

To assess the quality of public institutions requires analysis of the legal framework that influences the performance, capacity, accountability, and life cycle of government agencies and private instrumentalities.

Assessing Institutional Development:

The Legal Framework That Shapes Public Institutions

Thomas H. Stanton

Professional evaluators increasingly focus upon the quality of institutions and the way that institutions affect economic and developmental outcomes (World Bank Operations Evaluation Department, 1994). The quality of a country's institutions, in turn, is affected by the nature of its legal system (World Bank, 1994).

This paper provides an introduction to the law of public institutions and the way that the law shapes institutions that provide goods and services to the public. (Institutions intended primarily to serve political, legislative or judicial functions are not discussed.) This introduction is intended to help evaluators distinguish basic institutional types and understand how institutional choices can affect performance, capacity, accountability, and potential life cycles. Evaluators can then apply the conceptual framework of the law of public institutions to their diagnoses of the source of institutional shortcomings and the prescription of remedies.

The second section of the paper outlines the legal framework that helps to determine the quality of public institutions. It distinguishes between (1) agencies of government, including departments and government enterprises, and (2) private instrumentalities of government—that is, private entities that serve public purposes under the law. The law governing each of these types of institution contrasts with the legal framework that applies to (3) private companies that serve private goals. The paper's third section reviews some of the ways that the legal

framework helps to determine the external environment, capacity and incentives, nature of service to public purposes, and life cycle of each type of institution. The concluding section suggests aspects of the legal framework of an institution that deserve scrutiny in an assessment of its quality.

This paper represents the first part of a work in progress. It relies heavily on the author's analysis of the legal framework that shapes institutions in the United States (for example, Stanton 1994a) and on published studies of legal systems in other countries (for example, de Soto 1989). The author welcomes feedback on the applicability of the concepts outlined in this paper to particular institutions in developing countries.

The Legal Framework That Shapes Institutions

The Nature of Institutions. Thanks to the work of Douglass North (1990) and the new institutional economists, it is now well accepted that institutions matter and can help to determine a country's economic performance. The new institutional economics is producing a stream of important work concerning the economic rules of the game and the ways that the qualities of a legal system can contribute to efficient markets. (Williamson, 1994, and Levy and Spiller, 1993). Those qualities include (1) clear rules that establish private rights, especially in property, (2) enforceable rules that parties can rely upon in their transactions and contractual relationships, and (3) rules that represent a credible commitment to avoid arbitrary changes, for example in government economic regulation.

From a legal perspective, institutions are more than merely the economic rules of the game. They are the way that a society chooses to organize itself to carry out public and private activities. Thus, Hurst reminds us that, besides the market, institutions of society may include the family, the church, publicly and privately organized education, science, and technology: "Wherever we encounter substantial, continued, organized activity with means structured to pursue shared goals, we deal with behavior that at some stage of consequence can be called institutional. " (1977, p. 48).

Institutions are shaped by the law—the publicly enforceable rules of the game—and institutions that serve public purposes are based upon public law. The quality of a system of public law relates to many of the characteristics identified by the new institutional economics, including clarity, enforceability, and commitment. It is important to add the feature of legitimacy: to be effective, laws must be accepted as legitimate by those to whom they apply. Lessons from the colonial period (Furnivall, 1956) and from communist rule (Massell, 1968) indicate that even a legal system backed by an overwhelming monopoly of force needs legitimacy to succeed. Empirical research would be useful to establish the relative importance, in determining the quality of institutions and governance, of (1) the legitimacy of particular legal rules and (2) imperfectly associated variables such as "democracy" (e.g. Clague, 1994).

Trebilcock (1994) nicely frames the question of whether law and the legal system help to determine underlying social and economic realities, or whether the law depends upon and is molded by those realities. Mary Shirley similarly asks (1994): How much is law destiny? How much can we achieve by changing the law? and What causes a particular legal framework and how is it enforced?

None of these questions may answerable in the abstract. A country's economic development may prompt reform of archaic restrictions in the legal system; the emergence of better legal forms can in turn can facilitate further economic growth. In many cases it may be just as important to get the institutions—including the legal framework—right, as it is to get the economics right. A simple linear progression (Williamson, 1994, p. 36) may not capture adequately the complexities of the underlying relationships of institutions, law, and economics.

Public versus Private Institutions. A government makes a threshold decision when it selects an institution to serve public purposes. The basic choice of whether the institution is public or private affects the manner in which the intended public purposes will be served.

Government agencies include (1) departments and bureaus that carry out governmental functions and (2) public enterprises. With Gray (1984, p. 41), one can usefully define a public enterprise as one controlled by the government, producing goods and services for sale as its

primary function, and operating under a policy that its revenues should cover at least a substantial part of its costs. In countries governed by a civil code system of law, the formal designation of an enterprise as public or private may vary for sometimes inconsistent reasons (Friedmann, 1954). (This paper does not discuss agencies of sublevels of government such as localities.)

Private instrumentalities of government are privately owned and managed. Like government institutions, and unlike ordinary private firms, private government instrumentalities are permitted to engage only in those activities that are authorized by their enabling legislation. Often these restrictions involve application of detailed prescriptions by a government regulator. Private instrumentalities include investor-owned firms, cooperative enterprises, and nonprofit organizations. This paper discusses only investor-owned and profit-oriented instrumentalities, typical examples of which are investor-owned utilities such as railroads, power companies, or telecommunications firms, and banks and other financial institutions.

Private institutions may potentially offer better capability than that available from the state. In the age of mercantilism, private instrumentalities of government provided a broad range of services including mining, banking, and trade, at a time when governments lacked the capability to provide such services through public agencies. Privatized firms often become instrumentalities of government, if they provide services that by law are considered to embody a public purpose, for example as regulated monopolies. (Aharoni, 1986, pp. 72-121, traces the historical relationship of public enterprises and private instrumentalities in various countries).

The different laws applicable to public and private institutions shape them differently. Figure x.1 shows some of the ways that laws may differ in their application to private instrumentalities of government and government agencies. The legal framework of ordinary private companies is presented as a benchmark to illustrate the distinctive characteristics of the three basic forms of institution.

FIGURE x.1
LEGAL CHARACTERISTICS OF ORDINARY COMPANIES
vs. PRIVATE INSTRUMENTALITIES
vs. GOVERNMENT AGENCIES

Ordinary Companies	Private Instrumentalities	Government Agencies
Organized under generally applicable laws to serve private purposes	Organized to serve public purposes; are considered instrumentalities of government	Organized as a part of the government to serve public purposes
Can usually obtain a license to do business by registering with a government department	Must obtain a charter (1) from the legislature or (2) from an administrative agency according to statutory standards	Created by specific authority of law
Authorized to conduct all activities except as expressly prohibited by law	Authorized to conduct only those activities expressly permitted by their charters	Authorized to conduct only those activities expressly permitted by law
Can freely enter lines of business except where entry is prohibited by laws; can freely stop serving markets or customers	Can only enter lines of business expressly authorized by law; may be required to serve particular markets or customers	Can only provide services expressly authorized by law; may be required to provide particular types of service
Generally have no unique benefits granted by law; often operate in contested markets	Have unique benefits granted by law to a single company or category of companies; often protected by law from entry by competitors	Have special benefits granted by law and sovereign privileges and immunities unless expressly waived by law; often a monopolist in the provision of public goods and services
Often unregulated	Usually regulated	Regulated by other agencies, for example with respect to budget
Can be forced into bankruptcy by unsatisfied creditors	Probably cannot be forced into bankruptcy, even if insolvent; must be terminated by government action	Generally have sovereign immunity from bankruptcy; must be terminated by law

Combining Governmental and Private Attributes. Governments often have trouble combining the perceived strengths of public and private agencies into a single institution, and should be cautious about the legal framework that they apply to such hybrids (Seidman, 1988).

The public enterprise is a case in point. Ideally, the public enterprise is expected to be controlled by government but to operate in accordance with commercial principles to provide goods and services on a potentially self-sustaining basis. The availability of a revenue stream to support operations means that a public enterprise might be held accountable through its economic performance, rather than through many of the input and procedural controls (especially the budget) that usually apply to government agencies (Seidman, 1983). Also, at least in theory, the public enterprise may be able to allocate resources more efficiently than a private company that is driven by the need to increase profits and returns for private investors.

In practice, governments often use their enterprises to serve a wide range of noneconomic as well as economic purposes. (Gray, 1984). Public enterprises in many developing countries, for example, may provide goods and services on such highly preferential terms that they come to be "increasingly illiquid or on the verge of financial collapse" (Shirley and Nellis, 1991, p. 63). The net result can be a public enterprise that is not sufficiently accountable either to the government or to the marketplace and whose performance manifests both inefficiencies and allocative inequities (Floyd, 1984).

There may also be pitfalls when a government uses private instrumentalities for public purposes. To serve noneconomic ends, governments may hold the prices of private instrumentalities at unprofitable levels, require service to uneconomic market segments, or fail to adjust the legal powers of instrumentalities in time to meet emerging forms of competition. In such cases, they risk driving an instrumentality into financial failure. However, because the instrumentality is privately owned and managed, its failure may precipitate much greater financial loss than if it were either a government agency or a completely private company. This is especially true when a government tries to provide a financial guarantee for the obligations of

a private instrumentality. (Stanton, 1994a, explores these issues for financial institutions, such as banks, that are instrumentalities of government).

Institutional Consequences of the Legal Framework

Differences in the legal framework cause fundamental differences in the performance, accountability, capacity, and life cycle of public vs. private institutions. See Figure x.2, in which, again, ordinary private companies are presented as a benchmark.

Government Agencies. Government agencies are owned by the government and controlled by government officials. Created by law, they depend upon the terms of law to determine their capacity, accountability, and activities. Their staff are appointed according to law to offices or positions authorized by law. They are often subject to controls that tend to prescribe procedures and inputs rather than performance and outputs. And they are funded through a budget process authorized by law.

As institutions that serve public purposes, government agencies have strengths and limitations. The strengths involve the direct accountability of government agencies to policymakers, responsiveness to changing public priorities, and ability to serve constituencies whose financial standing might be considered marginal. The limitations relate to the conspicuous lack of operational capacity at some agencies, often including limited resources for staffing and systems. The combination of inadequate resources and managerial inflexibility means that the government may lack the capacity to administer some programs, either directly through government agencies or indirectly through regulated private instrumentalities, without risking significant financial losses.

Private Instrumentalities. As private sector institutions, private instrumentalities may be subject to performance controls, in the form of the financial bottom line. The advantages of using private sector institutions relate to their ability to use resources efficiently in search of profits. When necessary to achieve profitability, private firms will tend to invest in high quality personnel and systems that can be far more productive than those found in government. A

FIGURE x.2
 INSTITUTIONAL CONSEQUENCES OF THE LEGAL CHARACTERISTICS OF
 ORDINARY COMPANIES vs. PRIVATE INSTRUMENTALITIES
 vs. GOVERNMENT AGENCIES

Ordinary Companies	Private Instrumentalities	Government Agencies
External environment is more market-based than political	External environment includes the market, but political factors tend to dominate	Political factors predominate; the market affects some public enterprises
Accountable to private owners	Accountable to private owners; often regulated by government as well	Accountable to multiple parts of government and to influential constituencies
Financial disclosure to private owners; if a publicly held firm, also required public disclosures	Financial disclosure to private owners and possibly to government regulators	Some public disclosure; often less financial disclosure than is required for private firms
Market-based external controls based upon financial performance	Market-based external controls plus regulatory controls	Often heavy controls on inputs (e. g. budget and staffing) and procedures; public enterprises may have greater autonomy
Profit-oriented goals often force focus upon particular activities, market segments and strategies	Mix of profit-oriented goals and regulated service; orientation to serving diffuse purposes	Diffuse political pressures lead to serving multiple purposes that often may not be articulated
Life cycle: thrives or goes out of business. Forced exit of failed firms	Often stagnates over time; government backing can forestall easy exit until institution fails at great cost	Tends to stagnate over time, without ceasing to exist; for example primary function may shift from providing services to providing employment

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disadvantage of using profit-seeking companies is that they are likely to place the financial interests of private owners above the government's interests in promoting service for public purposes. This disadvantage can be compounded in countries that have private monopolies (for example as a result of having privatized state enterprises) but lack an effective legal framework to deal with the consequences—for allocative efficiency and the distribution of benefits—of the activities of such companies.

In return for the limitations imposed by law, private instrumentalities receive benefits such as tax privileges, subsidized loans, special access to foreign exchange, and government guarantees of their obligations, and, sometimes, protection from the entry of potential competitors into the market. Such governmental benefits loosen the competitive discipline that can help keep firms lean and efficient.

On the other hand, an instrumentality can suffer from impaired capacity if the law confines it to an inadequate market segment. While the government may assure a profitable and protected market niche at the start of an instrumentality's life, changes in technologies and competition can erode the advantages of the legally protected market. Public utilities, railroads, or financial institutions, for example, may find that evolving markets reduce the value of their current franchise, threatening their ability to thrive.

Politics Versus Market Discipline. Figure x.2 illustrates how the single most important aspect of the legal framework relates to whether an institution is public or private. If an institution is a government agency, then political factors predominate in its external environment. The agency is accountable to multiple parts of the government and to various influential constituencies. This usually results in the imposition of diffuse, even inconsistent, and poorly articulated goals. A special category of government agency is the public enterprise, which is accountable to political factors and constituencies but also possibly to market forces.

Ordinary private companies are affected by an entirely different set of laws, which ideally will create an external environment determined much more by the market than by politics. The profit motive results in much more operational focus than may be possible for a government

agency, but the company has no legal responsibility to serve those customers or market segments that it finds unprofitable.

Somewhere in between are the various private instrumentalities of government, including banks and other financial institutions, regulated monopolies such as utilities, and other firms whose activities are considered to embody a public purpose under the law. As privately owned firms, these institutions tend to serve the most profitable parts of their legally permitted markets. This contrasts to the government institution that is more motivated within the limits of its budget to serve all people who are eligible recipients of its services.

Instrumentalities are accountable also to the government, including the lawmakers who can expand, contract, or otherwise change their legal mandates and benefits, and any relevant government regulators. Thus, while the market is an important part of the external environment, political factors often dominate. While the goals of instrumentalities relate to the conditions in the market, government may impose diffuse purposes at variance with pure profitability, such as requirements to serve noneconomic market segments.

Once instrumentalities have become profitable, the government can find it difficult to influence their activities, either with respect to serving new and evolving public priorities or with respect to reducing financial exposure from their activities. Because private instrumentalities can live or die according to the terms of their enabling legislation, they have an incentive to use resources to dominate the legislature, their designated regulators, and others in government who might threaten their legal franchise or otherwise impose policies at variance with the interests of the private owners.

The Problem of Exit. Ideally, the private firm that fails financially can be thrown into bankruptcy under a well defined bankruptcy law and its resources reallocated to more productive uses. Government agencies and programs do not automatically exit when they fail to serve a useful purpose; it is hard for a government to terminate a governmental activity.

Some government agencies, when backed by powerful constituencies, may continue to draw resources long after their nominal public purposes have declined in public priority. Indeed,

a government subsidy can increase the number and strength of constituents of a program, thereby increasing the strength of an "iron rice bowl" that can become very costly. This pattern has been observed especially with respect to public enterprises, both in the developing world and in economically more developed countries.

Similar problems of exit may exist for private instrumentalities of government. The law may prevent instrumentalities from becoming bankrupt like private firms. Instead, it may provide that instrumentalities can be reorganized or wound up only by action of the government, possibly through a designated regulator of a particular instrumentality. For instrumentalities receiving certain kinds of subsidies, this distinction can be of fundamental importance: because of their access to special subsidies, private instrumentalities may be able to continue their activities long after they have failed financially.

Conclusions

Institutional Quality and the Legal Framework. The problems of government agencies are likely to be those of confusion about mission, inadequate capacity, and failure to be held accountable for the achievement of performance goals. By contrast, problems of private (investor-owned) instrumentalities that serve public purposes are likely to be those of missions that emphasize efficiency goals but neglect distributional goals, government's lack of capacity to hold these institutions accountable, and vulnerability to a mix of private ownership and governmental benefits that raises the likelihood of expensive failures.

Government agencies are more likely to stagnate than to die. A private instrumentality may begin by reaping handsome profits within its legally prescribed market segment, but become vulnerable to new forms of competition or to escalating legal or regulatory requirements to serve unprofitable market segments.

More generally, if laws are the enforceable rules of the game, then it is important to understand the elements of institutional quality that are reflected in the legal system of a particular country. The new institutional economics has begun this effort with respect to laws

applicable to ordinary private firms. Many economists would like to see the legal system provide a framework that promotes efficient behavior among parties, for example with respect to property rights, enforceability of contracts, and government commitment to avoid arbitrary changes in economic regulation.

The historical lessons of law and development add the important criterion of legitimacy. Ideally, law should reflect the values of a society, including its cultural, social, and distributional concerns. The expressions of social values in law are especially important when they apply to government agencies, including public enterprises, and private instrumentalities. Here, the whole point of many legal requirements may be to assure that public institutions serve noneconomic values. (The World Bank's increasing emphasis upon governance (World Bank, 1994) is a valuable step in assessing the nature of the tradeoff between economic and noneconomic values that are reflected in the legal framework of private and public institutions.)

Assessing Institutional Quality. The professional evaluator, mesmerized neither by the concepts of law nor those of economics, can play a valuable role in this regard. In applying the framework of this paper to assessing institutional quality, the threshold issues involve the assessment of the respective roles of politics versus the market. A diagnosis might proceed as follows:

(1) Is a particular public or private institution subject to market discipline? If so, could the legal framework be enhanced to promote the application of market discipline—for example by improving public disclosure requirements for investors, or by improving the effectiveness of bankruptcy procedures?

(2) If an institution is a private instrumentality, to what extent is it subject to market discipline? Could this discipline be enhanced through market-based improvements such as more efficient exit procedures or the removal of laws that may impose barriers to entry by competitors? Could some subsidies be phased out, so as increase the competitive pressure on the instrumentality to be efficient? Could cross subsidies and their consequences be made more transparent and more clearly understood in the political process? Could the form of subsidies be

changed so that the instrumentality can serve designated unprofitable market segments in the most efficient manner? Could explicit or implicit government guarantees be removed, so that increased market discipline can encourage practices that reduce the cost of failure of firms that otherwise would not exit in time?

(3) If the institution is a government agency that provides goods and services, could alternative institutional forms provide such goods and services more efficiently, while respecting the noneconomic values that may also apply? Here, the framework of Kessides (1993) is an excellent model of institutional options that deserves to be applied to a broad range of economic activities of government. An important underlying issue relates to the capacity of a government agency, either to deliver goods and services directly or to supervise competently the private parties it employs to deliver those goods and services. Professional evaluators of institutions in developing countries are ideally positioned to enhance the body of knowledge about the law of public institutions that can be applied across a broad range of countries, legal systems, and intended public purposes.

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Thomas H. Stanton is a Washington, DC attorney and a fellow of the Center for the Study of American Government at the Johns Hopkins University, where he teaches on the law of public institutions.

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