn for the orientation of official development co-operation.

It is not generally very difficult to call into question the policy recommendations of a particular school of theory, and development financing and the reforms proposed by neo-institutionalists are no exceptions. The main objective of this article is to examine the methodological basis for neo-institutional explanations and proposals in order to make it easier to understand the limitations on the applicability of this new paradigm.

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Successive Theories of Development and Financing

The predominant view of the objectives of development financing and the appropriate means of achieving them has changed several times in the last four decades. Three distinct phases can be identified:[1]

1. *Development financing as applied growth theory:* It was assumed that capital was the main determinant of macro-economic income. The way in which savings were generated and transformed into investible funds and the nature of the financed investment were largely ignored. The "savings gap" was therefore diagnosed as the main problem, and the provision of foreign capital aid was regarded as the remedy. The easiest way of doing this would be to finance major investment projects directly; at the same time, development banks were set up in almost all developing countries to finance smaller projects.

The financial theory counterpart to development financing as applied growth theory is to be found in the works of Modigliani and Miller.[2] They demonstrated that on the assumption of market completeness and perfect competition (in other words, in an Arrow-Debreu world) financial decisions (such as changes in a firm's level of debt or the maturity structure of its borrowings) are irrelevant from the point of view of the real economy.

2. *Targeted development financing:* Development financing as applied growth theory began to be questioned at the beginning of the seventies as the growing economic problems of the developing countries and the failures of development policy became apparent. Contrary to the prediction that the financing of major investment projects would have a trickle-down effect on the rest of the economy, economies became increasingly fragmented and broad sections of the population impoverished. Opinion then switched increasingly to the view that development financing should not aim primarily to increase macro-economic output but to achieve priority political and social objectives (such as employment, food production, combating poverty) by financing particular target groups, such as small agricultural and commercial enterprises and women.

This view is based primarily on the structuralist belief that rigidities in price formation, oligopolistic market power and other forms of so-called "market imperfections" hamper development.

The designated target groups belonged mainly to the poorer sections of the population, which were largely ignored by the existing banking system. Specialised development banks and non-banks (such as non-governmental organisations, cooperatives and associations) were to allocate the funds, which were generally heavily subsidised.

Just like development financing based on growth theory, targeted development financing assumes that the lack of capital is the decisive constraint on development. The frequent deficiencies of the financial institutions responsible for channelling international funds, both as regards their own viability and their ability to reach the target groups, created a readiness to accept approaches that emphasised the importance of financial intermediation.

It was some time, however, before the concepts of development financing would again be called into question.

3. *Theory of finance:* As early as the mid-fifties Gurley and Shaw[3] tried to focus attention on the importance of financial intermediation for real economic processes. The broadening of this debt intermediation approach by Shaw[4] and McKinnon[5] in the seventies laid the foundations for a new theory of development financing, later to be known as the theory of finance.

Basis of a Neo-institutionalist Theory

Ohio State University became the most influential proponent of the theory of finance. Within the debate about the financing of development by international donor organisations, its opinions increasingly came to represent the consensus view.

More or less in parallel with the spread of the theory of finance, a theory of institutions developed within

[1] J. P. Krahnen and R. H. Schmidt: Development Finance as Institution Building, Boulder 1994.

[2] F. Modigliani and M. Miller: The Cost of Capital, Corporation Finance and the Theory of Investment, in: American Economic Review, Vol. 48, 1958, pp. 261-297.

[3] J. G. Gurley and E. S. Shaw: Financial Aspects of Economic Development, in: American Economic Review, Vol. 45, 1955, pp. 515-538.

[4] E. D. Shaw: Financial Deepening in Economic Development, New York et al. 1973.

[5] R. McKinnon: Money and Capital in Economic Development, Washington D.C. 1973.

the neo-classical paradigm. This tendency, known today as New Institutional Economics (NIE),[6] has been highly successful in winning adherents in economics and the social sciences. Development theory was not spared either; neo-institutionalists claimed to have founded a "New Development Theory"[7] and even a new theory of development financing.[8]

In the main, the results NIE has achieved so far do not contradict those of the theory of finance, as reflected in the fact that the Ohio State University has recently begun to argue in strongly neo-institutionalist terms. There are two convictions underlying this "new consensus":

☐ The view that state institutions and interference with allocation by the market usually leads to inefficiency. Criticism focuses on the setting of maximum interest rates by the state and the channelling of financial resources to particular population groups. The latter can take the form of subsidised lending programmes or bank quotas for lending to particular sectors. Such policies are rejected on the grounds that they discriminate against poorer sections of the population and weaken financial intermediaries.

☐ The notion that the performance of an economy in general and the efficiency of development financing in particular depends more on micro-structures than on macro-economic policies. This view goes hand in hand with the deeply held neo-classical belief that general statements can be made about the macro-economic "efficiency" of micro-economic decisions and micro-institutions or that such statements are valid irrespective of the cultural and social context of the economic agents. In the field of development financing, this leads to emphasis being placed on the informational and incentive efficiency of financial contracts and companies' articles of association and to the disregard of macro-structural conditions for the development of a money economy and wider access to credit.

The bias in favour of individual property rights and micro-economic analysis has its methodological counterpart in the principle of individual utility maximisation that underlies the entire neo-classical theory. In essence, this principle consists in explaining all phenomena of a more or less economic nature in terms of the actions of rational individuals.[9] It therefore rests on the premise that individual decisions are not essentially shaped by social structures and institutions, or at least that the effects of such structures on individual behaviour can be ignored. This enables neo-classicism to adopt a logical deductive stringency, which is reflected in concepts whose validity appears to be independent of time and place, such as equilibrium and micro and macro-economic efficiency.

Neo-institutionalism attempts to integrate institutions into the neo-classical structure by modifying the behavioural assumptions of neo-classicism. In particular, it assumes that the social agents do not have complete information. The attractiveness of neo-institutionalism stems from its apparent success in explaining institutions without sacrificing the logical deductive stringency of neo-classicism and its underlying methodological individualism.[10]

A critical dissection of neo-institutionalist reasoning reveals, however, that the assumption of strictly utility-maximising individuals rules out the explanation of institutions, so that the neo-classical concepts must be abandoned as soon as institutions enter the picture. Thomas Hobbes[11] was the first to argue that in a world in which rational individuals can pursue their objectives by the most efficient means available, everyone is the enemy of everyone else. From this he deduced the need for an underlying state order. The contradiction between Hobbes' diagnosis and the belief of all the friends of the market economy from Adam Smith onwards that the self-interest of the individual leads to prosperity for all was increasingly obscured, beginning with Locke. Ricardo used Locke's[12] concept of a "natural identity of interests" as a heuristic assumption that simplified the analysis of economic phenomena. He thus laid the foundations for a pure economic science that was largely independent of the rest of the social sciences and in which institutions barely featured. Neo-institutionalism obviously ignored this implicit assumption of neo-classical theory or incorporated it unnoticed into

[6] I consider this new economic school to include property-rights theory, information economics and agency theory as well as transaction theory.

[7] J. E. Stiglitz: The New Development Economics, in: World Development, Vol. 14, 1986, pp. 257-265.

[8] J. P. Krahnen and R. H. Schmidt, op. cit.

[9] T. Parsons: The Structure of Social Action, Glencoe 1949, p. 44.

[10] See for example E. Terberger: Neo-institutionalistische Ansätze. Entstehung und Wandel – Anspruch und Wirklichkeit, Wiesbaden 1994.

[11] T. Hobbes: The Leviathan, 1651.

[12] J. Locke: Two Treatises of Civil Government, Cambridge 1967.

its models. This contradiction is also demonstrated by studies of game theory,[13] which show that even the explanation of simple institutions, such as agreements between two persons, comes to grief on the prisoner's dilemma: in non-cooperative games the traitor strategy is dominant! Even if it is assumed that the non-cooperative prisoner's dilemma game is repeated ad infinitum (supergame), the emergence of institutions can be explained only as a stochastic process. Moreover, their continued existence is constantly endangered, as players can benefit in the short term by breaking the rules.

The emergence of rules therefore presupposes conditionally cooperative behaviour and the abandonment of the assumption of individual utility maximisation. Instead, it should be assumed that there is a "circular causality" in the sense of a dialectic relationship between individual behaviour and the institutional environment governing that behaviour and that the institution is to be placed alongside the individual as a central element of socio-economic examination.

The bias of neo-institutionalism in favour of private property rights and micro-structures is due to its neoclassical origins:

- On the basis of methodological individualism, collective property rights appear as institutions. However, institutions always entail free-rider and other incentive problems.

- The greater the number of individuals involved and the more heterogeneous their interests, the more difficult it is for utility-maximising individuals to agree on rules. The relationship between individual and institution is at its most problematic in the case of constitutive institutions or macro-structures, such as a state order or value guidelines that "govern" the behaviour of large sections of a society. Neo-institutionalism therefore tends to disregard macro-structures when analysing micro-economic decision-making behaviour.

This bias of neo-institutionalism is particularly inconvenient when analysing developing economies, where constitutive institutions relate more strongly to specific social groups – such as ethnic, family or other groupings – than to the society as a whole. This means, for one thing, that the parties to a transaction cannot be assumed to belong to the same constitutive institutions; the behaviour of A towards B depends on whether B belongs to the same or another social milieu. As the primary social frame of reference is not the society but smaller social groups, reciprocity between members of the same group is generally more pronounced. This is reflected in the predominance of collective property rights, inter alia. For example, the family business is the basic form of organisation among poorer sections of the population in developing economies and is based on "watered-down" or collective property rights.

The bias of neo-institutionalism in the field of development financing is illustrated below by a few examples, which show that by limiting the principle of individual utility maximisation a better explanation of existing institutions can be given and that the individual property rights favoured by neo-institutionalism appear to be less efficient.

The examples relate to a number of central issues in the current debate about the factors impeding wider access to credit in developing economies and the institutional innovations that could facilitate it. The first two examples concern innovative lending techniques (guarantees and guarantee groups in the first instance and the principle of past performance in the other), the third relates to voluntary organisations as new financial intermediaries and the fourth to the reason why commercial banks currently refuse credit to the greater part of the lower and middle classes.

Examples

In the literature on financing, real security is the predominant means of enforcing credit claims. In neo-institutionalist literature, penalties also play a significant role, the most important form of penalty imposed on borrowers by banks being the denial of future loans. If, as proposed here, the parties to the loan are regarded as components of wider social formations or milieux, a third means of enforcing claims can be considered, which will be described here as moral obligation.

Moral obligation depends on three factors:

- The extent to which group members internalise solidarity values, which is reflected in conduct shaped to a greater or lesser extent by value rationality.

- The group's control capability, in other words the ability of and incentive for group members to recognise and punish rule violations by other members.

- The disadvantages a member suffers if he leaves or is forced to leave the group (the "exit costs").

[13] See for example W. Elsner: Institutionen und ökonomische Institutionentheorie, in: Wirtschaftswissenschaftliches Studium, Vol. 16, 1987, pp. 5-14.

Guarantees and Guarantee Groups

Neo-institutionalist authors tend to reject guarantee groups, their main objection being that they transfer risks from the bank to the group members (or the borrowers and sureties), even though for reasons of diversification it is more appropriate for the bank to bear the risks.[14]

This argument presupposes that those involved have only individual property rights. This is not a correct assumption, however, as the poorer sections of the population in developing economies generally have strong ties with their social milieu, with the result that property rights are held collectively. For example, the ubiquitous family businesses are usually not owned by a single person. It is not only members of the family business who have a say in business decisions but also persons from the social milieu who are linked to the family through generation agreements, sharing relationships or other arrangements. These persons can be adversely affected by the termination of lending, regardless of whether they act formally as sureties or not.

Neo-institutionalism commits another error in assessing guarantee groups and guarantees: like the entire neo-classical school, it tends to regard the conclusion of a bilateral transaction as sufficient indication that the transaction also has a positive macro-economic impact. In incomplete markets, however, credit transactions can generate pronounced externalities. For example, many older people protect themselves against the economic effects of old age and illness by transferring their surpluses to the younger generation. If the younger generation gains access to bank credit, there is a danger that the members of the older generation will lose their traditional investment opportunity, which performs a pension and insurance function. In the light of this, it may be recommended that in parallel with the development of the credit system the investment and insurance markets should also be expanded or state social security systems established. Such externalities could also be avoided, however, by requiring potential borrowers to submit guarantees from persons in their close social milieu. In that case, the guarantee would be a kind of declaration of approval from the individuals who would be indirectly harmed by the potential loan.

The Principle of Past Performance

The principle of past performance can increase the incentive for the borrower to repay his debts. In essence it consists in making future loans and loan terms contingent on the borrower's past conduct. It is frequently practised by banks, which implicitly maintain long-term or exclusive relations with their customers.

By comparison with constitutive institutions, past performance in the context of long-term economic relationships is a simple, implicit agreement between just two parties. However, even such simple institutions cannot be explained if an assumption of individual utility maximisation is made. On this basis, the critical condition for continuation of the relationship is that the borrower assesses its future benefit to be greater than the obligation he has towards the bank at that time. This condition is met only if the borrower expects that, if his payment record is good, every successive loan will be more favourable in terms of amount, interest rate and/or term than the previous one. It is self-evident that this condition cannot be met indefinitely. These considerations show that neo-institutionalism cannot explain the principle of past performance; for utility-maximising individuals, past costs and benefits are irrelevant to current decisions.[15]

The requirements for the stability of implicitly long-term credit relationships can be recognised only if it is assumed that the behaviour of individuals is governed by values. The good repayment record of borrowers in the context of such relationships then appears as the expression of their moral obligation towards the financial institution. The stability of such relationships therefore depends crucially on institutional arrangements that create a moral obligation on the part of the borrower and integrate the behaviour of the parties to the loan. The following are examples of such arrangements: customer participation in the control of the financial institution's decisions, the extension of the bank/customer relationship to include other financial services (in particular, deposit taking) and debt remission and moratoria in the event of "blameless" insolvency.

Credit Rationing

In many developing countries maximum interest rates are set by the government. If compliance with the ceiling is actually policed, banks operating in otherwise largely complete markets ration credit to borrowers with the highest transaction costs. These

[14] J. E. Stiglitz: Peer Monitoring and Credit Markets, in: World Bank Economic Review, Vol. 4, 1990, pp. 351-366.

[15] L. G. Telster: A Theory of Self-enforcing Agreements, in: Journal of Business, Vol. 53, 1980, pp. 27-44.

are predominantly borrowers from the poorer sections of the population, partly because they often cannot provide appropriate security and apply for small loans with a short repayment period. The theory of finance assumes that the liberalisation of interest rates is sufficient to eliminate rationing.[16]

By contrast, neo-institutionalist authors have tried to show that profit-maximising banks still ration credit to particular groups of borrower even in the absence of interest rate controls. They argue that high transaction costs cannot always be offset by high interest rates, as raising interest rates reduces the repayment incentives.[17] In order to reduce or eliminate rationing, in their view it is also necessary for banks to use lending techniques that enable them to make a better assessment of default risks and to enforce claims more effectively.

The ambition of neo-institutionalism to explain market failure such as credit rationing in an environment that differs as little as possible from the neo-classical model reduces the value of these models for explaining the observable rationing behaviour of banks. Credit markets in developing economies differ even more markedly from neo-classical auction markets than those in developed money economies; for example, many banks in developing countries are integral parts of conglomerates that are also active in industry and commerce. Profit maximisation is not their objective; instead, their function consists in providing cheap capital to associated companies. In addition, the financial markets in many developing economies are dominated by a small number of banks. In these conditions, banks maximise their returns by selecting relatively safe portfolios at relatively low interest rates. They therefore have little interest in granting high-risk loans to small enterprises, even if they could charge higher interest rates. The oligopolistic structure of many financial markets also provides greater scope for secret agreements and cartels. For example, in many Latin American countries the largest banks agreed among themselves on maximum retail deposit rates after the lifting of official interest rate restrictions.

If these and other features of capital markets in developing economies are taken into account, the liberalisation of interest rates and the availability of appropriate lending techniques appear to be far from sufficient conditions for eliminating rationing, as the neo-institutionalists assume. To improve credit access for poorer sections of the population, it is necessary, in particular, to demerge banks from non-banks and reduce concentration in the banking sector. This would require the establishment of cartel authorities, which exist in very few developing countries at present.

I have attempted to illustrate the bias of neo-institutionalism towards individual property rights and the neglect of constitutive institutions with the help of a few examples. The list could be extended by including neo-institutionalist-inspired analyses of other institutional arrangements in the field of development finance. Let just three further examples suffice here:

- The analysis of development bureaucracies and the suggestion that state development cooperation be financed not by means of taxes but by "compulsory donations" from taxpayers to their preferred development agency.
- The analyses of governmental organs, which generally conclude that they are unavoidably inefficient. From this it is often concluded that development should preferably be financed via private agencies.
- The analysis of family businesses by the "New Household Theory", which assumes that the household is a maximising agent.[18] In this way the complex relationships among household members are filtered out and the institutional structure of the family business – the division of labour between the sexes, for example – appears to be efficient.

Conclusions for Official Development Cooperation

In the light of this necessarily fragmentary criticism of neo-institutionalist arguments, development financing as currently practised appears to be misguided. This is particularly true of two aspects: first, the attempt to avoid working with state institutions, and secondly the concentration on financial contracts and financial institutions. Both aspects have their theoretical basis in the aversion of neo-classicism and its

[16] See for example J. R. Tybout: Interest Controls and Credit Allocation in Developing Countries, in: Money, Credit and Banking, Vol. 16, 1984, pp. 474-484.

[17] See J. E. Stiglitz and A. Weiss: Credit Rationing in Markets with Imperfect Information, in: American Economic Review, Vol. 71, 1981, pp. 393-410.

[18] See G. S. Becker: A theory of the allocation of time, in: The Economic Journal, Vol. 75, 1965, pp. 493-517.

institutionalist school towards state and collective property rights and towards taking account of overarching institutional structures when analysing micro-economic decision-making structures.

State Agencies

After the disappointing results achieved in the early development decades, when development agencies worked predominantly with state institutions, a change of direction has been evident since the end of the seventies. Where development financing is concerned, this comes most clearly to the fore in the turning away from state development banks and the increase in the financing of NGOs.

This re-orientation can be criticised on a number of grounds:

☐ Official administrations have a particular way of thinking, which makes it difficult for them to work with voluntary organisations. The low efficiency of almost all donor-funded NGOs is an expression of this different mentality. In many cases, official funding destroyed the moral commitment of those involved with the NGO, without this loss being compensated by a better production function (higher returns to scale and improved transformation) and the implementation of coordination mechanisms based on economic incentives.

☐ The economies of industrial countries are predominantly market-oriented, so that they have little experience with the funding of voluntary organisations. As such organisations also have strongly specific cultural features, development agencies in industrial countries are not the most appropriate sources of funding.

☐ Many developing countries that tried to integrate into the world economic system should combat the risk of becoming "extended workbenches" for the industrial countries. Development banks could help in this regard by channelling financial resources into sectors with a high value added.

Structure of the Financial Markets

Development financing is based on the illusory assumption that the financial markets can be integrated by promoting particular financial intermediaries and introducing innovative lending techniques. This self-serving optimism is the result of subsuming development policy into other policy fields. Other important preconditions for monetary development are largely ignored, in particular reform of the world economic and monetary system and the structure of financial markets in developing economies.

The present world economic and monetary system makes it difficult for developing countries to achieve trade surpluses and accumulate foreign exchange reserves,[19] with the result that their monetary authorities have only limited control over events and an incentive to make dysfunctional interventions in the financial system, which are generally described as financial repression. The elimination of financial repression in developing economies would therefore require the industrial countries to run trade deficits and tolerate the overvaluation of their currencies. In these circumstances, official development co-operation would perform a "cross-section" function: it would have to be directed towards ensuring that the home country's trade, agricultural and monetary policies were compatible with development. It is obvious, however, that the industrial countries are not yet prepared to subordinate their economic interests to the development needs of weaker economies.

Another precondition for large sections of the population of developing countries to gain access to market-intermediated financial services is reform of the structure of their financial markets. The central bank, the banking supervisory authority, a cartel authority, deposit protection schemes and a framework of laws, such as banking legislation and contract law, are important institutions transcending the actions of the parties to loans. Such institutions can reduce the uncertainty associated with the provision of capital. In addition, it would be necessary to establish social security systems to protect as much of the population as possible from material risks. In that way, temporary unemployment or illness can be prevented from leading to permanent insolvency.

Official development cooperation should be directed more strongly towards advising on the creation and reform of these institutions. However, stricter supervision and control of financial institutions impinges on the vested interests of influential social groups. For that reason, such advisory activities make sense only if at least the government of the country in question is prepared to contend with the conflicts and the threat to its own existence that the curbing of these interests would involve. Increased co-operation among multilateral and bilateral donor organisations would be helpful in carrying out such reforms.

[19] See H. Riese: Entwicklungsstrategie und ökonomische Theorie – Anmerkungen zu einem vernachlässigten Thema, in: Jahrbuch Ökonomie und Gesellschaft, No. 4, 1986, pp. 157-196.