

Institutional Change, Growth, and Poverty Levels in Pakistan

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I. INTRODUCTION

It is now well-recognised that institutions matter in the growth process both directly and indirectly. Well-functioning institutions lead to higher investment levels, better policies, increase in social capital stock of a community, and better management of ethnic diversity and conflicts [see for example North (1990, 1994); Jutting (2003); Rodrik, *et al.* (2002); Dollar and Kray (2002); World Bank (2002); Aron (2000); Chu (2001) and Frischtak (1995)]. That the decay of institutions has led to poor governance—and the urgent need for improved governance in Pakistan particularly—has been well-documented in DRI/McGraw-Hill (1998); Pakistan (1999) and Hassan (2002). Transparent, participatory, and efficient working of institutions ensures correct priorities and appropriate policies; their effective and efficient implementation results in high growth, better income distribution, and alleviation of poverty.

Institutional development has been very slow in Pakistan, and more often than not these have been abused by the elite to extract rent [Hussain (1999)]. Over the last three decades, and especially in the 1990s, even the institutions that existed have degenerated. Poor governance resulting from the mal-functioning of institutions has denied the poor any participation in the decision-making process, and they have failed to derive any benefit from the rising levels of per capita incomes.¹ The rising poverty in turn has led to further decay of institutions and the poor are caught in the vicious circle [see Hassan (2002)].

Pakistan's financial indicators have become quite strong and one hopes that this will result in higher levels of private and public investment. However, it needs to be ensured that the poor also benefit from the development process. To ensure that

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¹Decline in the growth rates, deflationary policies, regressive incidence of the tax structure, and withdrawal of the subsidies have also contributed to the rising poverty levels.

public investment does not go waste and adds to productive capacity, and that private sector investment results in higher level of welfare, the country needs a credible and proper institutional framework which is transparent and predictable. The present paper examines the role of institutions in the growth and in poverty reduction in the context of institutional development in Pakistan. It also analyses the prospects of better governance in Pakistan.

The plan of the paper is as follows. Following this Introduction, the definition and typology of institutions are analysed in Section II. The transaction costs associated with different types of institutional framework and the evolution of institutions are examined in Section III. The institutional framework and the impact on the poor in Pakistan are analysed in Section IV. The recent initiatives to improve governance and institutional framework are examined in Section V. The main conclusions are summarised in Section VI.

II. DEFINITION AND TYPOLOGY OF INSTITUTIONS

The Definition of Institutions

The World Bank (2002) defines institutions as *rules, enforcement mechanisms, and organisations*. According to North (1990), institutions are any form of constraint that human beings devise to shape human interaction including prohibitions on individuals, and the circumstances under which individuals are permitted to undertake certain activities. Institutions are the rules, including behavioural norms, by which agents interact; the organisations implement rules and codes of conduct to achieve desired outcomes.

The policies and institutions interact; whereas policies impact the evolution of institutions, the institutions affect the policies that are adopted. We may note that the institutions work as systems; improvement in one part affects the efficiency of the whole system. Therefore, institutional development must have a holistic approach, wherein various small reforms complement each other to improve efficiency and build a momentum for larger reforms. Strength of the rule of law, risk of expropriation, and the security of property rights are mainly the outcome of the institutional set-up of the country.

The Typology of Institutions

Institutions may be classified in three ways, viz., by degree of formality; levels of hierarchy; and area of analysis [For details, see Jutting (2003)]. Institutions may be formal, i.e., existing in written rules, but in general they are based on the unwritten codes of conduct. Formal rules comprise constitutions, laws, property rights, charters, bye-laws, statute and common law, and regulations; and enforcement characteristics. Alternatively, the institutions may be informal, basically extensions, elaborations, and modifications of formal rules; socially sanctioned norms of

behaviour (customs, taboos, and traditions); and internally enforced standards of conduct. Whereas both types of institutions are present in the developed and developing economies, the reliance on informal institutions to facilitate transactions is high in developing economies. This is because formal institutions are less developed and they rarely come to the rescue of the poor. World Bank (2002) suggests that the informal institutions go a long way towards resolving information and enforcement problems without resorting to the formal public legal systems. While this is true, we must also note that even the informal institutions are misused by the elite for its own benefits. The formal or informal institutions would result in a higher level of welfare only if they are judiciously employed.²

Informal institutions can be superior to formal alternatives, either because they are more efficient at achieving the objective or because they embody features that formal institutions are unable to provide. However, informal institutions may prevent further market development if closed networks restrict the scale and extent of possible transactions. They may also exclude potential entrants and partners. Formal institutions are important because they can deal with a larger group of participants and because, if well-designed, they can serve to include more people rather than exclude them.

Williamson (2000) proposes classification of the institutions based on different hierarchical levels. The Level 1 institutions are social norms, customs, traditions, etc. and most of the transactions undertaken are regulated by expectations based on beliefs and identities. Because non-compliance may result in economic and social sanctions, they are well respected and are easy to enforce. Level 2 are the formal institutions such as conventions or laws but sometimes they also include informal institutions such as rules governing access to natural resources. These institutions define and enforce property rights. Level 3 institutions relate to order and incentives and build the governance structure of a society resulting in the organisations such as local or national government, state agencies, NGOs, etc. The Level 4 institutions define the extent to which adjustment occurs through prices or quantities, and influence the resource allocation mechanism.

The institutions may be economic, political, legal, or social [see Bowles (1998) and Beck, *et al.* (2002)]. The economic institutions include markets and determine production, allocation and distribution process of goods and services. Political institutions relate to holding of elections, electoral rules, type of political system, opposition and the government, measures of checks and balances and political stability. The legal institutions refer to the type of legal system, the definition and enforcement of property rights and legal origin. The social institutions relate to rules that govern access to social sectors such as health and education and social security arrangements, and gender balance.

²In developing markets, informal institutions tend to substitute for the lack of formal systems, whereas informal and formal institutions tend to complement each other in developed markets.

The efficient institutions promote growth, and efficiency of the institutions may be defined in terms of allocative efficiency and in terms of reduction in the cost of using the system of rules. Posner (1998) argues that “affluence in developed countries is a cumulative result of efficient institutions; poverty in poor countries of inefficient institutions.” Obviously, for promotion of economic activities, rules relating to laws, regulatory measures, policies, and decrees should be stable so that economic agents are able to predict how the rules would affect returns on their investment. Rules should be interpreted and implemented objectively and without discretion.

III. THE TRANSACTION COSTS AND EVOLUTION OF INSTITUTIONS

Economic transactions comprise exchanges between buyers and sellers, between creditors and debtors, and more broadly among competitors. Political transactions comprise exchanges between rulers and constituents, between representatives and voters, and among competing political groups, etc. [see North (1990) and Chu (2001)]. Transaction costs rise due to inadequate information, incomplete definition and enforcement of property rights, and barriers to entry for new participants. The institutions help manage risks from market exchange, increase efficiency, and raise returns to investment.

With a view to improving the efficiency of the institutions, distinction between rule-making and rule-implementing needs to be clearly understood. If the formulators and implementers of the rules are the same, those benefiting from the existing institutions may encourage organisations and interest groups having stake in the existing set up to forestall the possibilities of changes in the institutions.

There is a need for nondiscretionary rule implementation, and, therefore, organisations need to be made independent of political and other interventions. This may be done through establishment of autonomous and independent organisations. These organisations must be held accountable to the public on the basis of strict and transparent performance requirements. There should be a well defined, accountable selection and removal procedures criteria for their officers.

The institutions for economic transactions evolve in two phases. In the first phase, intracommunity transactions rely on personal ties and intercommunity transactions take place with inadequate intercommunity institutions. In the second phase, there are efficient institutions for impersonal intracommunity and intercommunity economic transactions throughout a nation state. Legal and other rules with third-party enforcement also govern intergroup and intragroup political transactions. A low-cost transaction system provides opportunities for specialisation and efficient production, and institutions in developed economies have these features.

Institutional development is a learning process, and they evolve as a result of interactions among rules, organisational or individual agents, and institutional entrepreneurs. The institutions are country-specific and depend on the values in the system. For example, Rodrik, *et al.* (2002) points out that “desirable institutional arrangements have a large element of context specificity, arising from differences in historical trajectories, geography and political economy or other initial condition. Similarly, International Monetary Fund (2003) found that what specific institutional setting will work best in a specific local context is difficult to ascertain because countries with a similar level of income have different institutional settings with varying degrees of success. North (1994) points out that culture plays an important role in characterising informal norms and in reinforcing, or interfering with, the functioning of formal rules.

North (1990) points out that institutional change depends on changes in the relative costs associated with such changes and preferences of the society. However, once a particular course is chosen, the network externalities, the learning process of organisations, and the historically derived subject matter reinforce the process.

For the development of effective institutions, World Bank (2002) suggests a four-pronged approach:

- *Design them to complement what exists—in terms of other supporting institutions, human capabilities, and available technologies;*
- *innovate to design institutions that work—and drop those initiatives that do not;*
- *connect communities of market players through open information flows and open trade; and*
- *promote competition among jurisdictions, firms, and individuals.*

In designing the formal institutions, efforts need to be made that they properly interact with collective values of the society and, therefore, various dimensions of a country’s culture are kept in view. The governments in developing countries like Pakistan must accept the challenge for designing and adopting efficient rules, and ensuring the effective implementation of the rules. The government must ensure that *property rights and contracts are clearly defined and enforced* and information is shared in a transparent way. It must ensure competition as well.

Institution need to be so designed that the incentives to all the actors in the market, viz., consumer, producers, capitalists, workers, and entrepreneurs, are in accordance with the desired objectives. Effective institutions are those that are *incentive-compatible*. They channel information about market conditions, goods, and participants. They increase competition in markets.

Policy-makers are not the only ones who develop the institutions. Business people and community members also create institutions. Corporate, collateral, and bankruptcy laws are *public institutions*, while reciprocity between community

members and land inheritance norms are *private institutions*. Many private institutions exist under the aegis of public institutions. Enforcement of rules can be internal, implemented by the parties affected by the rules; or it is external, implemented by a third party. Informal institutions and private formal mechanisms generally rely on their own members for enforcement; individual agents organise themselves into informal groups, such as business associations or mutual insurance systems when the cost of collective action is low and the rules can be easily monitored. Expulsion from the community acts as a deterrent. External enforcement mechanisms, such as judicial systems or third-party arbitration, are critical mechanisms for the development of integrated markets. They allow access to market opportunities for a broader group of market participants. For external enforcement mechanisms to be effective, the legitimacy of the enforcer is vital. When the state acts as an agent that shares the objectives and beliefs of its citizens—and implements rules consistent with these objectives and beliefs—it is more likely to build effective formal institutions to support market development.

IV. INSTITUTIONAL CAPACITY AND GOVERNANCE IN PAKISTAN AND THEIR RELATIONSHIP WITH POVERTY

As pointed out earlier, institutional decay in Pakistan has led to poor governance, which has resulted in *ad hoc* policy-making. Instability and unpredictability has discouraged long-term investment and encouraged lobbying, corruption, and misuse of power, resulting in frustration and dysfunctional behaviour [For details, see DRI/McGraw-Hill (1998)]. Poor governance is manifested in corruption, inefficiency, ineffectiveness, inaccessibility, intractability, and lack of motivation and incentives, and has contributed to the slow growth and increase in poverty [For details, see Pakistan (1999)].

Poverty in Pakistan reflects an interaction of economic, social, legal, and political processes, and the failure of the institutions in all of the four areas has led to the governance problem. The failure of governance and the domination of political power and state apparatus by the elite has excluded the majority of the population from institutionalised decision-making, which is almost completely irrelevant to the poor. Management and delivery of public services and public utilities are poor, because, virtually, there is no accountability or discipline, and improper incentives and controls are in place. Whereas the poor rightly believe that the state has the responsibility to provide affordable, effective, and equitable public goods and services, the inability of the public sector to deliver has meant that the poor can not make much use of these services. For example, UNDP (2003) observes that if the poor fall sick, they rarely go to the public health facilities because they fail to deliver the services. The poor perceive that public agencies are responsible for their vulnerability and erosion of their household, political, civil, and natural resources and social assets. It needs to be underscored that the slow pace of institutional

reform, the presence of vested political interests, and political interference in the location of projects, excessive centralisation in the management of services, and weak implementation capacity have precluded community involvement. This perception can be removed only through proper functioning of the institutions.

Because of the failure of the formal institutions, the poor resort to informal institutions and are thus adversely impacted. The informal legal system is particularly has deleterious effects on the poor, who possess neither economic nor social capital to receive adequate justice. The National Human Development Report [UNDP (2003)] notes that whenever there is a dispute, the resolution mechanism is such that the commoners fall below poverty levels. Efforts must be made to limit the vulnerability of the poor to the vagaries of the system of administrative, political, civil, and criminal justice. The failure of state institutions to provide law and order and security is a function of the existent police, legal, and judicial structures and these are affected by the performance of the four domains of justice including administrative, political, judicial and policing.

The police force is perceived by the poor as a symbol of immense repression and exploitation in Pakistan. For them the police is largely responsible for making it difficult for the informal sector to function effectively. Various studies indicate that the police harasses small traders and vendors, especially women.

The poor are denied justice, making them quite vulnerable. Their vulnerability is exacerbated by the everyday harassment, under-performance, exclusion, or denial of basic rights by public officials. The local officials responsible to license and regulate economic activities extract rent from the informal sector workers. Because of malpractices, including corruption of the local officials, the poor suffer from inadequate health cover, education, land management, etc.

V. THE PROSPECTS OF BETTER GOVERNANCE

There has been increasing realisation over the last decade that without the creation of institutions and respect for them, the growth prospects would be seriously compromised [Kemal (2001)]. The Government of Pakistan presented a strategy for improvement in governance to the Pakistan Development Forum in 1999, and it was well-received by the donor community. However, very little effort was made to implement the strategy.

Various efforts have been made in recent years for the restoration of existing institutions and for creating new ones to ensure larger participation of the poor, especially the females. The PRSP reiterates the resolve of the Government for a series of fundamental transformations, including the devolution of power to the grassroots level and decentralisation of administrative and financial authority; improved access to justice at the local level; police reforms; civil service reform; improvement in financial governance; freedom of information; participation of the people in the decision-making process; transparency; and accountability.

Devolution

Perhaps the most significant policy change in the institutional development in Pakistan has been the devolution of power from the federal and province level to the districts. Under the new system, the district administration and police are answerable to the elected chief executive of the district. A system of checks and balances, together with citizen monitoring by elected representatives, is necessary to ensure security against the abuse of authority. The devolution provides an opportunity for local accountability of government—to achieve efficiencies in the way the services may be delivered to the poor.

Devolution assigns service delivery to the local bodies, and these are accountable to the community. However, it would be practicable if the district administration felt so and if they had to rely on the local revenues to meet the expenditures. If devolution is not accompanied with fiscal decentralisation, the impact will be limited. Nevertheless, to ensure that the poor communities also develop at a rapid rate, a reliable and predictable transfer of funds from the upper level of government is necessary.

Devolution is expected to improve service delivery as local governments can better assess spending priorities and can utilise their resources in a cost-effective manner. However, the risks need to be recognised. Given that a poorly implemented local government reform could harm rather than improve the delivery of services, it is important that it succeeds.

With a view to improving governance, a system of checks and balances between *Nazims* (Civil Administrators) and the District Co-ordination Officers (DCOs) needs to be ensured. As Hassan (2002) points out, the DCO should be the sole representative of State at the district level to monitor all the departments. In case of serious disagreement with *Nazims*, they should have the right to report independently in writing to the provincial governments.

Access to Justice

The judicial systems play an important role in the development process as they help in resolution of disputes between private parties and between private and public parties, by providing a backdrop for the way that individuals and organisations behave outside the formal system, and by affecting the evolution of society and its norms while being affected by them. These changes bring law and order and promote the development of markets, economic growth, and poverty reduction. Judicial systems need to balance the need to provide swift and affordable justice to the people.

The basic problems of judicial administration in Pakistan relate to governance and administration; case management and delay reduction; automation and court information systems; human resources; and infrastructure. These constraints hinder the performance of the judiciary. In particular, their performance relating to the financial sector leaves much to be desired.

The success of judicial reforms depends on increasing the accountability of judges; that is, providing them with incentives to perform effectively, simplifying procedures, and targeting resource increases. One of the most important elements affecting judicial accountability is transparency, or the provision of information that makes it easy to monitor judicial performance—for example, judicial databases that make it easy to track cases and make it hard to manipulate or misplace them.

Simplifying legal procedures tends to increase judicial efficiency. The procedures are particularly important in countries like Pakistan where complementary institutions are weak. Judicial independence needs to be coupled with a system of social accountability. The channels for such accountability can be the free media and civil society organisations; or accountability can be built into the judicial system itself.

With a view to improving the access to justice, the Poverty Reduction Strategy Paper (PRSP) outlines the strategy:

- security and equal protection to all the citizens, particularly the poor;
- securing and sustaining of entitlements and reducing the vulnerability of the poor;
- strengthen the legitimacy of state institutions; and
- creating conditions conducive to pro-poor growth, especially by fostering investor confidence.

To address the vulnerability of the poor, the PRSP suggests various actions aimed at alleviating the vulnerability arising from everyday harassment, under-performance, exclusion, and denial of basic rights by public officials. As pointed out earlier, the informal sector is vulnerable because of the rent-seeking behaviour of officials responsible for licensing and regulating people's access to economic and environmental assets.

Police Reforms

The police force needs to be reformed in such a way that instead of being an instrument of government coercion, it is a service delivery organisation that protects people's rights. Public Safety Commissions at the national, provincial, and district levels, comprising elected representatives, can be helpful in this direction. While ensuring functional autonomy of the Police, local control and institutionalised accountability at the grassroots can be helpful. An independent Police Complaints Authority would also be helpful in expediting investigation of allegations of excesses and neglect by the Police.

The District Public Safety Commission (DPSC), Criminal Justice Coordination Committees at the district level, an independent Prosecution Service, and strengthening of Police's capacity for delivery would go a long way towards improving the Police force. These measures will hopefully provide the poor and the

illiterate a more effective recourse to have their grievances redressed, and will also provide more open access to justice in their own communities—an important element for empowerment, dignity, and rights.

Civil Service Reforms

Civil services of Pakistan have deteriorated rather sharply over time. Whereas the number of public sector employees has increased, the average level of competence has fallen. The wages and salaries have been eroded by the sharp growth in the size of public sector work force. There are perverse incentives leading to corruption. Whereas various Commissions have been set up to downsize the work force, the results have been mixed. Though in recent years the salaries of public employees have increased, they are still significantly lower in real terms than they were in 1990 or 1994.

Good Governance Report 2010 enumerates 10 factors that animate the crises in civil services, including (i) the perception that government is to provide jobs in public sector; (ii) poor salary structure; (iii) protecting status quo; (iv) resistance to sharing information; (v) centralisation of decision-making; (vi) lack of discipline; (vii) lack of professionalism and performance orientation; (viii) corruption; (ix) archaic operating procedures and regulatory mechanism; and (x) public aversion to public servants.

The purpose of civil service reforms is to improve the effectiveness and performance of the civil service and to ensure its affordability and sustainability over time. These reforms are expected to improve upon the service delivery mechanism which citizens consider necessary and to enhance the level of institutional capacity in the public sector to carry out core government functions. The main elements of the Government's civil service reform strategy include:

- a flatter structure of civil service;
- merit-based recruitment and promotion criteria;
- performance-based compensation;
- incentives to improve innovation (i.e., encourage prudent risk-taking); and
- to increase the demand for professional skills (i.e., for training and education).

Financial Governance

Because of the misuse of discretionary power at various tiers of the government, there has been rampant corruption. The government has established the National Accountability Bureau (NAB) to investigate and prosecute cases. Besides punishing the corrupt, preventive measures such as instituting a system that collects information and raise the possibilities that corruption is detected would also be required.

The government has outlined an anti-corruption strategy which, among other measures, includes legislation for access to information by ordinary citizens; code of conduct for eliminating corruption; prohibiting participation in decision-making whenever private interests may be present in the performance of public duties; declaration of assets by all prominent holders of a public office and their effective monitoring; establishing vigilance units; citizen charters; and service delivery surveys and report cards.

Freedom of Information

Free Media can act as a watch-dog, and for this function the access of media to all the sources of information is absolutely essential. Whereas access to information has improved already, further opening and access to information would go a long way towards transparency in the use of public funds and predictability in the economic policies. The Freedom of Information Act can go a long way in this direction.

Whereas Pakistan's statistical system may not be any inferior as compared to those in the neighbouring countries, the fact remains that the statistical authorities do not have much credibility with the public. While some data are not available, the others come after a significant lag. Besides, the data collection procedures, editing and processing leave much to be desired. There is a need for reforms in terms of legal framework governing statistics, institutional reform, and investment in human capital. The statistical authority should be autonomous which could release the data without any clearance from any Ministry. There is a need for a long-term plan to strengthen the statistical system including training and motivation of the staff and strengthening infrastructure.

VI. CONCLUSIONS

There is sufficient empirical evidence across the countries that well-functioning institutions help in the promotion of growth and reduction of poverty. Poor institutions result in higher costs mainly due to inadequate information, incomplete definition and enforcement of property rights, and sometimes the barriers to the entry of new participants. The better institutions help manage risk from market exchange, increase efficiency, and raise the returns to investment. The policy formulation and implementation of policy need to be separated because the policy implementers may obstruct the evolution of institutions. We may note that there has been a decay in the institutions of Pakistan leading to poor governance, which has created the problems such as corruption, inefficiency, ineffectiveness, inaccessibility, intractability, and lack of motivation and incentives. The poor in particular have been hit hard by poor governance. They have to resort to the informal institutions and unfortunately even those have been used in Pakistan by the elite group for their own

advantages. The service delivery is so poor that they prefer not to avail those facilities. Police force instead of protecting the rights of poor harass them and in general the public officials take certain actions which deny them their basic rights.

With a view to creating better institutions, it is of great significance that formal and informal institutions are integrated better. Given the fact that it might be very difficult and may not even be desirable to change the indigenous social structure, there is an urgent need to know more about the conditions that would help in functioning of the institutions. This would be quite helpful in the governance structure of a country, ways of participation in political decision-making processes, ways of fighting social exclusion, etc.

While formulating and reforming the institutions, the following should be taken into consideration:

- the differentiation between the development of exogenous and endogenous institutions;
- existence of different levels of institutions with different time horizons of change; and
- importance of the local setting.

The government has taken various measures over the last few years to set up new institutions and to reform the existing ones. The PRSP reiterates the resolve of the government for further reform of the institutions. Whereas devolution is the most significant policy change in the institutional development in Pakistan, it must be ensured that the experiment succeeds. Similarly, the effort for better access of the poor to justice should continue. Police force needs to be so reformed that instead of being an instrument of government coercion, it emerges as an institution which is trusted to be a protector of the poor. The civil service reforms as enumerated in the PRSP would help in improving the governance structure. Similarly, financial governance needs to be strengthened and the freedom of information may play an important role in this direction.

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