6
Institutions and Policies

Key Words: Institutions; governance; time consistency; property rights; markets.

Big Ideas:

- Cross-country differences in productivity (TFP) are connected to differences in institutions that shape productivity and policy.
- Good institutions include good governance; time consistency; rule of law; property rights; open and competitive markets.

The enormous international differences in GDP per person reflect, in large part, enormous differences in productivity. But where do these differences in productivity come from? It's tempting to attribute them to the ability and dedication of the people who live there, but (on second thought) there are smart, dedicated people everywhere. We now believe that productivity reflects the quality of local institutions and policies. Stated more concretely: it's not Steve Jobs who makes an economy productive; it's the institutions and policies that allow and encourage someone like Jobs to operate effectively. Some countries have environments that encourage productive activity, and others do not. What's striking is not that this is true, but how big a difference it seems to make.

6.1 Good institutions

So what do we mean by good institutions? The world's a complicated place, and it doesn't come with any simple recipes. But countries with good economic performance share some features. We would say good institutions are social mechanisms that facilitate good economic performance. Here's a short list.

Good governance. It's essential that the government be strong enough to guarantee the security and safety of the country and people, but not so strong that those in power abuse others for their own benefit. It's a delicate balance, but most productive economies have both strong governments and clear limits to the government's power.

Time consistency. Policy consistency over time reduces uncertainty and supports economic growth. Institutions that allow governments to commit credibly to good long-run policies (low inflation, fiscal prudence, etc.) help reduce risks and allow businesses to plan with confidence.

If governments can easily renege on promises (say, to keep inflation and taxes low) when it suits them, economic performance suffers. Finn Kydland and Edward Prescott shared the 2004 Nobel prize partly for their analysis of this "time consistency" problem, which arises not just in economics but in many walks of life, from child-rearing to diplomacy, to military strategy.

In formal research, the lack of time consistency is known as the "dynamic inconsistency of intertemporal plans," which arises when a future policymaker is likely to be motivated to break a current policy promise. Institutions and practices that help governments pre-commit to future policies in a credible way — such as the announcement of inflation targets by independent central banks or the constitutional prioritization of debt payments by state governments — help overcome the time-consistency problem.

Such pre-commitments typically involve the introduction of rules that limit *policy discretion.* You might think that allowing future policymakers complete discretion would result in the best possible policies. However, in these notes you will find numerous examples in which the ability to pre-commit results in better economic outcomes (such as keeping inflation low or fostering greater investment). The reason is that a commitment to prudent policies has a favorable influence on the expectations and behavior of households and businesses today. When economists incorporate the analysis of time consistency into their assessment of various policy approaches, the age-old choice between policy rules and policy discretion usually tips in favor of rules.

Rule of law. It's also important that the legal system enforce the law: that the police and judiciary are honest and enforce the laws of the land.

Property rights. We sometimes take this for granted, but the laws should be clear about who owns what. Without that, effective economic activity is impossible. How can you sell something you don't own? Imaginative people may be able to do just that, but it's not a sound basis for a productive economy. How can you get a mortgage if you can't establish that you own real estate? Why would anyone lend on those terms?

Open and competitive markets. You often hear about "free markets," but what seems to work best are honest, open, flexible, competitive markets for products as well as capital and labor. That's different from what you might term business-friendly governments, those who protect sellers from competition or fraud. The idea is not to protect producers, but to allow them to compete honestly.

We'll give examples of each in class, but you might try to think of your own.

6.2 Institutions or policies?

Institutions bring to mind the difference between North and South Korea. The two countries have the same culture — and the same history until 1950. At that time, living standards were similar, probably a little higher in the North. Today, best estimates indicate that GDP per capita in the South is more than 15 times that of the North. The huge difference in performance surely reflects the huge difference in institutions between the countries: the form of government and the nature of economic activity.

In other cases, policies may play an important role. We think of policies as less fundamental aspects of the economic environment than institutions. An honest judicial system is an institution, but tax rates and government spending are policies. There's a fuzzy line between the two, but the idea is that policies are more easily changed than institutions.

Peter Henry (our dean) and Conrad Miller illustrate the role of policies in a comparison of Barbados and Jamaica. We'll draw liberally from their paper. They note that the two countries have similar backgrounds and institutions:

> Both [are] former British colonies, small island economies, and predominantly inhabited by the descendants of Africans.... As former British colonies, Barbados and Jamaica inherited almost identical political, economic, and legal institutions: Westminster Parliamentary democracy, constitutional protection of property rights, and legal systems rooted in English common law.

Nevertheless, Barbados grew 1.3 percent a year faster between 1960 and 2002, giving it a substantially higher standard of living. (This difference is larger than it looks — the power of compound interest and all that.)

One clear difference between the two countries was their macroeconomic policies. In the 1970s, Jamaica increased government spending on job creation programs, housing, food subsidies, and many other things. When tax revenue failed to keep up, the government found itself with large, persistent budget deficits, which they financed by borrowing from the central bank. This, in turn, led to inflation rates of 20 percent and higher. A fixed exchange rate raised the price of Jamaican goods relative to imports, which led to restrictions on imports and wage and price controls.

Barbados also had a fixed exchange rate, but combined it with fiscal discipline, monetary restraint, and openness to trade. The result was a very different macroeconomic outcome. It's possible other factors played a role, too, but in this case policies were arguably as important as institutions.

Executive summary

1. Good institutions are the primary source of good economic performance.
2. A short list would include: governance, rule of law, property rights, and open competitive markets.
3. Stable and predictable macroeconomic policies matter, too.

Review questions

1. Foxconn's next frontier. Hon Hai Precision Industry Co. Ltd. ("Foxconn") is a Taiwan-based manufacturer that makes products for Apple, Intel, Sony, and others. Known for its plants in China, including one in Shenzhen that makes iPads, it also has operations in Brazil, Malaysia, Mexico, and other locations.

   With wages rising rapidly in China, Foxconn is exploring other locations. As a private consultant, you have been asked to write a short report outlining the advantages and disadvantages of locating in Thailand and Vietnam and to compare both to China. You collect the information in Table 6.1 and begin your report.

   (a) Which of these indicators are most important to your venture? How do the two countries compare on them?

   (b) Which country or countries would you recommend to your clients? What are the primary challenges they would face?

   Answer. This is a qualitative question, but here's an outline of what an answer might look like. A good answer should put some structure on the analysis, not simply list what's in the table.

Indicator	China	Thailand	Vietnam
General			
GDP per capita (2005 USD)	8400	9200	3500
Doing Business overall (percentile)	50.8	90.3	46.5
World Economic Forum overall (percentile)	80.0	73.6	47.9
Governance			
Political stability (percentile)	25.0	16.5	52.8
Govt effectiveness (percentile)	60.7	59.7	45.0
Regulatory quality	45.5	56.4	29.4
Rule of law	41.8	48.8	39.9
Control of corruption (percentile)	30.3	43.6	33.6
Labor			
Minimum wage (USD per month)	204	118	65
Severance after 10 years (weeks of pay)	43	50	43
Labor market efficiency (percentile)	71.5	47.2	64.6
Literacy (percent of adults)	94	94	93
Years of school (adults)	8.2	7.5	6.4
Infrastructure and trade			
Infrastructure quality (percentile)	66.7	68.1	34.0
Export documents required (number)	8	5	6
Export delay (days)	21	14	21
Export cost (USD per container)	580	585	610

Table 6.1: Institutional indicators for China, Thailand, and Vietnam. Percentiles range from 0 (worst) to 100 (best). Sources: Penn World Table, World Economic Forum, World Bank, Governance Indicators, Doing Business.

(a) If you build a plant in another country, you'll be concerned with overall institutional quality, property rights (whether the government might steal the plant), labor cost and quality, labor market institutions, and the challenges of exporting your product. There's no clean link to the indicators, but you might guess that property rights would be related to the governance indicators, esp political stability and the rule of law. The labor indicators obviously address concerns with labor. Infrastructure and trade address the challenges of exporting.

As a rough guide:

- Overall: It's interesting that Doing Business rates Thailand highest, but the World Economic Forum rates China highest. And the differences are large. In the real world, this would call for a closer look. Ditto the source of political instability in Thailand.

- Property rights and overall: Thailand looks a bit better than the others on Control of Corruption and Rule of Law, Vietnam looks better on Political Stability.
- Labor cost and quality: Vietnam is considerably cheaper than the other two, if we use GDP per capita or the minimum wage as rough guides to wages. Literacy is similar in the three countries, China is highest, and Vietnam lowest, on education.
- Labor institutions: The World Economic Forum ranks China highest, and Thailand lowest, on overall labor market efficiency. Another thing that's worth a closer look. Severance looks similar.
- Exporting: cost and delay look similar, but Vietnam has the worst infrastructure. You'll want to look into this, see what aspects of the infrastructure are likely to affect you.

(b) They both look like reasonable candidates. For Thailand, we would look closer at political stability, see what that represents and think about how it would affect us. (And that's an understatement!) For Vietnam, we would look closer at infrastructure.

2. Business analytics in the EU. As a graduating MBA at the prestigious ecole des Hautes Etudes Commerciales (HEC) de Paris, you face a daunting job market. Together with two classmates, you start developing plans for a business analytics startup. The idea is to provide data insights to a broad range of businesses located throughout the European Union. The beauty of the plan, you think, is that you can do it anywhere. The three of you have begun to compare the pros and cons of Paris, Barcelona, and Stockholm, your respective home bases. You collect the data in Table 6.2 and begin to sketch out a plan.

   (a) What features do you need in a city to make it attractive to you and your business?

   (b) What are the pros and cons of each city along these dimensions?

   (c) Which city do you think best fits your plans?

   Answer. This question is less than black and white, here is one possible answer.

   (a) You need, among other things: an environment friendly to startups, access to the internet and related infrastructure, and possibly a pool of well-educated talent. There are other things, but these seem like the important ones.

   (b) How do they stack up?

   - Paris: looks good on ease of starting a business, as well as ease of doing business in general; ditto education; questions/concerns

Country Indicators	France	Spain	Sweden
Ease of doing business (rank)	38	52	14
Ease of starting a business (rank)	41	142	61
Protecting investors (rank)	80	98	34
Getting electricity (rank)	42	62	9
Resolving insolvency (rank)	46	22	20
Minimum wage (USD/month)	778	1009	none
Mandatory severance (weeks of pay)	4	14	none
Unemployment rate	10.5	24.4	7.4
Employment rate	64.3	55.8	74.7
Difficulty of dismissals (index, 1-6)	2.6	2.0	2.5
Education of workers (years)	12.6	11.5	12.5
Internet quality (Ookla, index)	81.3	84.0	86.9
City Indicators	**Paris**	**Barcelona**	**Stockholm**
Quality of life (rank, Mercer)	34	44	20
Cost of living (index)	226	223	157

Table 6.2: Business indicators for three cities and countries.

about getting electricity and internet quality; the same for cost of living.

- Barcelona: huge red flag over ease of starting a business; concerns with getting electricity.
- Stockholm: looks good on overall ease of doing business, getting electricity; solid on ease of starting a business; highest internet quality of the three; and lowest cost of living.

(c) Stockholm looks like the clear choice. It would take a good argument to suggest otherwise. Also highly rated for quality of life, which is something you definitely want to consider.

The World Economic Forum has a similar take: "Sweden has managed to create the right conditions for innovation and the knowledge-based economy. The education system is of high quality and seems to deliver the right skills. But it should address its labor market regulations and high tax rate, which are considered the two most problematic factors for doing business."

Update. Since using this as an exam question, we're learned two things. One is that rent control in Stockholm makes it virtually impossible to find a place to live — unless you have enough money to buy. The other is that Berlin might be better than all of these places. A friend in the business tells us that rents are low and there's a huge amount of technical talent available from central Europe at modest cost.

If you're looking for more

The comparison of Barbados and Jamaica comes from Peter Henry and Conrad Miller, "A tale of two islands."

Here are some other good reads, in order of increasing length:

- Ben Bernanke, "Lessons from emerging markets." Nice short summary of what good institutions and policies look like.
- Nicholas Bloom and John Van Reenan, "Management practices across firms and countries." They connect productivity to management practices, including monitoring, targets, and incentives. Some find this obvious, but we find it reassuring that good management has a measurable difference on performance.
- Bill Easterly, *The Elusive Quest for Growth*. Essentially a collection of essays on topics related to helping poor countries, unusually witty for an economist.
- David Landes, *The Wealth and Poverty of Nations*. Less witty than Easterly, but he gives us an interesting historical perspective on the major countries of the world: Europe, India, China, etc.

The idea of good institutions has been around forever, or close to it, but we now have better measures of institutional quality than we used to. One of the leading sources is the World Bank's Doing Business, available at

`http://www.doingbusiness.org/`.

The reports of the Economist Intelligence Unit are thoughtful aggregators of this kind of information.

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