

Impact of Informal Institutions on Development: Analyzing the Socio-Legal Equilibrium of Relational Contracts in India

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Abstract : Relational Contracts (informal understandings not enforceable by law) are a common feature of most economies. However, their dominance is higher in developing countries. Such informality of economic sectors is often co-related to lower economic growth. The aim of this paper is to investigate whether informal arrangements i.e. relational contracts are a cause or symptom of lower levels of economic and/or institutional development. The methodology followed involves an initial survey of 150 test subjects in Northern India. The subjects are all members of occupations where they frequently transact ensuring uniformity in transaction volume. However, the subjects are from varied socio-economic backgrounds to ensure sufficient variance in transaction values allowing us to understand the relationship between the amount of money involved to the method of transaction used, if any. Questions asked are quantitative and qualitative with an aim to observe both the behavior and motivation behind such behavior. An overarching similarity observed during the survey across all subjects' responses is that in an economy like India with pervasive corruption and delayed litigation, economy participants have created alternative social sanctions to deal with non-performers. In a society that functions predominantly on caste, class and gender classifications, these sanctions could, in fact, be more cumbersome for a potential rule-breaker than the legal ramifications. It, therefore, is a symptom of weak formal regulatory enforcement and dispute settlement mechanism. Additionally, the study bifurcates such informal arrangements into two separate systems - a) when it exists in addition to and augments a legal framework creating an efficient socio-legal equilibrium or; b) in conflict with the legal system in place. This categorization is an important step in regulating informal arrangements. Instead of considering the entire gamut of such arrangements as counter-development, it helps decision-makers understand when to dismantle (latter) and when to pivot around existing informal systems (former). The paper hypothesizes that those social arrangements that support the formal legal frameworks allow for cheaper enforcement of regulations with lower enforcement costs burden on the state mechanism. On the other hand, norms which contradict legal rules will undermine the formal framework. Law infringement, in presence of these norms, will have no impact on the reputation of the business or individual outside of the punishment imposed under the law. It is especially exacerbated in the Indian legal system where enforcement of penalties for non-performance of contracts is low. In such a situation, the social norm will be adhered to more strictly by the individuals rather than the legal norms. This greatly undermines the role of regulations. The paper concludes with recommendations that allow policy-makers and legal systems to encourage the former category of informal arrangements while discouraging norms that undermine legitimate policy objectives. Through this investigation, we will be able to expand our understanding of tools of market development beyond regulations. This will allow academics and policymakers to harness social norms for less disruptive and more lasting growth.

Keywords : distribution of income, emerging economies, relational contracts, sample survey, social norms

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