The Role of Institutions in Development

A history of thought and analysis of the Country Performance Assessment data

The project

The intern will do a **statistical analysis of data** from the **Country Performance Assessment** exercise

The objective is to **test hypotheses** about **institutions and governance**

Book: Emerging Trends in **Governance** and **Public Sector Management**: Focus on **Institutions**

Literature on **New Institutional Economics**

?

History and econometrics

- The rise of institutions in development economics
- The relationship between the CPA data and GDP

History

- Institutions matter
- Though this wasn’t always appreciated

‘Institutions’??

“A set of humanly devised behavioural rules that govern and shape the interactions of human beings in part by helping them form expectations of other people will do” (Lin and Nugent, 1995)

“The application and extension of concepts such as transaction costs, property rights, public choice, and ideology” (Tebaldi and Elmslie, 2008)

“*Institutions are the rules of the game in a society, or more formally, are the humanly devised constraints that shape human interaction”* (North 1990, p. 3)

Institutions

- **An established law, practice or custom**

- Examples:
  - Driving on the right-hand side
  - Democracy
  - Corruption
  - Property rights
  - Laws of contract
  - Attitudes toward work
  - Attitudes toward individual freedom

Institutions

Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular ***administration of justice****, in which the people do not feel themselves* ***secure in the possession of their property****, in which the faith of* ***contracts is not supported by law****, and in which the* ***authority of the state*** *is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the* ***justice of government****.*

-- Adam Smith, 1776

Capital Fundamentalism – 1950s and 60s

- Interest in development economics emerged after WWII
- Because of:
  - Decolonization, which increased number of independent countries
  - A desire to make developing countries communist or capitalist
  - Altruism

- Capital fundamentalism was the first phase of thinking

Capital Fundamentalism – 1950s and 60s

- Has it’s basis in the Harrod-Domar model of the 30s and 40s

$$Y = \kappa K$$

- Supported by the success of the Marshall plan

Emphasis on free markets – 1980s

- Margaret Thatcher and Ronald Regan were elected
- Their believe in the benefits of free markets, reduced regulation and privatisation influenced thinking on development

- Supposedly free market economies like Singapore, Taiwan, South Korea developed
- Interventionist economies in Africa and Latin America generally did not

Institutions – 1990s onwards

- Contributors to the rise of intuitions over the 1990s and 2000s. Rodrick (2000):
  - Failure of privatisations and price-reform in Russia
  - Dissatisfaction with of market-oriented reforms in Latin America
  - Experience of financial liberalization that resulted in the Asian financial crisis

Institutions – 1990s onwards

- Out of the literature on intuitions, the concept of ‘Good Governance’ emerged
- The term ‘Good Governance’ is vague
- The term ‘Things governments can do to reduce poverty’ would have been better

Good Governance

- Grindle (2004)
  - The good governance agenda has grown unrealistically long
  - We need to:
    - Think about the link between specific governance reforms and poverty reduction
    - Accept that there is no one-size-fits-all approach to governance for development

Current thinking

- Is influenced by all of the stages of development
  - Capital is important because it increases productivity
  - Free markets are important because they allocate resources efficiently
  - Institutions are important because they reduce transaction costs and encourage investment

Econometric Analysis

- The ADB’s Country Performance Assessment data
  - The same as the World Bank’s Country Policy and Institutional Assessment data
- Are they related to GDP per capital or GDP growth?

The Country Performance Assessment Data

- **Cluster A – Quality of macroeconomic management**
- Monetary and exchange rate policies
- Fiscal policy
- Debt policy and management
- **Cluster B – Coherence of structural policies**
- Trade
- Financial sector
- Business regulatory environment

- **Cluster C – Equity and inclusion**
- Gender equality
- Equity of public resource use
- Building human resources
- Social protection and labour
- Policies and institutions for environmental sustainability
- **Cluster D – Quality of governance and public sector management**
- Property rights and rule-based governance
- Quality of budgetary and financial management
- Efficiency of revenue mobilization
- Quality of public administration
- Transparency, accountability and corruption in the public sector

From the ADB website…

“Aid is most effective in accelerating economic growth and poverty reduction in countries where policy and institutional performance is strong.”

Regressions for real GDP per capita

- $GDPPC_{it} = \alpha + \beta_1 ClusterAverages_{it} + \beta_2 YearDummies_t$

- $GDPPC_{it} = \alpha + \beta_1 ClusterAverages_{it} + \beta_2 YearDummies_t + \beta_3 CountryDummies_i$

- $GDPPC_{it} = \alpha + \beta_1 IndividualIndicators_{it} + YearDummies_t + \beta_3 CountryDummies_i$

Regressions for GDP growth

- $g_{it} = \alpha + \beta_1 ClusterAverages_{it} + GDPPC_{it-1} + \beta_2 YearDummies_t$

- $g_{it} = \alpha + \beta_1 ClusterAverages_{it} + GDPPC_{it-1} + \beta_2 YearDummies_t + \beta_3 CountryDummies_i$

- $g_{it} = \alpha + \beta_1 IndividualIndicators_{it} + GDPPC_{it-1} + YearDummies_t + \beta_3 CountryDummies_i$

Regression for average growth over succeeding three years

- $G_{it} = \left(\left(g_{i(t+3)} + g_{i(t+2)} + g_{i(t+1)}\right)\right)/3$

- $G_{it} = \alpha + \beta_1 ClusterAverages_{it} + GDPPC_{it-1} + \beta_2 YearDummies_t$

- $G_{it} = \alpha + \beta_1 ClusterAverages_{it} + GDPPC_{it-1} + \beta_2 YearDummies_t + \beta_3 CountryDummies_i$

- $G_{it} = \alpha + \beta_1 IndividualIndicators_{it} + GDPPC_{it-1} + YearDummies_t + \beta_3 CountryDummies_i$

Econometric analysis - conclusion

- The CPA data are not significantly related to GDP per capita or GDP growth
- Possible reasons:
  - Timing
  - They’re not aiming to increase GDP directly
  - Regression analysis simply isn’t the right tool for assessing the relationship between intuitions and economic performance

Conclusion

- The thinking role of institutions in development has emerged over time
- Grindle (2004) encourages practitioners to ensure that they make the link between their actions to improve governance and poverty reduction
- There is no evidence of a statically significant relationship between the CPA measures and economic performance.

Future work

- Assess the relationship between the CPA indicators and the things they are supposed to improve

Spares

- Theory of why institutions are important
  - They reduce transaction costs (Coase, 1960s). Most of the benefits of strong institutions can be thought of as reductions in transaction costs.
    - They encourage investment by reducing the cost of monitoring and enforcing property rights and compliance with terms of contracts

Annual Report on the 2016 Country Performance Assessment Exercise

Institutional Document | December 2016

ADB conducts annual country performance assessments and uses the results to derive Asian Development Fund allocations. This annual report provides information on the results of the 2016 assessments.

ADB links the allocation of Asian Development Fund (ADF) resources to country performance. This system is based on the principle that aid is most effective in accelerating economic growth and poverty reduction in countries where policy and institutional performance is strong. Under the performance-based allocation policy, ADB gauges the relative performance of eligible borrowers with access to the ADF by conducting annual country performance assessments (CPAs), and uses the CPA results to derive ADF allocations.