Jonathan Pincus
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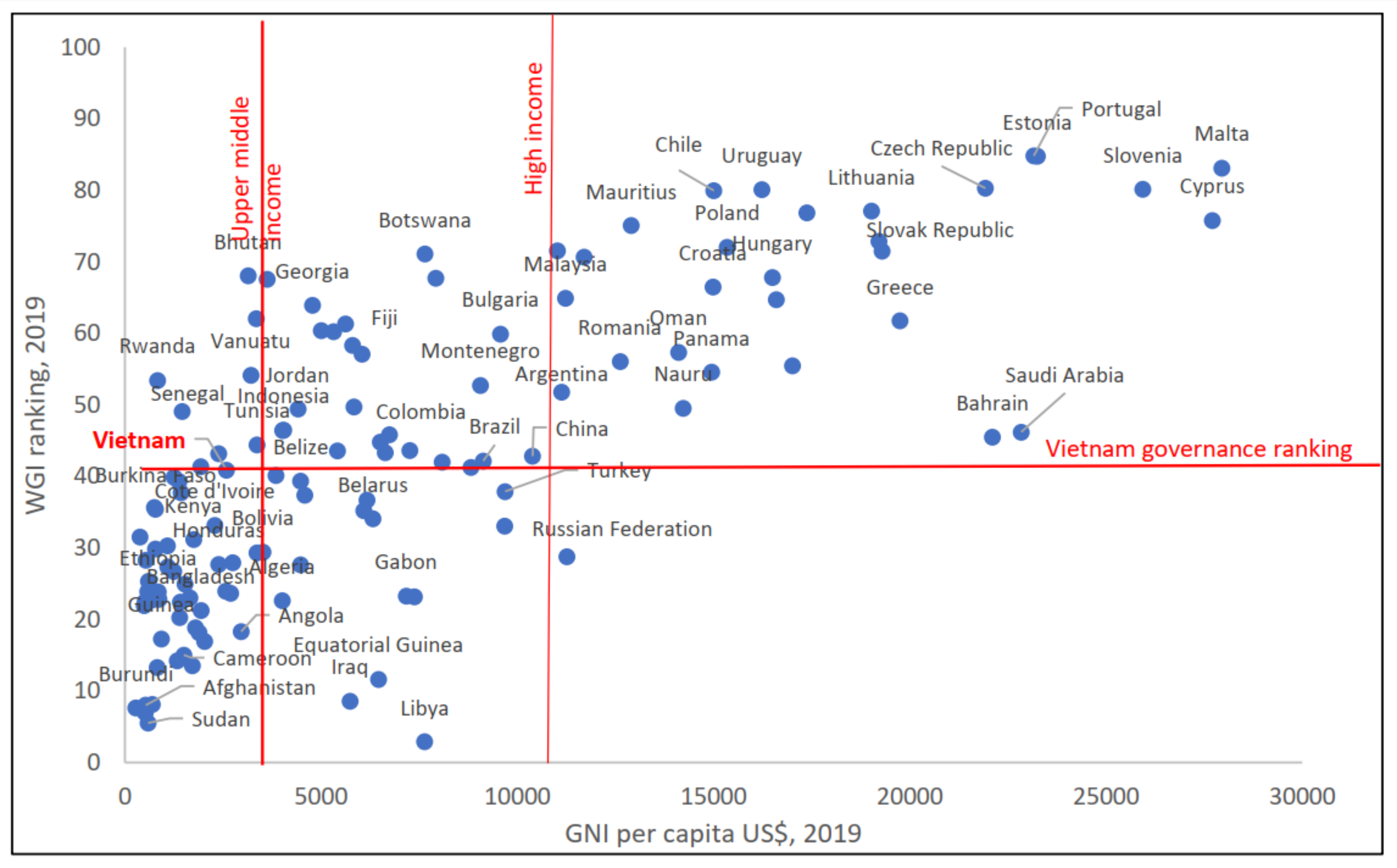
INSTITUTIONS

Development Policy

FSPPM

WORLD BANK: VIETNAM STUCK IN A “MIDDLE-INCOME INSTITUTIONAL TRAP”

World Governance Indicator rankings and per capita income, 2019



Source: World Bank (2021) “How Will Vietnam Blossom? Systematic Country Diagnostic Update

WORLD BANK: RICHER COUNTRIES HAVE BETTER INSTITUTIONS

Therefore, improving institutions is the key to economic growth

- Economic institutions are the rules of the game governing economic activity
- Formal institutions are laws, regulations and government agencies; also informal institutions like customs and traditions (caste system in India)
- Institutions create economic incentives and disincentives
  - Secure property rights encourage investment (intellectual property)
  - Disclosure rules increase access to information (insider trading the equity markets)
  - Traffic laws facilitate collective action (dangerous driving)
  - Public health regulations reduce risk (food safety, quarantine)

THE COASE THEOREM AND INSTITUTIONAL ECONOMICS

- Conventional economics focuses on individual decision making and ignores institutions
- Ronald Coase revealed the role of transaction costs and property rights in shaping incentives
  - Transaction costs: time and effort needed to reach agreement or complete deals
  - Property rights: Who owns what and what is the cost of protecting rights of ownership, for example who owns the data that you give to Facebook? You or Facebook? Can Facebook sell it to a third party without your consent?
- Coase theorem: When property rights conflict, parties can negotiate terms to achieve an efficient outcome
  - Water pollution: If property rights are clearly specified, the factory owner will negotiate with the people who use the river (the factory owner will compensate the river owners, or the river owner will pay the factory to stop polluting)
  - But if transaction costs exist, it may not be possible to reach an agreement
  - For example, the river has many owners, or no clear ownership

PROPERTY RIGHTS AND CONTRACTS

- People will not save and invest if they cannot be certain that they can protect their property from those who want to take it from them
  - Farmers who do not own the land will not make improvements to it
  - Savers will not keep their money in banks if their deposits are not protected by law
  - Banks will not lend money to businesses if they cannot enforce contracts
  - Bankruptcy procedures and courts: who gets the property when the business fails?
- Rule of law
  - Quality of courts: impartiality, independence from government, technical competence
  - Do the courts restrain the government from making decisions that impose costs on the public?

PRINCIPLE-AGENT PROBLEMS

- Principle-agent problems: Conflicts between a person or group and representatives authorized to act on their behalf
  - For example, workers are hired by managers to carry out tasks
  - But if labor is unpleasant, workers will do the minimum amount necessary to receive payment
- Employers incur costs to monitor workers and contractors
  - "Moral hazard": when it is in the agent's interest to act against the principal, for example a salesperson paid by the day will not chase new sales
  - Asymmetric information: Workers know more about their abilities and effort than employers; borrowers know more about their company than the banks that loan them money
- Institutions are created to reduce principle-agent problems
  - Piece-work payment or sales commissions to encourage effort
  - Financial disclosure rules

WHY DO DYSFUNCTIONAL INSTITUTIONS SURVIVE?

- If bad institutions are less efficient, why don’t they disappear? (an example of a functionalist argument)
- Institutional change is not costless:
  - New institutions create winners and losers
  - Coase theorem: Can’t winners compensate losers? Maybe not, if transaction costs are high (collective action problems, measuring costs and benefits) and benefits are low (organized crime and New York/New Jersey ports)
  - Institutional innovation will not occur if opposed by powerful elites (civil rights legislation blocked in US Senate for 100 years).

INSTITUTIONS MATTER – BUT CONTEXT IS IMPORTANT

- Economists assume that “good” institutions are easy to identify
- But every society/economy is different, and needs its own “rules of the game”
- Beware of “institution isomorphism” (under globalization we all end up with the same or similar institutions)

- Property right encourage investment, but every country has its own approach to land laws, patent laws, etc.
- “Corrupt” behavior defined differently, e.g. political donations in the United States.

POLITICAL INSTITUTIONS: DOUGLASS NORTH

- “Limited access order” versus “open access order”
  - In limited access orders elites use rents (profits) to build political loyalty, which prevents challenges to the social order (violence)
  - In open access orders elites agree that rents are distributed based on competition within a framework of rules and laws (constitutions) → loyalty to the rules (not to elites) is paramount
- How to transition from a limited to an open access order? Why would the elites decide to compete rather than cooperate?
  - Just creating formal institutions (property rights, independent central banks, parliaments) doesn’t guarantee movement to an open access order
  - Elites have to decide that their interests are served better by impersonal than personal relations

INCLUSIVE POLITICAL INSTITUTIONS: ACEMOGLU & ROBINSON (WHY NATIONS FAIL)

- Extractive institutions: Elites use their power to extract resources from the majority, reducing incentives to invest and innovate.
- Inclusive institutions: Guarantee of property rights and control over profits from enterprise.
- Nogales Arizona (USA) vs Nogales, Sonora (Mexico) same geography, climate but different outcomes because of inclusive and extractive institutions
- Glorious Revolution (1688) made Industrial revolution possible in England because it limited the power of the King and expanded the role of parliament to protect the rights of citizens.

THE COMMITMENT PROBLEM: HOW TO CONVINCE RULE MAKERS TO FOLLOW RULES?

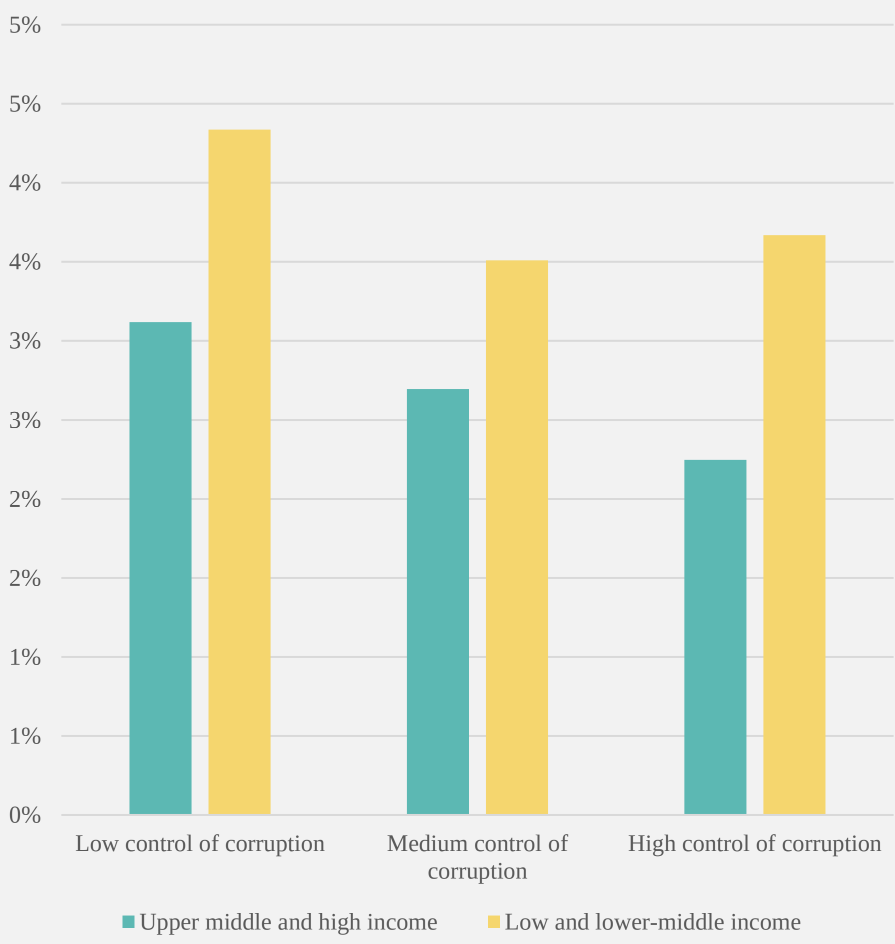
- Japan, Korea, Taiwan and China are examples of limited access order that grew quickly.
  - Discipline imposed by external market pressures or other external pressures
  - In Meiji Japan, South Korea, Taiwan and China elites convinced that loyalty to transformative states was in their interest
- North and A&R see the development problem as small elite groups extracting rents at the expense of the majority
  - In many countries, pressure for unproductive rents comes from below.
  - India’s electoral democracy has underinvested in health and education for 70 years.
  - Indonesia’s elected governments built less infrastructure than the military regime.

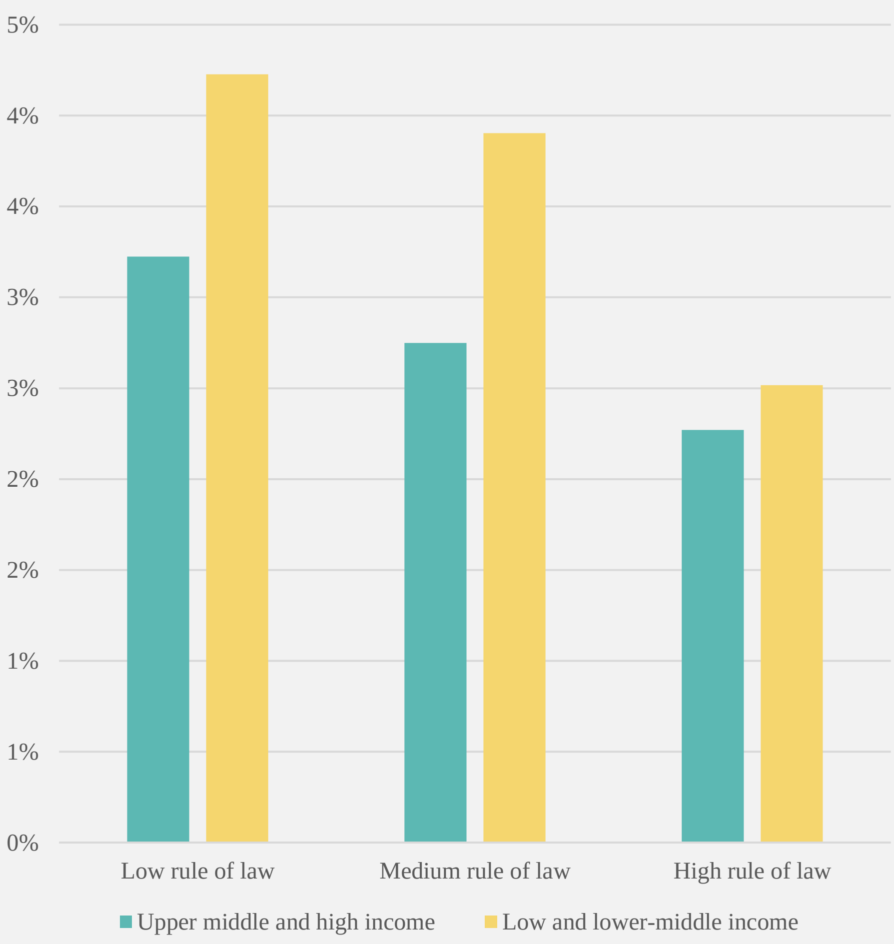
A SIMPLE EXPERIMENT WITH WGI DATA

What is the relationship between World Governance Indicators and GDP growth?

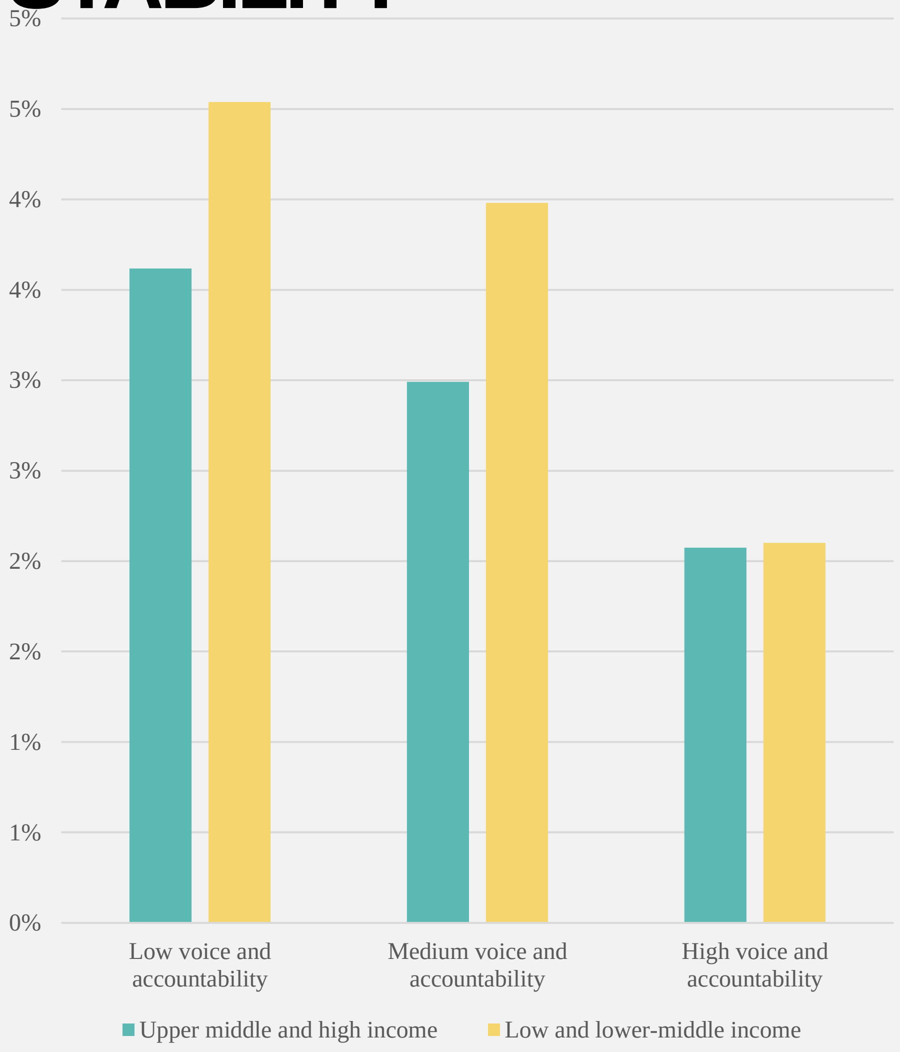
- https://info.worldbank.org/governance/wgi/
- Indicators compiled from a combination of perception surveys and outcome indicators, normalized on a scale from -2.5 to +2.5
- 174 countries divided into two groups
  - Low and lower-middle income countries in 2001
  - Upper-middle and high income countries in 2001
- Examination the relationship between average GDP growth (2001-2020) and:
  - Initial level of GDP per capita in 2001 (PPP) (because poorer countries grow faster)
  - World Governance Indicators average for 2001, 2010 and 2020, divided into three groups by average scores: low (less than -0.5), medium (-0.5 to 0.5) and high (above 0.5)
    - Control of corruption
    - Voice and accountability
    - Political stability and absence of violence
    - Rule of law
    - Regulatory quality
    - Government effectiveness

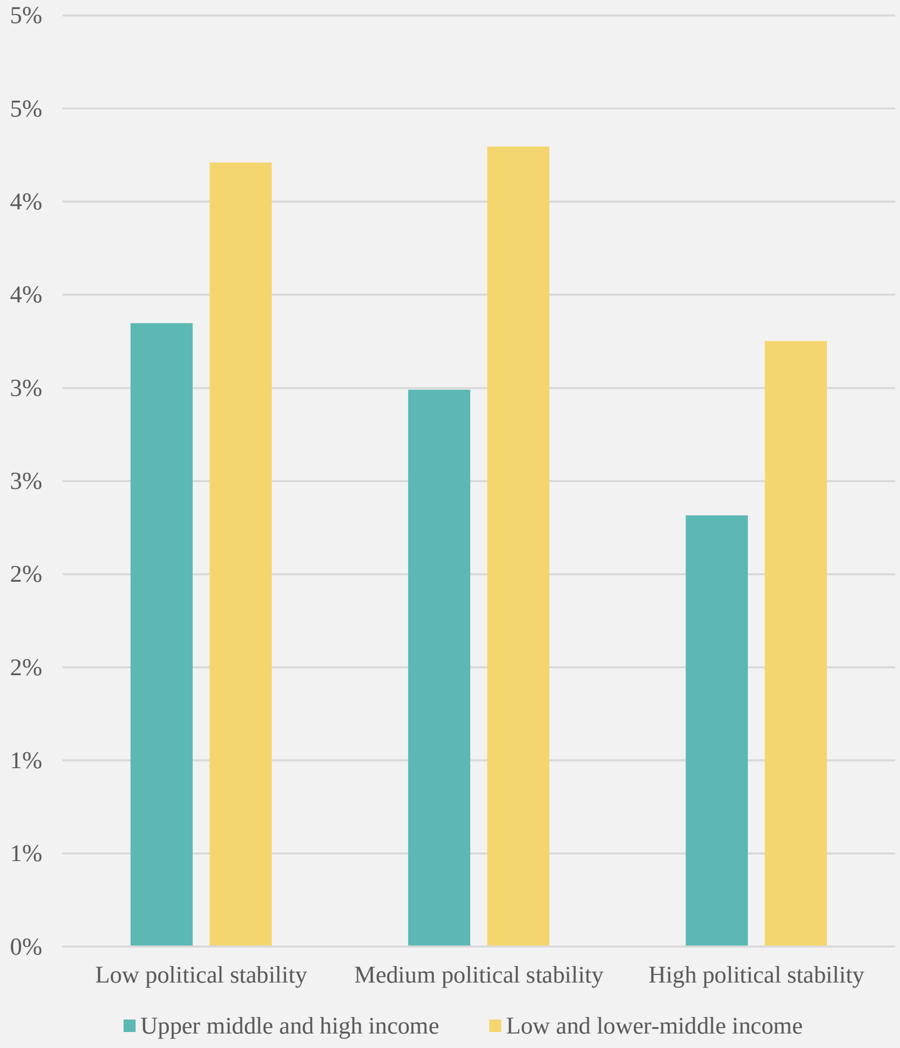
GDP GROWTH AND CONTROL OF CORRUPTION AND ADHERENCE TO THE RULE OF LAW



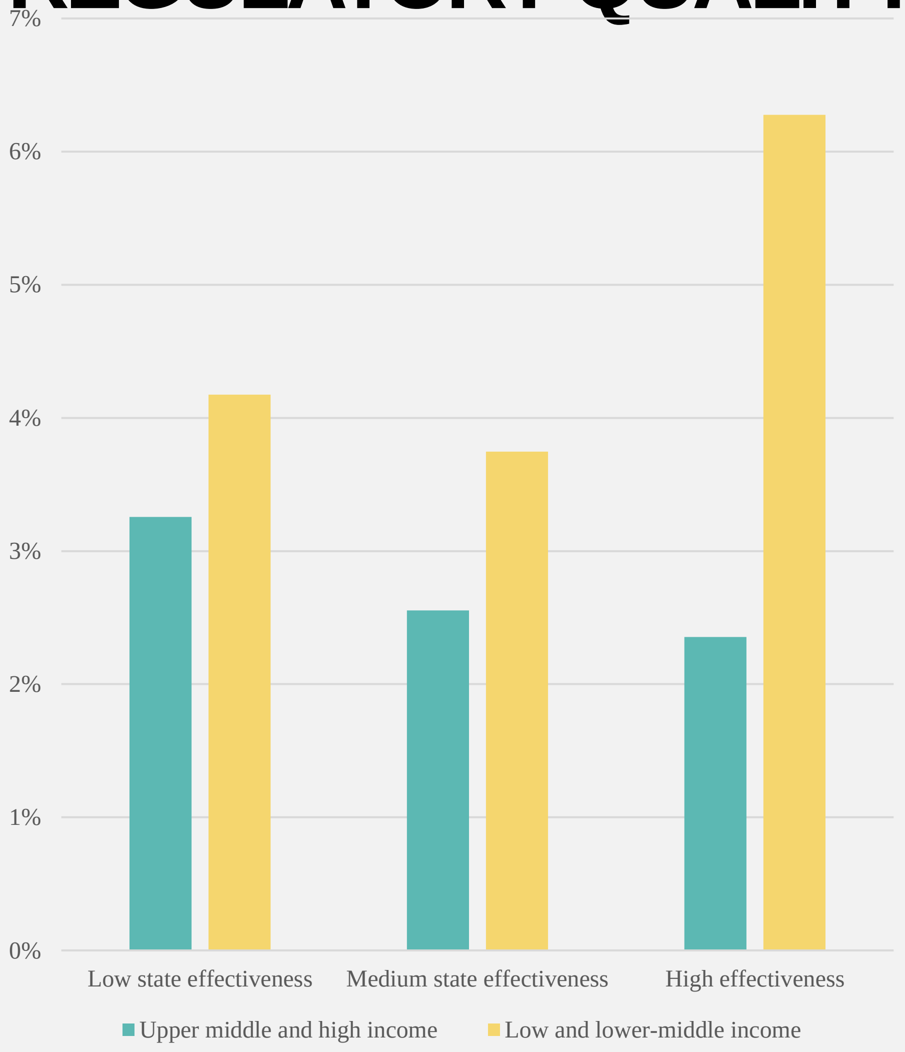


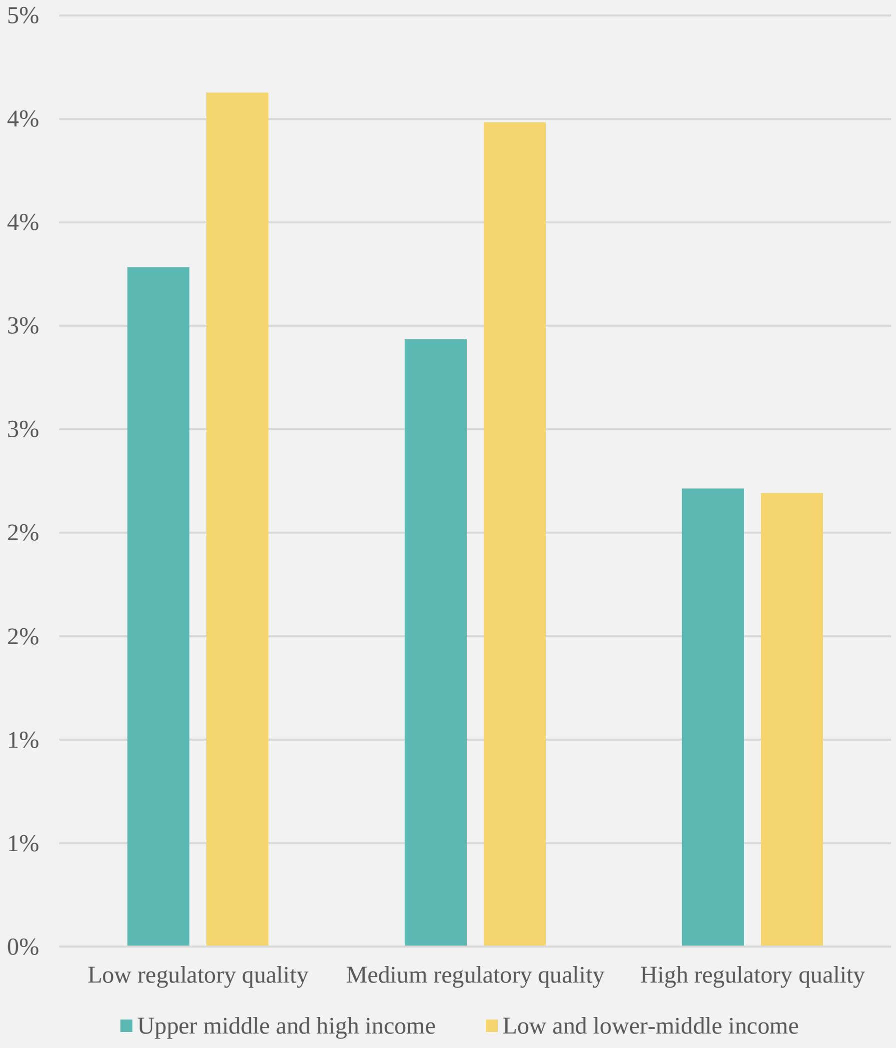
GDP GROWTH AND POLITICAL VOICE AND STABILITY





GDP GROWTH AND STATE EFFECTIVENESS AND REGULATORY QUALITY





GOVERNANCE AND GROWTH

- The only significant relationship is between GDP growth and government effectiveness.
- The other indicators are not related to growth or have a negative relationship to the rate of growth.
- https://info.worldbank.org/governance/wgi/
- How should we interpret these findings?
  - Measurement error? Combination of output indicators and perception surveys.
  - Direction of causality? Do higher incomes cause less corruption?
  - Other factors are more important, especially at the early stages of development
  - Diverse range of successful institutions that may differ from the standard western model.

CHAD CASE STUDY

- Test case of a multilateral institution (World Bank) attempting to promote institutional change using conditionality.
- The underlying theory: Chad is a limited access order in which the government uses oil money to buy loyalty from militias and other privileged groups
- Create new rules to limit the discretion of elites to spend oil money, forcing them to spend it on public goods.
- Did it work? Why or why not?

"We must root out corruption at the highest levels of government and make it look like it's happening at the lowest levels of government."