FULBRIGHT UNIVERSITY VIETNAM

FULBRIGHT SCHOOL OF PUBLIC POLICY AND MANAGEMENT

Institutions and Development

Development Policy

Summer 2023

The first US Transcontinental Railroad

- Omaha to Sacramento section completed May 10, 1869
  - Pacific Railroad Act 1862 gave land grants and subsidies to Central Pacific and Union Pacific Railroads
  - Granted companies 4.5 million ha of land
  - $16-48,000 govt subsidy per mile of track
  - Amended Act 1984 allowed companies to issue their own bonds and doubled land grant
  - Central Pacific owners (including Leland Stanford) set up construction companies to contract from themselves
  - California gave Central Pacific $1.5 million when Leland Stanford was governor
- Land promised to homesteaders at $2.50-$5 per acre (0.4 ha)
  - Prices later raised by the railroad as land values increased
  - Violence as homesteaders evicted

Workers building the Central Pacific Railroad in Nevada, 1868

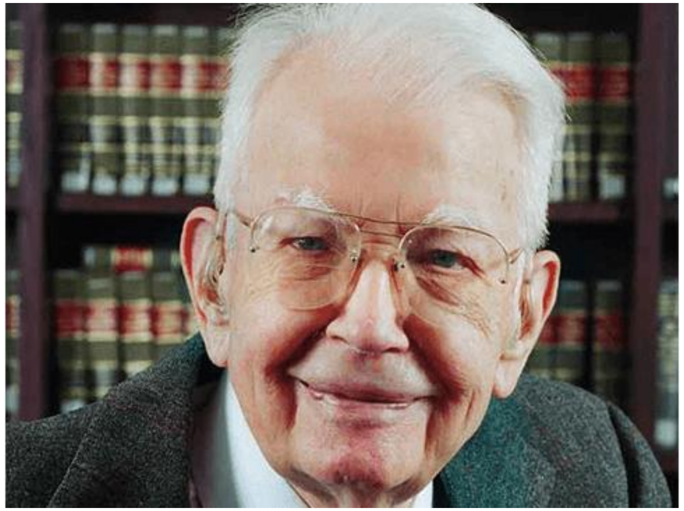
90% of the labor force building the Central Pacific was Chinese, recruited from Guangdong and California

What are economic institutions?

- The rules of the game governing transactions
- Laws, regulations and government agencies (formal institutions)
- Customs, habits, traditions (informal institutions)
- What role do institution play?
  - Share or conceal information: Disclosure requirements; privacy laws
  - Manage risk: Coping with natural disasters (Covid-19), price fluctuations (energy prices); life risks (pensions and health insurance)
  - Establish, limit and protect property rights: patent laws (intellectual property); land laws.
  - Promote cooperation (facilitate collective action): following traffic rules, recycling waste, picking up after your dog)

Ronald Coase

- “The Nature of the Firm” (1937): Why do companies hire people rather than contract their services on the market?
- Transaction costs: Searching for the service, bargaining, contracting the service, protecting trade secrets, incentivizing good performance.
- “The Problem of Social Cost” (1960): If transaction costs are low, and property rights are complete, external costs can be resolved through bargaining regardless of the initial distribution of property rights.



The Coase Theorem: An example

- A factory producing plastics releases toxic effluent into a local river.
- Two solutions if property rights are complete and transaction costs are low:
  - The factory can compensate the owner of the river
  - The owner of the river will pay the factory to stop releasing waste
- Bargaining will produce an efficient solution: if the market value of the plastics is greater than the market value of clean water, the factory will continue to operate.

Principal-Agent problems

- Conflicts between a person or group and representatives authorized to act on their behalf
  - Workers agree to carry out tasks for their employer.
  - But it is in their interest to do the *least amount of work* possible and still receive payment
  - Costs are incurred monitoring the behavior of workers or companies hired to perform specific tasks
- "Moral hazard": when it is in the agent's interest to act against the principal
  - A salesperson paid by the day rather than the sale will not work hard to make new sales
  - The recipient of a bank loan may use the proceeds of the loan for something other than that agreed
- Asymmetric information: Workers know more about their abilities and effort than employers

Institutions and market efficiency

- Economists have focused on rule of law and property rights as institutions essential to achieve efficient market outcomes.
- 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?

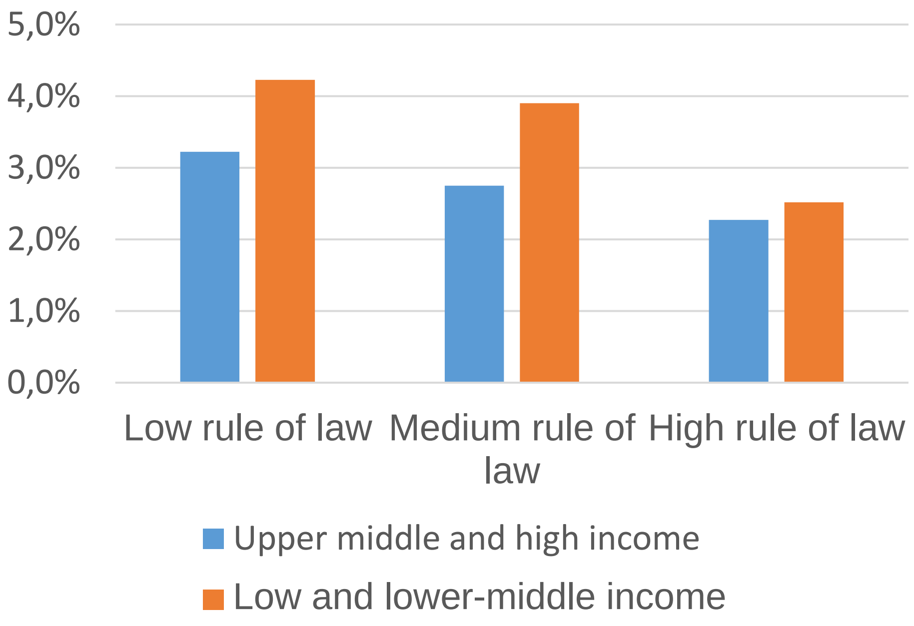
Corruption

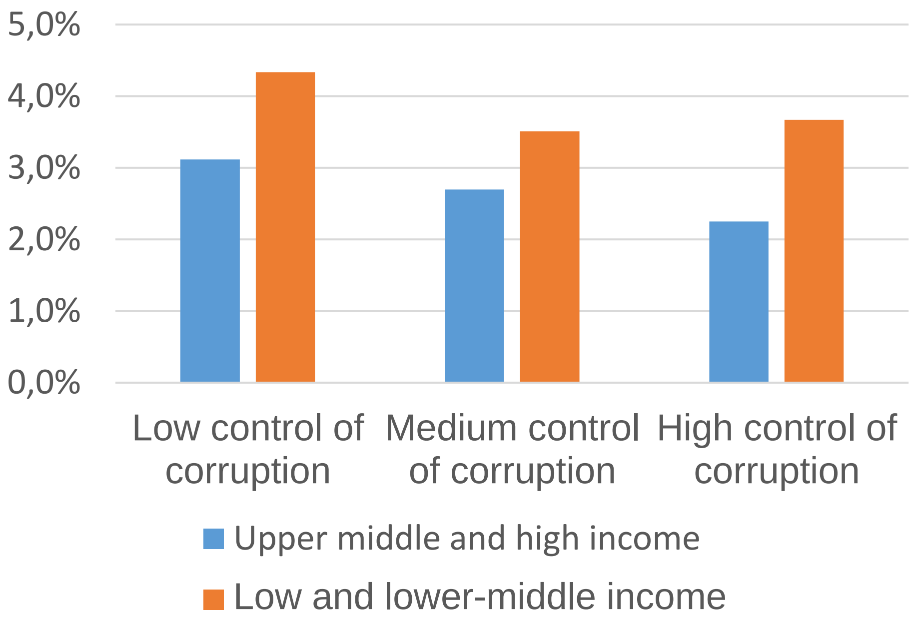
- Using the power of the government for private gain
- Diverts public resources and public action (regulation) from public to private purposes.
  - Increases the cost of public administration.
  - Favors connected inefficient businesses over unconnected ones
- But "greases the wheels" and reduces the effects of bad regulation and slow government?

World Bank: World Governance Indicators

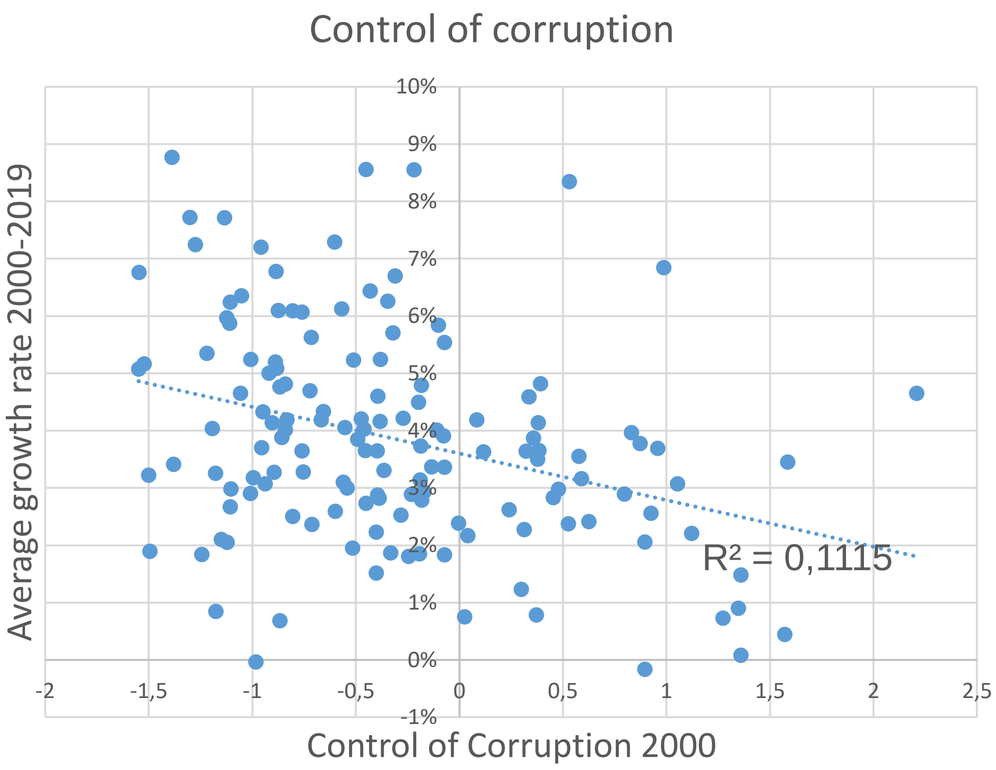
- https://info.worldbank.org/governance/wgi/
- Governance indicators for over 200 countries 1996–2021
- Six dimensions
  - Voice and Accountability
  - Political Stability and Absence of Violence
  - Government Effectiveness
  - Regulatory Quality
  - Rule of Law
  - Control of Corruption
- Based on a combination of perception surveys and outcome indicators.
- Normalized on a scale from -2.5 to +2.5

Governance indicators and growth: Rule of law and corruption

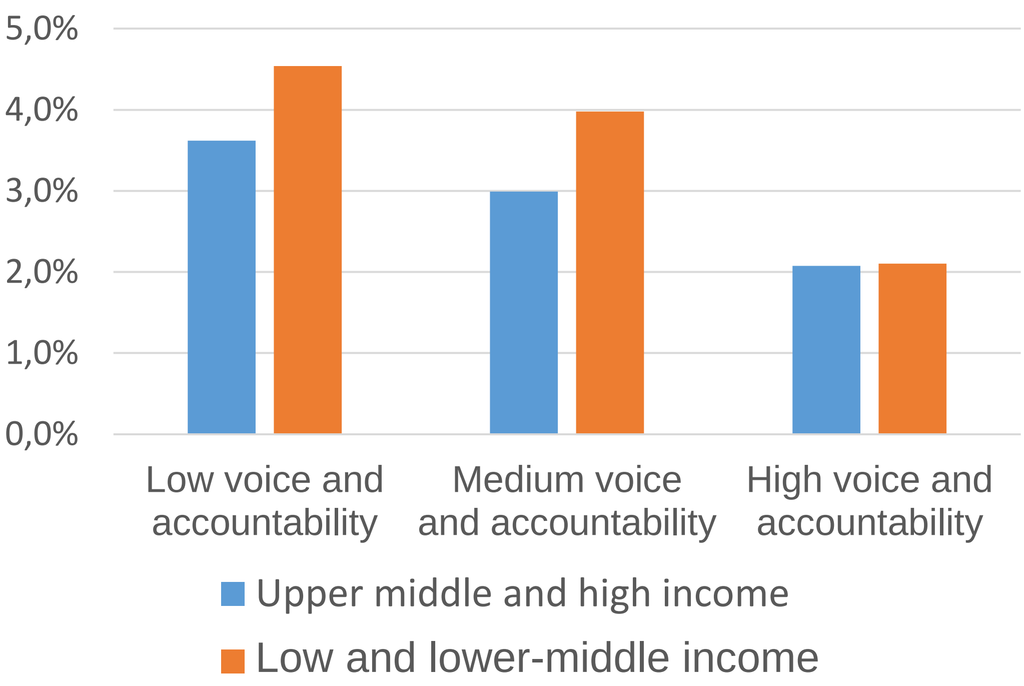


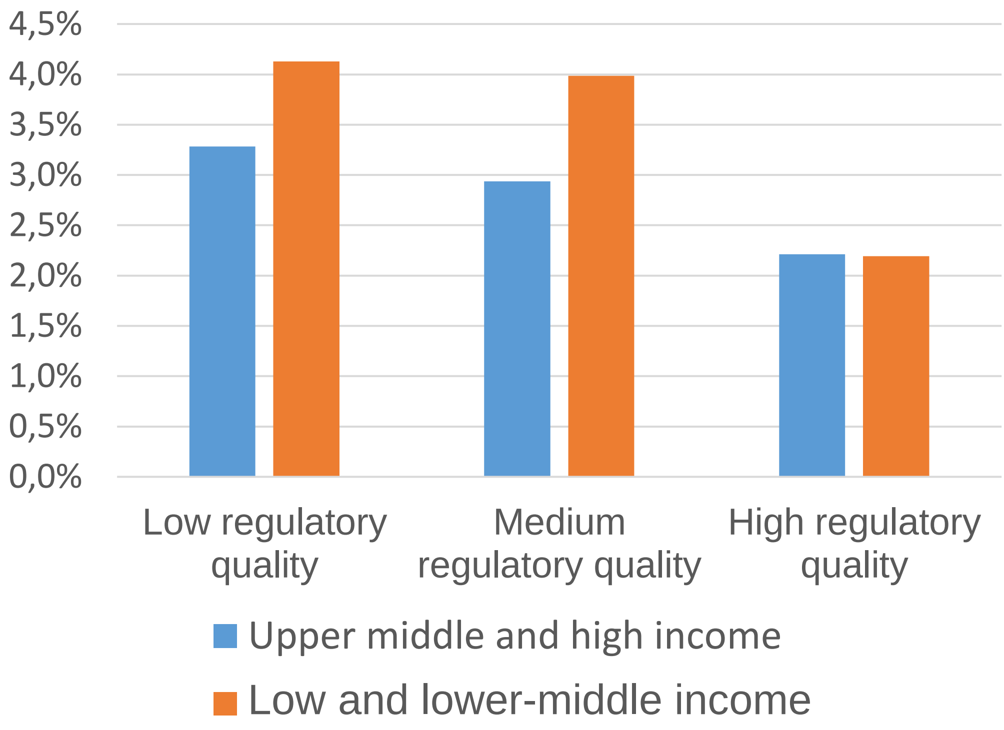


Long run balance depends on achieving growth of exports equal to growth of exports



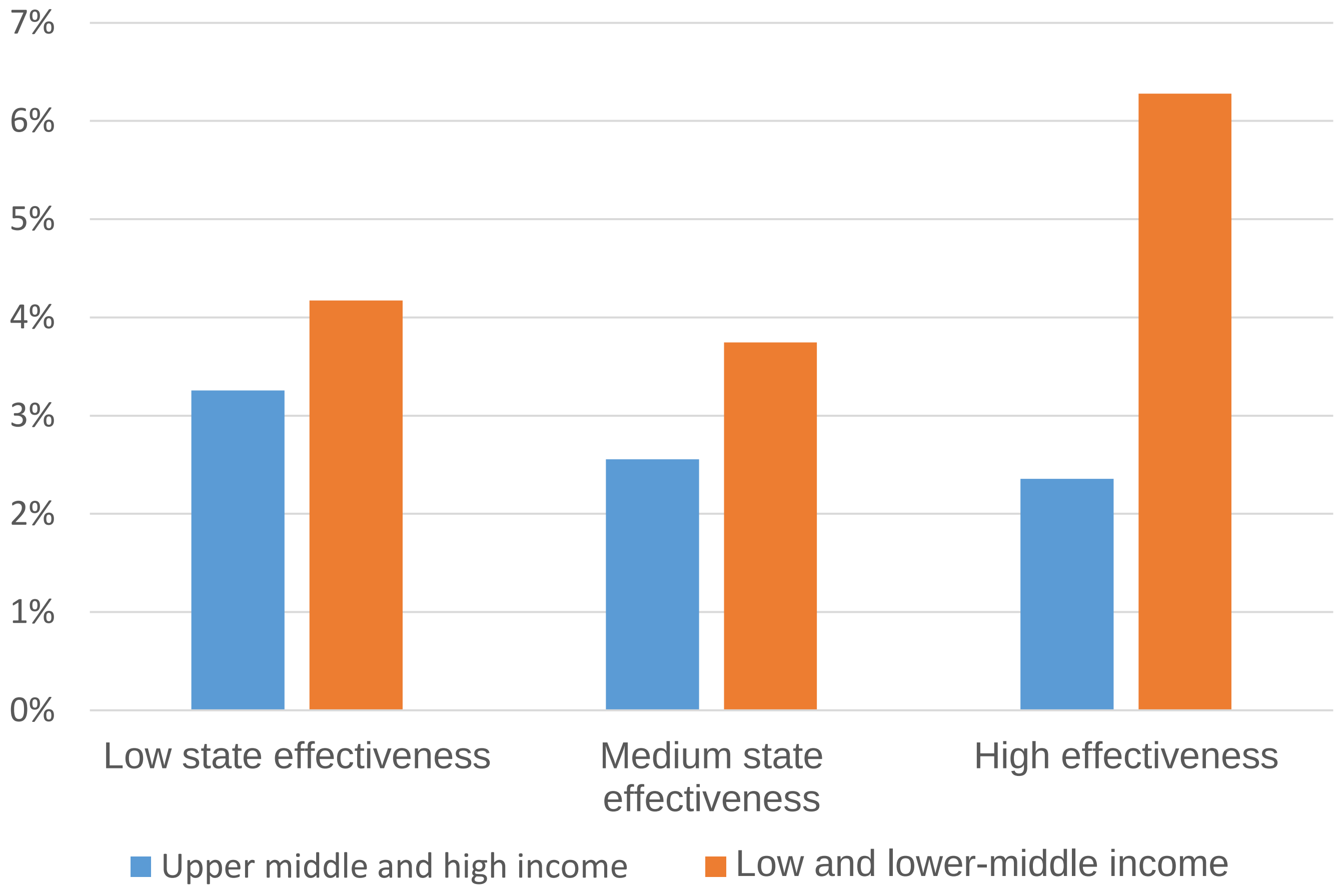
Governance indicators and growth





Government effectiveness and growth

- The only significant relationship between growth and governance is government effectiveness.
- Measures capacity of government to deliver programs, build infrastructure, collect taxes.



What explains the absence of relationship between governance indicators and growth?

- Many factors contribute to growth with or without good 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 if 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%

Acemoglu and Robinson: Inclusive political institutions

- Nogales Arizona (USA) vs Nogales, Sonora (Mexico) same geography, climate but different outcomes because of institutions
- Inclusive institutions: Guarantee of property rights and control over profits from enterprise; provide public goods, allow markets to flourish.
- Extractive institutions: Elites use their power to extract resources from the majority, reducing incentives to invest and innovate.
- 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: When do elites promote development and why do they block it?

- Development in Japan, Korea and China is difficult to explain using 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
- 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

America was not an inclusive society as a developing country

- Transcontinental railroad as an example of extractive institutions?
- Racism as an extractive institution
  - African Americans, slavery and Jim Crow
  - Asian prevented from owning land or joining labor unions in California
- Buying and selling public offices was a common practice in the 19th and even 20th centuries
- Civil service reform coincided with expansion of government, not contraction.
- Direction of causality: Do good institutions cause growth or does growth lead to good institutions

Institutions: Beyond methodological individualism

- Economists (following Coase) prefer market solutions: Stories about individuals responding to price signals are favored over stories that emphasize collective action.
  - Property rights, information and risk all fit neatly into a methodological individualism, which leads to policies favoring minimalist institutions
  - Institutional isomorphism: economic forces will act to make institutions look the same 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

Policy implications

- We should be careful about the assumption that "all good things come together"
  - Good institutions are not necessary for growth; growth does not necessarily generate good institutions
  - The process of institutional change is slow and unpredictable
- We should resist institutional isomorphism.
- Controlling the behavior of political and economic elites is a big challenge everywhere.
- The rule of law, less corruption, property rights are good in themselves, regardless of their relationship to growth

Discussion questions

1. Are “inclusive institutions” necessary for rapid growth? Why or why not?
2. Do the World Bank’s governance indicators explain differences in growth and development outcomes in Southeast Asia