ECONOMIC DEVELOPMENT & INSTITUTIONS

Appraising institutional challenges in the early stages of development

Introduction

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About Economic Development & Institutions
Institutions matter for growth and inclusive development. But despite increasing awareness of the importance of institutions on economic outcomes, there is little evidence on how positive institutional change can be achieved. The Economic Development and Institutions – EDI – research programme aims to fill this knowledge gap by working with some of the finest economic thinkers and social scientists across the globe.

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Introduction

Faced with disappointing performance under the ‘Washington Consensus’, international organisations and bilateral development agencies switched to what was called the 'post-Washington consensus'. This extended set of principles was seen as a way of compensating for the neglect of institutional considerations in the original consensus. Market-oriented reforms thus had to be accompanied by other reforms, including the regulation of various sectors, making governments more efficient, and increasing the capacity of human capital. Most importantly, however, emphasis was also placed on good governance as a necessary adjunct to market-led development, especially in regard to its capacity to protect property rights and guarantee contract enforcement. With time, governance then became a key criterion among donors for allocating aid across low-income countries, and also to monitor its use.

It is fair to say that, practically speaking, governance has been defined and evaluated in a rather *ad hoc* way, based on expert opinion, firm surveys, and simple economic parameters like the rate of inflation or the size of the budget deficit. The relationship with the nature and quality of institutions is thus very indirect. This still seems to be the case today, even though the recent World Development Report, entitled ‘Governance and the Law’ (World Bank, 2017), intends to go further by showing how governance, or policymaking in general, including institutional reforms, depends on the functioning of institutions, the role of stakeholders, and their relative political power. Practically speaking, however, there remains something mechanical and schematic in the way institutions are represented in the 2017 report, which is actually more about effective policymaking than about the diagnosis of institutional weaknesses and possible pathways for reform.

If there is absolutely no doubt that institutions matter for development, and for development policies and strategies in the first place, the crucial issue is knowing how they matter. After all, impressive economic development achievements have been observed despite the presence of clear failures in particular institutional areas. In other words, not all dimensions of governance may be relevant at a given point in time in a given country. Likewise, institutional dimensions that are not included in governance criteria may play a critical role. Despite intensive and increasing efforts over the last few decades, there remains limited knowledge about how institutions affect development, how those institutions are formed, and how they could be reformed in specific contexts.

Searching for evidence on the role of institutions: three approaches

Three approaches have been developed to identify institutional factors that may hinder or promote development, and to think of ways of remedying or enhancing specific factors. Each of these approaches have their drawbacks.

The first approach consists of historical case studies, understood as in-depth studies of successful and unsuccessful development experiences in history or in the contemporary world. The formation and success of the Maghribi traders’ coalition in the 11th-century Mediterranean basin, the effects of the Glorious Revolution in Britain, the experiences of land redistribution in South Korea and Taiwan after the demise of Japanese colonial rule, the reform programme known as the Rural Household Responsibility system in China, or the violent fight for the appropriation of natural resource rents in several post-independence African states all epitomise various possibilities of institutional change: while some of them led to vigorous development headed by developmental states of different types, others caused underdevelopment under the aegis of predatory states. Such studies are of the utmost interest because they show, at work, the mechanisms that may govern the transformation of institutions, often under the pressure of external circumstances, and they show the unequal success that can be attributed to institutional change. In *Why Nations Fail*, for instance, Acemoglu and Robinson (2012) masterfully highlight the role of institutions in several historical and contemporaneous cases of development, and in failed development experiences. They place a special emphasis on the key role of inclusive institutions, as compared with predatory ones, and, most importantly, on the role of politics in encouraging or impeding development (see the last part of Section 1.3). The problem, however, is that the lessons from most history-oriented studies are rarely transferable across time or space, and they are not necessarily – or completely – relevant for today's developing countries.

The same conclusion applies to studies emanating from the quickly proliferating strand of economic history research based on natural historical experiments. Variation in some key determinant whose presence or absence was observed a long time ago is considered as exogenous, and therefore is used as a valid instrument to explain today's different outcomes. Because many geological and geographic characteristics have the appearance of being deterministic, they are often seen as the deep causes behind the institutional divergence that is responsible for different growth and development trajectories. In other words, institutions are assumed to be proximate determinants of present-day development performance. Two particular difficulties arise here. First, as underlined by Dany Rodrick (2004) and others, it is not because a researcher finds an appropriate econometric instrument that s/he is able to offer an adequate explanation. We tend to agree with Avinash Dixit (2007) that 'the notion that geographic and historical variables are merely instruments for institutional determinants of economic success is supported more by the intuitive appeal of the stories told than by the statistical significance of the tests performed' (p. 137). Second, results that highlight the role of historical factors, particularly when they are rooted in physical determinants, give no guidance when the problem affects the relevant institutions directly: 'the recommendation to change one's geography or history is useless' (Dixit, 2007: 137).

The second approach to identifying institutional factors that may hinder or promote development involves cross-country studies in the contemporaneous era. It relies on indicators which describe the strength of a particular set of institutions in a country – for example, property rights, legal regimes, the extent of democracy, the strength and nature of controls on the executive, corruption etc. – with the aim being to identify whether there is a correlation between these indicators and growth or other development outcomes. Institutional and governance indicators are generally based on the opinions of experts, who compare the performance of different countries on which they have specialised knowledge along a number of selected dimensions. As such, they are grounded in largely subjective assessments and lack the precision needed for statistical analysis. This being said, correlations between these indicators and development outcomes are sometimes significant, and they are often intuitive. However, the use which can be made of cross-country studies is limited since, by construction, they essentially refer to an abstract 'average country'. They may therefore be of little use when it comes to a specific country. Most importantly, they say nothing about causality, and still less about the policy instruments that could improve particular institutions. For example, corruption is generally found to be bad for development. However, we would like to know the direction of causality, and whether this conclusion is true in all countries and in all circumstances. And what should we think about cases where corruption serves to 'grease the wheels' of the bureaucratic system, speeding up procedures in the presence of too stringent administrative constraints? In sum, cross-country analysis is an interesting exploratory approach, yet we need to delve deeper into the issues when focusing on a particular country and trying to conceive of potential institutional reforms.

To understand the third approach to identifying institutional factors that may hinder or promote development it must be borne in mind that in some cases institutional weaknesses or strengths are readily observable, as in the delivery of public services like education or health care. For instance, the absenteeism of teachers in public schools reveals a breach of contract between civil servants and their employers, and/or a monitoring failure by supervisors. This state of affairs raises two interesting issues. On the one hand, there are ways of incentivising teachers so that they show up to school. Numerous experiments that have been rigorously evaluated by randomised control trial (RCT) techniques in various community settings have successfully explored such incentive schemes in various countries over the last two decades or so. On the other hand, it is not clear whether there is always the political will, or an adequate coalition of interest groups, to fully correct this institutional failure of civil servants who do not comply with their official duty, and to make successful experimental schemes universally compulsory.

Identification of institutional weaknesses at the microeconomic level, and experimentation to identify ways to correct them, has multiplied over recent years. Yet this line of research generally addresses simple cases which can be suitably designed for experimentation. Identifying institutional failures and devising remedies is much less easy, if not impossible, in more complex situations where a bundle of attributes rather than a single or a few factors seem to play an important role. Moreover, if RCT studies (and this is their strength) are able to establish causality between well-specified institutional interventions and outcomes of concern, they are often less successful when it comes to shedding light on the underlying mechanisms. This limitation makes thinking about the generalisability of their conclusions difficult. This is especially so because the impact that is assessed typically consists of short- or medium-term effects and we therefore need a good theory to persuade us that these effects will endure. Doubts are of course reinforced when comparable studies of the effects of a given intervention in different countries do not converge (see Dal Bo and Finan, 2020, for a recent survey of results).

The two empirical approaches to institutions and development summarised above leave a gap between an essentially macro view of the relationship – stylised historical facts or cross-country correlations between GDP growth and governance or institutional indicators – and a micro view that is grounded in, say, the direct observation of the behaviour of absentee civil servants or corrupt tax inspectors. It can be assumed that economic growth results from the combination of many factors, including structural changes, which depend themselves on the way institutions work. Industrialisation may be made easier because of institutions that are conducive to local entrepreneurial initiative, or more difficult due to institutions that protect importers' rents. Agricultural productivity may grow faster if land rights are well-defined and well-implemented, yet the need for the state to intervene may be confined to certain situations, which themselves have to be specified. To understand the relationship between institutions and development we must be able to identify how institutions facilitate or hinder the basic changes that govern economic growth.

Moreover, development is not exclusively about economic growth. Inclusiveness, and therefore the way institutions distribute the products of growth, is an essential attribute of any genuine long-term development process. And growth needs to be sustainable over time, too. For another thing, focusing on micro aspects is fine as long as one does not lose sight of the bigger picture. There are thus many possible causes of corruption among tax collectors, including lack of monitoring, or the propensity of supervisors to take their cut, or of rich taxpayers to bribe the budget minister for looser tax controls. It is almost trivial to say, but it is still worth emphasising, that the fundamental institutional factor(s) behind a specific dysfunction must be uncovered in order to reach a correct diagnosis and to correctly identify the policy implications. There are innumerable instances where, because only proximate causes have been identified, the problem at stake quickly resurfaced after the remedy inferred from an incomplete diagnostic was applied. Even if some experimental anti-corruption device is found to work for a given tax and a given group of tax collectors, there is no guarantee that the government will make the decision to implement it on a broad scale and on a permanent basis.

Moving from the rigorous identification of what appears to be an efficiency-improving policy or institutional arrangement to an understanding of the conditions in which it may be effectively put into practice requires that we decipher the surrounding political economy context. In other words, considerations of political feasibility need to be added to considerations of economic efficiency. As we have learned from the political economy approach discussed earlier, politics may act as a constraint, and it is not clear *a priori* how a trade-off between economic efficiency and political objectives should be resolved. Even working in partnership with a government agency and obtaining its agreement on the soundness of a particular treatment that has been revealed in the course of an experiment that was run with its full support does not ensure that this treatment will actually be implemented. Interests or considerations that were abstracted away at the time of the experiment may come into play or may emerge only at the time of implementation.

These limitations of standard analyses of the relationship between institutions and development have motivated the exploratory research that is being undertaken within the present Institutional Diagnostic Project (henceforth labelled IDP). Even though we do not claim to be able to close the gap between research on the role of institutions and a diagnostic that will be directly relevant for policymakers, we believe that we can narrow it down somewhat. At least, this is our hope – and that is the purpose of this book. One of the main reasons why we believe that this project is worth undertaking is that the above gap is currently quite large – too large, actually. Here, we cannot resist the temptation to cite Avinash Dixit (2007) extensively, not only because he emphasises the size of the gap between research and policy prescriptions in the present state of affairs, but also because he aptly warns us that this gap is impossible to close. Hence the need for a division of labour between researchers and policymakers:

> '…the econometric and theoretical studies are not the best way to generate policy prescriptions. Most cross-country regressions are a far from perfect fit: the myriad explanatory variables that have been tried explain only a fraction of the variance. Theoretical modelling explores the implications of one cause or mechanism in depth,

> deliberately isolating it from others, whereas policy prescriptions require that one consider all the different causes or mechanisms at work in a country and how they interact. The question policy prescribers must address, is not what creates success on average across countries, but what is going wrong in this country, and how can we put it right. This seems to suggest a division of labor. Academic researchers should look for general tendencies and patterns and should not offer specific prescriptions for individual countries. That should be left to policy practitioners in the countries or in international organizations, who have much more detailed knowledge of the circumstances and needs of individual countries.' (p. 150)

Institutional diagnostics as a new approach to institutions and development

The IDP aims to develop a meso-level methodology and a framework that will make it possible to identify major development-impeding institutional weaknesses, or dysfunctions, in a specific country at a specific point in its development process, and to propose lines of reform which take the political context into account. Development is defined as inclusive and sustainable economic growth. The approach is expected to contribute to both a better understanding of the relationship between institutions and development, and a more complete stocktaking of policies and reforms that are likely to improve the development context should they be adopted. It is a country-centred approach differing from historical case studies in the sense that the focus is not on a particular event, circumstance, or episode but on the overall functioning of a country's economy. It also goes beyond the mere use of governance or institutional indicators, which are deemed much too rough or imprecise when dealing with a real economy. Furthermore, the IDP approach makes use of microeconomic evidence on institutional failures or deficiencies and, where available, of experimental studies conducted in the country concerned. These include historical studies based on natural experiments and mimicking RCTs that we mentioned earlier.

Unlike the approach of the 'growth diagnostic' of Hausmann, Rodrik, and Velasco (2005), the decision was made not to design *a priori* a diagnostic framework that would be subsequently tested through application to various countries and progressively revised in the light of accumulated experience. Rather, the choice was made to carry out in-depth studies of the relationship between a large range of institutions and development performances in a limited number of countries. Only after completing a particular country study will we be ready to examine whether, based on the extensive knowledge acquired, it is possible to derive some kind of diagnostic of its institutional problems and to highlight the political economy of reforms which could alleviate them. In an ultimate step, a diagnostic methodology with some broader applicability will eventually be worked out. In sum, the IDP has a more heuristic character than the 'growth diagnostic' approach.

The funding agency behind our whole research programme, the UK Department for International Development (now the Foreign and Commonwealth Development Office), required us to focus on low-income and lower middle-income countries. Accordingly, and within the constraints of the available resources, the four following countries were selected: Bangladesh, Benin, Mozambique, and Tanzania. The rationale for this choice will be explained in each individual case study.

Structure of the case studies

Equipped with a precise definition of institutions and institutional failures (see Chapters 1, 2, and 3), the in-depth review of the relationship between institutions and development in a country, and the identification of institutional dysfunctions that might slow down or hinder development, will proceed in three steps, which are described in much more detail in the next chapter.

The first step is rather ‘mechanical’: it consists of reviewing the economic, social, and political development of the country, surveying the existing literature, and soliciting from various types of decision makers, top policymakers, and experts their views on the functioning of institutions in their country. Based on this material, it will be possible to identify the most obvious ‘binding constraints’ on economic development, understood in the same way as in the ‘growth diagnostic’. Moreover, hypotheses regarding whether and how these constraints are related to institutional factors will be put forward. This rather straightforward approach to institutions and development in a particular country is also expected to point to several thematic areas where critical institutional factors seem to be at play. Some of these areas readily come to mind, although the precise manner in which they matter is not *a priori* evident. For instance, various aspects of state capacity must be explored, as well as the extent to which it is affected by politics and its relation to private groups, including business interests, traditional authorities, and civil society organisations. The characteristics of political elites also need to be investigated. Other problem areas are likely to be more country dependent.

The second step consists of a thorough analysis of the critical areas revealed by the exploration in the first step. The challenge here is to unearth the root causes of institutional dysfunctions, and to understand how they could be remedied, while taking account of the stakes involved in the reforms. Using these detailed analyses of key thematic areas, the third step of the case studies then consists of synthesising what has been learned into a repertoire of some basic institutional problems that are common to the different problem areas, their negative consequences for development, and, most importantly, their causes, proximate or more distant, as well as the potential for remedies and reforms. This is the essence of the ‘diagnostic’ which each case study intends to deliver.

What is thus intended is a diagnostic, not a reform agenda. Because there are winners and losers of most reforms, political economy factors, as well as political and economic circumstances, will determine whether they can be undertaken or not. This will be thoroughly discussed, but it must be clear that no firm conclusion about the political economy feasibility can be reached without a precise evaluation of the distribution of political power in the society, something that goes far beyond the present exercise. From the strict point of view of the diagnosis, however, its most important contribution is to put squarely on the table the nature of the institutional problems, the needed reforms, and the stakes involved. In other words, it is to make sure that all key actors are aware of the most serious implications of the reforms, the ensuing collective gains, and, possibly, the losses for various categories of agents. If successful, our approach to institutional diagnostics should allow us not only to predict the future effects of an absence of the required institutional reforms, but also help us to get a grasp of the reasons why, on repeated occasions, countries which were presented as development models, and hence treated as aid darlings, later turned out to have a disappointing development performance and to have regressed on several fronts. It must be the case that, concealed behind signs of apparent strength and success, some deep forces are at work that are liable to make today's good performance unsustainable in the longer term.

It is a very hard challenge to detect institutional anomalies and dysfunctions that are capable of derailing a growth process that seems to be well under way. Argentina before the rise of Peronism, a nationalist-populist movement which governed the country for 25 of the 38 years after democracy was restored in 1983, or Iran before the Islamic revolution of Khomeini (1979) and the subsequent establishment of a theocratic regime, are cases in point. We can also think of Pakistan, which recorded one of the highest rates of growth in Asia under the rule of General Ayub Khan (1958–1969) and, somewhat later, under the rule of General Zia ul-Haq (1978–1988). It was actually under the latter that the country embarked on a dysfunctional pathway marked by political instability and institutional regression.

It would, of course, be a rather vain effort to try to say whether, equipped with the IDP approach, we would have succeeded in decoding the situation then prevailing in Argentina, Iran, and Pakistan, and in identifying the symptoms of their ill-fated destiny. Such a task is formidable if only because contingent factors may be at play which, by definition, are almost impossible to anticipate. We do well here to remember the important role of luck and bad luck in influencing development successes or failures in many countries (Easterly, 2001). Nevertheless, the purpose of the IDP exercise is to get as close as possible to a diagnostic that is capable of detecting serious flaws or ill-boding imperfections in the institutional scaffolding of a country or, by contrast, healthy tendencies which seem to portend continuous progress on the way to development.

In line with what has been said earlier, our ambition is not to formulate precise policy prescriptions. Moreover, the conclusions we have in mind will be fraught with uncertainty. In other words, we essentially aim to unveil weak points that have the potential to cause severe problems in the future. This is with a view to hopefully prompting policymakers to become more aware of them, monitor their evolution, and ponder feasible remedies. As will become clearer as the discussion of our empirical material proceeds, a sound IDP requires that two types of analysis be performed: an analysis of the structural transformation of the economy, and the possible imperfections in the way it does or does not take place, on the one hand, and a political economy analysis that identifies how political factors constrain static and dynamic economic efficiency through institutional and policy choices, on the other hand. In the whole endeavour, the role of informal rules and institutions, and their interactions with formal institutions, receive great attention. This is justified given the important role and the great resilience of traditional local rules and institutions in many developing countries. They permeate the whole social fabric and the question as to how they will be antagonised by newly established formal institutions, or complement them, or accommodate them in some way or other, cannot be escaped. This is particularly evident in matters of contract enforcement and land property rights.

In order to gain even richer insights from our lines of investigation, we enrich our comparative perspective by adding two countries to the list of our four in-depth country case studies. These new countries, for which we rely on second-hand literature, are South Korea and Taiwan, two East Asian tigers known for their spectacular development records. It bears emphasis that our idea is not to erect these two cases as benchmarks against which institutional imperfections in other, less successful countries must be measured. That one-size-fits-all solutions are inadequate is a principle which we should apply to any attempt to mechanically transplant institutions not only from economically advanced countries of the Western world but also from advanced countries of Southeast Asia. What we have in mind is different. We want to use the experiences of South Korea and Taiwan to get a better idea of the key issues which a country must tackle in order to develop in a sustainable manner.

To make things more concrete, we do not wish to claim that, because these two Asian countries followed such a path, a military-based authoritarian regime is a prerequisite of sustainable development. It is evident that this sort of advice is fraught, if only because we do not know how a benevolent despot can arise in a particular country. In fact, many examples from our contemporaneous world seem to indicate that malevolent military rulers are the rule rather than the exception, as attested by the present-day regimes of countries such as Mali, Myanmar, Pakistan, Thailand, and many others. What is of interest to us, and where we can learn a lot from the study of South Korea and Taiwan, is that their military regimes succeeded in preventing business interests from capturing the state and influencing its development policies. This is an issue which must be addressed and solved in some way or other, and the experiences of these two countries should be considered as sources from which to get inspiration and not as models to copy *in toto*.

The outline of the book is as follows. In Chapter 1, we define the concept of institutions and then move forward by discussing interactions between formal and informal institutions and then presenting and illustrating the main existing economic theories of institutional change. In Chapter 2, the methodological approach of the IDP is explained and justified. In the four subsequent chapters, the IDP approach is applied to the four countries which we have thoroughly investigated: Benin and Tanzania in Chapter 3 and Mozambique and Bangladesh in Chapter 4. We then address the two big achievers: South Korea in Chapter 5 and Taiwan in Chapter 6. Then come the synthesis chapters. First, Chapter 7 looks at various aspects of the structural transformation in the six countries' economies, pointing to strengths in South Korea and Taiwan, and to weaknesses in the four countries selected for in-depth study. Chapter 8 probes the role of politics and the initial conditions prevailing at the time development efforts were initiated, while Chapter 9 focuses on issues of state capacity and property rights, still upholding the comparative perspective that is at the heart of the book. Finally, Chapter 10 offers a general conclusion, in which basic lessons from the analysis, and the implications for development assistance, are identified.