Development Policy

INSTITUTIONS AND DEVELOPMENT

Frank Hague: The King of Bosses

Frank Hague, Mayor of Jersey City, 1917-1947: "I am the law"

- Built the Jersey City Medical Center, one of the largest in the country, provided free care to all city residents
- Jersey City was a major manufacturing center and home of Italian, Irish and German migrant workers
- Built up the public payroll (took 3% from every public employee for himself)
- Harassed and even arrested political opponents, banned rallies against him
- Worth $10 million when he died but his salary was never higher than $8,000 per year

What are economic institutions?

- The rules of the game that govern economic transactions
- Can be formal (laws, regulations, market rules) or informal (customs, traditions)
- Institutions that share or conceal information: Information is not free
- Risk sharing: how society deals with risks like bad weather, market price fluctuations
- Property rights and the costs of protecting property from others, especially from greedy elites
- Collective action problems: Costs of getting everyone to cooperate, but benefits of cooperation may be large

Economics of institutions

- Until recently most economists focused on individual decision making and assumed that institutions were passive
- Property rights and transaction costs shape decision-making in public and private organizations (Ronald Coase, Oliver Williamson)
  - Why do we organize labor contracts annually or longer rather than on the daily spot market?
  - Why do corporations have their own marketing, accounting and legal departments rather than hiring these services from outside?
- Principle-agent problem: Costs involved in monitoring the behavior of workers or companies that you hire to perform specific tasks
  - “Moral hazard” occurs when it is in the agent’s interest to act against the principal
  - Contributed to rise of performance pay and other incentives in contracting

Why do dysfunctional institutions survive?

- Economists used to argue that bad institutions would eventually disappear because they are less efficient (functionalism)
- Induced innovation: Higher rice prices in Thailand 19th century forced change from property rights in people to property rights in land (land had become valuable)
- But institutional change is not costless
  - Even if the new institution is more productive it will create winners and losers
  - May be obstacles to the winners compensating the losers (collective action problems, transaction costs like measuring the benefits)
  - Institutional innovation may not occur because it is opposed by custom and tradition, or powerful elites.

Institutions matter – but which ones? And how much?

- Economic growth models assume that incentives work the same way everywhere – do they?
- Which “rules of the game” are needed for incentives to align with innovation and productivity growth?
- Economists have focused on
  - Property rights and enforcing contracts
  - Protection from the state (anti-corruption)

Rule of law: 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 that do not own the land will not make improvements to it
  - Savers will not keep their money in banks
  - Banks will not lend money to investors
- Enforcement of contracts
  - Quality of courts: independence from government, quality of legal education
  - Bankruptcy procedures and courts: who gets the property when the business fails?

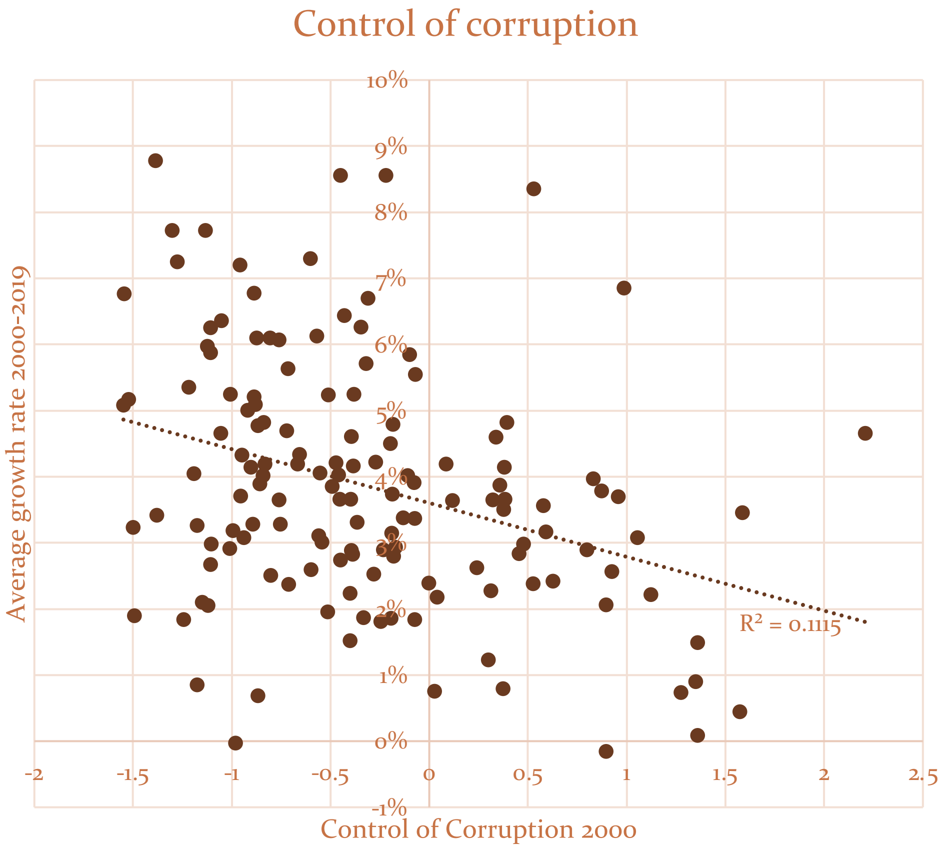
Corruption and development

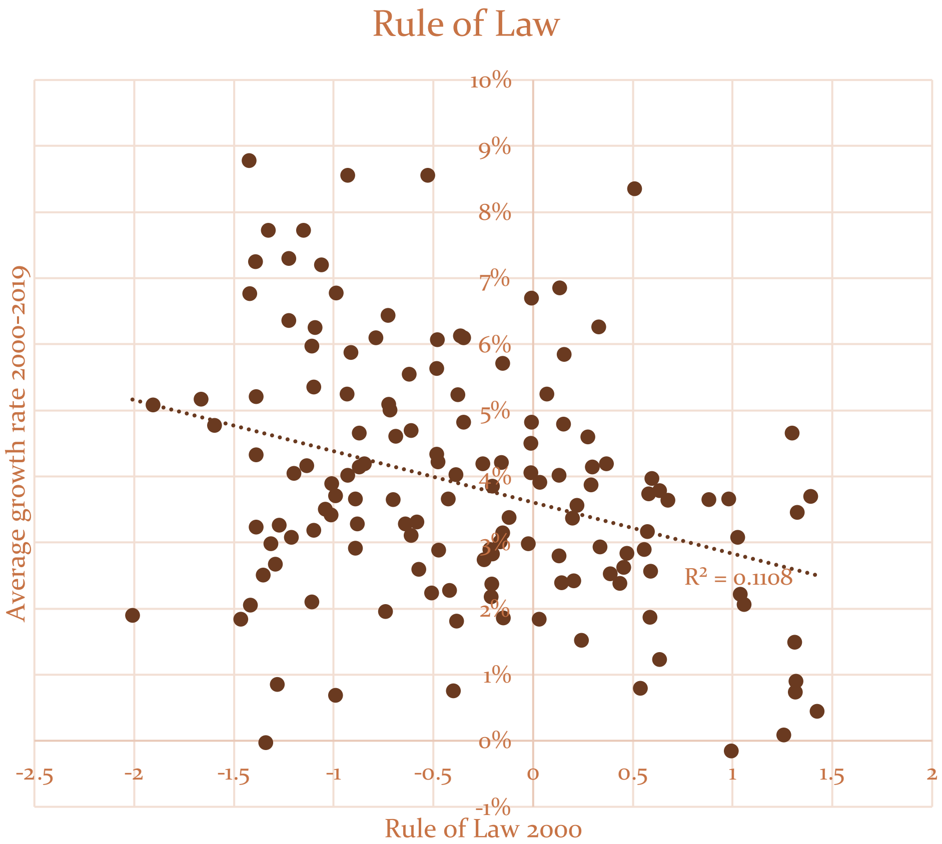
- Corruption is using the power of the government for private gain
- Diverts public resources and public action (regulation) from public to private purposes.
- Increases the cost of public administration.
- Favors connected inefficient businesses over unconnected ones
- But "greases the wheels" and reduces the effects of bad regulation and slow government?
- Mauro, P. (1995), "Corruption and Growth," Quarterly Journal of Economics, Vol. 110, No. 3: 681-712

World Bank governance indicators

- https://info.worldbank.org/governance/wgi/
- Governance indicators for over 200 countries 1996–2019
- Six dimensions
  - Voice and Accountability
  - Political Stability and Absence of Violence
  - Government Effectiveness
  - Regulatory Quality
  - Rule of Law
  - Control of Corruption
- Based on a combination of perception surveys and outcome indicators.
- Normalized on a scale from -2.5 to +2.5

World Bank governance indicators and growth (low- and middle-income countries)





Why don't we see a clear relationship between governance and growth?

- Many factors contribute to growth with or without governance (export manufacturing, for example)
- Perception indices are subjective: why does Thailand have a negative corruption and positive rule of law score?
- There are many ways to reduce risk, protect property and share information that don't look like standard "western institutions"
- What is control of corruption is an outcome not an input to growth?

Country	Control of corruption	Rule of law	Growth 2000-2019
Cambodia	- 1.0	- 1.1	7%
Indonesia	- 0.9	- 0.7	5%
Vietnam	- 0.6	- 0.4	6%
Lao PDR	- 0.9	- 1.0	7%
China	- 0.2	- 0.5	9%
Thailand	- 0.2	0.6	4%
Korea, Rep.	0.3	0.9	4%
Malaysia	0.3	0.2	5%
South Africa	0.6	0.2	2%
Costa Rica	0.9	0.6	4%
Uruguay	0.9	0.6	3%
Chile	1.6	1.3	3%
Singapore	2.2	1.3	5%

Political institutions: Douglass North

- Limited access order (almost every country in the world) versus open access order (rich countries)
  - Limited access orders elites use rents (profits) to build political loyalty, which prevents challenges to the social order (violence)
  - Open access orders use rules and laws (constitutions) and competition to distribute rents, which builds loyalty to the rules
- It is difficult to transition from limited to 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 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.

Mushtaq Khan: North and A&R ask good questions, but leave others out

- Development in Japan, Korea and China is difficult to explain using either the open access order or inclusive institution framework.
  - Discipline to transform these societies imposed by export (external market) and transformative states
  - In Meiji Japan, South Korea, Taiwan and China elites motivated by external threats and security conscious regimes
- North and A&R see the development problem as small elite groups extracting rents at the expense of the majority
  - But in many countries pressure for many groups—often large groups—for unproductive rents
  - Power of small businesses to demand protection in India has held back investment and technological change

Policy implications: Institutions matter but improving them is harder than it seems

- Economists are skeptical about collective action and prefer individualist solutions – recognition of the role of institutions came late, with a tendency to copy western examples
- Property rights, information and risk all fit neatly into a methodological individualism, which leads to policies favoring minimalist institutions (which may not work everywhere)
- Economists are less adept at understanding how institutions change and especially power dynamics that lead to change
- Politics often appears irrational to outsiders – path dependence, ideology, risk perceptions and intangible benefits/costs beyond immediate self-interest