Institutional Bypass: An Alternative for Development Reform

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Abstract

Beginning in the 1990s, an institutional perspective on development has become increasingly prominent in development thinking, captured in the mantra, “Institutions Matter,” or “Governance Matters.” Based on the assumption that “institutions matter”, there has been a massive surge in development assistance for institutional reform projects in developing and transition economies involving investments of many billions of dollars. However, these reforms have had mixed to disappointing results thus far. Against this backdrop, this paper identifies successful institutional reforms, and claims that they have one common feature: instead of trying to fix dysfunctional institutions, as most failed reforms do, they simply bypass them. For this reason, they will be called “institutional bypasses”. Like a “coronary bypass” surgery, an institutional bypass creates new pathways around clogged or blocked institutions. Institutional bypass uses the same strategy: it does not try to modify, change or reform existing institutions. Instead, it tries to create a new pathway in which efficiency and functionality will be the norm. Understanding what is a bypass and how it works can provide answers to an important question in the law and development literature: how to reform dysfunctional institutions. This paper argues that under certain circumstances an “institutional bypass” presents a promising alternative for institutional reforms in developing countries, but at the same time it should not be regarded as a panacea for development problems.

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Introduction

Beginning in the 1990s, an institutional perspective on development has become increasingly prominent in development thinking which is captured in the slogans, “Institutions Matter” or “Governance Matters”.¹ This was followed by a massive surge in development assistance for institutional reform projects in developing and transitional economies. However, these reforms have had mixed to disappointing results thus far.² In an attempt to move away from the pessimism that can easily impinge on law and development scholars as a consequence of this dismal track record, this paper will take a look at successful institutional reforms and ask if we could learn anything useful with them. My claim is that these reforms have one common feature that could be potentially replicated in future reforms: instead of trying to fix dysfunctional institutions, they simply bypass them. For this reason, they will be called “institutional bypasses”.³

What is an institutional bypass? Like coronary bypass surgery, in which transplanted blood vessels are used to create a new circulatory pathway around clogged or blocked vessels, an institutional bypass creates new pathways around clogged or blocked institutions. Unlike other procedures that try to unblock clogged arteries, or expand narrow ones, the coronary bypass simply ignores the existence of the unhealthy artery and creates a new pathway for blood flow. An institutional bypass uses the same strategy: it does not try to modify, change or reform existing institutions. Instead, it tries to create a new pathway in which efficiency and functionality will be the norm.

One example of an institutional bypass is a bureaucratic reform in Brazil called Poupatempo (Saving Time). In 1997, the government of the state of São Paulo created a one-stop shop for bureaucratic services. In contrast to the pre-existing system, in which government services were accessed by the public at multiple service points, offices of the federal, state and, in some cases, local administration were placed in one location in order to provide easy access to a variety of services. Services were provided more quickly than within the pre-existing bureaucracy, and largely because of that Poupatempo became the

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¹ This is largely based on the work of Douglass North, a founder of the school of thought that became known as the New Institutional Economics. Some of North’s most relevant pieces are Douglass C. North, Institutions, Institutional Change and Economic Performance (Cambridge: Cambridge University Press, 1990) and “The New Institutional Economics” (1986) Journal of Institutional and Theoretical Economics 142.


³ Shoshana Zuboff, “Our Health-Care System Needs a Bypass”, Bloomberg Businessweek, January 16, 2009 (using the same analogy, but using a much broader concept of institutional bypass than the one proposed in this paper).
main provider of governmental services within the state shortly after its creation. In 2007, it provided services to an average of 50,000 people a day in the state of São Paulo. In that year, 18 units together serviced 23 million people. *Poupatempo* is an example of an institutional bypass because it created a new pathway for the provision of the same services that were being provided by the existing bureaucracy; also services were provided in a more efficient fashion.\(^4\)

Why is this relevant? It is now widely acknowledged that institutions matter for development, but less is known about how to change them. My main argument in this paper is that institutional bypass presents a promising alternative to efforts directed at reforming existing dysfunctional institutions in developing countries because it can help reformers overcome a number of obstacles to reforms. Thus, this paper aims at understanding how institutional bypasses work, to assess their potential and their limits.

More specifically, I argue here that institutional bypasses can overcome, or avoid, three common obstacles to institutional reforms: social-cultural-historical factors, lack of resources, and political economy problems. An institutional bypass avoids social-cultural-historical factors by creating a new pathway with fewer (or no) strings attached to the old one. By not changing the existing institution, the bypass helps to avoid resistance to reforms that are associated with institutional culture and stable equilibriums where certain social values and historical practices prevail and govern people’s behaviour. The bypass also mitigates constraints imposed by limited resources because the smaller ones, like *Poupatempo*, can start with pilot projects, in a highly experimental mode, without disrupting the functioning of the entire system. This is possible because the traditional institutions are kept in place, and disruptions to society are kept to a minimum. Finally, the bypass reduces political economy problems because it does change the pre-existing institution. An institutional bypass avoids this obstacle by not disturbing the groups resisting reforms (at least not initially or explicitly), while at the same time offering an alternative to those who want some change.

In overcoming obstacles to reforms, an institutional bypass is like a road bypass: it pleases drivers and city residents. The fact that the bypass is a mere option offers the possibility of promoting change (which pleases drivers) while simultaneously maintaining the status quo (which pleases residents). However, there are circumstances in which a bypass may become dysfunctional over time, or it may generate negative consequences for the pre-existing institutions, ultimately changing the status quo. In this regard, an institutional bypass is also quite analogous to a road bypass. The road bypass may fail if city zoning allows for buildings along a bypass, in which case it might become just as busy and slow as a town street. Similarly, a road bypass can reduce the number of customers of the businesses in the town, such as filling stations and restaurants, forcing many of them to close. This may negatively affect some city residents. Thus, understanding under which circumstances a bypass is likely to generate negative consequences, and when it may fail is of utmost importance for reformers.

\(^4\) Mariana Mota Prado & Ana Carolina Chasin, “Bureaucratic Reforms and Development: How Innovative was the *Poupatempo* Experience in Brazil?”, paper presented at the Canadian Law and Economics Association Conference, Toronto, Canada, October 2009 (on file with the author).
I do not seem to be alone in suggesting that bypassing dysfunctional institutions could be a good strategy to promote development. For instance, Paul Romer has formulated a controversial proposal to create new cities from scratch, with new rules and governance structures, called "charter cities". According to Romer, “all it takes to grow a charter city is an unoccupied piece of land and a charter”.\(^5\) Such cities should provide leaders with “more options for improving governance and investors more opportunities to finance socially beneficial infrastructure projects” without the need to struggle with existing and dysfunctional institutions. Similarly to the case of Poupatempo, existing dysfunctional institutions are kept in place and are not touched directly by reformers. People can then choose to either move to the new charter city or not. A charter city will become an attractive option if it is a "place with rules that provide security, economic opportunity, and improved quality of life".\(^6\) In other words, its success depends on being better than the existing option, like Poupatempo. However, there is a difference between this example and Poupatempo: there is a multitude of institutions being simultaneously bypassed in charter cities – courts, bureaucracy, political institutions, etc. This adds more complexity and requires a reform effort that is much larger than the one required by Poupatempo. This not only requires substantive resources, but it also adds a lot of uncertainty to the enterprise. On the other hand, simple bypasses, like Poupatempo, seem to be a more promising option as they seem to be better able to overcome well-known obstacles to reform, such as lack of resources and political economy problems. For this reason, the type of bypass analyzed in this paper (a stand-alone institutional bypass, which involves one single institution) seems to be more advantageous than multiple bypasses – such as the one proposed by Romer.

The paper will be structured as follows. In the first section, I will show that development scholarship has identified a major problem stifling development, but has thus far struggled to identify an effective remedy: we came to the conclusion that institutions matter for development, but we do not know how to reform them. In section 2, I will argue that an institutional bypass may offer a promising alternative to institutional reforms. In this section, I will further define the idea of an institutional bypass and identify its constitutive elements. I will also discuss in more depth the obstacles to development reforms and show how an institutional bypass can help developing countries overcome these obstacles. In section 3, I provide a taxonomy of the different kinds of institutional bypasses that exist and the main differences between them. I also analyze how the benefits of the bypass can go beyond provision of good services to citizens. An “institutional bypass” can generate a feedback effect in the pre-existing institutions (the bypassed institution), provoking broader changes in the institutional framework of a developing country. I will also discuss some risks and potential pitfalls of institutional bypasses. I conclude by exploring the implications of institutional bypasses for a long-term development agenda. While institutional bypasses are a reason for hope in the law and development field, they are not a panacea for development problems.

\(^5\) Paul Romer, online: <http://www.chartercities.org/concept>.

\(^6\) Ibid.
1. The Problem: Persistent Failure of Institutional Reforms for Development

1.1 Institutions matter for development: from a theoretical assumption to concrete reform proposals

Beginning in the 1990s, an institutional perspective on development has become increasingly prominent in development thinking. Largely based on the work of new institutional economists, this perspective assumes that people respond to incentives and argue that many of these incentives are created by institutions. New institution economists often adopt Douglass North’s definition of institutions:

Institutions are the rules of the game of a society, or, more formally, are the humanly devised constraints that structure human interactions. They are composed of formal rules (statute law, common law, regulation), informal constraints (conventions, norms of behaviour and self-imposed codes of conduct), and the enforcement characteristics of both. Organisations are the players: groups of individuals bound by a common purpose to achieve objectives. They include political bodies (political parties, the senate, a city council, a regulatory agency); economic bodies (firms, trade unions, family farms, cooperatives); social bodies (churches, clubs, athletic associations); and educational bodies (schools, colleges, vocational training centres).

An institutional perspective on development argues that developing and transitional economies struggle because institutions create incentives that are ill-suited for economic growth: “Third World countries are poor because the institutional constraints define a set of payoffs to political/economic activity that do not encourage productive activity.”

These assumptions were tested and a number of authors have now concluded that there is empirical basis to support the idea that institutions do matter for development.

The idea that “institutions matter” has prompted a massive surge in development assistance for institutional reform projects in developing and transitional economies involving investments of many billions of dollars. Since 1990, the World Bank has spent

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8 Douglass North, Institutions, Institutional Change and Economic Performance (1990) at 110.

$2.9 billion supporting 330 rule of law projects. However, these efforts have so far yielded mixed to disappointing results. In their most recent book, Rule of Law Reform and Development: Charting the Fragile Path of Progress, Michael Trebilcock and Ron Daniels discuss numerous cases of failed reforms in Africa, Asia, Latin America and Eastern Europe. And they are not alone: others have called attention to the fact that significant resources have been employed to promote good governance in developing countries, but there are no significant signs of improvement.

In sum, academics have proved that institutions do in fact matter, but efforts to reform them are plagued with difficulties. The inability to promote successful institutional reforms is therefore the main problem now confronting the development agenda.

1.2 Obstacles to reform and the problem of uncertainty

Michael Trebilcock and Ron Daniels offer some insight on possible reasons for these disappointing results thus far. According to them, there are three main obstacles to the reforms. First, despite the political will to promote reforms, countries may lack the necessary financial, technological or human resources to implement changes. Second, a series of social values, norms, attitudes and practices, which Trebilcock and Daniels loosely classify as social-cultural-historical factors, may form a hostile environment for implementing reforms. Third, there are political economy-based impediments. Groups of interests will resist reforms that eliminate their privileges, do not foster their interests, or do not offer any gains (material or otherwise).

Trebilcock and Daniels offer solutions to these obstacles. A lack of resources can be addressed by contributions from developed countries which can provide money, technology and expertise. However, very rarely is the problem only a lack of resources. In most cases, a lack of resources is entangled with the other two obstacles: political economy problems and social-cultural-historical factors. Political economy impediments involve the resistance of interest groups that benefit from the status quo. For instance, people who receive bribes may actively resist anti-corruption reforms that may deprive them of these rents. One possible strategy to overcome this resistance is to strengthen interest groups that will benefit from the reforms, making them able to press for change.

11 Trebilcock & Daniels, supra note 2.
13 Trebilcock & Daniels, supra note 2.
14 Ibid at 39 (there may be “social-cultural-historical factors that have yielded a set of social values, norms, attitudes, or practices that are inhospitable to even a limited conception of the rule of law.”)
15 Ibid at 39-40.
16 Ibid.
Once the resources-related impediments are overcome, and political resistance is reduced or eliminated, reformers are left with what Trebilcock and Daniels loosely call social-cultural-historical factors. These factors present a unique set of challenges to reformers as they are often perceived to be the black box of institutional change. Douglass North acknowledges that informal institutions, such as culture, play a role in influencing human behaviour. However, until recently, North’s observations have not prompted a detailed and comprehensive discussion of informal institutions in the field of new institutional economics.

The economics literature has hesitated to address the internal structure of informal institutions. Values and norms are ‘taken as given by most institutional economists’; culture is often treated as a black box. Lack of sufficient theory as well as the methodological challenges of operationalizing informal institutions and discerning causality have contributed to the paucity of research on this issue until recently.

Indeed, much of the academic discourse and reform efforts have been focused on formal institutions. If one analyzes the “governance matters” project at the World Bank, one will see that all elements that define good governance pertain to the realm of formal institutions. The same trend is observable in law and development discourse in general. As Rosa Ehrenreich Brooks explains, “rule-of-law promotion efforts continue to focus on establishing the formal dimensions of the rule of law, assuming with little evidence that this will lead reliably and predictably to the emergence of robust societal commitment to the more substantive aspects of the rule of law”.

The economics literature has already produced strong evidence that culture matters for a large variety of economic outcomes, even when different cultures are placed in the same economic and institutional environment. This evidence provides support to the idea that “culture matters” for development. There is, however, some controversy as to how culture changes and evolve. Most importantly, there is some controversy as to how it interacts with formal institutions.

At least two empirical studies have provided support to the idea that culture precedes institutions, and therefore that institutions are unlikely to be changed by formal institutional reforms. Amir Licht, Chana Goldschmidt and Shalom Schwartz argue that there is empirical evidence to support the idea that the existence of formal institutions, such as rule of law and democratic accountability depends on certain underlying cultural

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19 See note 8, supra.
values, such as individualism and lack of hierarchical structures.\textsuperscript{22} Along the same lines, Katharina Pistor, Antara Haldar and Amrit Amirapu in a recent paper show that the status of women in society is relatively weakly associated with various Rule of Law indices and that in poor countries this association disappears altogether. They suggest that this occurs because the status of women in society is determined primarily by social norms about gender equality and that these norms are only weakly affected by formal legal institutions.\textsuperscript{23} This study suggests that we probably need to change culture before reforming formal institutions.

In contrast, other studies analyzing the cultural attitudes and practices of immigrants suggest that

there is some convergence over time both in economic outcomes and in attitudes. This indicates, not surprisingly, that culture changes in response to a new environment. (…) Culture, however, also influences the economic and institutional environment. (…) Thus culture and the economic and institutional environment interact and influence one another. Studies of this interaction would be an important addition to the literature.\textsuperscript{24}

To be sure, the pace of change will vary from case to case. In some cases, it will be quicker than in others. But this does not invalidate the overall proposition that culture does change in response to a new institutional environment, as argued by many scholars.\textsuperscript{25}

The end result is that there is currently a heated controversy in the law and development literature. While the “institutions matter” discourse assumes that people respond to incentives, the “culture matters” discourse emphasizes the powerful way in which cultural factors shape behaviour. The consequence is that the “institutions matter” discourse assumes that changes in incentives that accompany formal institutional reforms will produce changes in individual behaviour. These changes may even be sufficient to change culture. The “culture matters” proponents, on the other hand, reject that view. They argue that changing institutions without changing the underlying culture will lead to failure.\textsuperscript{26} Thus, what could be a productive conversation looks more like a battlefield.

\textsuperscript{22} For an analysis suggesting that there is empirical evidence to support the idea that there is a significant influence of culture on governance, see Amir Licht, Chana Goldschmidt & Shalom Schwartz, “Culture Rules: the Foundations of the rule of law and other norms of governance,” (2007) 35 Journal of Comparative Economics 659-688.


\textsuperscript{24} Fernandez, supra note 20 at 33-34.


\textsuperscript{26} For a summary and critique of this literature, see Amy J. Cohen, “Thinking with Culture in Law and Development” (2010) 57 Buffalo Law Review 511-586, at 512.
This controversy suggests that the nature of institutions has not been adequately analyzed, and academic studies need to acknowledge that there is a complex interaction between formal and informal norms and rules of behaviour, and to understand when and how informal institutions and norms can reinforce formal institutions and vice versa.27

Partially in line with this, the “institutions matter” discourse has largely tried to move away from “one size fits all” and “best practices” in recent decades, favouring local solutions and decentralization.28 The rejection of the idea that there are foolproof blueprints for institutional reform, and the ever-growing literature on the failure of legal transplants, has lent support to the idea that formal institutions need to be adapted to informal institutions in order to be functional. This concern with adaptation of institutional reforms to the conditions on the ground illustrates an attempt to account for the role that culture plays in development reforms.

Similarly, some “culture matters” scholars have also tried to move away from proposals that promote radical changes in an entire cultural system of informal norms and values. These scholars, who are known as neocultural interventionists, advocate a cultural turn in institutional reforms for development, as follows:

development programs should inculcate a ‘rule of law culture’ not only among legal elites but in the everyday users of the legal system: ‘culture’ must change so that it perpetuates a readiness to turn to law and legal institutions for solutions to conflict, and expectation that law will be decisive, consistent, and fair, and a willingness to abide by legal outcomes even when they fall short of what might be imagined possible through violence. Development professionals should … instill these ideas in ordinary individuals by directly teaching and promoting them.29

There are, however, problems with both proposals. On the institutional side, the discourse has moved away from the hard-core formalism that characterized institutional prescriptions in the neoliberal period, but the concern with formal institutions is still predominant.30 On the neocultural side, as Amy Cohen suggests, scholars present a conceptualization of culture that is very similar to the conceptualization of law that they are trying to supplement and correct:

[For neocultural interventionists,] law’s failure to produce its intended effects in weak states … becomes a problem of competing normative orders: one order being law’s rules, which are formal, acultural and indeterminate (or incapable of producing their intended effects), and the

30 Ibid.
other being culture’s rules, which are relevant, powerful, and determinate.\textsuperscript{31}

Cohen’s criticism of this conception is that it will lead to the problems faced by formalist accounts of institutional reforms. She provides a series of concrete examples of failed attempts to promote the “rule of law culture”. These examples illustrate her main point:

Deploying lawlike conceptions of culture as a means of addressing the indeterminacies and ineffectiveness of rule-of-law projects immediately generates a new set of problems – partly by reviving the old ones in a new form. The neocultural interventionist project has yet to grapple directly with the indeterminacies, conflicts, and social struggles embedded in culture, configured, paradoxically, as a corrective for “formal” understandings of law.\textsuperscript{32}

This brings us back to square one: institutions matter for development, but we do not know how to reform them. Our lack of a proper and full understanding on how institutions work, and how they change, seems to be largely contributing to our inability to promote successful reforms. In this regard, culture in general, and the interaction between formal institutions and informal ones more specifically, seem to be the point about which we know the least.\textsuperscript{33}

In sum, there is a significant level of uncertainty regarding the outcome of institutional reforms. This means that reformers do not know what will be the outcome of their reforms, what is different from facing the risk of having an unsuccessful reform. The difference between risk and uncertainty, as defined by Frank Knight, is the following: if there is risk, “the distribution of the outcome in a group of instances is known, whereas in the case of uncertainty the outcome is not known as it is impossible to form a group of instances because the situation dealt with is in a high degree unique”.\textsuperscript{34} The lack of knowledge about the interaction between formal and informal institutions generates uncertainty about possible outcomes. By reforming formal institutions, reformers may or may not be modifying informal rules and norms of behaviour. And if they are, it is hard to say which ones, and it is even harder to predict how these modifications will unfold. This is the reason why social-cultural-historical factors have haunted reformers in a more significant way than political economy problems.

1.3 Path dependence: can reformers ever write on a blank slate?

Michael Trebilcock and I, in a recent paper, suggested that the concept of path dependence may help us to better understand why it is so hard to eliminate the three

\begin{footnotesize}
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\item \textsuperscript{31} Ibid at 542-43.
\item \textsuperscript{32} Ibid at 546.
\item \textsuperscript{33} Fernandez, supra note 20.
\item \textsuperscript{34} www.econlib.org/library/Knight/knRUP.html.
\end{itemize}
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obstacles mentioned earlier and successfully promote institutional reforms.\textsuperscript{35} Path dependence theory offers three useful concepts: switching costs, network effects that create self-reinforcing mechanisms and institutional interconnections. Switching costs are present both in political economy problems and social-cultural-historical factors, as both can be seen as forms of behaviour caused by or influenced by incumbent institutional arrangements. When actors within a system are consciously aware that present institutional arrangements are to their advantage, they will consciously resist reform to maintain these rents, generating political economy problems. Alternatively, they may simply resist change if modifications in the existing institutions will impose a cost on them such as changed existing practices or attitudes, as it is the case of social-cultural-historical factors. In both cases, the decision to resist is determined or influenced by past arrangements. Accordingly, path dependence theory provides explanatory power for both phenomena and may offer insight into how to overcome both political economy and social-cultural-historical obstacles (such as identifying and reducing some of these switching costs).

It may be tempting to distinguish social-cultural-historical factors from political economy obstacles on the basis that the influence that these factors have on human behaviour appear to occur on a less self-conscious level. If, for example, an informal institutional culture does not praise punctuality, it seems difficult to attribute persistent tardiness in the face of new rules to voluntary decision-making or rent-seeking. Instead, the persistence of this informal institutional culture seems to be connected with a self-reinforcing social dynamic. Self-reinforcing mechanisms may be one of the possible reasons why informal norms change much more slowly than formal institutions.\textsuperscript{36}

In addition, there is another factor that complicates matters even more: institutional interconnections.\textsuperscript{37} Although institutional interconnections do not need to operate as obstacles to reforms, they do operate as constraints by adding complexity to the task. Reformers need to be mindful that the reformed institution will be operating in a certain institutional environment. Thus, one certain institutional feature that may be the subject of reform can operate perfectly in a certain institutional environment but not in another.\textsuperscript{38}

The regulatory agencies in Brazil provide a good example of how institutional interconnections can constrain institutional reforms. Between 1996 and 2002, the Brazilian government established independent regulatory agencies to regulate important sectors such as telecommunications and energy. These agencies were largely patterned on similar agencies operating in the developed world and were founded on the principle that they should be insulated from political influence. I argued elsewhere that these agencies failed to achieve the hoped for level of independence and that the President was able to influence regulatory outcomes in some cases. One of the reasons for this failure was that guarantees of institutional independence failed to function in a predictable way.

\textsuperscript{35} For an analysis on how path dependence may negatively impact on reforms, see Mariana Mota Prado & Michael Trebilcock, “Path Dependence, Development and the Dynamics of Institutional Reforms” (2009) 59:3 University of Toronto Law Journal 341-379.

\textsuperscript{36} Ibid.

\textsuperscript{37} Prado & Trebilcock, supra note 33.

\textsuperscript{38} Ibid.
when transplanted into the Brazilian context. Such guarantees proved not to be effective when put into operation within the machinery of a system of government very different from that of the United States.\textsuperscript{39}

Given the difficulties of overcoming path dependence and dealing with the complexities of institutional interconnections, one might be tempted to assume that reforms would be much easier to implement if reformers could write on a blank slate. It is unlikely, however, that reformers will ever operate in an environment in which they are not building on pre-existing social, cultural or institutional structures. It is also improbable that they will encounter no organized interest groups and individuals motivated to maintain an existing allocation of benefits. Therefore, due to path dependence, the three obstacles to reforms described in this section are likely to subsist as impediments to institutional reforms for development.

While reformers are unlikely to find pure opportunities to construct institutions from the ground up, there are situations that offer a better prospect of comprehensive institutional reform. One example is what may be called “abnormal times”, which include times of economic collapse, major political crises, civil wars and military invasions. Ambitious reforms are unlikely to be feasible and to succeed during normal times because they will engender greater disruption and therefore more (voluntary or involuntary) resistance.\textsuperscript{40}

The scenario is different during abnormal times because the credibility and legitimacy of the incumbent elites may be weakened, and established patterns of social behaviour may be more easily disrupted. In such cases, more ambitious and comprehensive reforms may become possible.\textsuperscript{41}

During “abnormal times” there is the possibility of changing numerous institutions at once, reducing the complexities related to institutional interconnections. The primary example is institution building in failed states. Countries that have recently emerged from civil war or are currently undergoing major democratic transitions allow for numerous and simultaneous reforms in different institutions. This reduces constraints that are related to institutional interconnections, such as the ones related to regulatory agencies that I described earlier.

One interesting example is a successful reform to fight police corruption in Georgia.\textsuperscript{42}

Georgia is a former Soviet republic that became independent shortly after the collapse of


\textsuperscript{40} Prado and Trebilcock, supra note 33.


the USSR in 1991. However, throughout the 1990s, the international community considered Georgia a failed state. The state was largely incapable of providing basic services, such as education and health, due to corruption problems. While Georgia is known for a culture of corruption that precedes its annexation to the USSR, in the post-Soviet period, these problems took a turn for the worse as the country plunged into a deep economic crisis and started facing major problems of institutional failure. In this context, problems that plagued the Georgian police force became rampant. Police officers were not only openly corrupt, but were also engaged in organized crime and other criminal activities.

The window of opportunity for reform came in 2004, when the Rose Revolution deposed an autocratic government and brought to power a democratically elected leader, Mijëil Saakashvili. Saakashvili started a strong campaign against corruption and implemented radical reforms in the police force. One of the most important characteristics of these reforms was mass dismissals: over an initial period of two years, close to 60% of police officers were fired. The reforms also entailed a restructuring of the police force, in which some of the functions allocated to the police were transferred to other governmental departments. For instance, border and immigration control was first transferred to another ministerial department; currently a new police force (Patrol Police), created during the reforms, performs the border patrol functions. Certain positions that were particularly prone to abuse of power and discretion, such as the people known as “investigators”, were eliminated.

One of the key aspects of the reform was the creation of a new police force previously mentioned, the Patrol Police, which changed the standards of the pre-existing force and effectively moved away from its internal culture of corruption, ineffectiveness and lack of professionalism. Patrol Police officers had a series of significant salary increases (from US$25 a month to US$600), which turned the position into a good job. The selection criteria also became more rigorous and largely based on merit, instead of personal connections. Once officers were accepted into the force, they went through training in a new police academy, which had a philosophy largely modeled on urban police forces in Europe and North America, based on concerns such as serving and protecting the community in a courteous and effective way.

The reform is considered a success according to a number of different criteria. Petty corruption such as bribes and extortion disappeared. Public perception and levels of trust of the police changed drastically from negative to positive. Also, a “911” type of call service was created and the speed and rate of response improved. Moreover, rates of service provision have significantly improved for matters that were not properly addressed by the police before, such as neighborhood disputes and domestic violence. As a result, the reform has gained a great deal of international recognition.

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43 Ibid at 6-8.
44 Ibid at 11-12.
46 Ibid at 13-16.
The reasons for the success of the police reform in Georgia can easily be mapped against the obstacles to reform described in the previous section. First, regarding resources, there were significant Western investments in the reform, especially through foreign aid. This helped to provide the government with the financial resources needed to offer salary increases to new officers, for instance. It also helped with technological innovations, such as cameras to monitor the activity of border patrol officers so as to inhibit the request for or acceptance of bribes. Second, regarding political economy problems, there was a window of opportunity provided by internal and external threats that have both affected the supply and the demand side of reforms. On the supply side, the government was concerned with eliminating security threats from Russia. On the demand side, the population brought to power a new President primarily with a platform to rebuild the state. As Light emphasizes, the Rose Revolution was presented to the West as a bid for democratization, but many supporters saw it “mainly as a necessary means towards the end of restoring the efficacy of the Georgian state and reestablishing control over its separatist-dominated regions”. Thus, reforming the police force was part of a broader strategy to recreate and revamp the state in Georgia, which was strongly backed by the popular support that drove the Rose Revolution. As Light argues, “Georgia represents a case where a confluence of circumstances has largely (although not completely) brought these two demands into alignment, with mainly beneficial results for both the state and society”.

This confluence of circumstances certainly facilitated the most radical feature of the reform, which were the mass dismissals. The mass dismissals also allowed for radical changes in institutional culture, given that it would be hard to modify embedded behaviours in officers who have operated according to pre-established rules for many years. The opportunity to hire new personnel and offer training (that was molded to eliminate old traits in the organization) was an effective way to eliminate self-reinforcing mechanisms that tended to maintain an institutional culture of corruption. Finally, the opportunity to reform other institutions mitigated the obstacles and constraints imposed by institutional interconnections, given that new institutions could be easily created and old institutions could be reorganized if necessary to make the police reforms effective. Indeed, the reform of the police force was coupled with a massive effort to fight corruption in other areas, such as institutions of higher education, where Georgians were able to pay for university degrees and grades. There were also attempts, which were far less successful, to reform the court system. This is not the kind of opportunity that reformers can expect on a daily basis in Georgia or anywhere else. Instead, in this case, the opportunity for such an ambitious and radical reform was created by a massive state building effort, led by a President who was motivated to promote these changes due to external threats, while being supported by the population and the international community. This was a very peculiar set of circumstances that can be hardly replicated in other contexts. The circumstances which fostered successful police reform in Georgia can be likened to a “perfect storm”.

47 Ibid at 10-11.
48 Ibid at 24.
49 Ibid at 15.
It would be an exaggeration to say, however, that reformers in Georgia were writing on a blank slate. The political, economic and social context in Georgia in the early 1990s provided reformers with more leeway than most reformers generally have. Nevertheless, they also faced constraints and obstacles. For instance, reformers were not able to implement radical changes in the top echelons of the institution, and there is currently a great deal of concern with nepotism and lack of transparency in political appointments.\(^{50}\) There has also been concern with a lack of police restraint and police neutrality, as illustrated by a violent repression of demonstrations in 2007. Despite the success in eliminating corruption, the Georgian police have been increasingly operating as an instrument for political repression. Thus, it is questionable whether the reform process can be considered an overall success. There has also been very little decentralization of decision-making power, and no civilian control over the police force. Therefore there is currently very little democratic accountability of the police. What this case illustrates is that even under very unique circumstances that allowed for one of the most radical institutional reforms in recent history, reformers faced significant constraints. Despite having a window of opportunity, they were not able to proceed in an unconstrained manner.

The circumstances that prevailed in Georgia following the Rose Revolution provide a good illustration of a “window of opportunity” for significant reforms. The expression “window of opportunity” can also be applied to refer to different circumstances that afford opportunities to implement even more significant reforms. Often the most extreme cases are post-conflict societies, in which there are massive disruptions of structures within a society that may allow for even more radical reforms than the one implemented in Georgia.\(^{51}\) While the newly-elected leader in Georgia was able to dismiss 60% of the police force, in many post-conflict societies there is no longer a police force. In such cases, the exercise is not as much one of institutional reform as it is one of institution building, and reformers may have an even higher degree of freedom than that experienced by the Georgian reformers. But even in these extreme cases, reformers are not writing on a completely blank slate.\(^{52}\)

In sum, although abnormal times may attenuate or reduce some of the existing obstacles to institutional reforms, these circumstances will not completely eliminate these obstacles and constraints. In this sense, they can be considered “windows of opportunity” for reform because obstacles may be fewer or easier to overcome. However, reformers will still not be writing on a blank slate. Thus, some of the obstacles discussed earlier are likely to remain in place. The only difference is that in some cases these obstacles will be more formidable than in others.

\(^{50}\) Ibid at 26.

\(^{51}\) Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven, CT: Yale University Press, 1982) (citing examples in which the conflict has destroyed existing patterns of influence by certain interest groups, opening room for reforms).

\(^{52}\) Susan Rose-Ackerman, “Was Mancur a Maoist? An Essay on Kleptocracy and Political Stability” (2003) *15 Econ. & Pol.* 163 (indicating that Olson’s post-war examples, supra note 50, are not analogous to the situation of post-conflict societies in Africa).
1.4 Dilemmas of institutional reforms for development

As suggested in the previous section, there may be significant obstacles and constraints to reformers even in abnormal times, but these are likely to be lighter or attenuated if compared to the obstacles that reformers are likely to face during periods of stability. Should this translate into a recommendation for reformers to wait for windows of opportunity in order to promote institutional reforms? The answer is no, for at least three reasons: (1) windows of opportunity are unpredictable and may never come or they might not be noticed when they come;53 (2) even when reformers use windows of opportunity to promote ambitious reforms, they will still face constraints that may require further reforms down the road. This happens because even in abnormal times, there might be path dependency problems. It is unlikely that absolutely all social-cultural-historical factors will be changed by major crises. Although in a weaker form, these pre-existing economic, social and cultural factors may still create obstacles for reforms;54 and (3) even if the “window of opportunity” creates circumstances that are as close as they can be to providing an opportunity to write on a blank slate, there is no guarantee that the best ideas or the most promising reforms will prevail.55 More specifically, it is likely that pre-existing political, social and historical structures among the societies and communities will influence the decision-making process and may impair reforms.

These would all be reasons to caution against a recommendation for reformers to wait for “abnormal times” in order to have a window of opportunity for reforms. But what is the alternative? One alternative would be to create a window of opportunity, as Paul Romer does with the charter cities. These cities try to create a blank slate for reformers during normal times. However, creating a charter city is likely to require significant resources and a robust amount of political support, and these two requirements can become obstacles for the implementation of these reforms.

The other alternative is for reformers to try to promote institutional change during “normal times”. This strategy also raises its own set of complexities, among which uncertain outcomes seems to be the main one, as discussed in section 1.2 above. As a result, a dilemma emerges from the new institutional economics literature: absent windows of opportunity, there appear to be considerable obstacles to promote reforms of dysfunctional institutions, and even if we overcome these obstacles, we still need to deal with a significant level of uncertainty in the outcomes. This degree of uncertainty affects strategies to promote reforms both during normal and abnormal times, which supports the conclusion that even though we can safely say that institutions indeed matter for development, we still do not have a firm understanding of how to transform dysfunctional ones.56

53 Prado & Trebilcock, supra note 33.
54 Prado, supra note 40.
56 North, supra note 15 at 67. (“To put it bluntly, we may know a lot about polities, but not how to fix them.”)
The remainder of this paper proposes a shift of perspective. There is a large literature looking at poor institutional performance and failure in institutional reforms in developing countries. While this literature has advanced our understanding on these dysfunctionalities and failures, it has not provided many insights on how to succeed. The shift proposed here is that we look at successful cases, and try to learn some lessons from them.\textsuperscript{57}

2. A Possible Alternative: Institutional Bypass

One possible alternative for overcoming the difficulties that plague institutional reform efforts is an approach that I call an “institutional bypass”. An institutional bypass is analogous to a road bypass. A road bypass goes around a town or village, allowing drivers to deviate from the town centre, avoiding the slower speed limits and possibly traffic jams. Similarly, an institutional bypass creates a new pathway around clogged or blocked institutions.\(^{58}\)

In the case of a road bypass, the needs of drivers travelling on the road and the needs of people living in a town are in tension. Drivers want to complete their trips quickly, while inhabitants of the city centre want safety in crossing roads and reduced levels of noise and pollution. In this context, the road bypass offers a compromise: it reduces traffic in the city centre (reducing noise, pollution and increasing safety), while at the same time allowing drivers to travel at a faster pace. Institutional bypasses use the same strategy: they do not try to modify, change or reform existing institutions. Thus, they do not affect the interests of those who want to maintain existing institutions. At the same time, bypasses create a new pathway in which efficiency and functionality will be the norm, attending to the interests of those who are unhappy with the existing institutions and want change. The advantage an institutional bypass is that, instead of reforming or changing existing dysfunctional institutions, reformers can just go around them.

An institutional bypass has four main characteristics:

1. It keeps the traditional institution in place;
2. It creates an alternative pathway through which to deliver government services or discharge governmental functions (which becomes an option to those using the services);
3. It aspires to be more efficient or functional than the traditional institution; and
4. It changes a specific point in the system (instead of modifying the entire system).

To better understand what an institutional bypass is, I would like to clarify what I mean by “institution”. As I indicated earlier, the new institutional economists define institutions as “the rules of the game”, distinguishing them from organizations, which create, apply and enforce these “rules of the game”.\(^{59}\) Thus, according to this definition, property rights would be institutions, while the land registry and the police would be organizations.

Despite being widely used in the literature, this is an odd definition of institutions from a lawyer’s point of view. As Michael Trebilcock and I have argued in a previous paper, \(^{60}\)

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\(^{58}\) It is worth noting that my concept of institutional bypass is not related to the term that Keith Rosenn used to describe the Brazilian habit to “bypass” rules and regulations in order to get things done. See Keith S. Rosenn, “The Jeito: Brazil's Institutional Bypass of the Formal Legal System and Its Developmental Implication”, \textit{The American Journal of Comparative Law}, Vol. 19, No. 3 (Summer, 1971) at 514-549.

\(^{59}\) See note 6 \textit{supra} and accompanying text.

\(^{60}\) Prado & Trebilcock, \textit{supra} note 33 at 348-349.
lawyers would not tend to think of institutions as ‘the rules of the game.’ For example, the legally prescribed speed limits on given highways would not be considered an institution but, rather, a legal rule promulgated by one set of institutions, enforced by another, and, in the event of disputes, adjudicated by yet another. Also, the distinction between institutions and organizations that North draws is idiosyncratic in that many of his forms of organizations, such as ‘political bodies (political parties, the senate, a city council, a regulatory agency),’ would be conceived of by lawyers as institutions charged with making law, administering law, or enforcing law. Finally, by including informal constraints (‘[cultural] conventions, norms of behaviour and self-imposed codes of conduct’) in his definition of institutions, North renders his conception of institutions so all-encompassing that it includes almost any factor that may influence behaviour. Thus, for the purposes of this paper, I will use the word ‘institutions’ to refer primarily to bodies (formal and informal) charged by a society with making, administering, enforcing or adjudicating its laws or policies.

In addition to adopting a definition of institutions that differs from the one adopted by new institutional economists, I also challenge the distinction they make between institutions and organizations. If I were to use the terminology adopted by new institutional economists, an “organizational bypass” would be distinguished from an “institutional bypass” as follows: while the former would refer to a new body that is created to perform one of the functions described above, the latter would refer to substantive changes in specific law and norms which are used in attempts to try to overcome obstacles for legal reform. However, institutions and organizations often interact with each other in a dynamic fashion, as the content and expression of laws or policies (rules) are determined by the bodies that make and enforce them, and these bodies are also often created and governed by a set of rules created by other bodies (to avoid conceptual confusion, I will refer to these bodies as institutions from now on).

For instance, public officials (police officers, traffic enforcers, etc) have the power to issue speed limit tickets only if authorized to do so by the legislature or by regulations. This authorization, in turn, may grant a higher or lower level of discretion to these officials. For instance, the authorization may or may not allow them the discretion to exempt drivers taking people to the hospital. In any event, a court may decide not to enforce a speed limit ticket if the driver can prove that she was taking someone that required medical care to the hospital. Thus, it would be artificial to analyze one single law, such as the one imposing speed limits, without considering the institutions that enforce this law (such as the ticket issuing officials and courts that can review the decisions of these officials). It would also be difficult to analyze an institution such as the police force without considering the laws that govern its acts, such as the law that grants police officers the authority to issue tickets for speeding. This law may grant more or less discretion to these officials, significantly impacting on the way speed limit rules will be enforced. In sum, there is no clear line that distinguishes what new institutional economists call institutions and organizations. For this reason, I will combine both concepts in my definition of an institutional bypass. Thus, for the purposes of this paper, an institution is comprised of what North would call an organization and the laws and rules that set up such organization (which North would call institutions).
Having set out the concept, I will now explore (section 2.1) how a bypass is able to overcome the obstacles to reforms identified in the first part of this article. Despite offering effective ways to deal with a lack of resources, social-cultural-historical factors and political economy problems, I believe that the most important advantage of institutional bypasses is that they provide us with an effective mechanism to deal with uncertainty regarding the consequences of institutional reforms. They do so by allowing for a great deal of experimentation, a point which I further develop in section 2.2. Finally, in section 2.3, I claim that an additional benefit of the institutional bypass comes from the fact that it allows for institutional competition. As a consequence, the bypass indicates which institutional arrangements are superior before we commit to them. For all these reasons, the bypass seems to be a promising alternative to institutional reforms for development.

2.1 Overcoming obstacles to institutional reforms

As discussed in section 1 above, there seem to be at least three significant obstacles to institutional reforms for development: lack of resources, social-cultural-historical factors, and political economy problems. In addition to these obstacles, reformers also need to deal with the fact that these obstacles are largely path dependent and will be difficult to change. Moreover, reformers need to account for institutional interconnections, which add a high level of complexity to any attempt to promote institutional reforms. How can an institutional bypass help reformers overcome these obstacles, while at the same time accounting for path dependence and dealing with institutional interconnections?

First, a bypass can help overcome a lack of resources because it does not require significant resources to be implemented. Given that bypasses keep the traditional institutions in place, they can start off as small pilot projects. This is not often the case for institutional reforms. Reforms to change bureaucratic or judicial institutions in developing countries are normally all-encompassing and ambitious reforms. They try to promote massive change in the entire system, such as salary increases or imposing sanctions for corruption to the entire organization, without knowing whether these reforms will be effective. It is worth noting that multiple and simultaneous bypasses, such as Paul Romer’s charter cities project, will probably not offer this advantage and in this sense will be significantly different from a single bypass, which is the focus of this paper.

There may be reasons to explain why institutional reforms are so encompassing. For instance, a series of problems could ensue if reformers tried to promote piecemeal reforms in existing institutions. For example, consider a piecemeal reform in which bureaucrats performing the same function may or may not be given salary increases, depending on whether they are located in the unit that is being used as a guinea pig for institutional experiments. This would certainly generate protests. The same outcome can be expected if a proposed reform mandated that officials working for federal courts in a
certain state or city will be severely sanctioned for corruption, while the same sanctions will not apply to other cities.61

The feature that the bypass offers in order to escape these constraints is to present itself as an alternative, not a replacement of the pre-existing institution. Thus, the bypass creates “an alternative pathway”, as described earlier. This alternative pathway can be created by a new institution (or organization, in North’s definition) that is separated from and independent of the existing institutions. However, the bypass does not necessarily require a brand new institution. A new pathway can also be created if a pre-existing institution assumes a new role that overlaps with one of the roles currently performed by another institution, creating an alternative pathway in the system. In this regard, the bypass would be able to operate according to different rules from the existing ones, despite the fact that it would be performing the same functions. In section 2.3 below, I discuss in great detail what can be considered a “new pathway” for the purposes of an institutional bypass.

Second, a bypass can help us deal with socio-cultural-historical factors. As explained in the previous section, these factors present relevant obstacles to institutional reforms because they do not allow for a great deal of predictability. Reforms in formal institutions may generate unexpected results, depending on the way these reforms interact with informal rules of behaviour, for instance. As a result, one of the major challenges of pursuing institutional reforms as a means for development is the fact that there is a significant degree of uncertainty regarding the outcomes of these reforms. In this sense, an interesting feature of the bypass is that it is easily reversible. Thus, if the reform does not work due to these unpredictable factors, it can be easily undone. The fact that the pre-existing institution was kept in place means that undoing or abandoning the bypass will not generate significant disruption.

In contrast, the reforms that are implemented in existing institutions are hard to reverse for a number of reasons. First, these reforms are likely to have created interest groups that are now benefiting from the institutional changes and will fight hard to maintain the status quo. Moreover, undoing reforms could leave an impression of institutional schizophrenia or unstable political environment that would not be positively perceived either by the public or by those working for these institutions. Finally, constant reforms in existing institutions are likely to generate a lot of disruption and social instability, because society needs to adjust to the new dynamics of the system. In contrast, the bypass can start as a small project, which would offer the possibility of reversing or canceling the initiative very easily if it does not work out as expected. A bypass is likely to have fewer consequences for society than other institutional reforms, and as a small pilot project it is unlikely to generate significant consequences if reformers decide to abandon or cancel the project. Again, this may not be the case for multiple bypasses, such as charter cities, but these multiple bypasses are beyond the scope of this paper.

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61 While there are attempts to promote all-encompassing reforms in developing countries, there is a limit as to how encompassing the reform could be during normal times. I have explored this problem in Prado & Trebilcock, supra note 33 and Prado, supra note 40.
Third, institutional bypasses help to avoid political economy problems that arise when efforts are made to directly reform an institution. Recall that these kinds of problems are associated with voluntary resistance to reforms that impair rent-seeking activities by individuals who benefit from the status quo. Although citizens benefit from services that are fast, have high quality, and are not provided on a discriminatory basis, actors within a bureaucracy often do not. Bureaucrats may earn additional income from corruption and probably do not want to be deprived of these rents. Also, bureaucrats may not want to employ greater efforts and increase their workload if a reform increases the pace in processing requests for services. In this context, normally two groups are formed: one group demands reforms, whereas another group will resist them. The prediction is that institutional reforms will only happen if the group demanding reforms has more power and influence. Efforts to overcome political economy problems therefore require empowering the groups that want reforms, and weakening the groups that do not. In most cases, this can be a formidable goal.

Finally, an institutional bypass is as close as a reformer can be to writing on a blank slate during normal times. Accordingly, an institutional bypass can avoid problems of path dependence (switching costs and self-reinforcing mechanisms). It certainly does not eliminate the problem of institutional interconnections, but it does allow for more room to redefine how the bypass will interact with other pre-existing institutions. Thus, an institutional bypass eliminates many of the dilemmas that reformers need to face when considering institutional change during normal times.

In sum, an institutional bypass has unique characteristics that not only differentiate it from traditional institutional reforms, but also allow reformers to overcome some of the most significant obstacles to reforms for development that we observe today.

2.2 Institutional Experimentation and Innovation

In the first part of the paper, I identified the most significant obstacles to institutional reforms and also highlighted the uncertainties involved in institutional design. Literature shows that detailed blueprints and legal or institutional transplants are likely to fail, and there is very little that we can predict in terms of what will work in a particular development context. While most efforts to reform institutions have tried to move away from blueprints, they still rely heavily on best practices, or principled approaches that often face the same fate as the other reforms.

In an attempt to move away from blueprints or principled approaches, a number of scholars have advocated for institutional experimentation in the development context. Experimentation allows law reformers to test what works and what does not work, before

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63 See Kennedy, supra note 27 and accompanying text.

64 For an overview, see Kevin Davis, “Legal Universalism: Persistent Objections”, University of Toronto Law Journal, Volume 60, Number 2 /2010, at 548 and ff.
committing to a particular institutional solution. One of the mechanisms proposed to conduct institutional experiments is called randomized trials:

So how would this work? Say, for example, that you are trying to decide whether to adopt a new bankruptcy law that gives debtor firms time to propose a plan of reorganization that involves creditors’ rights being modified without their consent, subject to court approval. What I think the experimentalists would propose is that you would randomly select one-tenth of the companies in the economy and tell them that if they go bankrupt, they will be subject to a bankruptcy regime that includes the new reorganization law. Those firms will be your treatment group; the remainder of the companies will be the control group. Then you wait and see what the impact is on outcomes such as the cost of credit, levels of employment, rates of bankruptcy filings, and the cost of bankruptcy proceedings. More specifically, you would figure out the impact of the bankruptcy law by comparing the experiences of the treatment group and those of the control group. The idea is that before enacting any new law you would run this kind of controlled experiment.

These randomized trials have a number of advantages from an academic perspective. The main one is that it allows researchers to answer counterfactual questions, while at the same time avoiding the problem of selection bias. As Esther Duflo et al. explain, one attempt to measure the impact of reforms is to compare a case in which a certain institution or a certain policy is present with others in which such feature does not exist. However, this type of analysis has to account for the problem of selection bias, i.e. it needs to consider the possibility that the observable outcomes may be attributable to systematic differences between the cases that are not related to the existence of that particular institution or policy. For instance, we may observe that countries with a certain type of bankruptcy regulation have lower rates of bankruptcy than countries that do not have this regulatory framework. However, this correlation does not prove that this particular set of bankruptcy laws is the cause of this outcome. The cases of success may have some features that both explain the result and may have determined the adoption of a certain type of bankruptcy law in the first place. Unless there is a way of controlling for all that, it is hard to reach any conclusion. Randomized trials claim to do just that, providing useful and reliable information to reformers. Another advantage is that randomized trials do not require large budgets, large teams and complex implementation, unlike “social experiments” conducted in the United States.

However, randomized trials have some problems. One is that the findings of a certain experiment may not be generalizable to other settings, as it only tests a particular

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66 Davis, supra note 63 at 549.
68 Ibid.
program in a particular context.\textsuperscript{69} One way to address this problem would be replicating the test in many different settings, but this largely increases costs and it is difficult to determine how many cases would be necessary to validate a certain result.\textsuperscript{70} Another problem is that randomized trials provide useful information, but may not translate into concrete reforms. While there are examples in which the positive evaluations seem to have supported the expansion of the project (such as the conditional cash transfer program, \textit{Progressa}, in Mexico) there are also cases in which “despite the accolades heaped on the program by the [Randomized Experiments], it was discontinued and never revived” (such as the case of private school vouchers in Colombia).\textsuperscript{71}

While institutional bypasses may not be able to address these concerns as they may not be generalizable or provide concrete policy advice, there are practical issues that suggest that from a policy-making perspective institutional bypasses are a preferable experimentation mechanism. First, randomized trials do not deal with the obstacles to reforms described earlier in this paper. Instead, proponents of these trials seem to assume that the main - and perhaps the only - problem of reformers is a lack of information. Certainly these trials provide useful information about the consequences of certain reforms, eliminating a great deal of uncertainty. There is much value in that, but lack of information may not be the main reason why reforms are not being implemented. As Romer says, “policymakers are constrained, but rarely ignorant”.\textsuperscript{72} In contrast, the institutional bypass is a mechanism that allows for experimentation while at the same time offering a strategy to overcome obstacles to reform.

Second, there are ethical concerns in randomized experiments that are not present in institutional bypasses. As Kevin Davis puts it:

\begin{quote}
divergent conceptions of what is right and good can lead to disagreements about the virtues of experimentalism. Legal experiments involve using people as guinea pigs, typically without their consent. In particular, the members of the treatment group are used as a means to the end of generating information for their fellow citizens. Reasonable people can easily disagree about the ethics of that kind of exercise. Experimentalists might try to finesse this issue by proposing to conduct only experiments that are expected to help rather than harm the treatment group. But if experimenters are confident that the treatment will be helpful, then how do they justify failing to make it available to everyone else in the society? Of course, it is possible that the experimenters are genuinely uncertain as to whether the reform is better than the status quo. But what if one of the subjects disagrees? Can we really justify subjecting someone to what he or
\end{quote}

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\begin{itemize}
\item \textsuperscript{70} Jessica Cohen & William Easterly, “Introduction: Thinking Big versus Thinking Small”, \textit{ibid} at 9.
\item \textsuperscript{71} \textit{Ibid} at 17.
\item \textsuperscript{72} Paul Romer, “Comment”, \textit{ibid} at 128.
\end{itemize}
she believes to be a harmful treatment purely for the sake of generating information? It seems plausible that reasonable people will disagree.\textsuperscript{73}

Bypasses do not raise these issues because they do not select “subjects” randomly. Instead, they offer a choice that individuals and companies may or may not take.

Third, randomized trials may be an interesting mechanism for academics but they are not a useful and practical tool for policymakers. On the one hand, it is unlikely that most governments will have the capacity to run a credible field experiment before implementing a certain policy.\textsuperscript{74} And if these governments decide to cooperate with academics, “implementers may have a stake in finding positive results”.\textsuperscript{75} Moreover, randomized trials do not allow for the level of experimentation that normally characterizes policy-making. In a seminal piece called “The Science of ‘Muddling Through’”, Charles Lindblom argues that policy making and policy change normally happens through trial and error.\textsuperscript{76} In contrast, randomized trials change the policy once and test for results, not accounting for the fact that probably a better outcome would be reached if there were changes and adjustments every time the results were produced and evaluated. Similarly, James Scott in his book \textit{Seeing Like a State} offers a series of case studies of failed attempts to create social order. Similar to Lindblom, he makes a case for “the indispensable role of practical knowledge, informal processes, and improvisation in the face of unpredictability”.\textsuperscript{77} In contrast to institutional bypasses, randomized trials do not allow for the type of experimentation suggested by Lindblom and Scott. Moreover, bypasses do not require reformers to operate outside of their comfort zone by engaging in complex academic endeavours or vice-versa. In sum, institutional bypasses seem to be a preferable mechanism from the point of view of policymakers.

Despite these differences, randomized trials and institutional bypasses share at least one commonality. Both are attempts to find a mechanism to generate institutional experiments that are neither costly nor socially disruptive, and allow reformers to select the ones that produce desirable results, so that time and resources are not squandered on bad ideas. The difference is that randomized trials offer an academically accredited method of filtering information, while institutional bypasses offer an informal system in which the best institution is expected to thrive and consequently it should naturally stand out. In this sense, an institutional bypass is analogous to the process of technological innovation in markets where innovation creates new products or technologies, as well as destroying the value of old products or technologies by making them redundant. Joseph Schumpeter described this processes as "incessantly revolutionizing from within, resulting from the development of new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organisation that capitalist enterprise creates".\textsuperscript{78}

\textsuperscript{73} Davis, \textit{supra} note 63 at 550-51.
\textsuperscript{74} \textit{Ibid} at 551.
\textsuperscript{75} Cohen & Easterly, \textit{supra} note 69 at 16.
While an institutional bypass is one possible way to filter out the good reforms from the bad ones, I am certainly not claiming this is the only way.\(^{79}\) Instead, I am claiming that this could be one viable mechanism, because the bypass project functions as a kind of technological innovation, which can potentially move the system to a new equilibrium if successful. Just as technological change is a driver of growth in an endogenous model of development economics,\(^{80}\) with a bypass institutional change can push the institutional arrangement (rather than economic growth) closer to a more desirable level. Instead of replacing it immediately, the new pathway created by an institutional bypass co-exists with the old institutions for a certain period of time (like the new technology co-exists with the old technology). There is no prediction as to whether and how a bypass will work (see section 3.2 below). Like a new technology, it is an attempt to promote change that may or may not produce expected results.

There is, however, one aspect in which institutional bypasses may be different from technological innovation: they may not be subjected to the same degree of path dependence problems. The path dependency framework was originally developed to explain why, in certain circumstances, there are no changes in the dynamics of the economic system despite the fact that a significant technological innovation was produced. Switching costs and network effects can explain why society remains in a sub-optimal technological arrangement, in certain cases, despite the existence of a technological innovation that could have moved us forward. As discussed in section 1.2 above, the same applies to institutional reforms. Switching costs and network effects can also hinder the prospects of institutional change.\(^{81}\) These effects will be more evident in cases in which the new technology attempts to replace the old one, imposing costs on consumers who decide to adopt the former. For instance, in the case of keyboards, operational systems for computers and other technologies, consumers who have already invested money in acquiring equipment with the obsolete technology, or time in learning how to use it, will lose that investment if they decide to adopt the new product. Thus, they are likely to resist. These effects can be attenuated, however, if the new technology does not try to replace the old one. For instance, in conjunction with the ever-increasing production of ethanol in Brazil, the car manufacturing industry developed flexible-fuel (flex) vehicles that can run on gas, ethanol or any combination of both. Introduced on the market in 2003, flex vehicles currently constitute 92.3% of all new car and light vehicle Brazilian sales.\(^{82}\) This technology is attractive to consumers because they are not forced

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\(^{79}\) William Easterly, for instance, has suggested that a democratic system could be such a filter. The Paul Cadario Visiting Faculty Lecture, "Global poverty has no solution ...and it's called Democracy", University of Toronto, February 23, 2010. Slides are available at <http://www.publicpolicy.utoronto.ca/NewsandEvents/Lists/Upcoming%20Events/Attachments/91/Global%20poverty%20has%20no%20solution%20-%20Feb.23%20Easterly%20Cadario%20Lecture.pdf>.


\(^{81}\) Prado & Trebilcock, supra note 33.

to choose between a car that runs purely on gas, or a car that runs solely on ethanol. The institutional bypass does the same: it helps overcome path dependency problems because it does not force anyone to choose which institution should prevail, at least not in the short term (I will discuss the long-term effects of the bypass in section 3.2 below).

2.3 Promoting institutional competition

Competition is the type of reform program recommended by Thomas Heller to overcome obstacles to rule of law reforms in developing countries. Heller argues that fostering competition ought to be considered as a means of disrupting legal cultures adapted to political economies that reform aspires to displace. Effective change in established organizations, Heller argues, can only come about when they are motivated by incentives that come with competition, and he notes that competition between legal institutions already occurs within the developed world. An example is the “horizontal” competition that arises when actors within a federal system are able to select between the various regulators established by sub-national governments, and transnational dispute resolution mechanisms of the kind established by NAFTA, which permit litigants to review administrative decisions in Canada, the United States and Mexico. Heller argues that in cases such as these, where multiple legal organizations have non-exclusive jurisdiction, the ability of the incumbent institution to resist change is reduced.\(^{83}\)

The central argument of this section is that competition is a driving force in the case of institutional bypasses. By creating two parallel institutions that perform the same function, the bypass opens up room for some institutional competition. If the users of the service choose the bypass over the pre-existing institution, this can signal that the bypass is superior to the existing institutions in the provision of services. The implicit assumption here is that the bypass and the existing institution would be “competing” for the users and the best provider is likely to prevail.

For competition to exist, however, there needs to be choice. Thus, institutional innovations that simply replace pre-existing arrangements, but do not offer a choice, will not be considered bypasses. An illustrative example is the case of the procurement process in Brazil.\(^{84}\) In 1986, the Brazilian government enacted a statute governing tender process through which it must make most of its purchases. The legislative scheme was improved in 1993 but retained a rule that allowed bids to be submitted in either sealed or unsealed envelopes. The process was considered faulty for a number of reasons but numerous attempts to amend the legislation failed. During the privatization process in Brazil, the government created new institutions, independent regulatory agencies, which are supposed to regulate privatized utilities and operate independently from the government. Despite their independence, however, prevailing law would have required these agencies to conduct tenders using the flawed process. In order to avoid the


\(^{84}\) I would like to thank Carlos Ari Sundfeld for calling my attention to this example.
perceived problems with the tender process, policymakers designing the regulatory agency for the telecommunications sector designed a new tender process, in which the bidding process by envelopes would be replaced by a live auction. Provisions authorizing the new process were included in the draft bill creating the new regulatory agency. Advocates of the new process were able to argue to legislators that the new process applied only to the new agency - not to all bodies of the public administration - and the bill was approved by Congress. As soon as the telecommunications agency started using this new tendering process, the benefits became evident: the process was much faster and generated significant savings for the government as the live auction significantly reduced the prices. As a result, other government bodies started pressing the government to adopt the same system. In 2002, a new statute was enacted by the Brazilian Congress establishing the live auction process for the entire public administration.

While this example illustrates that successful institutional innovations can feed back into the system and result in system-wide improvements, it is important to note that the legislation that exempted the telecommunications agency from the normal tendering rules was not an institutional bypass. The new regulatory agency could not choose between the new tendering process or the old one. By the same token, other offices of the public administration also did not have any option: they were forced to abide by the old system. Thus, there was no competition between the new or the old system. Thus, there was no alternative pathway.

It is important to note, however, that in not all the circumstances in which there is choice can one find institutional competition. If there is choice, but no competition, there is no institutional bypass. In legal systems there are often many instances in which individuals or companies have a choice of legal regime. In these cases, different legal systems offer distinct legal arrangements and individuals or companies can choose the legal arrangement that best suits them. In some of these cases, there will be competition and therefore a bypass. One example of this type of competition is what Gilson, Hansmann and Pargendler have called regulatory dualism, which “seeks to mitigate political opposition to reforms by permitting the existing business elite to be governed by the old regime, while allowing other firms to be regulated by a new parallel regime that is more efficient”. An example of regulatory dualism in capital markets is the New Market (Novo Mercado) in Brazil, “a voluntary premium segment within the São Paulo Stock Exchange that allows companies to commit credibly to significant protection of minority shareholders without imposing reform on companies controlled by the established elite”.  

However, Gilson, Hansmann and Pargendler clarify that regulatory dualism is different from menus – statutory rules that one can opt out of or into – because the latter incorporates options in the same statutes that regulate corporate law more broadly. In

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86 Ibid.
contrast, in the case of regulatory dualism, the reformist regime has been created and maintained by an institution — such as a stock exchange or another federated state — that is to some degree independent of the political forces supporting the established regime. Thus, for the authors, the success of regulatory dualism largely depends on some form of institutional competition. The competing institution that will be challenging the pre-existing regime is either a private institution that will implement the rules (what they call private regulatory organizations), parallel states within a federal system, or independent states (in which a sovereign country may provide different institutions).  

While the existence of institutional competition is a prerequisite for the existence of a bypass, not all types of institutional competition are bypasses. There are cases in which there is choice and competition, but still there is no institutional bypass. In the realm of public services, the example is vouchers. A voucher program is a demand side subsidy that attempts to align principal and agent interests by offering stronger incentives for agents to respond to consumer needs. In this case, the funding is offered directly to the consumers, who choose where to spend it. What is so innovative about this system is that the funding itself is put in the hands of the consumers, entrusting them to make decisions for themselves. This forces consumers, who each have a specific and limited amount of funding, to spend it rationally and with suppliers they feel best represent their interests. Rational behaviour on the part of consumers, and competition among suppliers, is expected to determine which suppliers will be sustainable. Promoting competition is a unique feature of the voucher system, and this largely falls back to the idea of the funding dollar following the consumer’s choices.

Similarly to vouchers, bypasses also offer choice on the demand side and foster competition on the supply side. In this regard, vouchers are similar to institutional bypasses. There is, however, one important difference between them: while vouchers offer a means to choose, an institutional bypass offers the choice itself. The basic principle of vouchers is that public funds are allocated according to citizens’ preferences, as opposed to the state deciding who will be the provider of services and how much money will be allocated to it. By receiving the vouchers, citizens are receiving funds that allow them to pay for their choices. In the case of a bypass, in contrast, citizens are offered an alternative to the existing services. For instance, Poupatempo was an alternative to the offices of the bureaucracy. 

In both the voucher system and the bypass, there is competition among service providers, so that only providers who are supplying a desirable product at an appropriate price are able to succeed. In this sense, both schemes promote competition between suppliers in the market by creating a new market of consumers/citizens for whose service suppliers must compete. However, the way they promote this competition is rather distinct. Demand side subsidies provide the means for consumers to influence the market directly

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87 Ibid at 46-52.  
89 Ibid at 27.  
90 Ibid at 35.
according to their preferences.\textsuperscript{91} But consumers need to choose between the providers that are in the market. While the institutional bypass follows an analogous principle, it does not provide citizens with funds, but instead it provides them with a choice they did not have before. In the case of \textit{Poupatempo}, for instance, the consumer now has the choice to either continue using the existing traditional bureaucracy, or to switch to the newer and more efficient alternative.

In both cases, by making a choice, consumers in the aggregate will begin to directly (vouchers) or indirectly (bypass) determine which program deserves greater funding. In the case of vouchers, where one option is more heavily pursued, there is also more funding. As a consequence, demand will force this service to expand and succeed. In the case of bypasses, the expectation is that increasing investments in the bypass can be determined by measuring whether citizens prefer to use the bypass or the traditional institution. However, this increase in investments may not necessarily happen, as the state may not allocate the money in the most efficient way in the case of a bypass. Some of the reasons why this may happen will be explored in section 3.2 below. In any event, from the point of view of the consumer/citizen, what both the vouchers and the bypasses offer is an option to express their preferences by exiting the system. Competition is promoted or enhanced by the fact that consumers have either a means to choose (vouchers) or are offered a choice (bypass) and therefore they acquire a real interest in voicing their preferences through their actions.

The fact that institutional bypasses offer the actual choice, instead of providing the means to choose (as vouchers do), does not imply that a bypass needs to be a brand new institution. The alternative pathway can be offered either by a new institution, or by a pre-existing institution performing a new function, which overlaps with the functions performed by another institution. Again, \textit{Poupatempo} offers an interesting example in this regard. Reformers housed the project in a state-owned company in charge of information technology and data processing (Prodesp). Managing offices to provide bureaucratic services was certainly a function that this state-owned company never performed, but the company seemed to be the best option available to reformers at the time. The alternative was to house the project within the chief of staff’s office. However, in this case \textit{Poupatempo}’s budget would need to be approved yearly by the state legislature. In addition, the office of the governor needs to use public bids for everything. For instance, hiring architects to design and build new units could easily take six months. In contrast, this state-owned company had more flexibility in managing its budget. It could, for instance, hire an architect within a day.\textsuperscript{92} Thus, \textit{Poupatempo} is an example of an institutional bypass in which a new institution was not created.

This example also illustrates another important issue: by using an old institution to implement an institutional bypass, reformers will have less flexibility to determine the rules that govern such institution. For instance, by housing \textit{Poupatempo} at Prodesp meant that the project could not be included as a formal item in the government’s budget, making its budgetary situation very precarious, with no guarantee of funding from year to

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\textsuperscript{91} Ibid at 40.
\textsuperscript{92} Prado & Chasin, \textit{supra} note 3 at 19-20.
\end{flushleft}
year. On the other hand, even in cases where reformers have a great deal of flexibility to change rules related to one particular institution (the bypass) they are not necessarily able to overcome the problems related to institutional interconnections. For instance, one of the pitfalls of the relatively successful Brazilian stock market experience (Novo Mercado) is the fact that the Stock Exchange offered companies a choice between different systems of protection of minority shareholders, but the same judiciary is in charge of enforcing these two different systems of rules and norms, what impose on both of them problems with judicial inefficiency and corruption.  


While bypasses can perform a number of different functions, in this section I will focus on bypasses that deliver services directly to citizens (or companies) or perform adjudicative functions. The four examples that will be briefly explored here are: Poupatempo in Brazil, Debt Recovery Tribunals (DRT) in India, charter schools in the United States, and international arbitration tribunals. These bypasses should be distinguished from those that perform rule-making functions, such as the regulatory dualism described earlier, which will not be discussed in greater depth here.

3.1 Types of bypass

A bypass as described in section 2 embodies four key characteristics: (i) it leaves the original institution as is; (ii) it creates an alternative pathway; (iii) the alternative aspires to be more efficient and functional; and (iv) it targets a specific point in the overall system. This definition does not indicate, however, who is promoting or implementing the bypass. A bypass may be implemented by the government or by private parties. Bypasses implemented by the government can be divided into two types. The first type involves the creation of a bypass within the government itself. The second type of bypass is operated by a private entity funded by the state to perform public services or a governmental function, such as adjudication. In contrast to these, there are bypasses fully implemented by private parties, with no governmental involvement. An example is when private companies offer services similar to those offered by a public institution or perform a governmental function, such as adjudication of disputes, but that are not financed, selected, or in any way connected with the state.

3.1.1 Public bypasses

A public bypass offers services that are either financed or supported by the state. To be a bypass, the new institution or the old one performing new functions needs to provide the same services that are already being provided by an existing state institution. In contrast to the existing institution performing old functions, however, the bypass will aspire to provide the same service in an improved fashion (i.e. more efficiently, more equitably, etc.).

93 Ibid.
94 Gilson, Hansmann & Pargendler, supra note 84 at 19-21.
Why would the state decide to duplicate its services, as opposed to simply getting rid of the existing institution and replacing it with a new one? There are primarily two reasons that may guide this decision. The first reason is to overcome political economy obstacles to reforms. As discussed in section 2 above, entrenched interest groups may resist the replacement of an existing institution by a new one, but the resistance may be attenuated if the pre-existing institution is not being changed or modified in any fashion. One reason for this is the fact that while the groups that support the reforms do not have enough power or influence to promote an overhaul of the entire system, they may still be willing to accept a more modest compromise solution, such as a bypass. A second reason is that the state may want to experiment with a new institutional arrangement before subscribing to it. Thus, an institutional bypass in the form of a small pilot project may be the perfect opportunity for this experimentation. If successful, the government can decide to invest more resources in it. On the other hand, if the outcome of the institutional innovation does not turn out as initially predicted, the state can easily abandon the project without generating much social disruption.

However, implementing a public institutional bypass may not be as easy as described above. While a bypass may not create resistance in the institution being bypassed (i.e. the executive branch or another institution currently delivering services), it may face strong opposition from other branches of government. In the context of Poupatempo, the executive branch decided to create the bypass via decree, as it feared that it would not be approved by the state legislature and enacted as a statute. One of the possible reasons for this resistance is that interest groups in the legislature could fear that there would be less resources available to other projects if the bypass were approved.

Moreover, the body delivering the services has no incentives to try to improve them. Thus, it may not resist a bypass, but it will also not promote it. As a consequence, the initiative to bypass institutions that deliver services often comes from other institutions. In analyzing the case of capital markets regulation, Gilson, Hasmann and Pargendler find that “with perhaps the exception of the Japanese case, it is in fact difficult to find an example of a single jurisdiction that offers two markedly alternative systems of corporate law, one established and one reformist. In theory, it should be perfectly possible. (…) But – aside from an arguably quixotic recent effort in North Dakota – we do not see this.” This is what they call the problem of a unitary lawmaker, which is the lack of incentives for a single body to take the initiative to improve its own regulatory framework. The same problem may be observable in the context of institutional bypasses to deliver public services or perform adjudicative functions. In the case of Poupatempo, while services were delivered by the bureaucracy, which is primarily composed of civil servants, the reform was proposed by the office of the governor, an elected body. In the case of charter schools in the United States, the reform was initially proposed by members of civil society and implemented by the legislature. Finally, DRTs have been established by the

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95 Prado & Chasin, supra note 3.
96 Gilson, Hasmann & Pargendler, supra note 84 at 46-47.
Institutional Bypass
Prado (2011)
Draft

Government of India under an Act of Parliament (Act 51 of 1993)\(^97\) as an executive arm of the government and fall under the purview of the Ministry of Finance, unlike civil and criminal courts which are part of the judiciary.\(^98\) In other words, it was not the judiciary that implemented these courts. Thus, public bypasses may only be possible if another governmental institution is actually interested in guaranteeing the delivery of services.

There are also other problems that may follow after the implementation of a bypass. The idea is that once the bypass is implemented, consumers of these services have a choice: they can request services at the traditional institution or in the bypass. The assumption is that as the bypass enjoys greater success (more consumers opt for the bypass), the more likely it is that the traditional service will become obsolete. However, in the case of a public bypass, this is not a necessary outcome because the allocation of funds to the bypass depends on governmental appropriations. Unlike vouchers, where consumers decide where public funds will be allocated, the government itself decides whether the bypass will receive more funds in light of increased demand. This process of allocating funds, however, can be derailed due to resistance of interest groups.\(^99\)

The case of Poupatempo in Brazil illustrates this problem. In this case, the allocation of resources required legislative approval, and therefore met with the resistance of those who did not want the reform in the first place. As I have described in a previous paper (co-authored with Ana Carolina Chasin):

> Increasing the Poupatempo budget, however, was not as easy as it might seem. The state government has a complicated budgetary process in which what is defined as budget for one year is replicated in the next year. Therefore, adding a brand new project in the budget was a difficult process, because it meant taking money out of other items, what was always met with fierce resistance. To overcome this difficulty at the early stages, the governor’s office presented Poupatempo as a temporary project entitled to exceptional funding (crédito suplementar). Eventually, the success of the project created political support for this allocation.\(^100\)

Another reason for funds not to be allocated is a change in governments, such as when a new party comes into power and wants to discontinue the reform initiated by the previous government. In such cases, the allocation of funds based on demand may not happen and the public bypass may not succeed. Private bypasses do not face the same problem, as I discuss below (section 3.1.2).

As mentioned above, public bypasses can be divided into two types. The first type, which I call public-public bypasses, requires the bypass to be located within the government

\(^97\) *Recovery of Debts Due to Banks and Financial Institutions Act*, 1993, online: Debt Recovery Tribunal, <http://www.drt.co.in/>  
\(^99\) See section 2.3 above.  
\(^100\) Prado & Chasin, *supra* note 3 at 12.
itself. The bypass is therefore a public institution. An example of a public-public bypass is the aforementioned Poupatempo experience in Brazil, which is a one stop shop for governmental services. It is a bypass because it kept the pre-existing governmental departments from the federal, state and local bureaucracy in place, and created a new place where citizens can request these very same services. Thus, the state is providing an option to citizens, who can choose to request such services in the pre-existing bureaucracy or in the bypass.

Another example of a public-public bypass is Debt Recovery Tribunals (DRTs) in India. The jurisdiction of DRTs partially overlaps with the jurisdiction of regular courts, offering an alternative pathway to those who want to recover their debts.\footnote{New courts will only be bypasses if they have overlapping jurisdiction with pre-existing courts. If they have exclusive jurisdiction, they are not bypasses. For instance, in Canada courts have exclusive jurisdiction on claims of a certain value, i.e. you cannot sue someone in Superior Court if you are claiming less than $10,000 and you cannot sue someone in Small Claims Court for more than $10,000.} While there is no limitation to the regular court's jurisdiction, the cases brought to the DRTs must be over 1 million Rupees. While all the cases brought to DRTs fall under the jurisdiction of regular courts, the reverse is not true: DRTs do not have jurisdiction over all cases brought to regular courts. They only provide recovery of debts due to banks and financial institutions.\footnote{Supra note 95.} This means that these tribunals change a specific point in the system, while keeping the pre-existing institutions in place. Indeed, “Debt Recovery Tribunals were established as the Indian government's attempt to improve the legal channels for loan recovery, without overhauling the entire judicial system.”\footnote{Visaria, supra note 96.}

As to efficiency, there is no conclusive evidence that DRTs outperform Indian civil courts, but the evidence available seems to suggest that they are faster than the judiciary. “[T]he DRT issues summons about 4.5 months after the case is filed, and has the first hearing at 211 days (7 months). The civil court took more than a year to issue summons.”\footnote{Ibid at 11.} Their alleged efficiency is ascribed to (i) a streamlined "summary" procedure, which demands faster processing by tribunals and greater accountability by the litigants; (ii) power to issue injunctions preventing defendants from transferring or disposing of the assets in question; (iii) swift execution of the verdict, as “the ‘recovery officer’ has the authority to attach and sell the property of the defendant, arrange for a ‘receiver’ to manage the property of the defendant, or arrest the recalcitrant defendant and detain him in prison”.\footnote{Ibid at 7.}

It is worth remembering that simply offering a choice of simplified procedures is not an institutional bypass.\footnote{In this sense they are similar to menus in Corporate Statutes. See note 85 above and accompanying text.} In some countries, litigants can opt in to different (simplified) procedural rules in cases that are worth less than a certain amount (in Canada, for instance, this is around $75,000). DRTs are a bypass not because they offer a simplified procedure, but because they do so outside of the regular court system and these simplified procedures reduce the time of litigation. And it is a public-public bypass because DRTs...
are governmental institutions. In contrast, if the government sponsors some form of mediation to reduce the amount of cases brought to the judiciary, but the mediation services are delivered by private institutions, this would constitute a public-private bypass. If the parties adopt some form of private alternative dispute resolution system (such as private arbitrations) that is not sponsored or funded by the government, then it is a case of private bypass. Private bypasses can encompass a large array of civil society initiatives both in the private and in the non-profit sector.

In the second type of public bypasses, which I call public-private bypasses, a private entity (a company, an individual, or a civil society association) receives the responsibility or the power to perform public services. In some cases, the entity is hired by the state to provide such services (contracting out). For instance, the most recent units of *Poupatempo* do not rely on public servants. Instead, they contract out the functions to private companies, which are obliged to follow strict guidelines regarding service provision. It is important to note, however, that a public-private bypass only exists if the private institution is performing a service that is already performed by another institution. Thus, processes of contracting out state services in which the private entity replaces the public entity would be considered bypasses.

Another example of a public-private bypass is charter schools in the United States, which suggests that institutional bypasses can also be an interesting strategy for developed countries facing obstacles to institutional reforms. These are primary or secondary schools established by private parties, such as teachers, parents, non-profit groups, universities or corporations. However, they are considered public schools as they are funded by public money and are not allowed to charge tuition. They offer an alternative pathway to public schools, as students can choose to go to a charter school or to remain in regular public schools. Finally, they try to offer better education than regular public schools, taking advantage of the fact that they are not subject to the same rules, regulations and statutes that apply to other public schools. In general, they seem to aspire to provide better services than public schools, although their actual level of success is extremely disputed in the academic literature. In sum, they meet all the criteria of a bypass.

In both types of public bypasses (public-public and public-private bypasses), the government becomes the agent, while consumers are the principals. A fundamental requirement for the bypass to work, in this context, is the existence of an alignment of

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107 As mentioned above, they are part of the executive branch.
109 Caroline M. Hoxby, “School choice and school competition: Evidence from the United States”, Swedish Economic Policy Review 10 (2003) at 9-65 (showing that charter schools disproportionately attract students who are performing badly, and make their achievements rise). Jay Greene, Greg Foster and Marcus Winter, “Apples to Apples: An Evaluation of Charter Schools Serving General Student Populations”, Manhattan Institute for Policy Research (2003) (showing that charter schools outperformed regular schools in math and reading tests). Carol Hoxby and Jonah Rockoff, “The Impact of Charter Schools in Student Achievement” (November 2004) (showing that the impact was positive in students who applied in kindergarten to grade five, but there was no impact on students who applied in grades six through eight).
interests between the government and the citizens/consumers. The fact that dysfunctional institutions are in place may be explained by the lack of an alignment of interests to begin with. And both public-public and public-private bypasses require that the institutions providing services have an incentive to please consumers. In the case of purely private companies, profit motivations may force them to align with consumers’ needs in order for both parties to be satisfied. The issue that arises, however, is that in representing the government, private companies will align more with government interests. If there is a financial price tag associated with the project, there will be even more of an incentive for them to keep the government happy. This only further perpetuates divergent interests and the principal-agent problem.\(^{110}\)

Some charter schools try to align incentives by making public funding proportional to the number of students they manage to attract. But even for the schools where funding is not proportion to enrollment, “the ‘charter’ establishing each such school is a performance contract detailing the school's mission, program, goals, students served, methods of assessment, and ways to measure success”\(^{111}\). The school has a strong incentive to meet the goals established in the charter (which are often related to academic performance of the students) and abide by the charter, lest its contract with the government not be renewed. In exchange for these commitments, the government offers regulatory flexibility, exempting these schools from the regulatory framework that would apply to public schools. “The basic concept of charter schools is that they exercise increased autonomy in return for this accountability.”\(^{112}\) In sum, charter schools cease to exist if they are not meeting the goals established in the charter, and the evidence seems to suggest that charter schools close more often than regular public schools.\(^{113}\)

Thus, incentives should be in place for the state to protect the consumers’ interests. Without a scheme of incentives, interests will not be aligned, and the principal-agent problem previously described will not be solved. In this regard, it may be important to give citizens not only the exit option, but also a voice. If consumers are not offered a voice, or a feedback mechanism in order to speak out, they will have no incentive to communicate their opinions and it will be hard to keep the service providers (being public or private) accountable.\(^{114}\)

The possibility of exiting the system is one important way of manifesting preferences. The work of Albert Hirschmann has shown that when consumers have the option to exit, they have fewer incentives to use their voice to press service providers to improve their services. Hirschmann argues that this is especially true in competition for public services.\(^{115}\) This could imply that in the case of institutional bypasses analyzed here, consumers will be less likely to use their voice, given that they have the option to exit.

\(^{110}\) Trebilcock & Daniels, \textit{supra} note 86.

\(^{111}\) \textit{Supra} note 106.

\(^{112}\) \textit{Ibid.}


\(^{114}\) \textit{Ibid} at 22.

There are, however, two reasons why we should not assume that Hirschmann’s claim would apply to these bypasses. First, the bypass is the only institution, between the two, that is trying to answer consumer needs and attend to consumers interests. If the bypass is indeed doing a good job in offering at least the same quality of services of the pre-existing institution, it may be worthwhile for consumers to use their voices to make the service improve even further, for two reasons. First, between the two institutions, the bypass is the one in which consumers’ voices are more likely to be heard. Second, by exiting the bypass, consumers may be killing it. And without the bypass, citizens are left with no alternative but the one dysfunctional governmental institution that normally provides the service. Charter schools may be a good example of the increased incentives of consumers to use their voice in bypasses, as opposed to simply exiting the system. The issue is whether there are incentives for the bypass to respond to this feedback. As suggested above, these incentives do seem to exist in the case of charter schools where funding is proportional to the number of students they can attract.

Assuming that consumers would have more incentives to use their voices in the case of a bypass than they would in the case of traditional public services, one might still ask why a voice is important. Can reformers not simply rely on the fact that by having the option to exit the system consumers will have an effective mechanism to manifest their preferences? Isn’t the exit option enough to provide incentives for the bypass to improve its services? The answer is no. The idea of a voice, which will be encapsulated in a feedback mechanism, ensures that the state is informed of the actual preferences of consumers, as opposed to assuming what their preferences would be. This allows the bypass not only to be marginally better than the pre-existing institution, but it also allows it to implement further improvements in the services once the bypass is operating. Moreover, such feedback allows reformers to account for and adjust to unexpected outcomes of institutional change. In other words, it is very unlikely that the bypass will be perfectly designed from the beginning. Instead, what seems more likely is that the bypass at first will be innovative enough to outperform the dysfunctional institution, but it will still need further adjustments as it starts to operate. ¹¹⁶

For these feedback mechanisms to be effectively translated into improvements, however, there need to be effective incentives for a bypass to respond to consumer feedback. Charter schools provide an example of a bypass in which these incentives are present. Indeed, they will only be present in a bypass if the success of the project is evaluated according to consumer preference and satisfaction. If the bypass is not pleasing consumers, the state may simply let it fade off and die. In this arrangement, there will be an embedded incentive in the institutional bypass to consider consumers’ preferences and encourage them to use their voices. There is, however, a limit to the power of this incentive: since the bypass just needs to be slightly better than the pre-existing institution to become attractive to consumers, it may be appropriate to adopt contractual mechanisms that condition state funding or support on effective performance, which should be in turn measured in conjunction with customer satisfaction. This is exactly

¹¹⁶ See notes 75 and 76 supra and accompanying texts.
what *Poupatempo* does.\textsuperscript{117} These mechanisms aim at keeping a healthy and self-sustaining balance of the interests between the government as an agent and the consumers as principals.

### 3.1.2 Private bypasses

The advantage of a private bypass is that the institution promoting the change or the innovation is not directly connected with the state. A clear example of private bypasses is private arbitration tribunals. In general, private arbitration involves the adjudication of a contractual or other dispute by private tribunals. It typically arises in cases where parties to a contract have included a clause that precludes them from suing in state courts in the event of a dispute arising out of the contract, and requires them instead to bring their disputes before a private tribunal. Because they are negotiated by private parties, in various kinds of business arrangements and commercial agreements, arbitration clauses vary widely. Some simply require the parties to arbitrate while others provide codes of procedure that govern the selection of arbitrators, rules of evidence and disclosure and appeal procedures. Even where parties have not agreed to arbitration ahead of time, the option to arbitrate a dispute remains available once a dispute has arisen, provided that they can negotiate an agreement to arbitrate. Private arbitration can be considered a bypass because even though the ordinary legal dispute resolution system (state courts) remains in place, the parties can choose to have their legal dispute adjudicated by a private party. Arbitration tribunals could therefore be considered a means for private parties to avoid perceived shortcomings in state judicial systems.

It is worth clarifying that private bypasses are not divided into private-public and private-private. A private bypass exists when a private institution is performing the similar functions that a governmental institution would perform. A private-private bypass would require a private institution to be performing a similar function that another private institution is performing, without governmental sponsorship. However, this idea simply describes a market system where companies are competing for consumers. In this context, one could ask if certain enterprises, such as the Grameen Bank in Bangladesh, could not be considered a bypass of the private financial institutions, which have consistently failed to provide adequate financial services to the poorest of the poor. While acknowledging the importance that microcredit initiatives have had in reducing poverty in developing countries, I do not think that they could be easily qualified as a bypass as the financial institutions were not providing the service the Grameen Bank provides in the first place, i.e. microcredit. Moreover, a bypass assumes that the institution is performing some type of governmental function (rulemaking, adjudication and provision of basic or essential services). In this sense, the provision of credit does not seem to meet the criterion.\textsuperscript{118}

\textsuperscript{117} Prado & Chasin, *supra* note 3.

\textsuperscript{118} I acknowledge that what constitutes governmental function, or public service (i.e. services that should be kept in the hands of the state, or are considered primarily as state obligations) is a matter of great dispute, and therefore drawing this line may not be an easy task.
Private bypasses raise a number of issues that still need to be addressed before we can safely conclude whether these are promising avenues to promote development. Are private bypasses independent from public institutions? If not, can they be considered bypasses? What are these private bypasses trying to achieve? Do they have the same goals and objectives that public institutions do? If not, how should we measure if they are an efficient alternative to the existing system? These are complex questions that are beyond the scope of this paper. Given the uncertainties regarding how promising a private bypass could be, the next section will analyze under which circumstances public bypasses could potentially realize this potential of becoming a promising alternative to development reforms.

3.2 Broader institutional implications

This section will explore the possible consequences of a public bypass. I will not analyze under which circumstances a bypass is likely to be more or less successful, as this will largely depend on the type of bypass and the place where it is being implemented (and there is always a great deal of uncertainty that is involved in any institutional reform, as I argued in section 1). Instead, the focus of this section is on the broader implications that a public bypass may have on the institutional landscape of developing countries.

My central argument in this section is that the impact a bypass may have on the broader institutional landscape of a certain country will largely depend on the impact the bypass will have on the pre-existing institution (the bypassed institution) and on how this institution will react. I will explore the following five possible reactions:

(i) the pre-existing institution fights back, and decides to boycott or destroy the bypass;
(ii) the pre-existing institution may simply fade off and die, as an increasing number of citizens/consumers opt for using the bypass;
(iii) the pre-existing institution may shape up in the face of competition;
(iv) the pre-existing institution and the bypass may merge into one single entity; or
(v) the pre-existing institution may propose a division of labour and simply assume responsibility for the most easily dealt with tasks (cream skimming), while offloading the rest onto the bypass; or the opposite, i.e. the bypass may take the cream and offload the rest.

I will explore each of these hypotheses and their consequences to the broader institutional environment of developing countries below.

3.2.1 Fighting back

Fighting back occurs when the existing bureaucracy resists the implementation or operation of the bypass. This can take place either before the bypass is created or after. Fighting back before the bypass is established would aim at stalling or preventing the program’s approval or implementation. This can be done by lobbying against its creation, or, once approved, through efforts to block allocations of human capital and resources to
the bypass. If the pre-existing institution is not able to block the creation or implementation of a bypass, it may try to sabotage its ability to provide services efficiently by employing tactics analogous to anti-competitive practices, where the existing institution adopts strategies that make it difficult for the bypass to succeed/realize its goals.

A possible motivation for the pre-existing institution to try to fight the bypass and/or boycott it is because it may recognize the bypass as a threat to its ongoing viability. It may fear being replaced or losing its political power, its social influence, or its status as the monopoly service provider. While the perception that the bypass is a threat may generate a desired response, in which the pre-existing institution shapes up in the face of competition and tries to compete for consumers (see section 3.2.3 below), there is no guarantee that this will happen. Instead, in cases in which the pre-existing institution is itself battling with obstacles to reform, initiating a boycott of the bypass may be an easier path to follow.

There is a series of mechanisms that the pre-existing institution can use to lobby against or to boycott the bypass project. In terms of lobbying, the pre-existing institution may appeal to third parties to increase the number of people pressing the government not to pass enabling legislation or executive decrees necessary to implement the reform. Good candidates are typically those benefiting from the existence of a dysfunctional and inefficient institution. For example, individuals who currently benefit from providing expedited bureaucratic services to citizens that pay a premium, or taking a cut under the table. Public sector unions representing employees at the existing institution may be motivated to participate in efforts to fight back if they anticipate future redundancies caused by reduced demand for services in the incumbent institution or threats to working conditions stemming from competitive pressures. Senior civil servants too may be motivated to lobby against bypasses for similar reasons. These individuals and groups can help to lobby against the creation of the bypass, and if they are an important source of political support, the elected government might be tempted to listen to their demands.

As for boycotting, there are some other mechanisms that could be used. To the extent that the pre-existing institution is expected to contribute or compete for resources (expertise, information or human capital) it can create barriers and obstacles for the bypass to obtain these resources. For instance, it could do so by lobbying to prevent adequate budgetary allocations to the bypass. Another strategy that can be potentially used is to argue that the government is wasting resources by duplicating services and institutions within the public system. The redundancy argument can potentially create public resistance to use the bypass. Moreover, the pre-existing institution can use negative publicity and spread misleading information, making citizens/consumers hesitant to use the bypass alternative. It could, for instance, spread rumours aimed at reducing public confidence in the bypass.

What are the possible outcomes if the pre-existing institution decides to fight back as part of an effort to boycott the bypass? Fighting back is inefficient because it increases the costs for the government to implement the bypass. By creating obstacles to the creation or implementation of a bypass, the pre-existing institution will make it more expensive
for the government to pursue the project. However, as I mentioned earlier, there are reasons to predict that the resistance to the creation or implementation of a bypass will not be as strong as resistance to changes in the pre-existing institution. Moreover, this type of resistance will require a fair amount of foresight on the part of those interest groups threatened by the bypass, which they may not have. Thus, although it is possible that such resistance may arise, it is certainly less likely than the resistance to traditional institutional reforms, and likely will not be as strong.

If such resistance is, however, successful, it can destroy a potentially successful bypass by depriving it of resources, or by using asymmetry of information to make consumers afraid of using it. Basically, the outcome would be that a potentially successful institutional reform would be killed by a kind of anti-competitive behaviour. Thus, the prediction is that such reaction will not generate any type of positive outcome.

### 3.2.2 Fading off and dying

Considering that a bypass is replicating a function that is already performed in the system, one can imagine that a successful bypass will grow by progressively absorbing the demand for services that was previously satisfied, if less effectively, by the pre-existing institution. As more government resources move to the bypass as a result of the increased demand for the bypass services, it grows from a pilot project into an established service provider that attends the needs of an ever greater number of consumers. If a significant number of people switch to the bypass, this may leave the pre-existing institution obsolete and with no work. Thus, for example, if drivers are able to obtain and renew licenses more quickly and efficiently from an institution that bypasses the existing licensing agency, fewer drivers will make use of the existing agency as time passes. This will in turn reduce the agency’s political influence, social status, and can possibly eliminate its ability to resist a proposal to simply expurgate it from the public system.

In order for this to happen, a series of circumstances need to be present. First, consumers/citizens need to effectively use the exit option by switching over to a service provider that suits their needs better than the pre-existing institution. Second, the pre-existing institution either must not have perceived the bypass as a threat, or was not able to react in a timely fashion to eliminate such threat (i.e. it must have been unable to boycott the bypass or to shape up in light of competition). The inability to react in a timely fashion can happen because of a lack of foresight or because of collective action problems: the traditional institution may identify the threat but it may be unable to organize its constituents to react in any effective way. Third, a person or an institution needs to take the active step of proposing to eliminate what became a useless institution from the system. Institutions do not simply fade away.

The possibility that the pre-existing institution might become redundant and shut down shows the ultimate appeal of public bypasses reducing obstacles to institutional reforms for development. Whereas the pre-existing and dysfunctional institution may be a strong and powerful entity before the creation of a bypass, it may turn into a less relevant institution incapable of resisting reforms once the bypass has evolved successfully to take
over the “market” for certain public services. Thus, one of the best outcomes that can be produced by a bypass is that it might reduce the pre-existing institution’s ability to resist reforms. However, all this potential will not be realized if nobody proposes the elimination of the pre-existing institution. In this case, the bypass will actually generate a vestigial body simply wasting public resources. And there is a real possibility that this could happen, as employees with little or no work are less likely to complain, and may be happy to remain unoccupied with work for as long as it is tolerated. This suggests that there would be a strong incentive to eliminate that dead body from the public system only in certain contexts, i.e. where there is significant pressure to free up valuable resources. In these cases, there should be little resistance to its elimination. Indeed, in a context of scarcity, people will be motivated to eliminate redundancy, an important concern that is likely to be raised once the bypass is created.

Eliminating the pre-existing institution is one of the possible outcomes that make bypasses an attractive alternative method of pursuing reform, a way to achieve effective institutional change without facing political resistance and opposition when reform more directly targets dysfunctional institutions. In the long term, this is a positive outcome as it resolves redundancy issues and leads to fundamental changes within the government. There is, however, a risk that the bypass, after becoming a monopoly, will begin to develop the same inefficiencies and problems that plagued the old institution.

3.2.3 Shaping up

The success and popularity of a bypass program might force the pre-existing institution to mimic the bypass or to seek other improvements of its own processes. This might happen for one of two reasons: (1) the current institution is inspired by the success and efficiency of the bypass or (2) the fear of becoming obsolete. It can also happen for a mix of both reasons. In the case of the second reason, shaping up becomes a natural outcome of a competitive process, in which the pre-existing institution perceives the bypass as a threat but reacts to it in a positive way by fairly competing in this market for a certain public service and trying to win consumers by offering a product of higher quality.

There are different strategies that a pre-existing institution might adopt in order to shape up. In cases where it is possible, the pre-existing institution may shape up simply by mimicking the bypass in terms of the way it provides services and modeling its own processes to fit that of the bypass. This is a relatively cheap alternative, but it may not be possible in all cases. For instance, in the case of Poupatempo, many benefits come from the fact that multiple services are offered in one single location. Thus, even if, for example, the department responsible for driver licensing starts issuing driver’s licenses faster than it used to, it will still be incapable of offering additional services such as criminal record checks, identity cards, and the other services available at a Poupatempo outlet.

Even in cases in which the pre-existing institution could perfectly mimic the bypass, and offer all the advantages offered by it, this would only allow it at best to match the
efficiency of the bypass. This might prevent further decline in demand, but it would probably not generate any positive effect in terms of attracting new consumers to win over the “market”. If the pre-existing institution decides merely to “catch up” to the bypass, a possible outcome is that both the bypass and the pre-existing institution would be good candidates for a merger into a single entity. In such a case, the government would be probably facing pressure to eliminate redundancies in the system. The possibility of such a merger will be considered below.

Alternatively, instead of mimicking the bypass, the pre-existing institution might decide to innovate to become even better than the bypass. In this case, the result would be even better, from the perspective of institutional reform, than a case where the pre-existing institution becomes irrelevant and is shut down. The question would then become how long the two institutions (the bypassed and the bypassing) would be able to sustain the competition and their ultimate fate. There are multiple equilibria that are possible to imagine. They include: (1) a stalemate in which the two institutions become merger candidates; (2) specialization, whereby both institutions divide responsibility over the services they both previously provided; and (3) one eventually loses its ability to compete successfully, becomes redundant and a target for elimination.

The risk is that before one of these equilibria develops, there may be a long period of time in which policy-makers are confronted with a redundancy problem, where citizens have two efficient service providers that consume significant fiscal resources unnecessarily (as they are just duplicating the state capacity to provide a certain service). The coexistence of two efficient institutions for a long period of time could lead to a waste of time, money and human resources if both institutions together have the capacity to serve more citizens than the actual demand for the services. There are also some other risks. If, for example, the government divides the allocation of resources equally between the two institutions, it could hinder the optimal development of each institution. In other words, it might be the case that each of them could improve even more if they had additional resources to invest. Once both of them start to improve and resources are divided, their potential to improve even more could be hindered. There is yet another risk: since the state is the one making allocation decisions, there is a risk that the state will try to pick the winner and favour one institution over the other. This might lead the state to invest more resources in one institution or the other regardless of its capability to offer more promising or self-sustaining innovations. This risk arises from the fact that service provision is likely to be financed by the state (as opposed to being financed directly by consumers, as in the case of vouchers).

3.2.4 Merging

In the case of a merger, the bypass and the pre-existing institution become one single entity which then assumes a monopoly in the provision of services. One of the rationales for a merger, as discussed above, is the possibility that the pre-existing institution might incorporate the innovations embodied in the bypass and start providing service with the same quality and expediency. In such a case, the government would have a strong incentive to promote the merger: to eliminate redundancy in the public service.
However, the merger can also be seen as a strategy of the pre-existing institution to guarantee its survival. Thus, the merger may be conceived as a solution of last resort for an institution that is foreseeing its own death but is incapable of either generating a successful boycott of the bypass or of shaping up to the competition. In these cases, it is unclear what the outcome of the merger will be. Like in the case of an optimal corporate merger, it is possible that the less efficient entity will become more efficient as it is incorporated by the bypass and forced to adopt its more efficient modus operandi. However, there is also a risk that the pre-existing institution will simply drag the bypass down. This will largely depend on the terms of the merger and which procedures, methods and modus operandi will prevail: the one adopted by the bypass, the one used by the pre-existing institution, or a combination of both. Alternatively, it is possible that the government promotes the merger as an attempt to force the pre-existing institution into adopting improvements. However, as I mentioned before, this is not a guaranteed outcome and will largely depend on the terms of the merger.

A merger can be conceived of as a potentially good solution to the redundancy problem in cases in which the pre-existing institution’s relevance has faded, but there are still significant obstacles to expurgating it from the system. There are, however, two risks. The first is that if the government is pressed to solve the redundancy problem and rushes into the merger, it may be left with a bad outcome in which the merger will simply drag the bypass down. The other risk is that the merger can lead initially to a positive outcome, but may progressively become less efficient with the disappearance of incentives to improvement in the absence of institutional competition. As mentioned above, this is not an exclusive risk of the merger, but it may also happen if the bypass starts operating alone after the pre-existing institution fades off and dies.

### 3.2.5 Dividing tasks and cream skimming

The last hypothesis that I will analyze is the possibility of the pre-existing institution to preserve its existence by retaining an exclusive set of services, while downloading others to the bypass. In this scenario, the division is structured in a way that services would not overlap. The bypass would therefore no longer be a bypass. Instead each institution would have the monopoly in the provision of a subset of services.

This might happen as a result of a strategic decision on the side of the pre-existing institution to use the bypass to its own benefit, transferring a block of services to the bypass that it does not want to perform, while continuing to function by providing other services that are carefully chosen. In this case, the division of labour would be combined with cream skimming in the sense that the older institution wants to get rid of functions that are regarded as unimportant, more demanding or non-financially rewarding. This

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division of labour might be proposed either at the time of the creation of the bypass or once the bypass has shown signs of success and is identified as a threat. Alternatively, the division of labour might result from a strategic move on the part of a government facing mounting resistance of the pre-existing institution towards the bypass (such as boycotts, for instance) and wants to offset some of this negative reaction. In this case, the government might cream skim the services in favour of the bypass, while keeping unimportant or less popular services with the pre-existing institution. This might facilitate the process of making the pre-existing institution fade-off, while at the same time offsetting opposition that can potentially harm or even kill the bypass.

The division of labour might generate a sub-optimal outcome if the bypass is efficiently providing a block of services and the pre-existing institution continues to inefficiently provide other services. If the same individuals or entities are in need of both the services provided by the bypassed and the bypassing institution, they will be negatively affected by the inefficiencies of the bypassed institution. This might offset the benefits provided by the bypass. If there are different groups using each of these institutions, there will be negative distributive consequences of the division of labour: a portion of the population will have the benefits of the bypass while the other portion will still bear the costs of the pre-existing institution.

**Conclusion**

Recently, institutional reforms became the center of development efforts, informed by the assumption that institutions matter for development. The wealth of empirical evidence to support this assumption, however, does not translate into guidelines or formulas for concrete reforms. So, developing countries are left with little guidance on how to transform bad or dysfunctional institutions into good or functional ones. Proceeding often in a trial and error fashion, developing countries have encountered at least three major obstacles to institutional reforms: lack of resources, social-cultural-historical factors, and political economy problems (i.e. reforms are likely to be blocked by interest groups that benefit from the status quo).

The central claim of this paper is that there is a possible alternative to institutional reforms for development that may help overcome these obstacles. It is called institutional bypass and it has four characteristics. First, the bypass keeps the original institution in place and therefore is less socially disruptive and less costly. By keeping the pre-existing institution in place, institutional bypasses can start small, or in the form of a pilot project. This reduces start-up costs. At the same time it allows for easy reversibility in case the pilot project does not work out. As the original institution is kept in place, shifting back to the previous status quo will generate little social disruption. Second, the bypass creates an alternative pathway to dysfunctional institutions. In the case of Poupatempo, for instance, the citizen still had the option to request documents via the traditional system. By being merely an alternative, the bypass is less prone to resistance from those who...
benefit from the status quo, while at the same time allowing for an option for those who incur particularly high costs due to the same status quo. Third, the alternative pathway tries to be more functional than the traditional one. There is no guarantee it will succeed, but the data on the performance of Poupatempo cited above shows it decreased the time for documents to be issued and reduced costs for the citizens without significantly increasing the costs for the state. Fourth, the intervention is related to a critical knot in the system (instead of trying to reform the entire system). In the case of Poupatempo, for instance, it was the time and fairness in the delivery of services that was the main concern, not the entire structure of the bureaucracy. And even within this realm, these concerns were related solely to certain services, instead of being a reform of every single service provided by the state. As a result of these four characteristics, institutional bypasses can help reformers overcome obstacles such as lack of resources, social-cultural-historical factors, and political economy problems.

Institutional bypasses have at least three advantages over traditional institutional reforms. First, an institutional bypass provides a clean break with the existing institution, helping to overcome path dependence problems and reducing the complexities caused by institutional interconnections. At the same time, the new system is not as disruptive as starting something from scratch and replacing an entire institution. Second, by keeping the traditional institution in place, the bypass allows for experimentation. The fact that the bypass is simply replicating a service or function that already exists means that reformers can easily abort it and go back to the existing system if something goes wrong. Therefore, policymakers’ hands are not tied to what exists already or by the fear of social disruption caused by the unforeseen consequences of reforms. This helps deal with the uncertainty that is often attached to institutional reforms. Third, the bypass allows for institutional competition, and can possibly feed back into useful improvements into the pre-existing institutional framework. The positive feedback can come in many forms, such as forcing the pre-existing institutions to implement the same improvements, or allowing them to keep their traditional schemes and, as a consequence, allowing the demand for their services to dry up until they vanish.

It is important to note, however, that institutional bypasses can only address a limited number of problems of dysfunctional institutions. Thus, they do not replace the need for major and all-encompassing reforms and should not be regarded as a substitute for them. As indicated above, one of the positive consequences of institutional bypasses is that they can stimulate traditional institutional structures to promote changes. However, by the same token, the feedback effect can be negative. One of the circumstances in which this might happen is when the ultimate goal of the reforms is to get rid of the existing system while the bypass only ends up reinforcing and strengthening it.

For instance, many people have criticized the idea of a “notarial citizenship” that is promoted by Poupatempo. The claim is that the Brazilian state requires too many documents, stamps and seals of approval from its citizens (i.e. citizens depend on notary services for most of their activities). It might be argued then that we should not be providing these services in a more efficient way. Instead, we should be getting rid of the need for Brazilian citizens to have so many government documents. Thus, the reform
should be aiming at eliminating the requirement, not allowing citizens to obtain them faster. And the problem is that the creation of Poupatempo might just reinforce this “notarial” system, making it more difficult to implement reforms that eliminate it down the road. If that is the case, the bypass might not be a good option. On the other hand, if the bypass can generate immediate benefits for the population without completely stopping future reforms, there might be a case to proceed with it as an intermediary step that is feasible in the short term and capable of producing immediate (and much needed) benefits.

This example raises a concern about how to measure an institutional bypass’s success. I acknowledge that such concern needs to be addressed carefully on a case-by-case basis. At the same time, institutional bypasses have the potential to become one of the most effective ways to promote institutional change in developing countries. Thus, this concern should not prevent us from investing more time and resources to continue exploring this promising option, while at the same time being cautious about its risks.