1 Do (formal) institutions matter for growth?

So first we defined which institutions matter for growth, now we discuss which forms such institutions should have based on the consensus view.

- Once a marginal topic, the role of institutions has become one of the most popular research areas in development economics over the last 10–15 years, gaining popularity as the root cause of economic problems in developing countries.
- While there is no agreed definition of what they are, GSIs (Global Standard Institutions) promoted by IMF, WB, OECD are modeled on Anglo-American systems emphasizing market freedom/private property. The idea is that institutions maximizing market freedom and protecting private property rights lead to growth.
  - Ex. 1 Common-law (Anglo-American) legal system is seen as more encouraging of enterprise, and thus economic growth.
  - Ex. 2 shareholder-oriented (once again, Anglo-American) corporate governance system promotes investment by giving assurance to investors.
- Imposed via 'governance- related conditionalities', which required that the borrowing country adopts 'better' institutions that improve 'governance'. Around the same time, many rich country governments also started to attach governance conditionalities to their bilateral aids (TRIPS in WTO). The increasing opening of developing nations capital markets has significantly increased the power of foreign investors, who are strongly influenced by the international financial press.

1.1 Macroeconomic Theory Behind the "Consensus"

- Microfounded models with represenative agents optimizing saving, labor supply, education etc over an infinite time based on some preferences and constrains. Such microfoundarons is embeded in a geenral SOlow type growth model with complete markets and no market failures (except R&D and some specific frictions (fiscal frictions (taxes), labor market frictions (minimum wages, unions, EPL), rigidities (sticky prices and wages).
- The microfoundation:
  - Limits consideration of distributional issues (e.g., income inequality).
  - Leaves little space for externalities (if they are homogenous how can one create externalities) and coordination failures (e.g., bank runs, herd behavior).
- The Solow framework:
  - leaves little room to market failures

$\longrightarrow$ The (obvious) implicaitons are:

- the Superiority of Liberal Market Economies (LMEs)
- **Limited justification for public intervention:** Models suggest public intervenctions create inefficiencies

Solow (2008) doesn't feel guilty:

- *"Accidentally or not, folding an imperfection into the Ramsey model is likely to push the policy implications in the laissez-faire direction."*
- *"I feel guilty about something, but not about 'modern macro'."*

1.2 Alternative views

- Unfortunately, economics as a field is characterized by a lack of pluralism (and pragmatism) both in tools and ideas.
- About tools: there's an over-reliance on a narrow set of theories / methods.
- The "consensus view" in economics is increasingly criticized for relying on thoery-driven simplifications that distort reality

- LMEs appear more "efficient" by construction, due to model assumptions (Only selective and highly stylized, Not enough to overturn core efficiency result, Used mainly to explain short-run fluctuations.). Somehow the diffiulty to integrate a more complex assumption shaped resutls and policy consequences. No equity concerns can emerge if agents are assumed to be homogenous! consequences In macroeconomics, policy prescriptions are derived from models built on naïve assumptions—e.g., perfectly competitive markets, representative agents, and rational expectations. As Naidu et al. (2020) argue, *neoliberalism is not the consistent application of modern economics but its "primitive, simplistic perversion," ignoring key insights on institutions, market failures, distribution, and behavioral factors.*Bold: These macro models cherry-pick idealized assumptions to justify deregulation and minimal state roles.
- Empirical analysis is underutilized. Such strong assumptions driving results are rarely tested rigorously with data. Even when that contraddicts evidence (eg. DSGE models often imply full employment, contradicting real-world unemployment (Blanchard, 2008).) we have Kuhnian anomalies and paradigm rigidity: Anomalies that contradict models accumulate without triggering shifts in macroeconomic paradigms dut to resistance to change.

- In development economics, recent shifts prioritize RCTs over structural theorization.
  - Duflo (2019) promotes this turn by emphasizing progress through *"well-defined questions,"*. READ APPENDIX ON RCTS.
  - Again there is an issue: while macro is overelying on theory, development is overelying on a narrow set of methodological approaches. The problem is that such. Empirical analysis (e.g., RCTs) is often treated as the main source of truth even without theoretical support. Often context speciic, you give me a situation but not a generalizable motivation.
    - Leamer, 2010: Part of the problem is that we data analysts want it all automated. We want an answer at the push of a "randomization" button on a keyboard without intellectual reflection.
    - Deaton and Cartwright (2018): Sound empirical work should integrate research purpose, theory, context, and prior knowledge alongside rigorous experimentation. Depending on what we want to discover, why we want to discover it,and what we already know, there will often be superior routes of investigation. RCT not necessarily best way.
    - RCT is wasteful and even unethical when it unnecessarily exposes people.
- General points:
  - Sound empirical work should integrate theory, context, and prior knowledge alongside rigorous experimentation. Case studies, narrative evidence and history of economic thought are often neglected as evidence, however they can provide some extrenely valuable insights. For example, history of economic thought allows to see economics as the integral of a curve of learning.
  - both approaches requie 1) high quality datam, 2) credible identificqiton strayehies (RCTs, IVs etc), 3)**Unbiased scientific practice** (MORE IN NEXT SET OF SLIDES)

2 Critiques

Claim: Markets and property rights matter, but understanding requires deeper, contextual analysis. Defining what constitutes *good institutions* is inherently difficult and context-dependent.

2.1 Reverse Causality

Better institutions often follow—not cause—development.

- **Growth increases D for institutions** and affordability of expensive good quality instiutions.
- **Historical evidence: Development creates agents (e.g. industrialists, workers) who demand reforms:** the rise of industrial capitalist vs landlords lead to regime change in the Uk, the growing power of the working class lead to the rise of the welfare state.
- Rich countries adopted key institutions (e.g., IPRs, limited liability, bankruptcy law) **after** development.

2.2 Free Markets, Market failures and the Oversimplification Institutions' Impact

2A. About impossibility of the "Free Market"

1. No objective definition: Should a country pursuing the maximum degree of freedom in the labour market allow child labour? *Many considered it unacceptable for governments to impose any legal limits on working hours, even for adult men ("deprived the baker of the liberty of working as long as he wished"). In the 19th century, most free-market economists believed that patents violated free-market principles by restricting competition in idea markets.*

2. Theories show max business freedom $\neq$ social efficiency (e.g., liberalize and let companies free to acquire others and become monopolist, financial deregulation and 2008 crisis).

3. Theories show max business freedom $\neq$ business: There are regulations that may restrict business freedom in the short run but may promote the long-term interest of all firms. For example, individual firms may benefit from using child labour (and thus child labour regulation will hurt them) in the short run, but that may harm all firms in the long run, by harming children's health and education and thereby reducing the quality of the future labour force.

4. Theories show max business freedom $\neq$ economic development: Huge debate. 1) it is difficult to judge a priori whether a higher degree of market liberalization will result in higher allocative efficiency, unless all markets are completely liberalized (Lipsey and Lancaster, 1956). 2) higher allocative efficiency does not necessarily imply higher levels of growth (e.g., Krueger, 1980). 3) On top of that, there are many non-neoclassical eco-nomic theories that say that free markets may be less good at generating growth than markets that are, depending on the circumstances, protected, regulated, managed, or monopolized – such as the infant industry argument and the more recent literature on the economics of technology.

   *Assumption (0): all markers must be completely liberalized. Assumption (1): complete information (false in practice, see Akerlof & Shiller 2005) Assumption (2) of complete markets is huge: Autarky (absence of markets) is the norm rather than the exception (Buiter, 2009): THEORETICALLY IMPOSSIBLE TO HAEV COMPLETE MARKETS. Markets do not exist for many goods, services, risks, and future events. Example: No market exists today for externalities on future generations, e.g. pollution. You can't trade with unborn people. Huge literature on imperfect/asymmetric information (e.g. Akerlof & Shiller 2005). .

2B. Misconceptions about Private Property Rights

- The currently dominant discourse fails to give full attention to forms of property rights other than private, state, and open-access. The superiority of private ownership is asserted on the around that state ownership is inefficient due to the restrictions on competition and the principal–agent problem, while open access leads to the 'tragedy of commons'. Alternatives (e.g., cooperatives: private property in some inputs (e.g., land, livestock) with communal property in others (e.g., tractors), TVEs) ignored.
- State ownership may be optimal under failures (capital markets, externalities, monopoly). Failures are way more pervasive than usually considered. State owned enterprises (SOEs) often led growth (e.g., Singapore, Taiwan). Coordination failures with multiple agents State capacity can help in resolving coordination failures
- Not all private rights benefit growth: e.g., landlord/shareholder overprotection $\rightarrow$ underinvestment.
- State led growth can be helpful when:
  - period of structural trasformation
  - financial markets in early stages of industrialization
  - interdependent investment
  - establish public development banks
  - Stimulate Demand
- Stiglitz (2017): *In some ways, there is a parallel between the welfare state and the developmental state. In the latter, it was recornized that markets on their own often didn't succeed in the structural transformations that were requires if countries were to achieve their developmental ambitions (...) The developmental state corrected these market failures, and had a catalytic role in promoting structural transformation.*

2C. Non-linearity and Context and time-dependence

1. **Dose**: Excessive IPRs → cost of monopoly ¿ benefits of innovation.
2. **Country heterog**: Second, even the same institution in the same dose may be good for one country but bad for another. A level of protection of IPRs that may bring net benefit to a rich country may be harmful for a developing country.
3. **Time heterog**: Landlord rights useful in early Japan, later damaging.

2.3 Empirical Evidence and Cross-section Bias

As far as we have empirical evidence that these institutions work, it may be argued, why should we worry even if we may not fully understand why they work? Truly, evidence from cross sectional studies is weak.

A. Time-Series Evidence

- time-series' evidence may offer better insights than can cross-section studies, which lump every country from Swaziland to Switzerland, as we development economists like to say.
- Especially if expanded with non-econometric evidence: historical narratives, comparisons.
  - Sub-Saharan Africa, Latin America, Korea (1997): due to enorrmous external pressures neoliberal reforms + institutional reform → poor growth.
  - Many examples of countries that succeed in catching- up adopting institutions and policies antithetic to the one promoted by the Consensus (China, Korea... West (see below)!)
  - West Golden Age (1945–1975): heavy regulation, welfare, nationalizations → 3-4× faster growth than liberal era.
    * In1841, a German economist, Friedrich List, criticized Britain for preaching free trade to other countries, while having achieved its economic supremacy through high tariffs and extensive subsidies. He accused the British of 'kicking away the ladder' that they had climbed to reach the world's top economic position
    * a form of historical amnesia (more infra)

B. Why Cross-section Misleads

1. **Institutional quality hard to quantify**; often based on biased towards the west isntitions business surveys, that: 1) do not try to identify and measure institutions that may help growth but do not fit into the liberalization narrative. 2)conflated with economic success.
2. **Indexes aggregate unlike features**; ignore complementarities/functions.
3. **Sample heterogeneity** (e.g., IPRs affect rich/poor differently): dummies to control is one thing, parameter heterogeneity is another. Issue is salient in this context because the relaitonship investigated is very complex.

2.4 Poor theory of institutional change

2.4.1 Hopeless Optimism vs Undue Fatalism

Paradox: The dominant discourse on institutions embraces contradictory corner solutions: either institutions are easily changed (optimism), or nearly immutable (fatalism).

- **Fatalism:**
  - Institutions are shaped by unchangeable factors (e.g., climate, culture), and thus can only change through epochal shocks like colonization.
    Example: Temperate U.S. climate supposedly led to small-scale land ownership, which fostered democracy and education; tropical Latin America fostered latifundia, inequality, and weak institutions (Engerman and Sokoloff, 1997). Similarly, bad colonial institutions are said to persist in Africa.
    Implication: Institutions are relevant – no, they are more than relevant, they are arguably the most important – but they are hardly changable as they are products of unchangeable factors.

- Institutions are meant to be stable – rules make them difficult to be modifies.
- potentially beneficial institutional changes are not made because only simultaneous changes in complementary institutions can bring about enough benefits.

- But is not true! INVENTED TRADITION rewtriting hitosty. historical amenesia
  - i) Ex post justidicatiosn: a country's institutional complex contains various elements, and therefore can usually be described as pro-developmental, anti- developmental, or whatever we want, depending on which particular elements we choose to highlight. So Confucianism was bad untile the 50s because we focus on hierachicla nature and pnehcnat for beaurocracy, but then become perfect foe emphasis on education etc... INVENTED TRADITION
  - ii) In the same country there are multiple traditions cultural/institutional complex that are pulling in different directions. Depending which interpretation wins in political and ideological battles, a country could evolve into very different directions.
  - iii) 'traditions' are not immutable. Cultures and institutions themselves change, often dramatically (fance from laissez-faire to dirigiste) amd ofren 1) as a reulust of economic development! 2) due to individual human decisions in a framework very difficutl to explain in framwworks where there is no true human agancy
  - History is re-written to fit a country's present self-image. As a result, many rich country people recommend free-trade, free-market policies in the honest belief that these are policies that their own ancestors used in order to make their countries rich.
  - Example: free trade, an invented tradition, Magnusson (2004)
    - The dichotomy between *free trade* and *protection* became a foundational concept in modern economics.
    - In the 19th century, an influential proposition emerged: *free trade was framed as a universal political goal*, and this view was retrospectively linked to Adam Smith.
    - According to this narrative, Smith's role was to defeat protectionism and mercantilism.
    - However, this interpretation is historically inaccurate. Classical economists, including Smith, often *supported both free markets and selective protection.*
    - The stark dichotomy only solidified in the **1840s**. Before that, economists could support market principles while also advocating protection in some cases.
    - After the 1840s, such duality became untenable. Two key shifts occurred:
      - Free trade was increasingly linked to *Smithian and classical political economy.*
      - This period marked the *triumph of British economics.*

3 Remark: Costs, constraints and Opportunity Cost of Institutional Reform

Institution-building is costly and slow. **Resource constraints** (Rodrick), such as limited public budgets or balance of payments issues, lack of administrative, political, human capital. E.g., copying US IPR law needs an enormous number of lawyers, inspectros, courts.**Opp costs:** Scarce resources might be better spent (e.g., doctors, teachers).

4 Institutional complementarities

Based on the theory of the **second-best**: solving some problems without addressing others may worsen outcomes. The Washington Consensus cannot be unconditionally expected to produce economic benefits without a long list of unlikely conditions being satisfied (complete markets, absence of externalities, full information, ...)" (Rodrick 2004)

5 Facing the Policy failure

Policy failure (e.g., liberalization) was blamed on institutional deficiency. Argument: policies would succeed with proper institutions. Two ways then: 1) stop adopting inappropriate policies and give policies designed with its institutional characteristics in mind. 2) Change institutions. Example: deregulation fails due to weak property rights ⇒ solution = strengthen rights, not revise policy.

6 Conclusion

6.1 Inadequacy of "One-size-fits-all" strategies

- Institutional complementarities
- Ignores constraints (administrative, political, human capital).
- **Development stage** greatly affects trade-offs

Solution, **The diagnostic approach**: identify country-specific bottlenecks and address them with specific reccoamndaiotns, start form the present situation!

6.2 Or worse: Inadequacy of the theoretical foundation of the neoclassical growth model

- Strategies that reflect models of developed countries and, probably, their interests
- Often misaligned with the actual experience of growth in developing countries.

7 Conclusion

- Several factors influence institutional effectiveness: 3.2, 4, 5
- Bardhan (2016) To proclaim the universal superiority of one coordination mechanism (institutions) over another is simplistic and anti-historical. Coordination Is Context-Dependent. What do markets do well? Coordinate decentralized agents, Reward efficiency, Discipline poor performance. What can the state do? Lead collective action, Use incentives/disincentives to encourage cooperation, Solve situations where individual interests conflict with group goals

7.1 What Next? Toward a New Consensus?

World Economic Forum 2017:

- **No single ideal policy mix**
- **Larger fiscal transfers** may be compatible with long-run growth