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Aid, Governance, and the Political Economy: Growth and Institutions

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Abstract

"Good Governance" is central to the agenda for growth and for aid in low income countries. The broad contours of what this implies are clear, and there is strong evidence that deep-rooted economic institutions are of first order importance for sustained economic growth. But we know much less about the specific policies or political institutions that are necessary or sufficient for good economic governance. There are no detailed road maps, only some sensible general directions. Furthermore, outsiders only rarely have a positive effect on deep institutions; to date, aid has not usually improved institutions. Institutional change is a top priority but remains largely a local matter. For countries without a natural institutional anchor, this represents a major difficulty for achieving and surpassing the Millennium Development Goals.

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I. **Introduction**

At the top amongst the list of the Millennium Development Goals (MDGs) is the eradication of "extreme poverty and hunger." Achieving this goal will no doubt require action on several fronts, but central to any such effort remains generating high and sustained growth.[2] What does this kind of growth require?

At least in part, it needs something called "institutions" or "good governance". There is little disagreement on this isssue. For example, this is the first point – although the term used is "governance failures" – explaining global poverty in the UN Millennium Development Project report, coordinated by Jeffrey Sachs, and released in January 2005.[3] It is also central to points 1 and 2 in the latest document circulated by the Commission on Africa convened by Prime Minister Tony Blair.[4] The Davos Global Governance Initiative Annual Report 2005 puts "improving governance to empower the poor and allow private enterprise to flourish" near the top of its lists of priorities.[5]

But what exactly are institutions (or what is governance?) and what do we know about the link from institutions to growth? This paper summarizes the current state of knowledge regarding the importance of economic and political institutions for growth. In particular, we distinguish what is known (Section II) and what remains unknown or uncertain about this relationship (Section III). We draw implications for the international community and low income countries (Section IV).

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[2] See Kraay (2004): "In the medium- to long-run, most of the variation in changes in poverty can be attributed to growth in average income, suggesting that policies and institutions that promote broad-based growth should be central to the pro-poor growth agenda".
[3] "Investing in Development: A Practical Plan to Achieve the Millennium Development Goals." See p.31, Chapter 3: Why the World is Falling Short of the Goals; http://unmp.forumone.com/.
[4] See "Action for a Strong and Prosperous Africa," initial Consultation Document, November 11, 2004; http://213.225.140.43/getting_involved/consultationdocument.htm.
[5] See "Global Governance Initiative, Annual Report 2005" at http://www.weforum.org/pdf/ggi2005_low.pdf.

II. Knowns

1) Post-1945 growth experience

Some of the key facts of the post-war experience with growth in the cross-section of countries are the following.

First, there has been disappointingly little convergence in income per capita between poor countries and rich countries. Since 1950, a few countries have grown spectacularly, but these have been the exceptions and concentrated mostly in East Asia (Chart 1). In Africa south of the Sahara, there was some respectable growth in the 1950s and 1960s, but only two countries (Botswana and Mauritius) have sustained a significant increase in per capita income. As a percent of U.S. GDP per capita, much of Latin America, with the notable exception of Chile, is where it was 50 years ago, having caught up to some extent through 1980 and then fallen back, despite significant reforms since 1985. Interestingly, there has been greater convergence between countries in health and educational attainment than in income per capita (See Chart 2, from Acemoglu and Johnson 2004).

A corollary of these developments is that much of the global reduction in poverty has been concentrated in Asia, with much less improvement in sub-Saharan Africa (Sala-i-Martin, 2003).

This lack of convergence over the last 50 years has occurred despite the widespread availability of high productivity technologies, a rapid increase in world trade, and unprecedented opportunities for countries to participate in global production chains.

Second, countries with worse average growth performance have also generally experienced more output volatility, i.e., poor African countries typically have a standard deviation of their growth rate that is 2 or 3 times higher than rich European countries (Chart 3).[6] In fact, it is not unusual for 10 years or more of good growth to be wiped out by a few years of deep decline (e.g., the repeated experience in Latin America).[7] Many so-called "growth accelerations," including some impressive performances in Africa during the 1960s, turned out not to be sustained.

Macroeconomic instability, in the form of high inflation or balance of payments crises or banking crises or an overvalued real exchange rate or some other form of economy-wide disruption, has consistently proved bad for growth (Easterly and Fischer 2001). But macroeconomic stability by itself has not proved sufficient for sustained growth (e.g., Andean countries over the last decade, and some post-communist transition countries.)[8] Even when macro stability has been combined with structural reforms, the results have sometimes been disappointing – as in Latin America during the 1990s (Chart 4).

Third, globalization of capital flows has in some instances helped growth but there is no strong pattern in the cross-section.[9] But in other instances, where a country's system was fragile for other reasons, these capital flows may have contributed to economic instability (e.g., in Asia, 1997-98). In particular, serious crises can now be triggered by a loss of confidence and capital flows, even when the fiscal position and current account are in good shape.

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[6] This difference is largely not due to terms of trade fluctuations (Acemoglu et al, 2003) but to country-specific shocks (World Economic Outlook, 2005). Ramey and Ramey (1995) first documented the connection between growth and its volatility.

[7] There is some evidence that after trade and financial liberalization growth and volatility have become positively correlated (Prasad et. al., 2004; Tornell, Ranciere and Westermann 2004). There is no doubt that stability of macroeconomic policies, including the avoidance of high inflation, has proved to be an important complement to sustained rapid growth.

[8] Sources: for example see "Bolivia: Ex-Post Assessment of Longer-Term Engagement", February 2005. For an early reference to this point for post-communist countries, see Aslund, Boone and Johnson, Brookings Papers on Economic Activity, 1997.

[9] See IMF (2001) for a survey of the evidence on the link between capital flows and growth.

In the light of this experience, economic thinking about growth has changed somewhat. The growth theory that was developed in the 1950s and 1960s stressed the need to accumulate factors of production – capital, and unskilled and skilled labor – and to increase the productivity with which these factors are used. But it left unanswered what has proved to be the more basic and essential question: under what conditions do countries accumulate factors and improve productivity? To answer this, attention has turned increasingly to institutions along the lines we now outline.[10]

2) Broad economic institutions[11]

One important dimension of governance is economic institutions. These come in two forms: broad and narrow. While the distinction between the two may not always be easy to make in practice, the latter are more restricted in the scope of their impact. We return to narrow economic institutions in section II below. Here we focus on broad institutions.

Broad economic institutions are the set of laws, rules, and other practices that govern property rights for a broad cross-section of society. Good economic institutions create effective property rights for most people, which encompasses both protection against expropriation by the state (or powerful elites), and enforceable contracts between ordinary private parties. Although this definition is far from requiring full equality of opportunity in

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[10] For a more detailed account of how ideas related to development have changed, see Easterly (2002). The danger, of course, is that the current focus on and consensus regarding institutions may turn out to be just another disappointing fad.

[11] The framework developed here and in the following sections builds directly on Acemoglu, Johnson, and Robinson (2004).

society, it implies that societies where only a very small fraction of the population have well-enforced property rights do not have good economic institutions.[12]

Property rights are essential if people are to invest in human and physical capital. Willingness to enter new lines of business is a particularly important form of investment that has received some attention recently, but all forms of investment matter for development.[13]

Perhaps this point is self-evident – after all, who invests if they do not think it is worth the risks? While this may always have been an issue for people working on growth, there is now much more emphasis on the need for strong economic institutions.[14]

Bad economic institutions mean insecure property rights for most people. Insecure property rights can arise from expropriation by the state or powerful elites (often, but not exclusively, manifest in the form of corruption) or from severe political instability (e.g., failed states and conflict/post-conflict situations). Serious crime and the collapse of the state capacity to maintain public order can undermine property rights surprisingly fast.

In addition to an understanding of economic institutions, policy and research require them to be measured. The Appendix reviews the available measures of broad economic institutions, which are far from being perfect. In the case of institutions, perceptions are key – if governments can persuade potential and actual entrepreneurs that they will protect them, you can do well with relatively little in the way of formal rights. This is one interpretation of what has happened in China over the past 20 years.

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[12] In a number of resource-rich economies, property rights are clearly reasonably protected in the resource sectors themselves, as evidenced in the foreign investment. But in many such economies, similar protection may not exist economy-wide.

[13] See one recent analysis of the importance of entry, see Laeven, Klapper, and Rajan (2004).

[14] For a nice synthesis, see The World Bank's World Development Report 2002, "Building Institutions for Markets."

However, perceptions eventually need to be underpinned by actual protections, i.e., if someone tries to take your property, there is recourse or appeal of some meaningful kind.[15] Property rights are never perfect, and conflicts often emerge between alternative claimants on property. The issue is the extent to which property rights are protected, preferably by a fair and transparent process of dispute resolution.[16] The extent of recourse depends closely on political institutions.

3) Political Institutions

The second key dimension of governance is political institutions. Political institutions are the laws, rules, and other practices that determine how people get political power and what they do with it once they have it. Political institutions place checks on those who hold political power, for example, by creating a balance of power in society. Without checks on political power, power holders are more likely to opt for economic institutions arrangements that are beneficial for them and detrimental for the rest of society. This makes political institutions highly sensitive and usually controversial within countries.

Economic institutions are typically deeply embedded in domestic political structures. A major issue, which we discuss further below, is the links between the two, and whether economic institutions can be substantially changed without changes in political institutions. If political structures, over which outsiders tend to have less influence, are the deeper problem, and all the difficulties with economic institutions are just symptoms, then actions

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[15] For disputes between private parties, the alternative mechanisms across countries have been documented and measured by Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Courts," *Quarterly Journal of Economics*, May 2003. These are part of the Doing Business database and website (see Appendix 1): http://rru.worldbank.org/DoingBusiness/ExploreTopics/EnforcingContracts/.

[16] There are also difficult grey areas. For example, if a person obtained state property illegally, should they have the full protection of private property?

by outsiders in this area (or in the more narrow domain of macroeconomics) may have less lasting impact.

4) Broad institutions are of first order importance for sustained economic prosperity

Economic and political institutions are of first order importance for growth in the medium to long run. This is not a new idea – in its modern form it goes back at least to Douglass North – but in the last 10 years the evidence has mounted that institutions have a very large effect (Chart 3) on long-run growth (IMF, April 2003).

If a country builds good institutions, entrepreneurs will invest in capital goods and ordinary people will invest in human capital. The empirical results accumulated recently all show that the magnitude of the impact is substantial. For example, an improvement in sub-Saharan Africa's level of institutional development from its current average to the mean of developing Asia would imply an 80 percent increase in its per capita income (from $800 to over $1400).

Note that good institutions are not necessarily the same thing as "free markets". Markets may be free of government intervention but highly skewed towards the rich and powerful. If the playing field is uneven, there will be little entry into the formal sector and a few large unproductive firms will dominate the economy. Indeed, good institutions entail strong and effective government capability that allows markets to be created and flourish. If physical infrastructure are the hardware of an economy, strong institutions are its essential software.

5) Broad institutions also help explain macroeconomic instability and crises of all kinds

There is more volatility and instability – both in real terms and in terms of inflation – when economic and, especially, political institutions are weak (Chart 6).[17] This is especially true in relation to shocks, where there is evidence that shocks are more damaging where political institutions are weak.[18]

The reason why political institutions in particular play an important role in relation to instability is that they determine the distribution of resources within society. For example, in the wake of shocks, the ability of countries to respond depends on economic adjustment. Strong political institutions facilitate a smooth or equitable distribution of the burden of adjustment in society, which will lead to stability. Distributional conflicts, which are likely when political institutions are weak, on the other hand, will aggravate instability.

The differential responses of Korea and Thailand versus Indonesia in the aftermath of the Asian financial crisis are also consistent with the importance of political institutions in response to shocks (see Fischer, 2002).[19] Even though democratic institutions had developed recently, they helped the two countries adjust in several ways: by facilitating a smooth transfer of power to a new set of politicians;[20] by providing mechanisms to enable policymakers to fashion the consensus needed to undertake the necessary policy

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[17] See Acemoglu et. al., 2003; Rodrik, 1999, Haman and Prati (2002), Satyanath and Subramanian 2004, and Rajan, 2004.

[18] Rodrik (1999) argues that weak political institutions mean that societies cannot handle the disputes that arise after negative shocks.

[19] For an innovative evaluation of what happened in Indonesia towards the end of the Suharto regime, see Fisman (2001).

[20] In Thailand, Mr. Yongchaiyudh resigned in the wake of the crisis and power transitioned smoothly to Prime Minister Leekpai. In South Korea, the veteran opposition leader, Kim Dae-Jung, was elected to office as the crisis broke. Both these candidates were seen as representing a break from the past.

adjustments;[21] and by providing mechanisms of "voice," obviating the need for riots, protests and other disruptive and economically costly actions (Rodrik, 1999).

Another famous example of political institutions having an effect on crises has been documented by Sen (1981) in his analysis of famines. He argues that the contrasting experiences of China and India in avoiding famines stemmed from the greater degree of transparency in India's political institutions which allowed quicker public awareness of the problem and speedier responses to it.

6) But institutions do not explain growth fluctuations in the short run.

We would stress that the growth record clearly indicates that countries can grow in the short run with weak institutions. In other words, institutions are not crucial in relation to short-run growth. Igniting growth may not be particularly difficult, but sustaining it is difficult without good institutions.[22] Growth spurts or transitions often happen by chance or due to other triggers, for example, because the terms of trade improve for a natural resource producer, or because there is a change in government, or an end to a civil war. They do not even seem to require major policy reforms.[23]

One particularly interesting episode is the end of the nineteenth century and the early twentieth century. Some of the fastest growing countries had weak institutions, such as

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[21] In the case of South Korea, the opposition's consent to the IMF's letter of intent was seen as representing a social consensus on the need for reforms.

[22] One manifestation of this differential impact of institutions is that measures of institutional quality are more robust in regressions involving the level of income than in growth regressions.

[23] There is a lot of randomness in growth experiences, i.e., a large component that is hard to explain with any kind of regression analysis. See Hausman, Pritchett, and Rodrik (2004). In the case of India, for example, growth was ignited in the early 1980s even in the absence of significant policy reform by an apparent attitudinal shift on the part of the government toward the private sector (Rodrik and Subramanian, 2005). Srinivasan (2005) contests this interpretation of events in India.

Argentina, Mexico and Russia. But each of them then experienced a major political and economic disruption that derailed growth.

There are two reasons. First, the elite can do a great deal for itself and among itself. Webs of personal connections can sustain investment even when the general environment is unstable.[24] The key point is that elites do not expropriate everyone all the time. It depends on the alternatives. For example, related lending by a bank to its owners may work fine during periods of prosperity. But these arrangements are quite vulnerable to collapse.

Elite expropriation may get worse as an economy experiences a sustained credit boom. This would be the case, for example, if there were less pressure to control corruption when times are good (e.g., when oil prices are high this is probably the case in some oil producers). Alternatively, or in addition, when there is a shock that shortens time horizons and reduces the value of repeated game interactions, elites may engage in a grab for resources.

7) Institutional persistence and change

Institutions persist, i.e., institutions tomorrow are very likely to be quite similar to institutions today. The most likely explanation is that they suit the interests of those in with power. One example of this was the relatively slow pace of reforms in the Commonwealth of Independent States (CIS) during the reform process, compared with the more rapid change in the Central and Eastern European countries. Institutions are also persistent because they are the result of historical factors, which are difficult to overcome.[25]

[24] For the fascinating historical case of Mexico, see Haber, Razo and Maurer (2003), and also the review by Bates (2004). Of course, it is not clear that a modern country could pull off the same kind of record.
[25] Two examples illustrate the role of historical factors. Banerjee and Iyer (2004) document the role of land tenure systems in pre-colonial India in affecting current institutions in agriculture. Nunn (2004) finds strong

But institutional persistence is not institutional predetermination. In fact, historical variables typically explain around a quarter of the variation in measures of institutions today. This means that much of the variation does not come from history. For example, between the 1970s and 1990s there have been some very notable changes in the quality of institutions (Chart 7 for political institutions). One indicator of institutional quality is the index measuring the constraint on the executive. Twenty countries improved their institutional quality ratings by more than 40 percent. Of course, how institutional change can be effected is a difficult question—perhaps at the core of many current debates about growth and development—but that they can change and have lasting effects on development should not be in doubt.

Effective institutional change is often fairly gradual, i.e., taking place over 10-20 years or even longer. It often comes about in a fairly piecemeal fashion, where changing one dimension makes it more appealing to change another complementary dimension. Most countries changed their institutions substantially in the 18th and 19th centuries. In the twentieth century, for various reasons, institutions around the world have changed less dramatically, but they have changed in many instances – for example, in all the East Asian countries that have sustained rapid growth. Occasionally, though, institutions, especially political institutions, can change suddenly, brought about by the collapse of the previous regime. Notable recent examples include the collapse of the Former Soviet Union, and the change in post-conflict states such as Timor-Leste, Kosovo, Afghanistan, and Iraq.

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evidence that the Atlantic and Indian Ocean slave trade between 1400 and 1900 has adversely affected Africa's growth performance in the last 40 years.

III. Uncertainties

1) Relationship between political and economic institutions

Rents themselves may be partly endogenous, but good economic institutions are more likely to arise and persist when there are only limited rents that power holders can extract from the rest of society (e.g., when there are limited natural resources), since such rents would encourage them to opt for a set of economic institutions that make the expropriation of others possible.

Good economic institutions are more likely to arise when political power is in the hands of a relatively broad group with significant investment opportunities. The reason for this result is that, everything else equal, in this case power holders will themselves benefit from secure property rights.

This puts political institutions at the center of the story. But what is the exact relationship between political and economic institutions? We know very little about this. Economic institutions may improve first, followed by political institutions, which has been the experience in much of East Asia and Chile. The converse, namely strong political institutions leading economic ones has been true for Botswana and Mauritius, the only two countries in sub-Saharan Africa that have enjoyed sustained growth. Indeed, there is very little correlation between economic and political institutions between 1980 and 2000 for countries around the world (see Chart 8A, which plots the correlation between changes in economic and political institutions between 1980 and 2000).

In Africa, there has been an improvement in political institutions – i.e., more democracy—but whether this will necessarily translate into better economic institutions remains to be seen; the simple correlation between economic and political institutions is insignificantly small (see Chart 8B on Africa). Indeed, as Chart 9 shows, economic institutions after having improved in the early 1990s have plateaued or perhaps even deteriorated, so there is little sign of convergence in economic institutions.

2) How do institutions change?

That institutions change is clear. But understanding change, and more specifically, identifying the policy actions or levers for change is perhaps one of the key unknowns in development. A number of forces may lie behind institutional change. The first is the desire of the elite to preempt problems with other groups in society. One example would be the extension of the franchise in 19th century Europe (Acemoglu and Robinson, 2001). But as remarked earlier, more often than not, elites have a strong interest in maintaining the status quo, especially if there are rents to be extracted from current arrangements.

A second reason for change is some extreme event or crisis such as a revolution or some other form of uprising by groups that do not have political power. The French, Russian and Chinese Revolutions are leading examples, although each of them obviously led to different institutional arrangements. The breakdown of the former Soviet Union is another example of extreme political change. Even in the post-war data, there is evidence that political institutions change due to crises.

Institutional change may be easier when there is economic growth, so losers can more easily receive at least partial compensation.[26] So economic growth per se should promote better institutions. Also, if good institutions and governance are superior goods, there will be greater demand for them as incomes rise, suggesting another channel of impact from growth

[26] Lau, Roland and Qian (2000) make a nice version of this argument for China, although their emphasis is more on the sequencing of reform).

to institutions. So is it the case that rising per capita income itself leads to better institutions? This is a long-standing view in political science and economics, for example articulated clearly in the work of Seymour Lipset (1959).

There has been both a general trend towards democratization and economic growth over the past 200 years. These trends have continued, in broad terms, since 1950. However, if we look at the within-country variation, there is no relationship between growth and the extent of democracy.[27] In other words, growth by itself does not lead to democracy, at least in the post-WWII period. Even within East Asia, South Korea and Indonesia offer contrasting experiences of institutional change in response to growth. But one robust stylized fact is that countries above a certain threshold level of income (perhaps $6,000) have not experienced the overthrow of democracy (Przeworski 1991).

Another driver of institutional change could be good leaders. Jones and Olken (2004) present important new evidence supporting this point; they also show that good leaders have more of an impact when institutions are weak.

Yet another driver of institutional change appears to be natural resource discoveries. The problem with them is that they yield enormous rents to a small elite that has no interest in broader economic development. In such a situation, a resource boom may actually undermine institutional development as the now more economically powerful elite has less incentive to develop a broad tax base or more generally improve property rights for a broad cross-section of society.[28]

[27] Technically speaking, this describes results from a fixed country and time effects panel regression. See Acemoglu, Johnson, Robinson, and Yared (2004a).
[28] Ross (2001) and Sala-i-Martin and Subramanian (2003) document the adverse impact of natural resources on institutional quality.

The above makes clear that a wide variety of factors can cause institutional change. Moreover, most of the factors identified—crisis, revolutions, growth, natural resources, and leaders—are typically not easy to influence: for example, how can a country chose "good leaders?"—and provide frustratingly little guidance on what policy levers can be used to effect institutional change.

3) Can outsiders change economic and political institutions?

This is a very important question, especially for the international community, which through a combination of assistance and conditionality seek to change institutions and outcomes in aid receiving countries. It is especially important for interventions in low-income countries through the PRSP process, because in these cases there are explicit institution-related interventions. For example, PRSPs require extensive "process" requirements, in terms of participation and consultation.

Historically, external military action including colonialism has been a primary way in which some countries have shaped the institutions of other countries. But colonialism imposed various forms of expropriation, and with a few exceptions it established bad institutions.[29]

Of course, outsiders can have an important impact in preventing, minimizing, or resolving conflict (the interventions in Bosnia and Sierra Leone being two recent examples). But whether they can play a crucial role in the positive engineering of institutions remains unclear.

[29] The origin of the term colonization lies with the idea of sending settlers – something that Greek cities, for example, did around the Mediterranean in ancient times. Settlers tend to take the institutions of their home country or even improve them (as labor tends to be freer in new settlements, so it acquires greater rights.) The quality of institutions in former European colonies is higher where settlements were more important (Acemoglu et al 2001).

One recent example of change from the outside is accession to the European Union. Countries that have joined the European Union have changed their institutions in far-reaching and fundamental ways to comply with EU norms—the famous *acquis communautaire*. There are, however, significant differences between EU accession and Bank-Fund programs (Roland, 2003). First, the lure of accession to the EU can be so overwhelming, going beyond financial assistance to benefits in the realm of politics (e.g. the consolidation of democracy in Spain and Portugal, the move away from the Soviet sphere of influence for many of the Former Soviet Union and Eastern European countries) to market access benefits in good, services and labor mobility, as to provide the necessary incentive to countries to undertake institutional reform. The ownership-conditionality dilemma that fundamentally afflicts Fund-Bank involvement is thus largely resolved because the lure of prospective benefits provides adequate incentives for serious ownership. Second, the mechanisms for ensuring compliance with norms pre-entry are very strong in the EU (Roland, 2003).[30]

Another oft-cited example of a successful external anchor is the WTO. In the case of China, the goal of WTO accession encouraged the authorities to undertake significant reforms of the trade system, the restructuring of state-owned enterprises, and encouraging the removal of internal trade barriers such as obstacles to labor migration. But this has been more the exception than the rule. For the vast majority of developing countries, the WTO has not played the role of anchoring domestic policies reflected in fact that countries' actual trade

[30] Arguably, the Fund has played an important constructive role in facilitating accession to the EU in many instances. Particularly for countries that did not need Fund resources and where the policymakers had a clear picture of what needed to be done, the Fund's role in large part was to validate and endorse, as well as to provide implicit insurance in case a shock knocked the country off-track.

policies—in both manufacturing and services--are more liberal and open than what they have committed in the WTO.[31]

So, unless there are substantial benefits that outsiders can offer, it remains a big challenge for positive institutional change to be driven from the outside.

4) Form vs. Function

A related issue, which is of great operational significance, is whether we can know good institutions by particular forms, or whether we have to look at the functions that these institutions are playing.

For each of the functions performed by institutions, there is an array of choices about their specific form. What type of legal regime should a country adopt—common law, civil law, or some hybrid? What is the right balance between competition and regulation in overcoming some of the standard market failures? What is the appropriate size of the public sector? How much discretion and how much flexibility should there be in arrangements for the conduct of fiscal, monetary, and exchange rate policies?

Unfortunately, economic analysis provides surprisingly little guidance in answering these questions. Indeed, there is growing evidence that desirable institutional arrangements have a large element of context specificity, arising from differences in historical trajectories, geography, political economy, or other initial conditions. This could help explain why successful developing countries have almost always combined unorthodox elements with orthodox policies. East Asia combined "outward orientation" with industrial intervention. China grafted a market system on top of a planned economy rather than eliminating the latter

[31] See Mattoo and Subramanian (2004) who provide evidence of the substantial wedge between the stance of developing countries' actual trade policies and what they have "bound", i.e., committed in the WTO.

altogether. Much of the growth in "private" investment in China during the 1980s and early 1990s came from township village enterprises (TVEs), which embodied a unique system of property rights. It could also account for why major institutional differences persist among the advanced countries of North America, Western Europe, and Japan—in the role of the public sector, the nature of the legal systems, corporate governance, financial markets, labor markets, and social insurance mechanisms, among others. Moreover, institutional solutions that perform well in one setting may be inappropriate in another setting without the supporting norms and complementary institutions. In other words, institutional innovations may not necessarily travel well.

As far as we know, quite a wide variety of different institutional forms can serve the same useful functions, i.e., there is not one recipe for good institutions. For example, the discussion of whether French institutions are bad for economic performance is largely a red herring.[32] There are different ways to construct the institutions that are consistent with a high level of productivity. It is very hard, and probably not helpful, to argue whether Japan or Germany or France or anyone else has "the" ideal institutions. Countries can and do develop their own institutions. There is definitely not one size that fits all.

Furthermore, it is also unlikely that we have seen the full range of institutional innovations. We are also not confident that we will always recognize sensible innovations when we see them.

5) Relationship between broad and specific institutions

A lot of the international community's work, lending and technical assistance, involves creating or changing specific institutions—central banks, regulatory bodies, public

[32] See Acemoglu and Johnson (2003). This point remains controversial.

expenditure management systems etc. The question that arises is whether these specific institutions can be changed if the more basic institutions are weak. In relation to monetary policy for example, there is the issue of whether independent central banks contribute to low inflation because of being an efficient commitment device (Kydland and Prescott, 1977) or whether they represent the outcome of a prior political and social consensus reflected in strong political institutions in favor of low inflation. [33]

Similarly, can corruption in customs, i.e. customs reform, be addressed independently of the state of corruption in the public sector as a whole?[34] Can revenue authorities perform better than conventional tax agencies? Can financial development lead to growth when more fundamental institutions remain weak? There are considerable uncertainties here and yet these are very important if donors' intervention, even their areas of expertise, is to be effective.

Overall, we can recognize institutional change when it occurs, but realistically this happens often only with a time lag. We know little about how to systematically change or induce change in institutions. This is a very important gap in our knowledge.

6) Relationship between policies and institutions

There is strong evidence that institutions affect policies and policy effectiveness. For example, the strength of political institutions is an important determinant of the success of disinflation programs (Hamann and Prati, 2002). An even more stark example relates to oil-exporting countries such as Nigeria, where the basic principle of saving while oil prices are low and drawing upon savings when prices decline had been studiously avoided for decades

[33] Subramanian and Satyanath, 2004, provide evidence in favor of the latter.
[34] Yang (2004) provides evidence that institutional reform such as the appointment of pre-shipment inspection companies to manage customs may not have the desired effect.

despite IMF-Bank conditionality. The underlying governance did not make prudent fiscal policy feasible. Similarly, weak financial regulation and supervision lead to excessive risk-taking, exposing countries to major financial crises.

From the perspective of changing institutions, however, a key question is whether policies can change institutions. Is there something that governments can do that will foster the development of institutions? It is clear that if attempts to improve competition are successful, (that is, if such attempts are not thwarted by the very institutions that are sought to be changed), they can have a major positive effect on institutions, provided and especially if the opportunities fall substantially into the hands of entrepreneurs outside the established elite. Domestic competition and trade reform are policies that fall into this category (see Djankov and others, 2001, World Bank 2003, and Wei, 2000).

Another important area where policies can have an impact on institutions is tax policy. On the one hand, the experience with natural resources and aid suggests that when governments are relieved of the pressure to tax citizens, long-run institutional development suffers. The incentives for two-way engagement between governments and citizens/taxpayers are undermined. Citizens have less incentive to hold governments accountable because of not being taxed.

On the other hand, taxes, especially high and complicated taxes can also undermine entrepreneurial development. There has been a great deal of discussion recently on the regulatory barriers to entry, i.e., the costs that entrepreneurs have to pay in order to register their businesses and operate officially. But the most obvious cost is simply that, once registered, these entrepreneurs have to pay taxes. If taxes are high, entrepreneurs may stay underground. Underground business is very unlikely to be an effective lobby for improving institutions.[35]

Transparency and information dissemination can clearly have a positive impact on institutional outcomes. Transparency can again be part of the broad institutional framework, for example a free, privately controlled press, which may help reduce corruption and government effectiveness (the work by Sen on famines is relevant here), or can relate to specific contexts. Evidence for the latter is provided by Ritvikka and Svennson (2004) for Uganda, di Tella and Schargrodsky (2001) for public procurement, and Glennerster and Shin (2004) for the case of data dissemination standards promoted by the International Monetary Fund.

7) Aid, Institutions and Growth

What do we know about the impact of aid on institutions and growth? The literature on aid and growth is mired in controversy. Burnside and Dollar (2000) made the claim that aid is not unconditionally beneficial but can help where recipient country policies are good. Easterly (2003) and Easterly et. al. (2004) contest these claims, arguing that the results are not at all robust. Recently, Clemens et. al. (2004) argue that short-term aid has a positive effect on growth, which still leaves open the question of the long-run impact, which is of central concern to policy-makers. Rajan and Subramanian (2005) depart from the question of whether aid helps to examining the question of the channels through which aid might help or hurt growth. They find strong evidence of an adverse impact of aid on an economy's competitiveness and hence on long-run growth.

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[35] See the discussion of recent Ukrainian experience in the IMF's September 2004 World Economic Outlook. The World Bank's Doing Business indicators do not currently include measures of tax rates faced by entrepreneurs. However, these will likely soon be added to their dataset.

There is the related question of the impact of aid on institutions, which development practitioners have loosely articulated as “aid-dependence,” which is about the incentive effects of aid on those in power to reform policies and institutions. The obvious analogy is with natural resource revenues, which are known to undermine institutions. Clearly, during the cold war period, examples of aid propping up “our guy” were not difficult to find. There is relatively little research on whether this was phenomenon was more widespread and discernible in the cross-country evidence. Even if it were, there may be reason to believe (or not) that strategic considerations will play less of a role in the future and that aid may not have a corrosive effect on isntitutional quality going ahead.

Overall, though but a careful reading of the evidence suggests that it is difficult to take comfort in the view that aid, or at least, aid as we knew it, can build institutions and sustain long-run growth.

IV. Implications for the International Community and Aid Recipients

This section draws some implications from the above analysis.

1) Perhaps the most important implication is in delineating the limits of the possible. Given that basic economic and political institutions are important for growth, that they take a long time to change, and that they cannot easily be altered from the outside (something supported by the mixed record of conditionality), and even if they could the relevant levers (for example, basic economic and political institutions) are outside the scope of the international community’s mandate and competence, there is a fundamental problem regarding expectations and time horizons.

Accordingly, there is the risk that donors may be setting inappropriate expectations in terms of how much growth and how quickly. The horizon over which progress can be realistically made and assessed is likely to be far greater, for example, than that of the typical Poverty Reduction Strategy Paper.

2) That said, the international community obviously has an important role to play in helping maintain macroeconomic stability, prevent crises or manage recoveries. The evidence suggests that developing countries, especially those in Africa are especially prone to volatility. Mitigating volatility may not in itself deliver high growth, which again argues for a moderation of expectations about high growth over short time horizons.

However, not mitigating volatility may entail large costs in terms of institutional deterioration and failure, and hence long-run growth. In Africa, for example, rainfall-related shocks have a sizable impact on the probability of civil war (Miguel et. al. 2004). Limiting the impact of these shocks would therefore seem to be an important role for the international community to play.

A shocks facility for low-income countries would, in effect, provide insurance to countries affected by shocks. It might be desirable for the insurance to be provided at highly concesssional rates (perhaps even as grants) given the income level of countries and the magnitude of the shocks, especially if the adverse incentive problems can be avoided through appropriate design of the facility.

3) Donors could talk more openly about the problems of economic governance and serve as an honest and independent assessor of governance. This assessment of governance could be

based in part, but not exclusively, on existing governance indicators. These are complex phenomena with important nuances that vary across countries. Measures of institutions change more slowly than the reality and may not reflect what is actually happening. Hence, donor assessments will have to be supplemented with other data. One useful indicator to which more attention could be paid is private sector investment.[36]

Without a high level of investment in the productive sector, it is not possible to sustain growth. If there are problems with governance, presumably it will be manifest in investment. If a country can find ways to sustain, say over 10 years, high private sector investment with weak governance that is fine. However, we should constantly warn countries that private sector investment can and does collapse suddenly unless it is underpinned with strong institutions.

4) Given the idiosyncratic and context specific nature of institutional change, there may be a role for legitimate experimentation by countries in regard to economic institutions and policies. Of course, this is easier said than done because distinguishing good from bad experimentation may be difficult to identify in practice.

Take two examples from recent history, where there was some heterodoxy in policy reform. In the case of China, the township and village enterprises (TVEs), were for some time, the drivers of industrial growth. In the case of Mauritius, two-track reforms were pursued with a protected import sector, and an outward-oriented enclave in the form of export processing zones with special benefits. These are not experiments that the US-based economists would have obviously endorsed. There are other instances where the US

[36] Focusing on growth outcomes is less attractive, because these contain a lot of noise. Also there are ways to boost growth in the short- to medium-run, for example through high levels of public spending, and this may prove unsustainable.

economists' assessment and endorsement proved correct (Chile, Korea). And yet others where despite outside endorsement of reforms did not lead to the expected growth outcomes (the Andean Region). How should donors distinguish these cases? Are there early indicators that would help the donors to do so?

5) Insofar as transparency is a key element of institutions, donors should consider making transparency in public finances, and norms, more routinely integral to conditionality. This is particularly appropriate for natural resource-based countries, where there are a few relatively centralized sources of government revenue. Transparency in this area can presumably have significant macroeconomic consequences. Transparency could include observance of ROSCs, adherence to relevant international standards (such as the U.K. Extractive Industries Transparency Initiative), and open public expenditure management systems. Recent steps in this direction in Angola and Congo (Brazzaville) appear legitimate in the eyes of all, and are arguably consistent with the donors' mission and expertise.

6) The importance of institutions also raises challenging questions about conditionality. If institutions are indeed the deep determinants of development, then policies traditionally subject to conditions—fiscal, monetary, exchange rates, structural reforms—cannot be evaluated simply by looking at their intended effects. When the underlying institutions are not being changed in the appropriate way, conditionality on policies may be ineffective. Therefore, the exclusive focus in conditionality on "getting policies right" may need to be re-thought.

Clearly, a response of setting conditionality on institutions or institutional change per se may not be feasible either. For one, conditionality on the basic institutions may be considered overly intrusive, while conditionality on the range of narrower institutions may run counter to the September 2002 guidelines calling for parsimony in conditionality.

One alternative to detailed policy conditionality is to find the right institutional preconditions for lending. Spotting opportunities for example through a tough ex ante screening process (based say on an assessment of institutional strength) combined with less onerous ex post conditionality may be worth considering. Such a move could also have another advantage. Detailed conditionality can be inconsistent with the spirit of ownership, which properly defined necessarily involves allowing countries a certain measure of freedom to find appropriate institutional and policy solutions to development problems. The U.S.' Millennium Challenge Account tries to incorporate this principle of ex ante screening of institutional conditions.

Another alternative to addressing the dilemma of conditionality is to draw upon the EU example. The key point here is whether the international community can offer—for example, through a seal of approval that investors would respond to—benefits that countries might consider attractive enough to want to change domestic institutions without the need for onerous conditionality. That remains to be seen.

Even if the international community itself did not serve as an anchor, the presence of other anchors for countries could be helpful. For many of the FSU and Central and Eastern European countries, the International Monetary Fund's role has been – in part – one of helping manage the economic transition until the anchor of the EU was in sight. The question is whether the poorer developing countries can find such an anchor. Outside of the

European region, broadly defined, the EU is unlikely to play this role. The WTO can play this role for some countries, but not likely for most, and even then the anchor would only guide trade policy. Unless an anchor can be created for Latin America, Africa and perhaps some parts of Asia, the ability of any outside organization to play an important validating role may be quite limited.

7) Another challenge relates to post-conflict situations. Should countries in these situations be treated differently? Here there are two views.

Requiring these countries to immediately improve their institutions is arguably unreasonable. An alternative would be grants with light conditionality, with help on all macroeconomic management issues, and a graduation to lending only when institutions have improved sufficiently.

A second view is, to the contrary, that post-conflict situations allow outsiders to have a great deal of impact on public expenditure management systems and other issues that fall within the scope of our technical assistance mandate. This may be possible, but much of the previous discussion cautions against the idea that we know enough to enter into broader institutional engineering or that such attempts can be successful when the basic institutions are weak.

V. Conclusion

The problem is not that we do not know what is needed for growth. There is nothing much wrong with the advocating macroeconomic stabilization, trade liberalization, deregulation, and privatization – provided institutions are strong. However, these policies may be insufficient for growth when institutions are weak.

Such policies are also presumably much harder to implement when institutions are weak. The experience of Latin American reforms since the mid-1980s (Chart on Latin America here), and of Africa, over a longer period, are suggestive of the importance of institutions. Probably everyone involved in development had a good sense of the importance of institutions long before the 1990s. However, recent experience has strengthened our intuition and deepened our understanding on this point.

But the reality is that there are considerable uncertainties in our knowledge about how institutional change can be promoted, if at all. And the policy levers that outsiders can control or influence to promote institutional development may be limited. This calls for a moderation of expectations about what can be delivered on growth and poverty reduction and a greater openness to experimentation on policy and institutional choices by countries. Of course, this experimentation needs to stay within the bounds of what can be considered reasonable and consistent with good economic governance.

Appendix: Measuring Economic Institutions

One entirely reasonable concern regarding the recent emphasis on institutions is the lack of uncontroversial measures. This is not surprising considering both the recent nature of empirical work on this subject, as well as the conceptual issues involved.

Brief History of the Indicators

The modern empirical work on economic institutions goes back to Mauro (1995), who used expert assessments of the investment environment.[37] The key findings from this early literature were that perception based expert assessments of corruption and the rule of law were significantly correlated with growth performance. Barro and Sala-i-Martin (1995) also found that rule of law was highly significant in standard growth regressions.

Since then there has been a great of work on these kinds of indicators.[38] Much of this has been pulled together and evaluated by a group at the World Bank headed by Daniel Kaufmann and Aart Kraay (see Kaufman, Kraay, and Loido-Zobaton, 1999). They have compiled a set of comparable cross-country governance indicators, using a clear methodology.[39] The six indicators provide country-level information on government effectiveness, rule of law, and control of corruption, voice, political stability and regulatory

[37] Knack and Keefer (1995) is another important early reference.
[38] Kaufmann and Recanatini (2005) provide an overview of alternative methodologies and tools to measure governance and institutions. Because of the complexity of governance, there is a variety of tools and indicators that have been developed recently. A detailed inventory of the indicators is available at: http://www1.worldbank.org/publicsector/indicators.htm and http://www.worldbank.org/wbi/governance/govdatasets/external.html. Major contributions – in terms of substance and in stimulating the debate on indicators – were made by, among others, Transparency International, Freedom House, and the Heritage Foundation.
[39] These indicators are constructed using information from about 20 different sources compiled by 18 different organizations**.** The information is then summarized and translated into six aggregate indicators using an unobserved component model.

quality. In addition, the authors calculate the confidence intervals (or "margins of error") for each indicator.

There are also some long standing measures of political institutions, such as the Polity IV dataset and, more recently, measures of State Failure put together at the University of Maryland by Marshall and Jaggers). Their website is: (http://www.cidcm.umd.edu/inscr/polity/. Again, the World Bank has put together a useful database (Beck et al, 2001:(http://www.worldbank.org/research/bios/pkeefer.htm)

Conceptual Issues

There are three main concerns with currently-used indicators of institutions, which are subjective and perceptions-based, i.e., the result of someone's assessment, rather than something that is objectively measurable.

The first issue is that outside expert assessments may be colored by biases of various kinds. However, what really matters is the assessment of people making investment decisions (and people who advise them), so the focus on opinions is not irrelevant. These subjective measures are correlated with firm's own assessments.[40]

The second issue is that subjective assessments move around in response to events often more than is warranted, which can be addressed by looking at averages over time.

These concerns create two problems for econometric work. First, they lead to error in the measurement of the underlying variable. Second, because perceptions are influenced by the outcome of interest (investors will say there is good protection of property rights when there is a lot of investment), there is "endogeneity" bias. In other words, we cannot

[40] The revised version of Acemoglu and Johnson (2003) documents this using the World Business Environment Survey.

distinguish whether to interpret an improvement in perceptions as a true underlying development or simply a consequence of higher investment.

There is a third concern with perceptions-based measures relating to prescription. Suppose that the previous concerns were somehow addressed and the analysis pointed to the need to improve institutions. But translating this conclusion into policy actions would be very difficult because the prescription would be to improve "investor perceptions," begging the question of how this might be done in the first place.

The alternative to such complex and perception-based indicators is to develop objective measures of quality of governance.[41] This is an appealing agenda, and substantial progress has been made in developing sensible indicators, particularly in the World Bank's *Doing Business* project,[42] the Investment Climate Assessment and the World Bank Institute Governance and Anti-corruption Diagnostic Surveys. The World Business Investment Surveys, in particular, focus on a multiplicity of stakeholders, such as public officials, households, and business people. Their objective is to gather specific, objective information about strengths and weaknesses within the country's institutions and uses it as an input to concrete anti-corruption strategy in the country level.[43]

Overall, it appears that the field of measurement in its early stages, and considerable work remains to be done. Governance evaluations are still, and likely to remain, more art than science.

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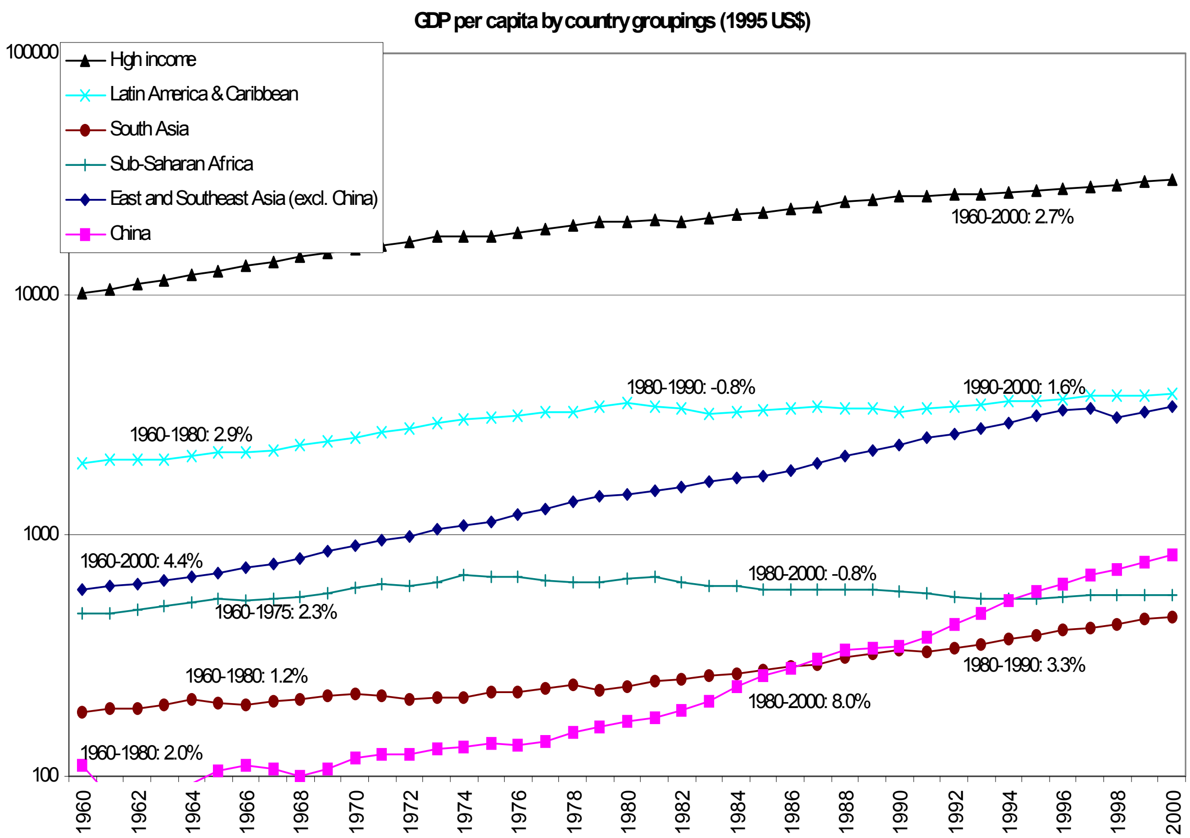
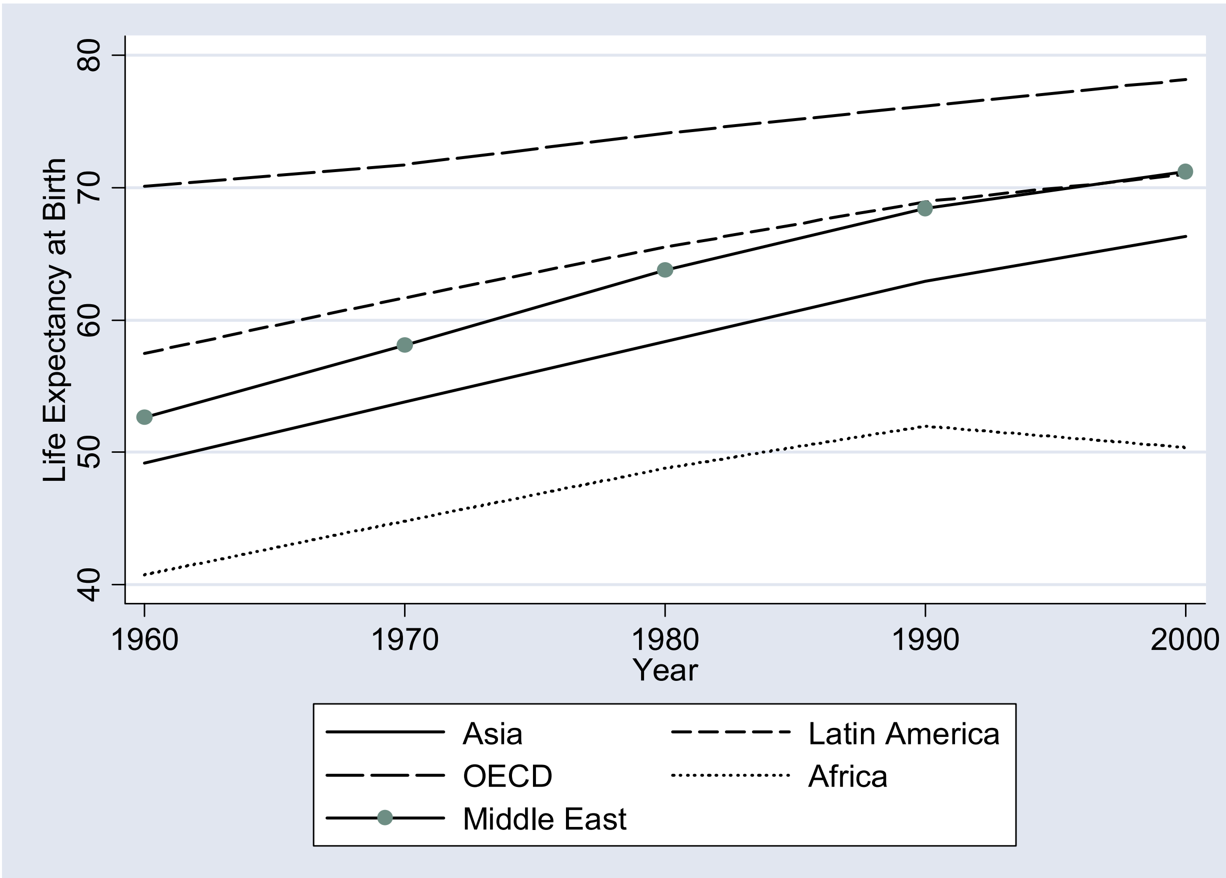
[41] But the leading objective indicators have proved not to be correlated with growth outcomes.
[42] See http://rru.worldbank.org/DoingBusiness.
[43] The key instruments used are detailed, country-specific surveys of thousands of households, business people and public officials. These tools are designed to provide the basis of technical discussions for policymakers and civil society for policy formulation, complementing the traditional sources such as experts' opinions or case study analysis. Furthermore, the combined surveys of households, business people and public officials permit consistency checks of the results. These surveys utilize experience-based (rather than 'opinions') type of questions, hopefully reducing the element of subjectivity.

Figure 1



Source: Rodrik (2004).

Figure 2. Life Expectancy at Birth 1960-2000



Source: Acemoglu and Johnson, (2004)

Figure 3a. Growth and Volatility, All Countries

(1960-2000)

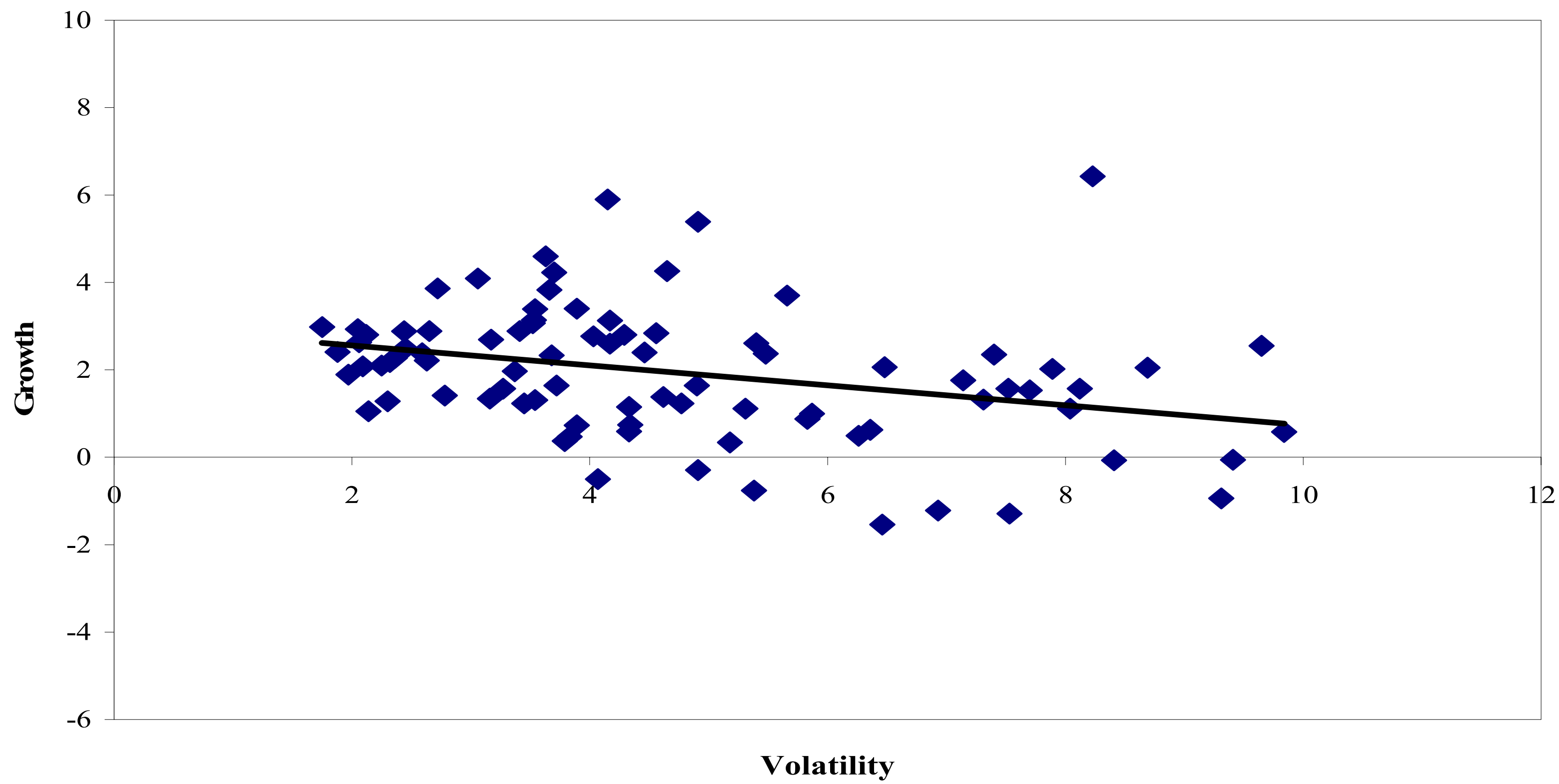
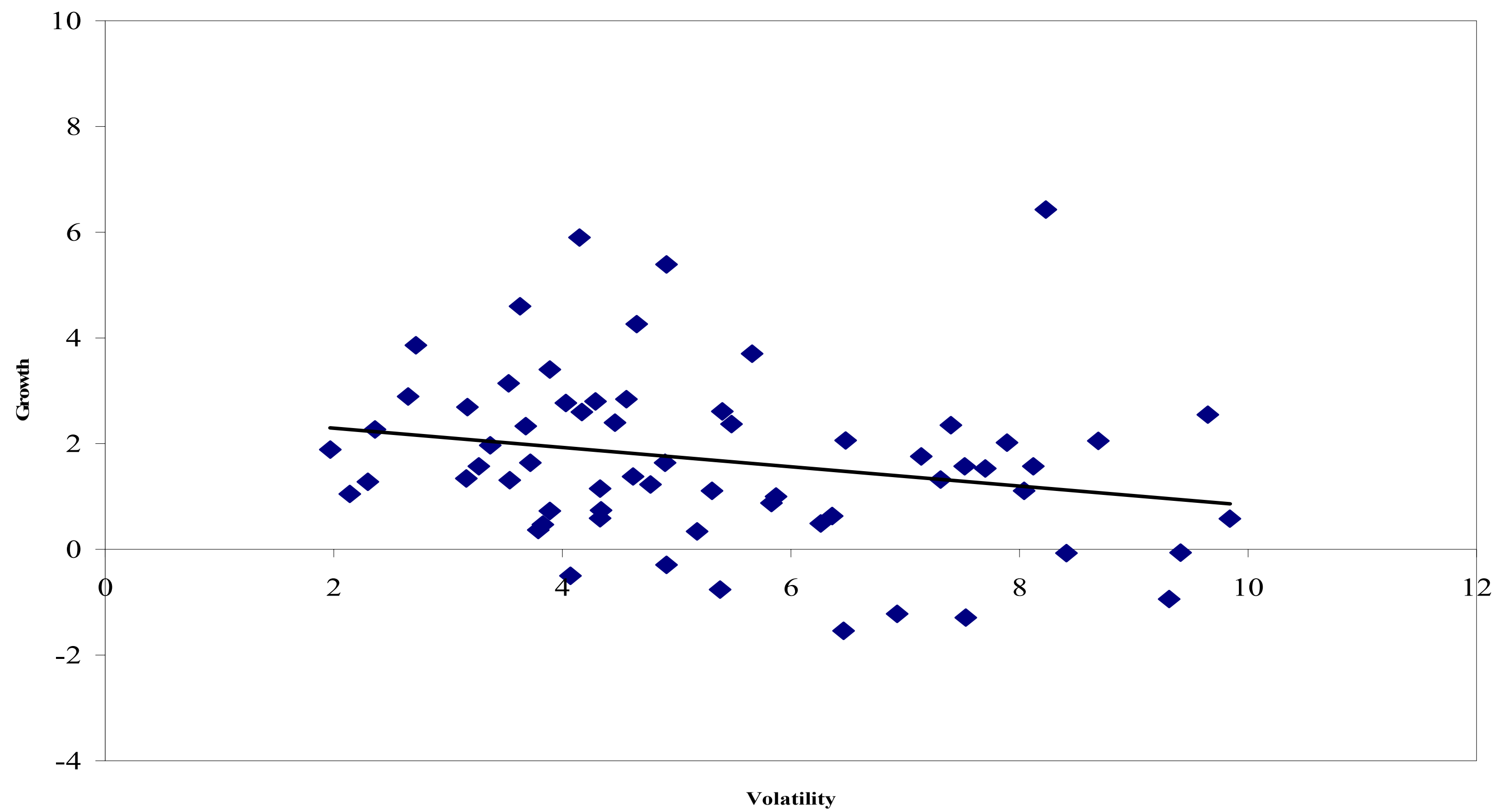


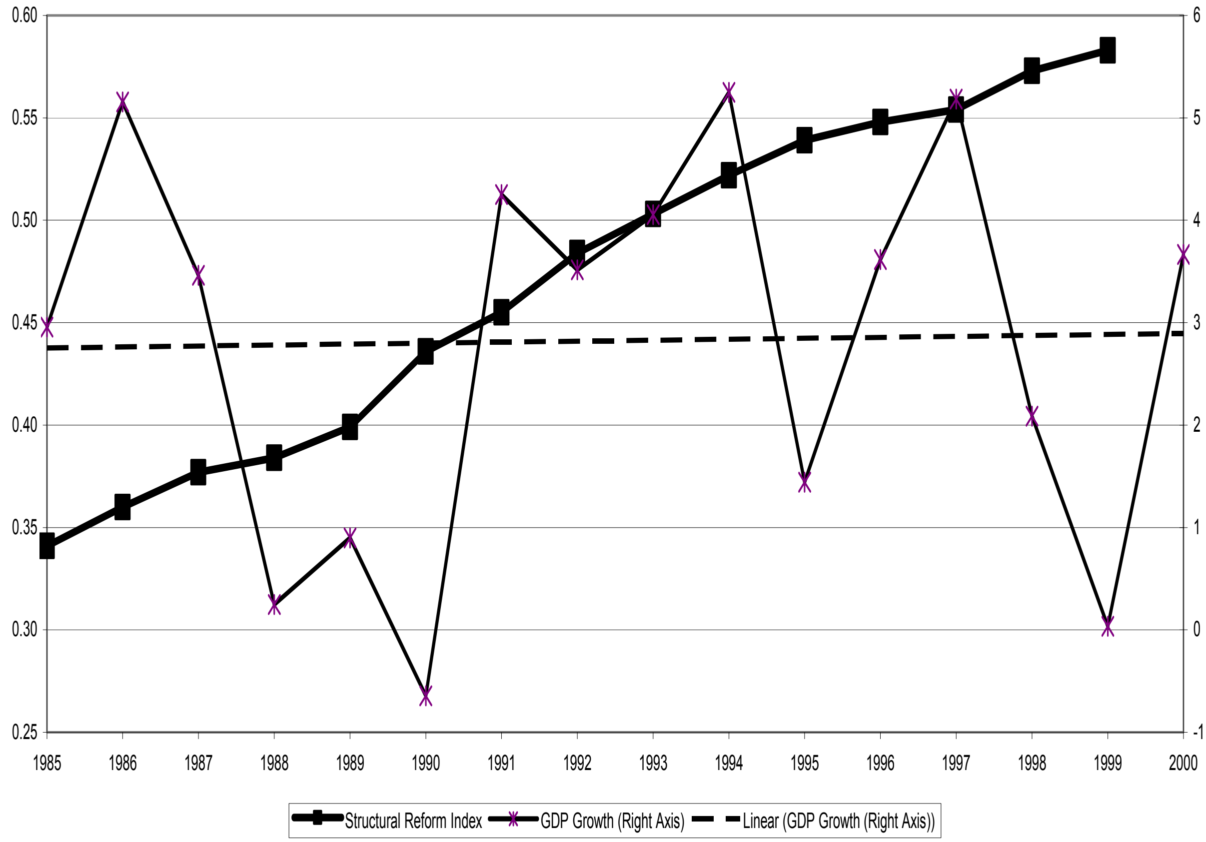
Figure 3b. Growth and Volatility, Developing Countries

(1960-2000)



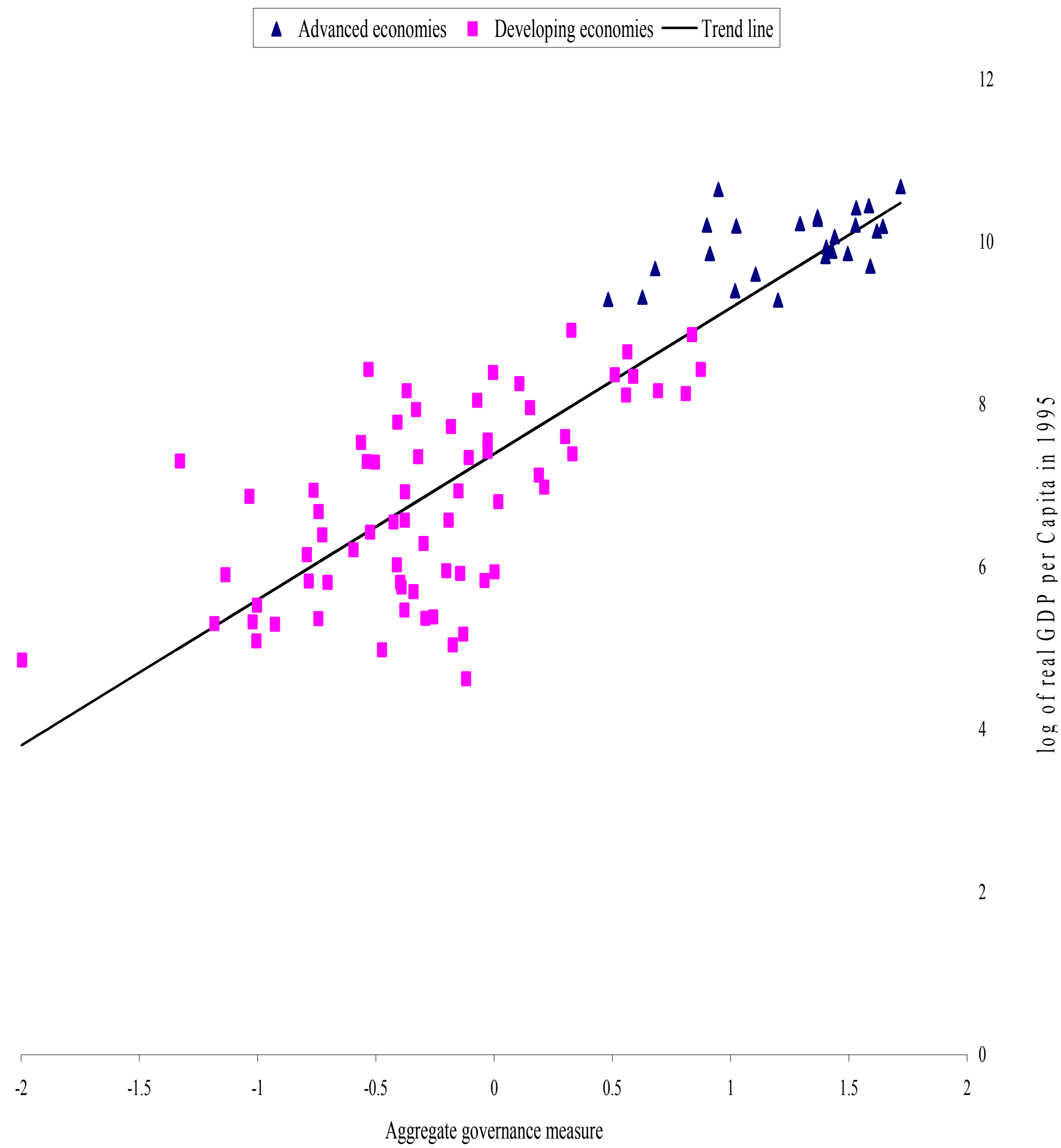
Source: Kose et. al. (2004).

Figure 4. GDP Growth and Structural Reform Index for Latin America



Source: Rodrik (2004).

Figure 5. Relationship Between Income and Institutions



Source: WEO (2003).

Figure 6a. Relationship Between Exchange Rate Instability and Political Institutions

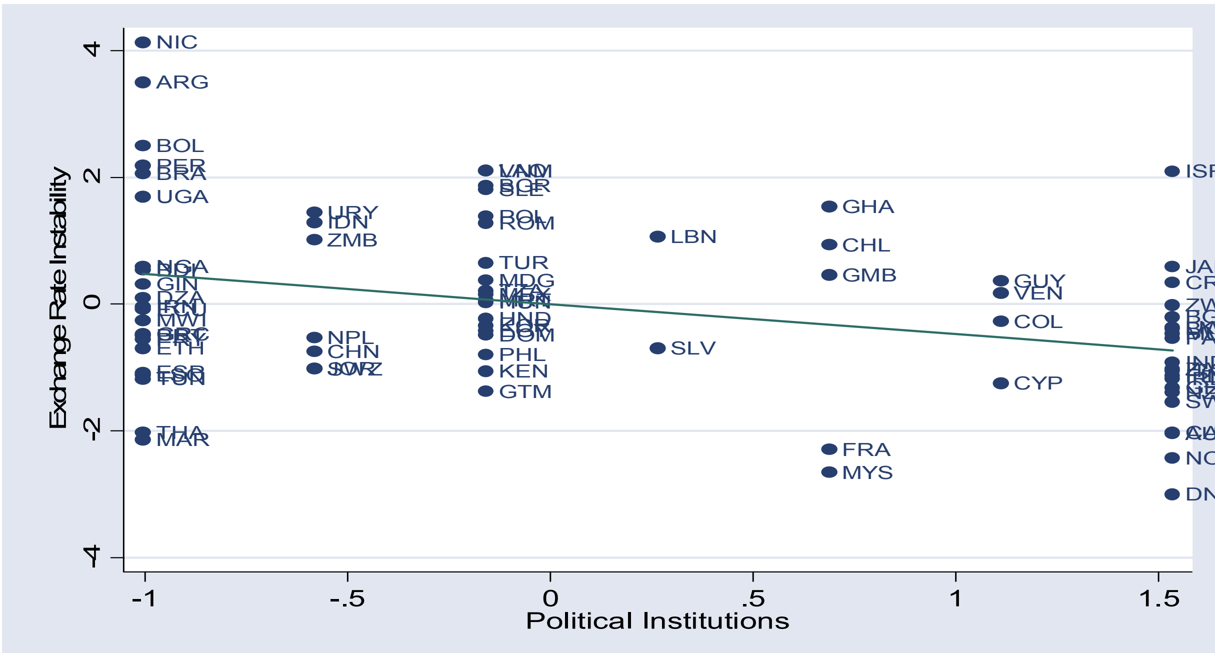
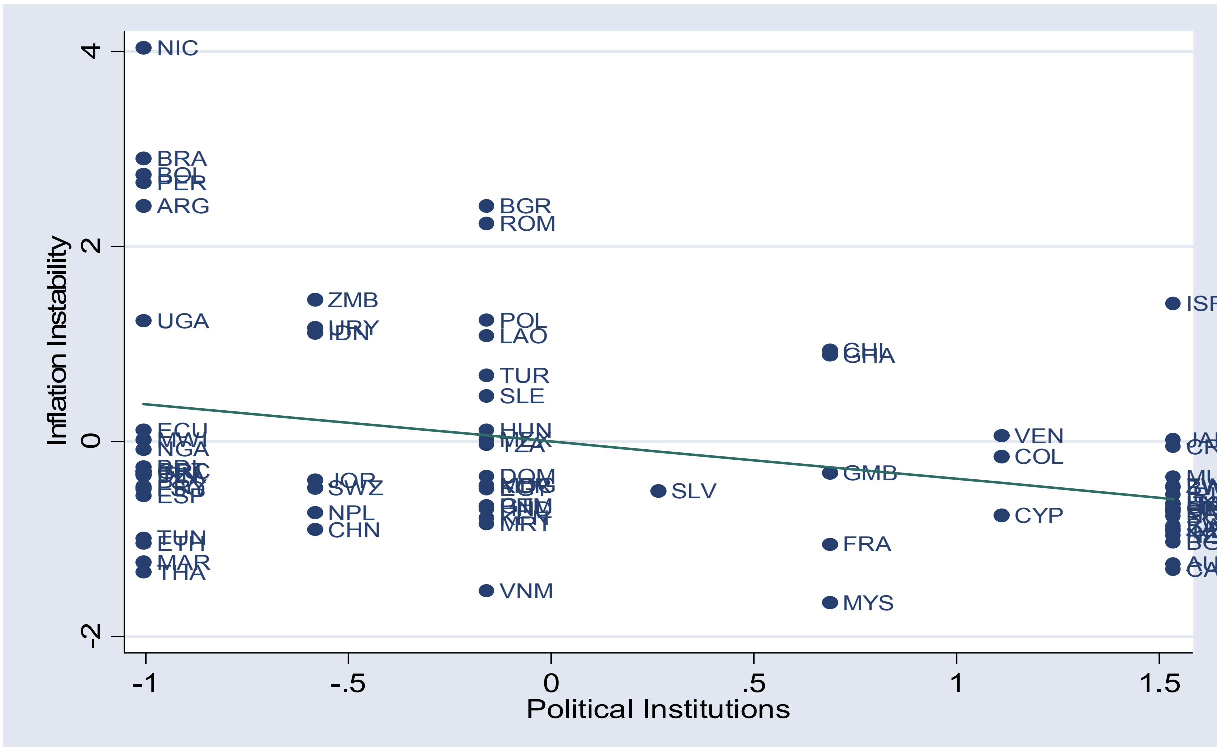
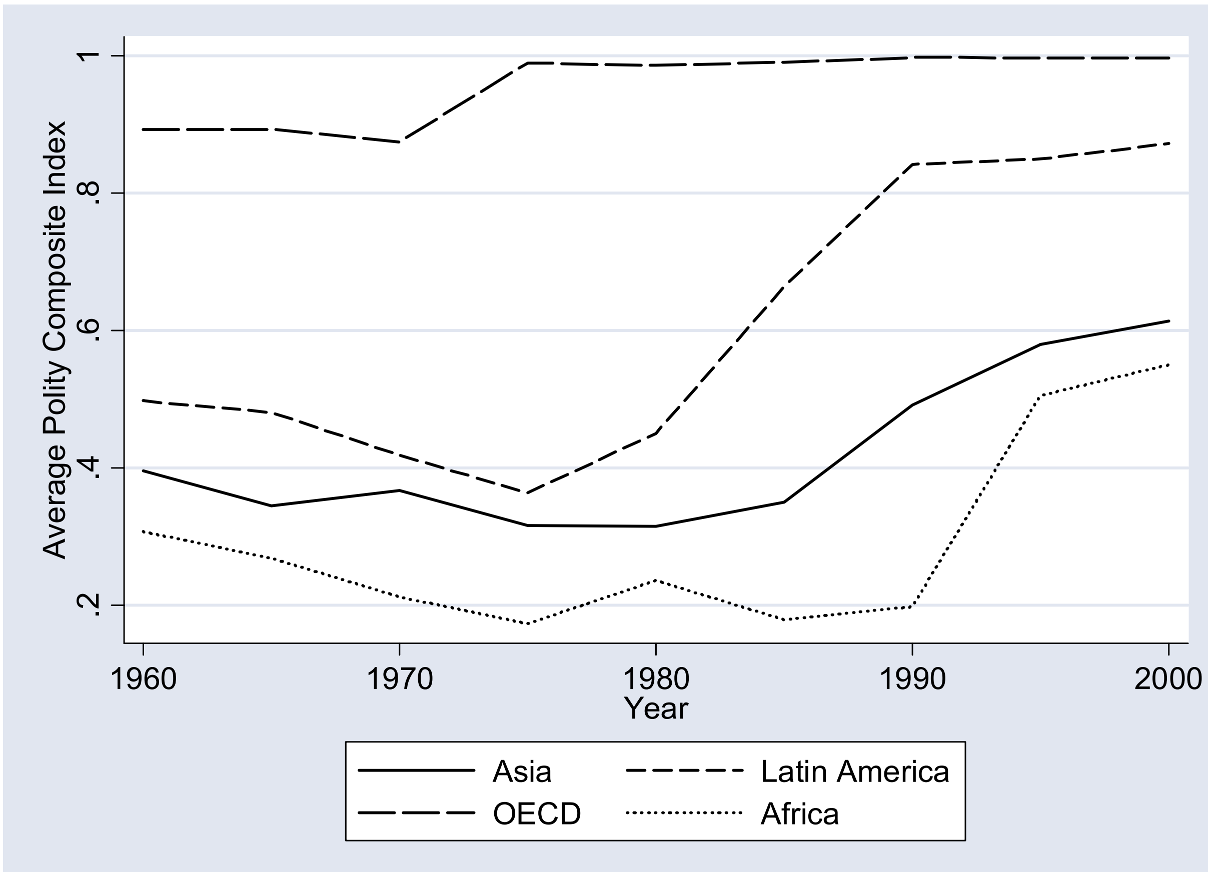


Figure 6b. Relationship Between Inflation Instability and Political Institutions



Source: Satyanath and Subramanian (2004).

Figure 7. Evolution of Democracy 1960-2000



Source: Acemoglu et. al. (2004).

Figure 8a. Change in Political and Economic Institutions, All Countries

(1980-2000)

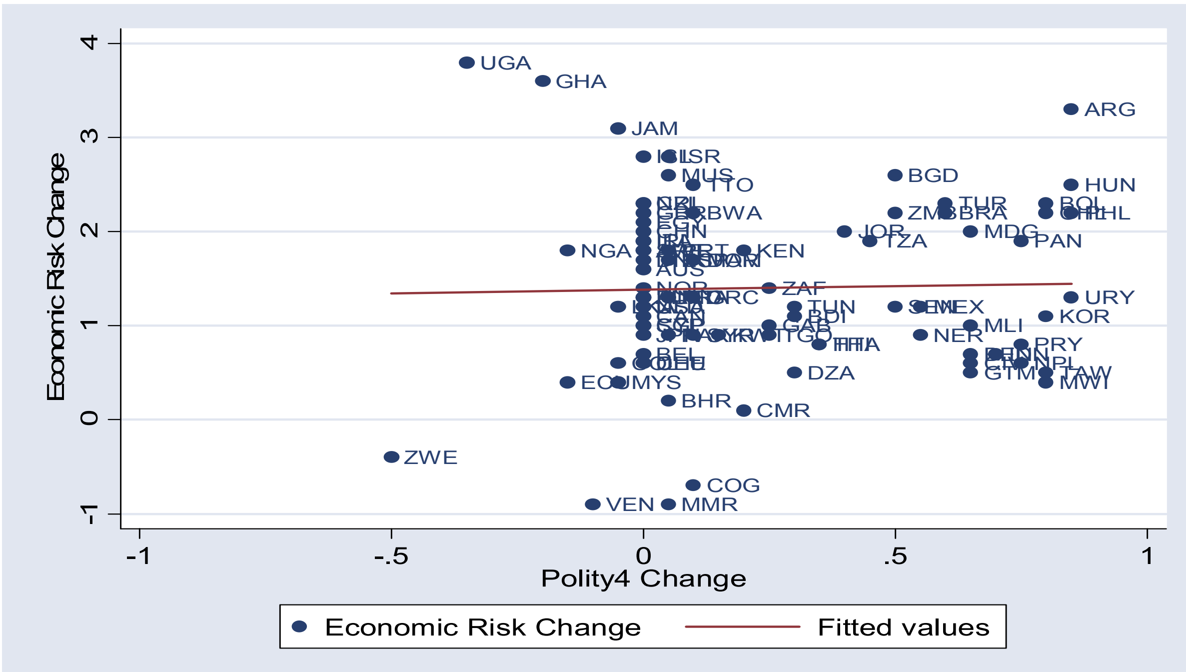
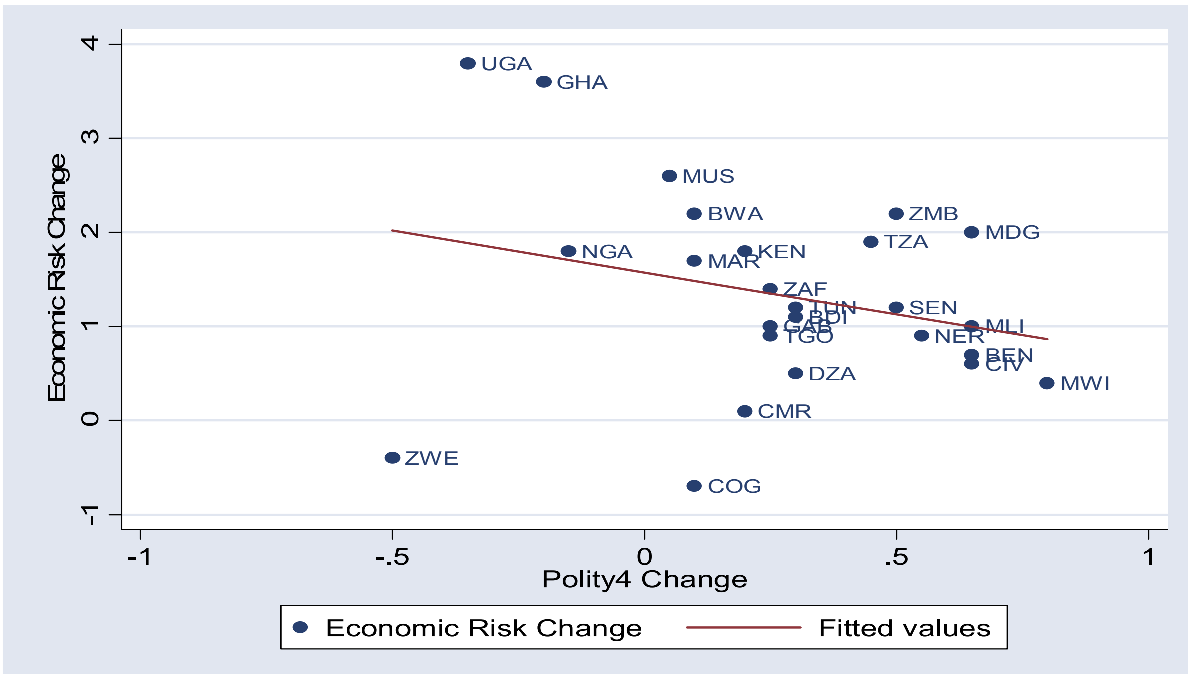


Figure 8b. Change in Political and Economic Institutions, Africa

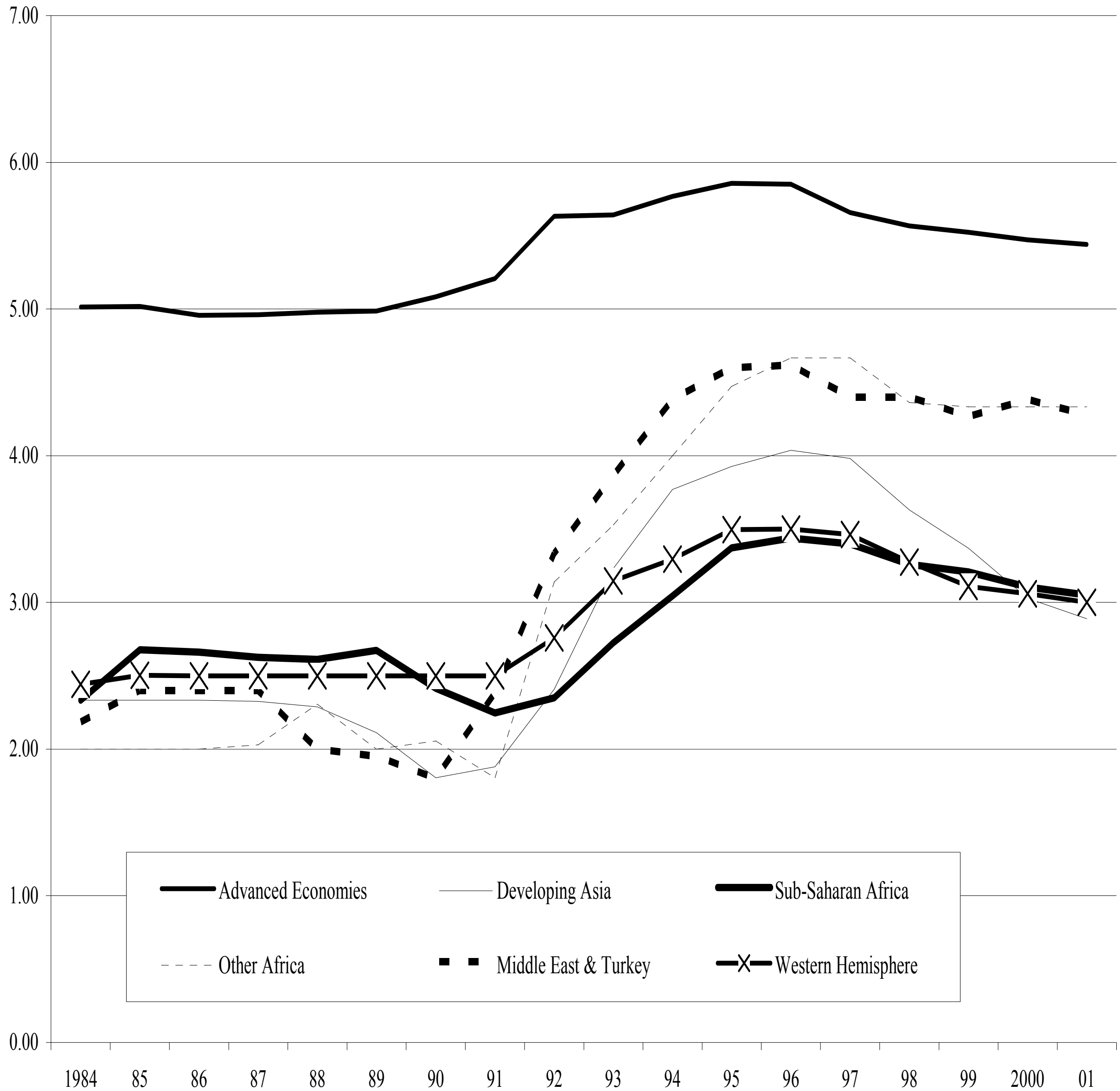
(1980-2000)



Source: Authors' calculations.

Figure 9. International Country Risk Guide: Rule of Law Indicator

(scores range from 0, high business risk due to poor observance of law and order to 6, low business risk)



Source: WEO (2003).

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