Institutions for Development

What are institutions and why they matter in development (1): NIE contributions

- D. North：Institutions are the rules for the game in a society, Providing the incentives for human behavior in their interactions
- Aoki：Equilibrium results out of the games
- New Institutional Economics (NIE): Information asymmetry ☞ Adverse selection, Moral hazard, Transaction cots…. ☞ Institutional innovation for development (ex. Market enhancing views)

⇨Influencing the market economy (Producer-Consumer)

⇨Reducing transaction costs may contribute to specialization and division of labor, productivity gains

ex. Property rights, Enforcement of contract

→ If provided correctly, the transactions are promoted, but if exploited or unenforced, transaction cost increases (exploitation by the government)

What are institutions and why they matter in development(2)

- Institutions include not only law and other "formal" ones (written contracts, recorded property rights…) but also custom, social norms, implicit code of conducts and other "informal" ones

→ Including *socially embedded structures*, *Path dependency*

(Coordination between tradition and modern institutions)

⇦ Institutions and performance (development)

⇦ Success and failures in structural reform

⇦ Transitional economies (1990s～)

What are institutions and why they matter in development(3)

- Institutional Darwinism? (Survival by the fittest)?: Dominating institutions….

1) May be the best options for the partners but may not be socially efficient: Ex. Sharecropping (Good for sharing risks but inefficient)

- Principal: Landlord (owns plot of land to rent), Agent: Tenant (r: share rent, R: fixed rent, L: Labor effort applied for the tenant)
- 3 system: Wage contract, Fixed-rent contract, and Sharecropping contract)
- Puzzle of sharecropping: Marshallian inefficiency

What are institutions and why they matter in development(4)

2) May be the best for the partners but inequitable: Ex. Principal-agent contracts (Allowing principal to extract from the agent's efficiency gains)

3) Efficient institutions may fail: *Path dependency* (institutional lock-down), *Lack of credible compensation for the losers, Uncertain distribution of benefits from the change, Procrastination, Resistance for the loss of status, Coordination failures,, Hold-up problems….*

Determinants of economic development

What decides "long-term economic development"?
: Geography (Resource, Colonization etc.), Integration (Technology and specialization, Openness), or Institutions (Gov., Law and Property rights, Market regulation….)

Reference:

Dani Rodrik & Arvind Subramanian & Francesco Trebbi (2002) "Institution Rules: The Primacy of Institutions over Geography and Integration in Economic Development," NBER Working Papers 9305, National Bureau of Economic Research

Acemoglu and Robinson (2013) *Why Nations Fail: The Origins of Power, Prosperity and Poverty*, Profile Books Ltd

Acemoglu, Johnson and Robinson (2002): "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", Quarterly Journal of Economics 117 (4):1231-94.

Determinants of economic development (2)

- Geography: Initial conditions matters (Nature→Natural resources and other endowments→Trading patters, Environment→ Health conditions, Property rights for market transactions, Physical infrastructures (trading costs), Technology diffusion mechanism
- Integration：Market opening matters (Trading policies: Neoclassic vs. Dependent theories → Import substitution strategies vs. Export orientation, → FDI and MNE)
- Institutions: Market function matters (Institutional settings: Property protection (exploitation risks), Rule of Laws (arbitrary risks) ← Economic development as the game: Incentive design changes the rule of games

→ ex. North Douglass C., 1990, Institutions, Institutional Change and Economic Performance, Cambridge University Press

→ ex. Kiminiori Matsuyama, 1995."Economic Development as Coordination Problems," Discussion Papers 1123, Northwestern University

Rodrik and Subramanian (2002)

- Regression over the long-term statistics; Which one of the 3 explains the income differences of countries?
- Conclusion: Institution rules

← Property protection and Rule of law determines economic development (On their own, impact of integration and geography remains minor)

- But the causality arguments remains for complementing arguments

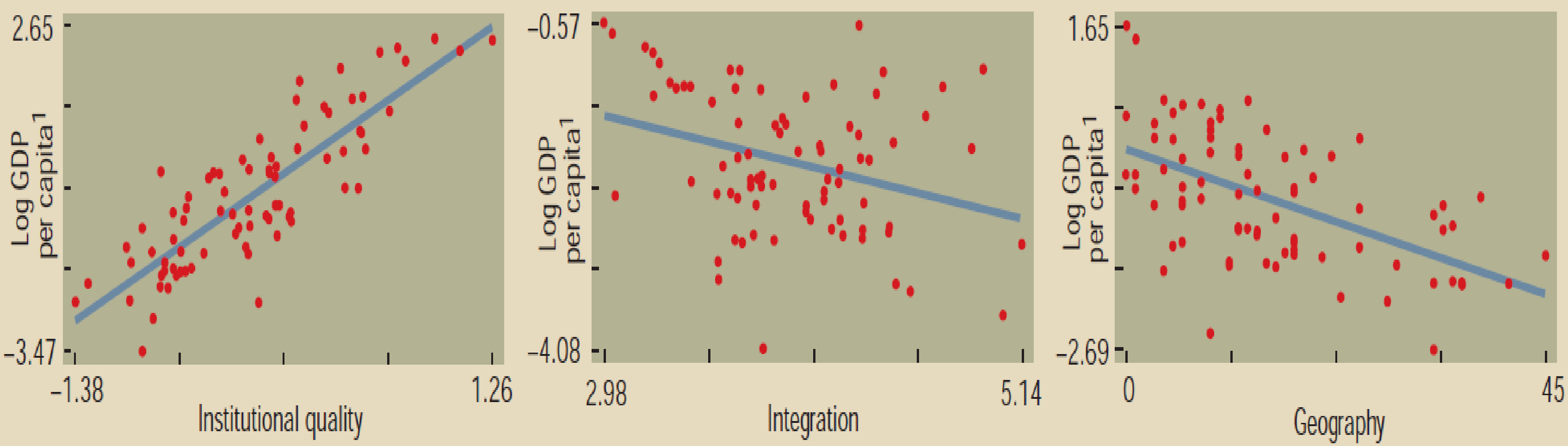
← Easterly and Levine (2002) "Tropics, Germs, and Crops: How Endowments Influence Economic Development", NBER Working Paper No. 9106 (Positive relations: integration ⇔ institution, geography ⇔ institution

Relationship between income, geography, integration, and institutional quality
(Resource: Rodrik,Francesco,Trebbi(2002)

Institutional quality scores high

Institutional quality can boost income significantly, while global integration and geography, on their own, do not.

As institutional quality rises, so does income ... **but increases in integration may not help** **... nor does a more benign geographic location.**

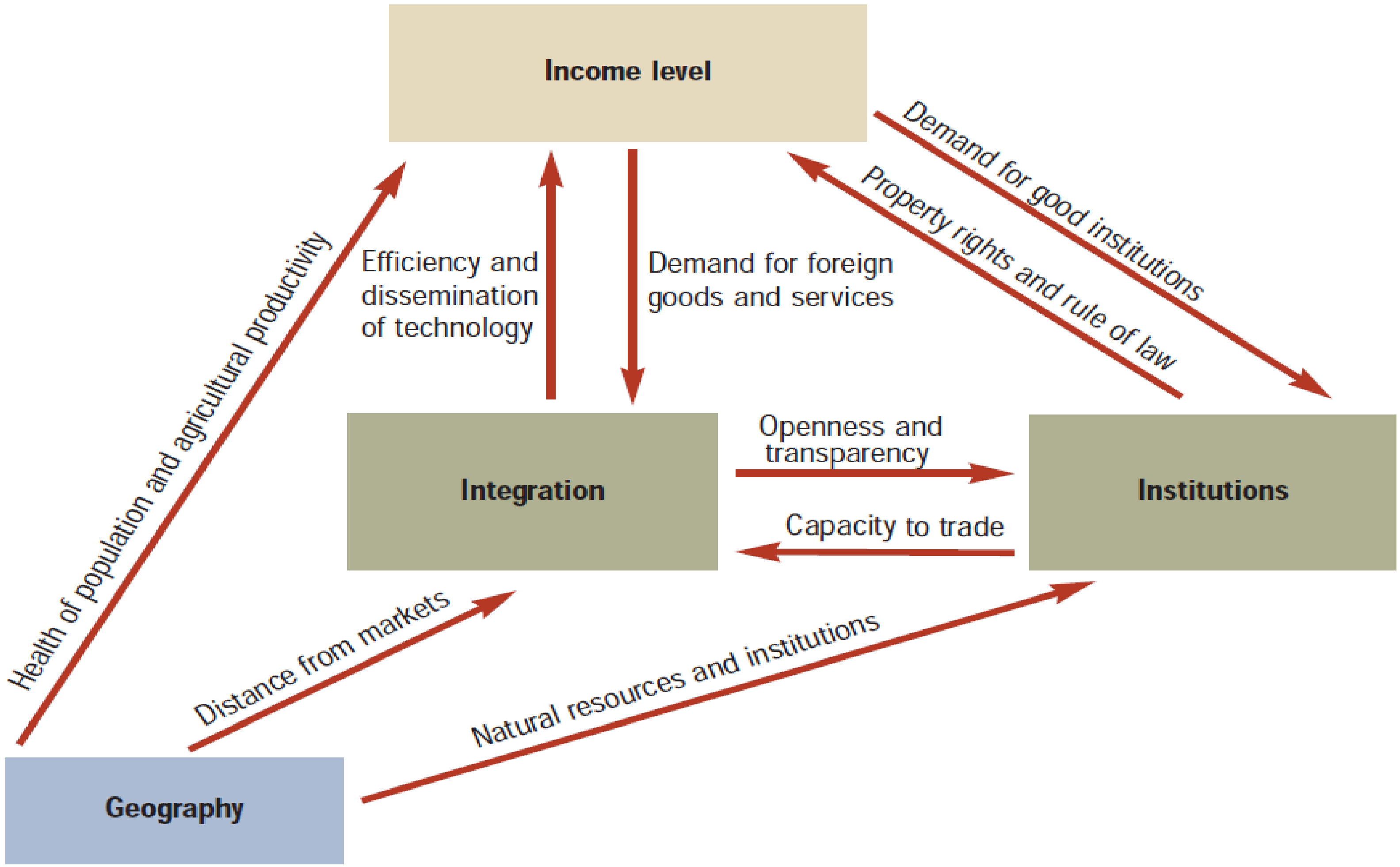


Source: Authors

Note: The graphs capture the causal impact of each of the determinants on income, after controlling for the impact of the others. The indicators of integration and geography used are the ratio of trade to GDP and distance from the equator, respectively. For further details, see Rodrik, Subramanian, and Trebbi (2002).

[1]Expressed in terms of purchasing power parity, 1995.

Income level, Geography, Integration, and Institutions (Resource: same as previous page)



Initial conditions and Institutional development

- Asia, Africa, Middle East, Latin America vs. U.S., Canada, Australia?
- Exploiting institutions or Common interests?
- Origin of present institutions: Colonial power with exploitative institutions
- Initial conditions?: Resource endowment, Tropical disease (Large scale plantation or Mineral resource development with labor exploitation

  (Class division: Ruling vs. Ruled)
- Colonial rules：Education investment for the class division, Infrastructural shortage, Limited political participation

Initial conditions and Institutional development(2)

- Strategic complementarity between institutions

→ ex. Initial conditions in colonial period→ Governing rules → Institutional setting → Present institutions → Present economic performance

- Accemoglu-Johnson-Robinson（2001）: AJR
- Private property rights：Positive relationship with income, Path dependent institutions (ex. Smaller number of settlers (due to diseases) →Exploiting structures

⇔ Mass settlers → Inclusive society (Causal relationship：① Private property rights ⇔ Development standard

② Private property rights protection (past) affects present regime (weaker-weak, stronger-strong)

③ Small number of settlers tends to be weaker in property rights protection

④ More disease, less settlers (Sab-Saharan Africa)

Initial conditions, Institutions, and Development

- Initial conditions: May influence on development but may not be directly per se, *through institutions*
- Ruling India: Tax collection for fiscal needs→ Institutions (different type of land ownership concentration)
- Land owners vs. Peasant owners⇨ Agricultural production (Banerjee and Iyer(2005): Land owner domination leads to less investment in agricultural sector, low productivity→ Class conflicts for worse performance in later years?

Initial conditions, Institutions, and Development (2): Constraints after AJR

- Exception may exist in initial condition-institutions-performance logics: poorer economies getting poorer
- Constraints in specific definitions on various institutions (ex. Democratic states vs. Authoritarian states?: fair elections, freedom of speech….)
- Constraints in indexation of “governance” (Government accountability, Rule of laws, Corruption controls…..)
- Discrepancy between legal institutions and implementation (Economic consequences depend on implementation)

Initial conditions, Institutions, and Development (3): Constraints after AJR (2001)

- Institutional legacies are not everything: Same legacy different results
- Causality (institutions for development but development for institutional innovation) without the process or mechanism?

Suggested Readings

- Acemoglu, D., & Robinson, J. A. (2012). Why nations fail: the origins of power, prosperity and poverty. New York: Crown Publisher
- ----, Johnson, S. and Robinson, J.A.(2001) "The Ayer Colonial Origins of Comparative Development :An Empirical Investigation", *American Economic Review Vol.91. No.1*
- *------, -------, ------ (2005)* "Institutions as a Fundamental Cause of Long-Run Growth", Aghion and Durlauf *eds., Handbook of Economic Growth, Vol.1, pp.385-472/*
- Dani Rodrik et al (2002)"Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development", *NBER Working Paper No. 9305*
- Pranab Bardhan, 2002. "Decentralization of Governance and Development," *Journal of Economic Perspectives*, American Economic Association, vol. 16(4), pages 185-205
- Banerjee, A. and I. Iyer (2005) "History, Institutions and Economic Performance: The Legacy of Colonial Land Tenure System in India", *American Economic Review*, Vol. 78, No.6
- North, D. (1990) Institutions, Institutional Change and Economic Performance, Cambridge University Press.