Chapter 6

Institutions and economic growth: Alternative views

6.1 The Current Landscape

Is there a need to transform economics?

- Longstanding debate (Until recently, often outside the academia)
- Linked to (lack of) pluralism (and pragmatism) in economics
  - multiplicity of theories and methodological approaches
    - to explain complex phenomena
    - to ensure a virtuous competition among them
  - definition of a scientific discipline
    - object of study
    - methodology
      - limits competitions among alternative methodological approaches
- ... and the role of history of economic thought
  - Scientific understanding as the integral of a curve of learning → Science includes its history
  - History of economic thought fundamental to develop new ideas

De Villanova's understanding of the issue

Economics is a multifaceted discipline

two relevant fields:

1. Macroeconomic theory behind the "*Consensus*"
   - policy prescriptions based on naïve assumptions
   - "*Neoliberalism (. . .) is not the consistent application of modern economics but its primitive, simplistic perversion*" (Naidu et al., 2020)
2. Development economics
   - Recently, giving up theorization

- "*Possible to make significant progress against poverty in the world by focusing on well-defined questions. (...) To assess the progress, we adopted the methods of randomized controlled trials*" (Duflo, 2019)

In both cases, large emphasis on methods

1. macroeconomic theory behind the "*Consensus*" → modern macro models
2. development economics → RCTs

6.1.1 Randomization

Equation of interest

$$y = \alpha + \beta T + \gamma W + u$$

where:

- T is the treatment (e.g. quality of institutions)
  - often treatment on individuals, but also other units
- Y is the outcome of interest (e.g. GDP per capita)
- W is a vector of characteristics relevant for the outcome

Randomization should ensure that W is balanced among treated and control groups

Randomization is perceived to yield causal inferences /estimates of the average treatment effects (ATEs) that

- are more reliable and more credible than those from any other empirical method
- require minimal substantive assumptions
- require little or no prior information

Main Issues (1): Additive Variables

- The propriety that the correlation between the controls W and the treatment T is equal to zero holds asymptotically (infinite sample or infinite replications on the same sample)
  - This is an issue if the sample is limited and/or replications infeasible
  - Issue even more worrisome if the variables in W are numerous
- If the number of variables in W is larger than the number of observations, then, whatever the treatment, it is perfectly corllinear with W
  - issue extremely relevant in cross-country regressions
    - A limited number of countries and a potentially enormous number of variables that influences y
  - however, studies on large samples can suffer from the problem (e.g. number of strata in medical studies)

Main Issues (2): Interaction Variables

$$y = \alpha + (\beta_0 + \beta_1 \nu)T + \gamma W + u$$
$$\beta = \beta_0 + \beta_1 \nu$$

issue of external validity:

- ATE should be transferred only into those settings in which the confounding interactive variables ν have values close to the mean values in the experiment
- Issue particularly worrisome in macro regressions
  - social and environmental contexts do matter in giving rise to causal relations
- But relevant in many contexts (new developments in medicine)

Other Issues (2)

- ATE (Average Treatment Effect)

> like the lawyer who explained that when he was a young man he lost many cases he should have won but as he grew older he won many that he should have lost, so that on the average justice was done. In other words, if you act as if the treatment effect is a random variable by substituting β_t for $\beta_0 + \boldsymbol{\beta}' \mathbf{z}_t$, the notation inappropriately relieves you of the heavy burden of considering what are the interactive confounders and finding some way to measure them.

- small and often selected samples
- trials not blinded (placebo effects) nor sufficiently controlled for other sources of bias

Some Final Thoughts

Leamer (2010) - "*Tantalus on the Road to Asymptopia*"

> "*Part of the problem is that we data analysts want it all automated. We want an answer at the push of a button on a keyboard. Faced with the choice between thinking long and hard versus pushing the (. . .) button, the single button is winning by a very large margin.*
> *Let's not add a "randomization" button to our intellectual keyboards, to be pushed without hard reflection and thought*"

Deaton and Cartwright (2018) - "*Understanding and misunderstanding randomized controlled trials*"

> "*Hierarchies that privilege RCTs over any other evidence irrespective of context or quality are indefensible and can lead to harmful policies.*
> *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 and, for a great many questions where RCTs can help, a great deal of other work—empirical, theoretical, and conceptual—needs to be done*
>
> *Randomization, by ignoring prior information from theory and from covariates, is wasteful and even unethical when it unnecessarily exposes people, or unnecessarily many people, to possible harm in a risky experiment*"

6.1.2 Macroeconomic theory behind the "*Consensus*"

- micro-foundation
- dynamic
- solow model + individual optimization
  - savings (*ramsey* model)
  - other choices (labor supply, education, R & S)
- same analytical framework for long-run and short-run
  - economic growth (long - run)
  - economic cycle (short-run)

Main ingredients of (most) models

- no market failures (and complete markets)
  - 1st theorem of welfare economics: Pareto optimality of market solution
- but in R & D
  - protect patents
- and few specific "frictions"
  - taxes and public expenditures
  - labor market (EPL, minimum wage, unions)
  - regulations in general
  - and other rigidities in the short-run (New Keynesian Macro)
- representative agent: there is little room for
  - distributional issues
  - externalities
  - coordination failures

Main implications of (most) models

- superiority of the Liberal Market Economies (good contracting and property rights institutions)
- Scarce justification for public intervention (taxes, public expenditures, regulation) - (neither efficiency or equity)
- On the contrary, public intervention likely to introduce inefficiencies/frictions in the economy

6.2 Alternative Views

Alternative views are linked to the explanation of the disappointing effects of the *Consensus* policies:

- inadequacy of "one-size-fits-all" strategies
- inadequacy of the theoretical framework

It is sparse literature. Only a few examples, with no sharp answer.

6.2.1 Chang, 2011

Main points:

- ***pervasiveness of market failures***
- present ***historical example*** that ***contradict the Consensus prescriptions*** to reach sustainable growth
- ***Invented tradition*** → importance of history (and history of economic thought)

Pervasiveness of market failures

- Market failures are pervasive
  - liberalization and monopoly power; financial market liberalization and financial crisis; child labor and long run growth; long- run consequences of short-run policies *(Chang, 2011)*
- huge literature on imperfect/asymmetric information
- "Autarky" (absence of markets) is the norm rather than the exception *(Buiter, 2009)*
  - Theoretically impossible to have complete markets
  - If any market takes a finite amount of resources (however small) to function, complete markets would exhaust the resources of the universe
- Coordination failures with multiple agents → State capacity can help in resolving coordination failures – Particularly so in structural transformation
  - financial markets in early stages of industrialization
  - interdependent investment
  - networks of producers and suppliers
  - establish public development banks

Historical examples at odds with the Consensus

In general, economic history and comparative history offer little support to the Consensus:

- Many examples of countries that failed to growth after following the Consensus' policies (Latin America, South Korea, many African countries)
- Many examples of countries that succeed in catching- up adopting institutions and policies antithetic to the one promoted by the Consensus (Korea, once again, Italy, France, US, UK, China)

6.2.2 Chang, 2008 - Free Trade

In 1841, 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:

> "*[i]t is a very common clever device that when anyone has attained the summit of greatness, he kicks away the ladder by which he has climbed up, in order to deprive others of the means of climbing up after him*"

- Rich countries have "*kicked away the ladder*" by forcing free-market, free-trade policies on poor countries

- historical amnesia → History is re-written to fit a country's present self-image

> "*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. When the poor countries protest that those policies hurt, those protests are dismissed as being intellectually misguided or as serving the interests of their corrupt leaders.*"

- The intention behind their policy recommendations may be honourable, but **their effects are no less harmful than those from policy recommendations motivated by deliberate ladder-kicking**
- People who act out of the belief that they are doing the right thing are often more stubborn than those who act out of pure self- interest.

6.2.3 (Magnusson, 2004) - Free trade in the history of economic thought

The dichotomy of free trade versus protection has been an important building block for contemporary economics.

- During the nineteenth century a highly influential and long-standing proposition was fabricated in which free trade as an overreaching political goal -and as a slogan - was said to have originated with Adam Smith.
- The historical role of Smith had been, according to this view, to combat and ultimately defeat protectionism and mercantilism.
- This thesis, however, is hard to reconcile with a historical reading both of Adam Smith and the classical economists.
- Before the dichotomy appeared in its stark form -from the 1840s- it was quite common among political economists to believe in the principle of free markets and the market process yet at the same time to argue for protection, at least in some restricted cases.
- However, after the 1840s this was hardly possible any longer.
- It was also during this dramatic period that two historical sequences occurred in combination:
  - the linking up of free trade to Smithian and/or classical political economy
  - the triumph of British economics

6.2.4 Implications

- The identification of "*good institutions*" is tricky
- Consensus Institutions (Global Standard Institutions - GSIs) might be unsuitable to promote development in some countries and/or periods of time
  - market failures
  - availability of resources
  - institutional complementarities
  - stage of development (late-comers): might be required to protect nascent industry from international competition
- New (non trivial) role for public intervention

– Stiglitz (2017)

> "*In some ways, there is a parallel between the welfare state and the developmental state. In the latter, it was recognized 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.*"

– Bardhan (2016, p. 886)

> "*To proclaim the universal superiority of one coordination mechanism over another is simplistic and ahistorical.*
> *Markets are superb coordination mechanisms in harmonizing numerous non cooperative interactions, disciplining inefficiency, and rewarding high-valued performance.*
> *The state can provide leadership (and offer selective incentives and disincentives) to stimulate individuals to interact cooperatively in situations where noncooperative interactions are inefficient.*"

How to address these ambiguities?

Empirical analysis:

- Underplayed to test macro models
- Probably oversold in other fields of research: source of knowledge, often without a theory

In both cases, one needs faith:

- quality of the data ✓
- randomization (and IV) ✓
- unbiased scientific research

6.3 "Institutions and economic development: theory, policy and history" - *Chang (2011)*

> Since the late 1990s, the view that poor-quality institutions are the root cause of economic problems in developing countries has become widespread. In accordance, the IMF and the World Bank started to impose many 'governance-related conditionalities', which required that the borrowing country adopts 'better' institutions that improve 'governance' (see Kapur and Webber, 2000). Around the same time, many rich country governments also started to attach governance conditionalities to their bilateral aids. There is no agreed definition of what these 'better' institutions, often called the Global Standard Institutions (GSIs), are. However, they are institutions that are typically found in Anglo-American countries, which are seen as maximizing market freedom and protecting private property rights most strongly.[1]

6.3.1 Theoretical problems with the dominant discourse on institutions and economic development

The currently dominant discourse on institutions and development suffers from two categories of theoretical problems.

1. almost **exclusively assumes that the causality runs from institutions to economic development**, ignoring the possibility that economic development changes institutions
2. even when we focus on the **"institutions to development**" part of the **causality**, the relationship is theorized in a rather **simplistic, linear, and static** way.

Do better institutions lead to more effective economic development?

The currently dominant view is that institutions are the ultimate determinants of economic performance. However, the causality in the other direction – that is, from economic development to institutions – is usually neglected.

Economic development changes institutions through a number of channels:

- increased wealth due to growth may create higher demands for higher-quality institutions (e.g., demands for political institutions with greater transparency and accountability).
- greater wealth makes better institutions more affordable
- economic development creates new agents of change, demanding new institutions

historical evidence to suggest that the causality may be stronger in the direction (economic development → institutions) than in the institutions → economic development

> Today's rich countries acquired most of the institutions that today's dominant view considers to be prerequisites of economic development *after*, not before, their economic development – democracy, modern bureaucracy, IPRs, limited liability, bankruptcy law, banking, the central bank, securities regulation, and so on (Chang, 2002a: chapter 3). More specifically, the Anglo-American countries, whose institutions today are considered to be GSIs, themselves did not have most of those institutions in their earlier stages of development and acquired most of them only after they became rich

> If the causality runs more strongly in the direction of development to institutions, rather than the other way around, the financial and human resources that developing countries are expending in order to acquire GSIs may be better used for other policies that more directly stimulate economic development – be they educational expenditure, infrastructural investments, or industrial subsidies – especially when they also indirectly promote institutional development, which can then further promote economic development.

Are liberalized institutions better for economic development?

Even restricting the direction of causality to economic development → institutions the theories about the relationship are rather simplistic.

Basic Argument: "*liberalized*" institutions that protect private property rights most strongly and provide maximum economic freedom (especially business freedom to seek profits) will best promote investment and thus economic growth

> for example, the (Anglo-American) common-law legal system is seen as more encouraging of enterprise, and thus economic growth, than the (Continental, especially French) civil-law system because it provides better protection of investors and creditors while minimizing state regulation.

> it is argued that a shareholder-oriented (once again, essentially Anglo-American) corporate governance system promotes investment and thus growth by giving assurance to investors that they will not be ripped off by other stakeholders in the company they invest in – the managers, the workers, and the suppliers, who will get the same fixed compensation regardless of the profit performance of the company and thus have no incentive to maximize profit.

However, the relationship between institutions and economic development is far more complex:

- Question (1): ***do institutions that provide greater economic freedom lead to faster growth?***
  1. even if we agree that the freest market is the best for economic development, there is actually no objective way to determine what is in fact the freest market
     - Examples:
       * *should we allow people to set up banks without minimum amount of capital and issue their own currency?*
       * *Should a country pursuing the maximum degree of freedom in the labour market allow child labour?*
       * *should patents exist ?*
     - Since there's no clear definition, we can't say which institutions truly maximize economic freedom.
  2. maximum business freedom is unlikely to be the most efficient from the social point of view
     - Even mainstream economists agree that completely free markets can cause problems.
     - Example: Unrestricted mergers can create harmful monopolies.
     - The 2008 financial crisis showed that too much freedom for banks can hurt the whole economy.
  3. there are regulations that may restrict business freedom in the short run but may promote the long-term interest of all firms
     - Short-term freedom for firms (like using child labor) can harm long-term growth.
     - Regulations (like banning child labor) can benefit businesses by ensuring a healthier, better-educated workforce.
     - Sometimes, limiting individual business freedom helps the entire business sector.
  4. highly debatable whether greater market freedom is better for economic development.
     - Lipsey–Lancaster Second Best Theorem: we cannot judge *a priori* whether a higher degree of market liberalization will bring result in (allocative) efficiency, unless all markets are completely liberalized
     - even if a more liberalized economy is allocatively more efficient, it cannot be argued that such an economy will grows faster

- Question (2): ***Is a stronger protection of private property rights better for growth?***
  1. Property Rights Are More Diverse Than Just "Private vs. State"
     - The debate often ignores communal and hybrid property systems
     - Research shows that well-managed communal systems can avoid the "*tragedy of the commons*."
     - Examples:
       * Open-source software rules
       * shared farming equipment
       * China's TVEs (locally controlled but privately run businesses).
  2. State or community ownership can sometimes be more efficient
     - Market failures (like monopolies or externalities) can make state ownership better for growth in some cases.
     - Examples: Efficient state-owned enterprises (SOEs) in Singapore, France, and Norway helped drive technological progress and exports.
  3. Private Property Rights Depend on a Strong State

4. Not All Private Property Rights Help Growth - Strong protection of certain private rights can hurt growth:
   - Landlord rights can block development (e.g., feudal systems).
   - Excessive shareholder rights may pressure companies into short-term profits over long-term investment
   - Protecting risky financial assets (like before the 2008 crisis) can destabilize the economy.

- Question (3): ***Is the relationship between institutions and economic development always the same?***

1. even if an institution in some dose promotes growth, it may actually hamper economic growth in a larger dose
2. even the same institution in the same dose may be good for one country but bad for another
3. even in the same dose and in the same country, the same institution may promote growth at one point in time but not in another

6.3.2 What about the evidence?

Cross-section versus time-series

most of the evidence provided in the dominant discourse is from cross-section econometric studies. Very few studies look at the relationship between institutional changes and growth over time in the same country.

there is some pretty strong time-series evidence against the dominant theory of institutions and economic development.

- developing countries of Sub-Saharan Africa and Latin America

> First, economic growth has fallen rather dramatically in developing countries of Sub-Saharan Africa and Latin America, which have, under enormous external pressures, rather faithfully reformed their institutions in the neo-liberal direction during the last three decades. They were growing much faster in the 1960s and the 1970s, when they lacked those 'liberalized' institutions.[5] Especially when we consider that these institutional reforms were preceded and accompanied by supposedly 'good' policies of liberalization and opening-up (see above), it is difficult to avoid the conclusion that institutional reform along the neo-liberal line may not help growth.

- case of Korea

> Second, take the case of Korea. Being one of the countries hit by the 1997 Asian financial crisis, Korea was told by the IMF, the US Treasury and other creditors to introduce a sweeping institutional reform and adopt GSIs, especially in relation to finance and corporate governance. However, following these reforms, the country's trend growth rate has fallen, rather than risen, quite dramatically –

- rich capitalist countries (end of WWII - neo-liberalism)

> Third, between the end of the Second World War and the rise of neo-liberalism in the late 1970s, the rich capitalist countries introduced or strengthened a host of regulatory institutions – tougher business regulations, heavy restrictions on financial activities, nationalization of industry and finance, laws protecting workers, higher taxes (amounting to expropriation of private property), the welfare state, and so on. However, during this period – known as the Golden Age of Capitalism – they grew three to four times faster than during the period of classical liberalism (1820–1950) and twice faster than during the subsequent neo-liberal period (1980–2009).[6]

6.4 Distortions in scientific research

Economists are economic agents themselves, that respond to incentives (PPP: power, patrimony, publications)

At least three possible sources of distortions in the production of scientific research:

- economic interests
- geographical distortion
- institutions of (economic) scientific production

6.4.1 Economic Interests

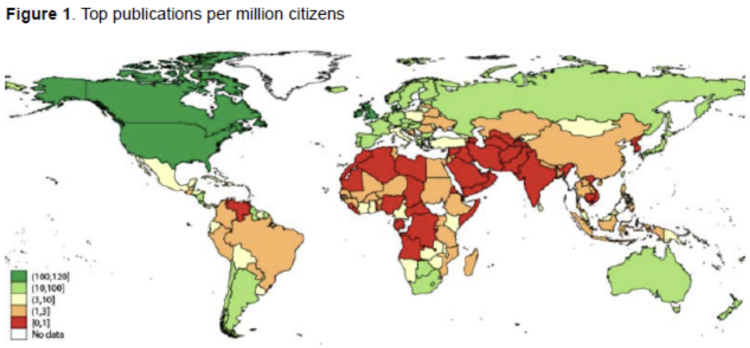
The "Consensus" might represent the interests (and the vision) of (particular interests in) advanced countries in a specific point in time:

- "*"better" institutions (...) are institutions that are typically found in Anglo-American countries*" Chang (2011)
- "*By and large, the rules of globalization have been determined by the advanced industrial countries, for their interests, or more precisely for the interests of special interests*" Stiglitz (2003)

The intellectual foundations of the "*Consensus*" deliberately created also through financing of the research (Roemer (2011))

- the success of the conservative tide in the United States is in large part a consequence of the successful intellectual work that the right-wing has engaged in since the mid-1970s.
- the right-wing took theory seriously → In the 1970s, a number of right- wing think tanks were formed
- Their function was to create a sound conservative ideology, with the following tenets:
  - freedom is possible only under laissez-faire
  - governments are corrupt and inefficient
  - interference with markets is always bad for economic welfare
- these ideas were promulgated through the media, in many publications, and by providing expert testimony to legislators
- since the television and newspaper media are typically owned by wealthy interests, they were surely not indifferent to helping propagate these ideas

6.4.2 Geographic Distortion



Top publications is top-5: The American Economic Review, Econometrica, The Journal of Political Economy, The Quarterly Journal of Economics, and The Review of Economic Studies.

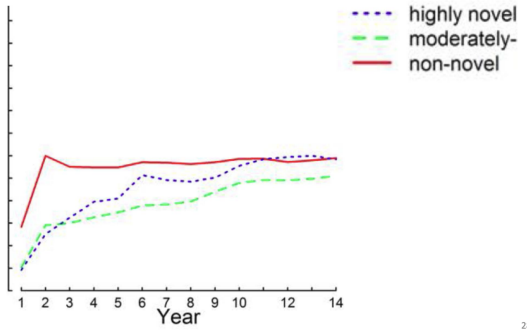
Considering a 20-year span (1985 to 2004) and the top-five economics journals together the published articles comprised:

- 34 papers on all of Sub-Saharan Africa
- 39 papers on India
- 65 papers on China
- 2,383 papers on the US

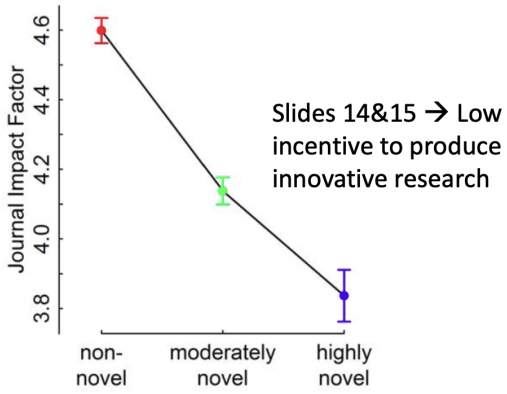
Researchers have an incentive to study specific contexts

6.4.3 Institutions of Scientific Production

Citations within the field



Estimated journal Impact Factor



"*The Norms of Sciences*" - (Romer, 2016)

coordination in science

> Like the market, science is a social system that uses competition to direct the self-interest of the individual to the advantage of the group. The problem is that competition in science, like competition in the market, is vulnerable to collusion.

social norms in science

> When the person who says something that seems wrong is a revered leader of a group with the characteristics Smolin lists, there is a price associated with open disagreement. This price is lower for me because I am no longer an academic. I am a practitioner, by which I mean that I want to put useful knowledge to work. I care little about whether I ever publish again in leading economics journals or receive any professional honor because neither will be of much help to me in achieving my goals.

culture in science

> Several economists I know seem to have assimilated a norm that the post-real macroeconomists actively promote – that it is an extremely serious violation of some honor code for anyone to criticize openly a revered authority figure – and that neither facts that are false, nor predictions that are wrong, nor models that make no sense matter enough to worry about.
>
> A norm that places an authority above criticism helps people cooperate as members of a belief field that pursues political, moral, or religious objectives.

To me, this reveals a disturbing blind spot. The trouble is not so much that macroeconomists say things that are inconsistent with the facts. The real trouble is that other economists do not care that the macroeconomists do not care about the facts. An indifferent tolerance of obvious error is even more corrosive to science than committed advocacy of error.

Should you care?

- Paul M. Romer, Nobel **2018**
- Willem Buiter, 06 March 2009
  - The Monetary Policy Committee of the Bank of England I was privileged to be a 'founder' external member of during the years 1997-2000 contained (…) quite a strong representation of academic economists and other professional economists with serious technical training and backgrounds. This turned out to be a severe handicap (…)
- Leamer, 2009, Macroeconomic Patterns and Stories, Springer
  - "The bad news is that I am not a macroeconomist and thus cannot claim an expert's knowledge of the theory of the field. The good news is that I am not a macroeconomist, and I do not carry the heavy intellectual baggage that most macroeconomists lug around",
- John Kay, FT, May 20, 2014
  - Students of economics are in revolt – again. (…) In no other subject do students express such organized dissatisfaction with their teaching.
  - The need is not so much to teach alternative paradigms of Economics as to teach that pragmatism, not paradigm, is the key to economic understanding.
- Reis, Oxford Review of Economic Policy, Volume 34, Numbers 1–2, 2018
  - The popularity of criticisms of **macroeconomics** likely has less to do with research, which most people know and care little about, but rather with their exposure to macroeconomics in the way it is taught
  - At the undergraduate level, I see a productive debate taking place.
  - At the graduate level, there is more room for improvement. Teaching is still tied to a benchmark neoclassical framework in masters class in macroeconomics, or in the core PhD sequence, and this deserves to be questioned

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