“From Fragmentation towards Innovation, the Application of Institutionalism towards Financial Market Theories”

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SHORT FORMS

NIE: New Institutional Economics
NIE1: NIE focus on information properties between two actors
NIE2: NIE focus on institutional change
OIE: Old Institutional Economics
NC: Neo-Classical Economics
TC/IC: Transaction Costs/Information Costs
DE: Development Economists
ISA: Institutional and Structural Approach
LDC: Less Developed Country
DC: Developed Country
INTRODUCTION

Today the reductionistic view as apparent in neoclassical theorising is dominating the field of economics. However, criticism developed and is apparent in all other subfields such as household, gender, ecological and development economics. Surprisingly, although starting from a different angel, all came to the same conclusion that social factors or non-economic factors do matter and that the neoclassical approach is dissatisfying. The contradiction between development economics and neo-classical economics¹ is probably the oldest in this field since the mechanistic view of human beings developed simultaneously with colonialism. On the one hand, we had the first economists, namely Smith (1776) Wagner (1876) and Marshall (1890) who developed the idea of an homo oeconomicus which was scientifically supported by Darwin’s (1859) famous book, “On the Origin of Species” on the other hand, we had the first case studies of African, Asian and Latin American societies as completed by Waitz (1859) Bastian (1860) Bachofen (1862) and Ratzel (1882) and it became apparent that those “primitive societies” did not follow the idea of economic actor as assumed by Smith, Wagner, Marshall, and many other economists.

As voices from scholars (Kopper 1915, Levy-Bruhl 1910, 1921, Boas 1911, Thurnwalds 1922) studying “primitive economics” became louder considering social variables as opposed to pure reductionism, economists declared those scholars as anthropologists and hence, not belonging to the same science as they do.² To date economics has remained a reductionistic, social free and universal applicable science. Irving Fisher’s words have become common treatment in economics “each individual acts as he desires all questions of content and limit lay completely within the realm of psychology, which is beyond the pale of economics“ (1892, quoted by Coats 1976:51) The reason is that economists became aware very early about difficulties of combining economic theory with non-economic aspects. The most sustained expression of this reductionism in relation to ‘primitive economics’ is

¹ Neoclassical economics got its representative name much later, but what was meant by that time, although generally called classical political economics, is, what was latter called neoclassical
² in 1929 the Encyclopedia Britannica included in its 1929 edition an article by Firth “Economics, Primitive”, by 1970 the same article was called “Anthropology, Economic”
apparent in Goodfellow’s (1939) study and serves as a good example as to why economists defended economic actor in such a fierce and effective way:

“The aim of this book is to show that the concepts of economic theory must be taken as having universal validity, and that, were this not so, the result would be not only scientific confusion, but practical chaos…When it is asked indeed, whether modern economic theory can be taken as applying to primitive life, we can only answer that if it does not apply to the whole of humanity then it is meaningless.”

And in case one dares to suppose otherwise, then as a practical matter

“…the economist has before him no less a task than that of designing a ‘new economics’, which would apply to the primitive people. The inevitable Further, task of establishing some correlation between the two ‘systems’ of economics would then be so vast that we choose not to attempt to consider it”

(Goodfellows, 1939, p. 3-5)

Although today nobody would talk about ‘primitive societies’, we are still facing the situation of developed countries (DC) functioning next to less developed countries (LDC). Quite often economic theory applicable for DCs appears to be valueless to LDCs or the other way around, and this is particularly the case in relation to financial markets. In an age of globalisation, any economic theory can only be relevant if it is applicable to all countries irrespective from their developmental state. Therefore, a financial market theory should be developed allowing for Goodfellow’s “two systems of economics”. My attempt is not to develop this theory, but to demonstrate that institutionalism is able to provide the foundation for such a theory.

Goodfellow was quite aware of the difficulties combining ‘primitive economics’ with the reductionistic view. With the former reflecting the extreme influence of non-economic variables, it seems to contradict economic theory focusing on efficiency. The same contradiction becomes apparent if we focus on financial markets in less developed countries suffering from financial dualism, a

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3 Throughout the dissertation DC and LDC will be used as short form for developed and less developed countries. Writing about ‘LDC’ does not imply any degrading valuation.
situation in which a large informal sector coexists alongside a formal one. While the interest rate in the formal sector reflects the scarcity of money, the interest rate in the latter reflects the kind and degree of social relations. Contemporary financial market theories are not able to incorporate an understanding of the informal sector and are, therefore, only applicable to the formal system which is unsatisfying – or reflects Goodfellow’s ‘two economic systems’. With over 80 percent of the world’s population relying on informal financial arrangement (World Bank 2001), financial informality is not just a small exception. From a macroeconomic perspective a well functioning financial system is critical for economic development therefore, ignoring informal financial segment can be critical to understanding the effects of economic policy.

This dissertation intends to show that sustainable economic growth is only possible if the two financial market segments are linked, therefore, a financial market theory is required which including as well non-economic as well as economic variables. In this context, I suggest that institutionalism could provide the foundation for such a theory. However, institutionalism is not one unified theory. The conflict of focus between economic and non-economic variables is reflected in the contemporary discussion between New Institutional Economics (NIE) and Old Institutional Economics (OIE)\(^4\), but if we assume that we can combine the theories of NIE and OIE to NIEOIE and we are also able to find empirical evidence supporting such a theory it can be the beginning of solving Goodfellow’s unbearable task.

Therefore, the first Part will examine whether it is possible to combine NIE and OIE towards a theoretical continuum called NIEOIE. Such a theoretical foundation would allow considering as well informal influences as efficiency aspects in the process of institution building. However, although both NIE and OIE have their origin in the dissatisfaction with neo-classical economics (NC), both come to opposing conclusions in relation to institution building and criticise each other on those. Therefore, my intention is to investigate whether the criticism, often

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\(^4\) Throughout the dissertation NIE is used as synonymous with New Institutional Economics; OIE is used as synonymous with Old Institutional Economics, and NC as short form for Neo-Classical Economics.
announced in the dichotomy of formalism versus description, rational choice versus rule following, evolution versus design, methodological individualism versus holism and quantity versus quality are consistent. However, the findings suggest that both schools apply equally the concepts of both sides of the dichotomy, with methodological individualism versus holism as the only exception. Therefore, a discussion about an alignment between NIE and OIE can only be conducted if the view about economic actor can be shared. On first sight, this is not the case. Hence, a more detailed discussion about the respective view about *homo oeconomicus* in NIE and *homo sociologicus* in OIE will be done. As a closer look shows, OIE does not mean *homo sociologicus* in a Marxist manner, rather an *institutional individual* is meant allowing for both, informal and efficiency aspects. Further, NIE, by introducing bounded rationality can not convincingly reject that the economic actor is an *institutional individual*. Under these circumstances, the dividing line between NIE and OIE is blunted and it seems that NIE and OIE can form a theoretical continuum of NIEOIE.

The intention in the second Part is to investigate whether the theoretical continuum of NIEOIE can find relevance in reality and, in turn, if today’s reality requires the theoretical foundation of NIEOIE. In this context, I choose to focus on financial markets in LDCs since they exhibit a special situation of financial dualism. Financial dualism refers to a situation in which an extremely large proportion of the population is excluded from the formal financial sector and engaged in informal financial arrangements such as borrowing between relatives and therefore, reliant on non-economic mechanisms. Since over 80 percent of the world’s population (World Bank 2001) is dependent on informal finance, a financial market theory which is not able to deal with informality, can never be applicable. Apparently, contemporary financial market theories are not able to consider informality suggesting that a new financial market theory is required. Furthermore, the question is whether the mechanisms behind informal financial arrangements follow similar economic reasoning as OIE’s theory proposes and whether formal finance is in line with NIE. The findings suggest that this is the case. Moreover, it seems that a linkage between informal and formal financial institutions is necessary for economic growth therefore, suggesting that NIEOIE is relevant. In other words, a financial market theory able to deal with informal markets can be built on NIEOIE foundations.
Hence, the necessity to build a financial market continuum of informal/formal finance reflects the theoretical continuum of NIEOIE.

The intention of Part three is to investigate whether the application of NIEOIE towards financial markets in LDCs is consistent. The argumentation of Part II was built on the assumption that the informal financial institution is successful because it is built on non-economic variables, in contrast, to the formal institution. In case that the same mechanisms causing the formal institution are also decisive in the functioning of the informal institution, only NIE and not NIEOIE is relevant. Hence, it will be examined if NIE is able to explain the advantage and growth potential of the informal sector. Since NIE is either concerned with information problems between two actors (either individual or institution – bounded rationality, like limited knowing about cheating, creates problems) or with information problems caused by the environment on institutions (shared mental models create inefficient institutions) the focus is limited to removing information constraints. However, the findings suggest that the advantage and growth potential of the informal financial sector cannot be reduced to information properties, therefore, NIE is inappropriate in application towards financial markets in developing countries and requires an OIE extension.

The intention of this dissertation is to show that financial market theories can never be applicable without considering OIE mechanisms. The reasoning is not only limited to informal/formal institutions in less developed countries, but also to developed countries as Part IV shows. While politicians often argue that financial market fragmentation in less developed countries is caused by inefficient formal institutions, fragmentation in developed countries is caused by too efficient formal institutions. In this sense, the relevance of a financial market theory solely focusing on efficiency becomes questionable it itself. Further, the reasoning does not stop at the micro level of ‘poor people’ banking, but is also important on the macro level concerning the relationship between the national banking system and the international banking system. Therefore, NIEOIE is not only a theoretical experiment, rather it builds the theoretical foundation for future financial market theories. Such a theory would build a bridge between Goldfellow’s two systems of economics and would allow for growth enhancing financial innovations.
PART I – THEORIES OF INSTITUTIONALISM

The contemporary political reality shows, an institutional economic theory is required. The most interesting aspect of such a theory is how to align informal with formal institutional forces and how to guide them in a positive manner. This task is of particular importance to countries with different cultural backgrounds which are in need of a new institutional environment such as today’s Iraq. The contemporary existing schools focusing on institutions of NIE and OIE, with the former concentrating on formal and the latter concentrating on informal rules, are both not productively able to come to terms with such questions. This might be because one of their main objectives is still to defend each other according to old prejudices often pronounced in the dichotomy of formalism/description, design/evolution, efficiency/reform, liberalism/government intervention and individualism/holism. (Rutherford 1994, Peukert 2001) Although proponents of both strands are continuously highlighting the differences among each other, it is common knowledge among economists that both form rather a continuum than opposite sides. (Rutherford 1999, Vandenberg 2002, Groenewegen 2000) Since apparently only a combination of NIE and OIE would be able to overcome their respective shortcomings, and thereby, producing a valuable institutional theory, it is the purpose of Part I to enquire whether it is theoretically possible to combine NIE and OIE to NIEOIE.

The task is not to create a new theory, rather an attempt is made to summarise what is generally accepted and to reflect these insights by suggesting that it is neither the theory of NIE nor of OIE, but a theoretical complement of both called NIEOIE. The purpose is to overcome the shortcomings of each approach. NIE neglects informal mechanisms, OIE rejects the importance of efficiency and information, but apparently, the contemporary political situation suggests the importance of both. Although pure NIE or pure OIE form the two ends in the spectrum of institutionalism in general, neither is nowadays pursued in economics (apart from strict economic theory). Hence, it seems to be useless and deconstructive to follow old arguments within antique frameworks while hoping for proven validity. I will start my query of the possible alignment of NIE and OIE to NIEOIE by defining neo-classical (NC),
new institutional (NIE) and old institutional economics (OIE) in the first chapter. The second chapter considers the criticism between NIE and OIE and examines if these are justified. It appears that NIE and OIE are actually applying each other’s concepts in relation to formalism, efficiency and reform and thereby, forming a continuum. The distinct assumption between the two, which is not possible to combine, is the view of human beings. The essence between their opposing views is the contradiction of *homo oeconomicus* in NIE and *homo sociologicus* in OIE. Therefore, the question of a theoretical continuum in form of NIEOIE can only be answered if it is examined as to what kind the actor in such a theory would be and to what extent he can be aligned to both theories. Hence, Chapter 2 defines *homo oeconomicus* of NIE and *homo sociologicus* of OIE, while asserting their respective shortcomings. However, the surprising finding is that OIE does not suggest *homo sociologicus* in a Marxist manner, rather an *institutional individual* is meant which is less reductionistic than the NIE actor. In contrast, to OIE, NIE continues to insist on its *homo oeconomicus* actor and explains informal rules with maximising terms under bounded rationality. Under these circumstances, it seems that NIE cannot be combined with OIE. Therefore, chapter 3 questions the definition and application of *homo oeconomicus* under bounded rationality with the finding that the bounded rational *homo oeconomicus* equals the *institutional individual* of OIE.
1 Institutionalism

1.1 Why focus on Institutionalism

That institutions matter seems to be almost self-evident, yet, in economic theory, it is not the case: established growth theory is without institutions. In contrast, advocates of NIE as well as OIE claim that economic growth and development would have to be explained primarily by the institutional framework. (Olson 1996, North 1998) Following the decade of transition in Central and Eastern Europe, it becomes obvious that implemented macro policies in line with the Washington consensus, varied considerably in their economic performance. (World Bank 1998) Currently, awareness is emerging that those variations are caused by different institutional systems. This ‘rethinking’ can be found, for example, in the World Bank, which is increasingly interested in institutional economics. The World Banks famous publication, ‘World Development Report’ of 2001/2 focuses solely on the institutional foundations of a market economy. Some scholars are actually arguing that the failure of development in the Third World is not so much a failure to mobilise aid or loans or to make machinery available or anything else of the sort, but essentially a failure to provide clear ideas on how to set up the appropriate economic institutions and to shape the appropriate international economic institutions. (Pasinetti 2001, Williamson 2000, Coase 1998) Similarly one can argue that today’s Iraqi situation is mainly caused by the mistake to consider institutional forces and historical context. Being aware of the importance of the institutional environment, Sachs and Warner (1997) created the ‘institutional quality index’, which often applied. Reported, what differentiates modern societies in terms of economic development today are differential institutional-cultural patterns. (Zafirovski 2003:804) Since social factors and cultural habits have significant effects on development (North 1998, Williamson 2000), the question remains on how to align those insights from ‘reality’ with economic theory. Mainstream economics is not

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5 The term Washington consensus was originally termed by John Williamson (1990) implying the agreement to follow policies of liberalisation, deregulation and privatisation. He himself is very critical about the contemporary meaning, see recent publication. (John Williamson 2000)

6 The approach by Sachs and Warner (1997) is extremely interesting but still limited, as they argue that the focus of economics should be only on the macro-economic side. In this sense, they miss the link between institutional forces on the micro-level and the institution on the macro-level.
only institution free, but seems to contradict the existence of institutions. Therefore, the question is, whether one can ensure a research programme in which economic theory and economic institutional analysis are compatible with each other.

1.2 Neo-classical economics

Neo-classical also called mainstream or orthodox economics, continues to be the textbook-economics students are learning when studying economics. The question remains therefore, what it is and why it is institutional free, although institutions seem to be play ‘some’ role. Therefore, section (1.2.1) gives a short summary about neo-classical economics (NC) to make the distinction to institutional economic In general, clear. Hence, an overview will be given concerning the major assumption concerning rationality, actor, equilibrium, and competition. In section (1.2.2) it will be shown why NC is institutional neutral. Further, section (1.2.3) summarises general criticism in relation to neutral institutional economics. Section (1.2.4) shows that neo-classical economics has little relevance for institutional factors when considering property rights, educational systems, and political regimes.

1.2.1 Summary of NC assumptions and theory

NC is based on the Enlightenment notion that humans are rational (it is possible to calculate potential outcomes to a course of action) and intentional (human have will and thus, are unlike animals which are guided by instinct).\(^7\) Hence, the smallest unit of account is a rational maximising individual. A maximising actor implies that the purpose of each individual is to achieve highest utility or profit. Rationality can be bounded, which denotes a situation in which decisions are rational within the context of available and processable information. Rational maximising allows NC to predict and model individual responses to explain economy-wide behaviour. Within the economy, individuals have various endowments (natural, human, and man-made), which are useful in producing the goods, and services that satisfy their preferences. All goods and services are homogenous with all others in their class, but

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\(^7\) See Hume (1742), Smith (1776) and Turgots (1769)
distinct from those in a different class. Equilibrium is ensured through relative prices, ensuring that goods supplied, and goods demanded are equal and that the market clears to avoid oversupply or undersupply. The approach is based on efficiency. If the market mechanism is not obstructed, competition between economic agents will result in a more efficient use of scarce resources and this will benefit the economy as a whole. Therefore, the favoured policy regime is market liberalisation with as little government involvement as possible. The extent to which the individuals can be satisfied is limited to resources available and the level of technology: to increase per capita incomes, a society must either accumulate more capital or other resources or discover new technologies. There are no economies of scale, endowments and preferences are determined exogenously. A market with zero transaction costs exists for every economic good and markets are natural entities that emerge spontaneously, not artificial creatures of governments. When this general competitive model comes to equilibrium, allocation and distribution are perfectly efficient. This implies that no reallocation of inputs can increase the output of one good without reducing the output of another. Hence, it maximises the output of resources and best satisfies consumer’s preferences and endowments.

1.2.2 NC is institutional neutral

In mainstream theory, characterised by welfare economics and the general equilibrium models of Arrow-Debreu, institutions play no specific role. (Richter 2000:1) However, neoclassical theory is not as Robert Langlois asserts, (1986) a “theory without institutions.” A set of institutions is presupposed, but they are the institutions of a perfectly functioning free-market economy. (Pasinetti 2001:333) In this sense, NC is only compatible with such a set of institutions. NC treats the internal workings of its three primary agents – the consumer, the firm, and the government – as given, nondescript, and beyond analysis. This procedure reflects the adoption of mechanistic metaphor in economic theory. (Mirowski 1989) In this rational functioning of individuals and free markets, there is little attention to habitual, cultural, or historical processes and little recognition of how power and coercion might affect the operation of markets. The approach is clear, logical and precise, although narrow. It is a universal applicable theoretical framework in which
exchange takes place between buyers and sellers without reference to institutional arrangements, which have developed over time. Hence, it is a-historical and a-institutional.

1.2.3 General criticism on institutional free economics

At a fundamental level, the core element binding different groups of critiques on NC together is the conviction that orthodox neoclassical analysis is overly abstract and incapable of dealing effectively with many problems of interest to theorists and policymakers. Perhaps it is as Schwartz says “the greatest mystery of economic thought is that the discipline chose to ignore for so long how firms and governments come into existence and what determines their true behaviour.” Both the NIE and OIE rose out of concern with the lack of institutions in conventional neo-classic economics. “The costs of exchange depend on the institutions of a country: it’s legal system, its political system, its social system, its educational system, its culture, and so on” (Coase 1998:73). The NC assumptions of unlimited knowledge and foresight, unrestricted competitive markets, stable preferences, fully specified property rights, a neutral state are considered as overly abstracted. In this context, both schools of new institutional economics and old institutional economics instead, of focusing on resource allocation emphasise the institutional framework for distributional matters, where markets have no superiority as control mechanisms. In the center are not anonymous mechanical market mechanisms, but goal-oriented personal transactions of individuals and groups. Government intervention is not bad per se. “It does not imply, when transaction costs are positive, that government actions…. (regulation or taxation, including subsidies) could not produce a better result than relying on negotiations between individuals in the market” (Coase 1992:717).

1.2.4 Summary NC economics

Neo-classical economics focuses on a self-interested, utility maximizing individual which is rational and has complete information. The equilibrium is the most efficient solution and changes of equilibrium are only caused by relative prices.
Since prices ensure efficiency, market liberalization is decisive for setting the prices right. Government intervention is bad *per se* and institutional entities like states, governments, firms are considered as black boxes which act like individuals. In this sense, neo-classical economics are institutional neutral. Critiques of NC point out that this does not reflect reality and that institutional factors like property rights, educational system, and political regime have economic decisive influences.

Table 1: Summary NC

<table>
<thead>
<tr>
<th>Objectives</th>
<th>The objective is normative, not positive and designed to predict optimal end states</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technique</td>
<td>A specifically constructed actor, with a specific motive (maximise utility/profit), placed in a specific environment cannot do anything else than calculate the one and only optimal position. Principal-agency theory belongs to the same approach with the only difference that it includes information asymmetry and opportunistic behaviour, but because of substantive rationality complete contracting can solve the problem of “hidden action.”</td>
</tr>
<tr>
<td>Limitations</td>
<td>Because the assumptions are very abstract the explanatory power of the theory is questionable. The assumptions are very different from reality Therefore, correlation does not show causality. It assumes universal relevancy, but modern micro theory accepts the fact that “all purpose” theory cannot exist and that the relevancy of the theoretical building depends on the correspondence with the conditions in hand. “There is much economic theory that is pursued for no better reason than its intellectual attraction; it is a good game” (Hicks, 1979, VIII)</td>
</tr>
</tbody>
</table>


1.3 Definition Institution

The definition of an institution is an issue not easy to solve and the term has been used to cover a grab bag of varied things. Given the variety of types of institutions, it is difficult to provide a definition which is clear and precise (and thus, possesses analytic value), but which is also encompassing. Various phrasings have been used to define an institution: a usage that has become axiomatic by habituation; collective action in control of individual action; widely prevalent, highly standardized social habits; a way of thought or action embedded in the habits of a group or the customs of a people; prescribed patterns of correlated behaviour. (Neale 1994, 405) Others broadly define it as a commonplace organisation such as households, farms, and firms where much of society’s economic activity takes
place. (Cohen 1996:60) Generally, an institution governs interaction between separate units. It is the behaviour among humans that governs social interaction. Negotiating, monitoring, and enforcing this relationship is the fundamental aspect of institutional analysis. (Vandenberg 2002:6) This definition is different from common understandings of the term such as “financial institutions” or “government” to which North (1990) refers to as organisations. An institution in form of socially accepted regularity or behaviour governs the relationship between organisations or among people themselves and organisations or between people. Different definitions of institutionalism are surely part of the individual focus of scholars, while Williamson is concerned with the firm, North deals with institutional change and OIE with the social whole. Aoki (2000:21) makes a similar point by arguing that the definition of an institution is not an issue of right or wrong, rather it depends on the focus of analysis. Hence, it is important to consider what the purpose of each scholar applying the term ‘institution’ is. The most general definition is done by Vandenberg (2002) who defines an institution as “a way to govern interaction between separate units.” (Vandenberg 2002:6) I will apply Vandenberg’s definition of the term of institution throughout this paper.

However, my focus is not on what exactly the ‘institution’ is, rather I am interested in institutional forces behind institution building. One of the more interesting aspects of institutionalism is the manner in which formal rules interact with informal rules, in form of cultural norms, and established patterns of behaviour. It is the interplay between informal and formal rule that might allow for a particular institution to successfully emerge or to fail. Neither New nor Old institutionalism has fully come to terms with these questions, although the matter is of enormous relevance as becomes obvious is cases like contemporary Iraq, Afghanistan or Serbia.

1.4 New Institutionalism and Old Institutionalism

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8 See for example, Alessandra Casella and Bruno Frey 1992 or Nelson (195:80-81) who use the institution to refer to particular structures and bodies of law like GATT.

9 See Ruterhford (1994:183) for a similar ‘simple’ definition
On a fundamental level, the element binding different groups of institutional researchers together is the conviction that orthodox neoclassical analysis is overly abstract. The NC assumptions of unlimited knowledge and foresight, unrestricted competitive markets, stable preferences, fully specified property rights, a neutral state are considered as over simplified. In this context, two schools of institutionalism can be defined which are competing for superiority in the fields of economics. The first one is NIE attempting to work within the logic of mainstream economics and thus, extends NC theory from one with neutral institutions to one with active institutions. Section (1.4.1) will deal with NIE theory in general, while section (1.4.2) defines a NIE definition of institutions. The other strang, competing with NIE is OIE which was developed at the early twentieth century and focuses on how social norms influence economic activity through institutions. The theory of OIE will be outlined in section (1.4.3) and its respective definition will be summarised in section (1.4.4). Finally, section (1.4.5) will give a short summary about NIE and OIE.

1.4.1 New Institutionalism

NIE is founded on the contribution of Ronald Coase (1937, 1960) and is based on the neo-classical principles of rational and maximising behaviour. It includes work of Alchian, Demsetz, Williamson, and North. Sometimes NIE is extended to game theoretic approaches and Austrian approaches built on Carl Menger and Frederick von Hayek. In general, NIE takes the self-interested, maximising individual (methodological individual) as given with exogenous tastes and technology. Standard neoclassical economics based on rational actor is extended with the aim to explain the existence of political, legal, or more generally social, institutions by reference to a model of individual behaviour and the reliance on the concept of positive transaction costs, which are considered zero in NC. However, as Rutherford (1994,2) demonstrates NIE itself is not as coherent as often argued. One major strang deals with property rights (Demsetz 1967, Alchian and Demsetz 1973) and common law (Posner 1977, 1981). Another strang is concerned with public choice, rent seeking and distributive coalitions. (Olson 1982, Mueller 1989) Other elements deal with organisations (Jensen and Meckling 1976) and agency costs
(Coase 1937), which is utilised by Williamson (1975, 1985). Further, aspects include game theory (Shubik 1975, Schotter 1981). NIE is also usually defined as including Austrian and neo-Schumpeterian economics (Hayek 1967, 1973, 1979; Nelson and Winter 1982).

However, in general, all agree that development and functioning of institutions are caused by efficiency terms hence, they are analysed as ways to reduce transactions costs, uncertainty, internalising externalities and producing collective benefits from cooperative behaviour. In this framework, institutions are efficient solution to economics i.e. to select the most efficient organisational form, or set of routines, or rules. The individual is constrained, but not otherwise influenced by institutions. Institutions affect individual behaviour, but only in terms of choices, constraints and information presented to the agents, not by the moulding of the preferences and indeed the very individuality of those agents themselves (Hodgson, 1994:399). The possibility that individuals are themselves shaped by institutions is not considered. Hence, Neoclassicism becomes capable to deal with issues relevant to institutionalism.

1.4.2 NIE definition of institution

For analytical reasons, it is important to differentiate between two major strands within NIE. The first one which is called NIE1 throughout the dissertation focuses on intra-firm issues and considers the institutional environment as given, while the second one which is called NIE2, is more interested in institutional change itself and less in governance structure. In context of both strands, a definition of institution will be given below.

i) NIE1 definition of institution
The first approach focuses on the choice of governance structures of private actors under a given institutional environment. It is based on Coase’s market system of resource allocation. Coase (1937) points out those firms arise from the cost of using the price mechanism. At a very basic level, it asks how production is organized, either by the price mechanism across markets or within a hierarchically organized firm. (Coase 1937) Williamson improved the theory of the firm with focusing on the relationship within a bank or firm. In 1975, he introduced the role of the firm or hierarchy as an alternative to market resource allocation in a comparative institutional framework. (Hodgson 1994:240) Williamson typically represents specific choices between external markets and internal (intra firm) markets. i.e. internal labor markets, internal capital markets and internal intermediate product markets. (Kay 1992) By focusing on internal market, the relationships between i.e. workers and owners (principal agent problem) become significant. Williamson’s relational contract theory deals with complex long-term relationships between buyers and sellers and it is the governance structure of a contractual relationship that matters. (Furubotn and Richter 1997:170)

For Williamson, the relationship between workers and owners/managers (principal agent problems) or between divisions is of prime importance. Williamson’s definition of institutions is, therefore, quite specific: they are mechanisms, governing transactions, and a transaction occurs “when a good or service is transferred across a technologically separable interface” (Williamson 1985:1). Thus, there are three principle institutions in capitalism: the market, the firm, and supply (or relational) contracting. The firm is an institution because transaction between divisions represents interaction across this separable interface. The institutional choice of firms, of whether to make or buy a component, involves a choice between whether the interaction takes place between firms or between departments within a firm. The make-or-buy (or buy on supply contract) decision is the key and indeed almost the sole problematic of Williamson’s work, and it is analysed with reference to a number of concepts like bounded rationality, opportunism and asset specificity.

ii) NIE2 definition of institution
The second approach does not take the institutional environment as given. It is interested in ascertaining the effects that various institutional environments have on economic performance and development, as well as in explaining the change of the institutional environment over time. (North 1998, Harris 1998, Bates 1998, Ball 1999) The study of governance – in particular the theory of the firm – is more developed than the study of the institutional environment (Klein 1999) and plays a more prominent role in the module of competition and regulations. Among the representatives of this second line, it remains an open question whether the NIE basically remains within the neoclassical paradigm and simply deals with a number of questions previously neglected by mainstream theory or if NIE is indeed an entirely new paradigm that is incompatible with neoclassical economics.

The NIE2 work is broader, it does not only deal with private sector decision, but also less precise and less interested in intra-firm issues. The definition of institutions is consciously broad: “a framework within which human interaction takes place “(North 1990:4). It can encompass both inter- and intra-organisational issues of private transacting, as well as the legal and regulatory environment, which requires an understanding of the political system. Furthermore, it includes the cultural, ideological, and cognitive processes, providing norm structures and thus guide human interaction. Partly, it has borrowed extensively from game theory. Thus, Douglas North (1990) in line with Thrainne Eggertsson (1990) has also proposed that institutions are “the rules of the game.” The institution as “rule of a game” has been further developed by Greif (1998, 1994, 1997, 1998), Milgram, North, and Weingast (1990), Greif, Milgrom and Weingast (1994) and Calvert (1995) who rely on sophisticated concepts of equilibrium, such as sub-game perfect equilibrium, in repeated prisoners dilemma games. Regarding the origin of an institution, the rule-of-the game theorists tend to subscribe to the design view that rule-making is susceptible to conscious design either by legislators, political entrepreneurs, or mechanism design economists. (Aoki 2000:19)
Table 2: Summary of New Institutional Economics

<table>
<thead>
<tr>
<th>Objectives</th>
<th>The objective of NIE is to explain the institutions that coordinate transactions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Techniques</td>
<td>Two stream can be distinguished (Rutherford 1994): the formalist (game theory) and literary (transaction cost economics)</td>
</tr>
<tr>
<td>Technique Game Theory</td>
<td>The players and the rules of the game are given, although this looks like a single exit construction there is no optimal outcome guaranteed. More equilibria are possible, but also none. What outcome depends on conditions assumed</td>
</tr>
<tr>
<td>Limitation Game Theory</td>
<td>Without complementary information about institutional conditions game theory is silent about economic issues like subcontracting</td>
</tr>
<tr>
<td>Technique Transaction Cost</td>
<td>TCE explain governance structures that match specific types of transactions. It uses as basic unit the transaction and identifies potential governance structures, like vertical integration, a classical market contract or a hybrid like subcontracting. Further, it makes plausible matches of types of transactions with governance structure using asset specificity, opportunism, safeguards, farsightedness, and the like. Transaction A will be matched with governance structure X because of cost economising reasons.</td>
</tr>
<tr>
<td>Limitation Transaction Cost</td>
<td>Because of the introduction of bounded rationality next to opportunism, complete contracting is not possible anymore – in contrast, to NC. However, TC does not explain different governance structures in case of identical transaction. Apart from this TCE is only appropriate for comparative static analysis. Economic issues of dynamics, processes, analysis of adaptation, are not within the reach of TCE.</td>
</tr>
</tbody>
</table>

Based on Groenewegen, Institutional economics, from black sheep to white knight, Paper prepared for the Societa Italiana Degli Economisti, XLI Riunione Scientifica Annuale, 27 October 2000

1.4.3 Old Institutionalism

Old Institutionalism is built on a tradition associated with Thorstein Veblen, John R. Commons, Wesley Mitchell and Clarence Ayres and continued in recent contributions by Geoffrey Hodgson, Warren Samuels, Dugger and Malcolm Rutherford. OIE does not represent a single well-defined or unified body of thought, methodology, or programme of research. The core ideas of institutionalism concern institutions, habits, rules and their evolution and is built on Veblens main criticisms (1919) that orthodox economic theory does not address the analysis of long-term growth. The neoclassical approach, with its rational actor, is abandoned in favour of one placing economic behaviour in its cultural context. Development and functioning of institutions is caused by social and political factors as status, group, identity, ...

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10 Even within the early institutionalists did not represent a unified school which becomes obvious with the two differing strands of either Veblen or Common. While the first one concentrates on political and economic power of large corporate interests, the second one focuses on property rights and organisations, and the impact on legal and economic power.
ideology, and economic, political power. (Rutherford 1995, Hodgson 1998, Galbraith 1967) Issues of influence, coalitions, and competing values are central in OIE, along with power and informal structures. (Clark 1960, 1972, Selynick, 1949, 1957, Greenwood and Hinings 1996) In an OIE view, the concept of habit connects crucially with the analysis of institutions. This has important implications for both microeconomic and macroeconomic analysis. (Hodgson 1998:167-68) Every transaction, Commons smallest unit of analysis, reflects more than efficiency alone. It also incorporates a stable social order – a kind of higher order efficiency, therefore, most transactions are habitual and repetitive. (Groenwegen 2000:469) OIE rejects individualistic welfare criteria and static equilibrium while favouring greater government involvement to correct institutional failures. (Rutherford, 1994:4) The structure of social and economic reality is seen as complex, functional, and interdependent, while the dynamics of this structure are described in evolutionary terms. In this respect, there is an affinity between institutionalism and biology. Evolutionary biology has a few laws or general principles by which origin and development can be explained and it requires both specific and general theories. In summary, OIE is descriptive, anti-formalistic, holistic, behaviouristic and collectivistic. (Hodgson 1998) OIE has not a hard-core assumption that defines it, except that rather than the individual the institutions is considered as unit of analysis. With tastes and technology as endogenous and economic behaviour as interdependent the approach is organic and hence, descriptive and non-formalised.

1.4.4 OIE definition of institution

OIE focuses on the cognitive-behavioural aspect, based on the insight of Veblen, who defined institutions as the “settled habits of thought common to the generality of men”. (Veblen 1948:239) OIE economists have used the term to refer to those aspects of culture affecting human and organisational action. With this perspective, institutions refer to the complex of socially learned and shared values, norms, beliefs, meanings, symbols, customs, and standards that delineate the range of expected and accepted behaviour in a particular context. This view of institutions is
alive and well in modern sociology. (Walter Powell and Paul Di Maggio 1991). It gives the alternative school a behaviouralist bend and explains its emphasis on sociology and psychology. Thus, institutions include habits, cultural characteristics, and routinised behaviour, which may not involve the type of deliberative-rationalised action, which is the motivation behind neo-classical behaviour. In game theory, the concept is similar to those relying on evolutionary and repeated games as developed by Sudgen (1998), Aoki (1995, 2000), Young (1998), Okazaki and Okuno-Fujiwara (1998) and Bowles (2000). Concerning the question of origin of an institution in OIE, there is no clear consensus on this issue.
Table 3: Summary of Old Institutional Economics

<table>
<thead>
<tr>
<th>Objective</th>
<th>The objective is to understand the complex process of institutional dynamics. &quot;The institution in which he finds himself is both the cause and effect of his beliefs... Common beliefs and desire is the vitalizing, active force within the institution. (Commons 1965, 6-8, quoted from Hodgson 2000) By endogenising the relation between the individual and institutional environment the OIE is now capable to grasp variables like power, learning, perceptions and path dependency.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technique</td>
<td>When analysing a specific issue, one is forced to make general concepts specific with specific conditions of time and place. In doing so it s is unavoidable to incorporate different explanatory variables from different disciplines. The OIE analysis positions the issue in the broader context of the formal and informal institutional context. “However, since the new data are constantly coming in and since the system itself is evolving the model is constantly being revised and can neither be completed nor rigorously confirmed the techniques of observation and concept development should be such as to somehow capture and express the holistic quality. (Rutherford, 1994, 16) Obvious the purpose is to get hold of the dynamics of the whole.</td>
</tr>
<tr>
<td>Limitations</td>
<td>The theory is very abstract and rigorous and less relevant for understanding specific situations</td>
</tr>
</tbody>
</table>

Based on Groenewegen, Institutional economics, from black sheep to white knight, Paper prepared for the Societa Italiana Degli Economisti, XLI Riunione Scientifica Annuale, 27 October

1.4.5 Summary NIE and OIE

NIE as well as OIE is critical of NC theory in its a-historical and a-institutional approach. However, while NIE attempts to extend neoclassical thinking towards institutional theory, OIE rejects the rational-efficiency assumption by underlying the importance of social norms in relation to the institutional environment. NIE is split into NIE1 dealing with the institution itself like the firm previously considered as black box, and into NIE2 dealing with institutional change. NIE2, is in its nature very closely related to OIE since both focus on the political-economic sphere and sometimes are difficult to distinguish. However, the main difference between NIE and OIE is that the first one does not consider the possibility that individuals are shaped by institutions themselves.

⇒ NIE and OIE both criticise NC for the neglect of institutions
2 Relationship between NIE and OIE

2.1 Distinction between NIE and OIE

Although both the NIE and OIE deal with institutions and criticise NC for being too abstract, both represent a varying response to the same problem. These differences during, the past and present have resulted in theoretical conflicts. This discrepancy has become overstressed to such an extent that both schools have became a “paradigm discipline” (Stanfield 1989), rather than an innovative economic theory. Accordingly, the theoretical approach of NIE and OIE are often dichotomised into formalism versus description, methodological individualism versus holism, rational choice versus rule following, invisible hand versus collectivism, and non-interventionist government versus interventionist government. (Rutherford 1994:6, Peukert 2001:4)

Table 4: Comparison NIE and OIE

<table>
<thead>
<tr>
<th>NIE</th>
<th>OIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formalism: Mathematics, Models</td>
<td>Anti-formalism: Descriptive, anti-theoretical</td>
</tr>
<tr>
<td>Individualism: Everything can be explained by individual action</td>
<td>Holism: Deals with social influences on individual action</td>
</tr>
<tr>
<td>Rationality: The individual acts only rational</td>
<td>Rule following: The individual follows habits and routines</td>
</tr>
<tr>
<td>Evolution: Institution develop according to an invisible hand</td>
<td>Design: Behind the institution exists an intention and Hence, is the social outcome of an idea</td>
</tr>
<tr>
<td>Efficiency: Institutional change occurs if a higher degree of efficiency can be achieved</td>
<td>Reform: Institutional change is dependent on power and the preferences of those who have power</td>
</tr>
</tbody>
</table>

Table by Alexandra Bernstorff 2004

The dispute in relation to the dichotomy is the dividing line, which classifying scholars as either being NIE or OIE. It implies that if a scholar applies mathematical models or deductive reasoning, it is assumed that he belongs to NIE. Similarly, theories and assumptions only expressed by language are categorised as OIE. While the explanatory movement by NIE scholars is from individual to
institutions, the movement goes into opposite directions according to OIE writers. (Hodgson 2003) Thus, NIE scholars conceive social institutions as joint outcomes of rational individual activities; while in contrast, OIE writers define the former as societal phenomena modelling pattern in relation to the individual. (Zafirovski 2003:800) According to NIE in the “beginning there were markets” (Williamson 1975:20) which contradicts the OIE view that social institutions and rules are historically prior to and determinative of market phenomena (Zafirovski 2003, Hodgson 2002, Myrdal 1953, Pirker and Rauchenschwandtner 1998) Based on those opposing assumptions, NIE and OIE form contradicting schools having explicit characteristics. Accordingly scholars are categorised as either NIE or OIE in relation to assumptions made in relation to the dichotomy.

2.2 Criticism between NIE and OIE

As noted above, the dispute between NIE and OIE centers on the five main topics in relation to the degree of formalism, rationality, individuality, design and government intervention. (Rutherford 1994:174) The differing views are the foundation for criticism between each other. In this context, this chapter will consider the criticism of NIE on OIE in section (2.2.1) and respectively, the criticism of OIE on NIE in section (2.2.2). The criticism between both will be summarised in section (2.2.3).

2.2.1 Critique of NIE on OIE

NIE complains about the OIE lack of theory. The OIE tendency to argue in holistic terms rather than in individualist terms; the use of ‘behaviouristic’ rather than rational choice framework; the failure to give sufficient emphasis to economising as ‘the main case’; and the failure to appreciate the importance of unintended and evolutionary processes in institutional development as opposed to processes of collective decision making and institutional design causes a social, but not economic theory. (Seckler 1975, North 1978, Schotter 1981, Coase 1984,

“The problem with the Historical School and many of the early Institutionalists is that they are an economics with institutions, but without theory; the problem with many neo-classicists is that they want economic theory without institutions; what we should really want is both institutions and theory. “

(Langlois 1986:5)

“American institutionalists were not theoretical, but anti-theoretical…..Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire” (Coase 1984:230)

According to NIE, OIE is a descriptive theory which can not be modelled nor used as advice for any economic questions. OIE draws a picture without any resolution, due to its descriptive analysis, it is not possible to calculate outcomes and Hence, it rejects all quantitative methods. With the inclusion of psychology, habits etc. OIE introduces too many non-calculable variables and blunts the distinction between economics and other social sciences. (Rutherford 1994)

2.2.2 Critique of OIE on NIE

OIE criticises NIE for being too abstract and formal in which the individual is reduced to rational maximising actor which is constrained, but not otherwise influenced by institutions. (Mirowski 1981, Zafirovski 2003, Field 1981, 1984, Dugger 1983, Dow 1987, Hodgson 1998) Further, OIE criticises that NIE demands a universal applicable theory. In this form, NIE is inappropriate in relation to and explanation of certain classes or social phenomena. According to OIE, formal models of NIE use only those assumptions which are mathematically tractable and not those reflecting reality. For example, equilibrium analysis based on maximising behaviour is easier to trace than a process of adaptation. Even worse in OIE eyes, is the fact that a high degree of abstraction creates generalisation on the one hand, and indeterminacy on the other. The economic conclusion in formal models depends only on the specifics of the situation omitted from the model. (Rutherford 1994:8) Therefore, OIE rejects universal models and focuses instead, on case studies.
Additionally, OIE criticizes that the central concepts of NIE are indefinable. Although NIE uses formal models and mathematical equations, the inputs in those are too imprecise to identify economic laws. Transaction costs, for example, include search, information, bargaining, decision, and enforcement costs. (Peukert 2001) As it is nowhere stated how to calculate them, the estimated percentage of transactions costs of total costs varies considerably. Wallis and North (1986) assume that in modern western industrial societies, the percentage of transaction costs is approximately 45%, while Richter assumes that they are near 80%. (Furubotn and Richter 1997:9) Further, OIE argues that it is not necessarily positive to reduce transaction costs. The increase of transaction costs at one point of the economy may reduce transaction costs and uncertainty elsewhere (e.g. the Tobin tax or zoning laws).\textsuperscript{11} If positive transaction costs are accepted it follows “that all of the elements traditionally taken as data in neoclassical theory can no longer be accepted as objectively given.” (Furubotn 1997:11).

OIE also is critical towards the assumption that all aspects of life can be interpreted in economic terms. For example, Ensminger (1997) explains religious conversion to Islam with arguing that the new religion reduces transaction costs. Apart from the fact that transaction costs are not proper defined, as argued above, NIE is not clear as to how and why Islam has developed and not for example, Buddhism. In this sense, NIE always assumes that there is the one best solution and religion as an institution is reduced to the most efficient institution - which leaves the question of which religion has more right for existence than the others open. NIE has difficulties to explain why and how norms develop and is not able to deal with behavioral aspects other than opportunism. Additionally, NIE is not very convincing concerning economic development. On the one hand, it is assumed that a democracy and a free market economy will automatically develop through time. (Alchian 1950) On the other hand, neither democracy nor liberal market regimes did develop in many contemporary LDCs. “In comparing economic systems, the question is always what accelerated or inhibited growth? In pre-modern societies this leads to the question: what prevented growth? Was economic growth really always the system’s...

\textsuperscript{11} For Further, arguments see Hensler and Matzner (1994).
objective (see Sombart 1916) and not political power, salvation, prestige, the minimization of work effort or something else?” (Peukert 2001:11)

2.2.3 Summary Criticism between NIE and OIE

As demonstrated above, NIE and OIE are two contrasting oppositions. The contradiction is not only obvious in the theory and its respective assumptions, as demonstrated above, but also in political advice. While the former, for example, advises as little government intervention as possible the latter argues for a strong state to avoid poverty and inequality. In this sense, it is surprising that both strands, although they developed concerning the omission of institutions in economics, come to contradiction conclusions. Although the criticisms between both are overemphasized for analytical reasons, they can still be found in contemporary writings. For example, Zafirovski (2003) and Hodgson (1998) in relation to OIE critique on NIE, and Furubotn and Richter (1997) concerning NIE critique on OIE side.

⇒ NIE and OIE take two opposing positions in relation to modeling, rationality, institution, institutional change and the assumptions about the individual

Table 5: Criticism between NIE and OIE compared
PART I – THEORIES OF INSTITUTIONALISM

<table>
<thead>
<tr>
<th></th>
<th>CRITIQUE OIE ON NIE</th>
<th>CRITIQUE NIE ON OIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modeling</td>
<td>Too formal</td>
<td>Too abstract</td>
</tr>
<tr>
<td>Individual</td>
<td>Too reduced</td>
<td>Too holistic</td>
</tr>
<tr>
<td>Rationality</td>
<td>Too extreme</td>
<td>Too little</td>
</tr>
<tr>
<td>Institution</td>
<td>Do not influence Individual</td>
<td>The individual is not able think independently from its institutional surrounding</td>
</tr>
<tr>
<td>Institutional Change</td>
<td>Institution do not only change for efficiency reasons</td>
<td>It is not possible to design institutions</td>
</tr>
</tbody>
</table>

*Table by Alexandra Bernstorff 2004*

2.3 Is the criticism consistent?

The intention of this dissertation is to investigate whether the criticism and often cited dichotomy between NIE and OIE is consistent. In case the often cited dichotomy cannot be found in the writings of respective scholars, it could be that a more adequate solution to the problem of institution building be found if elements of OIE and NIE are combined. Therefore, it is essential to examine if the criticism between NIE and OIE are consistent and theoretically defensible. Hence, section (2.3.1) considers if the criticism from OIE on NIE is more than an objection against NC. Further, section (2.3.2) will examine if the often stated dichotomy between both strands in relation to formalism, efficiency, and design can find justification in the writings of scholars by either school. Section (2.3.3) concludes that the only position between both approaches which seems to be incompatible is the assumption about economic actor.

2.3.1 Critique of OIE on NIE only critique of NC?

It can be argued that the main critique of OIE on NIE is not based on NIE assumptions, but on those of NC. Therefore, the question remains whether NIE is basically compatible with the neoclassical paradigm and just dealing with questions previously neglected by mainstream economics or if NIE is indeed an entirely new school that contradicts with NC. The point is that attempts by OIE to criticize neoclassical theory from an institutionalist perspective may be quite valid, but proponents of the NIE can share such a critique. The critical question, then, is whether the OIE can muster a valid critique of the NIE or in fact whether the new institutionalism is a useful modification and extension of neoclassical theory.
(Vandenbarg 2002:221) This critical distinction is not always clearly defined and thus, the otherwise excellent alternative institutional analysis of Hodgson is for the most part a critique of neoclassical theory and only incidentally a critique of the NIE. This might be due conviction that it is impossible to produce an institutional theory that is compatible with neo-classic.

On first glance similarities of NC and NIE are obvious both use the concepts of scarcity, competition, efficiency, price theory, and actor with exogenous tastes. However, NIE introduces the concept of transaction cost (TC) and bounded rationality (BR) to be able to explain institutional phenomena as well as economic differences. TCE was originally introduced by Ronal Coase (1937) who defined them as the costs of using the market. They were introduced to give a rational for the existence of firms. If the market would function efficiently and costless, as assumed by NC, there is no reason for firms to exist at all. Dahlman (1979) later described transaction costs as “search and information costs, bargaining and decision costs, and policing and enforcement costs”. Bounded rationality was originally introduced by Simon (1955) and criticizes that conventionally in NC it is assumed that individuals try to maximize utility in a perfectly rational way. In the words of Kreps (1990:745) the NC actor is: “A completely rational individual (that) has the ability to foresee everything that might happen and to evaluate and optimally chooses among available courses of action, all in the blink of an eye and at not cost”. According to Simon, the brain capacity does not allow individuals to preview every possible state of the world, know all the options they can choose from, and be able to evaluate all their possible consequences instantaneously and costless. Simon criticized the assumption by arguing that humans are ‘bounded rational’, they are rational under the processable and knowable information. NIE adapted the concept by introducing uncertainty as a state of affairs in which actors are not able to calculate expected values because they are not able to foresee all states the world can possibly take on. (Jack Knight 1992) Inefficient economic decisions are therefore, not irrational, rather it was not possible to know or calculate the most efficient solution and hence, a less efficient solution was chosen. The application of non-calculable transaction costs and

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12 Throughout the dissertation the short forms TC is used for transaction costs, BR for bounded rationality and IC for information costs.
non-calculable information insights suggests that the theory of NIE differs greatly from NC, thus, most criticism of OIE is on NC and not on NIE.


Table 6: Comparison NIE and NC

<table>
<thead>
<tr>
<th></th>
<th>NC</th>
<th>NIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methodological individualism</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Choice Theory</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Price Theory</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Competition</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Bounded Rationality</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Transaction Costs</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Institutions</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Government Intervention</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Table by Alexandra Bernstorff 2004*

2.3.2 Dichotomy between NIE and OIE

Although often dichotomised, the differences between NIE and OIE are not as clear as often believed. It will be examined if political advice and economic statements between NIE and OIE are oppositions or if they are, indeed similar. After considering all points of the dichotomy in relation to formalism, efficiency, design, rationality and individualism, it shows that the criticism between NIE and OIE is reducible to the one assumption about rational man.

a) formalism versus description

The view of the OIE as primarily descriptive and anti-theoretical is quite misleading. Indeed, OIE rejected the mathematical modeling, but the discussion is not theory versus description rather concerns the appropriate degree of abstraction. (Rutherford 1994:9) Even the work of Mitchell and of Commons contains theoretical underpinnings and theoretical purposes. (Rutherford 1983, 1987) Moreover, new formal techniques are being developed and attracting interest in both not only in NIE, but also in OIE. Examples are chaos theory and other models applied to complex dynamic systems. (Rutherford 1994:184) See, for example, Anderson, Arrow, Pines (1988) Baumol and Benhabib (1989) in relation to NIE and Radzicki (1988, 1990) Dopfner (1991) in relation to OIE side. Although NIE is more formal in its theory than OIE, the degree of formalism within NIE varies widely. For example, it is at its greatest in the work of Shunick (1975) and Schotter (1983) who deal with agency- and game theory and little present in the work of North (1990) or Williamson (2000.
In this context, De Alessi (1999:11) argues that the NIE can be divided into ‘formalists’ and a ‘literary’ branch and claims to find a “growing bifurcation” between the two. (Rutherford 1994:21) This division within the NIE reflects some of the same issues that led to the separation of OIE from neoclassical mainstream. De Alessi (1999) places writers such as Alchian, Coase, Demsetz, North and Williamson in the literary group and points out that the desire to deal with institutional complexities leads to less formal approaches. For example, Coase (1984) hardly uses any mathematical models and argues that the assumption of the individual as “rational utility maximiser” is both “unnecessary and misleading”. He continues by stating: “Modern institutional economics should study man as he is, acting within the constraints imposed by real institutions”. (Coase 1984:231) It is interesting that, as well, NIE as OIE scholars acknowledged their respective shortcomings and urged for complementarity of both approaches. For example: Field (1979) as OIE scholar, and Basu Jones & Schlicht (1987) as NIE scholars.

“The best theoretical work has always been that which combines a detailed knowledge of the subject under investigation with the ability to abstract and interrelate its essential features” (Field 1979:67/OIE)...” It is only with the general acceptance of the value of both types of work that we may be able to effectively address the challenge of developing an adequate institutional economics.” (Field 1979:69/OIE)

"NIE tends to be structural, explaining an institution as an optimal institutional solution without reference to the past. This is the opposite of what historians tend to do. We urge....that both structural and historical explanations are needed in economic history, and that these are complementary rather than exclusive.” (Basu, Jones and Schlicht 1987:2/NIE)

Whatever the strengths of NIE or OIE, neither the highly formal nor the descriptive methods can, on their own, provide an adequate approach to an institutional economics approach. Therefore, it is necessary to “develop an institutional economics that is both theoretically compelling and historically relevant”. (Rutherford 1994:26)

b) evolution versus design
The terminology of evolution versus design might be misleading and should not be confused with the discussion about spontaneous order. According to OIE, institutional change is an unintended process, while NIE argues that institutional change is a purposive process. However, to my knowledge, the contradiction cannot be find in respective writings, as well NIE as OIE consider both as relevant to institutional evolution. The attempt of contradicting the NIE focus on design with OIE assumption of evolution is often done by overlooking the differences between Veblen and Commons view. While Veblen assumes that institutional change is an unintended consequence to new circumstances and not caused by a purpose, Commons believes that change can be attributed as well to purpose as to externalities like conflict. Contemporary OIE writers like Hodgson (1998) or Zafirovski (2003) assume that as well purposive as unintended consequences result in institutional evolution. However, neither Veblen emphasis on market power and technology nor Commons emphasis on conflict resolution is on odds with moral hazards and transaction costs. Similarly, most of the NIE discussion of economic history includes both evolutionary and design processes. (Rutherford 1994:126) Similarities between purpose versus design are quite obvious in the work of Commons and Williamson. Commons emphasis of political parties reflects Williamson focus on hierarchy and North’s discussion of judges. (For an interesting discussion of Williamson and Commons on vertical integration see Medema 1992) The connection between Veblen and NIE is less pronounced since NIE in general, deals little with technology. However, Veblen’s assumption that technological change causes unintended institutional movement has links to North’s discussion of the “ongoing interaction between organized economic activity, the stock of knowledge, and the institutional framework”. (1990:78).

c) Efficiency versus Reform

It is often argued that NIE focuses solely on market efficiency, while OIE rejects the assumption that a free market causes social positive outcomes. According to NIE, the free market creates automatically the most efficient solution for the individuals, therefore, the government should intervene as little as possible. In

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13 The view, that according to OIE institutional change is unintended has its roots Veblen who focused mainly on technology as driving force behind institutional change.
contrast, OIE criticizes that markets tend to create inefficiencies in relation to income distribution, wealth, economic opportunity, power, unemployment, macroeconomic instability, blocking of technological improvements and various forms of “waste” such as competitive salesmanship (Veblen 1904, 1975, Tugwell, Munro and Stryker 1930, Common 1934, 1961, Mitchell 1935-1950, Ayres 1962) Therefore, OIE tends to advocate a greater amount of regulation or direct intervention by government. However, many NIE scholars dealing with institutional change, criticize the use of pareto optimality (Demsetz 1969, De Alessi 1983, Eggertsson 1990) and favor institutional guidance. Typical representatives are of Buchanan and Tullock (1965) and Hayek (1967, 1973). While the former consider the constitution as an outcome of voluntary exchange, the latter stresses the importance of individual freedom on evolutionary processes. However, as well OIE as NIE have addressed the question of judging welfare in relation to institutional change and governmental guidance. The main difference between the two strands cannot be found in different governmental policy advice rather in the significance given to individuals in relation to voluntary exchange. (Rutherford 1994:170)

d) individualism/rationality versus holism/rule-following

NIE and OIE both agree that history matters and efficiency is not always achieved, both keep a distance from the assumptions of perfect rationality, perfect foresight and zero transaction cost. (Richter 1996:588) Nevertheless, they do not agree on assumption about the individual. NIE argues that the individual is rational and decides as rational and efficient as possible (homo oeconomicus). In contrast, OIE believes that the individual is rather a rule follower than a rational actor (homo sociologicus). While NIE assumes that institutions do not influence individual decisions apart from being constraints (methodological individualism), OIE is convinced that institutions do influence individual actions and preferences (holism). NIE and OIE actually apply both sides of the dichotomy noted above, formalism/description, evolution/design and efficiency/reform, but it is not possible to apply both assumptions about the individual. In this sense, the question concerning rationality and individualism versus rule following and holism seems to form the dividing line between NIE and OIE. The independency or interdependency of
institutions and individuals forms a contradiction which is difficult to come terms with. It is not only a theoretical twist between NIE and OIE, rather it forms the philosophical problem concerning the interrelationship between individuals and society in general. (Rutherford 1994:6)

2.3.3 Summary of consistent criticism

As demonstrated above, most criticism announced by OIE in relation to NIE is a critique on NC and is shared by scholars of NIE. Furthermore, it remains an open question to what extent the NIE assumption concerning bounded rationality and transaction cost is compatible with NC. Additionally, the often stated dichotomy between NIE and OIE in relation to formalism, efficiency, and design is nonexistent in respective writings. Both schools use and apply the contradicting issues of the dichotomy in their writings. The distinct position between both concerns solely the assumption about individualism/rationality (*homo oeconomicus*) versus holism/rule-following (*homo sociologicus*).

⇒ The dichotomy between NIE and OIE concerns only the assumption about the economic actor as either *homo oeconomicus* or *homo sociologicus*
3 Economic Actor

Chapter 2 has investigated to what extent the criticism between NIE and OIE are consistent. After examining the different views of the dichotomy, it became clear that scholars of both schools use equally formalist and descriptive techniques and appreciate, depending on the case, government intervention and institutional design. However, the view about the relationship between the individual and the institution cannot be aligned. Since the assumption about economic actor as either *homo oeconomicus* or *homo sociologicus* forms the basic dividing line between the two approaches, it then requires a more detailed analysis of the meaning *homo oeconomicus* (3.1) and *homo sociologicus* (3.2) and its actual application by NIE and OIE. Further, the concept of institutional individualism (3.3) and bounded rationality (3.4) will be examined. The intention is to explore if NIE or OIE actually keep to their assumption about the individual, or if indeed both are already using a ‘watered down’ version. In case both apply similar concepts about the economic actor NIE and OIE do not form contradicting schools, but rather a theoretical continuum of NIEOIE. Such a theoretical continuum allows an understanding of efficiency and pure market forces while simultaneously allowing informal mechanisms to be relevant and hence, overcomes the shortcomings of as well NIE as OIE. Section (3.5) summarises the findings of Part I while suggesting that NIEOIE is relevant.

3.1 Homo oeconomicus

This chapter focuses on *homo oeconomicus*. In section (3.1.1) the historical foundation of reductionism and the assumption *homo oeconomicus* is described. Section (3.1.2) characterises *homo oeconomicus*. Section (3.1.3) summarises the economic use and implication of applying *homo oeconomicus* and reductionism. Section (3.1.4) describes the advantages of using *homo oeconomicus* and reductionism, while section (3.1.5) describes the respective limits.
3.1.1 Historical context homo oeconomicus

Since the seventeenth century French philosopher Descartes, research has been reductionistic in nature. An increasing number of scientific researchers since have started to look at reality in an analytical way. They did so by subdividing the research object in particles to serve the idea of constructing models similar to Newtonian mechanics. (Verschuren 2001:389) Such models treat economic agents as if they were particles obeying mechanical laws whose behaviour could be described by a solvable system of equations. Application of atomism to the economic realm means treating human desires as fundamental data, which, like the masses of physical bodies in classical mechanics, are not affected by the relations being modelled. (Fullbrook 2002:1) Homo oeconomicus was considered as being the mental destiny of humans, hence, most economists of that time agreed with Adolph Wagner’s (1876, 1:i:82) statement that “the principles of economic nature are lodged fast in human bodily mental organisation, and they change as little as does external nature, at least during the epochs relevant to human history”. The idea that humans have emotions and do not act mechanically seemed to be ridiculous as becomes obvious with Irving Fishers statement in 1892 “ This foisting of Psychology on Economics seems to me inappropriate and vicious. (quoted in Coats 1976:51). The universal application of homo oeconomicus in all aspects of life is an expression of reductionism as it was and is apparent in economic theory.

3.1.2 Characteristic homo oeconomicus

Homo oeconomicus of today is a rational individual, which is generally used to characterize economic agents. Elster (1989:99) describes homo oeconomicus as forward looking, intentional, and responsive to incentives. According to Elster homo oeconomicus is guided by instrumental rationality and pulled by the prospect of future rewards. (See also Gambetta 1987) Homo oeconomicus adapts to changing circumstances, always on the lookout for improvements. It is easily caricatured as a self-contained, asocial atom. Homo oeconomicus has exogenously given and determinate preferences. These preferences apply to goods and services that are produced, consumed, and exchanged. Homo oeconomicus is outcome oriented,
caring about social interactions only insofar as they affect his final consumption and wealth. (Gintis 2000:21) *Homo Oeconomicus* has a rate of time preference allowing him to allocate consumption over time in a consistent manner, reflecting his welfare and his concern for the welfare of future generations. *Homo oeconomicus* is self-interested, caring only about personal bundle of commodities, work, and leisure acquired (Gintis 2000:312)

### 3.1.3 Economics and homo oeconomicus

The preference of economists for a rational maximising individual can be explained by the theoretical interest in explaining price formation. The idea is that prices are formed in an exchange process taking place after the agent is certain about which goods he prefers to exchange. Those agents are modelled as choosers and since they are engaged in an exchange, they must be utility maximiser. (Mazavinos 2001:55) Hence, NIE with focus on transaction costs use a *homo oeconomicus* or methodological individualist mode of explanation. (Toboso 1996:768) Although not all NIE present the same degree of reductionism, 14 all are built on a rational actor, which implies that the actor is treated as *homo oeconomicus*. (Mazavinos 2001, Gintis 2000, Hodgson, 2003) In the atomistic tradition, individuals form intentions and act, groups do not. Individuals may act as members of groups, but they still form their intention individually because only individual minds exist. (Davis 2002:13) For example, Hayek argued that supra-individual entities such as groups, classes, etc. should be thought of as theoretical concepts rather than real things (Hayek 1955), and Arrows asserts that “society is just a convenient label for the totality of individuals” (Arrow 1984:80) Accordingly social events as inflation, unemployment and organisational change are explained in terms of individual actions, assuming fixed preferences and incorporating nothing other than material constrains (natural, technological or monetary) into the analyses. Social factors are reduced or broken down into individual actions (Toboso 1996) and problems are solved by breaking them down into parts, and afterwards, by tackling the individual sub-problems. (Verschuren 2001, Ackerloff 1974, Easterby-Smith et al. 1991) Although traditional economic theory based on *homo oeconomicus* has focused on the allocation of goods

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and services in a market economy, recent developments in economics have expanded the scope of analysis to virtually all spheres of human behaviour. Economists have literally invaded other disciplines in their analysis of non-market behaviour and institutions such as crime and punishment, religion, marriage and family planning, history, and law. The trend to look at reality in an analytical reductionist way is now part of mainstream social science research, in large part under the heading of empirical-analytical research. (Verschuren 2001:390)

### 3.1.4 Advantages of homo oeconomicus and reductionism

The main advantage of homo oeconomicus is that it allows for reductionism. Reductionism in turn, gives the possibility of quantification and researcher-interdependence. (Verschuren 2001:390) The advantages of quantitative measurements are precision and standardisation, making comparison, as well as replication and control possible. A quantitative research methodology helps to achieve researcher-independent results, whereas the personality of the researcher is independent from the results. Therefore, only the abstract use of homo oeconomicus makes it possible to determine what kind/extent a political intervention should be.

### 3.1.5 Limit homo oeconomicus and reductionism

Homo oeconomicus and reductionism cause a bias of observational results that Verschurren (2001) calls ‘a tunnel view’. By isolating an object from its historical context, important influential factors may be omitted. (Guab and Lincol 1989, Denzin and Lincoln 1994, Miles and Huberman 1994, Yim 1989) This may, for instance, be the case in research with the purpose to measure and evaluate the impact of an intervention. A difference in the results of measurement before and after the intervention may be interpreted as a gain or a loss. However, this difference may be part of a long-term trend, in which case, it does not indicate an effect at all. (Verschuren 2001:401) Further, reductionism can be inefficient since some processes

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15 For example, Gary S. Becker (1976), The Economic Approach to Human Behaviour, and the recent writings about the new institutionalism in sociology.
are too complex to divide them analytically. Either it gives an incomplete or reduced picture of the reality because the number of relevant data is so big that the researcher has to make a choice, or the research will last too long or will be too expensive. This type of a problem may arise especially when processes, interactions, and communications between individuals belong to the research issue. Therefore, most management studies or business organisation studies are very seldom done mathematically. However, in general, the idea of *homo oeconomicus* is not convincing since everyday observations attest that people fail to conform to the rational model. People succumb to harmful temptations, behave charitably and/or vengefully, and have a concern for fairness - although it is argued by NIE scholars that those actions are pursued in the context of reputation, unusual preferences and asymmetric information. (Gintis 2000:312):

3.2 Homo sociologicus and holism

The main criticism of OIE on NIE concerns the assumption of *homo oeconomicus* and reductionism which they argue should be replaced by *homo sociologicus* and a look at the interdependent as a whole, which is called holism. The following chapters will describe the historical context of *homo sociologicus* in section (3.2.1). Section (3.2.2) characterises *homo sociologicus*. Section (3.2.3) considers the economic implications when adapting *homo sociologicus*. Section (3.2.4) summarises advantages of using *homo sociologicus*, while section (3.2.5) demonstrates the limits of its application.

3.2.1 History of homo sociologicus and holism

The idea of *homo sociologicus* and holism developed at the same time as the idea of *homo oeconomicus* and reductionism. The idea can be found in different schools, for instance, within the so-called diffusionist school of anthropogeographers founded in Germany and Austria by Friedrich Ratzel, which propounded

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16 Throughout this passage the extreme version of homo sociologicus, holism, methodological collectivism, homo psychologicus etc. is used.
the image of material culture, not the human mind as the protagonist of world history. According to W.D. Smith (1991, 144, 56), the diffusionists “moved the individual mentality out of its position as a prime object of study and replaced it with cultural traits…The real concerns of ethnology were not the understanding of individual psychology, but rather explaining how people came to act collectively in the ways they did – which was a function of the cultural patterns they shared with the other members of their communities”. (cited in Fulbrook 2002:23) Further, in the west the methodological fashion was holism, as evident in Durkheim’s concern for ‘social facts’ and ‘conscience collective’, in Radcliff-Brown’s ‘structural functionalism’ and in Kroeber’s ‘super organic’ level of analysis. Although ostensibly far removed from the dry positivism of the diffusionists, this tendency similarly constrained the supply of useful psychological data to primitive economics. The implications of this approach are visible already in Maunier’s (1907:105) work of the original division of labour

“The self-interested calculations of individuals cannot be the source of economic actions, and of the institutions which crystallise them until the individual spirit is sufficiently emancipated from the weight of the conscience collective to be able to deliberate and choose. For in primitive times, the social conscience absolutely dominates the individual conscience; all individual originality is annihilated: the greatest sanctions barely suffice to calm the collective emotion which provokes all innovation.” (cited in Pearson 2000:940)

In general, holism has been more popular in continental and especially German philosophy, while Anglo-American thought, with some exceptions, has tended to be hostile to it: the uncompromising individualism of British liberal thought and classical, as well as neoclassical economics are good examples. Nevertheless, homo sociologicus and holism have become considerably more respectable in analytic philosophy in the past two decades. The topic homo sociologicus and holism is itself much broader than outlined here. Methodological differences between causal holism, critical realism, methodological intersubjectivity are apparent in contemporary discussion for details see Boylan and O’Gorman (1995), Fleetwood (2002), Lawson (1998), Maeki (1997,1993) Fullbrook (2002). For analytical reasons, the term “holism” as used in this section, is a very simplified one
that only implies only the tendency to look at an object as a whole with interdependent parts.
3.2.2 Characteristics of homo sociologicus

According to Elster (1989:99) the behaviour of *homo sociologicus* is dictated by social norms, hence, it is ‘pushed from behind by quasi inertial forces.’ (See also Gambetta, 1987, Mazavinos 2001) *Homo sociologicus* is insensitive to circumstances, sticking to the prescribed behaviour even if new and apparently, better options become available. (Elster 1989:99) Therefore, the individual is a mindless plaything of social forces. See for example, Marx (1857, 1989:395-396) “man is individuated only through the historical process. He appears as a generic being, a tribal being, an animal of the herd”. (cited in Pearson 2000:935) The preferences of the sociologists for modelling the agent as a norm follower can be explained by their special theoretical interests. The Durkheim-Parson tradition in sociology sought to find a satisfactory solution to the Hobbesian problem of social order without invoking individualistic-utilitarian considerations. Norm-guided behaviour seemed to be the proper model to explain the maintenance of a workable social order. (Mazavinos 2001)

3.2.3 Economics, homo sociologicus and holism

The meaning of holism and methodological collectivism also captures the term *homo sociologicus*. (Hodgson 1998, 2003) In this context, holism describes the view according to which the parts forming a whole cannot be adequately understood or described individually, but only by considering their relation to the whole. The whole is more than just the sum of the individuals. (Zahle 2003:77, Verschuren 2001:400) Economic phenomena like unemployment are not reducible to individual actions rather institutional influences like political power of parties or unions can originate the occurrence. According to Wilber and Harrison (1978) and Rutherford (1994), methodological holism implies the presupposition that individual actions can only be understood and explained properly if individuals are considered as elements or components of some other entity. Therefore, in order to analyse human action and the events generated, special attention must be paid to the entities (groups, political parties, churches, states etc.) to which individuals mostly belong as
passive members. It is because of the aforesaid presupposition that these collective or social entities assume such a central position in most OIE contributions.

In the holist analyses, it is also frequently assumed, explicitly or implicitly, that these entities as institutions, groups etc. possess a kind of systemic force or logic which drives events in such a way that it is difficult for the analyst to discover personal responsibility for what is going on. Events such as continuous changes in prices, increasing unemployment, technological change etc., all tend to be explained mainly by way of revealing which systemic and impersonal forces are in place and how they operate. Of course, not all OIE contributions are systemic to a similar degree. Whatever the variety of methodological holism adopted, OIE gives primary importance to the social whole. According to Toboso words”this social whole is seen as influencing and conditioning individual behaviour.” (1996:767) However, the strength with which the social is seen as conditioning or determining behaviour of the individuals varies substantially between holists. In some cases, holists do seem to imply that macro or social entities have some sort of agential power of their own, but this is by no means a universal characteristic of the genre.” (See also Hodgson 2002, Rutherford 1994) Institutions shape human behavior, but are not essentially transformed by it. Influence on institutions is exerted from extra-institutional sources at the macro level and not in the organization itself. In this sense, actions are not the products of calculated decisions; rather, they are embedded in institutional structures of rules, norm, expectations and traditions that severely constrain the behavior of social actors. (Mule p-. 147)

3.2.4 Advantages of homo sociologicus and holism

In physical reality, the concept of homo sociologicus and holism for instance, is important for understanding and maintaining the steady state or equilibrium of a system. In general, not the sum of the individual parts of a system makes up an equilibrium, but the integrated whole of these parts. (Verschuren 2001:400) For instance, in chemistry, parts interact with each other and thus create a whole that is more than the sum of its parts. Here something with totally new characteristics is obtained by mixing two or more substances. (Verschuren 2001:401) Another
example in social reality is the performance of a football team. Even if the latter consists of capable and highly motivated individuals, the team may be losing one because of a lack of team spirit, communication, adequate tactics and strategies and mutual understanding. Therefore, in general, the quality of individual players is only a weak indicator of the quality of a group. Yet, measuring the qualities of individual team members is exactly what is done in the reductionist approach. Attributes at the level of a team or a group, such as team spirit, tactics and strategies are very difficult, if not impossible, to observe reductionistically in a satisfactory way. (Verschuren 2001:390)

Under holism, the observation itself is far less complicated and time-consuming than under reductionistic observations. An example is the registration of a social climate in a group. This phenomenon may be defined as the attitude of the individual group members in terms of being friendly, helpful and understanding to each other. Each of these attributes must be made operational by several indicators. Next, the social climate can be measured by asking the group members about the set of indicators by calculating an aggregated weighted or un-weighted score for the group. Instead a holistic researcher might take the role of participant observatory, and describe at face value the social climate in the group. (Verschuren 2001:403)
Lastly the holistic approach, due to its lack of pre-structuring and its stimulus-free, open-ended and empiric-driven character gives a better opportunity for obtaining new and unexpected findings than in the case of theory-driven and highly pre-structured research strategies. (Verschuren 2001:403)

3.2.5  *Limits of homo sociologicus and holism*

As noted above, when talking about *homo sociologicus*, a holist environment is implied, meaning the tendency to look at an object as a whole. However, in most cases, looking at something as a whole is a fiction. Human sensory observation is reductionistic by definition, as it consists of a serial registration of elementary sensations. The observer necessarily focuses on one or some aspects or particles of an object at a time. Therefore, in a sense, almost every observation more or less is reductionistic in nature. For that reason, different from its use in philosophy and
other contemplating disciplines, in empirical research it is necessary to define holism as a gradual phenomenon. Hence, holism can only mean ‘less reductionistic’. (Verschuren 2001:293) Further, the quality approach makes research dependent on the researcher, his personality and his perception of the object. Hence, it is neither possible to compare results nor to give the reader of the research an appropriate picture.

Some extreme versions of ‘holism’ are also reductionistic in the sense that they attempt to explain the parts entirely in terms of the whole. For example, attempts are sometimes made to explain all social phenomena solely in terms of structures, institutions, culture. Particularly some versions of Marxism and Durkheimian sociology have been criticised for placing an excessive weight of explanation on the society, system, or structure, to the neglect of the role of individual actor. (Hodgson, 2002:159) Nevertheless, individuals are not reducible to social structures, such as institutions. Such reductionist explanations are invalid. Individual behaviour cannot be explained entirely in terms of the social structures in which they are located. According to Hodgson (2002), such ‘upwards reductionism’ would have to deny “reconstitutive upward causation, but could only accept reconstitutive downward causation. Critics of the assumptions of holism rightly focus on their failure to accept reconstitutive upward causation.” (Hodgson, 2002:168)

3.3 Institutional individualism

In the previous chapter, it was shown that the often stated dichotomy between OIE and NIE in relation to formalisation/description, efficiency/reform and evolution/design is not existent since both schools apparently, use both concepts. It has been pointed out that this, in turn, is not the case with the consideration about the individual as it is not possible to use homo oeconomicus and homo sociologicus at the same time. The principal distinction between NIE and OIE is in the primacy given to the individual actor, as opposed to the social institution. However, scholars today using the holistic version of homo sociologicus agree on the fact that first, nobody is able to consider the whole, but only parts of it; secondly that the individual is not only determined by social forces, but also by individual calculations; and
thirdly, some supra-individual acorns do exist like the state. (Mazavinos 2001, Hodgson 1998, Rutherford 1994) Hence, dealing with OIE scholars using the expression *homo sociologicus* or holism one can only assume a ‘less reductionistic’ version, as Verschuren puts its. (Verschuren 2001:293) This less reductionistic version of *homo sociologicus* is captured in applying the concept of “*institutional individualism*”. Institutional individualism implies that a behavioural regularity is shown whenever old problems arise, while rational choice is applied under any ‘new’ situations.

“Strictly speaking, every situation that one encounters is unique in the sense that there will always be some respect in which it is different from any situation one has encountered before or will encounter in the future. We can, nevertheless, meaningfully speak of recurring situations in the sense that any given situation is, in certain aspects, similar to other situations, past and future.” (Vanberg 1993:175, cited in Rutherford 1994:48)

By assuming an *institutional individual*, the quantitative advantage of *homo oeconomicus* can be combined with the quality advantage of *homo sociologicus*. At the same time, informal mechanisms can be combined with the concept of choice and efficiency. In this context, the individual is a rule follower in recurring situations, but as each event has new features a choice is implicit. According to Rutherford (1994) and Hodgson (1998), in the majority of cases OIE already does so, since OIE does not appear to imply by holism the idea that social wholes possess and pursue their own distinct purposes or aims. (Rutherford 1994:38) For example, Ayres states that, all of mans actions involve some combination of tradition and intelligence (Ayres 1962:102), and Gruchy (1987:3) argues that the conduct of individuals reflects “the use of some reason” and Boudon (1993:101) remarks by referring to *homo sociologicus*:

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17 The term was originally introduced by Agassi (1975), and implies the same meaning of “methodological structuralism” (Lloyd 1986)
18 Rutherford examines the use of reductionism and economic reasoning in the works of Veblen (1904, 1914), Galbraith (1971), Ayres (1962), Hill (1989), Gordon (1980), Mitchell (1925), and Commons (1950)and comes to the conclusion that none uses the extreme version of *homo sociologicus* or holism
“The Moliersque explanations by ‘occult qualities’ bring us back to the dark side of the Middle Ages. They were considered a none plus ultra at the time when structuralism and Marxism ruled over sociology. This time is fortunately over in most places. These explanations are so easy, however, that they remain a permanent temptation in ordinary as well as academic thinking: “Why did he Y? Because he has internalised the norm telling him he should do Y.” (Boudon 1993:101)

While OIE leaves space for rational choice and hence, NIE theorising, the question is to what extent NIE is able to reduce its reductionism and thereby leaving space for the *institutional individual*. It is particularly interesting that NIE does consider ‘social influences’ by referring to: ‘all institutions given’, in this form, social forces rather through neglect than by design become part of the theory.19 Contrary to OIE, which is less obsessive in the handling of ‘economical reasoning’, there is a consistent effort in NIE to explain ‘social reasoning’ in rationalist terms. (Rutherford 1994:78) Stemming, perhaps, from Beckers (1976) argument that rational choice models can provide an understanding of “all human behaviour”. Where social influences are incorporated into the NIE, it is usually seen as the result of bounded rationality. Therefore, it is worth investigating if NIE when assuming bounded rationality may blunt the borderline between *homo oeconomicus* and *homo sociologicus* and thereby give a chance for the application of an *institutional individual*.

⇒ OIE assumes that the economic actor is an *institutional individual* and not a *homo sociologicus*

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19 See for example, the work of Alchian and Demsetz 1973 or others on property rights and game theory
Table 7: Reductionist versus holistic empirical research

<table>
<thead>
<tr>
<th></th>
<th>REDUCTIONISTIC</th>
<th>HOLISTIC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Object</strong></td>
<td>variables, relations individuel attri, butes set of observation units</td>
<td>patterns, types group attri, butes research units</td>
</tr>
<tr>
<td><strong>Observation</strong></td>
<td>stimulus-response closed, pre-structured measurement instruments extensive methods researcher at a distance serial</td>
<td>stimulus free/weak open unstructured via research questions intensive procedures interacting researcher parallel</td>
</tr>
<tr>
<td><strong>Strategy</strong></td>
<td>decomposition counting linear-serial one single method analytical deductive</td>
<td>composition comparison interactive-parallel triangulation analogous inductive</td>
</tr>
</tbody>
</table>

*Copied from Verschuren (2001:398), Figure 1*

3.4 Bounded rationality

The assumption of *homo oecononomicus* and *homo sociologicus* are the main opposition between OIE and NIE, hence, the previous section (3.3) considered the respective meaning and application of the terms. After examining OIEs use of *homo sociologicus* and holism, it shows that OIE does not use the term in a Marxist fashion, rather an *institutional individual* is. In OIE context, the *institutional individual* implied an actor, which is rational, but socially influenced. However, it is only possible to align NIE and OIE to a theoretical continuum if NIE is also able to accept the *institutional individual*. As NIE continuously attempts to interpret social influences in maximising terms this might seem impossible. Therefore, it is necessary to examine whether the NIE attempt to apply bounded rationality runs into logical difficulties if NIE persists to neglect the influence of informal mechanisms. In this context, the theory of bounded rationality is summarised in section (3.4.1). Section (3.4.2) will investigate the definition of bounded rationality as the concept, although often applied, appears to be badly defined. Section (3.4.3) considers explanatory difficulties coming from its weak definition and section (3.4.4) summarises the concept and implications of bounded rationality, while showing that bounded rationality does leave space for the *institutional individual*. 
3.4.1 Theory of bounded rationality

Firstly, fifty years ago, Herbert Simon noted two key limits to achieving perfect rationality. First it is usually not possible to obtain all of the information relevant to a problem by the time a decision has to be made. Secondly, Simon insisted that, in general, it would not be possible to deal with all that information in a manner that would permit optimisation. This let Simon to maintain that the best that one could hope for was “bounded rationality.” (Simon 1955) Simon urged scholars to substitute bounded rationality for substantive rationality (Simon 1976, 1978, 1979) and he noted, that "nothing is more fundamental in setting our research agenda and informing our research methods than our view of the nature of the human beings whose behaviour we are studying” (Simon 1985:303), a view that has also been very strongly stressed by Williamson as a reason to take bounded rationality seriously (e.g. Williamson 1985)

The concept of bounded rationality is too convincing to be further ignored by economists. It is as Conlisk argues (1996:691) “Bounded rationality, like elephants in a living room, are sometimes just too much to ignore. Standard economics is forced to recognise their presence.” Accordingly, even Becker has opened the door. In his Nobel lecture (1993), Becker says “Actions are constrained by income, time, imperfect memory and calculating capacities, and other limited resources” (p. 386) and he concludes “My work may have sometimes assumed too much rationality” (p. 402) And even Williamson (1998) argues that taking more account of the relevant psychological literature will improve the understanding of organisation “As an instrument for utilising varying cognitive and behavioural propensities to best advantage “(Williamson 1998:12). However, he seems mostly intent on demonstrating that the many findings of biased cognition and judgment are entirely consistent with “the transaction cost economic triple for describing human actors –bounded rationality, farsighted contracting, and opportunism” (Foster 2003:259) He, therefore, refrains from inquiring into how specifically these findings may add to and complement the transaction cost economics approach.
3.4.2 “Watered-down” version of bounded rationality

The term ‘bounded rationality’ later gained wide acceptance among economists and financial analysts, though in terms of a kind of constrained optimisation. Particularly since Milton Friedman (1953) bounded rationality was understood in terms of “the question is not whether people are rational, of course, they are not. The question is whether they act approximately as if rational; they do.” (Conlisk 1996:693) The reason why economists worked with such a “watered-down” (Foss 2003:258) version of bounded rationality is because of the well-known difficulties of aligning bounded rationality with the basic machinery of neoclassical microeconomics and game theory (Conlisk 1996, Rabin 1998, Camerer 1998). It was the common belief that bounded rationality simply could not be aligned with mainstream economics. (Foss 2003:258) Hart (1990, 700-701) sums up the sentiments of many formal economists when he argues that:

“I do not think that bounded rationality is necessary for a theory of organisations. This is fortunate because developing a theory of bounded rationality in a bilateral or multilateral setting seems even more complicated than developing such a theory at the individual level; and the latter task has already proved more than enough for economists to handle”

On the contrary, other economists have been less reluctant to work on explicit models of bounded rationality (Foss 2003:258), which shows in the massive body of largely psychology based research on the basis to human cognition and judgement. (See summaries by Conlisk 1996, Camerer 1998, Rabin 1998) Particular scholars in behavioural finance and behavioural law have achieved considerable success (as well as controversy). In addition, their success in turn, is due to the use of a more explicit and detailed views of bounded rationality, drawn from cognitive psychology. (Foss 2003:258) This could be the reason why Conlisk (1996:677) stated that evolutionary economics might be the mainstream economics of tomorrow. However, Simon himself never took much of an interest in, for example, the biases literature of Tversky, Kahneman, Thaler and Rabin although he was aware of it. (Foss 2003:258)
3.4.3 Explanatory problems with bounded rationality

Although many contributors to economics have agreed on the importance of bounded rationality, upon closer inspection, it turns out that there is little agreement on (1) what is the nature of bounded rationality (2) how it should be modeled and (3) its implications for the behavior and organization of firms. (Foss 2003:261) Hence, neither in mainstream nor in New Institutional Economics is rational individual behavior properly defined or modeled, which results in explanatory problems for these approaches. (Foss 2003:261) In general, the bounded rationality research effort in common economic theory may be understood as an attempt to elaborate and examine the insights that (1) the human capacity to process information is quite limited (2) humans try to economize on cognitive effort by relying on short-cuts, and (3) because of (1) and (2), as well as other factors, such as the influence of emotions on cognition, human cognition and judgment is subject to a wide range of biases and errors. (Foss 2003:261) The problem is that economists of organization have taken an interest in (1), have been less occupied with (2), and have almost entirely neglected (3). An attempt to bring bounded rationality more explicitly into economics should consider (2) and perhaps (3). According to Foss (2003:259) argument, the very “thin” version (essentially (1) above) which economists deal with has so far resulted in essentially no explanatory value-added, and it seems to be a reasonable expectation that being explicit about bounded rationality may yield more such value added. (Foss 2003:259)

3.4.4 Summary of bounded rationality

Bounded Rationality as originally introduced by Simon, means the impossibility to examine and calculate all possible options, therefore, ‘rational maximising’ is not possible. Although this fact is widely accepted, the theoretical implication is very limited in the sense that it is assumed that the actor is not rational, but acts as if he were rational. Therefore, with little exception like in behavioural economics it is seldom examined what exactly the nature of bounded rationality is,

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20 Foss suggests that the expression ‘procedural rationality’ is a more appropriate expression for bounded rationality (2003:256)
nor how to model it or what the exact economic implications of bounded rationality are. The reason for this ‘watered-down’ version of bounded rationality can be found in the difficulty of aligning neo-classical economics with cognitive aspects. However, the attempt to interpret rule following in maximising terms runs into logical difficulties as soon as bounded rationality is allowed to enter the picture. The recognition of culture, history and social embeddedness as decisive in being ‘bounded rational’ and moves NIE away from the *homo oeconomicus* assumption towards the *institutional individual* one. It is, therefore, no accident that Rutherford in relation to NIE and bounded rationality argues that “all of this is very reminiscent of much of the OIE” (Rutherford 1994:70) The acknowledgement of informal mechanisms behind observable outcomes moves us, according to DiMaggio, “beyond the polemical opposition of ‘calculus’ and ‘culture’ to ask not whether people act strategically, but rather under what conditions and how they do so”. (DiMaggio 1997:701)

⇒ By assuming bounded rationality NIE is simultaneously unable to reject the *institutional individual*

3.5 Conclusion Part I

As well, NIE as OIE criticizes NC assumption of unlimited knowledge and foresight, unrestricted competitive markets, stable preferences, fully specified property rights, and a ’neutral’ state. Both explicitly deal with institutions and do not consider them as a black box like NC and both shift the emphasis from physical-material allocation of scarce resources towards a focus on institutional parameters in which markets no longer posses a superiority as control mechanism. Both argue that growth is, to a large extent, institutional path determined with agents being conditioned by prevailing cultural norms, while simultaneously applying rational decisions. As a consequence, it may be asked what is left of the hardcore NIE or OIE propositions. It has been explored in the previous chapters that the only dividing line between NIE and OIE is in their focus on either *homo oeconomicus* or *homo sociologicus*. However, OIE writings show, that by applying the concept of *homo*
sociologicus and holism they do not mean the idea that economic actors are unable to do rational decisions. Rather OIE assumes a ‘less reductionistic’ version in form of an actor who chooses rational, but who is dependent on particular social circumstances and influences. Similarly, NIE applies bounded rationality as a concept to explain why actors are not able to choose rational. By applying the concept of bounded rationality, NIE acknowledges informal mechanisms behind the choice making process although they do not identify them. In this sense, both apply the concept of an institutional individual, which implies that a behavioural regularity is shown whenever old problems arise, but simultaneously, every problem has new features for which rational calculus is applied. In this sense, individuals are both rule followers and rational maximizer.

However, it is difficult to ascertain whether people choose or not since only behaviour is observable and not the choice. (Mazavinos 2001:55) As it is not possible to look into a persons mind, it is not possible to know if people act because they are following a rule or because they find a rational solution to a new occurring event. Therefore, it is not possible to differentiate whether a process is of NIE or OIE nature. However, since both NIE and OIE agree on the importance of rule following and rational choice they form a theoretical continuum rather than two opposing institutional thoughts. Such a theoretical continuum called NIEOIE applies an understanding of efficiency and choice while simultaneously allowing ‘non-economic’ variables to be decisive. In this sense, NIEOIE connects informal mechanisms with the formal institutional sphere and hence, overcomes the shortcomings of each approach.

Conclusion: NIE and OIE form a theoretical continuum called NIEOIE
PART II – INFORMAL FINANCIAL MARKETS

Part I examined the existing institutional theories of NIE and OIE and concluded that the use of an institutional individual connects the two approaches to a theoretical continuum of NIEOIE. The intention of Part II is to investigate whether reality reflects theoretical arguments of NIEOIE and in turn, if today’s economic situation requires the theory of NIEOIE. I chose financial markets in developing countries as the medium of investigation as they inhibit a special characteristic called financial dualism. Financial dualism refers to a situation in which informal forces create informal institutions while simultaneously formal institutions are created by the government. With over 80 percent of the world’s population being reliant on informal credit the interesting question is if contemporary financial market theories are able to incorporate an understanding of informality. In this context, chapter 1 explores whether an ‘institutional’ financial market theory is required, and whether existing theories are suitable. As the result suggests that a new financial market theory is needed, the interesting question is if NIEOIE could provide the theoretical foundation for such a theory.

However, question remains why NIEOIE should be able to do so since the approach in itself has little to do with ‘finance’. Therefore chapter 2 investigates the characteristics and functioning of informal and formal financial institutions. In this context it is asked whether OIE theorising, with focus on non-economic variables is applicable to informal finance and whether NIE, focusing on efficiency is suitable for formal finance. Apparently, the findings suggest that this is the case. Nevertheless, the pure existence of two institutional segments, one ‘belonging’ to NIE, the other ‘belonging’ to OIE, says little about the relevance of NIEOIE. Part I has shown that creating a theoretical continuum of NIEOIE is reasonable because it overcomes the respective theoretical shortcomings of both. Hence, the relevant question of Part II is, if connecting the two financial market segments to a financial market continuum overcomes the limitations of each sector. In this context, chapter 3 investigates if linking informal and formal financial arrangements is beneficial for both. In case that both institutional arrangements benefit from linkages, it suggests that the same reasons behind the theoretical continuum of NIEOIE are actually relevant for
building a financial market continuum between informal and formal financial institutions. Under these circumstances, NIEOIE has relevance to an actual market phenomenon, while simultaneously being able to serve as a theoretical foundation for future financial market theories.
I Financial Markets and Economic Development in LDCs

1.1 Why focus on financial markets?

The intention of this paper is to ask whether the theory of NIEOIE has potential applicability to economic policymaking and in turn whether reality requires the theory of NIEOIE. I chose to focus on financial markets for different reasons. Firstly, the factor trust in financial markets is more decisive and obvious than in goods market. In good markets transaction prices summarise all information relevant to the transacting agents. The issue of trust arises only in a peripheral manner such as vegetables might or might not be contaminated with chemical residues. The credit transaction, in contrast, involves a promise to repay in the future which may or may not be totally credible. This calls for the evidence of interpersonal trust which can only be partly established by a loan contract and collaterals. (Floro and Yotopoulos 1991:14) Since NIEOIE forms a theoretical continuum with the special feature to consider as well informal as formal institutional forces a market in which informal factors like trust play a great role from the beginning are interesting. The second reason for focusing on financial markets in developing countries concerns their condition of financial dualism. Financial dualism refers to a situation in which a large informal sector exists outside the regulations of the formal sector. In many countries, despite the knowledge of the existence of a large informal financial sector, policy makers have tended to direct economic policy without consideration of the likely impact informal financial activity will have on the efficacy of their policies. In view of the large size of informal finance and its weak linkages to formal finance, macro-economic policy-making becomes difficult and usually ineffective. Because informal finance is significant and has been growing there is increasing pressure on policy makers. (Aryeetey 1995:5, USAID 1998) Accordingly, there is an increasing need to design an economic theory that is able to deal with both informal and formal financial markets, and I believe that NIEOIE is able to provide this theory.
1.2 The importance of finance

Postulating a link between the financial system and economic development implies a rejection of neoclassical economics, since in orthodox models only exogenous factors have an impact on economic growth. Therefore, this section examines whether a relationship between finance and economic development can be found. The intention is to explore if an institutional economic theory for financial markets is required. In this context, section 1.2.1 deals with past discussions concerning the relationship of finance and economic growth; section 1.2.2 focuses on traditional growth theory in a neoclassical sense; section 1.2.3 deals with endogenous growth theory; and section 1.2.4 focuses on empirical evidence. Section 1.2.4 shows that financial deepening is decisive for economic development, although no causality can be established. Section 1.2.5 summarises the findings, suggesting that it is only possible to deal with financial markets by applying institutional theories.

1.2.1 Past discussion

There has been a considerable debate on the issue if and how the financial system or the level of financial development affects long-run growth. This discussion dates back to Walter Bagehot (1873) and Joseph A. Shumpeter (1912) stressing the importance of the banking system on the growth rate of national income. In 1911, Joseph Schumpeter argued that the services provided by financial intermediaries – mobilizing savings, evaluating projects, managing risk, monitoring managers, and facilitating transactions – are essential for technological innovation and economic development.21 On the contrary, Joan Robinson (1952) asserted that economic growth creates a demand for financial services. “Where enterprise leads finance follows” (1952:86) this view implies that financial deepening is just a “side-show” of economic development. Other economists just assumed that the financial-growth nexus is not of any importance. For example, Robert Lucas stated that “economists badly over-stress” the role of finance for economic growth. (1988:6) Particular

21 Other authors like Galbis continued in Schumpeter’s line and suggest “it may well be that financial development is a prerequisite, if not a major determinant, of the take-off into self-sustained economic growth.” (Galbis1977:59) Similarly, Gertler and Rose (1994) argue that economic growth and financial sector development are mutually dependent.

However, already in 1969 that Goldsmith demonstrated an empirical association between economic growth and the increasing size and complexity of the financial system (financial deepening) and broke with traditional growth theory. The contemporary body of empirical research (Levine 1997, Demirgüc-Kunt 2001) concludes that financial markets and institutions are critical for the development process and concludes that the level of financial development affects the speed and pattern of economic growth. (Levine 1997:689) Nevertheless, a direction of causality has yet not been established although common agreement exist that economic growth without financial stability and a proper working financial system is hardly possible.

1.2.2 Traditional growth theory

In traditional growth theory, financial intermediation could be related to the level of the capital stock per worker or to the level of productivity, but not to their respective growth rates. Postulating a link between financial development and economic growth entails relaxing some neo-classical assumptions. Firstly, in an Arrow-Debreu model with no information or transaction costs, there is no need for a financial system. Hence, it is the costs of getting information and making transactions that create incentives for the emergence of financial markets and institutions. Secondly, in a neo-classical growth model, only the exogenous technology factor affects the steady-state per capita growth rate. Thus, in this theoretical framework, the level or type of financial development could affect the long-term growth rate only via a very limited route if it directly affected the rate of technological progress. (Kotaro Tsui 2000:1)

1.2.3 Endogenous growth

A recent surge of interest in the link between financial development and economic growth has resulted mainly from the transformation of microeconomic
theory and the emergence of endogenous growth theory, driven by analysis of market failure due to asymmetric information and transactions costs. Different types and combinations of information and transaction costs motivate distinct financial contracts, markets, and institutions. (Levine 1997) This raises the possibility of an influence of institutional arrangements on growth rates by incorporating concepts previously thought of as non-economic: trust, customs, networks, commitment and so on. (Fine and Lapavitsas 2000:28) These models could thus offer important insights to the impact of financial development on economic growth. In an endogenous growth framework, financial development can promote economic growth either via its positive impact on capital productivity or via its impact on the efficiency of financial systems in converting financial resources into real investment. (Kotaro Tsui 2000) Although in a pure neoclassical framework the financial system is irrelevant to economic growth, in practice an efficient financial system can simultaneously lower the cost of external borrowing, raise the returns to savers, and ensure that savings are allocated in priority to projects that promise the highest returns, all of which have the potential for affecting economic growth rates.

1.2.4  Empirical evidence

The dynamic link between financial innovation and economic development is empirically investigated by King and Levine (1993). They prove by using the standard cross-country growth regression framework of Robert J. Barro (1991) that stock market liquidity and banking development both predict long-run growth, capital accumulation and productivity improvements.\(^2\)2 Recent microeconomic evidence complements Levine’s assumption. Asli Dermirguc-Kunt and Vojislav Maksimovic (1996) show that firms in countries with better-functioning banks and equity markets are growing faster than predicted by individual firm characteristics, and Raghuram G. Rajan and Luigi Zingales (1998) show that industries that rely more on external finance prosper more in countries with better developed financial markets. In those models, financial systems serve one primary function: they

\(^2\) However, their research had some fundamental weaknesses. Their empirical research could not establish that the direction of causality went from financial development to growth. The relationship could be coincidental, because other contemporaneous shocks affect both variables. Or, the causality could be reversed since high growth may lead to the emergence of more developed financial intermediaries and markets.
facilitate the allocation of resources, across space and time, in an uncertain environment. (Merton and Bodie 1995:12) In this context, it is assumed that financial institutions channel funds from surplus to deficit units by mobilising investible resources and ensuring efficient transformation of these funds into real productive capital. Nevertheless, it is important to note that growth in financial assets is not a sufficient condition for economic growth, and improved financial intermediation per se may not necessarily lead to economic growth (Bhatia and Khatkate 1975).

1.2.5 Summary finance and economic growth

The discussion whether finance pushes economic growth or whether economic development pulls financial deepening has still not been solved. However, one thing is certain, that finance, contrasting traditional growth assumption, does have an impact on economic development. In a pure neoclassical framework the financial system is irrelevant to economic growth, in practice an efficient financial system can simultaneously lower the cost of external borrowing, raise the returns to savers, and ensure that savings are allocated in priority to projects promising the highest returns, all of which have the potential for affecting economic growth rates. Therefore, traditional growth models have to be replaced by endogenous models where finance and growth are interrelated. Nevertheless, it is important to note that growth in financial assets is not a sufficient condition for economic growth, and improved financial intermediation per se may not necessarily lead to economic growth. On the contrary, economic growth without financial deepening is hardly possible. Since traditional growth theory built on NC theorising is not able to link finance and economic growth, NC models have to be replaced with institutional economic theory allowing for the relationship.

⇒ An institutional financial market theory is required because finance and economic growth are interrelated
1.3 Two opposing schools concerning financial markets

It has been shown in section (1.2) that financial deepening is related to economic growth and hence, institutional theory concerning the kind of a financial institution is required. In this context, two opposing schools emerged in relation to capital supply. Proponents of the bank-based financial system oppose those who argue that the market based capital supply system has the most positive effect on economic growth. The next section discusses these two prototypes of financial systems, the “bank-based” system and the “market-based” system with the intention to investigate which one is more appropriate. Section (1.3.1) considers the market based approach, while section (1.3.2) focuses on the bank based approach, section (1.3.3) outlines each concluding policy advice, section (1.3.4) searches for similarities between the bank-based approach and the market-based approach and section (1.3.5) shows that while both approaches differ, they are static due to their focus on information properties. Both build their approach around fixed institutional features and assets, while both do not consider that during development different assets and institutions are required. Therefore, neither can provide a sufficient policy analysis for financial markets in developing countries with changing financial demands and in particular not to countries suffering from financial dualism.

1.3.1 The market-based model

In the early 1970s, theoretical treatment of the relationship of the financial system to economic development came to be dominated by the literature on financial liberalisation originating in the work of McKinnon (1973) and Shaw (1973). The financial liberalisation model, developed by them, and exerted considerable influence on macroeconomic policy in developing countries in the 1970/80s, particularly through the recommendation of the IMF and the World Bank. This literature largely ignored the institutional structure of the financial system and concerned itself,
above all, with determination of interest rates. The analysis is based on the idea that many developing economies suffer from financial repression, a misguided development strategy of low interest rate ceilings and selective credit policies. Their main claim is that, if interest rates are kept artificially low by the state, savings will be low and inefficient investment will be encouraged thus fostering underdevelopment. It is argued that even though investment opportunities exist, growth is kept below its potential. (Fry 1989, McKinnon 1973: 59-61, Shaw: 1973:8).

1.3.2 The bank-based model

Post Keynesian models have focused on the assumptions about the availability and distribution of information between borrowers, lenders and financial institutions and the main work is usually undertaken within a principal-agent framework in which asymmetry of information allows participants in economic transactions to pursue divergent objectives. The relaxation of the perfect information hypothesis permitted these models to explain the role for financial intermediaries in a competitive economy: the lack of costless information gives financial intermediaries the role of assessing the credit-worthiness of borrower. A common theme in this new line of thought in financial economics is that informational asymmetries may introduce inefficiencies in financial markets which may have quantitatively significant real effects. Furthermore, the growing literature on information and incentives information also points out two problems in financial intermediation which can jeopardise the allocative role played by intermediation: adverse selection, where trading parties have asymmetric information prior to contracting, and moral hazard, where the asymmetries arise after contracting. Asymmetric information occurs when lenders have trouble determining whether a borrower is a good risk or a bad risk. Because of this lack of information, lenders will desire to pay for a security that reflects the average quality of firms issuing the securities – a price which is higher than the market value for high quality firms and too high for the low quality ones – a classical case of ‘the lemons problem’ proposed by Akerlof (1970). Hence, only low quality firms will be willing to sell their securities.
Stiglitz and Weiss (1981) also demonstrated, using a loanable funds framework, that adverse selection would generate credit rationing because low quality firms with riskier projects will be the one willing to pay the highest interest rates. If lenders cannot identify the riskiest projects, then the supply of loanable funds will shrink when interest rates increase, exactly the opposite result from that theoretically expected. The danger of moral hazard may prevent lenders from extending credit, if the interest rate makes it very attractive to do so. In other words, lending would be at sub-optimal levels. The two cases just point to the possibility that, due to asymmetric information, the financial system may not play its role as broker in the saving-investment process efficiently. In other words, in these cases loanable funds to investment will be lower than potential and allocation of resources will be distorted. This literature presents a challenge to the view that financial markets are efficient allocators of capital.

1.3.3 Policy implications

The market based models argue that financial repression reduces both the quantity and the quality of investment in the economy as a whole. Hence, McKinnon and Shaw (1973) conclude that financial liberalisation can increase economic growth by increasing investment and its productivity. What matters for development is free determination of interest rates, while the design of the financial system is not an important concern. This idea provides the basis for financial liberalisation which in turn, is often conditionally recommended by the World Bank and IMF. The first generation financial repression models are represented by, among others, Yoon Je Cho (1984), Vicente Galbis (1977), Basant Kapur (1976a), Yan-Pal Lee (1980), Donald Mathieson (1980), and Maxwell Fry (1978, 1980a/b).

25 It is important to differentiate between Stiglitz older and newer work since it reflects his personal development. While he in his early years supported the bank based approach he now states (1998, Prebisch Lecture, p. 9) “The ideological debate should be over; there should be agreement that while markets are at center of the economy, governments must play an important role. The issue is one of balance, and where that balance is may depend on the country, the capacity of its government, the institutional development of its markets. In other words, development advice should be adapted to the circumstances of the country.”
Stiglitz and Weiss (1981) argue that the theoretical approach of financial liberalisation is unsatisfactory since it treats price and quantity controls imposed by the state as the only reason for the absence of non-rationed equilibriums in credit markets. In contrast, they demonstrate that in the presence of asymmetric information, the unregulated operation of banks can lead to inefficiently high interest rates thereby discouraging productive investment and reducing the return to lenders by attracting increasingly risky borrowers. (Fine and Lapavitsas 2001:30) Further, it is pointed out that under asymmetric information the certainty and efficiency of contracting among financial institutions and productive enterprises might be unproductive. (Mayer 1987, 1988). Commitment by banks to enterprises is the key concept in this regard. A practical resolution of these problems is perceived through closer collaboration among contracting parties, encouraging long-term financial arrangements based on reputation and reducing reliance on anonymous market forces. (Fine and Lapavitsas 2001:30) Consequently, how banks relate institutionally to industry is of crucial importance for economic growth and performance. Commitment reflects a systemic reputational effect, or implicit contract, on both sides. (Aoki and Patrick 1994, see also Horuchi and Yoshino1992)

1.3.4 Similarities of market versus bank based approach

Despite their apparent differences, the two currents of market- versus bank-based policy share common conceptual foundations. Financial systems are compared with each other according to their basic functions concerning the ability of trading risk, allocating capital, monitoring managers, mobilising savings, and easing the trading of goods, services and financial services. (Levine 1997:689) However, both ignore, that although those basic functions remain constant through time and across countries, there are large differences across countries, in the quality of financial services and in the types of financial instruments, markets and institutions. (Boyd and B. Smith 1996). Reliance on the concept of asymmetric information prevents analysis of the financial system as a system in which various parts are organically

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26 For different ways of categorising financial functions, see Cole and Betty Slade (1991) and Robert C. Merton and Zvi Bodie (1995)
related to each other and the ‘real economy’. Instead, the financial system is treated as an agglomeration of institutions, markets and assets that might or might not exhibit certain informational properties. Hence, both currents treat information as an absolute fact in possession of market agents, rather than as a state of knowledge and trust among market participants that is conditional upon social, political and historical factors. (Lapavitsas 2001:29) Instead, the major aim of the two schools is to identify a design for the financial system that has optimal informational properties as shown in relation to (a) assets and (b) development advice.

**Assets**

Generally, the two opposing approaches proceed by constructing finance as a set of assets (for example, short- and long-term loans, or bonds as opposed to equity) and a set of institutions and markets (for example, money and bond markets, or commercial and investment banks). Usually a recommendation concerning state regulation (prudential or other) and of the degree of intervention in the allocation of credit is added. Correspondingly, *market-based* as opposed to *bank-based* systems are readily associated with the predominance of different types of assets, institutions, markets and regulations. (Fine and Lapavitsas 2001:35). However, in reality the distinction is not that obvious since developed countries usually possess the same types of institutions, markets and assets. The relative weight of particular types of assets in such systems often contradicts their conventional characterisation as bank- or market-based. (Corbett and Jenkinson1996) In Japan, for instance, market-based finance for investment purposes has been surprisingly high throughout the post-war period. Analogously, both German and US Corporation rely heavily on internally generated funds for investment (Corbett and Jenkinson 1997). Interestingly Corbett and Jenkinson conclude “that there is no market based Anglo-U.S. pattern of finance” (Corbett and Jenkinson 1996:71) and that “there is little evidence to support the view that Germany is a bank-financed system nor that the UK or the US are market financed” (Corbett and Jenkinson 1997:69) Thus, categorisation of financial systems on the basis of formal differences in institutions, assets, and so on will often result in misleading conclusions.

**Development context**
An additional misconception concerns the theoretical analysis of screening, monitoring and enforcing which are important for the relationship between finance and industry, but which are not continuous properties. The requirements of the real economy differ over time and at different stages of economic development. The specific social, historical and political context within which particular financial systems relate to industry is of importance and it can be misleading to follow a policy because it is consistent with either the market- or bank-based financial system. As Lapavitsas demonstrates (2001:35) it is probably, that the virtues of bank-based systems are less significant once large-scale corporations and conglomerates have been established that have the capacity to command sufficient long-term finance form a variety of diverse sources. Changes in telecommunications, computers, non-financial sector policies, institutions, and economic growth itself influence the quality of financial services and the structure of the financial system. (Levine 1997: 721)

1.3.5 Summary bank-based versus market-based approach

Section 1.2 concludes that although no causality between finance and economic growth exists, economic development without financial deepening is impossible. Therefore, an ‘institutional financial market theory’ is required. In this context, a discussion arose concerning the ‘best-practice’ concerning financial market policy and financial institution building. According to McKinnon-Shaw, free markets provide the most efficient development device for financial markets. (market-based approach) Stiglitz and Weiss in contrast, demonstrate the due to asymmetric information government intervention is often more efficiency enhancing than the free market. (bank-based approach) However, for both advocates the focus of analysis is mostly on the process of determining the prices and the quantities of credit under different informational properties. Reality proves this approach wrong since in less developed countries it is often not possible to determine either of them. Another problem embodied in as well the bank- as in the market-based is the static

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27 For example, differences in legal tradition (Rafael LaPorta et al. 1996) and differences in national resource endowments can produce different political institutional structures (Stanley Engerman and Sokoloff 1996)
nature of both models. Requirements of developing countries concerning capital supply are continuously changing, not only in space, but also in time. In this context, the discussion of market- versus bank-based approach seems to be rather useless. Accordingly Levine (1997:689) argues:

“...[My] approach discourages a narrow focus on one financial instrument, like money, or a particular institution, like banks. Instead, the approach prompts a more comprehensive – and more difficult- question: what is the relationship between financial structure and the functioning of the financial system. Indeed, the approach highlights the importance of examining an under researched topic: the relationship between financial structure – the mix of financial instruments, markets, and institutions – and the provision o financial services...”

Levine continues:

“...I do believe that we will not have a sufficient understanding of long-rung economic growth until we understand the evolution and functioning of financial systems. This conclusion about financial development and long-rung growth has an important corollary: Although financial panics and recessions are critical issues, the finance growth link goes beyond the relationship between finance and shorter-term fluctuations. Undoubtedly, the financial system is shaped by non-financial developments.” (1997:721)

The knowledge of factors decisive for financial development in individual cases and at particular times is important. Neither the bank- nor the market- based approach is a appropriate theory in dealing with changing financial demands. Therefore, neither is able to provide financial market policies necessary for economic development, in particular, not to countries suffering from financial dualism.

⇒ Existing financial market theories are not appropriate for LDCs because they are not able to deal with changing financial demands
2 The Financial Reality in LDCs

It has been shown that financial market policies require an institutional theory. Further, the findings suggest that contemporary existing financial market theories are too static to deal with changing economic demands and therefore, insufficient in their applicability to developing countries. It appears that a suitable financial market theory requires some non-economic variables as shown by Levine (1997:721) who states that “undoubtedly, the financial system is shaped by non-financial developments”. NIEOIE is able to combine informal with formal economic influences hence it appears reasonable to search for possible NIEOIE application towards financial markets.

Financial markets in LDCs are subject to financial dualism, a situation in which informal forces create informal institutions while simultaneously formal institutions are created by the government. The similarity of informality versus formality in reality and institutional theory is quite striking. Thus the aim of this chapter is to find out if the similarity concerning ‘informality’ exists just by using the term ‘informal’, despite different meanings or whether actually the same term is used in the same sense. In this context the intention is to examine the forces behind financial dualism (2.1) and to explore what informal finance implies and whether it can be justified to apply OIE (2.2). Further, it will be questioned whether the extent of informal financial arrangements is large enough to consider it as worth noticing or whether it is a small exception (2.3). Finally, it will be investigated in what respect informal finance differs from formal finance (2.4) and whether OIE is a suitable theory to capture the mechanisms behind (2.5).

2.1 Financial dualism

The main characteristic of financial markets in developing countries is financial dualism. Most LDCs are characterised by financial dualism a situation in which the formal financial sector co-exists next to an informal financial sector. The formal sector refers to an organised, institutional system catering to the financial needs of the monetarised sector, while the informal sector, itself unorganised and
'non-institutional', would deal with the non-monetarised spheres of the economy. Existing financial market theories do not consider financial fragmentation, although more than 90 percent of the population in developing countries is excluded from the formal sector. (Robinson 2001) Therefore, applicability and theoretical consistency of common financial market theories is extremely limited. In this context, Stiglitz (1998:3) argued that one of the biggest failures of development economics was to ignore the fact that most developing countries are dual economies.

⇒ Financial markets in LDCs are fragmented into a formal and an informal segment

2.2 Informal finance

Decisive for financial dualism is the existence of a large informal financial sector. Therefore, the following section defines informal finance by explaining (2.2.1) the terminology used (2.2.2) the main characteristics of informal finance; (2.2.3) the products of informal finance; (2.2.4) the fact of heterogeneity; (2.2.5) why informal finance is not an informal financial market; and (2.2.6) summarises informal finance as an unregulated, heterogeneous, dynamic sector which acquires its viability mainly through reciprocity.

2.2.1 Terminology

In this paper, the expression informal finance is applied to all financial transactions, loans and deposits, occurring outside the regulation of central monetary or financial market authority. An exact institutional definition is not possible because informal finance in itself is very heterogeneous. The terms informal, parallel, black, underground, fragmented, unorganised, and segmented and curb markets have all been used interchangeably in the literature to describe various forms of economic activity lying outside the officially regulated or monitored realm. (Montiel 1993:7)
2.2.2 People engaged in informal finance

Informal finance is of particular importance to those segments of the population who are excluded from the formal sector. Those people are usually poor and are not able not provide loan collaterals. Illiteracy rates make it impossible for them to sign and understand formal loan applications. Often distances from rural villages to the next bank are too far to travel and banks are seldom able to meet loan requirements as i.e. small overnight loans, consumption loans, seasonal loans. Alongside those who have no access at all to formal funds, informal finance also includes people who have access to formal sources, but who seek to supplement bank loans with informal funds or to take advantage of the speed of delivery of informal credit or to better integrate themselves into their community by participating in neighbourhood associations. (Germidis 1991:14) Informal finance reaches borrowers beyond the profitable reach of the formal sector. (Ghate 1992:6)

2.2.3 Characteristics

Informality is characterised by highly personalised loan transactions, entailing face-to-face dealings with borrowers and flexibility in respect of loan purpose, interest rates, collateral requirements, maturity periods and debt rescheduling. (Ghate 1992:6) Adams (1992) suggests that there are three types of informal sector activity:

1. non-commercial transactions among friends and relatives;
2. group arrangements for savings such as savings clubs, or arrangements combining savings and credit such as ROSCAs\(^\text{28}\);
3. Informal finance organised on a commercial basis, conducted by moneylenders, pawnbrokers, landlords, traders and other collector. (Nissanke & Aryeetey 1998:25)

Commercial informal transactions can be money-based, land-based or

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\(^{28}\) ROSCAS are rotating credit and savings associations, for descriptions of the working mechanisms of a number of ROSCAS see Ardener 1964, Besley et al. 1993, Bouman 1995, Germidis et al. 1991, Ghate 1988, Thomas 1993, von Pischke 1991
commodity-based, such as those used by trader-moneylenders for interlinked market transaction. (Germidis 1991) Such tied credits may be ubiquitous, accounting for a large proportion of total informal credit in many countries. (Nissanke and Aryeetey 1998:26) For example, Montiel (1993), reports a survey result from Malaysia, which suggest that the traders purchasing agricultural product provided almost two-thirds of all rural credit. Many group-based organisations operate on an agreed discipline and the principle of solidarity. They are often based on funds generated from member’s savings and this indicates the importance of reciprocity. Linking credit with savings encourages the poorest to save and generally ensures high repayment rates. (Nissanke & Aryeetey 1998:26)

Informal financial activity is present in both rural and urban areas; though, in terms of financial activity, the informal sector is generally more important in rural areas. (Germidis 1991:17) The informal sector in some countries may be rather more complex and evolved, not only from the point of view of structural and operational characteristics, but also in terms of the weight it carries in overall financial activity. Examples of partnership firms which are often found in Indonesia while indigenous bankers and pawnbrokers are found primarily in India. (Germidis 1991:16) By its very nature, informal activity is not specific to any one sector. If anything, it can be expected to pervade all sectors of the economy.

2.2.4 Heterogeneous informal finance

In general, informality is characterised by a strong flexibility and individuality in respect of loan purpose, interest rates, collateral requirements, maturity periods and debt rescheduling. (Ghate 1992:6) The economic components of informal finance are particularistic, and may even be unique to a particular borrower and his relationship with the lender. Informal finance as a term encompasses the mobilisation of savings as well as the extension of credit. Informal lenders provide financial services as well as credit, including the transfer of funds within countries, remittances between countries, guarantees, safe-keeping, and insurance. (Adams and Pitchett 1992:2)
2.2.5 Informal finance and not informal financial market

Economic transactions in the informal sector are embedded in social relations implying non-market institutions as borrowing and lending between friends and relatives, which is mainly based on reciprocity. Therefore, Ghate (1992:5) argues that the term informal finance is rather appropriate than informal market since market is misleading when applied to some types of credit such as interest free loans between friends and relatives, the terms of which are set not by impersonal market forces, but by social relations between parties. Accordingly the interest rate does not only reflect the scarcity of money and risk as in the formal sector but also to a large extent the individual relationship between lender and borrower. Even predominantly commercial informal transactions often have a residual non-economic component. (Nissanke 1998, Ghate 1992, Adams 1992)

2.2.6 Summary informal finance.

Informal finance is an important loan provider for underprivileged people excluded from the formal financial sector. Exclusion occurs because either the formal sector is not able to fulfil the requirements of the poor or because the poor do not fulfil the requirements of the formal procedure. Informal finance is unregulated and heterogeneous in its loan provision and agreements are often market-interlinked. Credit arrangements are mainly built on reciprocity and are often as individual as the lender-borrower relationship itself. Therefore, informal financial arrangements have few similarities with formal financial market mechanisms. Rather the efficiency focus of mainstream financial theories is replaced with an emphasis on the relationship between individuals. As shown above, the relevance of social connections on the interest rates composition is more prominent than the aspect of profit.\(^2\) Therefore, interest free loans between family and friends are quite common. However, exaggerated interest rates are also occurring when moneylenders have extraordinary power. In this context, the social embeddedness is decisive for market relations. Reciprocity, culture, class, gender, power and social status are the variables

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\(^2\) A more detailed analysis about the interest rate composition in the informal sector will be given in Part III, section 2.1
that mainly influence the interest rate of the informal sector. Those variables are
neither captured in mainstream economics nor in common NIE theorising. Instead,
these variables are, as shown in Part I, subject to OIE. Thus it is reasonable to argue
that OIE is a suitable theory to capture the mechanisms behind informal
arrangements.

⇒ The factors relevant for the working mechanisms behind informal
financial arrangements are also the relevant factors to OIE theory.
Therefore, OIE is a suitable theory in relation to informal finance.
Table 8: Informal Savings and Credit Arrangements

<table>
<thead>
<tr>
<th>TYPES OF LINKS</th>
<th>LENDERS</th>
<th>BORROWERS</th>
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<tbody>
<tr>
<td>Non-commercial arrangements</td>
<td>Friends</td>
<td>Small farmers</td>
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<td></td>
<td>Neighbours</td>
<td>Small business and relatives</td>
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<td></td>
<td>Households</td>
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<td>Commercial credit arrangements</td>
<td>i )money-based</td>
<td>Small farmers</td>
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<td></td>
<td>Professional moneylender</td>
<td>Small business</td>
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<td></td>
<td>Mobile bankers</td>
<td>and households</td>
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<td>Individual</td>
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<td>Private individuals</td>
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<td></td>
<td>From upper income groups</td>
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<td></td>
<td>ii )land-based</td>
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<td></td>
<td>Landlords</td>
<td>Tenants</td>
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<td></td>
<td>Farmer moneylender</td>
<td>Small farmers</td>
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<td>Moneylending</td>
<td>ii )commodity based</td>
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<td></td>
<td>Trader-moneylender</td>
<td>Small farmers</td>
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<td></td>
<td>Agricultural input dealers</td>
<td>Small business</td>
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<td></td>
<td>Equipment suppliers</td>
<td>Household</td>
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<td>Processors (rice miller)</td>
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<td></td>
<td>Produce traders</td>
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<td>Itinerant traders</td>
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<td>Market vendors</td>
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<td>Storeowners</td>
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<td>Savings arrangement</td>
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<td>Fixed-fund associations</td>
<td>Small farmers</td>
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<td>Mutual aid associations</td>
<td>Small farmers</td>
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<td></td>
<td>Savings clubs</td>
<td>Small business and households</td>
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<tr>
<td>Associations</td>
<td>Combined savings</td>
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<td></td>
<td>Informal credit unions</td>
<td>Small farmers</td>
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<td></td>
<td>Informal savings and loan</td>
<td>Small business</td>
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<td></td>
<td>Co-operatives (ROSCAS)</td>
<td>and households</td>
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<td>Partnership Firms</td>
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<td>Financial intermediation</td>
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<td>Pawnbrokers, Finance,</td>
<td>Small business</td>
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<td>Investment, Leasing and Hire-</td>
<td>and households</td>
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<td></td>
<td>purchase companies</td>
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<tr>
<td></td>
<td>Indigenous bankers</td>
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</table>


2.3 Size of informal finance

To underline the importance of the informal sector and its decisiveness concerning financial market policies, the following section will give a few estimates concerning the size. By its very nature, it is difficult to arrive at a reliable estimate of the relative size of informal finance. In general, two different kinds of estimates
dominate the literature (1) estimates size of the non-monetalised sphere in relation to GDP for example, the figure for Africa, Asia and Latin’s America range from a low 2% to a high 50% of GDP (2) Another way of assessing the extent of informal financial activity would be to consider the number of persons who are members of informal savings and credit associations. (Germidis 1991:41) In my opinion, the latter is the more appropriate approach since economic development not only implies GDP growth, but also decreasing income inequality. Just to mention a few figures in this context,

Approximately 70% of the population of Cameroon participates in the informal financial sector and informal sector saving is estimated to be more than 50% of the total. (Nissane 1998:47)

- It is estimated that over 80% of Zimbabwean smallholders have access to informal credit, while in Zambia over 80% of the urban population are estimated to participate in the informal financial sector (African Development Bank 1994)
- According to Zeller (2000),30 less than 5 percent of the amount borrowed by poor rural households Pakistan and Cameroon was obtained from formal lenders.
- Aryeetey (1995:12) concludes that 77% of market women saved with the informal Susu31 collector.
- Montiel et al. 1993, reckon that the share of informal credit in total credit varies from about a third to about three quarters in Asian developing countries.
- An OECD study estimates that the share of informal credit may range from 30% to more than 80% of total rural credit (Germidis et al. 1991).
- In sub-Saharan Africa, the share of the informal sector is larger than that of the formal sector in both credit provision and savings mobilisation (Aryeetey 1997)

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30 Zeller 2000 (IFPRI Policy Brief NO. 1, March 2000)
31 Susu collector are informal moneylender in Ghana
• In general, it is estimated by Marguerite s. Robinson (2001:9) that “about 90% of the people in developing countries lack access to financial services from institutions.

• And According to the World Bank, World Development Report 2000, 2001 Some 80 percent of the worlds 4.5 billion people living in low and lower middle income economies do not have access to formal sector financial services which are 3.6 mil. People

If it is assume that the latest estimate of the quite conservative World Development Report in 2001 is close to reality, the question arises how financial market theories can have any validity without considering those markets. In the view of the large size of informal finance and its weak linkages to formal finance, macro-economic policy making becomes difficult and usually ineffective. (Aryeetey 1995:4) This suggests that informal activity in the financial market may be critical to understanding the effects and the efficacy of economic policy. (Montiel 1993:10)

⇒ The understanding of informal financial markets is due to their size and the number of people engaged decisive for financial market practices

2.4 Formal financial sector

The interest rate of the formal financial sector is dominated by the scarcity of money and risk. In contrast the interest rate composition of the informal sector is mainly based on relational factors. In the formal financial sector information properties and their influence on efficiency are the decisive factor. The following section discusses the formal financial sector by demonstrating the characteristics (2.4.1); defining the three levels of formal financial sector activity (2.4.2); differentiating the degree of regulations concerning formal finance (2.4.3); and contrasting informal with formal finance while simultaneously showing that formal finance is subject to NIE theorising (2.4.4).
2.4.1 Characteristics formal financial sector

According to Germidis (1991:13), the formal sector refers to an organised urban-oriented, institutional system catering to the financial needs of the monetised modern sector. The formal sector institutions are regulated and licensed as financial intermediaries, usually comprising the central bank, commercial and merchant banks, development or other specialised banks and non-bank financial institutions. (Nissanke & Aryeetey 1998:25) Informal financial activities are usually localised and confide to small and short-term transactions or seasonal requirements e.g. cash flow and liquidity management. In contrast, formal institutions are largely located in urban areas, and their operations are characteristically urban-biased, involving larger transactions. Germidis (1991) depict formal institutions by their bias in the mobilisation and allocation of resources:

1. A preference for the public over the private sector
2. A preference for large-scale enterprises and upper income households over small-scale enterprises and low income households
3. A preference for non-agricultural over agricultural loans.

2.4.2 Three levels of formal finance

The formal financial sector can be represented on three levels. The first level is that of the central bank which, in developing countries, often oversteps the prudential functions it is assigned to and assumes an increasingly interventionist role in local financial activity. Another characteristic of formal finance is the predominant role of the treasury. The second level is composed of a myriad of banking and non-bank financial intermediaries, including commercial banks, merchant banks, development banks, savings banks, building societies, postal savings networks, specialised financial institutions, social security schemes, provident funds, and insurance companies. As for the third level, i.e. capital markets, developing country experiences are multifarious, ranging from the relative atrophy of money, bond, or stock markets, in Africa to what the IFC has labelled “emerging capital markets” in certain Asian and Latin American countries. (Germidis 1991:15)
2.4.3 Regulation in formal finance

As regards the formal financial sector, two main cases may be distinguished: the first is that of a closely “regulated” financial sector where government control over and intervention in the activities of financial institutions is extensive, often at the expense of the development of financial markets; the second is that of a more liberalised financial sector, where financial institutions have great leeway in carrying out their intermediation activities, and where market mechanisms are promoted. Centered between these two theoretical archetypes, there is a whole range of ways and degrees too which control is exercised. For example, controlled financial systems such as that of Ethiopia can be contrasted with the more liberalised systems of Zimbabwe (mid 1990), the Philippines and India; in between, the financial systems of Mexico, Indonesia, Burundi and Zambia could be described as “mixed and evolving” towards more liberalised policies. Regulation by the public authorities may be carried out through the market (Zimbabwe and Philippines) or through direct control of financial institutions (India, Indonesia). (Germidis 1991:13)

2.4.4 Summary formal finance

Formal finance focuses on information properties and is more readily able to accommodate large and long-term loans because of its greater reliance of the pooling of deposits and maturity transformation. It thus, enjoys greater economies of scale and scope, although not necessarily of specialisation. Modern telecommunications and data processing technology enable it to transmit claims over long distances almost instantaneously. Formal finance is better suited to the needs of large and medium-scale industry, organised trade and commerce and well to do urban household, but it is less successful in serving the needs of the large unorganised sector in developing countries, small and micro-entrepreneurs, small traders, and small and poor borrowers generally. (Ghate 1992:16) NIE is able to deal with large and medium-scale finance since both share the focus on efficiency under information

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32 See the previous discussion concerning bank versus market based financial growth perspective
constraints. Further, focusing on urban households makes it easier to hold the assumption of ‘rational individual maximising’ since personal relations are less relevant. In general, formal finance has an information advantage in exploiting economies of scale in portfolio management and in diversification to allow risk pooling and maturity transformation. However, NIE has a disadvantage in dealing with relational financing as apparent from the informal sector, which does not follow NC efficiency aspects.

⇒ NIE captures the efficiency enhancing assumptions behind the formal financial market mechanism

2.5 Financial dualism and OIE

Financial markets in developing countries are subject to financial dualism, a situation in which the financial market is divided into an informal and a formal segment. With more than 80% (World Bank 2001) of the world’s population being dependent on informal finance a financial market theory, not considering informal financial institutions, can never be applicable. In this context, the informal sector was examined while suggesting that efficiency aspects seem to be rather unimportant. The efficiency aspect in informal finance is replaced with a focus on the specific relationship between the individual borrower and lender. Informal financial agreements are based on culture, reciprocity, networking, family, kindness, and power. These factors are most important to OIE, hence, the informal sector reflects OIE theorising. In contrast, the formal sector focuses on efficiency, information, and economies of scale. The mechanisms behind the formal financial sector with its particular focus on information properties seem to reflect NIE theorising. The large number of people dependent on informal finance raises the question whether any contemporary financial market theory can be applicable without recognising the informal financial sector. Since the informal financial sector reflects the mechanisms relevant for OIE, it suggests that any applicable financial market theory must inhibit a degree of OIE reasoning.
⇒ Financial market theories in relation to LDCs must consider non-economic variables
Table 9: Financial Circuits in Developing Countries

<table>
<thead>
<tr>
<th>FORMAL FINANCIAL SECTOR</th>
<th>INFORMAL FINANCIAL SECTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>BANKS AND OTHER FINANCIAL INTERMEDIARIES</td>
<td></td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>Professional moneylenders</td>
</tr>
<tr>
<td>Indigenous banker</td>
<td>Finance companies</td>
</tr>
<tr>
<td>Pawnbroker, etc.</td>
<td>Investment companies</td>
</tr>
<tr>
<td>Merchant Banks</td>
<td>Trader-lenders</td>
</tr>
<tr>
<td>Landlord-lenders</td>
<td></td>
</tr>
<tr>
<td>Farmer-lenders</td>
<td></td>
</tr>
<tr>
<td>Storeowners</td>
<td></td>
</tr>
<tr>
<td>Development Banks</td>
<td></td>
</tr>
<tr>
<td>Savings Banks</td>
<td>Fixed-fund associations</td>
</tr>
<tr>
<td>Building Societies</td>
<td>Savings Clubs</td>
</tr>
<tr>
<td>Postal Savings Networks</td>
<td>Self-help organisations</td>
</tr>
<tr>
<td>Co-operative Banks</td>
<td>ROSCAS</td>
</tr>
<tr>
<td>Mutual Banks</td>
<td>Chit funds</td>
</tr>
<tr>
<td>Social Security Institutions</td>
<td>Mutual Aid Associations</td>
</tr>
<tr>
<td>Provident/ Pensions Funds</td>
<td></td>
</tr>
<tr>
<td>Insurance companies</td>
<td></td>
</tr>
<tr>
<td>CAPITAL MARKETS</td>
<td></td>
</tr>
<tr>
<td>Stock</td>
<td>Friends</td>
</tr>
<tr>
<td>Bond</td>
<td>Neighbours</td>
</tr>
<tr>
<td>Money</td>
<td>Relatives</td>
</tr>
<tr>
<td>Foreign exchange</td>
<td>Private individuals from upper income</td>
</tr>
<tr>
<td></td>
<td>Groups, Rural financial markets,</td>
</tr>
<tr>
<td></td>
<td>Informal foreign exchange markets</td>
</tr>
</tbody>
</table>

Source: Based on Table 2.1 Germidis, Informal Markets, 1992, p. 28
3 Relationship between Informal and Formal Finance

Associating NIE and OIE to a theoretical continuum called NIEOIE makes only sense if each is able to provide theoretical advantages in relation to the shortcomings of the other. While this is the case with the theory as shown in Part I the question remains if this is also the case in reality with informal and formal financial arrangements in LDCs. It has been shown that OIE is the appropriate theory to deal with informal financial markets, while NIE is equally suitable for formal financial markets. Further, it has been argued that the enormous size of people reliant on informal finance suggest that only a theory that includes informal markets can be appropriate. Despite this finding, it has been proposed by the financial repression school, that informal finance can be neglected because it is ‘only’ a negative side effect of financial repression and transition. If this is the case, informal financial arrangements can be ignored and hence, OIE is useless. Thus, only if informality inhibits an advantage in its own structure it makes sense to capture those advantages. Additionally, it can only be justified to apply NIEOIE theory towards financial markets if the linkage between informal and formal financial institutions is beneficial for both. Thus the first chapter will examine the origin of informality according to the financial repression school (3.1), following it will be investigated if the if the argument reflects reality (3.2). As the findings contradict the assumption announced by the financial repression school it will be questioned if the existence of informal institutions can be explained by having comparative advantages in their individual structure (3.3). In case advantages do exist, it will be further, explored if a linkage between informal and formal financial institutions is beneficial for both (3.4). In case, linkages are beneficial for the growth potential of both sectors, it suggests that the same reasons justifying a theoretical continuum of NIEOIE are relevant for creating a financial market continuum. Under these circumstances NIEOIE has relevance to an actual market phenomenon.

3.1 The financial liberalisation school

The informal sector, despite its size, was neglected in financial market theories due to the practical and theoretical domination of the financial liberalisation
school. Although the financial liberalisation school perceived credit markets as fragmented and imperfect, they argued that this is a result of government policies, which have repressed the growth of credit markets rather than an inherent characteristic of the market itself. (Floro 1991:9, McKinnon 1973, Shaw 1973) The following section summarises the financial liberalisation school by showing how repressive policies cause fragmentation (3.1.1); asking what the growth implication of financial repression are (3.1.2); explaining the interest rate/savings nexus according to McKinnon and Shaw (3.1.3); and the assumption that that financial liberalisation would eliminate financial dualism. (3.1.4) Finally the findings will be summarised in section (3.1.5).

3.1.1 How repressive policies cause fragmentation

Repressive policies are seen as the prime cause of fragmentation (Roe 1991, Montiel 1993, Frey 1988). It is argued that ‘informal financial markets develop and thrive in circumstances where formal financial institutions are severely hindered by distorted polices and generally repressed’ (Roe 1991:2) Ceilings on deposit and loan rates tend to raise the demand for funds and depress the supply. Dissatisfied demand for investible funds then forces financial intermediaries to ration credit by means other than the interest rate, and this encourages the development of an informal market at uncontrolled rates. A segmented credit market emerges with informal financial markets to fill the credit gap and serve as an alternative vehicle for saving. (Montiel 1993:45) On the formal market, favoured borrowers obtain funds at subsidised, often highly negative, real interest rates, while other must seek credit in expensive and unreliable informal markets. As McKinnon argues “Fragmentation in developing countries .in the sense that firms and households face ….different effective prices for land, labour, capital and produced commodities…has been largely the result of government policy.” (1973:5) Indiscriminate distortions of financial prices control over credit allocation, interest rate ceilings and rigidly fixed exchange rates are seen as retarding economic growth by reducing the relative size of the financial system and remitting distorted signals. (Nissanke 1998:19)

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33 The financial liberalisation school has heavily influenced World Bank thinking, throughout the 1980s and 1990s. This is evident throughout the World Banks own publications. For example, World Bank 1983, pp. 58-59, World Bank 1989, p. 171, and World Bank 1994, pp. 114-115
3.1.2 Growth implication of financial repression

It is important to note here that financial repression not only causes fragmentation, but also is the major obstacle for economic development. The main propositions of the McKinnon and Shaw school on the consequences of repressive policies are (Nissanke 1998:19):

Economic growth in a financial repressed economy is constrained principally by the low level of saving, not by the absence of good investment opportunities. Ceilings on deposit rates penalise financial saving and result in a lower rate of investment, which diminishes the potential for economic growth.

Real interest rates should reflect capital scarcity, and thus, interest rate ceilings reduce the efficiency of capital allocation and with it the quality of investment. By reducing the scope for risk premier, loan rate ceilings discourage risk-taking by financial institutions. A large proportion of potentially high-yielding investments are thereby rationed out of the market.

In short, financial repression is perceived to have a number of adverse macroeconomic consequences, including the creation of informal financial institutions.

3.1.3 Interest rate-savings nexus

According to McKinnon-Shaw, in developing countries money is held as a store of value, rather than simply for transactions purposes. Consequently, the real return on money represents the marginal return to savings while a low real interest rate on money, consisting of a low nominal interest rate on deposits, often combined with a high rate of inflation, tend to depress private savings. Because the accumulation of money balances and physical investment are complementary, as in McKinnon (1973), the reduction of savings reduces investment in physical capital. Moreover, low administratively-determined interest rates on bank loans ensure that credit will be rationed by non-price means, implying that many low-return projects
will be financed, artificially depressing the aggregate rate of return on investment. Financial repression, thus reduces both the quantity and quality of new investment, and thereby also the economy’s rate of growth. Economists in the McKinnon-Shaw tradition emphasise and additional feedback from low growth to lower saving through a standard life-cycle mechanism, which in turn, magnifies the adverse effects described above.\textsuperscript{34} (Montiel 1993:46)

3.1.4 Policy conclusion

The policy conclusions that follow from the financial repression thesis are financial liberalisation, deregulation, and the removal of government intervention form all aspects of financial markets which should enable the formal sector to expand its frontier and thereby, eliminate the need for informal finance. It is argued that financial liberalisation leads to financial deepening; improved efficiency, resulting in lower spreads between borrowing and lending rates; and increased flow of funds between segments, including better access to formal finance of previously marginalised savers and borrowers. (Steel et al. 1997:6; Nisanke 1998) Accordingly, what is needed is plentiful credit at high real interest rates. Such policies would increase total savings, improve the efficiency of investment and either because of the complementarities of money and capital or because of the increased availability of credit increase investment. (Montiel 1993:47) The financial liberalisation hypothesis (McKinnon 1973, Shaw 1973, and Frey 1982, 1988), which coined the term “financial repression” represents the currently dominant strains of thinking about developing country financial markets. Further, the forceful criticism of financial repression by economists in the McKinnon-Shaw tradition has provided the intellectual underpinning for the movement towards financial liberalisation in many parts of the Third World. (Montiel 1993:45)

3.1.5 Summary financial repression school

\textsuperscript{34} For a more detailed treatment and mathematical models see McKinnon 1973, Shaw 1973, Frey 1988, Montiel 1993
Financial market policies neglect the informal financial sector, despite its acknowledged existence because it is considered as a negative side effect caused by ‘financial repressive’ policies. Underlying is the assumption that interest rate ceilings tend to raise the demand for funds and depress the supply. Dissatisfied demand for investible funds then forces financial intermediaries to ration credit by means other than the interest rate, and this encourages the development of an informal market at uncontrolled rates. The policy conclusions that follow from the financial repression thesis are financial liberalisation, deregulation, and the removal of government intervention form all aspects of financial markets which should enable the formal sector to expand its frontier and thereby eliminate the need for informal finance.

⇒ According to the financial repression school, informal markets are caused by government intervention

3.2 Reality contradicts financial repression school

As can be seen in reality informal markets are not - or at least ‘not only’ – caused by financial repression or a transition phenomenon. Informal financial markets continue to exist and its proportion of GDP and population is continuously rising despite increasing financial liberalisation. (Aryeetey 1995, USAID 1999, World Bank 1998) Those findings contradict the McKinnon-Shaw reasoning. Under financial liberalisation policy, the informal sector was supposed to be a transitional phenomena becoming irrelevant during the course of financial liberalisation. Based on neoclassical reasoning it was assumed that the emergence of informal finance is a natural product of market mechanisms. The laws of supply and demand expect alternative sources of finance to appear as long as the official supply of credit falls short of actual market demand for credit. (Tsai 2002:7). However, reality proves that the explanation is not sufficient. For example, in Argentina, one of the most liberal financial systems, only 5 percent of the population has access to formal finance. (Schreiner 2001) Bagachwa and Naho (1994) estimate that the ‘second’ economy in the United Republic of Tanzania has grown from 20% of the official GDP in the late
1960s to a sizeable 40 percent of GDP after the mid-1980s.\textsuperscript{35} If commonly applied theories are not able to justify the existence and growth of the informal financial sector, despite many years of financial liberalisation, another explanation is required.

⇒ Financial market fragmentation exists despite financial liberalisation requiring another theoretical explanation, therefore another explanation is required.

3.3 Advantages informal sector

Section 3.2 demonstrated that despite increasing financial liberalisation, informal finance continues to be vital and growing. It seems that informal finance is not just a negative side show of economic development as argued by the financial repression school. Rather informal finance seems to be an inherent characteristic of the financial market itself. As such it should inhibit advantages in relation to formal finance. Identifying this advantage can give insights about financial market dynamics in developing countries and might be utilised for economic development. Further, identifying advantages gives the informal sector its theoretical ‘right’ for existence. Hence, the following section intends to search after informal finance advantages. The text will proceed by enquiring reasons for the preferences of informal arrangements over formal ones (3.3.1); the distribution of informal finance and its savings potential (3.3.2); the productivity of informal credit and the importance of consumption loans (3.3.3); the limitation of formal arrangements (3.3.4); the wrong assumption about monopoly rents (3.3.5). The findings will be summarised in section (3.3.6).

3.3.1 Preference of informal over formal

Poor people often prefer informal finance to formal finance, although it charges higher interest rates, because access to informal finance is relatively easy - in comparison to the formal sector transactions are easily understood. Formal finance

\textsuperscript{35} See also the section 2.3 concerning the size of the informal sector.
requires literacy rates and collaterals - both are not common between the poor. (Germidis 1991:17) Due to the rapid processing of requests and delivery of credit, it meets the demand of the lower income households concerning seasonal financing of consumption and production. (Germidis 1991:17) Transactions are based on the confidence engendered by face-to-face relationships between creditor and debtor; there is usually no collateral involved and security on loans is contingent upon the borrowers past savings and credit record and on social pressure to abide by certain rules of behaviour. Informal finance relies instead, on collaterals or interlinked credit contracts with land, labour or product markets36.

3.3.2 Distribution and saving

Informal finance is also much better distributed than formal finance. Informal finance - because it functions outside the purview of regulations imposed on the formal sector - has a flexibility that develops dynamism of its own, adapting to the needs of the communities in which they operate. (Nissanke 1997, Ghate 1992:6) The dissatisfied demand for credit of those excluded by the formal sector is met by heterogeneous informal lenders. (Nissanke and Aryeetey 1998) Although informal institutions are very heterogeneous all of them have the features of informality, adaptability and flexibility based on reciprocity. Therefore, informal finance is concentrated wherever there are substantial amounts of commercial transactions regardless of the state of development of formal financial markets. The proportion of poor people in informal finance is large and informal loans and deposits are common among all economic classes (Adams and Pitchett 1992:3)

Many group-based organisations are operating on an agreed discipline and the principle of solidarity. They are often based on funds generated from member’s savings and this indicates the importance of reciprocity. Linking credit with savings encourages the poorest to save and generally ensures high repayment rates. (Nissanke and Aryeetey 1998:26) Therefore, informal finance also provides deposit opportunities. Someone must save to provide each unit of money circulating in

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36 Product-related loans can be output-tied loans, input-tied loan or loans from market agents (Germidis et al. 1991)
informal finance. Large amounts of informal loans mirror an equally large amount of informal financial savings. (Adams and Pitchett 1992:3) Indeed, the link between prior savings and credit is stressed much more in the informal sector than in the formal one. (Germidis 1991:18) Informal finance allows millions of individuals, firms, and households in low income countries who have surplus funds to redeploy them as loans to individuals and firms who have better economic opportunities. This results in an increase in output and in capital formation over what would occur if informal financial markets did not or could not operate. (Adams and Pitchett 1992:4) While informal loans and savings may be small in absolute terms, they are often as large in relation to a borrower’s income and assets as are formal loans.

3.3.3 **Productivity and consumption loans**

In contrast, to common thinking, small borrowers often use credit more productively than borrowers in the formal sector. Hence, informal finance serves as well equity as efficiency. (Ghate 1992:6) Knowledge of borrowers, often based on close relationships, gives informal lenders a competitive edge in transaction costs, though at the same time it limits them to their local network. Informal associations and agents also have a competitive edge in small and short-term deposit mobilisation, which is untapped by formal institutions. (Nissanke and Aryeetey 1998) It has been argued that informal finance serves only unproductive consumption loans. However, according to Ghate (1988) consumption loans cannot be regarded as unproductive per se because (1) they serve as essential loans for emergencies and subsistence, (2) productive loans for housing, education, migration, (3) loans for the purchase of consumer durables which may be used for productive purposes, such as sewing machines and typewriters; and (4) loans for conspicuous consumption. It is also questionable as to what extend food at subsistence level can be considered as consumption in the common sense. Particular since on average 60-70 percent of expenditures is incurred for food.\(^{37}\) (Zeller 2000) Hence, in poor households, levels of consumption and investment are inseparable in the sense that consumption and

\(^{37}\) Zeller (2000) in one of the IFPRI studies uses data from Bangladesh, Cameroon, China, Egypt, Ghana, Madagascar, Malawi, Nepal and Pakistan.
nutrition are important to households ability to earn income since family labour is by far the most important production factor. (Zeller 2000)\textsuperscript{38}

3.3.4 Restriction of formal finance

Formal finance is more readily able to accommodate large and long-term loans because of its greater reliance on the pooling of deposits and maturity transformation. It thus enjoys greater economies of scale and scope, although not necessarily of specialisation. (Ghate 1992:16) Formal financial institutions tend to neglect the mobilisation of household savings, and devote their efforts instead, to allocating credit and creating money. (Zeller 2000) Formal financial institution display, as Germidis (1991:17) calls it, a ‘triple bias’ with regard to both the mobilisation and allocation preference for the public over the private sector, for large-scale enterprises and upper-income households over small-scale enterprises and lower-income households, and for non-agricultural over agricultural loans. (Germidis 1991:17) Formal institutions are limited in their scope of action because they excluded the large proportion of would-be clients for whom consumption credit may sometimes be a necessity before productive investment can follow.

3.3.5 Monopoly rents

Informal markets are usually characterised by free entry and exit. However, this does not guarantee active competitions because of the restricted information flows among participants. One of the central issues on the subject of formal and informal finance is that of interest rates and its determination. The ability of some commercial informal lenders to extract a monopoly rent is widely documented, and the share of monopoly rent in the interest rates is largely determined by the degree of competition prevailing in a particular market. (Nissanke and Aryeetey 1998:25) However, it is important to recognise that interest rates charged by such commercial

\textsuperscript{38} Particular banks frequently argue against consumption loans on the grounds that loans should finance activities that generate income for repaying the loan. The reality, however, is that consumption loans have to be considered as working capital loans for maintaining and enhancing the production factor labour. (Zeller 2000)
informal lenders must also allow compensation for transaction costs, risk premiums and the opportunity costs of funds, as well as monopoly rents on profits (Bottomley 1975, Germidis 1991) Monopoly rents or profits included are also related to the sunk costs of their operations and the contestability of markets. (Nissanke and Aryeetey 1998:25) Various empirical studies on the subject have led to differing results, particularly as regards the presence or absence of monopoly profits. What is certain, however, is that no market rate of interest can be observed in the informal sector; instead, there is a multitude of debt arrangements covering a wide range of interest rates which are often a function of the relationship between lender and borrower. (Germidis 1991, Nissanke 1998, Aryeetey and Udry 1995)

3.3.6 Summary advantages informal financial sector

Section 3.2 explored that despite increasing financial liberalisation informal finance continues to be vital and growing. Therefore, section 3.3 enquired if informal finance exists because it has an advantage in its individual structure. The findings support this view. The informal sector advantage is built on the dynamic of reciprocity and network building and has a positive effect on savings deposits, credit provision, poverty, and credit distribution. Heterogeneity and flexibility give informal finance a comparative edge. Policies dealing with economic development should find a way to utilize this positive effect. Although informal arrangements are limited in size, member, scale and place. By demonstrating advantages of the real life informal sector, OIE is not limited to theoretical advantages in relation to NIE, but extended with a field of advantages in reality. Reality shows that in contrast to common economic theories OIE is able to capture the mechanisms behind the informal financial market. The finding that more than 80 percent of the world’s population rely on informal finance because informality provides advantages, suggests, that a financial market theory is required that is able to acknowledge informality. Since OIE is able to capture the mechanisms behind informal finance, such a financial market theory requires elements of OIE.

39 For example, Thomas (1993) presents empirical studies to show that the share of monopoly rents in interest is relatively small if alternative returns and risk premiums are taken into account.
Informal financial institutions exist because they have an advantage in their individual structure which is mainly based on social relations. Therefore a financial market theory is required which incorporates an understanding of these functionalities.
Table 10: Comparison Formal and Informal Sector

<table>
<thead>
<tr>
<th>INFORMAL FINANCIAL SECTOR</th>
<th>FORMAL FINANCIAL SECTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The informal financial sector provides savings and credit facilities for small farmers in rural areas, and for lower-income households and small-scale enterprises in urban areas.</td>
<td>1. Formal financial institutions ignore small farmers, lower-income households, and small-scale enterprises in favour of a larger-scale, well-off, and literate clientele which can satisfy their stringent loan conditions.</td>
</tr>
<tr>
<td>2. The procedures of informal schemes are usually simple and straightforward; as they emanate from local cultures and customs; the population easily understands them.</td>
<td>2. Complex administrative procedures are beyond the understanding of the rural masses and small savers.</td>
</tr>
<tr>
<td>3. The informal sector mobilises rural savings and small savings from low-urban households.</td>
<td>3. Formal financial institutions do not mobilize income rural savings or small-scale deposits. Commercial banks could contribute but to rural and small savings mobilization if they had adequate branch networks and if they adopted the relevant procedures.</td>
</tr>
<tr>
<td>4. Informal groups operate at times and on days, which are convenient for their members.</td>
<td>4. The working days and opening hours of formal financial institutions do not take rural work schedules into account; banks are open at times when farmers are at work in their fields.</td>
</tr>
<tr>
<td>5. Informal sector associations accept any amount of regular savings, even the most modest sums which a saver can afford to set aside. The financial techniques on which such informal groups are based lend themselves to the management of a large number of small accounts.</td>
<td>5. Formal sector institutions are selective regarding clientele, so as to avoid having clients who make only small deposits. Their financial technology is not suited to the management of modest sums from a large number of savers.</td>
</tr>
<tr>
<td>6. Access to credit is simple, non-bureaucratic, and little based on written documents. Literacy is not a requisite.</td>
<td>6. Loan application procedures are complex and require reading and writing skills so that a file on the borrower may be established.</td>
</tr>
<tr>
<td>7. The simple and direct processing of loan requests allows for their prompt approval and a minimum delay in disbursement. Rejections are rare, but the level of risk is reflected in the interest rate charged.</td>
<td>7. Processing of loan requests is complex, resulting in long delays before final approval or rejection. Even when approval is obtained, loan delivery is slow.</td>
</tr>
<tr>
<td>8. Collateral requirements on loans are to local conditions and borrowers capacity. The</td>
<td>8. Collateral requirements correspond to the situation of relatively well-off urban-dwellers:</td>
</tr>
<tr>
<td>Condition</td>
<td>Formal Financial Market</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Conditions may be based either on regular contributions to ROSCAs or on</td>
<td>deposits or savings accounts in a commercial bank, property that can be mortgaged.</td>
</tr>
<tr>
<td>precise knowledge of farm size and/or crops harvested so as to</td>
<td></td>
</tr>
<tr>
<td>determine the borrower's capacity to repay a loan.</td>
<td></td>
</tr>
<tr>
<td>9. Transaction costs are low</td>
<td>9. Transaction costs are high</td>
</tr>
<tr>
<td>10. Repayment rates are high</td>
<td>10. Repayment rates are low.</td>
</tr>
<tr>
<td>11. Because they emanate from local environment, informal groups are</td>
<td>11. Formal sector institutions do not have close contact with the environment in which</td>
</tr>
<tr>
<td>aware of the problems that members may be confronted with, and</td>
<td>they operate. Sometimes they prosecute defaulters, which can have negative social</td>
</tr>
<tr>
<td>Therefore, they can deal with repayment difficulties in a pragmatic</td>
<td>repercussions, while at other times they do not sue for reimbursement, leading</td>
</tr>
<tr>
<td>manner. Debt rescheduling is possible.</td>
<td>borrowers to believe that formal loans are free.</td>
</tr>
<tr>
<td>12. The informal sector has a dense and effective information network</td>
<td>12. Unfamiliar with the grass-roots environment, formal institutions are ill-served</td>
</tr>
<tr>
<td>at the grassroots level for close supervision and monitoring of</td>
<td>by a mediocre supervisory and monitoring network, and are unable to gain insight into</td>
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<tr>
<td>borrower activity - particularly their cash flow - whether they are</td>
<td>the activities of their clientele.</td>
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<tr>
<td>members of an informal association or not. This contributes to the</td>
<td></td>
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<tr>
<td>efficient mobilization of savings and ensures high loan repayment rates.</td>
<td></td>
</tr>
<tr>
<td>13. Within the informal sector, information is widely diffused. The</td>
<td>13. Formal sector institutions do not have a good for dissemination of information.</td>
</tr>
<tr>
<td>regular meetings of informal savings and credit associations serve as</td>
<td>In addition, they are out of touch with the rural masses and make little to seek ways of</td>
</tr>
<tr>
<td>a forum for dissemination of information.</td>
<td>reaching them.</td>
</tr>
<tr>
<td>14. The interest paid on deposits in the informal sector compares</td>
<td>14. Some institutions of the formal sector do not even offer savings facilities. Others</td>
</tr>
<tr>
<td>favourably with that paid in the formal sector, thus providing an</td>
<td>apply low - or sometimes even negative - real interest rates, thus putting off many a</td>
</tr>
<tr>
<td>incentive for rural and small urban households to save.</td>
<td>potential saver.</td>
</tr>
<tr>
<td>15. The informal sector charges competitive lending rates; though they</td>
<td>15. Public institutions charge very low - sometimes negative - real interest rates on</td>
</tr>
<tr>
<td>are sometimes high, this reflects the scarcity of loanable funds. There</td>
<td>loans. Commercial banks apply moderate lending rates, which are nonetheless considerably</td>
</tr>
<tr>
<td>is little connection between deposit and lending rates.</td>
<td>higher than the interest paid on savings. The link between deposit and lending rates is</td>
</tr>
<tr>
<td>16. There are no investment opportunities for</td>
<td>weak.</td>
</tr>
<tr>
<td>16. There are investment opportunities for</td>
<td></td>
</tr>
<tr>
<td>17.</td>
<td>The informal sector usually does not keep a written record on the borrowing and/or saving activities of its clientele. When it does, the procedures are relatively simple.</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>17.</td>
<td>The formal sector keeps written records on the activities of clients, although the information recorded is sometimes irrelevant.</td>
</tr>
<tr>
<td>18.</td>
<td>The volume and availability of loanable funds are subject to seasonal fluctuations.</td>
</tr>
<tr>
<td>18.</td>
<td>The formal sector regularly has loanable funds available.</td>
</tr>
<tr>
<td>19.</td>
<td>The informal sector is not subsidized by the government, nor does it receive grants or other forms of support from donor agencies.</td>
</tr>
<tr>
<td>19.</td>
<td>Formal sector institutions are subsidized by the government and may also receive grants and other support from donor agencies.</td>
</tr>
<tr>
<td>20.</td>
<td>Savings and credit mechanisms in the informal sector are not geared towards accumulating funds before the peak season deprived when loan requests are highest.</td>
</tr>
<tr>
<td>20.</td>
<td>A regular supply of funds allows the formal sector to lend at any time of the year. This is not the case with government lending institutions, which are of sufficient funds because of high default rates on their loans.</td>
</tr>
<tr>
<td>21.</td>
<td>Despite the widespread dissemination of information within the informal sector, informal groups are often unaware of new farming methods, and so members do not learn of new techniques, which would allow them to increase production levels and raise their standard of living.</td>
</tr>
<tr>
<td>21.</td>
<td>Formal sector institutions could reach a widely dispersed rural clientele by collaborating with government extension units. In practice, though, they do not resort to such intermediaries and do not provide financial services in rural areas.</td>
</tr>
</tbody>
</table>

3.4 Linkages

Fragmentation of financial markets has persisted even years after financial policy reforms were initiated because they did not adequately address underlying institutional and structural constraints. Reforms have focused on the formal financial sector, but as research shows, simply removing financially repressive policies is not sufficient to increase financial depth or to induce banks to reach a wider clientele. (Steel 1997:41) As the section (3.3) suggests, the informal financial sector provides comparative advantages in relation to the formal financial sector. Therefore, it is analytically wrong to explain its existence only with financial repression as McKinnon and Shaw tend to do or to ‘regulate it away’ as often done in the past. If the informal sector exists because it owns a comparative advantage the question is if it makes sense to capture those advantages for economic development. Consequently, the issue of linkages between the formal and informal financial sectors has recently gained much attention in the literature on development finance. Policymakers in developing countries in context of the micro-finance revolution have considered these links seriously, and in some cases have implemented schemes for promoting such linkages. (Floro and Ray 1997:1) Thus the following section investigates the economic rationale for linkages (3.4.1) and explores why and how linkages provide advantages. (3.4.3.) In case linkages between informal and formal institutions create economic advantages by forming a financial market continuum, the application of the theoretical continuum of NIEOIE has a field of relevance. In this context, the interesting query is, if linkages are only a subject of relevance, or if linkages are a necessity (3.4.4.). In case linkages are a necessity for economic development, it’s a necessity to apply NIEOIE.

3.4.1 The Economic rational for linkages

Expanding the role of informal institutions appears to be an efficient way to gain its comparative advantage and reduce financial dualism. Consequently, different policies to enhance the role of informal markets were developed and implemented by different governments. A general feature of those policies was to include incentives for closer linkages between formal and informal institutions and a supportive legal
and regulatory framework. (Steel 1997:41) The theoretical rational for the approach is essentially three-fold: Firstly, it takes advantage of the lower transaction costs and risk premia of the informal sector to reach smaller and poorer borrowers beyond the profitable reach of the formal sector. This not only enhances the equity impact of the informal sector, but also saves society costly resources spent on intermediation. Because the formal sector pushes some of its transactions costs on to the borrower, the borrower benefits too in the form of lower borrower transaction costs. Secondly, to the extent that the shortage of funds for lending can sometimes confer market power on existing lenders, access to formal sector funds could promote competitions within the informal sector and reduce monopoly profits in those areas of the informal sector where they are being made. Thirdly, by enabling the two-way flow of funds, better linkages promote allocative efficiency by offering a broader choice for the productive use of savings, irrespective of which sector they are mobilised by. The first two rationals imply a flow of funds from the formal to informal sector, whereas the third assumes the possibility of flows in both directions. To the extent, however, that the formal sector has proved more successful in mobilising small savings than in making small loans, the basic advantage of the promoting linkages approach is that it combines the strength of both sectors to supplement the resources of the informal sector. 40 (Ghate 1992:177)

Ghate also observes that the two sectors are substitutes over a range of credit needs that occupy the middle range of a spectrum of credit markets and purposes. Within this range they impinge on each others share of the market, depending on lending and borrowing rates in each sector. “At both ends of the spectrum however, each occupies a number of markets which cannot be served by the other and which are, therefore, complementary” (Ghate 1988:75) In his study the financial system as a whole becomes more competitive as a range of demand, non-exclusive to one sector, has expanded. In the presence of overlapping demand, there is also spill over effects from the formal to the informal segments. An example of such effects is analysed by Bell (1990). When informal lenders act as intermediaries for formal

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40 See Bouman and Houtman 1988 and Sanderatne 1989 for support from Sri Lanka for the view that the formal sector is relatively more successful in mobilising small deposits that in making small loans. Excess liquidity is reported to have led the rural banks in Sri Lanka to refuse accepting deposits in the late seventies. Increasing the credit/deposit ration in the rural areas in India has been a long-standing concern of the formal sector.
institutions, Bell shows that the resulting lower costs of funds to informal lenders will be passed on to borrowers. Thus, where demand is non-exclusive, i.e. overlapping, direct credit links can have a positive effect on the efficiency of financial systems. (Nissanke 1998:47)

⇒ It is rational to link informal and formal financial institutions because linkages reduce financial dualism through spill over effects

3.4.2 Advantages of linkages

The advantage of linkages between informal and formal finance affects nearly every part of finance and therefore, growth. To clarify the context the following section gives a few distinct examples by (i) considering the effect of linkages on insurance markets; (ii) focusing on transaction and information advantages; (iii) dealing with the effect on low transaction costs on finance and demonstrating efficiency gains through the fact that informal and formal finance are complementary.

Insurance Markets

In the case that insurance markets are at loss and insurance possibilities are limited, an act of inter-temporal trade to affect resource transfers over time such as saving and credit becomes vitally important for consumption smoothing of the poor (Besley, 1995). There is potentially immense demand for financial intermediation as an effective device of risk-pooling and risk-sharing in developing countries. However, the risk management capacity of financial institutions in the formal sector is very restricted. (Nissanke and Aryeetey 1997, 1998, Nissanke 1998:4). In this case informal markets, seem to perform a useful economic function in the evolution of the financial sector in developing countries. (Montiel 1993)

Information and Transaction Costs
Informal financial market segments have long developed devices and mechanisms to cope with the agency problems within geographically and socially confined community settings. These mechanisms used by heterogeneous informal associations and agents are firmly rooted in indigenous social codes and norms. (Nissanke 1998:10) While financial reforms undertaken so far have focused on the formal sector, the comparably low transaction costs of informal agents and groups in dealing with particular market segments indicate that facilitating their capacity growth could provide a relatively efficient solution to the information and enforcement problems that characterise developing economies. (Nissanke 1998:48) Thus even in a country like Egypt, with a relatively dense coverage of formal financial institutions, the role of informal lenders remains important. (Zeller 2000)

Formal and Informal Finance as Complementary

Formal and informal finance has each its advantages and shortcomings. Both formal and informal segments of the financial system serve a distinct clientele and a narrow market niche. (Ghate 1992) However, financial systems as a whole continue to fail in capitalising effectively on potential comparative advantages of different market segments. In particular, there has been an absence of functional linkages. (Nissanke 1998) Instead each segment appears to struggle with its respective operational constraints. On the one hand, despite flexibilities and adaptabilities shown by some informal financial arrangements, the characteristics of informal financial agents and institutions are such that the growth of operations within the informal sector in is severely limited. On the other hand, despite their potential advantage in exploring economies of scale in portfolio management and diversification to allow risk pooling and maturity transformation, formal institutions suffer from a legacy of either conservatism of financial distress characterised by high transaction costs and severe loan recovery problems. (Nissanke 1998:14-15) However, there exists a potential in exploiting comparative advantages of each sector – formal and informal. In transitional periods, the capacity of financial systems could be enhanced if integrative mechanisms are developed that can reduce operational constraints facing each sector, and at the same time capitalise on the comparative advantages conferred by each sector.
Linkages between informal and formal financial institutions are beneficial because the two are complements over a range of financial services.

3.4.3 Necessity of linkages

The section above (3.4.2) summarised reasons why and fields where there are advantages of linking the informal and formal sector in general. However, I would like to go one step further and investigate whether it is a necessity to link financial informal and formal markets. The requirement is based on two arguments. The first argument deals with the impossibility to create macroeconomic policy and stability with more than 90 percent of the population in LDCs is excluded from the formal financial sector. (Robinson 2001) The second argument, by using case studies from Africa, Asia, and Europe, shows that economic development, independent from time and region, depends to a large degree on linkages between formal and informal segments. Therefore, the goal of economic development cannot be achieved without considering and utilizing informal finance.

Argument I

The first argument is developed by Montiel (1993) and based on macroeconomic implication. Given the size of informal credit and foreign exchange markets in many developing countries, their presence has enormous macroeconomic effects. Such markets play important roles in determining the manner in which exogenous and policy shocks are disseminated through out the economy, both on impact and over time. Failing to ingrate them into the short-run macroeconomics of developing countries may therefore, result in inadequate analysis and misleading policy advice. “By its very nature, informal activity is not specific to any one sector. However, from a macroeconomic perspective, the acknowledged role of well-functioning financial markets in industrial country macroeconomics suggests that informal activity in the financial market may be critical to understanding the effects and the efficiency of economic policy.” (Montiel 1993:10) Montiel further,
concludes that little has been achieved in the integration of informal credit markets in macroeconomic models. Although informal markets are the subject of a large microeconomic literature, their macroeconomic role has largely been ignored outside the context of the dialogue between analysts in the tradition of McKinnon and Shaw and Neo-Structuralists. (Montiel 1993:3)

At the macroeconomic level, Montiel additionally expresses concerns that monetary and fiscal policy is ineffective where informal finance is dominant. The large currency holdings that are accumulated outside government restriction therefore, have the potential of reducing the authority’s control of the money supply. Attempts at monetary creation, for example, may be frustrated by a flight of currency from the banking sector into the informal sector, hence, limiting the banks ability to create deposits. (Montiel 1993:26) On the fiscal side huge tax erosion takes place, because informal transactions are mostly officially unrecorded.

Argument II

The other argument is, to my knowledge, not generally expressed. It summarises different statements of scholars who evaluate evidence of individual case studies. Surprisingly, independent from the region and development stage, scholars express the assumption that economic development is not dependent on different policies as for example, small scale versus large scale industrialisation or bank based versus market based finance, but most decisive is the degree of linkages between the informal and formal sector. In this sense, linkages are the precondition for dynamism, the driving energy behind growth. Following examples will be provided from (a) Africa; (b) Europe and Japan; (c) China.

(a) Africa

M. Nissanke links, in one of her United Nations studies (1998) dealing with Sub-Saharan Africa, economic development to formal and informal institutional linkages. Nissanke (1998) concludes that financial market fragmentation becomes a problem when links between the different segments are weak because under such circumstances the transmission of price and policy signals across systems severely
limited. In such an environment, the weakness of each sector cannot be overcome, while their comparative advantages are not exploited in full for efficient specialisation. Consequently, the systems potential capacity for enterprise development is circumvented. (Nissanke 1998:48) Nissanke concludes that the question what hinders economic development cannot be found in the contemporary discussions between market vs. state led growth, but within the question of institutional linkages. This finding is also fostered by authors of different case studies, i.e. Floro and Ray (1997) in relation to the Philippines, Soyibo (1996) in relation to Nigeria, Aryeetey and Udry (1995) in relation to Kenya, Mohne (1996) in relation to South Africa.

(b) Japan and Europe

Teranishi (1997) shows how important the informal sector in past Japan was for contemporary successful institution building. During the Japan Meiji era (1868-1912), informal segments had been systematically nurtured by government policies so that they could be transformed and graduated into formal institutions. (Nissanke 1998:48) In this context, Teranishi (1997) demonstrates that many informal arrangements could be formalised without coercion for their own expansion and growth. He additionally emphasises that institutional innovations – not just technological ones - and related changes in the legal and regulatory policy framework could extend the feasibility frontier of sustainable finance to reaching the poor. The primary role of policy should therefore, be to foster institutional innovations. (Zeller 2000) Equally Marco Da Rin (1997) argues that the degree of economic integration in relation to formal and informal institutional arrangements was decisive for the development of technology and finance of early industrialised Germany and Britain. Lauren Morris Mac Lean (2002) explains that, despite nearly identical cultural and economic landscapes and homogenising pressures of globalisation, social security differs in Ghana and Cote d'Ivoire, two neighbouring countries in West Africa, due to different attitude towards the informal sector. While Ghana attempts to strengthen the informal social welfare system successfully, Cote d’Ivoire has tried to replace these informal social networks (unsuccessfully).

(c) China
However, the informal sector is not only relevant for very low developed countries, but also for transition countries like China. As PriceWaterhousCooper states “Chinas private sector is booming. Today, it is one of the fastest growing economic engines in the world economy.” (April 2003) The private sector has clearly been the most vibrant part of Chinas economy since the initiation of economic reform in 1978. Just to give a few numbers:\(^1\):

- More than thirty million private businesses were established since 1978
- Eight out of ten new employment opportunities are created by the private sector
- In 2002 the private sector generated 60% of Chinas industrial output
- In Zhejiang alone, over 90% of the local GDP flows from the private sector

Although those numbers are impressive, it is unbelievable that banks only extended credit to state and collective enterprises (SOEs), not to private ones. At the end of 2000, less than 1% of loans from the entire national banking system had gone to the private sector.\(^2\) If banks are not lending to private entrepreneurs, then how has Chinas “economic miracle” been financed? The short answer: informal and often illegal finance. (Tsai 2002:2) With an impressive study, Tsai documents the sheer variety of informal financing options used by entrepreneurs in China. Most interesting is his conclusion that “the scope and scale of informal finance” relies on the different orientation of local governments towards the informal sector, which in turn, “translates into varying degree of implicit support for informal financial activity in any given locality”. (Tsai 2002:14) Therefore the power of Chinas rapid development lies within the informal financial sector and the governmental attitude towards it.

\(^1\) According to a survey recently conducted by the Asian Development Bank
\(^2\) Calculated from Table 19.3 of the Zhongguo tongji nianjin 2000 Chinas Statistical Yearbook by Tsai
3.4.4 Summary necessity to link the formal and informal financial sector

Section (3.3) explored that the informal financial sector exists due to its comparative advantage in relation to formal finance. Furthermore, it has been investigated in section (3.4) that building linkages between a formal and informal financial institution do not only provide advantages, rather it seems to be a necessity for economic development. Section (3.4) derived that argument by highlighting the economic rational as well as the advantage of linkages between two complement segments. Furthermore, it appears that stable macroeconomic policies are impossible in a country confronted with a huge informal financial market. In this context case studies suggest that growth is dependent on the linkages between informal and formal institutional arrangements. The importance of linkages for economic development is independent from time, region and development stage of a country. Therefore, it seems to be appropriate to argue that linkages between formal and informal institutions are essential for economic development. As the informal sector reflects the relevance of OIE theorising and the formal sector reflects the relevance of NIE theorising, the necessity to link informal and formal financial institutions reflects the necessity of NIEOIE.

⇒ Linking informal and formal institutions to a financial market continuum is a necessity in the course of economic development, independent from time region and developmental state.

3.5 Conclusion Part II

Part I examined the existing institutional theories of NIE and OIE and concluded that the use of an institutional individual combines the two approaches to a theoretical continuum of NIEOIE. The intention of Part II is to investigate whether reality reflects theoretical arguments of NIEOIE and in turn, if today's economic situation requires the theory of NIEOIE. Therefore, the first chapter asked if an 'institutional' financial market theory is relevant and if existing theories are sufficient. The findings suggest that existing theories are insufficient and that a new
theory is needed. In chapter II it has been asked if NIEOIE could provide the theoretical underpinning for such a theory by examining the relationship between informal and formal financial institutions. As the former reflects OIE theorising, while the latter mirrors NIE theorising the finding that linking the two financial institutional environments is necessary for economic growth reflects the necessity to combine NIE and OIE to a theoretical continuum. In this sense, the theory NIEOIE is not only a theoretical experiment, but becomes its justification through the requirements of financial reality. The theoretical continuum of NIEOIE reflects the actual financial market continuum of informal/formal finance. Further, with over 80% of the world’s population relying on informal finance because of its advantages, a financial market theory is required which captures as well the mechanisms behind informality as well as the forces behind formal finance. Therefore, NIEOIE is suitable to provide the foundations for such a theory.

Conclusion: The necessity to link formal and informal institutions to a financial market continuum while creating the need for a new financial market theory reflects the demand and applicability for NIEOIE.
PART III – CRITICISM ON NIEOIE

It has been explored in Part I that as well, NIE as OIE apply an *institutional individual* as economic actor and that on this foundation NIE and OIE form rather a theoretical continuum, called NIEOIE, than contradicting schools. Part II investigated if reality reflects theoretical arguments of NIEOIE and, in turn, if today’s economic situation requires the theoretical foundation of NIEOIE. It was suggested that because the informal sector inhibits an advantage through its individual structure, it is necessary for economic growth to link informal and formal institutions to a financial market continuum. As the informal sector reflects those institutional mechanisms which are central to OIE, while the formal one mirrors NIE, it suggests that NIEOIE finds applicability and justification. This argumentation was built on the assumption that the informal sector has an ‘advantage’ built on its individual institutional mechanisms, which differ from those in formal institutions. However, critiques could argue that the advantage of informal financial institutions is built on the same fundamentals as the advantage in formal institutions. If the mechanisms causing the emergence of a formal institution are similar to those forces which create the dynamic of the informal financial institution, only NIE theorising and not NIEOIE is relevant. Therefore, the intention of Part III is to investigate if NIE theorising is able to explain and capture the functionality of informal financial institutions in less developing countries (LDC). Since NIE scholars do not explicitly deal with informal financial markets, the question is if development economists who do, are applying NIE reasoning (chapter 1). Further, it remains to be investigated if, in case they do apply NIE theorising, NIE theory is sufficient in explaining the advantage of informal financial markets (chapter 2). In case NIE is insufficient, it needs an enquiry if the ‘insufficiency’ is built on the same arguments OIE uses theoretically to criticise NIE. Only if the weakness, as demonstrated by reality, appears to be identical to the shortcomings of the NIE theory as criticised by OIE, NIEOIE finds justification in relation to informal financial markets.
1 NIE and Informal Financial Markets

1.1 Institutional and structural approach

NIE scholars do not deal with informal financial institutions, but development economists (DE). DE scholars applying NIE microeconomics with focus on information properties towards informal financial institutions are summarised as the “institutional and structural” approach (ISA). However, despite the fact that all ISA scholars focus on informal financial institutions, they are independent from each other, using different arguments and do not form a school. Some focus on the information advantage of the informal institution itself, others focus on structural reasons that cause information problems, however, all of them focus on information structures. Therefore, the following section will explore different approaches. Section (1.2.1) considers Hoff und Stiglitz argument that informal financial institutions overcome the shortage of credit when banks are having difficulties of monitoring. Section (1.2.2) deals with Aryeetey and Udry who demonstrate that informal institution have an advantage due to insider knowledge. Section (1.2.3) focuses on Teranishi and Caprio who argue that missing information infrastructure makes it necessary to rely on informal finance; and section (1.2.4) explores Gertler and Roses explanation that informal arrangements are caused by path dependency. In section (1.2.5), the hard core positions of all approaches are summarised.

1.1.1 Hoff and Stiglitz

For example, Hoff and Stiglitz (1990) who also developed the bank-based approach to financial development (see Part II) advance an explanation for persistent fragmentation based on imperfect information. The costs of screening, monitoring and contract enforcement between lenders in developing countries are too high for banking in relation to poor borrowers. (Steel et al. 1997:6) They argue, in contradiction to the financial repression school, that even when no ceiling on interest rates and excess demand for loans exists, it may be unviable to lend to certain categories of borrowers, such as small and medium-size enterprise (SME), if the
costs and risks exceed those of known, lower-risk clients. (Hoff and Stiglitz 1990) In addition, in developing economies, information about future prospects may be highly uncertain, especially if the economic structure is vulnerable to external shocks. In the absence of credible predictions, reliable information and appropriate financial instruments, perceived risk may be abnormally high for term lending, especially to small borrowers. (Nissanke 1997:23.) Market auctions, moreover, are often ineffective due to difficulties in specifying and monitoring the other agent’s actions. Contracting parties, as a result, are compelled to make use of non-price strategies such as quantity rationing and market interlinkages. (Floro 1991:12)

In developing countries characterised by these conditions, the growth of formal financial institutions is severely constrained. Formal institutions must retain their commercial viability and, in this environment of high risks and high transaction costs, banks are likely to be conservative and risk-adverse in their portfolio management. (Hoff and Stiglitz 1990) They may prefer to hold government paper, with its lower risk to extending loans to non-established borrowers. This explains both the failure to reach target groups of subsidised credit programmes administered through formal institutions and the high concentration of bank loans among the relatively well-off groups who have collateral or reputation at their disposal. Many credit guarantee schemes designed specifically to deal with the problems of high risk have not managed to alter this general tendency. Under such conditions, the dominance of informal finance based on limited social relations can be expected. (Nissanke 1997:24) Accordingly, the existence of inter-linked transactions between credit and other goods or service markets (inputs, outputs or labour) is explained by the need to overcome information problems about the future behaviour of clients in time based transactions (Hoff, Braverman et al. 1993)

⇒ The formal bank causes the advantage of informal credit arrangements because due to information asymmetries the bank may not be willing to lend to SMEs. Hence, the risk adverse characteristic of the bank causes the advantage of informality.
1.1.2 Aryeetey and Udry

Other institutional explanations of segmentation emphasise differences in the costs and characteristics of different types of transactions that can lead to specialisation within financial markets. In the context of imperfect information and transaction costs, the informal sector provides a comparative advantage which explains its continuous existence. Aryeetey and Udry argue “The segmentation that is observed arises because in the attempt to reduce the moral hazard involved in lending, informal units have to create distinct groups or associations that they can control or use to capture information about potential clients, one way or another.” (Aryeetey and Udry 1995:35) Informal financial arrangements are able to make use of local sources of knowledge and specific social mechanisms to overcome screening, monitoring and enforcement costs. For example, rotating savings and credit associations (ROSCAs) are able to operate due to degree of ‘insider’ knowledge they have about each member and their ability to enforce compliance through the use of local social sanctions, such as non-co-operation in other aspects of daily life. (Susan Johnson 2001:4)

⇒ The informal credit institution exists independent from the willingness of banks to lend because they provide an information advantage through their individual structure.

1.1.3 Teranishi and Caprio

Teranishi (1997), for example, attributes segmentation of financial markets in developing countries to a host of problems arising from imperfect information, where information disclosure is severely limited. He argues that “the efficiency of financial markets in such an economy hinges crucially on the degree of accumulation of information and establishment of information channels between lenders and customers as a device to cope with problems related to imperfect information”. (1994:315) In this context, Caprio et al. (1994) draw a particular attention to the fact that years of financial repression in developing countries have led banks to underinvestment in information capital. They emphasise, therefore, the importance of
developing equity markets, accounting and auditing systems in order to build the economy’s information capital base. (Nissanke 1997:23)

⇒ The informational infrastructure of a country causes the information asymmetries of banks and hence, their unwillingness to lend to SMEs.

1.1.4 Gertler and Rose

Institutional theories also deal with structural bottlenecks as cause of fragmentation. Historical weaknesses of the banking system in developing countries may have also exacerbated structural tendencies towards segmentation. In many former colonies, banks were established primarily to serve import-export trade with the colonial central. Many commercial banks of such an origin retain this particular feature. Their lack of interest and expertise in lending to indigenous, locally oriented firms has not been easily overcome. (Steel 1997:8) Segmentation may also result from weaknesses inherent in the infrastructure that supports the financial system. For example, the adequacy of the legal infrastructure affects the costs and risks of contract enforcement, which in turn, influence both the willingness of lenders to enter into financial agreements and the type of security they are willing to accept. In addition, the formal financial sector ability to offset the risk of default may be limited by the absence of a well-functioning insurance market and of markets for the sale of confiscated collateral (Binswanger and Rosenzweig 1986) Furthermore, inadequate bank regulation and supervision over the years has propagated financial mismanagement and poor portfolio performance, which, in turn, have raised the perceived risk of term lending to small enterprises. In this situation, financial sector reforms may prompt banks to address management weakness and to diversify portfolios, but the response may be slow, as many parameters and exogenous conditions essentially remain the same. (Nissanke 1997:23)

Within the general framework of transaction and information costs, other authors have concentrated on a range of structural and institutional features of developing countries financial markets to explain segmentations. In a New Keynesian tradition, they demonstrate that the structure of financial markets,
including market segmentation, closely mirrors the development and performance of the real sector. (Nissanke 1997:21) For example, Gertler and Rose (1994) analyse the symbiotic relationship between finance and growth based on two key concepts: a *premium for external finance* and a *borrowers net worth*. Based on these perceptions they develop an evolutionary model of the banking system with the purpose to determine the relative efficiency of a financial system and its dynamic evolution. Accordingly development of the real sector raises borrowers net worth and “tends to reduce the premium, attached to external finance which in turn, serves to stimulate further, development” (Gertler and Rose 1994:32). The premium for external finance then is inversely related to borrower’s net worth, and they jointly determine the level of investment. In this context, Gertler and Rose 1994 developed a model which links the evolution of an economics financial structure with firms changing financial needs over its life cycle. Thus, as self-finance develops into external finance, intermediation by banking institutions increases and a securities market develops. (Nissanke 1997:21, Steel 1997:7)

⇒ Weaknesses resulting from path dependency cause the resentment of banks not to lend to SMEs and Hence, the growing importance of informal finance.

1.1.5 *Summary ISA*

The financial regression school assumes that informal arrangements exist because the government intervenes in the financial market and destroys thereby, free market forces, which would never support informality. Contrary, scholars of the *institutional and structural approach* argue that the informal sector owns an advantage independent from the government’s attitude. Scholars demonstrate that problems arising from imperfect information are likely to be most pronounced in

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43 The former concept refers to an additional premium borrowers pay for uncollaterised loans and insurance due to frictions introduced by informational and enforcement problems. The latter is defined as the sum of a borrowers net liquid assets and the collateral value of his illiquid assets. This consists not only of frangible physical assets but also any perspective future earnings that the borrower can credibly offer as collateral. Thus, the borrowers accumulated net worth depends both on past earnings and anticipated future prospects.
low-income countries. Economy-wide information flows may be extremely limited, and gathering information is often costly. Poor information systems encourage segmentation by raising the costs to formal institutions of acquiring reliable information on both systemic and idiosyncratic risks for all, but the largest clients. In contrast, informal agents rely exclusively on localised, personal information, giving them local power, but constraints their ability to scale up. (Steel 1997:7). Accordingly, the informal sector is still a transitionary phenomenon caused by market failure, but the market failure is not ‘only’ caused by government intervention, but also due to the transition stage of country in which information asymmetries are decisive. Thus, the informal sector exists because it provides a comparative advantage in relation to imperfect information and transaction costs. Based on those “new microeconomics” ISA is able to explain the existence and advantages of the informal sector irrespective of financial repression. The policy advice to link formal and informal financial institutions in this perspective is based on the assumption that in the process of linking, the formal sector becomes able to utilise the information advantage of the informal sector.

⇒ According to the ISA, the informal sector exists because it has an information advantage

**Table 11: Comparison Financial Repression School and Institutional and Structural Approach**

<table>
<thead>
<tr>
<th>FINANCIAL RREPRESSION SCHOOL</th>
<th>INSTITUTIONAL AND STRUCTURAL APPROACH</th>
</tr>
</thead>
<tbody>
<tr>
<td>The informal financial institution is caused by financial repression</td>
<td>The informal financial institution emerges due to its information advantage in relation to the formal institution</td>
</tr>
<tr>
<td>The informal institution is a transitionary phenomenon</td>
<td>The informal institution is a transitionary phenomenon</td>
</tr>
<tr>
<td>The informal institution is bad</td>
<td>The informal institution has information advantages, but only in comparison to the shortcomings of formal institution</td>
</tr>
<tr>
<td>Linking informal and formal is unnecessary</td>
<td>Linking informal and formal institutions is positive so that the formal sector is able to utilise the advantages of the informal sector</td>
</tr>
</tbody>
</table>

*Table by Alexandra Bernstorff 2004*
1.2 Is ISA an extension of NIE?

Apparently, ISA scholars focusing on informal financial institutions are able to explain the existence of informal institutions independent from financial repression and are able to identify the advantages possessed by the informal sector. The interesting question is to what extent those ‘explanations’ equal NIE theory. Therefore, the intention is to find out if ISA is an extension of NIE in relation to financial markets in developing countries. However, it is important to differentiate between the early and the more sophisticated version of NIE. Both can have similarities with ISA, but the later version is far more difficult to differentiate from OIE. Section (1.3.1) deals with the terminology between NIE and ISA; Section (1.3.2) considers similarities between the early version of NIE (NIE1) and ISA; while section (1.3.3) focuses on the similarities between the more sophisticated version of NIE (NIE2) and ISA; section (1.3.4) summarises similarities and discusses if ISA is an extension of NIE in relation to financial market theories in developing countries.

1.2.1 Terminology between NIE and ISA

It is important to note that although many NIE scholars have explicitly built their theory on explanations concerning economic growth variances between developed and less developed countries, they are not development economists (DE)\(^4\). (North 1990, Harris 1996) Why is that of any importance? NIE scholars are building \textit{ex post} explanations for an institutional phenomenon like the Asian crises often within a game theoretic approach, while development economists are concerned with case studies and \textit{ex ante} recommendations.\(^5\) (Aoki 2000, Qian 2001) NIE as a theory intends to follow theoretical consistency and is concerned with the

\(^4\) DE will be used as short form for development economists
\(^5\) It is important to note that the class of Development Economists entitles all economists focusing on developing countries independent from their ideological and theoretical background. In contrast, ISA only refers to the sub-group of development economists, dealing with institutional and structural features of development while focusing on information properties.
effect of institution on individual and collective welfare. (Azfar 2002:2) In contrast, DEs are less concerned with theoretical consistency than with practical applicability and the focus on microstructures is replaced with a focus on growth. However, during the period of the transition process from socialism towards capitalism within the GUS states DEs became automatically concerned with institution building. It seemed to be natural that DEs dealing with institution building turned their attention towards the theory of “Institutionalism” as device. At exactly this intersection between DE and NIE, the confusion starts. Quite often DEs call themselves or their strategies NIE, while they are not. On the other hand, NIE experiences recommendation and practical application through the use of the word NIE which in turn, supports their theory while they are not meant.  

It is the intention to untangle those words, meanings, theories etc. and to find out if DEs who refer to NIE mean NIE or may be OIE.

For the comparison of the ISA and NIE approach, it is important to define the terminology between them. Despite the recognition by some NIE scholars that informal institutions play a crucial role in defining societal rules (Denzau & North 1994, Ensminger 1997, Greif 1997) the application of NIE to the study of micro-level issues relevant to financial matters in developing countries has largely focused on formal institutions. (Zenger 2001:2) At this point, it becomes obvious how little communication between scholars of NIE and scholars who work within the ISA exists. While NIE talks about informal institutions as the social and cultural embeddedness or as “shared mental models” of a society, ISA applies the term informal institutions to unregulated institutions.  

In contrast, for NIE the unregulated institution is still treated like a formal institution, a collective action solution towards an efficiency problem under imperfect information and bounded rationality. On the other hand, the informal institution of NIE, or in other words the shared mental model, is assumed by ISA to be the “cultural endowment”. Due to these “language problems”, many misspecification within the literature can be found.

46 The list of scholars is long see Sindzigre, Stein, Nissanke, UNRISD, Arestis, Demetriades etc. However, it is not the purpose of the dissertation to demonstrate each particular misuse of NIE but rather to explain why the misuse is happening.

47 See North 1990 on shared mental models and informal institutions in contrast, to Stiglitz 1990 on informal institution and the necessity of government action. For NIE use of informal institution see also Williamson, Eggertson, and other NIE scholars. For ISA sue of informal institution see also Aryeetey, Robinson, Nissanke, and other scholars working with microfinance.
Often development economists describe themselves as new institutionalists, while they are not. On the other hand, NIE economists regularly describe a solution towards a development problem without solving it, since the problem they are writing about is not the problem supposed to find an answer.48

Table 12: Terminology NIE and ISA

<table>
<thead>
<tr>
<th>TERM</th>
<th>NIE INTERPRETATION</th>
<th>DE INTERPRETATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Informal Institution</td>
<td>Shared mental models, like religion, tradition, culture etc.</td>
<td>The unregulated institution or non-official institution, like ROSCAs or any private agreement outside public law.</td>
</tr>
<tr>
<td>The Unregulated Institution</td>
<td>Equal to Formal Institution, collective action solution towards an efficiency problem under imperfect information</td>
<td>The Informal Institution</td>
</tr>
<tr>
<td>Shared Mental Models (norms, similar worldviews,)</td>
<td>Informal Institution</td>
<td>Cultural Endowment</td>
</tr>
<tr>
<td>Institutional Path Dependency (Geography, History, Law)</td>
<td>Informal Institution</td>
<td>Institutional Endowment</td>
</tr>
</tbody>
</table>

*Table by Alexandra Bernstorff 2004*

However, throughout the following part of the dissertation the unregulated and regulated institution will be contrasted while mirroring the formal and informal institution of Part II. The term informal institution will be used in an NIE manner as shared mental models. In case of relevance, the informal institution will be differentiated between institutional and cultural endowment, while the former reflects path dependency and the later shared mental models influenced by religion, history and other cultural factors.

1.2.2 The early NIE approach

It is important to note, that within the NIE approach development took place. The comparison done in this dissertation between the “institutional and structural” approach and NIE relates not only to the “early” (NIE1), but also to the more

“sophisticated” (NIE2) form of NIE. NIE1 is a pure efficiency-driven view of institutional change. Institutions are seen as emerging when the market mechanism fails to allow all the potential efficiency-enhancing transactions to be realised. (North 1990, Coase 1984) In this version, the rational wealth-maximising agents will not fail to seize upon the opportunities for efficiency enhancement, by setting up a new institution – formal or informal (Evans and Chang 2000:11) NIE1 treats efficiency, especially in the form of transaction costs (Coase 1998:73), as the only explanation of institutions in all societies at all times. In this version, therefore, all institutions that exist are efficient (examples will include authors like early Douglass North, Harold Demsetz, Armen Alchian and the “property rights school” of Furubotn, Richter, Pejovich and Yoram Barzel).

NIE1 is particularly obvious in the kind of “structural and institutional” approach which deals with comparative advantages of unregulated institutions as done by Aryeeetey and Udry (1995). (see section 1.1.2). The unregulated institution improves the market situation for credit due to its comparative advantage in relation to information and transaction costs. NIE1 is also apparent in ISA approaches done by Stiglitz et al. (1990) demonstrating that due to information disadvantage regulated institutions do not provide sufficient credit, thus unregulated credit institutions emerge. See as example Hoff and Braverman (1993) who demonstrate how credit institutions, due to the inter-temporal basis of transactions, are subject to information, monitoring and enforcement problems. These features give rise to moral hazards and adverse selection in credit transactions and the possibility of market failure. It is important to note, that in the former approach the unregulated institution itself provides a comparative advantage, while in the latter approach the unregulated institution arises in response to a market failure which is caused by information asymmetries. Nevertheless, both are in line with NIE1 theorising which explains institutions as an efficient solution towards an information and transaction problem. Phrases, such as ‘market failure’ and ‘market imperfections’, due to information asymmetry dominate the study of ISA’s in relation to developing countries. They are also fundamental to NIE1, given the focus on production externalities, public goods, 

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49 The use of the words ‘early’ and ‘late’ relates to differences in the early work of North, Williamson and the later work of North, Williamson. During the dissertation NIE1 and NIE2 will be used as differentiation.
imperfect information and the free-rider problem. Underlying is the assumption that institutions are the way in which economies cope efficient with ‘market failure’. (Harris 1995:2)

1.2.3 The sophisticated NIE approach

In the more sophisticated version of NIE (NIE2), it is admitted that due to path dependency, not all institutional changes are efficiency-enhancing, not even in the long run. Scholars like Brian Arthur, Paul David and Joel Mokyr, who work mainly on technological issues argue that certain institutions may be chosen not because of their inherent efficiency, but because of certain “irreversible events” in history. (institutional endowment) The best example is that of “network externality”, which gives the first movers a selection advantage through the frequency-dependent definition of “evolutionary fitness”. (i.e. the competition between different computer operating systems.) Similarities can be found in path-dependency approaches like those from Teranishi (1994) and Gertler and Rose (1994) in which history and past-structural decisions influence the present outcome. This approach is additionally extended in NIE2 to the “cultural dimension” in the sense that the worldview possessed by human agents matters. The proponents of this view start from the assumption that human agents suffer from bounded rationality, hence, they are not able to choose the most efficient institution. Bounded rationality, according to this vision, makes it inevitable that humans operate with a mental model of the world that may not necessarily be a good model of the real world. Given the devotion to a certain worldview by the actors, they may prefer a certain institution because it happens to fit their worldview (or “cultural endowment”), even when it is not necessarily efficiency-enhancing from an “objective” point of view. In this way, the optimality conclusion is negated. (Evans and Chang 2000:14)

The sophisticated version of NIE has grown together out of economic history and the advances in game theory and information theory. (Nabli and Nugent 1989, North 1990, Lin and Nugent 1995, Claque 1997, Olson 2000, Claque and Grossbard-Shechtman) This advancement lies in the possibility to link formal rules to social, economic, political and cultural factors, which allows “a systematic analysis of the
embeddedness of financial institutions”. (Johnson 2001:2) Scholars who deal with the institutional environment within a “bounded rationality” approach are very difficult to differentiate from OIE. Within the ISA, the strang dealing with history, infrastructure and geography as decisive for the existence of informal markets equals NIE2. In contrast, to the ISA equivalent to NIE1 which considers the fact of information problems between two actors and the influence on actors behaviour, the sophisticated version of NIE and ISA deals with the causes of information problems. According to the examples noted above the, Teranishi and Caprio explanation of unregulated institutions is an equivalent to the NIE2 version because it does not explain the action of informational constrained behaviour, but instead, explains the existence of the information problem with informational infrastructure problems. Similar Gertler and Rose demonstrate how history influences informational capital of banks.

For analytical clarity, I have chosen a few distinct examples of differing ISA approaches falling in the category of NIE2 although in general, each work of modern development economists which deals with the “transplant effect” belongs to it. The ‘transplant effect’ implies that an institution can only be built on the fundament of already existing institutional and existing cultural endowment. (A more detailed analysis will follow in section 3.1.5) There is a growing literature by development economists on the transplant effect. For example, Berkowitz and Li (2000); Roland and Verdier (1999); Zhuravaskaya (2000) who deal with the question why strong institutions emerge or fail to emerge in formerly socialist economies that are making a transition to a market economy. There is also a growing interest in tracing the determinants of differences among legal families. (Glaeser Shleifer 2000) Other studies like Rodrik (2000) provide empirical support for the theory that a well-designed strategy for institution building should take into account local knowledge, and should not over-emphasise best practice blueprints used in developed countries at the expense of local participation and experimentation. (See also Acemoglu 2001, Johnson 1997, and Robinson 2000, Sachs 2001)

1.3.4 Summary comparison NIE and ISA
In relation to financial markets, both NIE and ISA economists equally apply neoclassical analytical tools while incorporating an understanding of the influence of imperfect information and transactions costs under bounded rationality. Both suggest the need to focus on an analysis of the rules, monitoring and enforcement mechanisms of financial institutions and the financial services to which they give rise. Both visualise institutions as the outcome of games of social interaction, in which individuals rationally choose their actions, according to their mental models of the world, their information sets, and the behaviour of other players in the game. (Claque and Grossbard-Shechtman 1996:2) Both define institutions as socially devised constraints on individual action (North 1994) and both consider institutions as sets of rules that are recognised and frequently followed by members of the community which impose constraints on the actions of individual members. (Claque 1997:17) Although NIE theory has not been applied towards financial markets in developing countries before, and the ISA approach has been nothing else than a collection of different works by development economists focusing on information properties in relation to informal markets, both use the same methodology and causality. As the findings suggest that similarities between the “institutional and structural” approach and NIE are decisive, it makes sense to call the ISA an extension of NIE concerning financial markets in developing countries.

⇒ ISA is an extension of NIE towards financial market theories
2 Is NIE sufficient?

The obvious question following the Hypothesis that ISA is an extension of NIE towards financial market theories is, whether the NIE approach in explaining the advantage of the informal sector with its informational properties is sufficient. In case NIE is relevant, NIE is able to explain the advantage of the informal financial sector and hence, the relevance of NIEOIE for financial markets does not exist. Nevertheless, the application of NIE towards financial markets in developing countries has many different faces and often deals with unrelated areas; hence, the question of sufficiency is not easily to answer. I choose to focus on three levels of sufficiency. The first concerns reality, and enquires to what extent the theory of NIE mirrors the reality of developing countries (2.1). The second focuses on the theory itself and asks whether NIE is theoretical consistent to explain informality with information (2.2). The third level concentrates on the practical side by investigating the applicability of NIE for political advice (2.3). In section (2.4) the findings will be summarised.

2.1 The theory of NIE and reality in LDCs

It will be investigated if some of the basic assumption underlying NIE theory mirrors the reality of LDCs. In (2.1.1) the assumption of NIE concerning informal markets as single markets will be enquired; in (2.1.2) the explanatory power of information and transaction costs in relation to informal finance will be examined and in (2.1.3) the principle of homogeneity in informal financial markets will be explored. Section (2.1.4) summarises the findings which suggest that NIE theory is not able to capture the reality of financial markets in LDCs.

2.1.1 NIE assumption: single/multiple markets

One of the basic assumptions of NIE is that financial markets in LDCs are single markets. Traditionally, this means that a market-clearing price exists. NIE explains differences in the cost of credit, which relates to the market-clearing price of
credit, with differences in transaction and information cost. (Aryeetey 1995:16) Thus, differences in the interest rate are explained by the influence of imperfect information and transaction costs. (Stiglitz and Weiss 1981, Hoff, Braverman et al. 1993) According to NIE credit markets are subject to information, monitoring and enforcement problems due to the inter-temporal basis of transactions. These features give rise to moral hazard and adverse selection in credit transactions. In this approach, the interest rate comprises four components i) transaction costs, ii) risk premium, iii) cost of funds, iv) monopoly rent. If these would be included into calculations a market clearing price exists.

As an alternative method of defining a single market, NIE suggests looking at the products offered by the suppliers of financial services in terms of their end-use by borrowers. By this approach, if one sees a single or similar product i.e. a loan, then the conclusion was that a single market for loans existed, irrespective of its structure. In contributions to a workshop discussion of “markets in developing countries” various contributors took the view that financial markets were single with a common product, but acutely segmented/fragmented with significant price differences arising from a number of sources. (Aryeetey 1995:16) According to Roemer and Jones (1991:xvi), markets are single because in developing countries they are divided into segments in which different prices prevail for the same goods, services or factors.

Criticism I

The important question is: “Are the services and products of the financial agents all similar? Are they homogenous products?” Obviously, a small overnight loan from a savings collector based on a handshake must be very different from a large long-term one that is secured by 200% collateral. (Aryeetey 1995:17) Usually, the decision whether a product is a subsidy or a complementary is done by comparing the financial products offered by formal and informal financial units on the asset side from the end-use, but in developing countries it is not easy to decide if a product is consumption or a production good. A bicycle, usually considered as a consumption good, might be the only means in LDCs to transport goods to the market. Therefore, Adams (1992) suggested that looking out for financial markets purely on the notion of a uniform loan or other credit as the product was likely to
lead to a inadequate comprehension of the way financial systems operated. His argument was essentially based on the analogy of clothing that “informal finance was able to tailor contracts to fit the individual dimension, requirements, and tastes of a wide spectrum of lenders and borrowers”. Hence, only a few contracts, and therefore, products, in informal finance were similar. In other words, most of the financial products that borrowers receive differ considerably from another. (Aryeetey 1995:17)\textsuperscript{50} The point is of particular importance if it is considered that the dynamic of the informal sector is created by the diversity of credit products.

Criticism II

Critical is also the NIE assumption that differences in the interest rate are explained by the influence of imperfect information and transaction costs. (Stiglitz and Weiss 1981, Hoff, Braverman et al. 1993) In contrast, case studies relating informal markets to interest rates as Floro and Yotopoulos (1991) in relation to the Philippines, or Udry (1993) in relation to northern Nigeria suggest that the NIE approach is insufficient to explain the whole composition of interest rates. Variation remains within the result, which is not accounted for by transaction, information and default costs, but can only be explained by the presence of personal relations. (Nissanke and Aryeetey 1998) The point is that the operators in informal markets are mostly individuals, and transactions are based on the confidence engendered by face-to-face relationships between creditor and debtor. There is usually no collateral requirement since personal good faith and social pressure are sufficient to sustain payments. Many loans are non-commercial and/or linked to other markets as labour or product markets. The interest rate is flexible, reflecting the same components as in the formal market – transaction costs, risk premium, cost of funds and monopoly rent -, but additionally, including a “social” variable. \textsuperscript{51} Hence, Shipton (1994: 284) concludes that the concept of transaction and information costs in informal markets is a far too simple concept to capture reasoning behind rural individual or collective

\textsuperscript{50} Incidentally, Hoff and Stiglitz (1993) made a similar point when they suggested that credit markets in developing countries operated a matching system by which different prospective borrowers were sorted across different lenders according to the ability of the lender to screen particular borrowers and enforce particular kinds of contracts. Thus, ‘only an individual who markets his surplus through a trader can be matched with that trader-lender’ (Hoff and Stiglitz, 1993:6)

\textsuperscript{51} The discussion of NIE versus OIE is obvious in the very early debate between Stiglitz and Amyrta Sen concerning the debate of share cropping. Stiglitz explains share cropping with IF and TC, while contrasting Amyrta Sen considers existing power relationships as the foundation
decisions. Shipton further, concludes “if these (rural) financial systems are to be understood as markets, they are certainly no unified or discrete ones” (1994:311)

2.1.2 NIE assumption: transaction and information costs

NIE explains the existence of informal institutions as an efficient way to reduce transaction and information costs. The most cited example for the use of IC and TC concerning informal institutions are ROSCAs (Rotating Savings and Credit Associations) since ROSCAs are informal institutions which developed as well in Europe’s early transition period as in contemporary Africa and Asia. ROSCAs demonstrate that informal arrangements are timeless solutions due to the advantage of local information on transaction costs.

Criticism I

Case Studies demonstrate that women, in contrast to men, prefer to use ROSCAs over other informal arrangements. This fact would make sense according to TC and IC if the percentage of women participating in the informal sector is greater than that of men. Contrary, to what one expect that is not the case. The participation between men and women in the informal sector is 50% to 50%.\(^{52}\) (Tsai 2002) As different scholars point out women and men prefer different informal arrangements. Such differences are often only explainable by different attitudes i.e. towards drinking tea, which are caused by cultural influence on the matter of being male or female n general. (Johnson 2001) For an institution to be effective, norms must be internalised with an emphasis on trust and an extension of time horizons on lending. Both are important to reducing transaction costs and enhancing development (Stein and Nissanke 2003: 306)

\(^{52}\) Although in some countries, particular Islamic ones, the participation of women in the informal sector is higher due to female discrimination.
Criticism II

While focusing on transaction and information costs, NIE ignores other stipulations of contracts between lenders and borrowers or barriers to credit access. In this context, not the monopoly is meant by barriers of entry, but social power relationships in form of being a women or coming from a low cast. What is lacking is that credit relations which are embedded in wider social-economic relations are studied in isolation. As Mohan and Stokke (2000) point out, the romanticised notion of ‘the local’ represents the key point where it became possible for NIE to align institutional success or failure with social forces. In this version, the local is a homogenous passive actor searching for efficiency, but unfortunately constrained by shared mental models.53 (Mohan and Stokke 2000:264)

2.1.3 NIE assumption: the homogenous unregulated institution

NIE evaluates credit transaction and financial services in the unregulated sphere of LDCs in form of information and transaction costs. Therefore, NIE comes to the conclusion that the informal sector if linked to the formal sphere has a positive impact on market efficiency. Accordingly, direct links between regulated and unregulated institutions are recommended with the purpose to improve financial market efficiency. The unregulated financial institution has to be formalised to improve financial deepening, in the sense, that the unregulated institution becomes the semi-regulated institution, and finally, the regulated institution. NIE presupposes that each community creates its own homogenous efficient unregulated institution which politicians can easily ‘formalise’ to increase market efficiency.

Criticism I

This approach is useful in recognising that unregulated institutions are important is an advancement to orthodox theory it is not well thought through. As Bebbington (2001) shows, informal arrangements demonstrate a remarkable diversity

53 See also Hart 2001:655 who differentiates between the D/d dimension
of organisations even in a small area like the Andes. These organisations have differing interests, priorities and ideas about development suggesting that there are several development alternatives being pursued at any one time at local levels. Even if the different alternatives are not necessarily mutually exclusive they certainly pull in different directions and imply different ways of allocating local and external resources. (Bebbington 2001:15) Hence, the assumption that all those ‘unregulated’ organisations can be recognised and formalised with an upgrading intention is not realistic. What is missing within the NIE approach is the recognition of multiple forces at work. It is very interesting that Grameen Bank as the most innovative financial institution using informal forces is at the same time the greatest obstacle to future experimentation as Hulme and Mosley argue, since “most designers and sponsors of new initiatives have abandoned innovation, and replication is leading to a growing uniformity in financial interventions.” (1996:135) It is important to note in this context, that just because one microfinance institution using unregulated institutional forces is successful it does not mean that exactly the same microfinance institution is successful everywhere since at different places, different informal forces are at work. See also Murdoch (1997) and (Dunford and Woodworth 2003) for similar arguments.

2.1.4  Summary of NIE sufficiency in relation to LDC reality

NIE is not able to explain the existence of various informal institutions, nor is NIE able to explain the interest rate composition in informal financial markets. Further, NIE assumes homogenous institutional structures in relation to informal finance which does not mirror reality. NIE neglects power structures and forward/backward linkages. Therefore, NIE is not sufficient to explain the reality of LDCs

⇒ NIE is not sufficient as a theory in relation to the reality of financial markets in developing countries
2.2 Theoretical consistency of NIE in relation to unregulated markets

This chapter intends to enquire if NIE, while theoretically able to explain the existence of the comparative advantage of informal institutions in relation to formal ones, is also able to explain the advantage itself. NIE is able to explain growth with focus on formal institutions, but it is overlooked that growth is to a large extent driven by informal forces. For example, China’s contemporary growth is to the most part driven by informality. Therefore, NIE is only an applicable theory if its reasoning based on information advantage can be used to explain formal growth potential as well as informal growth potential. Section (2.2.1) explores if this is the case. Further, it will be investigated in section (2.2.2) if the NIE assumption of an institutional hierarchy, with the formal institution being better than the informal one is justified. In section (2.2.3) the findings will be summarised.

2.2.1 Uncertainty

This chapter intends to highlight that although NIE is able to explain the positive effect of linkages by using the concept of uncertainty, NIE is not able to explain the enormous growth potential of the informal sector with uncertainty. Therefore, section (i) examines the concept of uncertainty; section (ii) demonstrates why North argument is sufficient to explain the existence, but not the growth potential of informal arrangements; and section (iii) demonstrates how Williamson’s is able to justify linkages while being also unable to explain the dynamics. Section (iv) concludes that the concept of uncertainty is insufficient in relation to informal finance.

Concept of Uncertainty

According to the NIE approach, the advantage of the unregulated credit market is based on trust. Although ‘trust’ is a social phenomenon, in economics it is translated as a way to decrease uncertainty. Hence, the advantage of the unregulated sector is built on the ability to decrease uncertainty. However, the concept of uncertainty is not that simple. Although in the sophisticated version of NIE a more
complex understanding of uncertainty exists the approach is still limited. In general, it is differentiated between *procedural rationality* which means the mental limitation to calculate possible outcomes and *substantive rationality* which implies the lack of information which, in turn, has different subcategories in relation to probabilities. (Dequeche 2003)

**Graph 1: Different levels of uncertainty**

A detailed definition of substantive rationality, weak substantive rationality, strong substantive rationality, ambiguity and fundamental uncertainty is given below.

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54 The more sophisticated NIE version of uncertainty, risk etc. has yet not been applied to developing countries financial markets – but it could be.

55 Graph by Alexandra Bernstorff 2004
Table 13: Differences in uncertainty

<table>
<thead>
<tr>
<th>Procedural Rationality</th>
<th>Substantive Rationality</th>
<th>Weak Substantive Rationality</th>
<th>Strong Substantive Rationality</th>
<th>Ambiguity of Strong Substantive Rationality</th>
<th>Fundamental Uncertainty</th>
</tr>
</thead>
<tbody>
<tr>
<td>The limitations of mental ability to consider all possible outcomes</td>
<td>The lack of information in general</td>
<td>The lack of information is caused by risk, but probabilities exist.</td>
<td>The lack of information is caused by the absence of probabilities.</td>
<td>Although the lack of probabilities makes a risk calculation impossible, the probable events are known. For example, in relation to harvesting in developing countries, good weather, bad weather, insect plaques, war effects influence the crop size. These factors are ex ante known, but the probability of all factors together can not be calculated.</td>
<td>The lack of information is caused by the absence of the probabilities and the absence of possibility in turn, is caused by the fact that possible events can not be known.</td>
</tr>
</tbody>
</table>

The explanation by NIE scholars concerning institutional change implies that every institution decreases one of those uncertainty aspects. For example, North focuses on procedural rationality by focusing on the influence of shared mental models on institution building. Williamson, in contrast, focuses on fundamental uncertainty by emphasizing the importance of contracts. The assumption that decreasing uncertainty increases efficiency implies that the growth potential of informal institution is limited to the task of decreasing uncertainty for the formal institution. Thereby, it is lacking out that informal financial institutions show growth potential independently from formal institutions. To gain theoretical consistency, the same mechanisms of decreasing uncertainty for efficiency gains, in relation to the regulated institution, should be valid in relation to the unregulated institution. Hence, the following section will consider North and Williamson’s argumentation applied to the unregulated institution.

North

The differences in relation to uncertainty are quite decisive. For example, North focuses on procedural uncertainty in the sense that limited cognitive ability is decisive for uncertainty. In relation to informal credit markets, implying that the ‘social factor’ is missing in the interest rate composition stems from advancement in procedural rationality. Or in other words, due to social bonds, the mental ability to calculate uncertainty increases. It is obvious that North focus on procedural uncertainty cannot be convincingly applied towards the unregulated credit markets.
The problem is that North’s limited mental ability approach towards uncertainty is developed in the context of inefficient institutions. He explains the existence of inefficient institutions with cognitive limitations. The application of procedural rationality towards an efficient institution is confused and inconsistent. It would only make sense, if it is assumed that the mental ability to process information increases in a small network, but in North work mental ability is fixed\(^6\). In his work, the mental ability always causes uncertainty, but has no opportunity to reduce uncertainty. The critical inconsistence of North is that mental models are always considered as constraints to efficiency, while in contrast, increases in efficiency are always based on information advantages

Williamson

Another example for theoretical inconsistency of NIE is Williamson (1998) who focuses on fundamental uncertainty caused by the incompleteness of complex contracts. (Dequeche 2003) In relation to informal credit markets that would imply that social bonds decrease the complexity of contracts and hence, have a positive influence on the interest rate. Although the theory is advancement towards neoclassical theory the question is to what extent it is relevant for informal credit markets. As demonstrated in part II, the dynamic and flexible features of the informal sector are decisive for its viability and this implies a continuously changing interest rate. If the interest rate composition is mainly explained by complex contracts (Williamson 1998) which are static in a small network, variation of the interest rate should not be apparent. In this case i) transaction costs, ii) risk premium, iii) cost of funds, iv) monopoly rent and v) complex contracts (social factor) are constant. The failure is to explain fundamental uncertainty with complex contracts instead, of a characteristic of reality – in other words, market failure is caused by the need for complex contracts. The reverse conclusion would be, to argue that the dynamic of the informal credit sector exists only due to defined contracts. Critically, in this approach, is the assumption that fundamental uncertainty is bad, it makes the perfect contract impossible and each contracting party has to expect cheating. What is

\(^6\) In his later work North admits changes in the mental ability but the approach is still inconsistent because (1) he only assumes an improvement of the mental ability – a unidirectional development is always critical; and (2) changes in the mental ability are always caused exogenous. A more detailed analysis follows in the following section.
lacking is the fact that fundamental uncertainty causes innovation and the need for trust. Fundamental uncertainty causes flexibility and adaptability and is hence, substantial for the advantage of the informal sector.

Summary Uncertainty

This section demonstrated that, while NIE is able to explain the positive effect of linkages by using the concept of uncertainty, NIE is not able to explain the enormous growth potential of the unregulated sector with uncertainty. NIE assumes that the unregulated sector does have an advantage in relation to the formal sector, but not an advantage in its particular structure. The focus is on the formal sector. In this sense, informal arrangements are only a means to overcome constraints on the formal sector. The informal institution overcomes the information constraint of formal institutions. Therefore, their potential is limited to increase the functionality of formal institutions. This approach is insufficient to explain the dynamic potential of informal institutions. In other words, NIE assumes that formal institutions are the driving force behind growth, but reality proves that to an equal extent the informal institution is decisive for development. The theory of NIE is only applicable if the same reasoning that explains the advantage of informal institutions in relation to formal ones can be reversed, but this is not the case, therefore, the chain of NIE argumentation is inconsistent.

2.2.2 Formalisation

NIE argues that informal arrangements should be formalised with the intention to capture its comparative advantage. Critically with the aim of formalisation is that the purpose is not to design formal rules which are consistent with the unregulated institutional dimension, but to transform the existing institutional endowment for a specific purpose. (Sindzingre and Stein 2002:11) This is complicated because it presupposes that development is an hundred percent intentional process. It is as Cowen and Shenton (1996, 1998) argue: “one of the confusion, common through development literature is between development as immanent and unintentional process as in for example, the “development of
capitalism” and development as an intentional activity” (Cowen and Shenton 1998: 50)\textsuperscript{57} The attempt to formalise informal institutions overlooks the fact that as well endogenous as exogenous institution develop specific meaning and function in its relation with other institutions. According to Sindzingre and Stein, it is the environment of other institutions that gives it scope, content and meaning. (Sindzingre and Stein 2003:13) The problem with NIE is that institutional forces are not distinguished from institutional purposes and institutional outcomes.\textsuperscript{58}

The unregulated institution is missing in NIE because the distinction between the regulated/unregulated is only used in the sense of maximising an objective function subject to constraints. In this sense, the unregulated institution is never enabling. This approach limits the importance of the unregulated institution to the ‘least efficient’ institution on the way to reach the ‘most efficient’ institution. It implies a hierarchy of efficient institutions. For each unregulated institution, a higher order efficient institution is ex ante known. It seems that NIE (1994) does not deal with the unregulated institution because it would lead to theoretical inconsistence. On the one hand, North (1994) considers shared mental models as enabling in the sense that they simplify the complicated world which can never be fully accessible to humans on the other, he presupposes to know the right formal institution (the most efficient). Since all humans act with shared mental models then one wonders why humans know the perfect formal institution. The unregulated institution lies in a theoretical sense at exactly the point between knowing and not knowing. Therefore, it is only possible to use the NIE concept of institutional formalisation when institutions are analysed in a functionalist perspective and if historical change is explained by the reduction of transaction costs.

Additionally, the differentiation in institutional dimensions has to be considered carefully. It is assumed that an ‘institutional hierarchy’ exists where the formal institution has more value and strength than the informal institution, but as it is unknown which institutional force is the strongest, it can be a shared mental model like religion which transforms into a new formal institution like the Islamic bank, it

\textsuperscript{57} A similar point is made by Bebbington 2000, 2002 and Hart 2001

\textsuperscript{58} See also (Adelman 2001:118) “There are no unique sets of causalties, nor a linear path leading to development”
can be an institutional arrangement like ‘The Hanse’ which supports trade, it can also be an external factor like the implementation of the “Marshall Plan” in Germany after WWII. Sometimes shared mental models have to be aligned with formal institutions sometimes they do not need to. All institutional dimensions constitute a continuum of activities with changing relations. The informal rule is what makes formal rules compulsory, but the informal rule can as well ex ante as well as ex post emerge. For example, under the influence of the German Party “Die Grünen” the concept of Mülltrennung was established as compulsory for each citizen. Although the majority did not ex ante accepted it, it became with the years an ex post informal rule. It is as Sindzingre and Stein (2003:9) argue erroneous to oppose formal rules and institutions and informal ones, as if the “informal” level had weaker rules. However, it is also erroneous to assume that formal rules have weaker rules than informal ones. It depends on the exact rule, institutional arrangement, timing and other non-economic variables.

2.2.3 Summary theoretical consistency of NIE

This chapter shows that NIE is able to explain the positive effect of linkages by using the concept of uncertainty. However, NIE is not able to explain the enormous growth potential of the informal sector with uncertainty and information advantage. For NIE, informal arrangements are only a means to overcome constraints on the formal sector. In this sense, they assume an institutional hierarchy in the process of decreasing constraints. Underlying is the assumption that ‘formality’ is growth enhancing, what is missing is that to an equal extent ‘informality’ is growth enhancing. The theory of NIE is only applicable if the same reasoning that explains the advantage of informal institutions for formal ones can be reversed, but this is as section 2.2.1 shows not the case. Therefore, the chain of NIE argumentation is inconsistent.

⇒ NIE as a theory is inconsistent in explaining the growth enhancing advantage possessed by unregulated institutions

2.3 Applicability of NIE?
It will be examined if NIE is able to provide policy advice to countries facing financial market fragmentation. The economic field dealing with informality is microfinance, the institution which is extremely energetic in this area and built on NIE theorising is the World Bank. Thus, it seems naturally to observe if the World Bank is able to give policy recommendations for microfinance. Section (2.3.1) examines the World Development Report 2002, which summarises the recommendations as announced by the World Bank in relation to institution building. Further, it will be examined in section (2.3.2) if those recommendations can serve as a political advice and whether the approach is applicable in relation to women lending (2.3.3), interest rate setting (2.3.4) and social context (2.3.5) Finally, section (2.3.6) summarises the findings.

2.3.1 World Development Report 2002

The World Bank raises its voices in the famous World Development Report. In the context of microfinance, the World Development Report 2002 with the promising title “Building Institutions for Markets” is extremely interesting. The report is an extension of NIE theorising because it considers the importance of formal and informal institutions and is in agreement with the Post-Washington Consensus. The introduction of Part IV (written in big capital letters) states:

“Societal forces shape the effectiveness, growth, and legitimacy of market institutions, which in turn, affect the rules and values of societal actors. The chapters in this part of the Report explore the range of interactions between society and market institutions. Chapter 9 on Norms and Networks discusses how the informal institutions used by societal groups influence transactions in the market. “ (World Development Report 2002:170)

What follows is the recognition of the importance of the informal sector. It is recognised that “informal institutions tend to complement formal ones” (p.172). It is recognised that “When inadequate attention has been paid to norms and culture, formal institutions have not delivered desired outcomes.”(p.172) And it recognises that “Building bridges between existing formal and informal institutions is an
effective means of enhancing the success of formal institutions”. (p.178) The entire report deals with the question of “How do informal institutions aid market transactions? Why do informal institutions facilitate transactions for some and not for others? And how can the interaction of informal and formal institutions are used to ensure a dynamically supportive market environment?” However, if the reader attempts to answer those questions he is left alone by the report. The conclusion of the chapter “Conclusion” of the World Development Report is:

“Market activities are supported by a complex blend of informal and formal institutions. In many poor regions of the world, and particularly for many poor people, informal institutions such as community networks are the only ones that are relevant, because access to formal institutions is relatively scarce......Informal institutions can be superior to formal alternatives, either because they are more efficient at achieving the objective or because they embody features that formal institutions are unable to provide, but in other cases, informal institutions may prevent further, market development...” (p.179)

It is questionable whether there is a conclusion in any guide for economic development, which giving as little insight as that one. Apart from the fact, that those findings were common knowledge in the eighties by scholars dealing with microfinance. (i.e. Von Pischke 1980) However, the question remains why the World Bank, although recognising the importance of informal institutions is not able to provide policy advises for microfinance. Further, it remains an open question if the theory of NIE creates a theoretical barrier for applicable policies.

2.3.2 Why is the World Bank unable to provide policies for microfinance?

The World Bank was conceived in a very different context to informal finance. The World Bank is essentially a macro lender born in an era of central planning ideas. Therefore, the contextual distance form the informal sector in which the World Bank operates makes it generally adverse to informal market signals. The approach to combine microfinance and the World Bank in itself seems problematic since the organisation has only operated in the formal lending context until now. Therefore, its immense size and centralised organisation is out of date in the highly
dynamic world of microfinance. The largest obstacle to World Bank microlending programs is its lack of regionalisation necessary for both market and non-market operations. Informal lenders are an interactive part of the social and economic community in which they are lending and exactly that is the reason why they are successful. Informal lenders have access to non-formal credit histories and risk assessment information hence, their provision of credit is as dynamic as the market demand from the community. The World Bank has none of these resources available to them, so any microlending programme will be simply educated guesswork.

2.3.3 Lending for women

A very good example of the World Banks shortcoming is provided by “lending to women”. By now it is recognised that women have less access to credit than men in some developing countries (Valentine 1995). Often, investing in women will bring about a higher return in both the enhancement of human and physical capital than investing in men. Women are active in the markets of developing countries often by carrying out several micro-businesses and/or agricultural activities. Women are especially adverse to formal credit in some countries because of social and economic inequities. In some places where the society is highly patriarchal, women are required to have her husband or some other male relative co-sign for a loan. Therefore, the World Bank could lend to only women and try to rid LDCs of gender bias in credit allocation. Conceivably, such a policy is possible. Non-governmental organisations such as Women’s World Banking are lending primarily to women. Women do present a chance for economic development and are the victims of market failure, but the question of which women to lend at what interest rate remains unanswered.

2.3.4 Interest rates

Interest rates are another policy issue the World Bank would have to determine. Commercial banks will often not lend to micro enterprises because their inability to determine the risk involved with lending to any particular micro
enterprise. However, the World Bank is has no more information than commercial banks. Because the informal sector is heterogeneous and has varying levels of risk attached to different micro-entrepreneurial activities, setting the correct interest rate for an agency such as the World Bank is nearly impossible. Agencies like the World Bank operate outside of the market and do not have the intimate knowledge of the informal market as do informal lenders. Though, they can collect some market information and set rates accordingly, the centralised and detached nature of the World Bank prevents it from becoming an interactive part of the informal credit market. (Puglielli) Setting the incorrect interest rate can range from having no affect on the informal credit market to having perverse and malignant consequences. An artificially high interest rate has no effect on credit access by micro entrepreneurs because the demand for credit will be satisfied by other microlending firms in the informal credit market. However, when the rate is set too low, the demand for credit exceeds supply – at least at a sustainable level hence, crowding out private investment. By crowding out the private investment, the World Bank destroys the only self-sustained form of domestic investment in the informal sector.59 Similarly, crowding out will also occur even if the interest rate is set correctly.

The problem of information does not end with the setting of interest rates. Micro enterprises are highly dispersed in both economic activity and location. Lending models such as the credit cooperatives have recognised the regionalised and heterogenic properties of micro enterprise, and thus, have adjusted accordingly. Credit cooperatives, like the Grameen Bank are successful because they are regionalised to the extent of informal credit agencies, and thus, take advantage of the informal market information available to them. The Grameen Bank is able to evaluate risk, through its highly regionalised structure, and is able to disperse credit allowing it to find its greatest return. This is the reason why the Grameen Bank has such a high repayment rate of above 90%. (Stiglitz 1998, Otero and Rhyne 1992, Morduch 1997) However, the World Bank has no regional interaction. The administration costs of lending to every potential borrower would be enormous.

59 The topic about aid and crowding out is itself immense. Private sustainable investment is an important factor in LDC development. Aid that crowds out private market activity in both production and investment is detrimental to macroeconomic growth. This micro-macro paradox explains why of 245 projects evaluated by the World Bank, 85% of the World Banks projects fared well, but the countries in which the projects were implemented, the macro economy was not proven to be better off. (White 1992)
Therefore, the World Bank’s lending practices would be highly biased both in region and in the activity of the potential borrower.

2.3.5 **Social context**

Another obstacle of the World Bank engaging in microlending activities is its lack of social context. Informal credit agencies work, because they can hedge against default through the use of social pressures. The World Banks is a large centralised foreign agency, and its ability to monitor the cultural nuances that allow for successful microlending is limited. The lender in the informal market has intimate knowledge of their borrowers. The World Bank has no ability to gain such intimate knowledge. Therefore, the only way for the World Bank to hedge against default is to employ the methods of commercial banks – credit ratings, collateral, lengthy application processes. Coupled with a need to interact with both region and culture, is the need to react quickly to changing credit demands. Again the World Banks separation from the market hinders its ability to change and respond with the need of borrowers. In contrast, to the formal sector where the needs of borrowers do not change very rapidly, the requirements of informal borrowers change quickly. While assuming that the World Bank will always have difficulties by directly influencing micro credit, one could argue that they should serve as intermediary for the informal credit markets that already exist. On the outset, such a plan not only sounds feasible, but economically sounds. The reality is that neither is true for the same reason as with lending directly to micro entrepreneurs; detachment from market operations. The World Bank has no way to differentiate between good and bad existing informal credit arrangements hence, they do not know how to fight against corruption, set interest rates, allocate credit resources and have any impact in doing so without destroying the very economic context it wishes to enhance. All of these context problems have no solution.

2.3.6 **Summary applicability of NIE**

Informal lenders are successful because they are able to assess and respond to the information transmitted by informal market mechanisms. The small size of
informal lenders coupled with social and economic ties provides the advantage of informal financial arrangements. The advantage is not only an ‘information’ advantage which can, according to NIE, be captured and materialised in building linkages. The information advantage is based on individual social structures and therefore, a universalistic concept of how to formalise those is not possible to gain. Further, the heterogeneous structure of informality is decisive for its viability, but it is impossible to create a universal theory for a universal policy advice of how to proceed with informal institutions.

⇒ It is not possible to derive an applicable policy conclusion on NIE theorising

2.4 Is NIE appropriate?

It has been suggested that ISA is an extension of NIE theorising towards financial markets. Therefore, NIE, in contrast, to common financial market theories, is able to explain the existence of informal financial markets and able to justify the finding that linkages between informal and formal institutions promote growth. The task of this chapter was to investigate if the NIE approach towards financial markets is sufficient. Hence, the sufficiency in relation to reality, consistency and applicability was examined. The findings suggest that NIE is insufficient concerning reality, since transaction and information costs and are not enough to justify differences in interest rates and to explain the various constructions of institutional arrangements. NIE is also inadequate to derive policy advises since neither the heterogeneous structure of the institutional sphere nor power relations are considered. Thus NIE theory does not capture the financial reality of LDCs. Further, the theory of NIE itself demonstrates severe inconsistency by explaining economic growth with upgrading formalisation. By assuming an institutional hierarchy the content and meaning of an institution is confused. Although NIE is able to explain the existence of informal institutions they do so by limiting their function to decreasing information constraints for the formal sector. In this sense, informal institutions are only a means to overcome formal constraints. NIE neglects the fact that informal institutions are to an equal extent the driving force behind growth.
Therefore, NIE theory would be only sufficient when the reasoning that explains efficiency increases in the formal sector is also able to explain efficiency enhancement in the informal sector. As shown above, this is not the case. Further, the informal institution is not differentiated from the formal institution. Either informal or formal, institutions are just a means to optimise an objective function, with the former being the least and the latter being the most efficient solution. Institutional purposes, institutional outcomes and institutional forces are not differentiated. This becomes particularly problematic when NIE is used as policy advice as done by the World Bank. A universal theory can not be applicable for heterogeneous mechanisms. The great potential of NIE lies in its attempt to advance neoclassical reasoning. Using the World Bank as an example, it has been shown that NIE by recognising informal forces, allows mainstream theory and orthodox institutions to ask questions previously outside their sphere. This recognition is relevant because it underlines the importance of informality for economics.

However, one should not confuse the theory which acknowledges the informal sector with a theory which can answer the questions of how to built formal institution with informal forces or how to link formal and informal institutions or if an informal institutions is a good or a bad one. NIE cannot answer those questions on the foundation of ‘information theory’ and the World Bank due to its formalised and centralised feature cannot either, but maybe, this is not their job. It might be that those questions, due to their heterogeneity, can only be answered by a theory dealing with heterogeneous features, namely OIE. In this context, I argue that financial advises built on NIE theory can not be useful without OIE consideration. It seems that NIE and OIE are two sides of the same coin. NIE is able to identify the economic question, but only under consideration of OIE aspects it is possible to voice political advice.

⇒ NIE is not sufficient in explaining the advantage of the informal sector
3 Criticism on ISA reflects OIE

After examining that NIE is not sufficient in explaining the unregulated market existence, the question is to what extent these shortcomings reflect OIE reasoning. The criticism on the NIE approach in relation to informal financial markets was voiced by praxis oriented development economists and not by economic theorists. In this sense, the NIE approach was considered as insufficient on practical grounds. The question is whether problems arising from reality are similar to the criticism of OIE on NIE on a pure theoretical base. Thus the intention is to explore if development economists who criticise the NIE approach on practical grounds use the same arguments as OIE scholars when criticising NIE on theoretical grounds. Only if the weakness, as demonstrated by reality, appears to be identical to the shortcomings of the NIE theory as criticised by OIE, NIEOIE finds justification in relation to informal financial markets. Section (3.1) will consider the differences between NIE2 and OIE in relation to institutional change as these are not very clear identified in contemporary literature and otherwise may lead to confusion. Following, section (3.2) will proceed by investigating if the criticisms coming from the practical sphere reflect the criticism stemming from OIE on a theoretical foundation. In section (3.3) the findings will be summarised, suggesting that NIEOIE is relevant.

3.1 Borderline between NIE and OIE

It is commonly assumed that the sophisticated version of NIE (NIE2) is able to deal with the informal sphere of economics while working as a bridge between OIE and NIE. The following section will investigate if this is the case. I will proceed by examining if the criticism announced from OIE on NIE is justified (3.1.1). Further, it will be explored if North works as a bridge between NIE and OIE (3.1.2) and if the differences between Williamson (intra-firm issues) and North (institutional change) are as decisive as often stated (3.1.3). Following, the central role of information in NIE will be investigated and the implication of information focus for institutional change and economic growth will be explored (3.1.4). These points are of particular importance since the ambiguity between NIE and OIE is not due to
NIE’s neglect of social embeddedness. Rather, the disagreement exists in the conclusion NIE derives in relation to institutional evolution.

### 3.1.1 Wrong criticism on NIE

Before the dissertation continues, some justice has to be done concerning NIE, namely that most of its criticism found in the literature is wrong and relates if anything to the early version of NIE. For example, Zafirovski (2003:812) argues that NIE ignores institutional embeddedness. Similar Carlson (1997:754) argues that NIEs analysis is ahistorical with individuals who are resistant to any institutional, historical and other social influences. (See also Zafirovski 2003, Frank 1996, Piore 1996, Granovetter and Swedberg 1992)\(^6\) As should be apparent from the previous analysis, NIE theory is neither ahistorical nor neglects the influence or the importance of existing institutions. NIE explicitly does recognise and even differentiates between cultural embeddedness in form of religion, history etc. and institutional endowment in form of technological and institutional path dependency. While North is commonly cited as an exception with respect to ‘shared mental models’, he is by no way the only one.\(^6\) Other NIE scholars include Aoki (2000), Azfar (2002), and Williamson (2000). NIE scholars do not argue that all institutions are efficient and rational as claimed by i.e. Zavirovski 2003, Davidson and Ekelung 1994, Sjöstrang 1993 and many others. Rather NIE argues that institutions are inefficient because they are socially constrained. Hence, the criticism of Zafirovski (2003:816) that NIE does not consider institutions as constraints is just wrong even in relation to the early version of NIE.

### 3.1.2 Wrong conception of North

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\(^6\) Zafirovski (2003:803)”The negative attitude towards history indicates an a-historical approach to institution within NUIE with some notable exceptions (e.g. North 1994).” See also Granovetter, Vanderbuilt, Zavirovski,
Another mistake often found in the literature is to compare North with NIE. (Zafirovski 2003, Vandenberg 2002, Granovetter 1996) It seems to be a very common mistake to consider North as the bridge between NIE and OIE, while contrasting him with the ‘conservative’ Williamson. However, the point is that the use of shared mental models does not make North more an OIE than Williamson when using bounded rationality. The two of them focus on different information properties in distinct institutional spheres within a society, while coming to similar conclusion concerning institutional evolution. Both of them conclude that the most efficient solution is constrained by either bounded rationality (Williamson 1998) or by shared mental models (North 1994) and hence, both conclude that an attempt should be made to decrease those constraints. In relation to Williamson who implies that complete contracts increase efficiency while decreasing bounded rationality. In relation to North it implies that implies that new institution building alters existing shared mental models towards more efficient ones. Hence, the content of the terms bounded rationality and shared mental models the way they are used by North and Williamson is very similar. Both conclude that a more efficient solution exists, is known and can be formalised. It is this conclusion that makes them NIE.

3.1.3 Information focus

On the micro level Williamson focuses on exchange between two actors, or acting groups (i.e. firms, employees etc.) Consequently, he argues that efficiency is limited due to uncertainty caused by bounded rationality either in form of incomplete contracts or impossible calculations. (Dequeche 2003, see section 2.2.1) In his argument institution building acts as ‘efficiency device’ for the bounded rational individual. North in contrast, is not interested in the relationship between two acting parties, his ‘limited efficiency’ is not caused by the exchange between individuals, instead, he focuses on shared mental models which cause individuals to act inefficient. (See Graph below) Focusing on tradition, history, geography, infrastructure etc. and its respective influence on communities he partly explains the bounded rational individual. Similarly ISAs explain the existence of diverse inefficient/efficient informal arrangements with distinct world views and different institutional endowments. The unregulated arrangement equals the bounded rational
individual in the sense that due to incomplete information either the community or the individual act according to its best knowledge. Both act as efficient as possible, whereby the most efficient solution is limited either by bounded rationality or by shared mental models. While Williamson’s smallest entity is the individual actor, North operates with the smallest institutional arrangement, the unregulated institution. However, North’s use of shared mental models on the level of institution building is conceptually not different to Williamson’s use of bounded rationality within a firm. Or in other words, as long as ISA uses North version of shared mental models they will be open for exact the same criticism and inconsistency as OIE announces in relation to NIE

Graph 2: Differences in information focus

Graph 2: NIE1 focuses on information problems between two actors arising from the fact that the possible action of the other are not known illustrated in the graph as ‘focus of interest A’. NIE2 focuses on the institutional environment which cause information problems illustrated in the graph as ‘focus of interest B’. Important is that the focus points are not connected.
3.1.4 Transplant effect

On the first glance, it appears as if the focus on institutional endowment and its influence on information properties as apparent in ‘transplant approaches’ has similarities with OIE because the individual is embedded in a social context. The attempt is surely OIE, while the theoretical execution is not. Underlying the NIE approach is the assumption that the efficient market is similar to a natural law (spontaneous order). Financial markets in LDCs suffer from market failure causing credit shortages for SMEs. Unregulated financial institutions are then the best known community solution towards this problem, restricted by shared mental models. The most efficient institution cannot be built as long as it is not connected to the institutional endowment because the bounded rational individual would not understand how to use it. The ‘most efficient institution’ is outside the mental ability of individuals. For example, in NIE perspective Islamic banks are not the most efficient banking institution, but the shared mental model of religion which forbids Muslims to take interest, makes it impossible to construct the most efficient institution. Accordingly, the task of politicians is to build institutions which are in the mental scope of the nation inhabitants. In case the mental scope is extremely limited due to excessive traditions and other shared mental models, politicians should aim to build institutions that alter existing shared mental models. See Graph:

**Graph 3: Upgrading formalisation**

Graph 3 illustrates the NIE assumption that shared mental models like traditions are the least efficient while simultaneously the most efficient institution cannot be built as long as it is not connected to existing shared mental models. Therefore an effort should be made by building semi-regulated institutions to alter existing shared mental models. Important is that an upgrading intention is pre-assumed without backward linkages.

62 Graph by Alexandra Bernstorff 2004
This model is a great advancement towards the neoclassical approach. Nevertheless, it is oversimplified in three points. (1): it only assumes upward linkages and it does so because of (2) the rational homogenous community, which is (3) not adversely influenced by new power relations and other new societal influences. (Hodgson 1998) These three points mirror the criticism of ISA as demonstrated by chapter 2. To recall, critiques argued that humans are engaged in many different even contradicting community solutions at the same time, hence, the question of which institutional arrangement should be formalised in which manner is not as easy as ISA describes. Further, critiques on ISA pointed out that new formal institution alter shared mental models, but not necessarily in a positive way, new power structures can cause new inequalities etc. hence, the aim to build a more efficient institution without consideration of backward linkages is dangerous with an outcome which may contradict the original purpose.

3.15 Summary borderline NIE and OIE

NIE does deal with the influence of social embeddedness on economic institutional viability. Nevertheless, differences between the early and sophisticated version of NIE is not as important as often pronounced. While NIE1 focuses on information problems between actors NIE2 focuses on social factors that cause poor information properties on a national level. However, both strands derive the similar conclusion of formalisation and regulation while neglecting forward and backward linkages or power relations.

3.2 Criticism on ISA equals OIE

The intention of this chapter is to explore if development economists criticising ISA application towards financial markets on practical grounds, use the same arguments as OIE scholars when criticising NIE on theoretical grounds. The aim is to extend the theory, as outlined in Part I, towards reality and Hence, to give the theory value and justification. The dissertation will proceed by considering power
(section 3.2.1), cumulative causation (3.2.2), spontaneous order (3.2.3) and rationality (3.2.4). The findings will be summarised in section (3.2.5)

3.2.1 Power

In NIE, power is mentioned and treated, but only in form of monopoly power, which gets full attention as the outcome of a special market form. In general, NIE does not deal with power as motive force, economic position and extra-market actions for achieving power. NIE overlooks the fact that the emergence and operation of institutions is not only economically determinate, but also by factors like power struggles and class conflicts. (Dugger and Sherman 1997) It is rather as Perrow (1986:219) argues that “many institution look the way they do because some actors have power over others – and not because one type of organisation is more ‘efficient’ than another” (Perrow 1986:219) In light of such tendencies, one can depict economic institutions, including firms and markets, just as power systems (Brinkman 1997:1035) Power is one of the main objects of OIE see for example, Galbraith (1967) who describes the evolution from agriculture based society to large scale manufacturing as a shift in market power from the owner of land to the owners of capital. Or Lukes (1974) and Bartlett (1989) who conclude that power does not just affect what people do, but also what they are. It is important to note that power can go beyond an ability to define the terms or conditions of trade. It may even be the ability of a moneylender to shape the preferences of his customers. (Galbreith 1967, Bartlett 1989) The point mostly overlooked by NIE is that power does not just affect what people do, but also what they are. (Lukes 1974, Bartlett 1989) In general, power is one of the cornerstones of the political economy of Schumpeter, Veblen, Dugger, Galbraith (1967). This point is important for economic development because institutions and power “determine the structure of the market, even the whole economic system can be changed if those interested in change have enough political power”. (Myrdal 1953:198)

3.2.2 Causal cumulation
While the NIE conceives all social institutions as joint outcomes of rational individual activities, OIE defines the former as societal phenomenon with an autonomous structure (Weber 1968:341) and moulding capacities vis-à-vis the latter. This can be considered the most general discontinuity between NIE and OIE. (Zavirovski 2003) The picture NIE sketches is rather simple, by considering only how individual incentives and actions generate and perpetuate institutions, and ignoring the reverse impact. (Piore 1996:743-4). On the one hand, NIE considers institutions as efficiency constraint in the sense that shared mental model constraint the spontaneous order of efficient markets (i.e. North) on the other, hand institutions are considered as efficiency device which improve exchange between bounded rational individuals. (i.e. Williamson) NIE misses that the efficiency constraint influences the efficiency device and vice versa. Hence, neither of them is static which implies cumulative causation.63 NIE regards institutions as exclusively functions or outcomes of rational activities. By contrast, OIE entails the duality of institutions as both explanatory and dependent variables of individual economic activities. (Zafirovski 2003:804) OIE implies changes in one or another direction through the whole system. This is captured in Hirschmann’s (1958) idea of ‘vicious’ and ‘virtuous’ circles where forces move as well in positive as in negative direction.

The misconception, that institutional influences on individual action are just upgrading stems from the idea that individuals act as rational as possible following a spontaneous order of market efficiency. Since the more efficient institution is the one more natural according to spontaneous order, the institution would not influence individual action. In this circumstances, the individual finds himself in a ‘more natural environment’ than before and institutions are no more than aggregate effects. (Zafirovski 2003:800) NIE neglects the fact that social institutions do not emerge and persist in an automatic manner in response to efficiency imperatives, but are ‘socially constructed, reconstructed and sometimes deconstructed’ (Granovetter 1990:98)

There are uncounted individual choices, decisions and action within an economy, but they occur within or between either regulated or unregulated institution while reinforcing or weakening the bonds that keep institutions together. Hence, choice, action, bond and context go together. (Bunge 2000:151) Contrary, NIE insists on

studying “the components of social systems, that is, individuals, while overlooking their structure or set of connections (internal and external).” (Bunge 2000:149)

3.2.3 Rationality

OIE criticises methodological individualism (see Part I) in the sense that human motivation are reduced to efficiency maximising outside sociological influences emanating from group and political action. This equates DEs criticism of NIEs focus on community in which each community’s unregulated institution is an efficient solution limited by existing shared mental models. NIE sees communities as utility functions, while OIE sees persons as relational. (Myrdall, Marx, Hodgson) NIE would argue that not only markets, firms and other economic institutions are caused by private optimisation, but also non-economic institutions and rules, including governments, legal systems, democracy, families, morals, conventions, ideologies, education, science, religion.64 (Bunge 2000:806) On the one hand, the individual is assumed to act rational under bounded rationality on the other it is supposed that the community act rational under existing shared mental models. In relation to unregulated credit arrangements implying that each arrangement is the most efficient. However, OIE does not argue that rational maximising behaviour is not legitimate in some types of analyses, but it should be called ‘situational logic’. (Giddens 1984, Hodgson 1988, Lawson 1985)

3.2.4 Spontaneous order

Hayek and Menger conncluded that language, money, markets, morals and law are invoked by spontaneous order, meaning, that they are the inevitable outcome of human life. Similarly, NIE sees the efficient money market as the end of institutional evolution. The task of national politicians is to remove obstacles to this natural order, by altering existing shared mental models with new institutions which

64 NIE does not deny that the importance of the social context for institutions, but they leave the latter unanalysed. NIE assumes that individuals organise themselves into small communities such as families, tribes, villages, business firms, armies, schools, religious congregations, informal networks, or political parties.
work accordingly as efficiency device. Assuming that financial markets have a natural existence implies that removing obstacles is one-directional in archiving efficiency. In contrast, OIEs like Thorstein Veblen see evolution as an unending process of cumulative causation, in which habits and institutions are both causes and effects. (Hodgson 1996) In relation to unregulated credit markets DEs demonstrate that building one semi-regulated institution shifts as well the un-regulated as well the regulated institution in content and meaning. However, each new institution will develop its own individual failure or lack of components which will be sooner or later replaced with a new institutional component or arrangement. In this sense, the ‘perfect institution’ is not attainable because each new institution develops new properties with new shortcomings. The NIE approach overlooks that every human is born into a pre-existing tradition which he either follows or rebels against., but with tradition, he also inherits problems to which he may invents or discovers a solution towards. (Bunge 2000:150) Accordingly, NIE misses one of the most important events in economic development: the emergence of novelty. (Bunge 2000:150) In contrast, an OIE evolutionary perspective claims that micro diversities do not only work as an aggregate, but also are a necessary condition for the unknown innovative opportunities. (Hodgson 1996:72) OIE analyses the processes through which diversity emerges via innovative activities while it is simultaneously checked and selected. (Nelson Winter 1982, Eliasson 1986, Chiaromonte and Dosi 1992, Metcalfe 1992, Dosi 1988)

3.2.5 Summary criticism on ISA equals OIE

Chapter 2 demonstrated that NIE is not sufficient in the context of informal financial markets in LDCs. The criticism summarised was not voiced by economic theorists, but by praxis oriented development economists. In this sense, the NIE approach was considered as insufficient on practical grounds. The intention of this chapter is to examine if problems arising from reality are similar to the criticisms of OIE on NIE on a pure theoretical base. The neglect of power and cumulative causation make the upgrading intention of institution building extremely difficult. The idea of formalising informal arrangements according to an institutional hierarchy is for the same reason unrealistic for which OIE criticises spontaneous order.
Rationality, transaction and information costs are not sufficient to explain interest rate composition in developing countries, while OIE highlights on a theoretical based why this is the case.

⇒ OIE criticism on NIE reflects DE criticism on ISA.

3.3 Conclusion Part III

It has been explored in Part I that as well, NIE as OIE apply an institutional individual as economic actor and that on this foundation NIE and OIE form rather a theoretical continuum, called NIEOIE, than contradicting schools. Part II investigated whether reality reflects theoretical arguments of NIEOIE and in turn, whether today’s economic situation requires the theory of NIEOIE. It was suggested that because the informal sector inhibits an advantage through its individual structure it is necessary for economic growth to link informal and formal institutions to a financial market continuum. As the informal sector reflects those institutional mechanisms central to OIE, while the formal one mirrors NIE, it suggests that NIEOIE finds applicability and justification. The argumentation was built on the assumption that the informal sector has an ‘advantage’ built on its individual institutional forces, which differ from those in formal institutions. However, scholars could argue that the advantage processed by informal arrangements is purely an information advantage and hence, informal institutional forces follow the same efficiency reasoning like formal ones. Accordingly, a differentiation between the informal and formal institution does not exist. If this would be the case NIE and not NIEOIE would be relevant. Therefore, it was investigated if explanations using information as the main reasoning behind informal institutional change are in line with NIE. The findings suggest that all approaches built on information constraints either within the institutions or within the institutional environments reflect NIE theory. Furthermore, it was investigated if NIE theory is sufficient in relation to reality, theoretical consistency and applicability. Apparently, this is not the case since NIE rejects the influence of power and class relations, forward and backward linkages and the social content. By doing so, NIE neglects the possibility and
advantage of informality in creating innovation and dynamism, while simultaneously being unable to differentiate between ‘good’ and ‘bad’ informal institutions. Further, the conclusions based on NIE are mostly inappropriate since they pre-assume upward formalisation as always positive. These criticisms announced by DE’s equal the criticisms of OIE on NIE as stated on a theoretical base. Therefore, NIE requires to be extended with OIE to NIEOIE

Conclusion: NIEOIE is relevant in relation to informal financial markets.
1 Relevance and Applicability of NIEOIE

Does it make sense to suggest, on a pure theoretical foundation, that NIEOIE is relevant? Is it a ‘theoretical game’ with no implications? It could be that NIEOIE has no value, particularly since all the interesting questions remain unanswered. It has not been explored why the theoretical continuum of NIEOIE provides advantages or of what kind these advantages are. Neither has it been explicitly mentioned what exactly the advantage of the informal sector is nor how to capture these. Although it was said that the informal sector is more flexible and dynamic it has not been investigated why. Neither has it been mentioned what the advantage of using the theoretical continuum of NIEOIE as foundation for financial market theories is or how such a theory should look like. This has been done intentionally.

The purpose of my investigation is to show that NIEOIE is relevant and that financial market theories are insufficient in their application to LDCs if they do not consider non-economic variables. Therefore, I examined two questions:

(1) Is it possible that the institutional theories of NIE and OIE be complements and not contradicting schools?

(2) Are existing financial market theories sufficient while neglecting NIEOIE?

The findings suggest that NIEOIE form a theoretical continuum and that existing financial market theories are insufficient because they neglect non-economic variables decisive for viable financial system functioning - at least in LDCs. Although the findings appear to be very simple, they are not in their theoretical implication. The findings suggest that it is necessary for financial market theories to implement an understanding of the unregulated sector and therefore, of non-economic variables. Such a finding is particularly interesting since financial market fragmentation is not only occurring in LDCs, but also recently in DCs. The relevance
of NIEOIE in this context will be subject for the next chapter. The intention is to explore whether a financial system, in general, neglecting the continuum of informal and formal mechanisms can be viable at all. Therefore, chapter (1.1) examines if financial market fragmentation is a topic for DCs, chapter (1.2) will explore the reasons why efficient financial systems can cause financial fragmentation and chapter (1.3) investigates the relationship between German politics and NIEOIE. In Chapter (1.4) the findings will be summarised suggesting that NIEOIE, has political and economic relevance only by acknowledging the importance of informal and formal mechanisms.

1.1 Community banking

It could be argued that the argumentation about the relevance of NIEOIE is limited to LDCs as only these countries exhibit the feature of financial dualism and hence, the importance of heterogeneous local banking arrangements. Therefore, the following section will investigate if developed countries show similar problems of fragmentation. Fragmentation in developed countries usually does not stem from non-formalised credit arrangements as in LDCs, rather local bank branch closure excludes population segments from the formal sector. Thus, section (1.1.1) examines the extent and characteristics of bank branch closure in DCs. Section (1.1.2) considers the implication of bank branch closure and section (1.1.3) investigates if bank branch closure causes financial fragmentation in the developed world. Following section (1.1.4) summarises the findings.

1.1.1 Bank branch closure

Hitherto in the dissertation the concepts of microfinance and the importance of informality have been applied towards less developed countries. What is lacking and what is interesting is that microfinance is also apparent in DCs. Although in DCs it is (for no obvious reason) called ‘community banking’. The term ‘community banking’ is used here to cover a range of models: commercial development banks; community development credit unions; community development loan funds; micro loan funds and community exchange systems (Mayo1996). Similar to microfinance
in LDCs, community banking in DCs focuses on the failure of the formal banking sector to serve the needs of low income groups. (Johnson 1997) This failure arises from the need for the banking sector to increasingly respond to deregulation, new technology and the globalisation of international capital markets (Mayo 1996) and has resulted in the closure of bank branches world wide. Bank branch closure is not just a small problem affecting very few parts in the Western world. Instead, bank branch closure is a global trend, occurring from Australia to Europe to Asia. For example, almost one bank per day has closed in Australia over the past five years, with the total number of branches has been decreased by more than 33% since 1993. (University of NSW 2002) Simultaneously in New Zealand since the 1990s 40% percent of New Zealand’s bank branches closed with bank charges increasing 30%. As a remedy, New Zealand has established the Peoples Bank in 2001 which is used by approximately 42% of the population. (Newsweekly 7th April 2001)

1.1.2 Implication bank branch closure

Bank branch closure has many negative side effects. The government study “Regional Banking Services – Money too far away” was released by the Commonwealth Government in 1999 and concludes that bank branch closures affect people in a number of ways: (a) Loss of investment income; (b) Difficulties in cashing cheques; (c) Difficulty in obtaining credit from banks; (d) Lack of access to financial advise (e) Increased need for credit from local businesses in lieu of cash; (f) individuals suffer the inconvenience of having to travel to do their banking. This also adds to the cost of banking though fuel costs, wear on motor vehicles, and time required to travel; (g) specific groups may suffer i.e. the elderly, people with disabilities and physical restrictions, low-income earners who lack the means of transport. (House of Representatives Standing Committee on financial Institutions and Public Administration 1999:27) Nevertheless, the major impact of downgrading banking services is on local businesses through (a) the loss of cash sales due to consumers shopping in larger towns which have banking facilities; (b) an increase in bad debts due to the need to extend credit to local customers who do not have regular

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65 If one is interested in bank branch closures see the CCBS (Campaign for Community Banking Service) which works as a platform and provides different ‘bank branch closure action guides’. 
access to cash; (c) delays in the depositing of cheques which then delays the honouring of cheques; (d) increased security concerns due to the lack of secure facilities to deposit takings and the need to transport large amounts of cash to and from the nearest bank branch in an unsuitable vehicle such as a private car; (e) difficulties in obtaining small change; and (f) farming businesses are particularly disadvantaged by the loss of bank staff with intimate knowledge and experience in rural banking. (House of Representatives Standing Committee on financial Institutions and Public Administration 1999:27)

1.1.3 Fragmentation and bank branch closure

The problem with local bank branch closure is that branch locations, despite the rise in electronic banking, are still the primary means of financial services, particularly to low-income households and in rural areas. In rural areas, branch closings result in reduced local spending, a decline in financial investment and a loss of community confidence. (Skillern 2002) In economical terms, it seems that communities that lose their financial services tend to lose the race for economic development. (CAFI 1997:1) Dangerous is the fact that poorer areas have significantly higher rate of decline of branches per resident. For example, a CRA-NC (Community Reinvestment Association of North Carolina) study found that the number of branches decreases in the low-income neighbourhoods of Los Angeles despite population growth while the number of bank branches remained steady in the higher-income neighbourhood. The decline of banks and the rise of alternative services in low-income and rural areas mean that the communities most in need of economic development have less access to capital. Based on the recognition that poverty and fragmentation is not an exclusively southern phenomenon, some scholars already talk about the “South in the North”. (Johnson 1997, O’Brien et al. 1997)

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66 See also Kaur et al. who conclude that bank branch closure is the fastest in the more deprived wards of London, while exacerbating existing inequities.

67 It is very interesting that scholars talk about poverty in relation to less developed countries and about social exclusion in the context of the developed world while the same is meant. Similar microfinance institution in DCs are called “community banking” and not as in LDCs microfinance.
1.1.4 Summary community banking

Financial market fragmentation is not only a phenomenon restricted to LDCs, but also to DCs. Increased bank branch closure in poor and rural areas increases economic stagnation in those regions through limiting access to credit, cash and investment. In this context, particular the poor regions which are mostly in need of investment opportunities becomes excluded, thus causing scholars to speak about a “South in the North”.

1.2 The ‘inefficiency’ of ‘efficient’ banking

The contemporary trend in DCs for bank branch closure in rural and poor areas caused similar features of fragmentation as in LDCs. The surprising finding is that while it is argued in contrary that inefficiency of formal institution causes fragmentation in LDCs, it is contrary argued that increased efficiency of formal institutions causes fragmentation in DCs. Hence, the approach of efficiency for the banking sector itself becomes questionable. In this context, the following section will investigate the reason why local bank branch closure increases local stagnation by focusing on the local money multiplier in section (1.2.1) and Further, explores why local bank branches close by focusing on banking consolidation in section (1.2.2). Further, the effects of an efficient banking sector on the macro level in relation to the micro level will be examined in (1.2.3). Section (1.2.4) summarises the findings.

1.2.1 Money multiplier effect

Slowly scholars are recognising the importance of the role of financial intermediation in maintaining the health of local economies in DCs. (Douthwaite 1997, Johnson 1997, Mayo 1996) Significant is the fact that money has a local multiplier effect. The more money circulates locally before exiting, the more it will create jobs and wealth within the area. Hence, each community should object the possibility of money floating out of their area. Douthwaite (1997) illustrates the point, by the way in which banks literally truck money out of communities in the US. (See examples North Carolina) Another illustration is in relation to South Wales
miners whose past savings in the form of pension contributions invested through conventional financial systems might be currently enabling investments and employment for people in other parts of the UK or the world, while they themselves languish with little investment and few employment opportunities. (Johnson 1997) Douthwaite highlights the need for locally owned and controlled banking facilities as “investor’s interests are rarely compatible with those of a community”. (1997:58) However, local ownership and control are only possible if resources are locally generated. That is, the system must be able to mobilise sufficient savings and local equity rather than external capital in order for local control to be retained. (Johnson 1997) If the focus is on community growth it suggests an aversion to scale in financial intermediation which would tend to move surpluses of investible funds to areas of deficit to equalise rates of financial return across space. In this context, NIEOIE demand a different relationship between social and financial priorities.

1.2.2 Access to credit

One of the reasons for local bank branch closure is the increasing trend of bank consolidation. In other words, ‘big banks’ that are world players, buy ‘small banks’ that are local players. Interesting from a political economy perspective is the general finding that larger banks hold less small business loans than small institutions. (Berger et al. 1995, Levonian and Soller 1995, Berger and Udell 1996, Peek and Rosengreen 1996, Strahan and Weston 1996, 1998) According to NIEOIE this is caused by the cost advantage of small banks in supplying small business loans, which would not be profitable for larger banks. Hence, Di Patti and Gobbi (2001) point out that if this is true “the reduction in the number of small banks may lead to a permanent decrease in small business credit, because loans that had positive net present value for small banks are not longer profitable for larger ones” (2001:2213) In generalised terms, in an age of increasing banking consolidation an equal trend in reduction of small business lending occurs. Since SMEs are not only decisive for growth in LDCs, but equally important for growth in DCs it is a dangerous tendency. It is important to note that similar to the relevance of the regulated and unregulated market in developing countries, the answer is not to leave everything global or local. Rather the focus should be on the positive effects of unregulated or community
institutions, while recognising the negative effects. This focus should be extended by the attempt to complement the international financial sector with the local financial segments. Hence, Douthwaite (1997) advocates the development of local financial systems with an effort to complement and not to replace national and international finance. Application of NIEOIE as a theory gives this procedure value and a theoretical framework.

1.2.3  Macro level

Unfortunately, banking merger is not only problematic in relation to local economies, but also on the macro level towards the entire national financial systems. During the crisis in the 1990s, many emerging economies have sold their financial institutions to foreign banks. Concerning commercial banks the move has been particular strong in Hungary, Czech Republic and Tanzania. For example, The Czech Republic has sold off 95% of the banking sector to international financial institutions. (Arestis et al. 2003) However, instead, of fostering domestic finance, foreign banks in many countries are exporting national savings to safer havens thereby increasing financial instability. Moreover, the focus of international banks is on serving richer clients and multinational investors. Hence, they only provide less funds for domestic investors. That is dangerous since small and medium enterprises (SMEs) employ nearly 60% of the Czech workforce and generate about 40% of the GDP. However, it is estimated that only 2% of SMEs were able to obtain a loan in 2000. (Financial Times December 12, 2001, November 21 2002). Therefore, Arestis et al. (2003:14) point out that during transformation in many countries the banking system has simply moved from state ownership to foreign ownership. Although one can argue that selling the banking system has avoided the enormously costly exercise in financial liberalisation experienced by other emerging countries, the problem is not only restricted to less developed countries. New Zealand, for example, just recently noticed that the central bank lost its control over the banking system with over 90% of banks are sold to foreign banks, causing just lately the IMF to express a warning. (New Zealand Bankers Association 2003, IMF 2003) In other words, New Zealand lost its control over interest and exchange rates and hence, over its political governance because it followed the ‘financial efficiency approach’.
1.2.4 Summary of the ‘inefficiency’ of ‘efficient’ banking

The findings suggest that financial fragmentation is not only a subject for LDCs, but also for DCs because local bank branch closure in poor areas increases stagnation and therefore, fragmentation between rich and poor areas. Further, increased bank consolidation, with bigger banks buying smaller banks, decreases investment in small medium enterprises (SME). While according to mainstream financial market theories, the efficiency of the banking system increases, the growth potential of poorer areas decreases. Similar for poorer countries selling their entire national banking system global efficiency is increased, but national growth potential is decreased. In this sense, the efficiency approach on a global level causes inefficiency on the national level. In this context, NIEOIE has relevance in demonstrating the importance of local dynamic for national growth potential and allowing for efficiency aspects at the same time. The approach does not argue in favour of a closed or open financial system as in the Keynesian/Monetarist debate, rather it emphasises the view on the individual condition of one country under particular circumstances. NIEOIE highlights that not ‘one theory’ has to be followed; rather a careful consideration of the current political and economic situation is necessary. In this context, efficiency aspects have to be replaced with a system analysis.

1.3 Germany

Throughout the dissertation, the focus was on financial market theories and financial market practices with the intention to examine whether they can be growth enhancing while rejecting informal mechanisms. As the findings suggest that this is not the case the question is if the political practice in some countries looks different from the theory. Apparently, Germany is such a case, as will be shown at the example the ‘Sparkasse’ (1.3.1) and the political attitude towards the international interests of the ‘Deutsche Bank’ (1.3.2). In this context, NIEOIE is applied by a developed country as will be shown in section (1.3.3).
1.3.1 The ‘Sparkasse’

It is very interesting that the arguments above and the theory of NIEOIE are indeed a fact in relation to Germany.\textsuperscript{68} Just recently, the European Union expressed criticism on Germany's Sparkasse. (EU September 2003) The interesting feature of the Sparkasse, apart from the fact that Germany acts as lender of last resort, is that 25% of each bank branch is locally owned, or in other words, owned by the community. Additionally, each community has the right to sell its ownership to other banks although this is currently very seldom happening. (see contemporary discussion on Sparkasse Stralsund) The European Union criticises that the involvement of local politics with local finance contradicts the assumption of free markets and efficiency. According to orthodox economic theory the arguments are right. However, very often and particular from poorer regions Sparkasse manager pronounce that if they would not get involved with local politics, regional investment and growth would be negligible or even absent. There is not doubt that the major of 'Stralsund' is also deeply involved with the activities of the local Sparkasse. Nevertheless this involvement can have negative impact as well positive influences and the decision to abandon the 'Sparkasse system' has to be considered carefully and may be even on a case to case basis. On a theoretical base, the concept of the 'Sparkasse' gains theoretical validity from NIEOIE aspects The German Sparkasse is particularly interesting in the background of regulated-unregulated institution, because it acts like a semi-regulated institution. The bank is linked to the national banking system, but particular credit arrangements are subject to 'informal' forces.\textsuperscript{69} In this context, the 'Sparkasse' reflects NIEOIE theorising that efficiency is sometimes, but not always, the only growth enhancing variable and that informal social network conditions are equally important.

\textsuperscript{68} It is important to note, that Germany belongs to the few countries world wide which does not suffer from bank branch closure due to the existence of Sparkassen and Raiffeisen Banken.

\textsuperscript{69} Under this perspective it would be very interesting to investigate the relevance and appropriateness of Basel II. Basel II constructed categories of credit supply according to business, i.e. independent how successful a construction company or a bakery is, credit supply is fixed according to the world wide agreement of how much credit would be healthy to supply towards construction companies or bakeries.
1.3.2 The ‘Deutsche Bank’

Another subject for NIEOIE is that German banks operating on an international level, such as Deutsche Bank, Commerz Bank, Dresdner Bank etc., are temporarily very ‘cheap’ to buy for other international banks like The Royal Bank of Scotland, HSBC, City Bank etc. Since the German banks are not only cheap, but also in very good shape foreign banks just recently expressed a request to the German government if they would be ‘allowed’ to overtake them. (Spiegel, September 2003) So far, the German government has not answered these requests, but they will have to. I believe in questions like these, it would be a great mistake to use orthodox economic theory as a foundation for action. The effort of a national government should not be on fulfilling a ‘global efficiency’ goal, instead, they should attempt to improve ‘national efficiency’ under social, political and economic aspects. This is exactly the area of relevance of NIE.

1.3.3 Summary Germany

Apparently, Germany applies NIEOIE and not mainstream economics in many different areas. For example, the ‘Sparkasse’ combines local dynamics with the national system. Similarly, just recently, the German government intervened in the international activities of the Deutsche Bank by offering the Post Bank cheaply with the attempt to gain greater national involvement. The political process was supported by Germans large and medium enterprises which were afraid that the national banking system would provide too little national investment opportunities. These arguments are difficult to find in economic textbooks, but still reflect the theory of NIEOIE. Additionally the concept of NIEOIE with its greater focus on informal forces can be found in the unanticipated success of Ich-Ag’s and the increased involvement of the KfW in microlending. It seems that the political application of NIEOIE is three steps ahead than the theoretical development – at least in Germany.
1.4 Conclusion Part IV

The findings suggest that bank branch closure in rural and poor areas in DCs cause the exclusion of a population segment causing situation demonstrating similarities with financial fragmentation in LDCs. Although the exploration of similarities and differences of community banking and microfinance institutions is still at an early stage the reality of financial exclusion for each affected group mirrors the inability of the formal banking system to meet the requirements of the poor. Why is this interesting? The point is while the concept of efficiency caused rapid development in some areas of LDCs, and hence, causing a “North in the South”, the equivalent forces are decisive for financial exclusion in DCs and the creation of a “South in the North”. In contrast to LDCs in DCs, financial exclusion is born from the excess of market forces rather than their underdevelopment. New technology has led to the ability of financial service providers to segment their markets effectively in the context of competition. Hence, banks are being forced to ensure that returns in any market segment are being maximised and cross-subsidy between different parts of the business is being kept to minimums. While the problem of financial market fragmentation, due to imperfect information and high transactions costs exists in the South, the volume of information and low transaction costs in the North are creating new levels of segmentation. (Johnson 1997) Hence, the question comes up to what extent the concept of efficiency in its orthodox form is useful in relation to the banking system from a political economy perspective. This is exactly this is the point highlighted by NIEOIE. By overemphasising efficiency, mainstream economics neglects the importance of informal mechanisms for growth. In this context, it is not important of what kind informality is, rather it is important to acknowledge the impact of informal mechanism for as well, growth as stagnation, and NIEOIE does so. Hence, NIEOIE is not a new financial market theory, but the findings suggest that a new financial market approach can only be built on the foundation of NIEOIE.
GENERAL CONCLUSION

The dissertation started by citing Goodfellow’s view about the ‘two economic systems’, one for the ‘primitive people’, the other for ‘modern people’. While reading his view today, most probably a smile will come to the face. It seems ridiculous, inappropriate and, in a funny, way extremely political incorrect. An old fashioned comment announced by an antique scholar a long time ago. However, after examining the situation of financial dualism in less developed countries it became apparent that this view is not forgotten, rather it is well alive, although hidden under the political correct ‘curtain of financial liberalisation. While today nobody would dare to talk about ‘primitive people’ and two economic systems it is still the underlying assumption of contemporary financial market theories.

Goodfellow wrote: “When it is asked indeed, whether modern economic theory can be taken as applying to primitive life, we can only answer that if it does not apply to the whole of humanity then it is meaningless”. (1939:3) Applying the same argument, scholars today explain informal institutional functions with ‘modern economic theory’. This becomes particular obvious through the neglect of differentiating between the ‘informal’ and the ‘formal’ financial institution. According to economic theory an institution either way, is always an efficient solution towards a collective action problem, constrained by shared mental models and bounded rationality. However, as apparent from many case studies informality has individual characteristics and mechanisms which are not captured by modern economic theory focusing solely on information constraints. By neglecting the differences between informal and formal financial institutions, economic theory neglects the existence of informality. Apparently, this wouldn’t be of any consequences, if it was limited to a few ‘primitive people’, but with over 80 percent of the world’s population being reliant on those informal institutions the connection of economic theory and reality becomes questionable. Furthermore, macroeconomic policy making becomes difficult while economic theory turns out to be inconsistent.

In this context, the intention of the dissertation was to bring together insights from economic theory and development economics. Within the field of development
economics the consideration of non-economic variables for policy making is commonly pursued although not captured in economic theory. On the other hand, the institutional thought is well alive and could provide the theoretical foundation for future financial market theories if the theoretical discourse of NIE and OIE is left beside. The requirement for such a new theory is continuously rising not only in less developed countries. Increased segmentation within developed countries accelerates the need for a new understanding of financial market mechanisms while highlighting the inefficiency of efficient banking. Scholar’s today talk about a ‘South in the North’ implying social and economic exclusion, while they simultaneously talk about a ‘North in the South’, meaning prosperous spots of growth within developing countries. In this sense Goodfellows (1939:5) two economic systems are still alive and it is time to acknowledge the importance of both for sustainable economic development. While Goodfellow argued that a ‘correlation between the two systems of economic would then be so vast’ that he chooses not to consider it, I believe that after 65 years at least the attempt should be made to create such a correlation furthermore I suggest that this is possible within the framework of NIEOIE.


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