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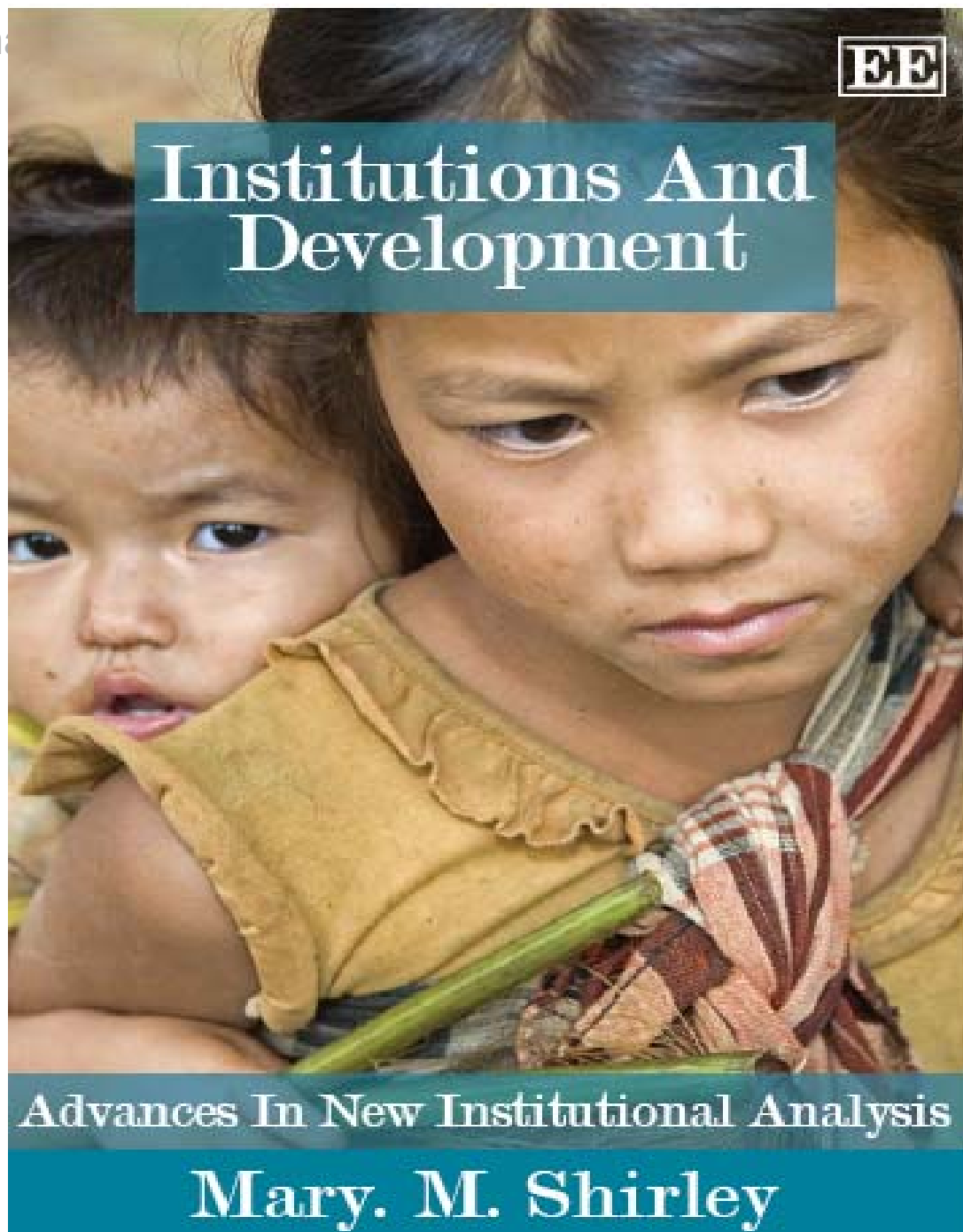
Institutions and Development

Mary M. Shirley

President, The Ronald Coase
Institute



The Roman



Institutions And Development

Advances In New Institutional Analysis

Mary. M. Shirley

Elgar, 2008

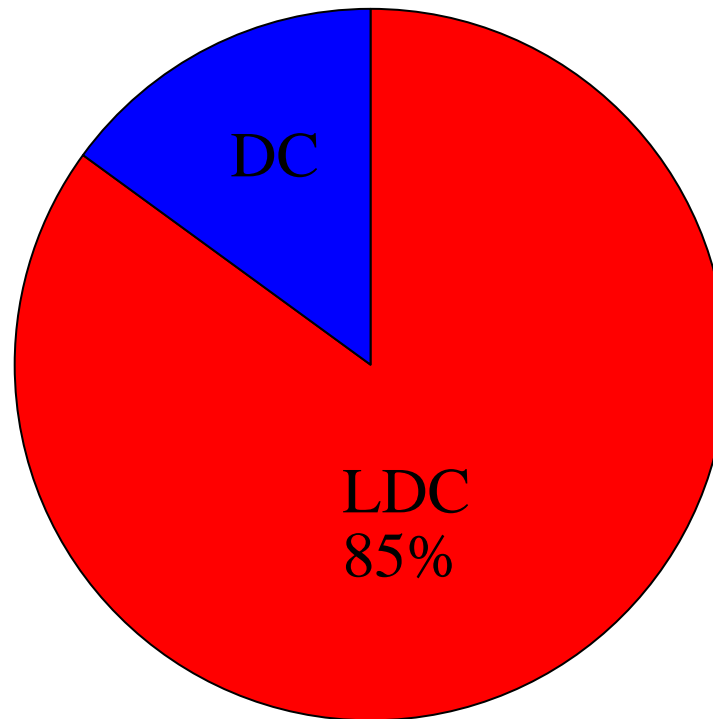


Questions

1. How do institutions affect development?
2. Can foreign aid improve institutions?
3. Can foreign aid avoid institutions?
4. What can be done?



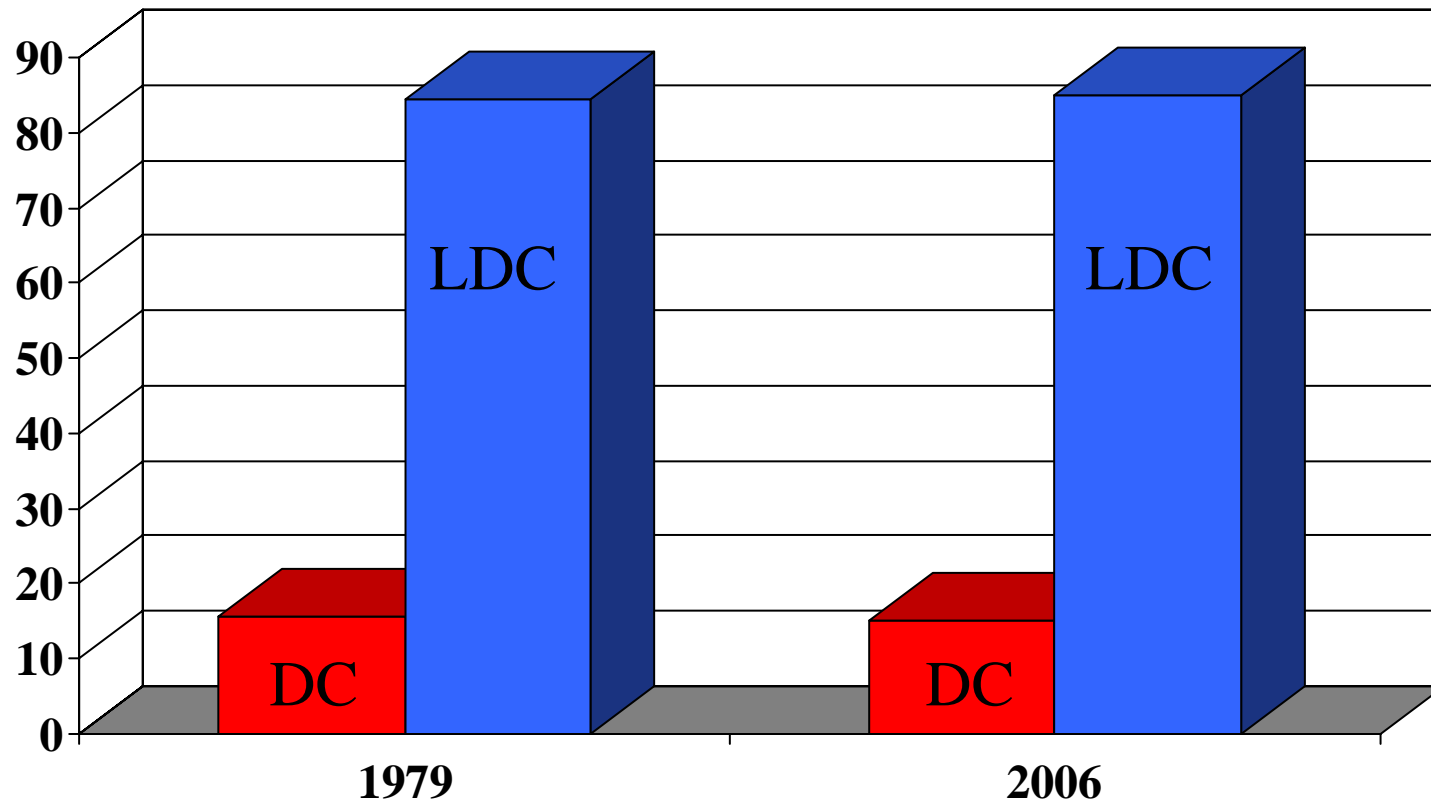
Most of world's population lives in less developed countries



World Bank, DC = $> \$11,115$ GNP p.c. PPP in 2006

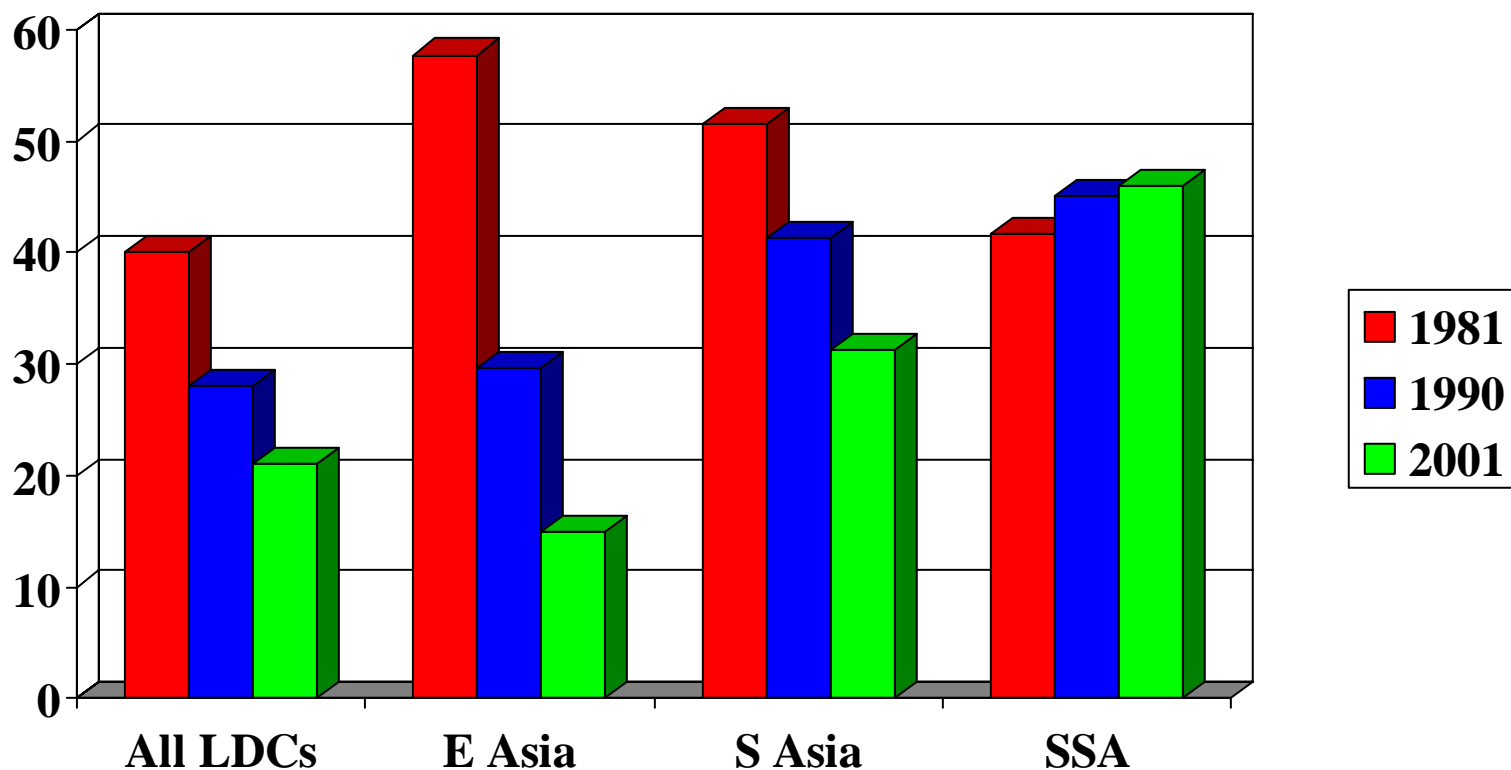


This has changed little





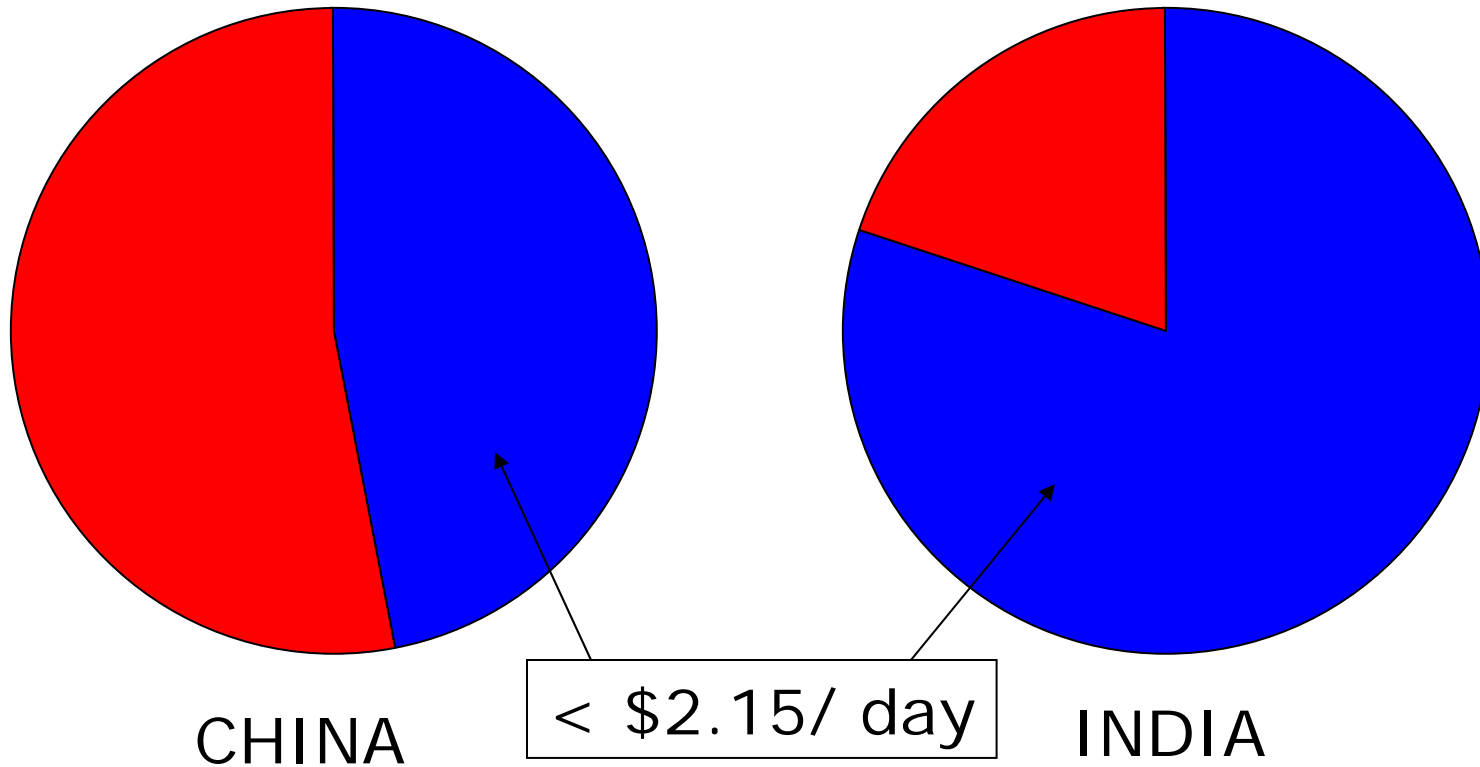
Population in Extreme Poverty Has Declined*



*% pop. in hh w/<\$1 per day (1993 PPP) per capita income. Chen & Ravallion, 2004



Still many poor people



Chen & Ravallion (2004)



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AID community is large



21 multilaterals



36 large bilaterals

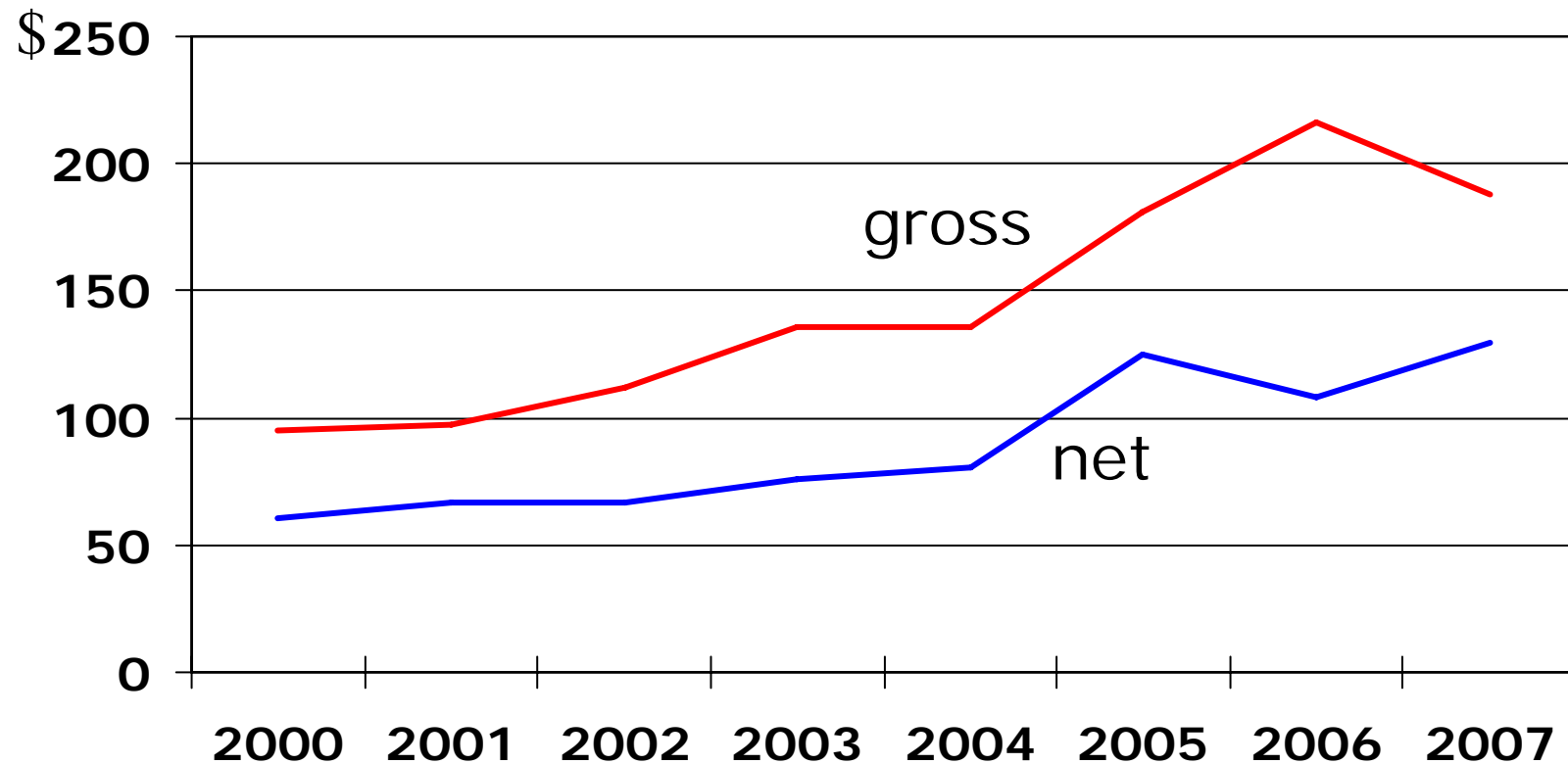


17, 428 internt'l NGOs



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Foreign aid is large & growing (\$billions)



Based on data from OECD 2009



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What Kinds of Institutions Are Needed for Development?

**Encourage
exchange** by
lowering
transaction
costs



Institutions that reduce transaction costs

- Contracts & enforcement mechanisms,
- Commercial rules, laws
- Norms (trust, shared values, etc.)



Institutions Needed for Development

**Encourage
exchange** by
lowering
transaction
costs

Direct the
power of the
state toward
**protecting
property &
individuals,**
not exploiting
them



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Institutions that control the state

- Constitutions, electoral rules, federalism
- Political checks & balances
- Norms (civic mindedness, probity, rule of law, etc.)



Institutional frameworks

1. Durable (usually)
2. Endure because powerful people benefit
3. Changes idiosyncratic & experimental (usually)



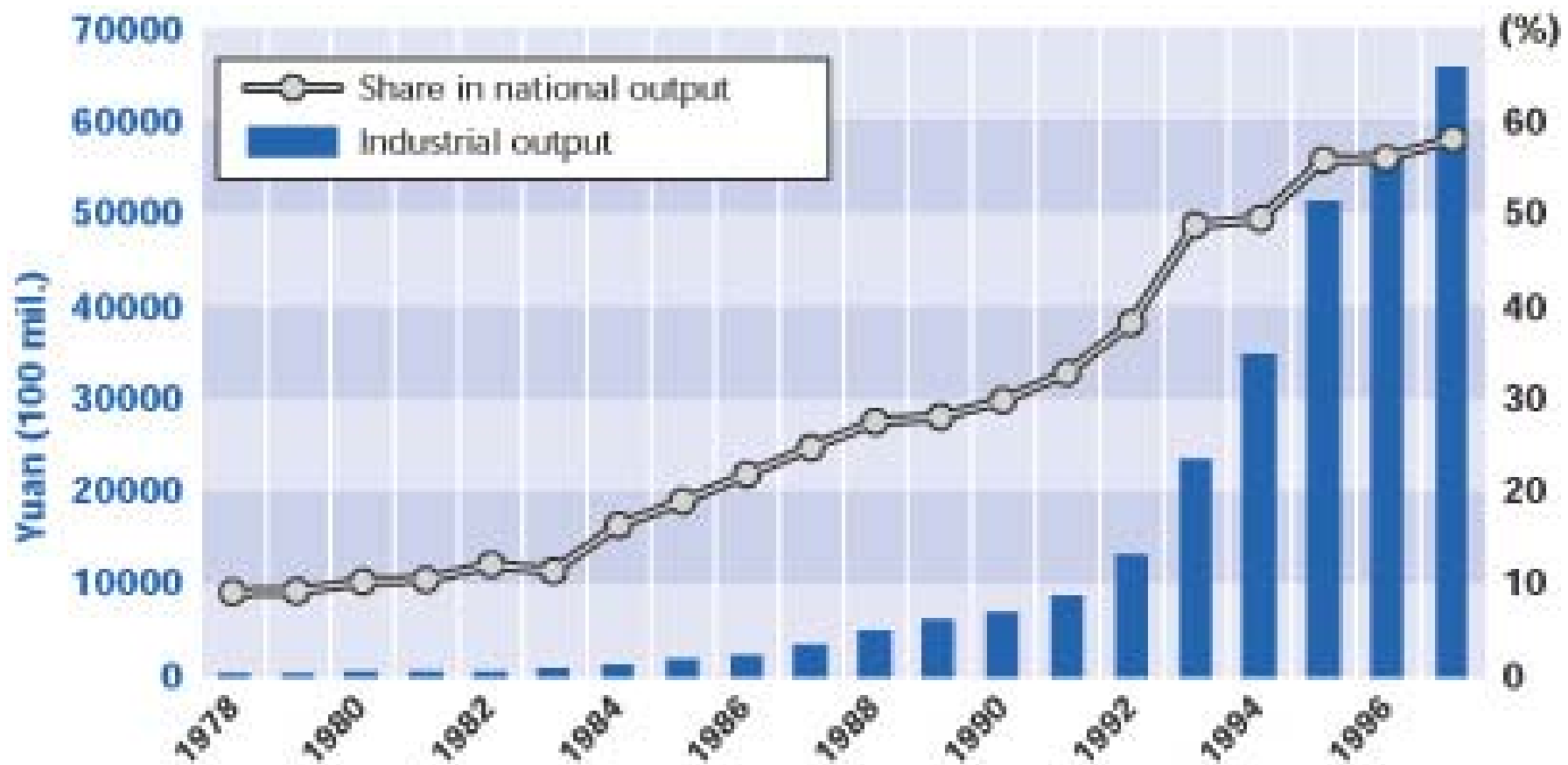
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E.G. idiosyncratic change: China's TVEs

- State owned enterprises run by private investors
- Overseas Chinese ties to village substitute for secure property rights
- Regular payments of profit shares to government officials



TVEs



Wei Zou, "The Changing Face of China's Rural Enterprises," *China Perspectives* #50, Nov. – Dec., 2003



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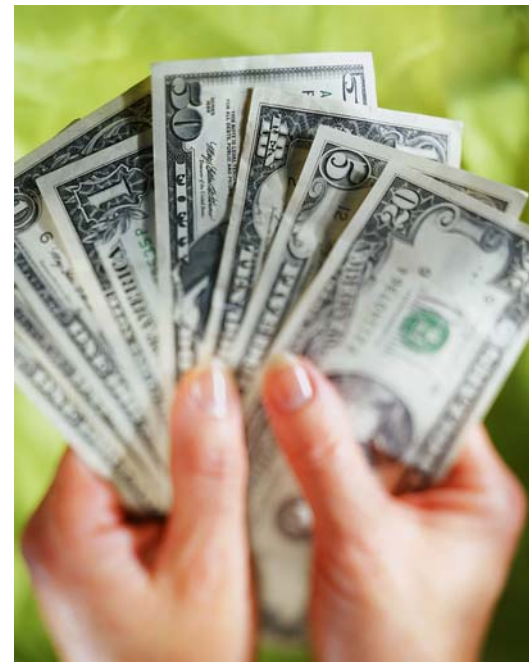
“Capitalism with a red hat”





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Can aid improve institutions?





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Focus is aid for economic
development, not
humanitarian aid



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Can development aid
promote growth?



Rajan & Subramanian, 2005 examine aid and growth

- 10, 20, 30, 40 time periods
- Only aid directed at growth
- Only countries with good policies
- Different regions, areas



Rajan & Subramanian, 2005
find no statistically robust
association between aid &
growth



What about aid and institutions?

- No effect on institutions (see cites in Burnside & Dollar 2004)



Evidence aid can **harm** institutions

- Associated w/ **lower bureaucratic quality, corruption, less rule of law** (Knack 2000)
- **Increased rent seeking** (Economides 2004)
- **Rent seeking, corruption, waste** (Bauer 1991, Kanbur 2000, Easterly 2002)



Evidence aid **harms** institutions

- Associated with **slower adoption of market oriented reforms** (Heckelman & Knack 2005)
- **Negative association with democracy** (Djankov et al, 2006) & **transition to economic freedom** (IMF 2005)



Cross Country Regressions

- Reverse causality
- Problems in establishing causal relationships
- But – can rule out hypotheses consistently rejected in most specifications



World Bank's evaluation department judged its projects to improve public administration, rule of law, etc. in Africa to be **“largely ineffective”** (2005)



Why?

- Samaritan's Dilemma (Buchanan 1977)
 - Payoff highest to Samaritan if Samaritan provides aid and beneficiaries respond by exerting higher effort



Why?

- Samaritan's Dilemma (Buchanan 1977)
 - Payoff highest to Samaritan if Samaritan provides aid and beneficiaries respond by exerting higher effort
 - Payoff highest to beneficiaries if they get aid without increasing effort



Why?

- Moral hazard:
“...aid helps to ensure incompetent governments from the results of their actions, thus weakening their incentive to find alternative revenue sources or better policies.” Ostrom, 2002



Why?

Mismatch between
characteristics of aid
agencies &
characteristics of
institutions



Institutions vs. Aid

Institutional framework

- Deep rooted & usually durable



Institutions vs. Aid

Institutions

- Deep rooted & usually durable

Aid

- Three year projects
- Policy, organizations, sector rules
- Staff rotates
- Rewards for approval



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Institutions vs. Aid

Institutions

Supported by
powerful



Institutions vs. Aid

Institutions

- Supported by powerful

Aid

- Requires permission government
- Aid incentives to cooperate
- Revolutionaries would be asked to leave



Institutions vs. Aid

Institutions

Changes are
often
idiosyncratic
&
experimental



Institutions vs. Aid

Institutions

Changes are often idiosyncratic & experimental

Aid

- Focus on Western best practice, not TVEs
- Rapid
- Defensible
- Benchmarks



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pro forma reforms



Performance Contract

SOE ← Government  AID GIVER

Promises:

- ↑ productivity
- ↑ profitability
- ↑ investment
- ⊕ other targets

Promises:

- autonomy
- bonus
- punishment



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Performance Changes After the Introduction of Contracts

Number of state-owned enterprises



Return
on assets

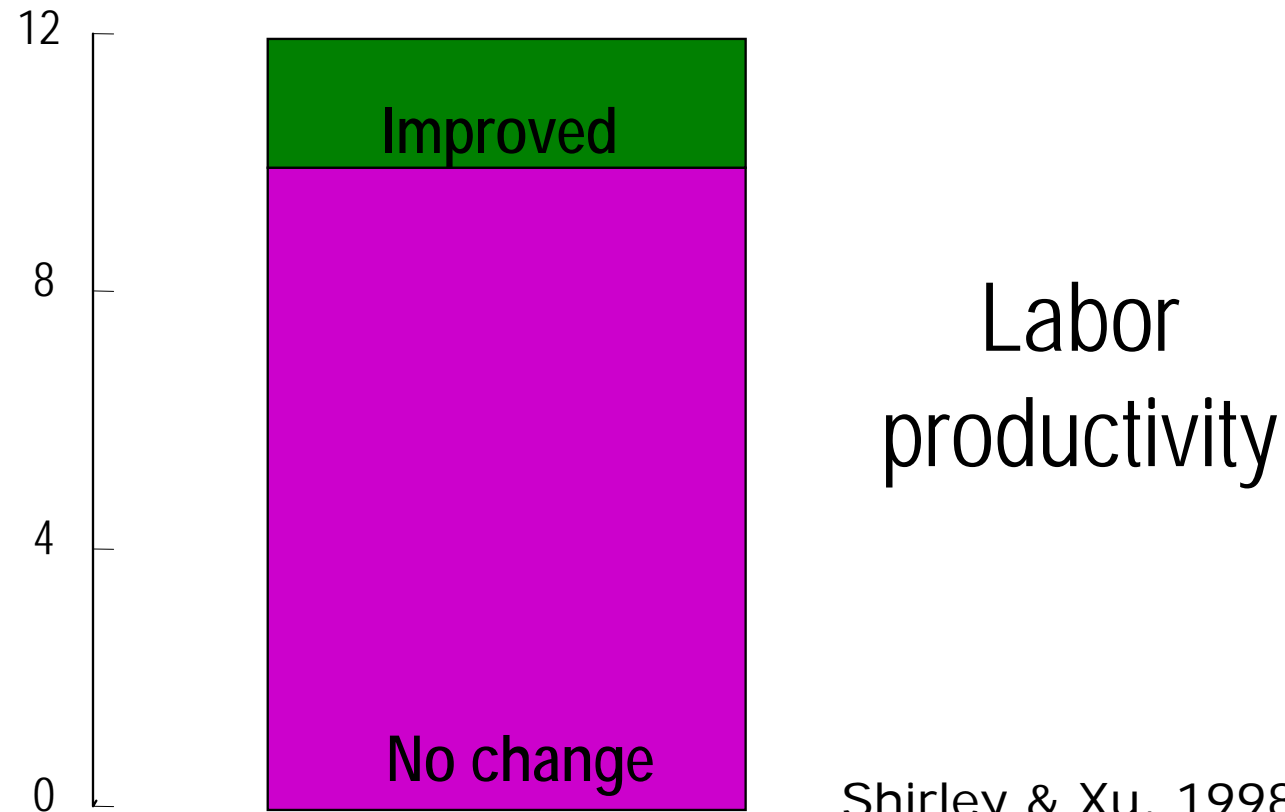
Shirley & Xu, 1998



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Performance Changes After the Introduction of Contracts

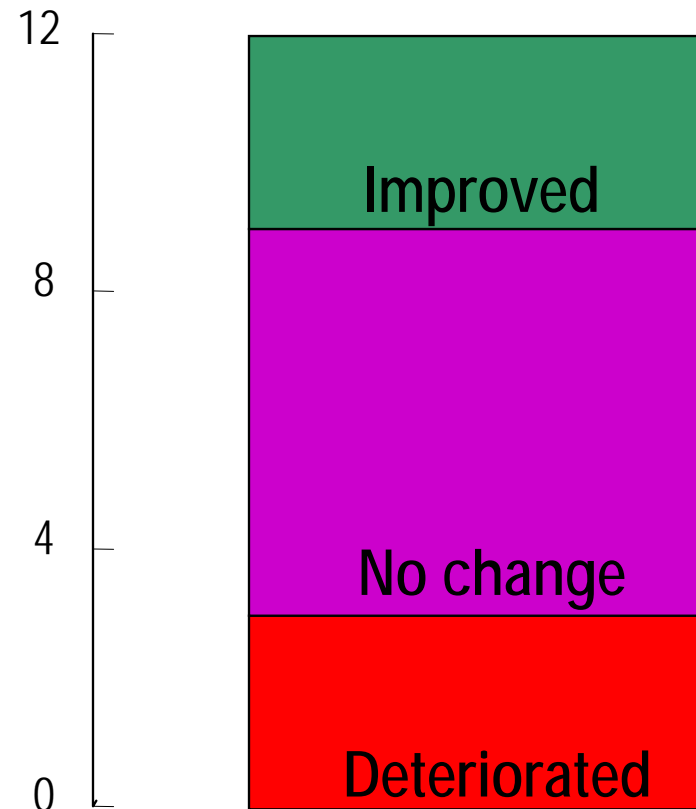
Number of state-owned enterprises





Performance Changes After the Introduction of Contracts

Number of state-owned enterprises



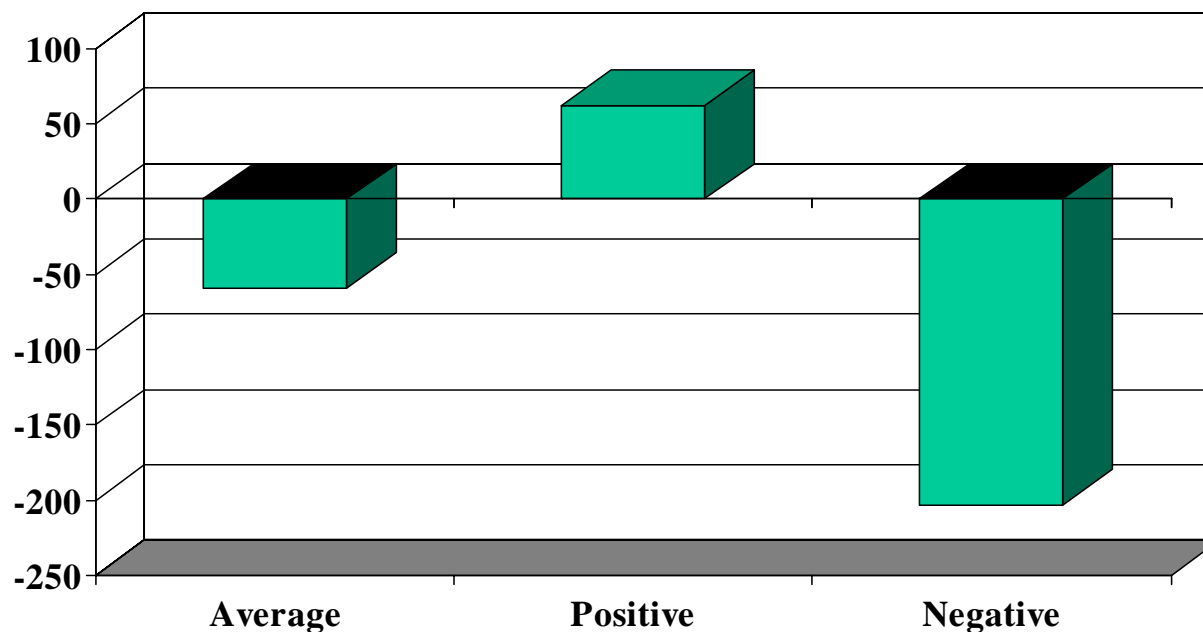
Total factor productivity

Shirley & Xu, 1998



No Significant Positive Correlation with TFP in over 500 Contracts

Graph 7: Effects of Performance Contracts on Total Factor Productivity in Chinese State Owned Enterprises



Shirley & Xu, 2001



Why such poor results?

- Weak targets
- Government renegeged:
 - No bonuses
 - No punishments
 - No autonomy



Why performance contracts?

Aid staff liked:

- Tangible action
- Tangible “success”
- Projects possible w/o privatization or layoffs, closures



Why performance contracts?

Aid staff liked:

- Tangible action
- Tangible
"success"
- Projects
possible w/o
privatization

Government liked:



Why performance contracts?

Government liked:

- Easy action
- Easy “success”
- Aid w/o political costly actions:
layoffs, closures,
privatization



Bottom line:
Fundamental changes
in deeply rooted
institutions do not
happen because of
outsiders' money or
pressures



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Can aid avoid damaging
institutions?



Problems

1. Measuring reform in institutions
2. Combating incentive to “move the money”



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E.G. US Millennium Challenge Account

Created 2002

Assists only 61 poorest countries
that rank in top half on:



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E.G. US Millennium Challenge Account

Control of corruption, and on:



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E.G. US Millennium Challenge Account

Control of corruption, and on:
Governance

- Political rights
- Rule of law
- Effective government



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E.G. US Millennium Challenge Account

Control of corruption, and on:
Governance

Investing in health, education

- Immunization, completion rates
- Expenditures



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E.G. US Millennium Challenge Account

Control of corruption, and on:
Governance

Investing in health, education

Economic policies

- Inflation, trade & fiscal policy
- Regulation
- Business environment



Dimension	Performance Criteria
Governing Justly	<ol style="list-style-type: none">1. Civil liberties2. Political rights3. Voice and accountability4. Government effectiveness5. Rule of law6. Control of corruption
Investing in People	<ol style="list-style-type: none">1. Immunization rates2. Public expenditures on health3. Primary education completion rate4. Public expenditures on primary education
Promoting Economic Reform	<ol style="list-style-type: none">1. Inflation rate2. Cost to start a business3. Days to start a business4. Trade policy5. Regulatory quality6. Fiscal policy



Institutional Criteria

- Civil liberties
- Political rights
- Voice and vote
- Government effectiveness
- Rule of law
- Control of corruption
- Days to start a business
- Regulatory quality



Problems

- Abstract – “rule of law”



Problems

- Abstract – “rule of law”
- Outcomes – government effectiveness



Problems

- Abstract – “rule of law”
- Outcomes – government effectiveness
- Static – governance



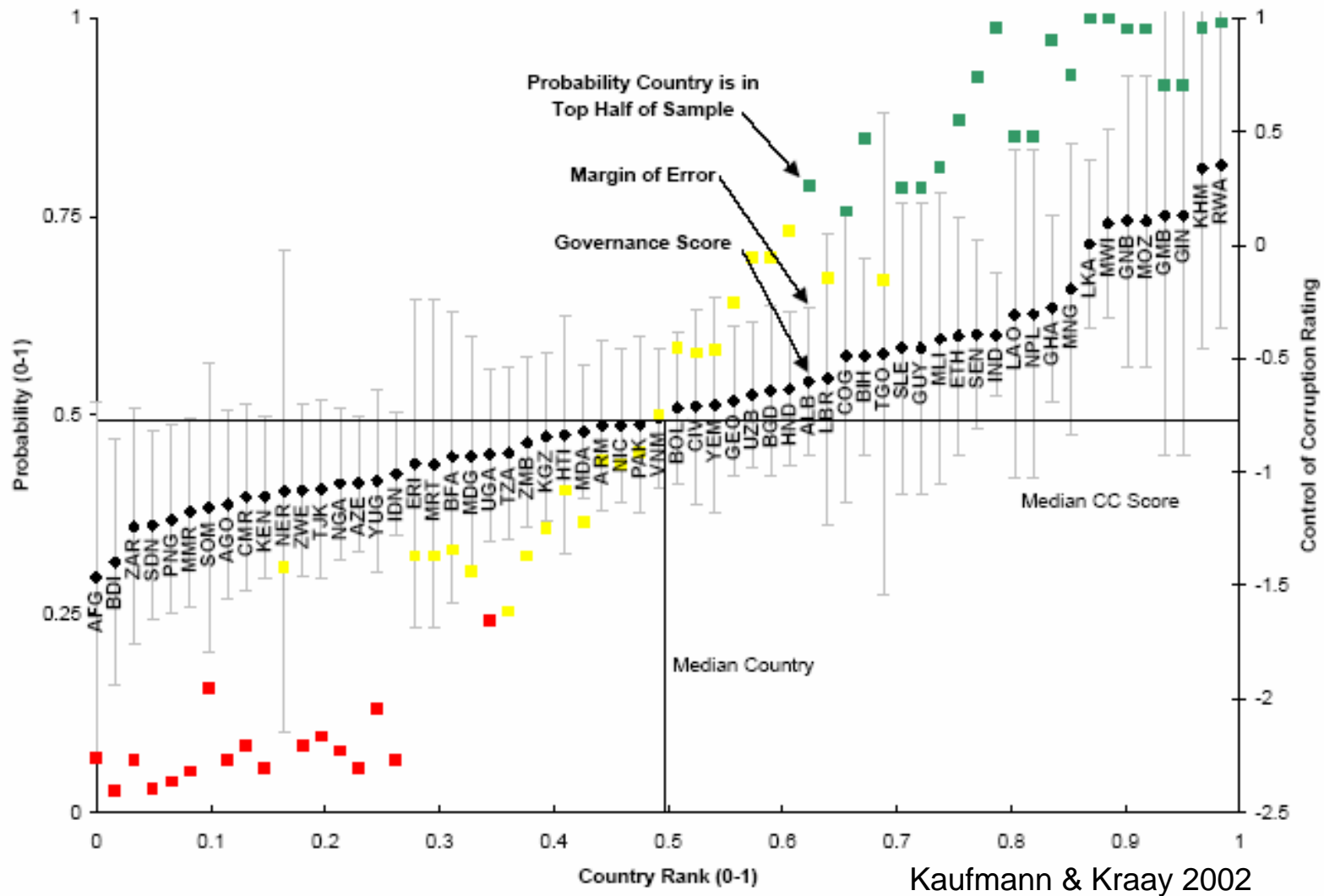
Problems

- Abstract – “rule of law”
- Outcomes – government effectiveness
- Static – governance
- Margins of error



Impossible to say w/90% certainty where 51 of 61 countries rank

Figure 1 – Margins of Error and Governance Rankings





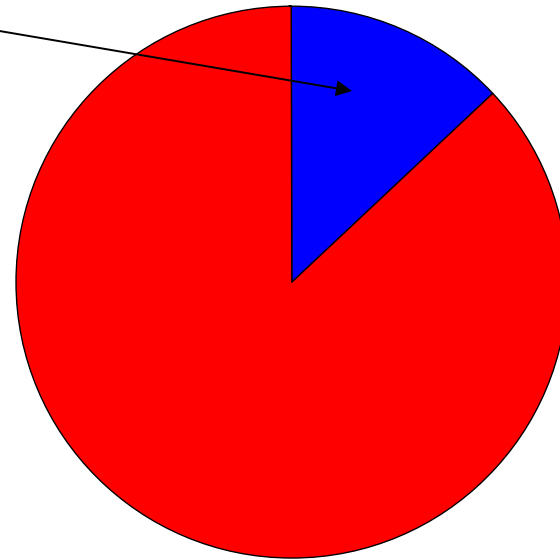
What should we measure?

Whether a country is improving
its institutional framework in
ways critical to **its** success



Few countries

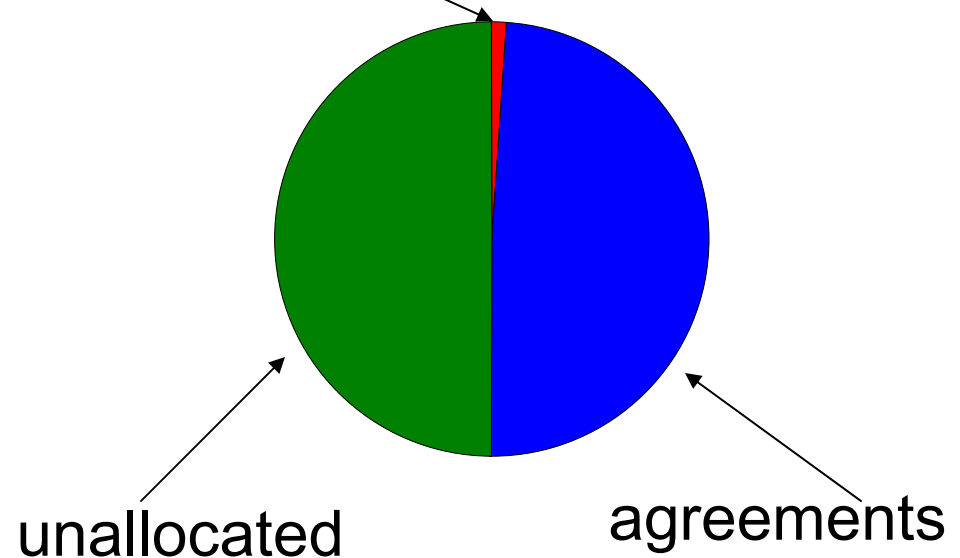
By June 2007 MCA
had agreements
with only 8 of 61
countries





Little disbursed

By June 2007: \$71 million disbursed out of \$3 billion for 8 countries with agreements (\$6 billion total to MCA)

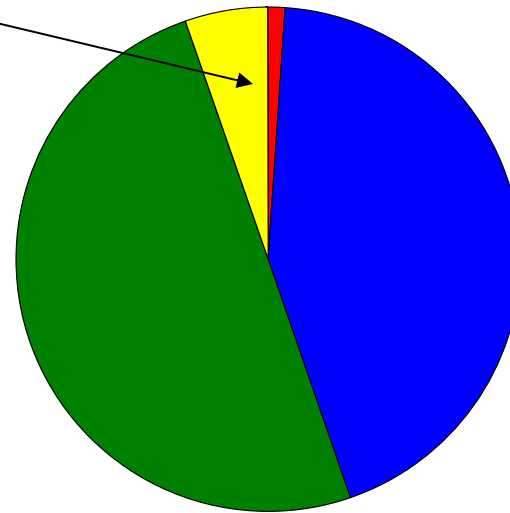




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New category created to “move the money”

13 “threshold
countries”
allocated \$310
million





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What can be done about
damaging institutions?



Societies cling to blatantly
damaging institutions
even when faced with
crisis, but...

Institutional frameworks
do change



Ideas and learning are powerful forces in overcoming beliefs and norms that inhibit change in institutional frameworks (North)



Critical mass of well
trained scholars in
receptive circumstances
(Shirley and Soto, 2007)



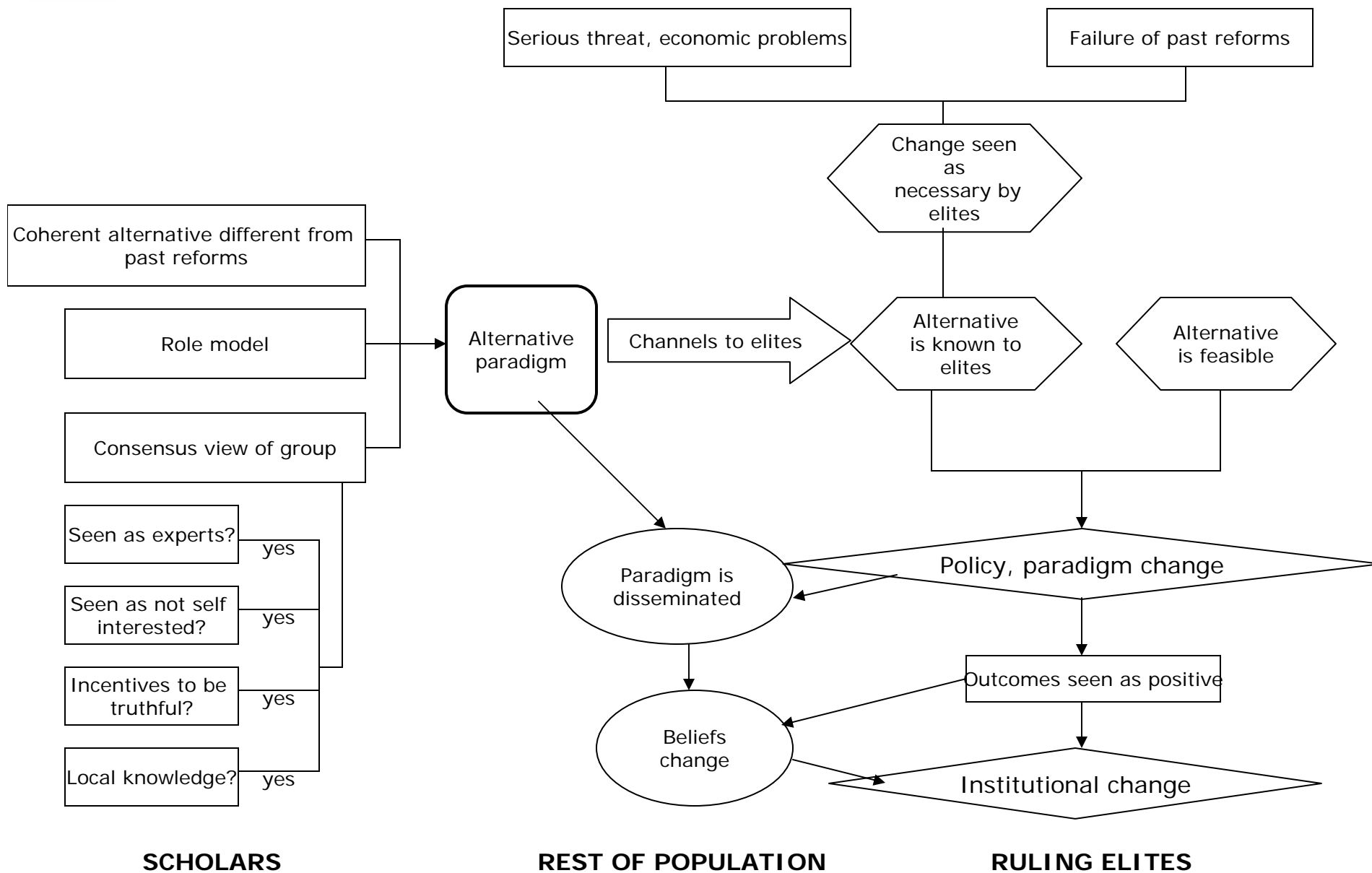
Case studies

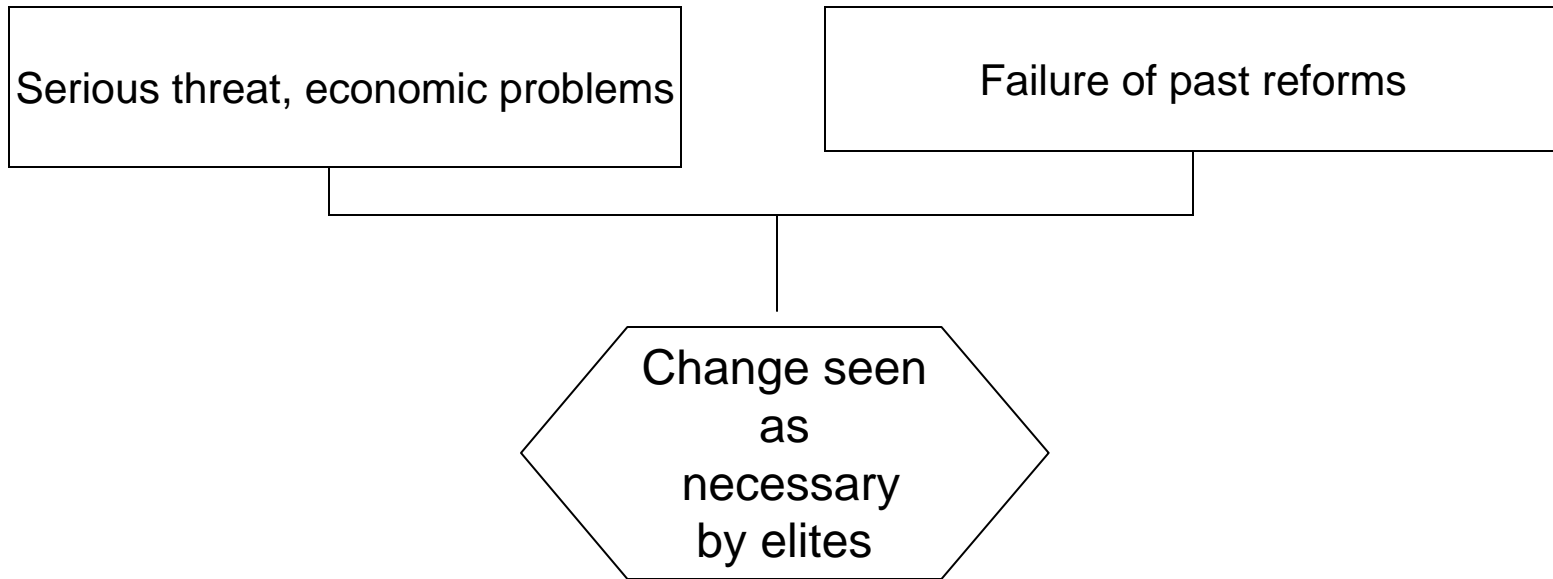
1. Chile: 1975
2. China: 1993
3. Korea: 1980
4. Taiwan: 1958-61/1986
5. Argentina: 1991
6. Indonesia: 1966/1983



Case studies

1. Chile: 1975 Chicago boys
2. China: 1993 "Socialist Market Economy"
3. Korea: 1980 EPB economists
4. Taiwan: 1958-61/1986 S.C. Tsiang, T.C. Liu, others
5. Argentina: 1991 Cavallo boys
6. Indonesia: 1966/1983 Berkeley mafia







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Scholarly group with alternative paradigm

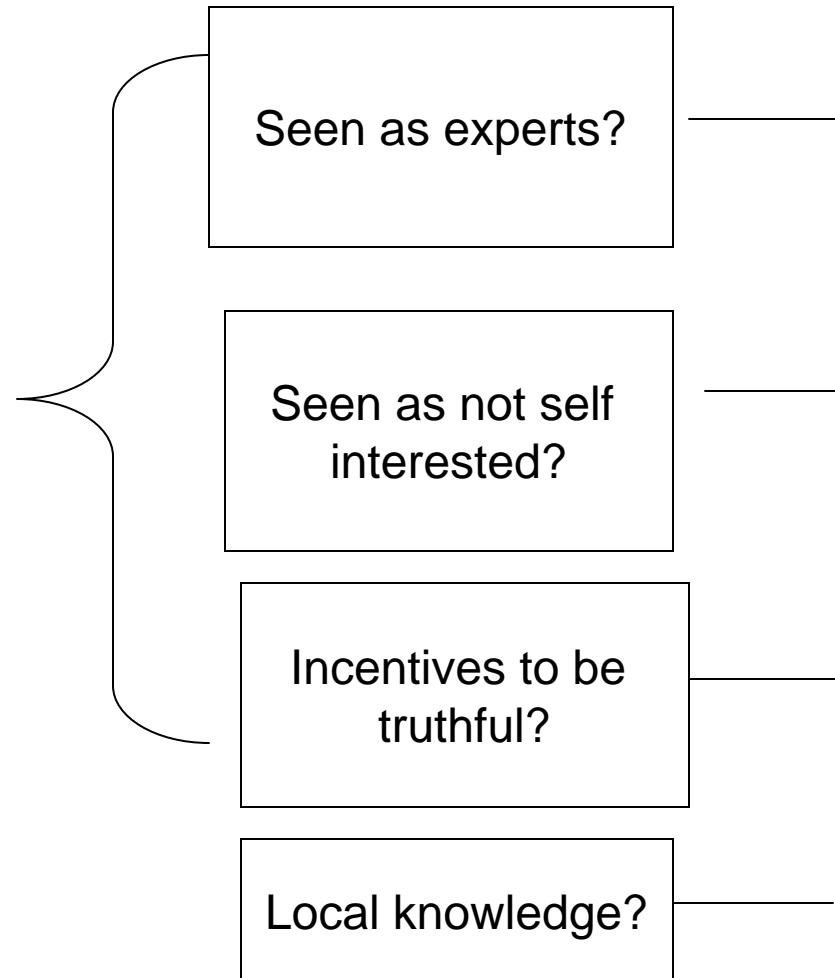
Coherent alternative different
from past reforms

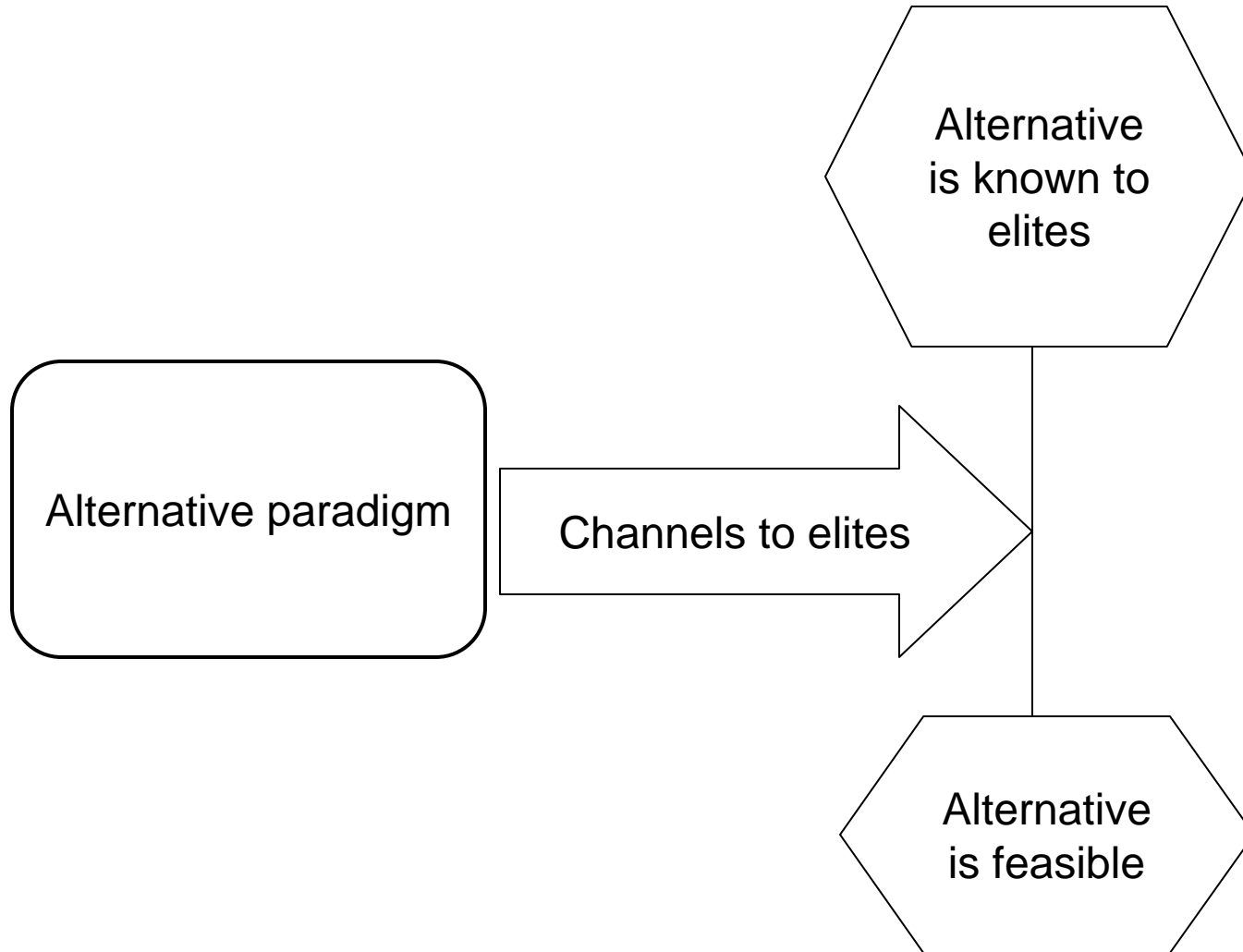
Consensus view of group

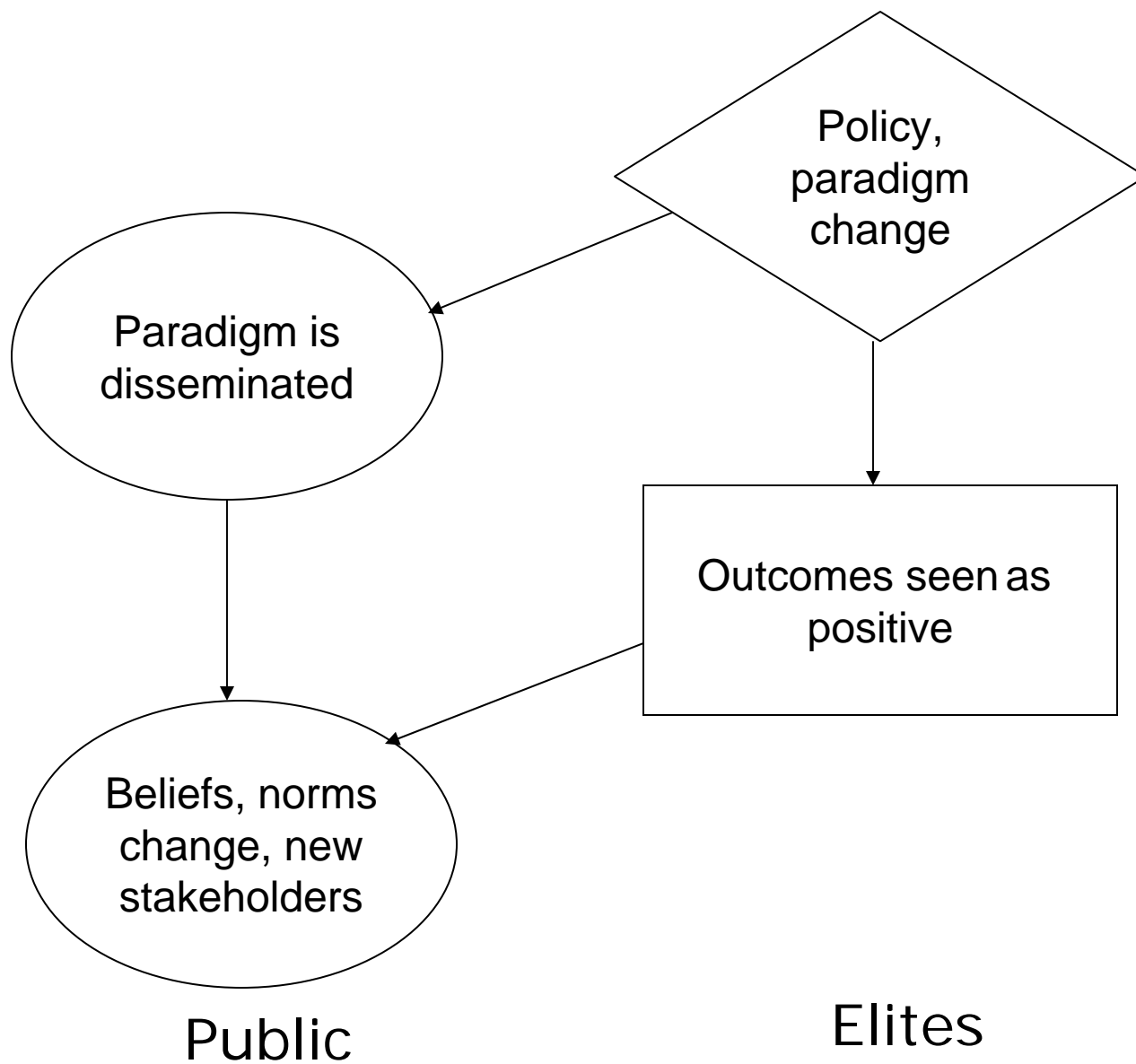


Scholarly group with alternative paradigm

Lupia &
McCubbins









Scholars in receptive circumstances:

- **Identified** barriers to reform
- **Persuaded** policy makers to adopt new paradigms and policies
- **Informed** public debate, contributing to changes in beliefs



Conclusion

- To develop countries need institutions that lower TCs and protect property and individuals



Conclusion

- To develop countries need institutions that lower TCs and protect property and individuals
- Aid cannot strengthen – and may undermine – such institutions



Conclusion

- To develop countries need institutions that lower TCs and protect property and individuals
- Aid cannot strengthen – and may undermine – such institutions
- Aid cannot avoid institutions



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Build Intellectual Capital

Local scholars provide ideas and analysis that can raise the potential for institutional change.





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Find out more at www.coase.org





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