Governance and Institutions

EC 390 - Development Economics

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Role of Government

What SHOULD Governments Do?

Governments promote **well-being and growth** for their population

Ideally, they:

- Strike a balance between **private markets** and **public policy**
- Set the rules of the game
- It **ideally** behaves as a **social planner**
  - Decision-maker that allocates resources to **maximize overall societal welfare** rather than individual interests

What DO Governments Do?

They can **directly** influence markets

- Price Controls
- Taxes, Tariffs
- Industry Regulation, Entry Restrictions, Licensing

They can also influence markets **indirectly**

- Infrastructure Investments
- Human Capital Investments
- Targeted Investments (promote import substitutions or target a specific export good)
- Policy, Protect Property Rights, Patents, etc.

Market Failures

Historically, **governments** primary role has been to fix **market failures**

- **Definition:** A phenomenom resulting from existing **market imperfections** that weakn the functioning of a market economy

This is a pretty general term, but it can be:

- The complete absence of a market (i.e. insurance)
- Disequilibrium due to errors in communication
- Misallignment between private incentives and social welfare goals
- Individuals/firms not experiencing the full cost of negative externalities (i.e. pollution)

Addressing Market Failures

Because **market failures** occur when the market has some sort of flaw, a **government** intervenes by correcting these flaws

This can be:

- **Provide public goods** that the market would not supply efficiently
- **Subsidize or increase investment** to overcome underinvestment
- **Regulate monopolies and ensure healthy competition** exists in markets
- **Correct externalities** such that they are factored in the market
- **Improve information access** by offering market data, setting standards, etc.
- **Strengthen property rights and legal institutions** to reduce costs and uncertainty

Governments in the Developing World

Up until around the 1980s the **developing world** strongly belived in coming up with and executing a **national development plan**

- This was thought to give the only **institutional** help to get past obstacles to development and achieve high growth'
- This acceptance of planning as a development tool rests on a number of **fundamental economic and institutional arguments**
  - We will focus on **market failure and later on, foreign aid**
- Unfortunately, all the planning in the world did not live up to the hype
- However, **economic planning** is an important role in accelerating growth, reducing poverty, and reaching human development goals

- **Definition:** A deliberate and conscious attempt by the state to formulate decision on how factors of production will be allocated across the economy

Government Planning Failures

So the results of development planning have been generally dissapointing

But what went wrong? **Many things**

1. **Theory Versus Practice**
2. **Deficiencies in Plans and Implementation**
3. **Economic Shocks (External and Internal)**
4. **Institutional Weaknesses**
5. **Political Will**
6. **Fragile States**

Government Planning Failures

What went wrong? **Many things**

1. **Theory Versus Practice**

- Most economic theory can be increasingly frustrating **(it doesn't make sense in the real world)**
- Policies may look sound on paper, but break down once implemented
- Planners may fail to properly understand constraints, incentives, and underestimate adaptability by agents

2. **Deficiencies in Plans and Implementation**
3. **Economic Shocks (External and Internal)**
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Government Planning Failures

What went wrong? **Many things**

1. **Theory Versus Practice**
2. **Deficiencies in Plans and Implementation**

- Plans were overly ambitious, poorly sequenced, or lacked clear priorites
- Weak capacity to implement can lead to delays, cost overruns, and unfinished projects

3. **Economic Shocks (External and Internal)**
4. **Institutional Weaknesses**
5. **Political Will**
6. **Fragile States**

Government Planning Failures

What went wrong? **Many things**

1. **Theory Versus Practice**
2. **Deficiencies in Plans and Implementation**
3. **Economic Shocks (External and Internal)**
   - Commodity prices collapse, financial crises occur, and things generally happen that derail plans
4. **Institutional Weaknesses**
5. **Political Will**
6. **Fragile States**

Government Planning Failures

What went wrong? **Many things**

1. **Theory Versus Practice**
2. **Deficiencies in Plans and Implementation**
3. **Economic Shocks (External and Internal)**
4. **Institutional Weaknesses**

- Governments are a collective of many people which may lack technical skills, coordination, and accountability
- This is where things like **corruption and rent-seeking** comes into play (diverting resources)

5. **Political Will**
6. **Fragile States**

Government Planning Failures

What went wrong? **Many things**

1. **Theory Versus Practice**
2. **Deficiencies in Plans and Implementation**
3. **Economic Shocks (External and Internal)**
4. **Institutional Weaknesses**
5. **Political Will**

- Political leaders prioritize short-term gains over long-term development
- Frequent changes in government may cause policy reversals and halt delivery of plans

6. **Fragile States**

Government Planning Failures

What went wrong? **Many things**

1. **Theory Versus Practice**
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- Ongoing conflict, weak sovereignty, or contested authority makes planning innefective
- Basic state functions (taxation, delivery of services, law enforcement) were unreliable

What Helps a Well-Functioning Market?

Although not an exhaustive list, a good foundation for a healthy market economy has:

1. **Property Rights**
2. **Commercial Laws and an Independent Judiciary**
3. **Freedom to Establish Businesses in All Sectors***
4. **A Stable Currency and Banking System**
5. **Public Supervision of Natural Monopolies**
6. **Available Information About Products in All Markets**
7. **Protection of Consumers' Preferences**
8. **Provision of Public Goods and Management of Externalities**
9. **Ability to Stabilize Monetary and Fiscal Policies**
10. **Safety Nets**
11. **Encouragement of Innovation**
12. **Security from Violence**

Democracy versus Autocracy

Which Facilitates Faster Growth?

If we think about individual incentives, it's not as straightforward an answer as we might think

Nuance

A lot goes into growth, so it should be no surprise that this is also a complex issue

- Overall, we value freedom more than not
- Democracy tends to be better for for broader development objectives like equity, education, health, and disaster prevention
    - Although many existing democracies have significant flaws and fall short

Possibly the most convincing argument (in my own opinion), is about stability:

- **Democracies** tend to be stable and **stable economies** grow faster than unstable ones
- This may mean that **the positive effect on growth by democracies** may be due to their stability

Governance and Institutions

Type of Institutions

We can break down institutions into two broad groups

1. **Inclusive Institutions**
2. **Extractive Institutions**

- Typically, places with **extractive institutions are less economically developed**

Type of Institutions

1. Inclusive Institutions

- Secure property rights
- Law and Order
- Markets and state support for these markets
- (relatively) free entry of new businesses
- Uphold and protect contracts
- Access to education and opportunity for large majority of citizens

- They sound great
- But they are not necessarily the starting point for many societies

Type of Institutions

2. Extractive Institutions

- Designed by the politically powerful elites
- Designed to **extract resources** from the rest of society

They have:

- Weak or insecure property rights
- Barriers to entry and limited economic mobility
- Little incentive for rulers to promote broad-based growth

This leads to **low investment, persistent inequality, and slower long-run development**

Colonial Origins Comparative

How come some places, with the same colonial origin, have **extractive institutions** and others do not?

The United States and India were both British colonies

- But the US is more developed than India and has "stronger" institutions
- Research has hypothesized that colonizers set up **extractive institutions** in places where they were unable to live (high disease burdens, difficult climates, etc.)
- The existence of **extractive institutions** in the colonized country sets them back
  - Even after independence from colonial powers
  - Makes development more difficult

What Are "Good" Institutions?

- One of the biggest points of contention is **defining a good institution**

- One person's idea of what a good institution is may be slightly different than someone else
- There is no standard measure of institutional quality, so often we have to come up with ways to measure it
- We can point back to our list of what comprises a well-functioning market and work from there