

## Chapter 7

# Conclusions

**B**AD institutions are harmful to economic prosperity. This follows not only from common sense, but receives support from a growing number of empirical and, to a lesser extent, theoretical studies. It is conceptionally useful to include the quality of institutions in the efficiency parameter of a production function because better institutions would allow an economy to produce more with the same amount of input factors (cf Jones, 2002, p 147). The key questions this book aims to address are related to the determinants of good institutions, and the possible means by which institutions may be improved where necessary.

Endogenous growth theory approaches a similar problem when it identifies the sources of technological progress. The key advantage of endogenous growth theory is that it relates technological progress to things people do—namely research and development of new ideas. Such an approach also seems appropriate for institutions. Admittedly, both variables, technology and institutions, are also driven by exogenous factors—ideas appear unintended or accidentally; certain rules are shaped by tradition or religion—but it would not be satisfactory to attribute all developments in technology or institutions to exogenous variations. Otherwise, it would be hard to explain the existence of R&D departments or the deliberate effort devoted to institutions building. Still, there are important differences between technology and institutions, and not all of the results of endogenous growth theory can be transferred directly to institutions. First, developing countries are rarely found at the technology frontier, but rather they struggle to adopt existing technology. The supply of skilled workers may be a limiting factor, which would support the human-capital-to-development link. However, many of the poorest countries have been early adopters of capital-saving technology,

such as mobile phones. Hence, relative resource endowment may also be an important factor. Second, effective institutions require ongoing design and enforcement efforts, whereas new technologies need little maintenance once they are discovered. The costs of maintaining, enforcing, and adjusting institutions can prove to be a formidable barrier to the improvement of the rules of the game. Therefore, it may be somewhat pointless to demand good institutions as a prerequisite to development assistance because this would require a poor country to deliver something it may lack the resources to create. The notion of costly institutions, as pioneered by Harold Demsetz (1967) and Armen Alchian and Demsetz (1973), points to reverse causality between institutional quality and the level of economic wealth. Hence, institutions may upgrade endogenously, in line with economic development.

The downside is that this endogenous evolution must not necessarily be a smooth and frictionless process. On the contrary, it may well exhibit severe collective-action problems and development traps. Since institutions are not for free, individual capital owners are assumed to spend a certain fraction of their capital holdings on institutions. This fraction is labelled private ordering. There is a wedge between private and social returns to private ordering which may discourage further capital accumulation and institutional upgrade.

The possibility of multiple equilibria and development traps with regard to institutional quality has received some attention in the literature (see Gradstein, 2004). The ideas and mechanics developed in chapter (6) go in a similar direction, but contrary to most previous approaches, the model in chapter (6) allows for a gradual evolution in institutional quality as well as capital mobility across countries. A poor country could potentially borrow the resources it needs to upgrade institutions abroad. The crucial question is, whether this will be in the interest of individual actors. The wedge between private and social returns creates situations where individuals have no interest to invest, even though this would be profitable from a social point of view. The problem is illustrated by the evolution of domestic returns in figures (6.2) and (6.3): there is no incentive to invest when domestic returns fall below the world-interest rate.

Multiple equilibria are a powerful instrument to explain the observable pattern of economic development across countries and across time. In particular the *twin-peaks* phenomenon and the failure of many of the poorest countries to catch up has been widely ascribed to development or poverty traps. Domestic returns in the model of chapter (6) show a roller coaster pattern with decreasing and increasing marginal returns to capital. This pattern gives rise to development traps because individual capital owners,

given they are not very large, turn their back once domestic returns fall below the world-interest rate, despite the fact that the economy could potentially produce much more.

The wedge between private and social return appears in two dimensions. First, individual capital owner must determine a rate of private ordering—ie, a percentage of capital holdings spent on institutions—which can either be binding to all or set individually. Failure of collective action may lead to a rate of private ordering below its optimum which aggravates the development trap, though it may appear even with an optimum rate of private ordering. Second, when domestic returns fall below the world-interest rate between capital densities  $k_A$  and  $k_B$ , individual investors are assumed to be too small to bridge the gap. A concerted action, however, might raise a sufficient investment volume to shift the economy from  $k_A$  to  $k_B$ . At  $k_B$  and until  $k_C$  domestic returns would exceed the world-interest rate. However, such a degree of collective action seems unlikely because coordination costs are paramount. A similar view has been developed within the high development theory of the early 1940s and 1950s, which triggered an argument for public industrial programming (cf Rosenstein-Rodan, 1943).

Development traps are not inevitable. Proposition (2) on page 128 identifies the parameter restrictions which constitute a development trap. It shows that an economy with a high endowment of social capital or where bad institutions are not very destructive is less susceptible to development traps. In particular, the latter element needs some qualifications. The destructiveness of bad institutions is captured by a parameter  $\theta$  in the model, which indicates the fraction of output loss that is recuperated by shady or illicit activities. The technical advantage of including such a parameter is that the low-income steady-state has a positive capital endowment (without  $\theta$  it would be zero) which fits with empirical observations and opens new policy options. The reasoning behind  $\theta$  is that bad institution may also offer opportunities (eg, violation of work standards) which make up some of the output loss. However, although production may continue even under dire institutional conditions, the distribution of revenues may suffer because government cronies and crooks might skim most of it. This may trigger some adverse consequences, for instance, rich and powerful crooks trying to protect their revenue flow by preventing institutional improvements, such as capital mobility. Furthermore, it may lead to a more concentrated distribution of wealth in the economy, which may also reduce spending for private ordering (see below).

The separation of private ordering into two dimension, the rate of private ordering and the capital endowment, has some conceptual advantages

because it allows one to study different political and economic settings. As detailed in section (6.5), failure of collective action and heterogeneity among capital owners may aggravate the development trap because spending on private ordering is reduced at a given capital density. One would assume that countries with an unequal distribution of wealth or with a focus on production that is less sensitive to institutional quality have *ceteris paribus* worse institutions. Such seems to be the case in some of the oil-producing countries as well as in a stereotypical banana republic.

There are some important limitations to the model in chapter (6). The notion of institutional quality is simple. It projects a multitude of different institutional arrangements to a single dimension. And its components—social capital and private ordering—are gauged against this dimension. Such an approach reduces the complexity of actual institutional arrangements, probably to a point where the meaning of institutions becomes blurred. Moreover, some comparative statics are used to analyse the model and its implications, while the adjustment processes are largely ignored. Hence, the model does not say how fast countries catch-up once they pass a development trap, or how institutional changes translate into adjustments in the business or political realm. Since substantial adjustment costs may be associated, additional obstacles may appear once one takes a closer look. At some points, these problems were mentioned, for instance when discussing the delicacy of the parameter  $\theta$  or the disintegration strategy, but there is no explicit treatment of this in the model. A model with different economic sectors and political factions could be employed to provide details on such adjustments, but given the inherent complexity of institutional settings, the results will always remain somewhat stylised. Moreover, all models reduce complexity in some respects. Many growth models, for instance, project technological progress to a single variable and ignore probable adjustment costs and opposition because a more detailed treatment would have led to more complicated models without adding much explanatory power. Hence, it has been one aim of this book to find a balance between explanatory power and complexity. Despite the reduced setting, the model comes up with some interesting results, such as the appearance of development traps.

From a policy point of view, the existence of development traps poses a problem. In such a situation it would be pointless to demand better institutions because the resource to put them in force are not available. By the same token, throwing donor money at this country in order to upgrade institutions might deliver disappointing results, since the institutions nec-

essary to allocate such cash flows efficiently are—by definition—missing. Everything counts in large amounts, but this analysis suggests that the effectiveness of foreign aid on institutional quality might be limited. This is not to say that international organisations and development assistance are useless. On the contrary, they should be powerful advocates of best practices and critics where governments pursue outright bad policies. They can also offer assistance and support to the creation of effective bureaucracies and legal codes as well as appropriate checks and balances on government discretion. The point is, that all these activities may be helpful and desirable in their own right, but they are probably not the silver bullet to terminate a development trap. Moreover, since institutions are assumed to improve endogenously with economic development, assistance in other parts of the economy will feedback into institutional quality. International donors may be better advised to direct their effort towards the most effective usage—for instance, an infrastructure project—if they want to make a positive impact on institutional quality.

Development traps—as in chapter (6)—are a threshold problem. Economic development is stalled below a certain threshold: here denoted with capital density  $k_B$ , and the economy contracts until  $k_A$ . If the economy would pass  $k_B$ , self-sustained growth would be triggered which eventually shifts the economy to  $k_C$ . A straightforward policy option could be trying to create regionally or functionally limited entities. While the country as a whole might have a capital density  $k_A$ , a limited entity—eg, an economic centre—might boast a capital density beyond  $k_B$ . If a strategy of institutional disintegration is successful, the centre would proceed to  $k_C$ , while the periphery would bounce back to  $k_A$ . Eventually, the centre could be enlarged to encompass gradually the entire economy. There are frequent examples of institutional separation within countries: special economic zones, for instance. On a smaller scale there are business associations, clubs, and guilds which create rules and enforcement mechanisms of their own. The trick is to prevent dilution of private ordering from the centre to the periphery and to find approval from the affected parts.

The existence of development traps with respect to institutional quality helps to explain the persistence of bad institutions and why people may accept to be ruled by corrupt and incompetent governments, despite the tremendous costs in economic output. Recall that the group of high income OECD countries is around 70 times richer than the group of poorest countries. There are many examples that show the absurdity of misallocations as

consequence of bad institutions and governments (cf Killick, 1978; Tangri, 1999). Apparently, there is no political Coase-Theorem which would ensure that best institutions and policies prevail, irrespective of who holds political or economic power. Otherwise, a bad government could simply be bought out of office. In a world where the Coase-Theorem holds, property rights must be well-defined and transaction costs low, so that economic agents will contract to achieve an efficient outcome. Acemoglu (2002) argues that the notion of a political Coase-Theorem is inappropriate because of serious commitment problems in politics—ie, that political contracts between government and electorate are unenforceable. A dictator, for instance, who agrees to cede power in exchange for some kind of reward could meet serious difficulties in claiming this reward after he has lost power. The lack of enforceability adds to transaction costs and renders a political Coase-solution unlikely. Hence, "[...] societies often choose the wrong policies and institutions, or even pursue disastrous courses of action, because these choices are not made for the society as a whole, but for the benefit of those who control political power" (Acemoglu, 2002, p 38). This book offers an alternative explanation of why soaring transaction costs may lead to failure of a political Coase-solution. The coordination between individual capital-owners may be too costly to generate the clout necessary to overcome a development trap. As in Acemoglu (2002, p 32), better outside options—here a higher interest-rate on the world capital market—make coordination more difficult.

The interaction between institutions and economic wealth leads to a somewhat paradoxical conclusion. Despite the importance of good institutions, they must not necessarily be the best target for policy action because they can be assumed to evolve endogenously in line with the economy. Where economic development fails and institutions remain bad, it is easy to blame tradition, religion, customs or other slow moving institutions as not being conducive to modern production. This book argues that incentive problems with the improvement of fast moving institutions may cause development traps which explain the persistence of poverty cum bad institutions.

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