Lecture 13
Institutions

INTRODUCTION
Proximate versus Fundamental determinants of development
What is providing the right incentives?
- Are the market forces sufficient?
- Is the state intervention needed and favorable?
What is the decisive determinant of development?
- Is geography the fundamental determinant
- Can institutions mitigate unfavorable geography conditions?

Very topical issues: recent advances by Nobel laureates:
Coase (1991 - transaction costs)
North (1993 - Institutions)
Stiglitz and Akerlof (2001) (market failures and asymmetric information)

Lecture Outline
Introduction
I - Controversy on the way to organize economic transactions
A - Transactions costs
B - Market forces versus State intervention dilemma
C - Historical perspectives
II - Towards a new consensus
A - Role of institutions
B - Empirical evidence
Conclusion

I - Controversy on the way to organize economic transactions
A - Transactions costs
In general, economists are interested in economic exchanges: those concerning goods, labor, and financial promises.
These exchanges typically take place in markets in developed countries, although the exchanges can be governed by other means.

Such economic exchanges (and other types of exchanges for that matter) are costly, and typically only take place if the benefits of the exchange exceed the costs.
According to Coase, transactions costs are the costs of negotiating, measuring, and enforcing exchanges.
"In order to carry out a market transaction, it is necessary to discover who it is one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on."

A - Transactions costs
Negotiation is all about the time and expense of finding the appropriate partner and writing an agreement that covers all sorts of contingencies: not just what you would like to do in the best possible world, but what happens in various other circumstances.
Measurement is all about the difficulties of determining the quality of the good or service that is provided. Quality has a lot of different dimensions, which normally take some time to determine.

Akerlof’s “The market for lemons”
Issues of “Adverse selection” and “Moral Hazard”

Enforcement is concerned with ensuring the deal is consummated appropriately – that the contracting parties honor their agreements, even though they have short term incentives not to do so, as in the short term it is often cheaper not to honor your commitments.

Ways to enforce: legal system, threat of violence, harms reputation or stop business.

I-Controversy on the way to organize economic transactions

B-Market forces versus State intervention dilemma

Question:
Can the private markets organize economic transactions appropriately in order to prompt development? Or is there a need for public policies?

1-Justification of state intervention

Conflict between private and social objectives

Private firms maximize profits and households maximize utility

Society as a whole values equity (no poverty and low inequality)

*luxury versus primary goods

Different Time horizon: short term profits to the detriment of long run:

*bad specialization: deterioration of Terms of Trade, no increasing returns
*consumption versus investment.

1-Justification of state intervention

Market failures

Inexistent or dysfunctional markets (Capital, Labor, Goods) lead to

*Insufficient and Inefficient allocation of resources
*Undesirable social results

Causes of failures: when perfection of market is not verified
-externalities (public goods and over/under production) and complementarity: issue of coordination
-lack of information: cf. credit market
-increasing returns: market power in terms of price (no supply atomicity)

Need for state intervention for mobilizing scarce resources in most socially profitable projects (social ≠ private returns), coordinating economic decisions, provide information and dismantle oligopolies.

2-Failures of government

Deficiencies of theories/models followed: wrong hypotheses

-insufficient and unreliable data
-inadequate supply of qualified personnel (economists..)
-unanticipated exogenous disturbances: vicissitudes of trade, aid, financial flows

Deficiencies of the implementation: gap between objectives and implementation

-lack of political will: vested interest
-institutional weaknesses: rivalries, no dialogue, unsanctioned incompetence.
2-Failures of government

**Interventions induce distortions of prices** potentially further away from social opportunity cost (shadow price: would be at social equilibrium). Typically undervalued price of capital, high education, overvalued price of labor and exchange rates (imports)

**Implications:**
- promote capital-intensive / high skilled projects to the detriment to labor intensive: anti-comparative advantages
- encourage wasteful rent seeking to capture extra-profits from distorted prices and protections

**Failure of 1970s state-led development strategy:** inefficiency, waste, amplified by debt crisis (partly due to exogenous interest rate shock).

I-Controversy on the way to organize economic transactions

C-Historical perspectives

**1970s: prevalence of state-led developmentalist strategy:** nationalization, import substitution, financed by foreign borrowing

**Theory:**
Harrod Domar, Lewis, Rostow → industrialization
Dependence model → autarky

**Results:**
Disappointing results (inefficiency, low incentives, rent-seeking)
But start of diversification when the debt crisis erupted.

**Change of paradigm:**
Context changes: recession and debt crisis
Conservative governments plus development of neoliberal models
Imposition of new medicine to countries under adjustment (IMF).

**1980-90s: neoclassical counterrevolution: market fundamentalism**
Privatization, stabilization, international opening.
Growth is sufficient to ensure development

**Theory:**
Public choice theory and free market

**Results:**
- Lost decade for development
- No resolution of initial debt crisis

**Change of paradigm:**
- Lack of recognition of market imperfections
- There are some preconditions for well-functioning market systems for which the state can help

Illustration with the Asian success
II-Towards a new consensus

A-Role of institutions

Economists call the rules and conventions that people follow in their daily lives institutions. They are man-made (contrary to exogenous factors like geography).

1-Three parts
-Formal rules
-Informal rules
-Enforcement mechanisms

2-Three main elements
-Enforcement of property rights: crucial for incentives to invest
-Constraints on the actions of elites: highly uneven playing field
-European opportunity for broad segments of the society.

II-Towards a new consensus

A-Role of institutions

3-Characteristics

Path dependency: “stock” analogy on which flows “policies” accumulate
-slow to change: not changed overnight
-low incentives for people in power to change it: “trap”

Externalities: positive if good: pressure to improve negative if bad: destabilization

No unique good institutional forms: China as an illustration (no private property rights)
And in the short-run, large-scale institutional reform is rarely necessary to accelerate growth

Good institutions do not mean democratization.

II-Towards a new consensus

A-Role of institutions

4-Impact

Incentives to invest and innovate (K, H and A)

Contrary of government for sale:
-stability in direction and values
-corruption costs fall disproportionately on poor and benefit disproportionately to rich

Institutions not only affect the size of the social pie but also how it is distribute:
-favorable to focus on equity: important component of development
4-Impact: correlation

Figure 1: Better governance is associated with greater country competitiveness.

Source: GCI is based on 2015 data of the World Economic Forum, control of corruption for 2016, from Kaufmann et al., 2015.

4-Impact: correlation


1. Voice and accountability (VA), the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and free media
2. Political stability and absence of violence (PV), perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including political violence and terrorism
3. Government effectiveness (GE), the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies
4. Regulatory quality (RQ), the ability of the government to formulate and implement sound policies and regulations that permits and promotes private sector development
5. Rule of law (RL), the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence
6. Control of corruption (CC), the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests.

II-Towards a new consensus

B-Empirical evidence of causality
Difference between correlation and causality:
- reverse impact
- omitted variable
1-Natural experiment: Korea
2-Large scale natural experiment: colonization

Ideal for Evaluation is to have
- *counterfactual*: what would have happened if everything the same but only different institutions
- *source of change that is exogenously determining institutions*

The great reversal:
Colonization brought institutions (inversely related to initial geography-based wealth)
Reversed the initial hierarchy: so dominated the exogenous forces
II-Towards a new consensus

- Timing incoherent with argument of colonization costs: germs/slaves
- Timing coherent with the fact that the institutions brought by colonies determined the potential to benefit from industrialization (incentives to invest)
B-Empirical evidence of causality

3-Instrumental-Variable method of empirical estimation

Mortality of settlers used as an instrument of institutions:
  - correlated with the colonization strategy (extractive versus good institutions) adopted
  - uncorrelated with current mortality rates in LDCs
    - yellow fever is eradicated
    - immunity to malaria versus high mortality of settlers

Results highlight:
  - crucial role of institutions for development
  - once institutions are taken into account, geography does not have much impact (so largely though institutions)

Figure 9

Log income per capita in 1995 vs. log settler mortality