Assessing theories of institutional change:

The cases of Bosnia Hercegovina and Uganda's microfinance markets

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Two theories of institutional change are assessed in two real world markets. Mahoney and Thelen (2010) identify spaces for gradual institutional change and Boettke, Coyne and Leeson (2008) suggest conditions under which changes 'stick'. Both theories take structural constraints and human agency seriously (Chang (2011) and both recognize the embeddedness of social norms in institutional change processes (Granovetter 1992, Williamson, 2000). Between 1997 and 2007 in Uganda and Bosnia significant microfinance sectors developed with international donor support and the dynamics of institutional change were analyzed. A focus on institutional functions (Rodrik 2008) aided definitional precision and comparability as did Williamson's (2000) categorization of institutional levels: social norms, constitutional and operational functions. Both theories offer insights into the dynamics of change and challenge the "extremes" (Chang 2011 p.494) of a fatalistic deference to path dependency and exogenous shocks or a simplistic "best practice" approach to change (Rodrik 2008, Djankov *et al* 2008, Booth, 2011). Yet, neither theory adequately addressed the problem of multiple agents (including external development agents) or multiple institutional functions in these markets. If these limitations are addressed, recognizing the complexity of institutional change processes, these two theories could be taken forward towards a mid-level theory of institutional change.

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1. Approaches to institutional change – an introduction

Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions) and informal constraints (norms of behavior, conventions and self-imposed codes of conduct) and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies" (North 1994, p.360).[2]

The idea that institutions matter for economic development was not in dispute for long.[3] By 2004, Rodrik, Subramaniam & Trebbi had declared that "institutions rule", trumping geography or trade in the contribution to average national income levels. Rodrik *et al*'s conclusions were questioned by Sachs (2003) amongst others, but research since has continued to show that institutions exert a profound influence on economic performance and other measures of development, (above and beyond feedback effects).[4] It has become common practice to recognize that "institutions matter" for economic growth and poverty reduction (Johnson 2009, Jameson 2006, Licht, Goldschmidt and Schwartz 2007, Acemoglu and Robinson 2008, Woolcock, Szreter and Rao 2009). And "the focus of reforms in the developing world moved from getting prices right to getting institutions right" (Rodrik 2008a p.100). Pande and Udry (2006 p.350) argue that the findings of this literature are "of fundamental importance for development economists and policy practitioners in that they suggest that institutional quality may cause poor countries and people to stay poor." Governance reform is the more accessible, but less precise, "buzzword" used by funders (Rodrik 2008a p. 100). It "deals with institutional process and the rules of the game for authoritative decision-making" (Grindle (2007 p. 555) and because it so closely mirrors the importance of institutions, governance is considered to be critical for successful development.

Chang (2011) identified and critically examined the existence of two "absurd extremes" in theories of institutional change. One was "hopelessly optimistic" that institutions can be changed easily and had a "simplistic, linear and static" (*ibid* p.476) theoretical basis and was fundamentally at odds with everything we know about institutions. The other was "unduly fatalistic" that only external shocks (like colonization) can change path dependent institutions and was based on theoretical views of the immutability of institutions due to climate and culture.

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[2] North's definition of institutions will be the basis for the remainder of the literature review and research because it explicitly recognizes the importance of both formal and informal rules and norms with their enforcement characteristics which means that is can be applied to the multiple levels of a financial market. It recognizes that institutions are humanly devised and imperfect and allows a focus on institutional function so it can be applied to methodologies which work with culturally determined institutional functions and boundaries. This definition also reflects the positioning of this research at the convergence of historical and rational choice institutionalism and is a useful basis for theories of institutional change that move beyond path dependency.

[3] The 2002 World Development Report (2001b), "Building Institutions for Markets", brought institutions to the forefront of development policy and poverty reduction debates. The findings of North (2000), Williamson (2000), Meier and Sitglitz (2001), Chong and Calderon (2000) and others had all supported the conclusion that the poorer the country the higher the influence of institutional quality on economic growth, although there is also reverse causality with economic growth improving institutional quality.

[4] For example, in a comparison of transition economies it was the quality of the legal system, the protection of private property rights and the structure and stability of the financial system, with a modest and supporting state which was found to contribute to a stable and high long-run economic growth (Redek and Sušjan 2005). Tebaldi and Mohan (2010) added income inequality to their growth and poverty reduction analysis and found that corruption, ineffective governments, and political instability will not only hurt income levels through market inefficiencies, but also escalate poverty incidence via increased income inequality

The "hopelessly optimistic" approach is exemplified by a preoccupation with "best practice" institutions, (by definition, non-contextual (Rodrik 2008a, Bardhan 2005, Evans 2004)) and transplanting those 'best practice' institutions from the north onto the global South. Rodrik (2008a p.100) argues that no single set of any institutional practices will serve the needs of all countries at all times, which is evidenced by the variety of institutional forms that prevail in advanced countries themselves. Bräutigam and Knack (2004) and Djankov, Montalvo and Reynal-Querol (2008) are unequivocal in their analysis that the "best practice" approach has failed. Their research found foreign aid using this approach had resulted in institutional weakening[5] and had a negative impact on institutions[6]. Conyers and Mellors (2005), Collier (2006a) Birdsall (2007) and Booth (2011) are in general agreement. Booth (2011 p.4) specifically states that importing institutional 'best practices' typically fails and in the African context has found that "institutions that have been designed elsewhere or with little or no connection to the specific factors in play will be unlikely to meet the real needs of the situation."

The "unduly fatalistic" approach falls into three main schools. Sociological institutionalists, interested in "non-codified, informal conventions and collective scripts that regulate human behavior" (Mahoney and Thelen 2010 p 5), often point to an exogenous entity or force which imposes their alternative scripts on the pre-existing ones. However, a framework has not yet been developed for understanding what makes some pre-existing scripts more vulnerable to the imposition of new scripts than others. Historical institutionalists emphasize the importance of historical processes when studying institutions "over a substantial stretch of years, maybe even many decades or centuries" (Pierson and Skocpol 2002, p. 698) and have tended to frame change in terms of enduring historical pathways periodically punctuated by discontinuous shocks. However, Greif and Laitin (2004) find that the historical institutionalist focus on process is "inadequate" to answer questions of how and why institutions change. Rational-Choice institutionalists also typically focus on the exogenous shock as the trigger to institutional change. Williamson states that there are "rare windows of opportunity to effect broad reform… such as massive discontent, civil wars, occupation, breakdowns, a military coup or a financial crisis" (Williamson, 2000 p.598). Greif and Laitin's (2004 p.633) analysis of a typical rational choice approach was that changes in self-enforcing institutions "must have an exogenous origin".[7] However, Greif and Laitin (2004), Ostrom (1990, 2000)[8] and earlier Hayek differentiate themselves from other rational-choice institutionalists by identifying the possibility of endogenously emergent institutional change.

Chang (2011) concluded that the dominant approach to institutional change of institutional transfers is fundamentally at odds with everything we know about institutions. He appears to generally concur with the historical institutionalists that path dependence "operates at a more fundamental level than we normally think", and that "the constitutive role of institutions, the inherent change resistance of designed institutions and the interdependence between institutions" (*ibid* p. p. 490) means that institutional change does not happen easily. But he does not agree that only exogenous shocks can change institutions and points to

[5] Bräutigam and Knack (2004) used the ICRG Quality of Governance Index to assess whether volumes of aid have improved this Index. This Index includes three elements: Corruption in Government, Quality of the Bureaucracy and Rule of Law (ibid p.279).

[6] Djankov *et al* (2008) found that for political institutions, aid is a bigger curse than oil.

[7] Greif (2006) also critiques North's monolithic and immutable view of cultural norms that does not recognize endogenous mechanisms for institutional change. This immutable view of cultural norms is one of the reasons for North's focus on "path dependence" in institutional change discussed below.

[8] To Ostrom exogenous appears to mean outside the nested set of rules and norms which comprise the action arena, which would which gives even greater space for change.

elements in a country's institutional complex that internally generate change as well as the effect of economic development and human agency. He is following Greif and Laitin (2004) and others in identifying the importance of endogenous change and following Cleaver (2002) in identifying the dynamic human "bricoleurs" (*ibid* p.11) who create "institutional bricolages", multi-purpose institutions which intersect both economic and social, formal and informal, tradition and modern domains. Chang (2011 p.494) concludes: "[o]nly theories that take both structural constraints and real human agencies seriously can help us". Two recent theories attempt to meet this standard.

2. Institutional change – two theories that take structural constraints and human agency seriously

Mahoney and Thelen

Mahoney and Thelen's (2010) purpose is to create a gradual theory of institutional change consistent with common themes in all three schools of institutional thought that moves beyond the fatalistic extreme of dependency on exogenous shocks for change. They build on Greif and Laitin's (2004) work, which focuses on endogenous sources of change. Their critique of Greif and Laitin's framework is that it has no predictive power and claim their theory, in contrast, does have some predictive power.

Their central argument is that the basic properties of institutions contain within them the possibility for change, particularly "the power-distributional implications of the institutions" that animate the change (*ibid*. p.14). To support this argument they carefully identify several attributes of institutions which allow space for change:

- Whether rules or norms, institutions require resource allocation, which creates space for change.
- Institutions reflect the relative power of different actors, which creates space for change.
- Rules cannot anticipate all future possible situations, so new situations will challenge the rules.
- Institutions represent compromises that are vulnerable to shifts and inherently dynamic.
- Formal rules are embedded in social norms that are often only implicit understandings held by the relevant community, so leave space for change.
- Enforcement mechanisms for rules or norms are a separate variable with their own potential for change.
- Enforcement is typically undertaken by actors other than the designers, which creates space for change to occur in implementation.
- Rules and norms can never be precise enough to cover all the complexities of life.

Given that enforcement can be uncertain or contested; the meaning of an institution can be undecided; an actor's interest in continuity may be equivocal; and that institutions are nested: there are multiple spaces where change can occur. Their argument recognizes that the source of institutional change are not only exogenous. By focusing on the endogenous sources of institutional change their argument recognizes human agency and works with structural constraints, meeting both of Chang's criteria.

However, there are two other endogenous aspects of institutions which contribute space where change can occur which are neglected in both the mainstream discourse and by Mahoney and Thelen (2010). The first is the multiple functions of institutional forms (Chang, 2007) and the second, the differences in spaces at different levels of institutions. First, the functional multiplicity of institutional forms may make the task of institution building difficult, but with the flexibility to perform multiple functions there comes the flexibility

to provide some space for change[9]. Second, Mahoney and Thelen (2010) do not appear to have recognized that different levels of institutions may have distinctive spaces or that there may be spaces between nested levels. For example, they note that rules and norms can never be precise enough to cover all the complexities – but how does the space created differ between, say, a law and a social norm? Furthermore, spaces for change could be expanded if the endogenous institutional change involves power sharing. Cornwall (in Hickey and Mohan (eds) 2004) noted how participatory approaches to development were explicitly "creating spaces where there were previously none, about enlarging spaces where they were previously limited opportunities" (*ibid* p. 77) to create "innovations in institutional design" (*ibid* p.85). So these spaces for change identified by Mahoney and Thelen (2010) are not static, as dynamic engagement in those spaces can generate increased opportunities for change.

Based on their argument, Mahoney and Thelen create a typology of four ways in which institutions change:

- Drift - neglect of old rules;
- Displacement - removal of old rules and introduction of new ones;
- Conversion - changed impact of old rules;
- Layering- introduction of new rules on top of old ones.

Institutions will change in these ways depending on two key parameters: the possibility of the change being vetoed for political reasons and the level of discretion in the institution's enforcement characteristics[10].

Figure 1 Mahoney and Thelen's typology of institutional change

	Characteristics of the Targeted Institution		
Characteristics of the Political Context		**Low level of interpretation/ enforcement discretion**	**High level of interpretation/ enforcement discretion**
	Strong Veto possibilities	*Introduction of new rules on top of old ones* - ***Layering***	*Neglect of existing / old rules* - ***Drift***
	Weak Veto possibilities	*Removal of old rules and introduction of new ones* - ***Displacement***	*Active change in functions of existing rules* - ***Conversion***

Source: Mahoney and Thelen 2010 p.19

Mahoney and Thelen (2010) provide a range of historical examples of institutional change to support their theory from the British House of Lords to a package of laws passed in France in 1981, which implies that the authors have an ambition for their theory to apply to an equivalent range of situations and that it has the potential for some predictive power. And the theory is useful because it describes ways an institution can change over time driven by endogenous attributes. However, two key points appear to be missing: a discussion of the time frame within which their theory operates and the link between their theoretical recognition of the power-distributional implications of institutions and changed institutions. In other words, what are the processes which translate their theory into changed institutions? This missing link is not

[9] Mahoney and Thelen (2010) do not use the terms institutional form and institutional function but in their examples they do outline institutional functions. For example, "the laws were designed to ..... bolster the voice and power of labour at the plant level" (Mahoney and Thelen 2010 p. 27)

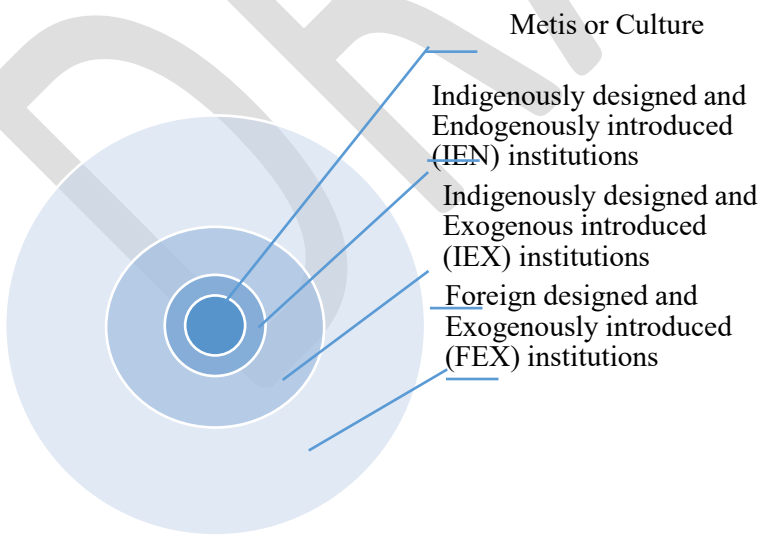
[10] Mahoney and Thelen 2010 p.19 are careful to state that this typology applies both to formal and informal institutions as there are also social actors with veto power. In addition to players, veto possibility also means veto points.

surprising because, as yet there is no consensus on what type of institutional change processes are effective in tapping the spaces for change, nor what role external development agents could usefully play. (Though there is some interesting research on the issue (Bastiaensen *et al* , 2005, Eversole 2010, Crook and Booth 2011).)

Boetttke, Coyne and Lesson's theorem of institutional stickiness

In contrast, Boettke, Coyne and Leeson (2008) focus entirely on "the missing how" of institutional change (*ibid* p. 331). They acknowledge the key features of each of the three schools of thought (although they do not classify them in the same way) [11]. From the rational-choice school of thought, they recognize the importance of path dependence, but also embrace sociological and historical institutionalism in their recognition of the importance of embedded norms and history to institutional change. They theorize that institutional changes are more likely to "stick" (*ibid* p. 343) when the process is indigenously developed and endogenous. Endogenous institutions are defined as those which "emerge spontaneously as the result of individuals' actions, but are not formally designed. Thus, by their nature, endogenous institutions are indigenously introduced." (*ibid* p.335) In contrast "exogenous institutions are constructed and imposed from above." (*ibid* p.335). Indigenously introduced endogenous (IEN) institutions will "stick" because they are close to the *mētis* i.e. culture, norms, and conventions. In contrast foreign introduced exogenous (FEX) institutions will rarely stick because they are so far away from the culture. In between are indigenous introduced exogenous (IEX) institutions which are more likely to stick because they have formal authority (e.g. internal policies created by national governments). They recognize that these are purely conceptual categories[12] that will change over time and be different in different places.

Figure 2 Boettke, Coyne and Leeson's theorem of institutional stickiness



Source: Boettke *et al* 2008 p. 344

[11] Boettke *et al* (2008) consider their work as following that of Hayek in the "spontaneous" institutional change category as well as that of Elinor Ostrom (1990, 2000) who have highlighted the importance and success of endogenously-emergent institutions (ibid p.5). In addition they recognize their work is consistent with the recent work of North (2005).

[12]The labels for their categories IEN, IEX and FEX are confusing and do not help the reader easily come to terms with their argument and using the term *metis* instead of culture appears pompous! However, these issues should not detract from their theory.

In summary, they theorize that new institutions are more likely to "stick" the closer the design is to the existing culture and the greater the degree to which it is seen to be endogenous. They recognize the importance of human agency in the development of endogenously introduced institutions and they also recognize that because of local structural constraints, foreign designed, exogenously introduce institutions will not "stick". Therefore, they also meet Chang's criteria.

Using an impressive range of historical examples, Boettke *et al* (2008) show that their theorem correctly identifies the stickiness of institutional change. However, they provide only very general guidance to those who want to catalyze institutional change as to how to maximize the chances of the institutional change sticking.

3. Assessing institutions across markets – establishing comparability

Rodrik's institutional functions aid definitional precision

Rodrik *et al* (2004), Sindzingre (2005), Acemoglu and Robinson (2008) and Chang (2006, 2007) are all clear that institutional functions are more important than the institutional form and there is no basis for the importance of any particular institutional form, (recognizing the differences even between developed economies). As Cleaver (2002) and Rankin (2008) respectively recognize institutions are "multi-purpose" and "invested with a purpose" (*ibid*. p. 1975), Chang (2006 p. 3) states the same function or purpose can be served by different institutional forms in different societies (or in the same society at different times). For example, Rodrik *et al* (2004) emphasized that the function of property rights was important, not the form and so their research did not provide an institutional recipe. A further example is the function of a stable political system, found by Tebaldi and Mohan (2010) to be important for economic growth, did not necessarily mean its form was a democracy since Decker and Lim (2008) found the effect of democracy on growth is insignificant[13].

However, the recognition of the importance of function in new-institutional theory is relatively recent and far from integrated. Chang (2006 p.4) noted there are those with a "form-fetish" who promote "global standard institutions" which he asserts has led to a dangerous denial of institutional diversity.[14] He likewise identifies (2007) the unfortunate tendency to assign a single function to each institutional form, noting that this is a mistake as there is not one inevitable and simple relationship between a desired institutional function and an institutional form. In financial market development Demirgüç-Kunt and Levine (2008 p.2) concur that it does not matter who provides the functions necessary for financial development. Indeed they argue that at a conceptual level it does not matter if they are formal or informal.

It has often been a challenge to "clearly distinguish between the forms and the functions of institutions" (Chang 2006 p. 3), which has led to some confusion. This has been the case in microfinance too. The more generic term "role" has typically been used instead of function, for example, "The Role of Central Banks in Microfinance in Asia and the Pacific" (Goodwin-Groen, 2000a,b). The "roles" in this case appeared to

[13]Although Bhagwati (2002) and Acemoglu and Robinson (2005) found that a political democracy provides the best prospect of achieving the efficient, dynamic society that allows development to thrive when combined with the institutional functions of markets and openness (information flows) (Bhagwati 2002, pp. 151–152).

[14] Furthermore, in Nelson's (2007) opinion, the "analyses that purport to identify the "right" institutions are superficial and unpersuasive" Nelson (2007 p.313).

be institutional functions and the central bank was the institutional form. This will also be a critical point for the analysis of the research data because a *de facto* or informal institutional form can perform important institutional functions as well as a *de jure* or formal institutional form. It will therefore be essential to clearly distinguish functions from form. The form matters insofar as it enables the key functions required in the financial market to be carried out, but this has not been explored in the financial inclusion literature to date. Recognizing the importance of institutional functions also raises the question of whether and how the boundaries of functions can be defined. Cleaver (2002) would argue that for a socially embedded multi-purpose institutional "bricolage" (*ibid* p. 11) the boundaries will be clear to those who operate within that cultural context.

Williamson's (2000) institutional categorization of: social norms, constitutional (rules of 'the game') and operational (how 'the game' is played) functions also aid precision and comparability

Williamson's (2000) framework identifies the various levels of institutions and explicitly includes informal norms as foundational incentives of the economy, which is consistent with the theoretical progress on social norms in the institutional literature discussed above. As Joskow notes "[t]he division of social, political, legal and economic institutions into four levels is necessarily somewhat arbitrary" (2003 p.12), but it provides a useful framework. Joskow also notes that Williamson's framework "makes it clear that the speed and direction of changes at these levels is not exogenous or necessarily monotonic" (Joskow 2003 p.13) which is important to remember when examining institutional change.[15]

Williamson's first level in Figure 3 below is "Embeddedness", which includes the informal social norms which impose constraints on the next levels. The title "Social Foundation" better represents the role of this level (Joskow 2003 p.12). For example, there may be a social norm that loans are paid back on time (as in the Bosnian case) or that loans need only be paid back when they can be paid (as in Uganda) – such norms provide a foundation for the financial market.

The social embeddedness of markets was first identified over sixty years ago and it is now well accepted that institutions in markets are "cultural embodiments" reflecting the value systems and historical antecedents of the societies (Platteau 2000, p. xvii). Power derived from class, gender and ethnicity patterns market operations and so influences entire economies (Granovetter's 1992, p.370). Notwithstanding this recognition, social institutions have until recently, largely been taken-for-granted in financial market development, because values and norms were taken as "given", but that is changing as measurement and understanding of these norms and their importance improves.

The second level is "Institutional Environment" which Joskow (2003 p.12) renames the "Formal Rules of the Game" and includes constitutions and laws. This is equivalent to Ostrom's constitutional rules. "Constitutional rules" will be used as the most appropriate title because all levels are "institutions" and "operational rules" can also be formal as distinct from informal so neither term is helpful. This level includes the rules conventionally recognized as institutions critical to economic growth such as property rights, contract enforcement and laws (rules) on different types of company or financial service providers which are enforced by the court system. Fergusson (2006 p. 62) notes that macroeconomic stability cannot be considered an institution in this category because "it is more appropriately described as a symptom of

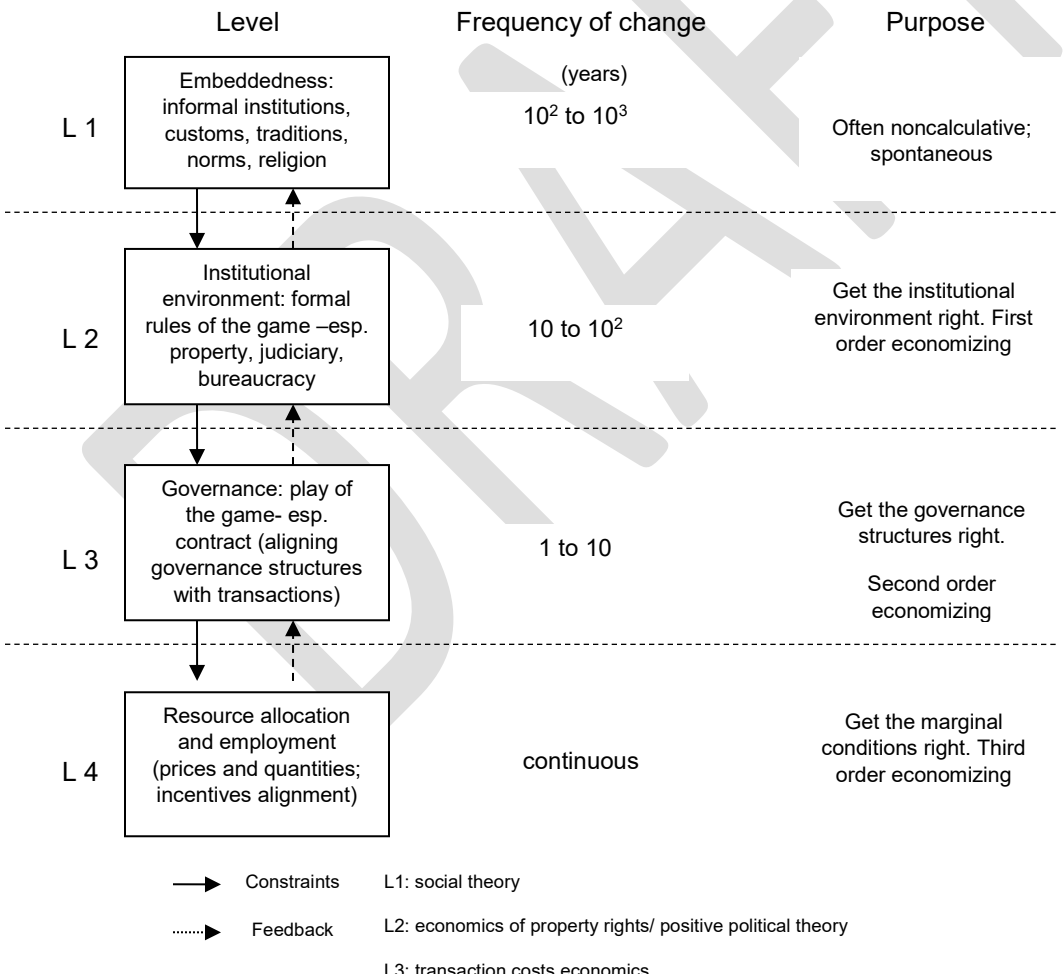
[15] Campbell (2004) argues that researchers must be able identify three dimensions of any institution– namely the regulative pillar that constrains it; the normative pillar that prescribes goals and how to achieve them and; the cultural pillar of the taken-for-granted-assumptions about reality. (Campbell 2004 p.36, citing Scott 2001). These categories do not appear to be substantially different from Williamson's levels of institutions.

underlying institutional problems rather than a fundamental contributor to financial development or backwardness."

The third level is "Governance"; "How the Game is Played" (Joskow, 2003 p.12); or "Operational level" (Ostrom 1990 p. 52). The term Governance has subsequently become a more general term (Grindle 2007 p. 555) so the term Operational rules will be used. This level includes the rules implementing the constitutional rules e.g. regulations implementing the laws. In financial markets these regulations are enforced by the Central Bank or Bank Supervisor.

The fourth level, "Pricing", is the domain of neo-classical economic analysis where there are adjustments to prices and output. These are therefore seen to arise out of the deeper institutional levels and in a dynamic way will also feedback into sustaining institutional arrangements at lower levels as they sustain the incentive structures involved. Given that it is the limitations of focusing on output and prices that has given rise to much institutional analysis, it is the first three domains that are emphasized in what follows.

Figure 3 Williamson's Institutional Framework



Source: Williamson 2000 p.597

Williamson's implicit assumption in this framework is that all social norms take over a hundred years to change in contrast to operational institutions which take from one to ten years to change. Roland's (2004) approach does not put numbers on categories. Instead he recognizes that change in social norms is "slow moving" as compared to politically driven institutions which are "typically fast moving" and can even change overnight. More importantly he recognizes that they are not independent speeds, rather, the interaction between the different levels of institutions at their different speeds will be affected by the other and also that this will vary in different economies and cultures.

Williamson's framework closely reflects the theoretical understanding of the foundational role of social norms and that the enforcement of formal rules is dependent on the social norms. It also provides a useful heuristic device differentiating between different levels of institutions in financial markets, which can be used to compare institutions across markets. There are an abundance of institutional functions found to be important for financial market development so this framework will now be applied …

To identifying the institutions, formal and informal, which changed in Bosnia and Uganda in order to examine the theories of institutional change outlined above.

4. The Bosnia microfinance market between 1997 and 2007 – key institutional changes

At the end of 1996 the Bosnian financial market was in chaos, with a cash economy, five currencies in everyday use, bankrupt banks which were not trusted, no effective national payment system and no financial services for the hundreds of thousands of those impoverished and displaced by war. Ten years later there was a stable financial system, trusted international banks leading the banking sector with a standard national payment system, credit reference bureaux and mobile collateral registry. There were ten financially viable microcredit organizations, performing very well by international standards, reaching almost 400,000 clients and continuing to grow fast as they served the credit needs of the low-income population. By any standards that is a remarkable achievement. In ten years, the foundations of a new financial system were put in place while ensuring access to finance for those affected by war and dealing with the challenges of a financial market in transition from a socialist to a market system. This is a positive story in a context where many of discourses are about dysfunction. But there is also a negative message from a low-income client's perspective. The microcredit market in Bosnia was not meeting her savings needs or providing other tailored financial services. There were also no checks or balances in the system to see if she was getting over-indebted. Furthermore, because there was not a single economic space across the Federation and Republika Srpska, MCOs could not merge their operations and improve their efficiency and expand services.

The institutions which provided the foundation for the expansion of this microfinance market and how they changed were identified from the perspective of market stakeholders through micro-ethnographic research which included interviews with an extensive range of stakeholders in a wide vairety of roles. The interviews were then processed through N'Vivo.

The social norms which formed the foundations for the microfinance market in Bosnia were identified. In addition they were found to have become embedded in the constitutional and operational institutions, which respondents identified as critical to the expansion of the microfinance market. Seven Level 1 institutions or social norms were specifically identified by respondents:

- women's economic participation was expected and represented a level of equality and an attitude of survival or "not giving up";
- a high level of importance placed on social standing ensured loan repayment;
- residual fear of the "financial police" reinforced loan repayment and an attitude that it was the government's job to regulate financial transactions;
- corruption was expected in big business and politics, but since microfinance was started under the radar of banks and politicians it reflected the values of "regular people";
- the private sector was well established in Bosnia before the war so a "business approach" was understood;
- there was a mistrust of regular banks due to a lack of oversight;
- and a cultural norm of respect for strong leadership.

The constitutional and operational institutions in microfinance which successfully contributed to expanding the market were those in which these social norms were embedded.

The most important constitutional institution which changed was the promulgation of the 2000 MCO Law which had the function of providing legality for lending by non-banks, namely MCOs, for the first time. This was the minimum change possible to provide the function of a legal basis for microcredit but did not allow for any form of deposit taking organization that served low income clients. The change process was not a transparent or inclusive participatory process, but the law was, none the less, important. Other constitutional institutions which have changed and which function to support the expansion of the microfinance market have included the establishment of an independent central bank, entity banking agencies, and a mobile collateral registry with limited functions. The private sector has set up a credit registry which MCOs can use to assess the credit worthiness of potential borrowers (and the government has set up one which MCOs cannot use directly).

At the level of operational institutions, the most important change was the establishment of the World Bank's Local Initiative Project (LIP) which had the dual functions of supporting the sector though training and disbursing funds to MCOs, as well as *de facto* supervising the MCOs under the project. This highlights another important finding that it is not the *form* of the institutions but the *functions* they play and their enforcement characteristics which are critical for market development. The participatory change processes used by the LIP to establish MCO performance standards, as respondents reported, were transparent and inclusive ones.

Operational Institutions and the establishment of the World Bank Local Initiatives Project

The Local Initiatives Project, designed by the World Bank Human Development Unit based in Sarajevo, was co-managed with the Federation and RS Government's Local Initiatives Departments. It started in 1997 under the World Bank Priority Reconstruction and Economic Recovery Program (World Bank, 2000). Its overarching goal was to assist people to "make the transition away from unemployment and dependency on humanitarian assistance to active employment and income generation" (ibid p.2). Its budget was USD 18 million over three years (under an International Development Association (IDA) Credit of SDR 4.9) with funding from the World Bank and seven other donors, , (ibid p.1). Its three development objectives were to:

1. address the urgent need to assist economically disadvantaged and war-affected

2. jump start the process of establishing financially viable microcredit institutions

3. support improvement of the business environment for self-employment and micro/small business development and the legal environment for non-bank microfinance institutions (World Bank 2000 p.2, Dunn 2005 p. 1).[16]

The donors to this project agreed with these goals and allowed the project manager and the World Bank to manage the project to achieve the goals. Local Initiative Departments (LIDs) were set up in Sarajevo and Banja Luka were considered by the government and by the banking sector to be the supervisor of the MCO's under the auspices of the World Bank. The two most important functions the LIDs undertook were: training local NGOs in the delivery of microfinance consistent with standards of international good practice; and to supervise performance and disburse funds based on that performance (because demand was high and the supply was limited). International experts were hired to train the PIUs and the NGOs (Goodwin-Groen 2003)[17].

NGOs funded under the project were required to participate in training that the Local Initiatives Project (LIP) provided. NGOs were assessed on portfolio quality, management and progress towards sustainability. They had to submit bank statements to show how the funds were moving in and out and to prevent corruption. They also knew that the project was under the reconstruction program so would end in three years at which point they had to be financially self-sufficient.

A Mid-Term Review (MTR) of the project was scheduled in 1998. As of 31 March 1998 all the MCOs under the project had 3,276 loans outstanding in the Federation and 475 in Republika Srpska (World Bank1998 LIP MTR). For being in operation only about a year this was impressive progress. The MTR recommended a change in strategic focus from disbursing loans to building sustainable microfinance institutions that would last beyond the project. The choice to deliver microcredit on a sustainable basis beyond the life of the project was made by stakeholders who had been part of a participatory process (Kuenhast 2001). The development objectives of the project were modified to:

1. Provide access to credit to the economically disadvantages and war-affected, specifically low-income entrepreneurs who have no access to credit from the formal banking sector;

2. Facilitate the development of independent, financially viable microfinance institutions that will continue to provide credit to low income entrepreneurs over the long term; and

3. Create an appropriate legal and regulatory environment for the provision of credit and savings services to low income entrepreneurs.(World Bank 2000, p.2-3)

After the intensive training and their experience of lending in Bosnia, the NGOs understood what was needed to build a sustainable microfinance institution (MFI). So, as part of a transparent, participatory process,[18] performance standards were debated and agreed with NGOs and LIP staff for the MTR (Kuenhast

[16] It is worth noting that missing from this list of objectives was the formation of a national network or association of microfinance services providers.

[17] The project manager personally hired international experts since she wanted microfinance experts, not post-conflict experts.

[18] The participatory process for determining objectives and standards built on the highly interactive training experiences of microfinance practitioners and their understanding of the market. It was conducted over a day by a skilled facilitator in English with discussions amongst participants in the local language as needed. While less than an ideal participatory process (as set out, for example, by Chambers (1997)), given that many of the participants would not have chosen to work together at all so soon after the war, the World Bank considered it an achievement to have any degree of participation and consensus. Reflecting on his experience of participatory practice over many years Drinkwater (2003 p. 61) recognized that participatory methods were "inevitably incomplete", and that the "dilemma

2001). Eight local NGOs met these standards, five in the Federation and three in RS. Eight of the others that did not meet the standards were required to repay their loans to the project. In order to survive, all but one merged with one of the stronger NGOs so they could keep serving their clients[19]. This reduction in the number of NGOs helped the project. Training became demand driven with MCOs partially paying for the training in which they participated.

In June 2000 the project officially came to an end. Its achievements exceeded expectations (World Bank, 2000 p.5) and an independent analysis of the benefit of the loans commissioned in 1999 found 79% of clients considered that the loan had significantly improved their economic situation.

As described above, the World Bank Local Initiatives project undertook two key functions, to develop the microfinance market through training[20] and funding, and to supervise it. There was a joke at the World Bank that the key to the Local Initiatives project success what that it had behaved like Tito – telling the people that if they followed his way they would be led into a glorious future. Those under the project learned and followed and were rewarded with a degree of success.

Constitutional institutions, institutional change process and the 2000 MCO law[21]

The donor sponsors of microcredit in post-war Bosnia thought the NGO legal form the most useful to serve as post-war lender to displaced people, demobilized soldiers etc. because: mainstream financial institutions were largely insolvent and widely mistrusted; wartime NGOs had proven their capacity to reach the targeted populations of those displaced and traumatized by the war and; NGOs had been the pioneers of microcredit in other countries. This was a pragmatic, short-term post-war choice and little consideration given to the long-term shape of the financial sector. But NGO law was not well-developed in the former Yugoslavia because NGOs were not a significant part of the Yugoslav socialist economy. Several new microcredit NGOs were quickly set up in various forms, including registered offices of foreign NGOs, citizens' associations and humanitarian organizations. The World Bank as the lead donor agency, tried to discuss the specific legal underpinnings of non-profit organizations, which could implement microcredit with the Entity-level governments, but failed. There were much higher priorities for the governments and the World Bank. Gradually the Entity-level governments grew acquiescent with the use of Foundations as vehicles for carrying out lending activities. (Lyman 2005)

The LIP project realized that this *ad hoc* arrangement would not provide the regulatory pre-conditions for a strong microfinance sector at national level. The legal reform component of the Local Initiatives Project, therefore, recommended the development of four new legal forms that would provide the basis for a robust microfinance sector:

• a form of nonprofit, NGO microcredit organization;

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of such partial understanding is how much and what part of it can we rely on." The Mid Term Review team, with local advice, decided there was enough consensus to modify the objectives of the project and recommend their standards.

[19] One large NGO one was allowed to continue lending with the project funds because it was still operating well and had significant international support.

[20] About US$900,000, or 4.3 % of total initial project costs, was spent on technical services in three years.

[21] The following description of the process to develop the 2000 MCO Law is derived largely from Lyman (2005) balanced by input from other respondents. Tim Lyman is a US lawyer specializing in microfinance law, who speaks and read the local language in Bosnia, and was a legal adviser to both the World Bank and the Government of Bosnia at different times between 1998 and 2005.

• a form of commercial finance company capable of serving as a vehicle for specialized commercial microlending, but not restricted to this activity;

• a form of member-owned and governed savings and credit association[22] and

• a specialized form of microfinance bank

But the legal and regulatory aspirations of the Local Initiatives Project proved grandiose given the political realities of early post-war Bosnia. The draft banking law for the Federation initially included a provision that would have permitted these four proposed legal forms, but the provision did not pass. Next the USAID-financed Banking Supervision Project drafted proposed amendments to the new banking law. But that was also over ambitious and it became clear that only the most limited legislation would have any hope of adoption by both Entity-level parliaments. There were several reasons why alternative legal options were not successful. The parliament was so divided and dysfunctional that little legislation got passed at all - as is evidenced by the need for the OHR to impose a national driving license and currency using the "Bonn powers". Only those with political connections could lobby effectively for legislation and none in the microfinance sector had, or wanted to have, those connections, and there was no association of MCOs which could have lobbied on behalf of the microfinance sector and its clients[23]. In contrast, the banks had very good connections with politicians and were effective lobbyist and were against any potential competition in a small market. That said, everyone thought the World Bank and the donor community would get the four options passed and so did not see the need to take action themselves. But it was apparently not a high enough priority for the World Bank to bring to the attention of the OHR. If the World Bank had placed it as a higher priority and requested the OHR to use the Bonn powers to force them through, the four legal options would have been signed into law. One MCO leader stated it clearly - the World Bank was "project oriented and did not have a clear long-term strategy for the financial sector" and so did not understand the national importance of getting these four options passed. The attitude of expecting the World Bank to have acted this way is consistent with the role in which the World Bank placed itself - as the technical leader on microfinance which others should follow - as the "Tito" for microfinance.

A choice was made by the World Bank, therefore to focus only on legislation to clarify the legality of NGO microcredit of the type already widely in practice throughout the country. The goal was a law that could be adopted in substantially identical form in the two Entities, with provisions for reciprocity between the two Entities and; a simple system of registration and minimal ongoing non-prudential regulation of MCOs. The MCO law passed the Federation parliament in 2000 and the RS parliament in 2001. During parliamentary debate in the Federation, parliamentarians replaced the Ministry of Finance with the Ministry of Social Affairs as the regulatory body responsible for MCOs. Also, Ministry of Finance personnel in the RS added features not included in the version adopted in the Federation. In particular, the version adopted in the RS reserved for the Ministry of Finance unspecified supervisory jurisdiction over MCOs operating in that Entity, as well as the power to adopt regulations further defining such important concepts as loan size maximums. Despite these differences, the two MCO laws jointly accomplished something pioneering for the country at the time: a system of reciprocity that made it possible for a legal entity formed in one Entity to be registered also to carry out business in the other Entity.

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[22] Theoretically cooperatives were a good idea but there was no general acceptance of the value of cooperatives in Bosnia because"they always think someone will cheat them" (MCO 5). So it is unclear why this option was part of the package.

[23] When asked why such as association was not set up to undertake lobbying, respondents noted that Bosnia was still a very divided place. Even though MCO leaders undertook training together and were colleagues, to ask them to set up a joint association so soon, seemed premature.

When discussing both the 2000 and the 2006 MCO Law a former government official noted that neither addressed savings. 'What we should have done was to have savings and credit associations like in Germany, to allow small savings and loans, leasing etc. – but the combination of the World Bank bureaucrats, the Government bureaucrats and the power of the banks - the banks did not want any other type of organization to be able to take savings - this did not happen. We did the minimum but that was it.' Other respondents thought that the World Bank left the sector too early, that change processes take a long time and that it should have stayed engaged longer to specifically build the constituency for a regulatory option for poor people's savings.

This institutional change process was consistent with both Boettke *et al* 's (2008) and Mahoney and Thelen's (2010) theories. To use Boettke's language, the new institution of the basic MCO law 'stuck" because it combined exogenously designed elements of microfinance good practice with already existing indigenous practices, endorsed by local formal authority (IEX). (The other three legal options, exogenously designed by the World Bank did not get approved because there was not widespread indigenous support and no local formal authority to endorse it.) According to Mahoney and Thelen's (2010) theory this was a situation with a strong veto possibility (by the parliament) and a low level of enforcement (because it was not a priority for the government) so "layering" of the new institution on top of the old ones is the best approach. This is indeed what happened because there was just a minor amendment to the banking law allowing MCOs to lend.

5. The Uganda microfinance market between 1997 and 2007 – key institutional changes

In 1997, the US Agency for International Development (USAID) launched the Private Enterprise Support Training and Organizational Development (PRESTO). It established a Centre for Microfinance (CMF) which offered training in micro-lending to all interested organizations, primarily the Grameen model of joint liability lending with savings required, to support the development of the microfinance sector. It then offered technical assistance and access to a grants program to help the institutions that implemented these "good practices" (Goodwin-Groen *et al* 2004 p.4). No standards were enforced before or after funding nor was there any rigorous monitoring of their activities to check whether they complied with good practices in microfinance or even maintained high portfolio quality. The goal was simply to expand access (Uganda Donors, 2001). This was the beginning of a massive donor effort in microfinance in Uganda with 62 financial access programs and total funding exceeding USD 75 million over the next ten years. It was the largest microfinance donor effort in sub-saharan Africa (CGAP 2007). Informal contacts among donors, MFIs and representatives of the Ministry of Finance were channeled into a more formal mechanism for collaboration - the Micro Finance Forum (MFF) in 1997 chaired by The Ministry of Finance, Planning and Development (Ledgerwood and White 2006). The MFF met almost monthly and acted as an information clearinghouse and, to some degree, a gatekeeper. It grew and developed several committees (working groups) to deal with specific issues, including finance, capacity building, lobbying and, most recently, consumer affairs. It was at the MFF that stakeholders discussed how to develop a legal framework for microfinance and because of this process the "culture of consultation became deeply rooted among microfinance stakeholders in Uganda" (Ledgerwood and White 2006 p.23),

By 2007 two new forms of microfinance providers were dominating Ugandan microfinance, Micro-Deposit taking Institutions (MDIs) and VSLAs, and the number of SACCOs was also increasing. There were four regulated and supervised MDIs which, together with a regulated commercial bank, were the leading formal sector providers of safe places for poor people to save, together reaching over 700,000 clients. The

sustainability of microfinance as a business had been proved to a sceptical financial sector. At the opposite end of the poverty spectrum VSLAs, village based (mostly) women's savings groups, were not even registered, but were meeting the financial service needs of over a hundred thousand of the rural poor. The Government's major programme to provide rural Ugandans with access to financial services, "Prosperity for All", was underway and SACCOs were being rapidly set up across the country. The growth and diversity of microfinance service providers in Uganda is a very positive story.

The institutions which provided the foundation for the expansion of this microfinance market and how they changed were identified from the perspective of market stakeholders through micro-ethnographic research which included interviews with an extensive range of stakeholders in a wide vairety of roles. The interviews were then processed through N'Vivo.

What has been importantly identified is how social norms are not only foundations for the microfinance market in Uganda but also became embedded in the constitutional and operational institutions which respondents identified as critical to the expansion of the microfinance market. Six Level 1 institutions or social norms were specifically identified by respondents:

- women are economically active across Uganda
- saving is a Ugandan tradition, often in community (the microfinance market has twice as many savers as borrowers)
- there is a culture of paying back loans (because of the group) but not within a specific time frame
- the prevalence and expectation/acceptance of corruption
- limited trust in the banking system, and
- a belief that the government is responsible for regulating financial services and should support the expansion of access

The constitutional and operational institutions which changed in the Ugandan market during the study period were the MDI Act and the MDI regulations respectively. The MDI Act fulfiled the functions of bringing poor people and their savings into the formal sector, making them safe and providing MDIs access to commercial financing. The MDI regulations fulfiled all of the functions there were designed for except perhaps the most important – bringing significant numbers of poor people's savings into the formal sector. This highlights another important finding: that it is not the *form* of the institution but the *functions* it plays and the enforcement characteristics which are critical for market development. The right form for a particular context is one that enables the key functions required in the financial market to be carried out.

Constitutional institutions, institutional change and the MDI Act

Around 1997, a long process of technical consultations on appropriate microfinance legislation with a wide range of stakeholders began led by the MFF, chaired by Ministry of Finance Planning and Economic Development (MoFPED). The consultative or participatory process[24] was remarkable because of the willingness of the government to include stakeholders in this process. AMFIU played a pivotal role, leading an initiative to educate politicians and the public, particularly on the issue of high interest rates, as reported

[24] This acceptance of a participatory process by all the technical participants would be an example of Tandon's (2008) observation of the mainstreaming of participation in the development discourse.

in Ledgerwood and White (2006)[25]. (AMFIU received technical and financial support from GTZ and SPEED). The resulting legislation, the Micro Finance Deposit Taking Institutions (MDI) Act, was passed in 2003 and was considered exemplary because rather than concentrate on legitimizing microcredit or other narrow aspects of microfinance (as is common in other microfinance regulation), it focuses on protecting poor people's savings (Mwenda and Muuka 2004, Ledgerwood and White 2006).[26] The MDI Act formalized microfinance as part of the financial system. and was the key formal building block identified as contributing to the building the sector. Recognition of the importance of the bill was unanimous, even though there was ambivalence about the subsequent regulations which enforced the Bill. According to respondents, the MDI bill fulfiled several functions. It:

- officially included poor people in the formal sector;
- provided safe access to savings services for poor people due to BoU oversight and;
- gave MFNGOs that transformed into MDIs access to commercial financing.[27]

Respondents agreed that in addition to the MDI Bill formalizing poor people's savings, it recognized that microfinance needs to be prudently managed and controlled and that formalization and regulation is a good thing. The Bill (and the subsequent regulation) forced the leading NGOs to make changes to improve their strength. There is much more transparency in MDI operations and they are financially stronger than the other Tier 4 NGOs. It improved their ability to serve their customers and their financial viability. Banks also understood the role of the MDI to 'mop up' the savings where they cannot go and they get more out of the relationship. The conclusion was that everyone benefited from the MDI Bill: the BoU had oversight; the clients had better products and; the MDIs had more capital.

The passing of the MDI bill was underpinned by the social norm of the importance of saving in Ugandan community life. Three other of the social norms identified by respondents that undergirded the importance given to supervision of poor people's savings was the recognition of pervasive corruption, the agreed role of the government to regulate financial services, as well as a lack of trust in banking sector. MFNGOs were managing millions of shillings of poor people's savings and they needed to have rigorous oversight. These are a powerful set of norms as the foundation for this formal institution.

For institutional change to occur the process by which new rules or institutional forms are developed requires both that they are close enough to the underlying norms to be accepted but also different enough

[25] High interest rates are a legitimate concern because there are no alternative risk-hedging mechanisms available to farmers (Okidi *et al* 2007)

[26] Mwenda & Muuka (2004 p. 156) argue that "an effective and efficient regulatory framework for MFIs should focus on regulating MFIs that accept deposits from the public. …..The argument supporting the view that MFIs engaging in deposit-taking should be regulated and supervised is premised on the need to protect the public from risk should such MFIs default. The objective of regulating MFIs is to let only the most trust-worthy institutions operate for the good of the community while leaving them enough flexibility for adapted operations. While sound practices of micro-finance call for interest rate deregulation and a freedom for MFIs to adapt to local conditions, regulators must ensure that barriers to entry into the micro-finance sector are not so low that un-viable (or even dishonest) financial institutions flood the market."

[27] This focus on the MDI Act must be seen in the context of a legal framework that did not enable the expansion of microfinance**. T**he options were either NGO or Coop or Company. There was no option for something like VSLAs which are a semi-legal hybrid. The SACCO law was designed for producer coops not financial coops and was not indigenous either. The producer coops failed because of lack of accountability and lack of skills and this was the law that was supposed to work for FIs. (PS3)

to offer a break with path dependence so do not just repeat existing rules and norms. In the Ugandan case, this process occurred for the MDI Bill when Government shared power with a broad cross-section of stakeholders in a transparent, inclusive participatory process. Support from a wide range of Ugandan stakeholders meant that the new institution was close enough to underlying norms so it was accepted. Using Boettke's language the process was indigenously introduced and endogenously designed so it "stuck". But, in the case of the MDI Regulations, just two donors (development agents) and the BoU made the decision, so the process was not transparent and inclusive. There was no process of adapting the exogenous regulations promoted by the donors to fulfil the intended functions. The MDI regulations have therefore achieved all but the most important intended function of including significantly more poor people in the formal sector. The regulations have so far "stuck" but there are now only three MDIs left and no more expected.

Operational institutions and the MDI regulations

After the euphoria of the MDI Bill, there was a loss of momentum. It was not until a year later that the BoU focused on the regulations. By then, the MFF was no longer functioning effectively and was not a place for engagement by stakeholders. According to those close to the process there were just two meetings between the BoU and a few non-representative stakeholders before the regulations were promulgated. The BoU did not appear to be willing to share power in this regulatory design process. There were no draft regulations circulated for discussions and no opportunity to question the BoU's decisions. Donors were assured that these were global best practice regulations. No-one appears to have grasped the implications of the regulations for microfinance before they came out. The focus was simply on getting the regulations quickly, not on the process or even the content of the regulations.

The contrast between these two processes is radical. The first had power sharing to address an injustice using an open, transparent process involving major stakeholders, with the key representatives having the technical capacity and time to debate the issues with colleagues and arrive at a result that all stakeholders were happy with. These seem to be the key factors which allowed the creation of an innovative MDI Bill. Whereas, for the second, the power was in the hands of the BoU, without a clear justice goal, without a transparent, inclusive participatory process, so the regulations were little different from the BoU's other bank regulations.

Using Mahoney and Thelen (2010), the process to agree the MDI Regulations was one with a weak political veto possibility, because the Bill had already been passed and everyone was anxiously waiting for the regulations, and a high level of enforcement discretion on the part of the BoU. This meant that "the changed enactment of existing rules due to their strategic redeployment" which (Mahoney and Thelen 2010 p. 16) define a "conversion" was the most likely outcome. There could not be a better description of the MDI regulations – they were effectively a modification to the function of the existing Banking regulations.

In Boettke's language, the design of the regulations was a combination of BoU and external advice but the primary effort in the design was exogenous. The regulations were introduced indigenously by the BoU although there was not an inclusive process, unlike the MDI Bill. Other indigenous stakeholders such as the parliament, the private sector and NGOs were not involved at all. So, with this analysis it should be classified as an Indigenously introduced, Exogenously designed (IEX) process although it is closer to a foreign introduced exogenously designed process. This helps explain why the regulations have been enforced but are not considered to have achieved their goals.

The analysis of this Ugandan case using Boettke *et al* 's (2008) framework indicates that an indigenous process is more important than whether the institution is endogenous or exogenously designed. This appears to support Boettke *et al* 's conclusion that "any path to progress with a reasonable probability of success must ultimately be rooted in indigenous institutional order." (Boettke *et al* 2008 p. 354) But this analysis goes further by showing that for institutional change to be rooted in the indigenous institutional order, the process of the change must include all major stakeholders. Indeed, it appears that an inclusive indigenous introduction process is the means by which exogenous institutional forms are negotiated to become endogenous. In Uganda where the lengthy process of designing and introducing the MDI Bill included all major stakeholders, this process was effectively a negotiation so that the final institution was indeed endogenous and indigenous. Logically then, an inclusive indigenous introduction process, would be consistent with social norms and as a result, would enable the functions of the institutional form to be fulfiled as designed. Since all key stakeholders were involved in the design process they would have agreed on both the new institution's form and function and would be working to support them, not against them.

6. Assessing institutional change theories in Bosnia and Uganda microfinance markets

The institutional change theories of Mahoney and Thelen (2010) and Boettke *et al* (2008) take elements of all three institutionalist approaches and address incremental institutional change. The two theories, however, have very different purposes. Mahoney and Thelen aim to predict the type of change that can be expected, and Boettke *et al* at predicts whether the change will "stick". So each set of researchers have pared down the variables they focus on to two very different key drivers of change: Mahoney and Thelen on political veto possibilities and enforcement characteristics; and Boettke *et al* on where the change is designed and how it is introduced.

Consistent with findings about the foundational role of social norms, they both specifically include social norms as critical to the institutional change process, but Mahoney and Thelen do this rather less directly. Boettke *et al* include the *metis* or culture directly in their theorem, recognizing that unless the institutional change is close to the *metis* it will not 'stick'. In contrast, Mahoney and Thelen take time to identify the attributes of institutions which create the spaces for change all of which apply to both informal norms as well as formal rules. Furthermore, they state that the two major variables which affect change apply to both "formal or informal" (*ibid* p.19) rules. So although there is less overt reference to social norms they are integrated into the theory. However, Mahoney and Thelen and Boettke *et al* substantially differ on addressing the role of external agents. Boettke *et al* recognize that institutional change can be foreign designed and exogenously introduced, but Mahoney and Thelen are silent on whether change agents are internal or external. (Although their discussion about agents' "short-run behaviours" and "long-run strategies" (*ibid* p.22) appears to refer to internal agents.) When the institutional change theories of Mahoney and Thelen (2010) and Boettke *et al* (2008) are assessed against the two real world case studies, there are some surprising results.

Applying Mahoney and Thelen (2010) to the introduction of the MCO Laws in Bosnia, there was a strong political veto possibility (because of the dysfunction of the government) and a low level of enforcement discretion by the Departments of Social Welfare / Finance and the Banking Agencies as the target institutions. So "Layering" of the MCO law on top of the banking law was the result as Mahoney and Thelen (2010) would have predicted. Applying it to the introduction of the new MDI Bill in Uganda, there was a weak veto possibility because of the consensus building process that had been undertaken by AMFIU

and the MFF) and high level of enforcement discretion by both the Parliament who will pass the law and the BoU that would implement the law. So according to the theory the result should be "Conversion" when there is a "change in function of existing rules". But it was a totally new law, which raises the question about whether the theory is limited to situations where there is change in *existing* institutions, but perhaps does not apply to totally new institutions. In fact, Mahoney and Thelen's (2010) theory does apply in this case because they are referring to institutional *forms*, not institutional functions. There was "Conversion" because there was "a change in functions" of existing form of the Parliament and the BoU, reinforcing the empirical power of their theory. However, it also usefully highlights the need to explore whether Mahoney and Thelen's (2010) theory could usefully be adapted to be address changes in institutional functions.

These examples raise a further question about what is an appropriate time-frame within which to apply Mahoney and Thelen's (2010) theory. If the time frame for this research considering the MDI Bill had started in the early to mid 1990s, intead of 1997, then there would have been strong veto possibilities as this was before awareness had been raised of the importance of microfinance for poor clients, and particularly savings in the Ugandan context. It identifies what appears to be missing from their chapter, a discussion of time frames within which their theory operates. This study used a ten year time frame but that may not be long enough to identify changes in social norms or to effect changes in laws. Furthermore, the discussion about change agents is clearly too limited to be useful in these cases as it does not does not address the multiple different stakeholders involved in institutional change, nor any process for them to be engaged which would translate into changed institutions and nor does it identify what role external development agents could usefully play.

Boettke et al's theorem has social norms (the "metis") at the centre and has the design and introduction of the institution as the drivers of institutional change. Either the institution is designed endogenously or exogenously and it is introduced either through an indigenous process or by a foreign agent. The theorem explains whether the institutional change will "stick" or not depending on how close it is to the local culture. This theory appears to embody Chang's (2007) and Woolcock's (2009b) views that the effectiveness of 'institutions' depends crucially on their legitimacy in the eyes of those living under them (Woolcock 2009b p.13). In order to gain legitimacy, "the new institution has to have some resonance with the existing culture/institutions," (Chang 2007 p.30)

Applying Boettke *et al* 's (2008) theorem, both the performance standards the Bosnian MCOs followed and the Ugandan MDI law were both endogenously emergent (from the MCOs and MFIs) and indigenously introduced (i.e. an IEN process); so according to the theorem the changes would "stick", which indeed they have done. In contrast, both the MCO Law which was indigenously introduced by the LID and exogenously designed by World Bank experts and the MDI regulations which were indigenously introduced by the BoU but exogenously designed by donor experts (IEX) were more likely to 'stick' than not stick, but not as well as one that was endogenously designed, as it was not expected to be close to the *metis.* But there is not such a simple dichotomy between the two Bosnian examples as there appears to be. In practice, to get to standards being set by the Bosnian MCO's, the World Bank project experts had to teach the MCO leaders first, raising the issue of whether it was really an endogenous or an exogenous design process. The theory appears to be unable to problematize the complex nature of the relationship between the endogenous and exogenous design (nor between indigenous and foreign introduction). Furthermore, it is clear from these cases that institutional change closest to the *metis* will "stick" and that change furthest away is unlikely to "stick" but it is not clear what will happen to the majority of institutional changes which result from processes between

these two extremes. Unlike Mahoney and Thelen (2010), Boettke *et al* (2008) do include an element of process in their theorem and have differentiated the roles of internal and external agents, but there is still no discussion of what process will result in an institutional change closer to the *metis,* what the time-frames are for such change nor recognition of how power relations affect outcomes; so much more work is needed on these issues.

Evidence from the institutional change processes in the two microfinance markets indicates the usefulness of both Mahoney and Thelen's and Boettke *et al*'s institutional change theories. They both accurately predicted the institutional change outcomes according to their parameters. By showing ways in which institutions change, these findings challenges the theoretical position of path dependency and exogenous shocks and the primary way institutions change. These findings also seriously question the basis for the blue print approach commonly practiced. However, neither theory appears to be complex enough to theorize multiple sets of stakeholders / agents or multiple institutional functions of an change process that has the potential to "stick" (as identified in the Bosnian and Ugandan cases). Grindle (2007) has recommended that the *process* of institutional reform (or change) be understood as the "process is a complex one that unfolds over time" (*ibid* p. 569) and Bebbington (2004) recommends that "theory workers and practice workers ought never to lose touch" (*ibid* p.281). So perhaps a deeper engagement between theorists and participatory practitioners (some of whom are trying to theorize their experience e.g. Crook and Booth, 2011)[28], could provide useful input to both Mahoney and Thelen (2010) and Boettke, Coyne and Leeson's (2008) theories. [29] Such engagement, however, might need to be facilitated to enable communication between two the different languages.

In addition, both theories would benefit from the insights of the other theory to arrive at a three-dimensional approach. Boettke *et al* (2008) has the potential to predict whether an institutional change will "stick" and therefore challenges change agents to modify their approach accordingly, but it does not help change agents prepare for a particular change option as Mahoney and Thelen's theory does. This theory has the potential to predict what type of change option can be expected given the political context and enforcement characteristics, but it cannot anticipate whether a change process will stick or not, as it is designed to frame incremental institutional change, and the multiple agents and institutional functions in the new microfinance markets overwhelm the theory. Together, this would enable them to move them from being theories which have shaken off the limitations of both path dependency and blueprint approaches to institutional change, to being theories which can usefully frame analysis of complex institutional change processes.

In addition, the interrogation of institutional change theories in these comparative contexts shows the inadequacy of dominant theories of institutional change: either transplanting institutional blueprints from developed economies; or immutable institutions that are path dependent and will only change with exogenous shocks. Mahoney and Thelen's (2010) institutional change theory and Boettke's *et al* (2008)

[28] For example, Crook and Booth (2011 p. 101) state their "research is suggesting that the institutions most likely to contribute to development in low-income Africa are 'practical hybrids', combining the authoritative coordination which can come from a developmental neo-patrimonial state with an enabling environment for local problem-solving and a constructive use of culturally legitimate ways of working." This is consistent with both Mahoney and Thelen (2010) and Boettke *et al* (2008) and the processes arriving at these types of institutional forms and functions could very usefully be mined.

[29] Bebbington (2004) recognizes that some participatory practitioners view theoretical abstraction as" tyranny that obstructs change-oriented action" and "privileges elite form on knowledge" (in Hickey and Mohan (eds) 2004 p.278) and so engagement is not an easy process.

institutional change theorem each move beyond path dependency and provide a useful contribution to explaining the success or failure of change efforts. Each have weaknesses exposed by the other theory which, if addressed could make them more powerful and enhance their usefulness. The apparent conclusions for change agents is either: to only engage in institutional change process that they are prepared to continue with until the local stakeholders can stand alone, or, to ensure that there are endogenous design methods and indigenous introduction processes that will last.

7. Conclusions

The importance of the definition of institutions and institutional functions

While North's contribution to our understanding of the role of institutions in economic development is pivotal, his definition of institutions has faced criticism. These include that: it was a vague concept, (Sachs 2003, Portes and Smith 2008); there was a preoccupation with defining "best practice" institutions, (Rodrik 2008a, Bardhan 2005, Evans 2004); and there was an unfortunate tendency to assign a single function to each institutional form (Chang 2007). Given that an institutional form may have multiple functions and multiple different functions in different economies, it is not surprising that institutional forms are considered vague.

This empirical research has shown that identifying discrete institutional functions for markets allows for a specificity which can be assessed across markets. In these cases, defining institutional functions for markets meant that attempts to define global "best practice" institutional forms became redundant. There was no consistent mapping from institutional function to form across these markets. The forms varied, but the functions were consistent. The form only mattered in that it fit the purpose of the function. This supports Chang's (2006) argument that the same function or purpose can be served by different institutional forms. Chang also recognizes that it is a challenge to "clearly distinguish between the forms and the functions of institutions" (Chang 2006 p. 3). The 'micro' ethnographic methodology used was able to overcome this particular challenge because it was the market participants who defined the functions (not an external observer). This is consistent with North's (1994 p. 360) definition that institutions are "humanly devised constraints that structure human interaction".

These empirical findings show that Chang (2007) and Rodrik (2008a) are right: institutional functions are what matter, not institutional form. Further defining of institutional functions in both financial and other markets will need to be undertaken to test this further. However, it may not be too great a step to assert that institutional functions better represent North's definition of institutions, recognizing that institutions provide the incentive structure of economies. This assertion is clearly very preliminary but has the potential to usefully reframe institutional theory. Further research and analysis to test this assertion would enable progress to be made in arriving at a common useful definition of an institution.

Helpful theories of institutional change

By 2011 Chang (2011 p. 494) was able to critically examine two main theories of institutional change. He identified two "absurd extremes". One was "hopelessly optimistic" that institutions can be changed easily and had a "simplistic, linear and static" (*ibid* p.476) theoretical basis. The other extreme was "unduly

fatalistic" that only external shocks (like colonization) can change path dependent institutions. Chang (2011) concurs that path dependence "operates at a more fundamental level than we normally think", and that "the constitutive role of institutions, the inherent change resistance of designed institutions and the interdependence between institutions" (*ibid* p. 490) means that institutional change does not happen easily. But he did not agree that only exogenous shocks can change institutions. He concluded: "[o]nly theories that take both structural constraints and real human agencies seriously can help us".

Mahoney and Thelen (2010) set out to design a theory for gradual institutional change and identified the key drivers of change to an institutional form (not function) as the possibility of political veto and the enforcement characteristics of the target institution as well as the role of different types of internal agents of change. They also usefully identify the many spaces for change within institutions, often around social norms. When tested in the microfinance markets of Bosnia and Uganda this theory showed some predictive power. Their theory, however, has three limitations in these cases, in addition to addressing institutional forms, not functions. First is a lack of clarity around the theory's timeframes. It is possible to define the veto possibilities and enforcement characteristics at different points in time and so generate different results but it is not clear how one makes these choices. Second, the theory assumes that given these processes, the changed institution will last but there is no discussion about the other factors that would contribute to it lasting or not. Finally, although it recognizes the power dimension in the possibility of veto, it does not address process more generally and does not incorporate a role for external change agents, or multiple internal change agents and multiple institutional functions. Such cases would appear to overwhelm the theory. These limitations could arise because Mahoney and Thelen (2010) prefer to take a longer term view of institutional change in which case timing might not matter so much. Nevertheless, the examples Mahoney and Thelen (2010) provide include shorter time frames similar to this study and they appear to want to apply their theory to a range of contexts. Therefore, it would be useful to address these limitations.

Boettke *et al* 's (2008) theorem also focuses on institutional forms and hypothesizes that when institutional change is endogenously designed (as distinct from exogenous design by external agents) and indigenously introduced (as distinct from a new form that is introduced by foreign partners) it will "stick" - i.e. will function effectively for the foreseeable future. This theorem usefully puts congruence with social norms as the focus and key to success of institutional change and when tested in the microfinance markets of Bosnia and Uganda it showed some predictive power. However, there are also three flaws in Boettke *et al* (2008) theorem, in addition to addressing institutional forms, not functions. First is the lack of clarity of the parameters and timeframes. For example, when local consultants working for external donors design a new institution, is this endogenous or exogenous design? Or, when a local decision maker takes an external agent's "expert" opinion without question, is that indigenous or foreign introduced? Second, it is clear that institutional change closest to the *metis* will "stick" and that change furthest away is unlikely to "stick" but it is not clear what will happen to the majority of institutional changes which result from processes between these two extremes. Are they simply ineffective institutions? Finally, the theorem only takes a one-dimensional view of the process of institutional change without recognizing the complexity of the power dynamics in institutional change processes. Nevertheless, this theorem was found to be a generally useful guide for predicting whether institutional change will "stick".

Both Mahoney and Thelen (2010) and Boettke *et al* (2008) have provided useful contributions to theories of institutional change but if they are to be used to reach a mid-level theory of institutional change then the

limitations identified will need to be addressed. Further iterations of these theories are needed, with subsequent additional empirical research to test them out. In particular they need to address the two common limitations of ambiguous processes and uncertain timeframes. Therefore, the challenge to institutional researchers is to take these theories forward to reach a mid-level theory of institutional change and engaging with participatory development practitioners may be a useful part of that process. Grindle (2007) recommended institutional reform (or change) be understood as the "process is a complex one that unfolds over time" (*ibid* p. 569).

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