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Institutions and Economic Development

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Development Policy, 1960s to 1980s

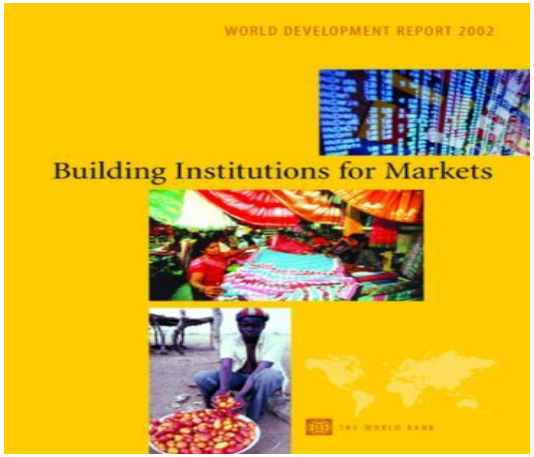
- The failure of ISI in many countries.
- Rise of the Washington Consensus: liberalisation of markets + “good governance” reforms (promotion of democracy, and civil service reforms).
- A somewhat naïve view that market based reforms can lead to economic progress.

Critiques of the Washington Consensus

- Structural adjustment programmes implemented by the IMF-WB mainly not successful in Africa and Latin America.
- Big bang market reforms did not seem to have the desired effects in transition economies.
- Developmental states in East Asia – strong and effective states that were interventionists and disciplined capitalists. Not free market economies.
- International efforts to fix governance problems through "good governance" reforms and new modalities of aid largely failed, both in terms of outcomes and in terms of addressing the root causes of the problem.

The Institutional Turn in Development Agencies

- The World Bank's 2002 WDR



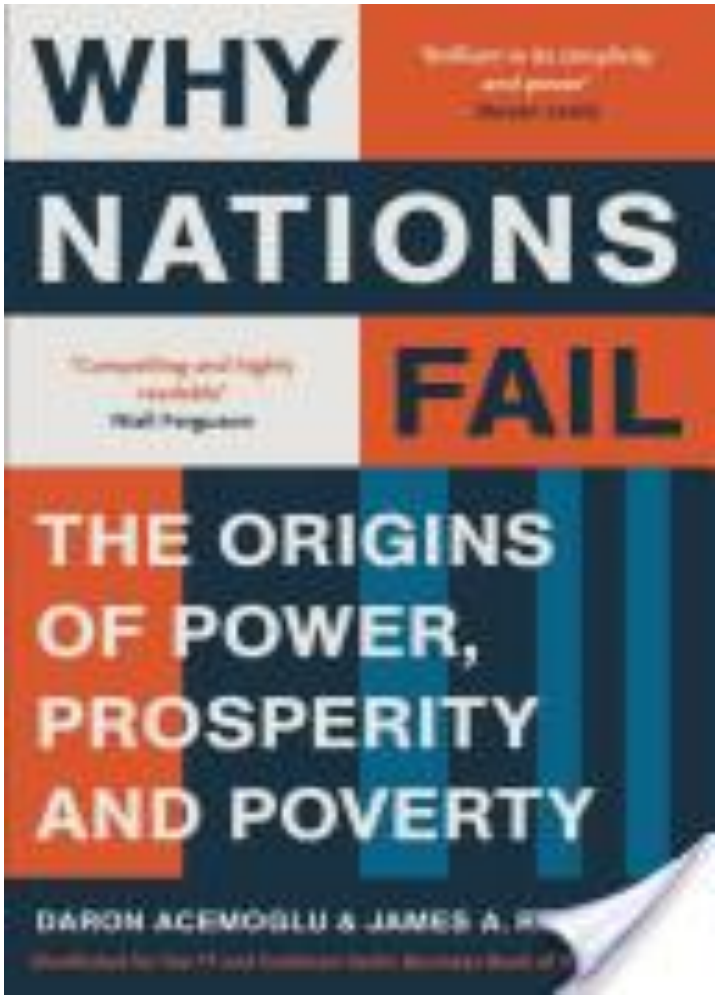
- Followed by DFID, the OECD and the IMF
- *DFID Issues* paper on 'Promoting Institutional and Organizational Development' (DFID, 2003)
- OECD - *Institutions and Development: A Critical Review* (Jűtting, 2003)
- IMF's *World Economic Outlook* for 2005 was devoted to 'building institutions'.

The Rise of New Institutional Economics (NIE)

- NIE, to separate it from the “old” institutional economics of Commons, Veblen, Mitchell.
- Several protagonists: Ronald Coase, Elinor Ostrom, Douglas North, Oliver Williamson (to name a few)
- A growing body of empirical research showed that institutions, understood as “the rules of the game” in a society, are central to the understanding of why some economies have performed better than others (Hall and Jones 1999, Acemoglu, Johnson and Robinson 2001, and Rodrik, Subramanian and Trebbi 2004).
- The common tenet in this body of work was the emphasis placed on transactions costs and imperfect information in understanding market failures in developing countries – institutions that evolve to lower transactions costs are key to the performance of economies.

Limitations of NIE

- If weak or poor institutions were the cause of growth and development, surely we could change these institutions?
- Why do we then observe the survival of apparently inefficient or extractive institutions?
- How and why do institutions persist once established?
- **Not enough to purely focus on institutions as the cause of development.**
- "the question of efficiency improving institutional change cannot really be separated from that of redistributive institutional change … when issues of collective action, bargaining power, class conflicts, mobilisation and struggle in the historical process are important" (Bardhan 1989).
- We need to understand <u>the political conditions</u> under which growth-impeding institutions persist, and why we very rarely see such institutions being replaced by growth-enhancing institutions.
- **Power and politics are central in understanding institutional change and persistence.**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NATIONS
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THE ORIGINS
OF POWER,
PROSPERITY
AND POVERTY
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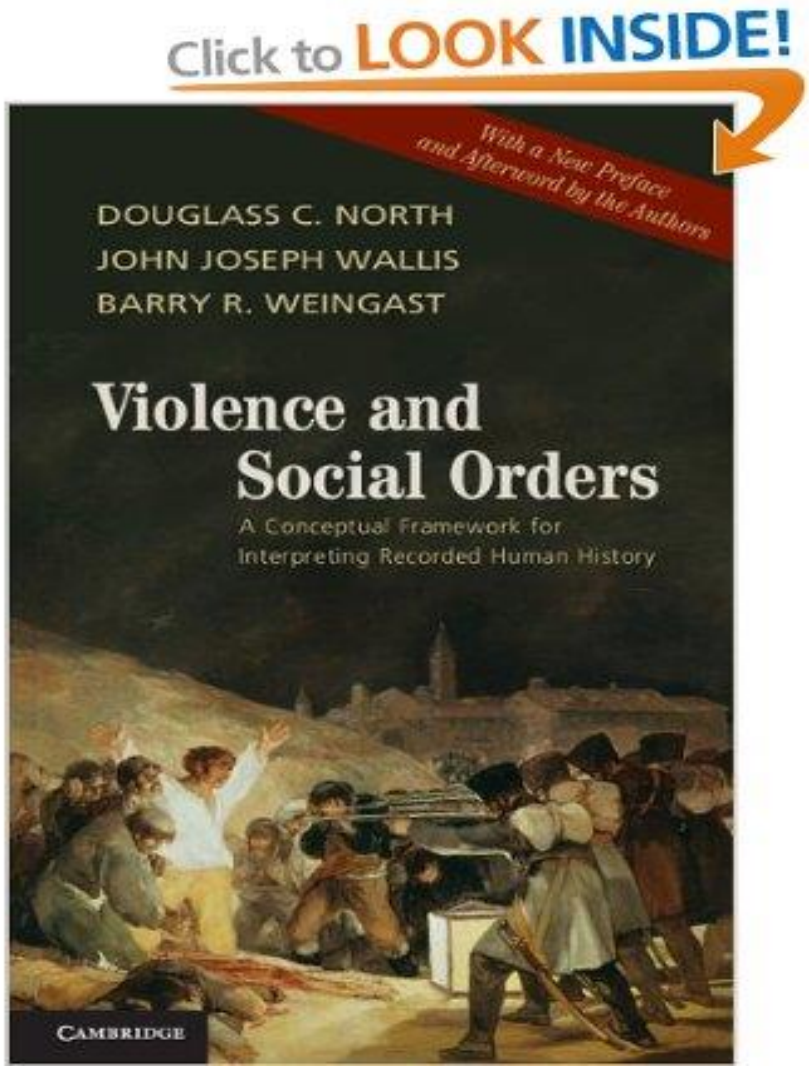
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Power and Elites

- Elites make bargains between themselves and establish institutions that align the distribution of benefits with the underlying distribution of power.
- Elite bargains give rise to institutions that shape social, political and economic change.
- Rent-seeking & -sharing/patronage becomes the norm
  - Between elites: incentivises powerful groups to remain onside; build credibility with economic elites (e.g. property rights, expropriation)
  - With middle/lower groups: public sector jobs; club goods to particular localities/groups; petty benefits through vote-buying etc.

A Summary of AR's Main Arguments

- Broadbased economic growth due to **inclusive economic and political institutions**. On the other hand, economic stagnation due to persistence of "extractive" institutions.
- Economic institutions and political institutions are determined by the **political equilibrium** - the prevalent power relations will determine which set of economic and political institutions are more likely to emerge.

		Economic Institutions	
		Inclusive	Extractive
Political Institutions	Inclusive	↻	⟵↓
	Extractive	↑⟶	↻

The dynamics of institutional change in AR

$$\text{institutions}_t \xrightarrow[\text{drift}]{} \text{institutions}_{t+1} \longrightarrow \begin{array}{c} \nearrow \\ \uparrow \quad \searrow \\ \text{critical juncture} \end{array} \begin{array}{l} \text{institutional} \\ \text{divergence} \end{array}$$

NWW

- **Economic development is the transition from limited access orders (LAOs) to open access orders (OAOs).**
- In LAOs, members of the ruling coalition use their privileged positions to create rents, **which are the glue that holds together the institutional arrangements between members of the dominant coalition.**
- The defining feature of OAOs as compared to LAOs is that interactions between different elite groups as well as between elites and non-elites take place through impersonal institutions, and that the rule of law is enforced impartially to all citizens.
- In contrast, exchanges between elites in LAOs take place through personalised interactions.

- For a LAO to transition to an OAO, elites need to find it in their interest to expand impersonal exchange, and by doing so, incrementally increase access to the organisations that create and sustain rents in the society.

Limitations of AR and NWW

- Both frameworks try and explain long-term economic development (or steady state growth) (e.g AR's emphasis on colonial origins, and NWW's only two successful countries are Chile and S Korea).
- But they are unable to explain medium growth.
- What triggers institutional change that can lead to growth accelerations or collapses?
- Institutional change in AR occur during "critical junctures" which are **stochastic** – not clear "under what circumstances political equilibria that lead to economic growth will arise" (AR 2008).
- Are the institutions that matter for medium term growth episodes <u>formal or informal</u>?

Institutions and Economic Growth

	R-Squared of regression				
	Bureaucratic Quality	Corruption	Law and Order	Democratic Accountability	Average
Level of income on level of quality of 'institutions'	0.457	0.434	0.464	0.476	0.472
Growth of GDPPC on initial level of 'institutions'	0.094	0.064	0.077	0.058	0.074
Growth of GDPPC on changes in 'institutions'	0.027	0.001	0.014	0.016	0.016
Number of countries (non-oil)	92	92	89	89	
Initial Year	1985	1985	1985	1985	
Duration	20	20	20	20	

Revisiting the Stylised Facts of Growth

- Long-run growth averages within countries mask distinct periods of success and failure.
- Massive discrete *changes* in growth are common in developing countries.
- Most developing countries experience distinct growth *episodes:* growth accelerations and decelerations or collapses (Kar et al . 2013, Pritchett et al. 2016, The Visual Handbook of Economic Growth available at www.esid.org).

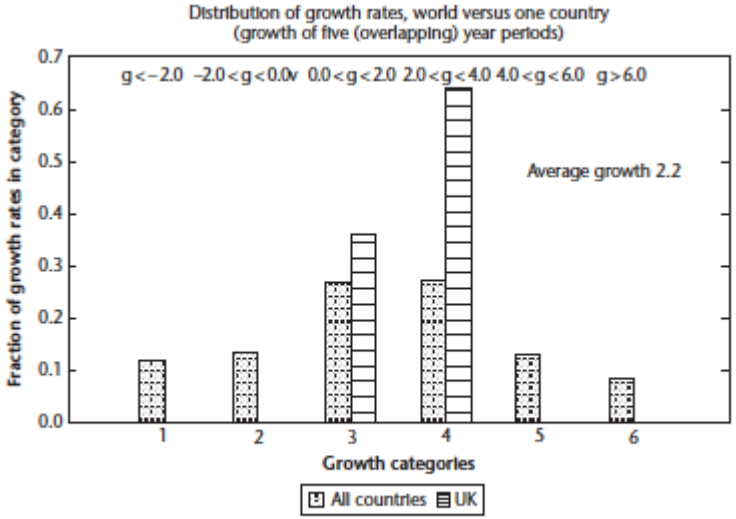


Figure 1.2. Steady growth—most growth concentrated in a narrow range
Source: Authors' calculations with PWT6.3 data (Heston et al., 2009).

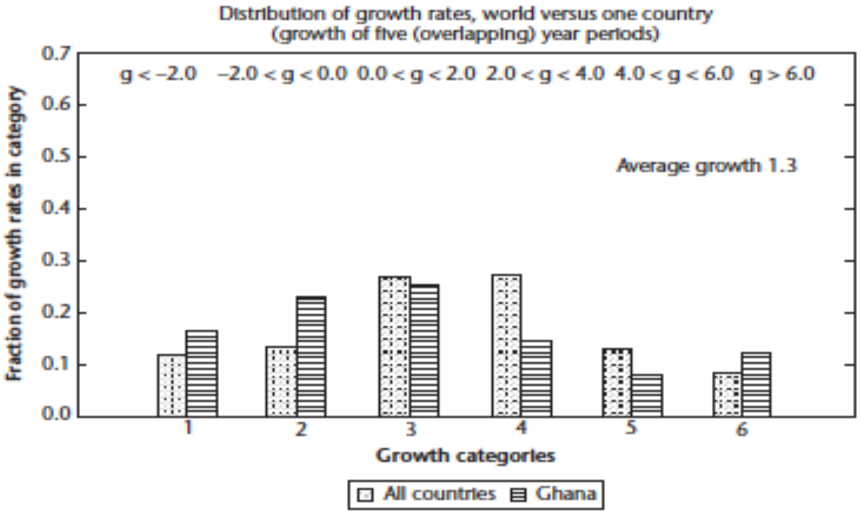
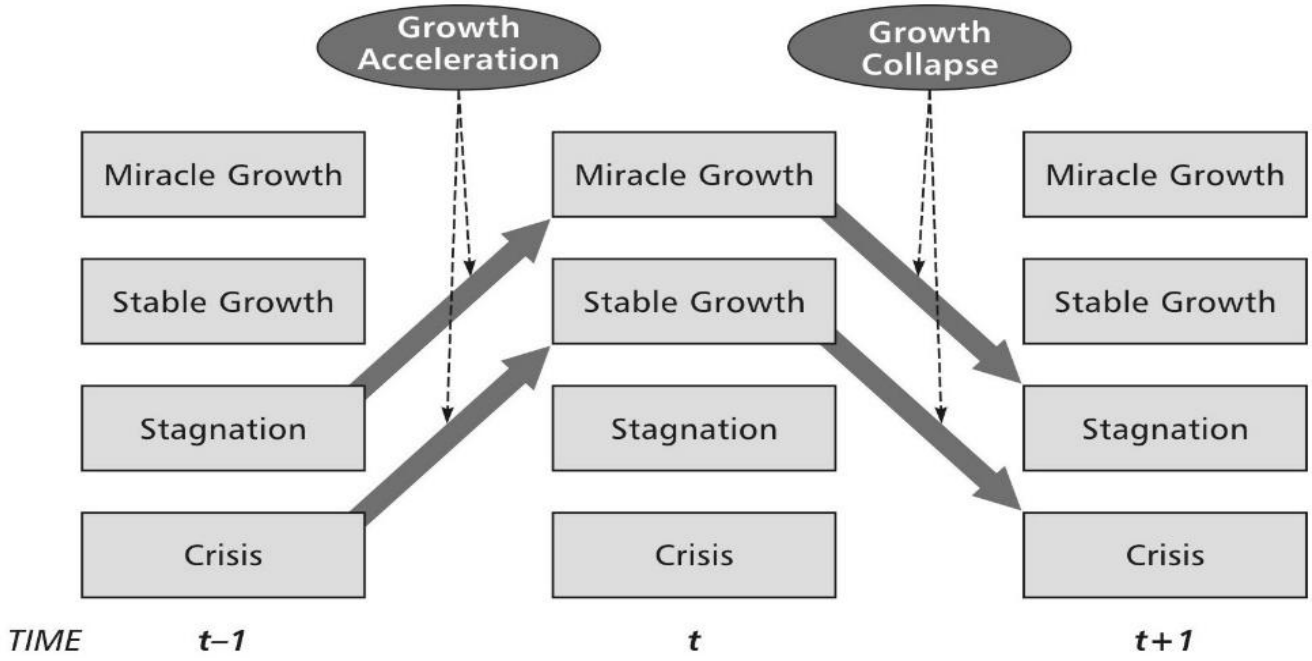


Figure 1.3. Unstable growth—episodes of boom and bust
Source: Authors' calculations with PWT6.3 data (Heston et al., 2009).

What We Need to Explain



esid | Effective States and Inclusive Development

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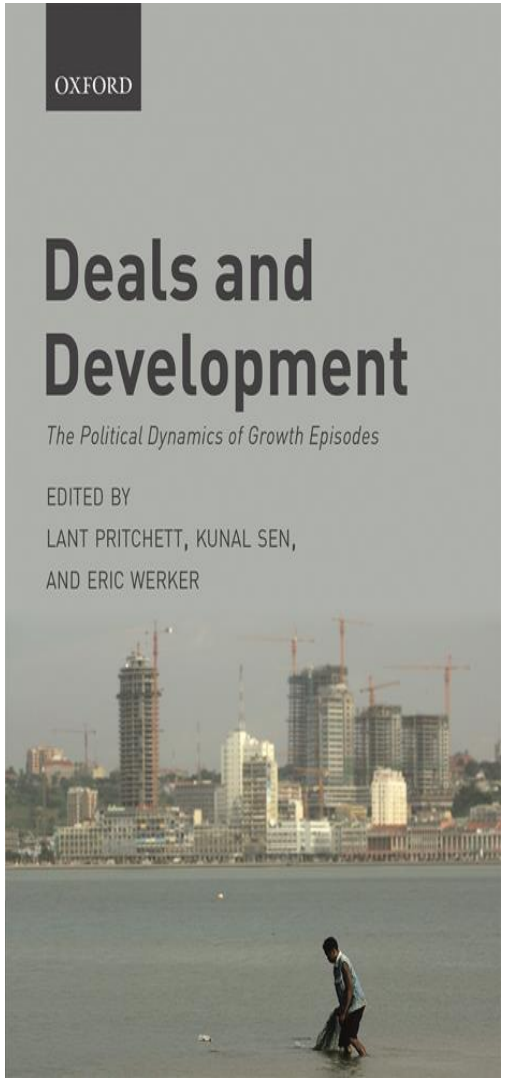
http://fdslive.oup.com/www.oup.com/academic/pdf/openaccess/9780198801641.pdf

Also Sen (2013), paper in World Development.



Why are formal institutions not able to explain economic growth?

Pervasiveness of informal 'de facto' institutions, particularly in developing countries, which can neutralize or even counter the effect of formal institutions on economic outcomes.

Deals, not rules, dictate the terms of the investment decision.

Deals: personalized relationships between political/bureaucratic elites and economic actors, investor terms and protections selectively enforced.

”For my friends, anything; for my enemies, the law”

Figure 11a: DB versus ES 10th percentiles: Construction Permit

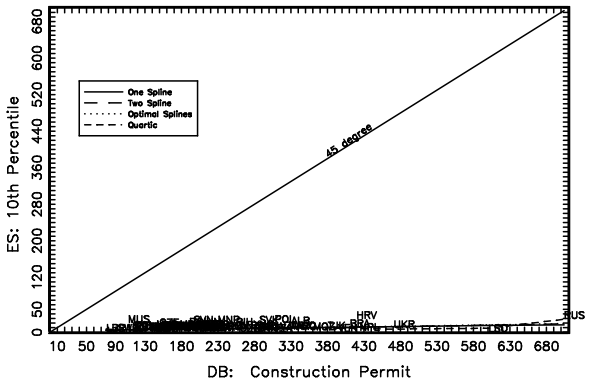


Figure 11b: DB versus ES (25th Percentile) (Construction Permit)

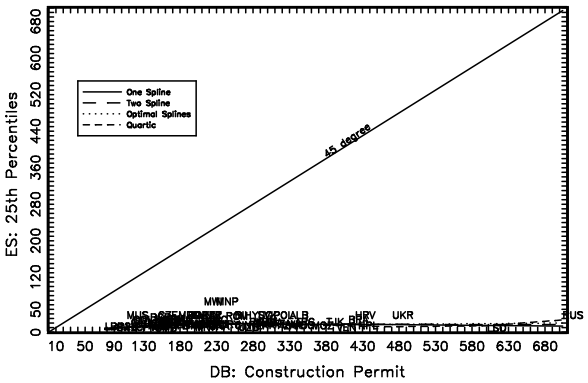


Figure 11c: DB versus ES 75th Percentiles (Construction Permit)

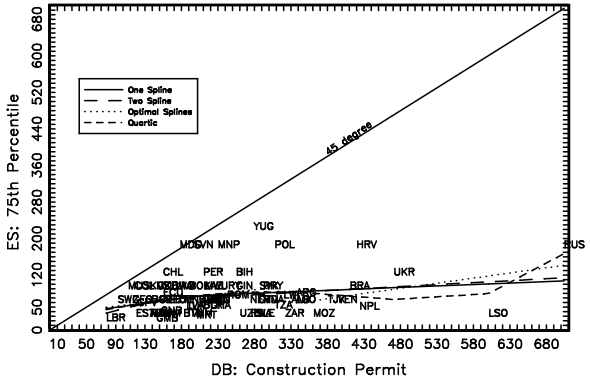
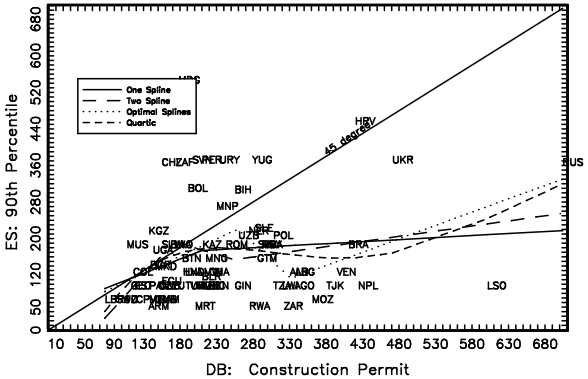


Figure 11d: DB versus ES (90th percentile): Construction Permit



Understanding variation in growth requires understanding differences between countries with similarly "bad" institutions

Rules Capitalism (OECD countries)

- What happens to the typical firm/investor is determined *primarily* by the neutral application of policies
- This *both* "protects property rights" *and* "allows for creative destruction"—that is, does not protect incumbent "rights" to existing profits
- Explains *lack* of variation in growth regimes

Deals Capitalism (most developing countries)

- What happens to the typical firm/investor has *little or nothing* to do with neutral application of policies but is a firm/investor specific "deal"
- Subject to change, depending on regime/administration and business-government relations
- Deals can be open/closed, and ordered/disordered

Not all deals environments are alike

Typology of "deals" environments		
	Open	Closed
Ordered	Anyone can make a deal, and they can be certain that the deal will be delivered - Retail corruption (e.g. driver's licenses in Delhi)	Only those with political connections can make a deal and they can be certain that the deal is delivered - Cronyism (e.g. Indonesia under Suharto, Russia under Putin)
Disordered	Anyone can make a deal, but they cannot be certain that the deal is delivered - Informal sector in many countries	Only those with political connections can make a deal but they cannot be certain that the deal is delivered -Fragile states

The “rents space”

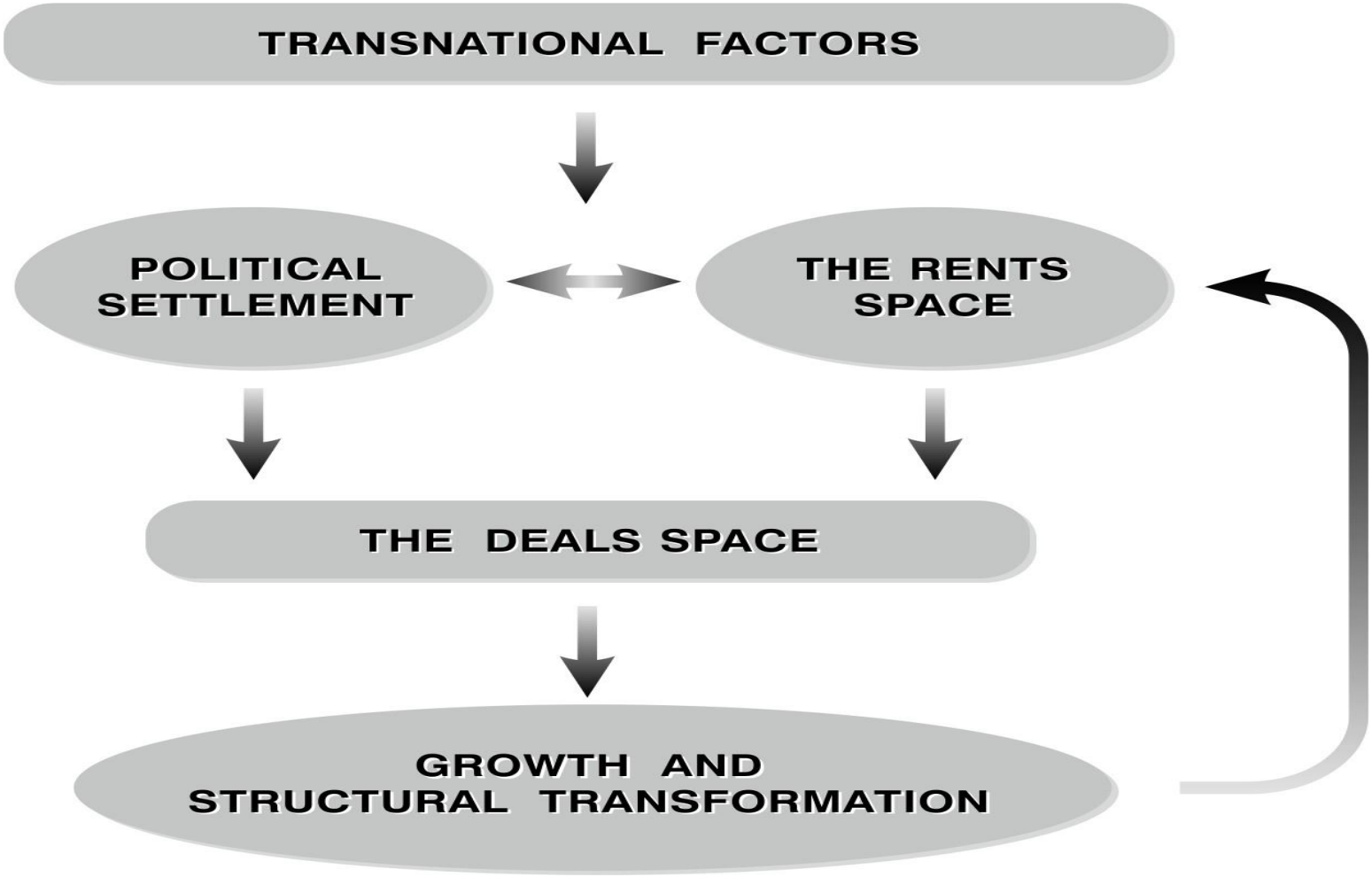
	Market Competition	Discretionary Rent
Export-Oriented	**MAGICIANS** Manufacturing, tradable services	**RENTIERS** Oil and gas, mining
Domestic Market	**WORKHORSES** Small-scale farmers, restaurants, retailers	**POWERBROKERS** Power generation and distribution, ports, natural and regulatory monopolies

- Firms in different parts of the rents space have different “asks” of the state. Rentiers and powerbrokers would like closed ordered deals, magicians and workhorses would like open ordered deals.

Political factors: the “political settlement”

- “the balance or distribution of power between contending social groups and social classes, on which any state is based” (De John and Putzel 2009)
- If the distribution of benefits by a particular institution is not accepted by powerful groups in the society, possible increase in political instability, even though the institution may be growth-enhancing.
- **The political settlement shapes who gets the deals, and whether deals are delivered.**

Describing and predicting growth episodes



What explains growth accelerations?

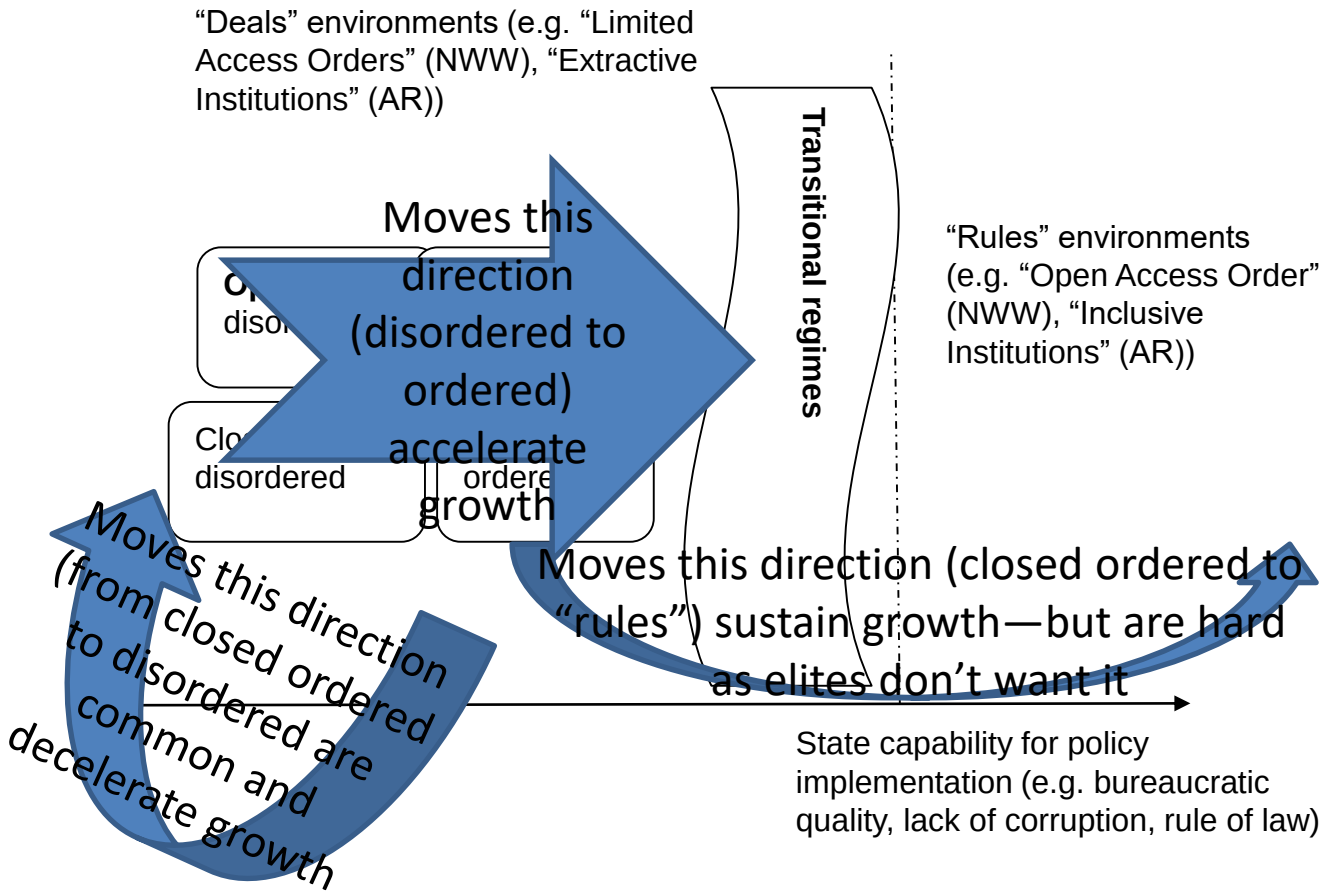
- Economic growth is likely to accelerate when there is a movement in the deals space from disordered to ordered deals. In this case, investors can be assured that the political elite can deliver on the deals they make with the latter.
- On the other hand, growth is likely to stagnate/collapse in disordered deals environments, where there is no certainty that deals that investors make with the political elite deal will be delivered.
- In our country case-studies, we found that a shift from an unstable political settlement which underpinned a disordered-deals environment to a stable political settlement (usually in authoritarian settings) led to a closed ordered-deals environment that kick-started growth.
- Thanarat in Thailand in 1957, the UMNO in Malaysia in 1959, Banda in Malawi in 1964, Rawlings in Ghana in 1981, Museveni in Uganda in 1986, the Cambodia People's Party in Cambodia in 1993, the Rwandan Patriotic Front in 1994.

Why is maintaining growth a challenge?

- An ordered, even if closed, deals environment, may be able to sustain growth for some time.
- But for growth to be sustained over the long run, the deals space must, while maintaining order, also needs to become more open.
- This is because openness in the deals space drives economic competition and facilitates new firm entry, which leads to growth-maintaining structural transformation.
- Closed ordered deals can be increasingly challenged by non-elites (civil society, middle class) and "excluded" elites, leading to disordered deals.

- **Very few countries make the transition to open ordered deals – as open ordered deals implies the destruction of rents and is resisted by both economic and political elites.**

Deals and long run growth, accelerations and sustained accelerations



A Summary of D&D

- In most developing countries, economic growth is episodic and the business environment is defined by “deals” not “rules”
- Even booms can generate the conditions for the next episode to be stagnation or decline if the political and institutional development serves to bolster non-growth-enhancing elite interests
- Decline can bring about more decline. Collapses/stagnation are the norm, not the exception.

What next for institutions research?

- A stronger focus on informal institutions, and much more specificity on the type of informal institutions that matter for economic development (i.e., deals).
- A more convincing explanation of institutional change, where triggers of change are seen as endogenous to the polity and economy, and not exogenously determined.
- In the policy world, a move away from “institutional monocropping” and transplanting “best practice” institutions in low income contexts towards “best fit” institutions.
- A more nuanced understanding of the incentives that elites have to bring about institutional reforms that lead to growth and development (avoiding “isomorphic mimicry”).

- **A fuller recognition of how a country´s political settlement (aka the elite bargain) is fundamental to shaping institutional change and persistence, and hence, the country´s development prospects.**