FULBRIGHT UNIVERSITY VIETNAM

FULBRIGHT SCHOOL OF
PUBLIC POLICY AND MANAGEMENT

# Institutions

Introduction to Public Policy

Fall 2023

# Slavery: A unique American institution

- American slavery (1619-1865) was the first commercial, inherited, race-based enslavement in history
- 12.5 million Africans were brought to the Americas (400,000 to the US), as part of history's largest forced migration.
- Two million died during the voyage.
- At its peak, slave states produced 66% of the world's cotton, and more than half of US exports.

- Cotton was the oil of the 19th century and fueled American industrialization.
- Northern (non-slave) states operated 5 million cotton spindles by 1860.
- Slaves were prohibited from learning to read, could not own or inherit property, had no rights to their own children, and could legally be worked to death.
- Cotton exhausted the land so slave owners opened up the Southwest for cotton cultivation on land largely taken from Native Americans.

# What are economic institutions?

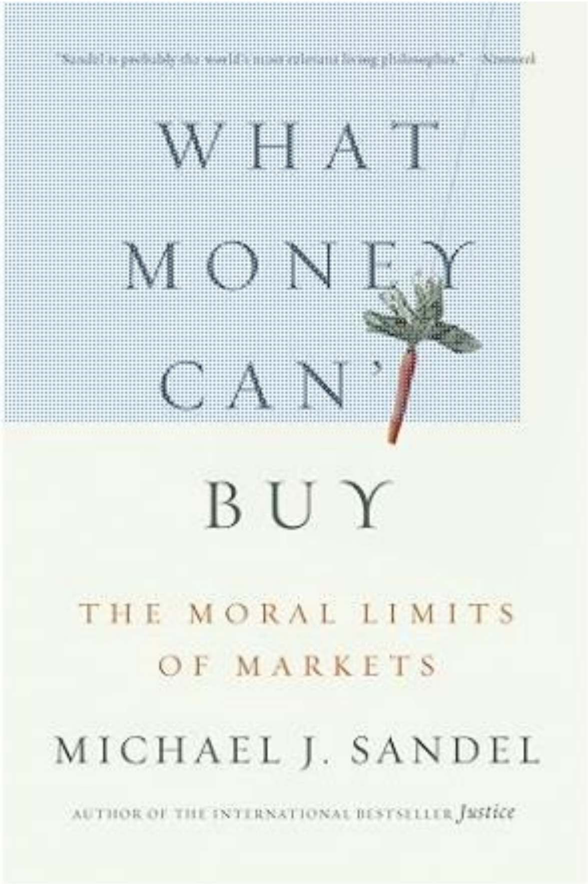
- The rules of the game governing economic transactions
- Laws, regulations and government agencies (formal institutions)
- Customs, habits, traditions (informal institutions)
- Institutions establish, define, limit and protect property rights—patent laws (intellectual property); land laws; Slaves.
- Share or conceal information: Disclosure requirements; privacy laws.
- Share and manage risk: Futures and options markets; health monitoring and control (Covid-19); manage price fluctuations (energy); life risks (pensions and health insurance).
- Promote cooperation (facilitate collective action): following traffic rules, recycling waste, picking up after your dog).

# Market institutions and 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?

# Market institutions and fairness

- Well-functioning markets are fair in the sense that if we are in control of our own choices (and so have no one else to blame?).
- Michael Sandel: Market reasoning has reached into new areas of life, and this is not always a good thing
  - Israeli day care center began fining parents who were late to pick up their children.
  - The parents came to see late pick up as a service that they bought, rather than a collective responsibility.
  - Markets are efficient but can undermine norms of acceptable behavior and accountability.



# Principal-Agent problems can produce inefficient outcomes

- 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

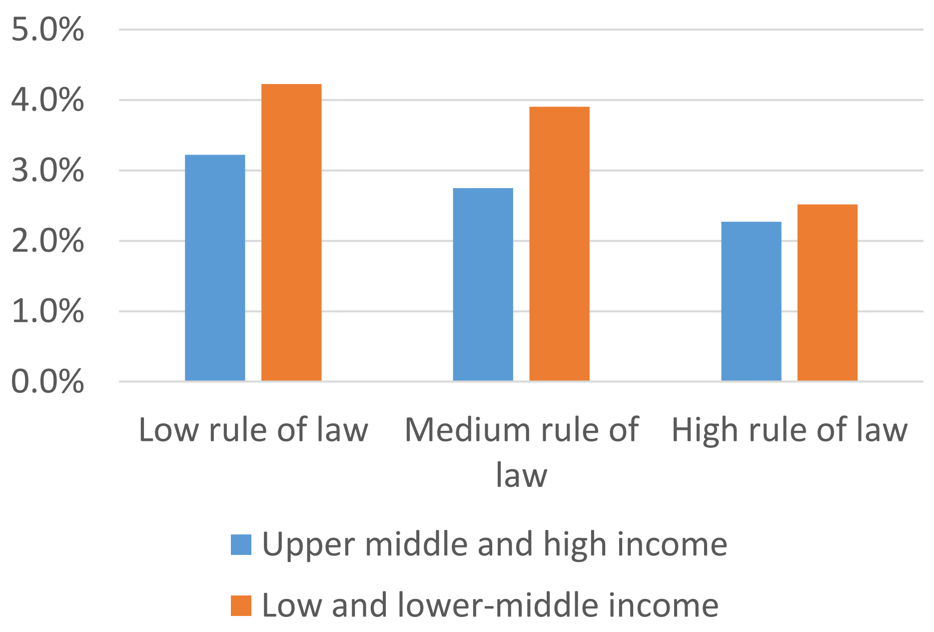
# Corruption as a principal agent problem

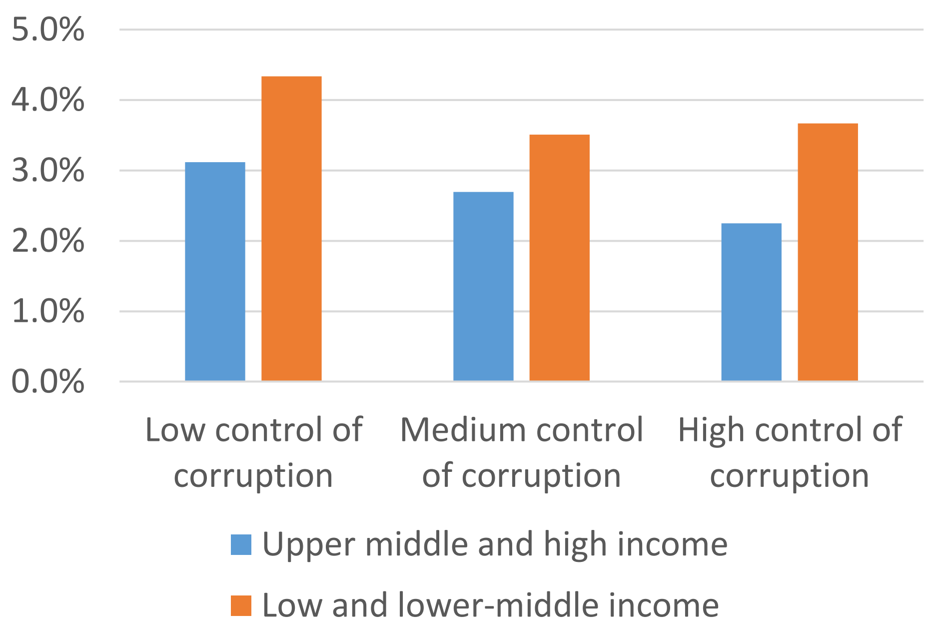
- The citizens are the principal and government officials work on our behalf.
- But we do not have complete information about their actions and intentions.
- The misuse of authority (over public decision and resources) for personal gain.
  - Increases the cost of public administration.
  - Favors connected and possibly less efficient enterprises.
- Corruption can “grease the wheels” of government and reduce the negative impact of regulations and slow government procedures.

# World Bank: World Governance Indicators

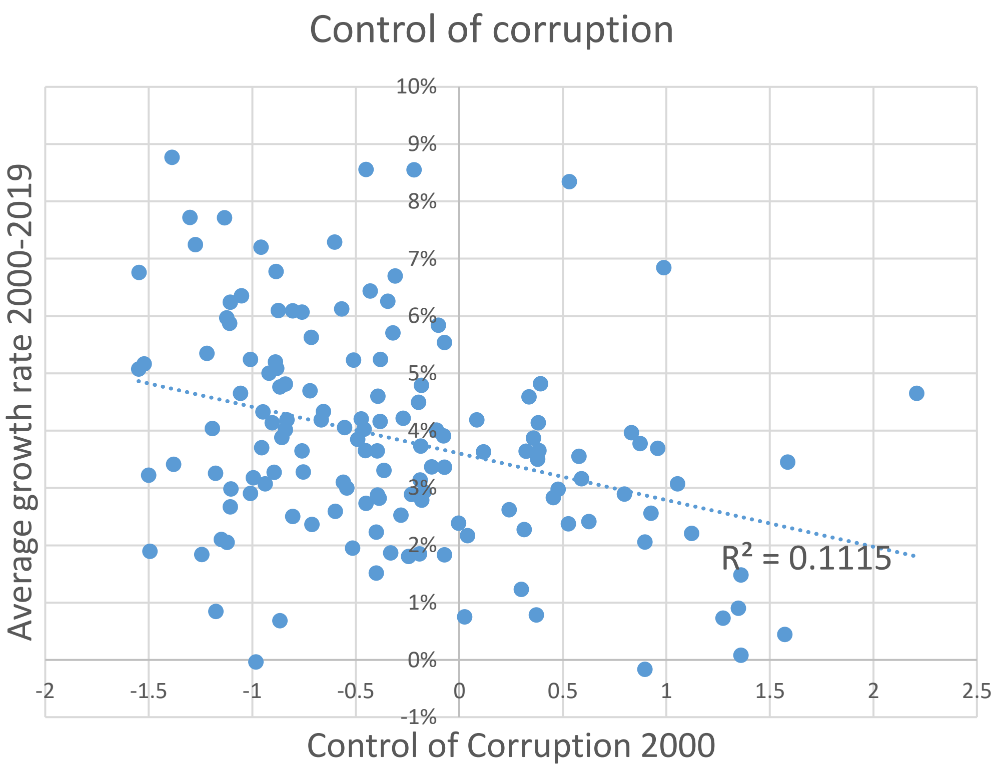
- https://info.worldbank.org/governance/wgi/
- Governance indicators for over 200 countries 1996–2022
- Six dimensions
    - Voice and Accountability
    - Political Stability and Absence of Violence
    - Government Effectiveness
    - Regulatory Quality
    - Rule of Law
    - Control of Corruption
- 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

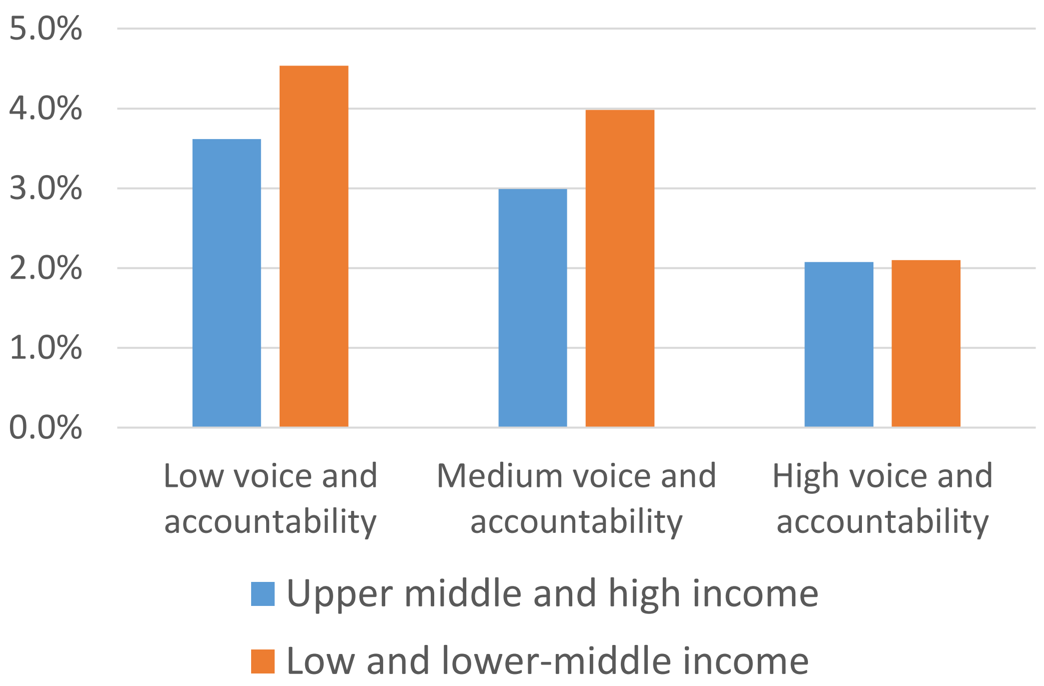


# Long run balance depends on achieving growth of exports equal to growth of exports

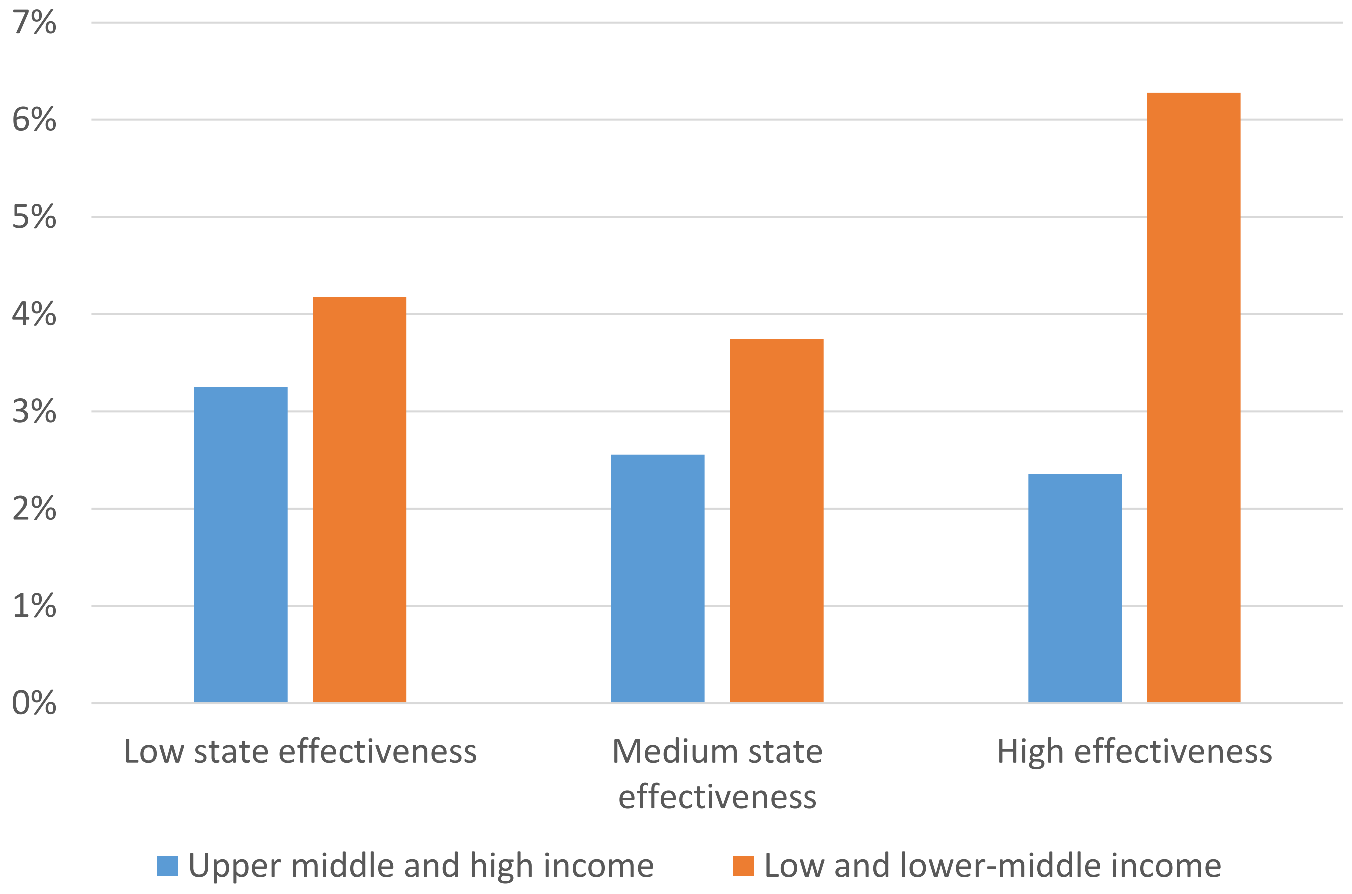



# Governance indicators and growth




# 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 cause good institutions?

# Policy implications

- We should be careful about the assumption that "all good things come together"
  - "Good" institutions (as defined in the literature) 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" the idea that "good" institutions always look the same wherever they are found.
- 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.