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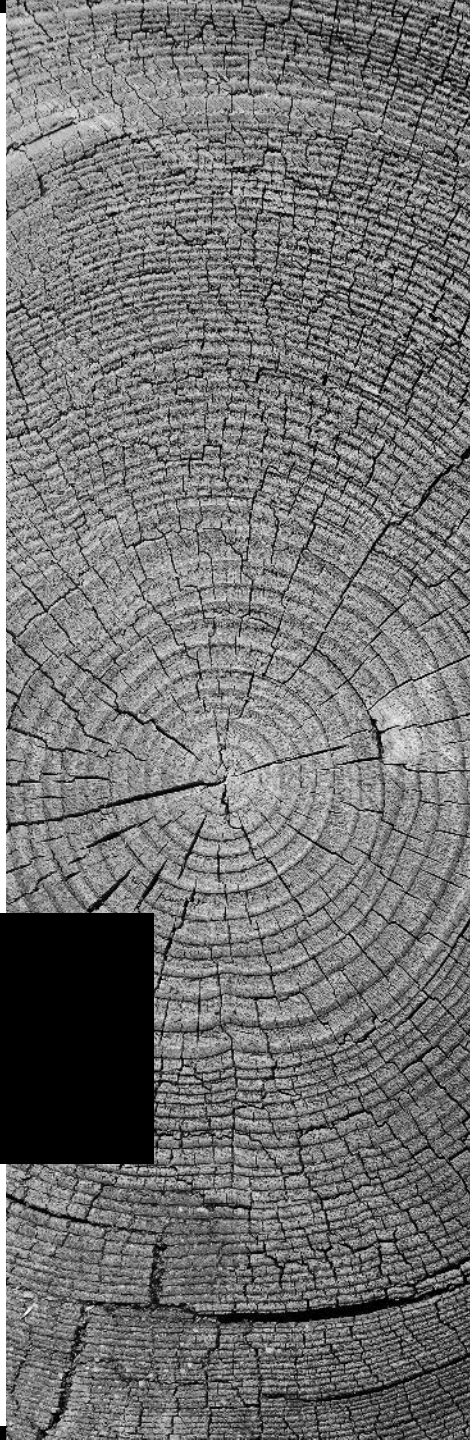
INSTITUTIONS AND DEVELOPMENT

Development Policy

FSPPM



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
- Formal institutions are laws, regulations and government agencies
- Informal institutions are customs, habits, traditions
- What do institution do?
  - Share or conceal information: Disclosure requirements; privacy laws
  - Manage risk: Coping with natural disasters (Covid-19), price fluctuations (energy prices); life risks (social protection institutions)
  - Establish, limit and protect property rights: patent laws (intellectual property); land laws.
  - Facilitate collective action: Social benefits of cooperative behavior (following traffic rules, recycling waste, saving water)

ECONOMICS OF INSTITUTIONS

- Conventional economics focuses on individual decision making and ignore institutions
- Ronald Coase and Oliver Williamson demonstrated the role of transaction costs and property rights in shaping economic outcomes
  - 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
  - If a factory is discharging toxic waste into a river, if property rights to the factor and the river are specified, negotiations will take place to reach an efficient outcome (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

PRINCIPLE-AGENT PROBLEMS

- Principle-agent problem: 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
  - Workers agree to carry out tasks but it 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” occurs 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 (so they are typically rewarded based on sales value)
  - Asymmetric information: Workers know more about their abilities and effort than employers
- In-house versus outsourcing: principle-agent problems
  - For example, a company can outsource legal work or create a legal department
  - Technology has played a role in increasing outsourcing by reducing the cost of monitoring

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
  - Coase theorem: Can’t winners compensate losers? Maybe not, because transaction costs are too high (collective action problems, measuring costs and benefits)
  - Example: Racial discrimination in labor markets is inefficient but persists
  - Institutional innovation may not occur when opposed by 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?

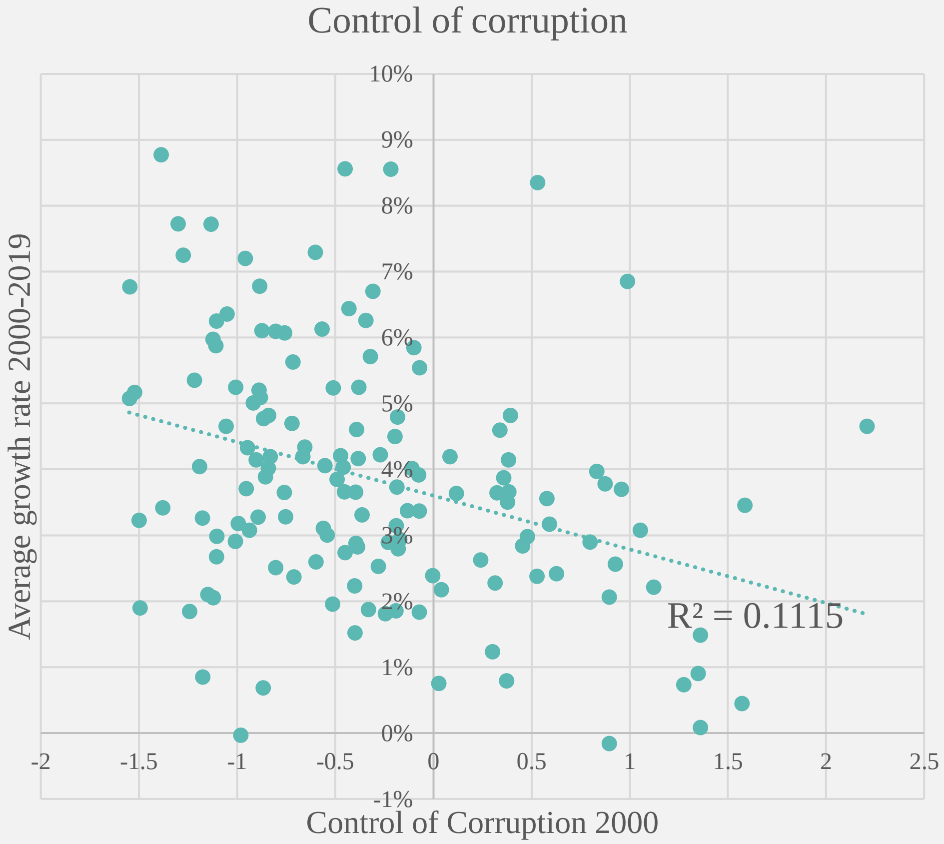
CORRUPTION AND DEVELOPMENT

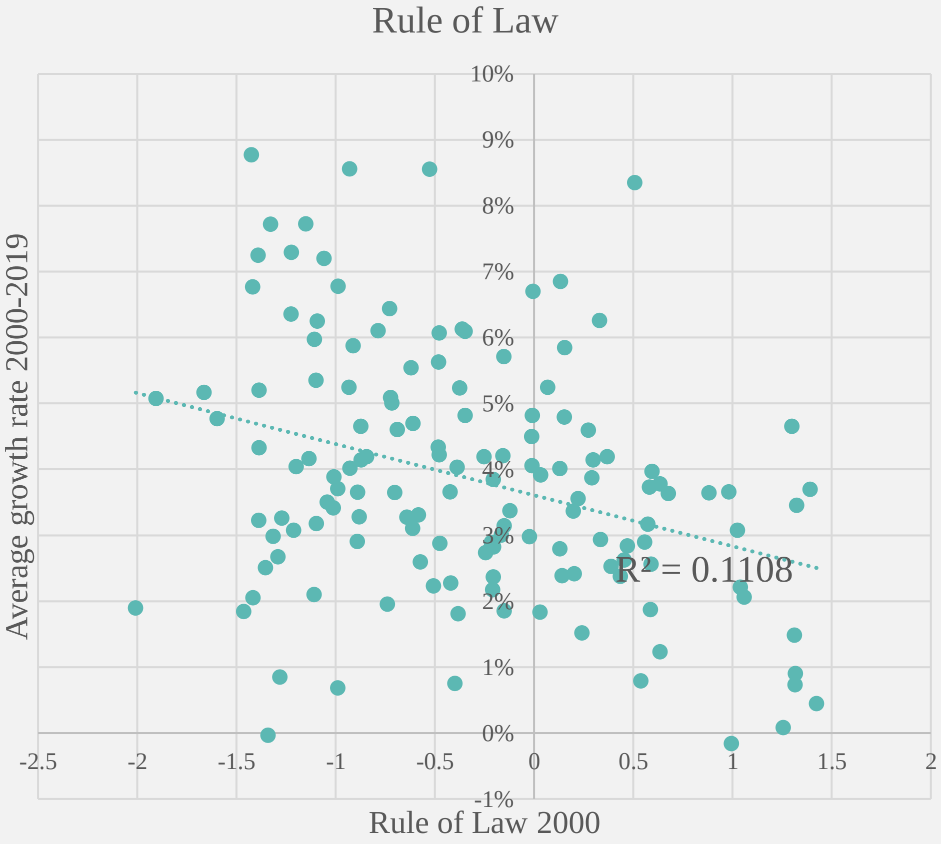
- Corruption is using the power of the government for private gain
- Diverts public resources and public action (regulation) from public to private purposes.
- Increases the cost of public administration.
- Favors connected inefficient businesses over unconnected ones
- But “greases the wheels” and reduces 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 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%

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 individual 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

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?