

Economic Growth and Welfare Systems

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Institutions and economic development

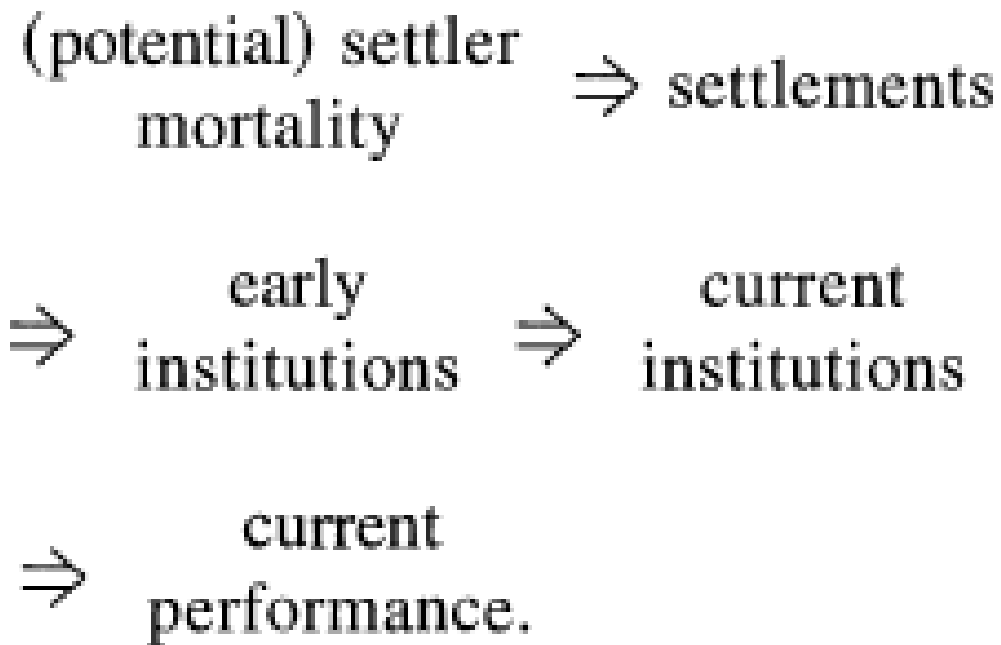
Main articles

- Acemouglu et al., 2001
- Rodrik et al., 2004

Acemouglu et al., 2001

- **Differences in European mortality rates to estimate the effect of institutions on economic performance.**
- **Europeans adopted very different colonization policies in different colonies, with different associated institutions.**
- **In places where Europeans faced high mortality rates, they could not settle and were more likely to set up extractive institutions.**
- **These institutions persisted to the present. Exploiting differences in European mortality rates as an instrument for current institutions, to estimate large effects of institutions on income per capita.**

The Acemoglu model



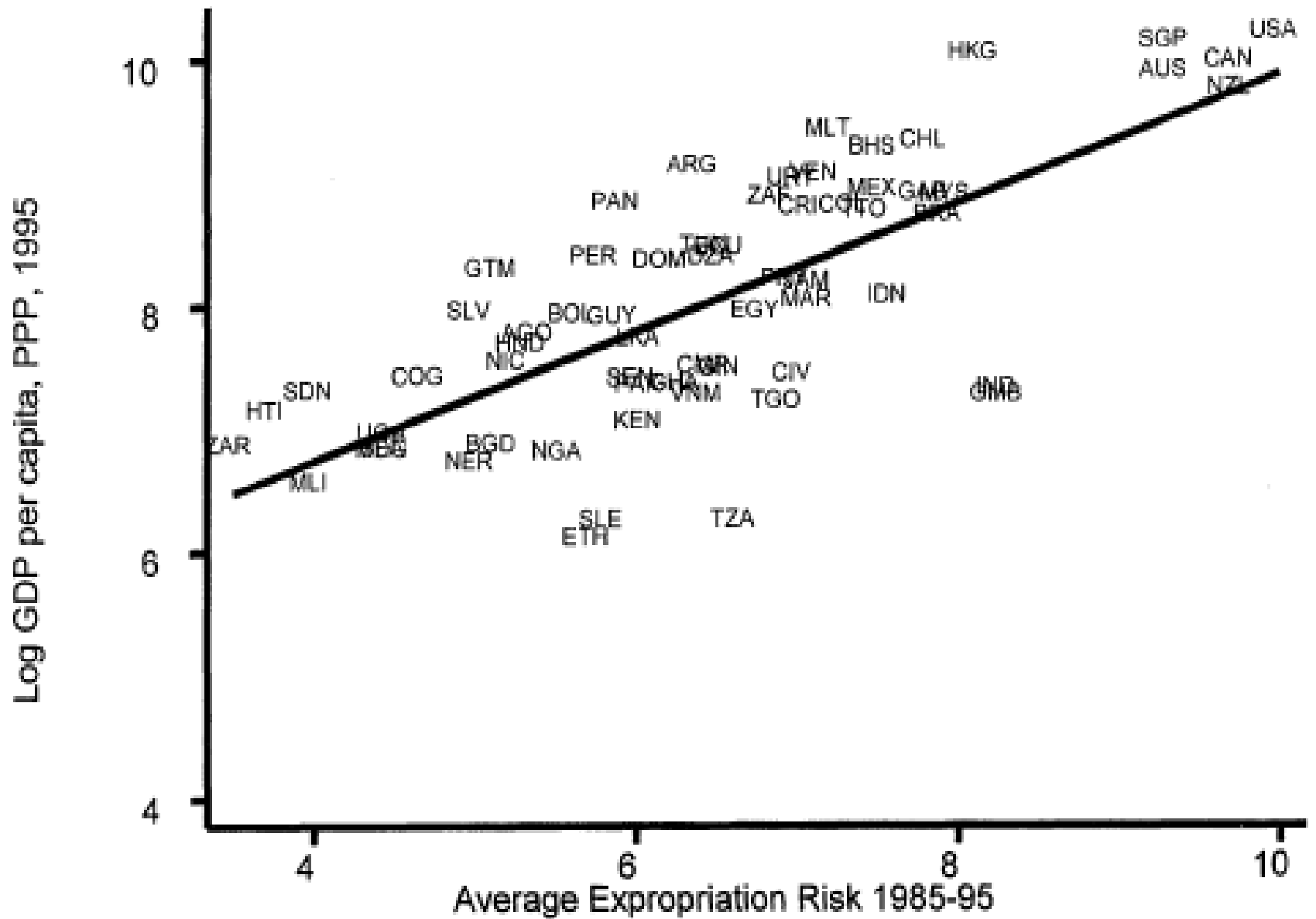
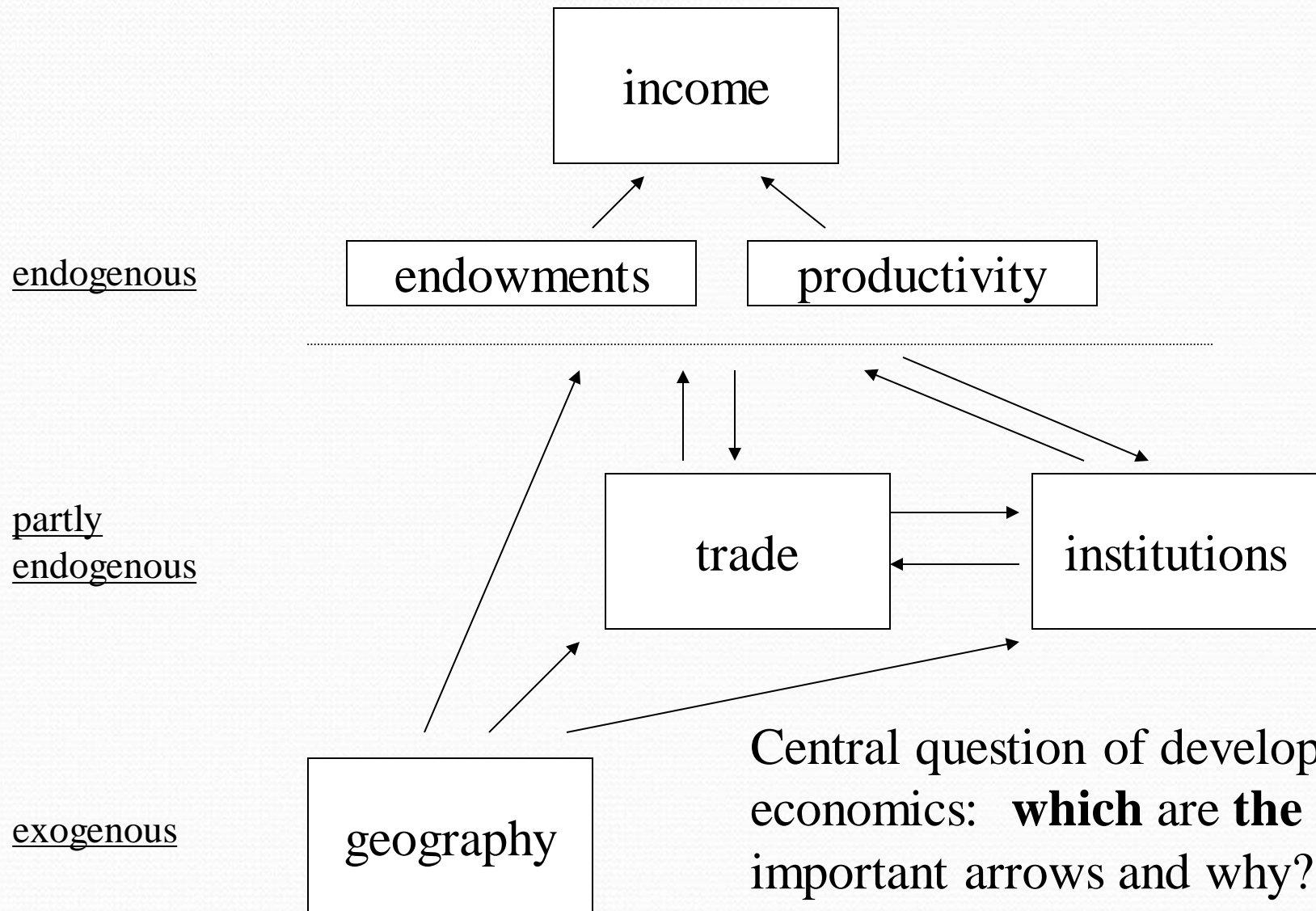


FIGURE 2. OLS RELATIONSHIP BETWEEN EXPROPRIATION RISK AND INCOME

All of development economics

... on one page Rodrik et al, 2004



The recent debate on institutions

- There has been burgeoning literature within economics that discusses and analyses institutions (see North 1990; Nugent and Lin 1996; Nelson and Winter 1982; Jones and Hall 1998; Olson *et al.* 1998; Robinson *et al.* 2001; Glaeser *et al.* 2004; Bardhan 2005; Hodgson, 2007).
 - Acemoglu *et al.*, 2001
 - Rodrik *et al.*, 2004
- The attention of international organisations and policy makers has focused more on the importance of institutions for economic growth. Institutional economists, economic research centres and international organisations have built indexes of governance which measure an institutional quality of developing and advanced countries.

Institutions and development

- The importance of institutions in the economy and on the economic development is recognized from nearly all the economists who worked on LDCs (Lewis, 1955; Myrdal 1968; Kutznets 1973; Sen 1981; Hirschman, 1990; Solow 1994).
- However the institutional economics remains too much often outside from the analysis of the neoclassical economic paradigm and from the greater part of the text books, where the neoclassical assumptions (perfect information, zero costs of transaction, profit maximizing etc) prevents whichever debate on the role of institutions in the economics.

Endogenous growth theory

- Also the recent contributions of the endogenous growth theory (Romer 1986, Lucas 1988), take into consideration elements (such as increasing return to scale, human capital, externalities) whose origins it is not difficult to make to go back to the economic relations that are settled down between the agents, and therefore to the institutions.

SOLOW RESIDUAL (1956)

$$\Delta Y - rK/Y * \Delta K - wL/Y * \Delta L = \text{SOLOW RESIDUAL} = \Delta TFP$$

SOLOW RESIDUAL IS A BLACK BOX WHICH CAN BE EXPLAINED WITH INSTITUTIONS

Questions concerning institutions role

- The role of the institutions in the economy;
- Existence of different institutions;
- The contribution of institutions on the productivity;
- The existence of inefficient institutions;
- The mechanisms of the institutional change

Things we should have a look at

- Religion (religiousness)?
- Cultural issues?
- Freedom?
- Anything else...

Religion and religiousness

- **Religion and Economic Growth Across Countries (Barro & McLeary)**
 - Motivations of the study:
 - previous studies neglect the influence of culture
 - need for incorporation of social and political variables
 - investigated the effects of church attendance and religious beliefs on economic growth

Also in Europe: east orthodoxy vs west catholic/protestant

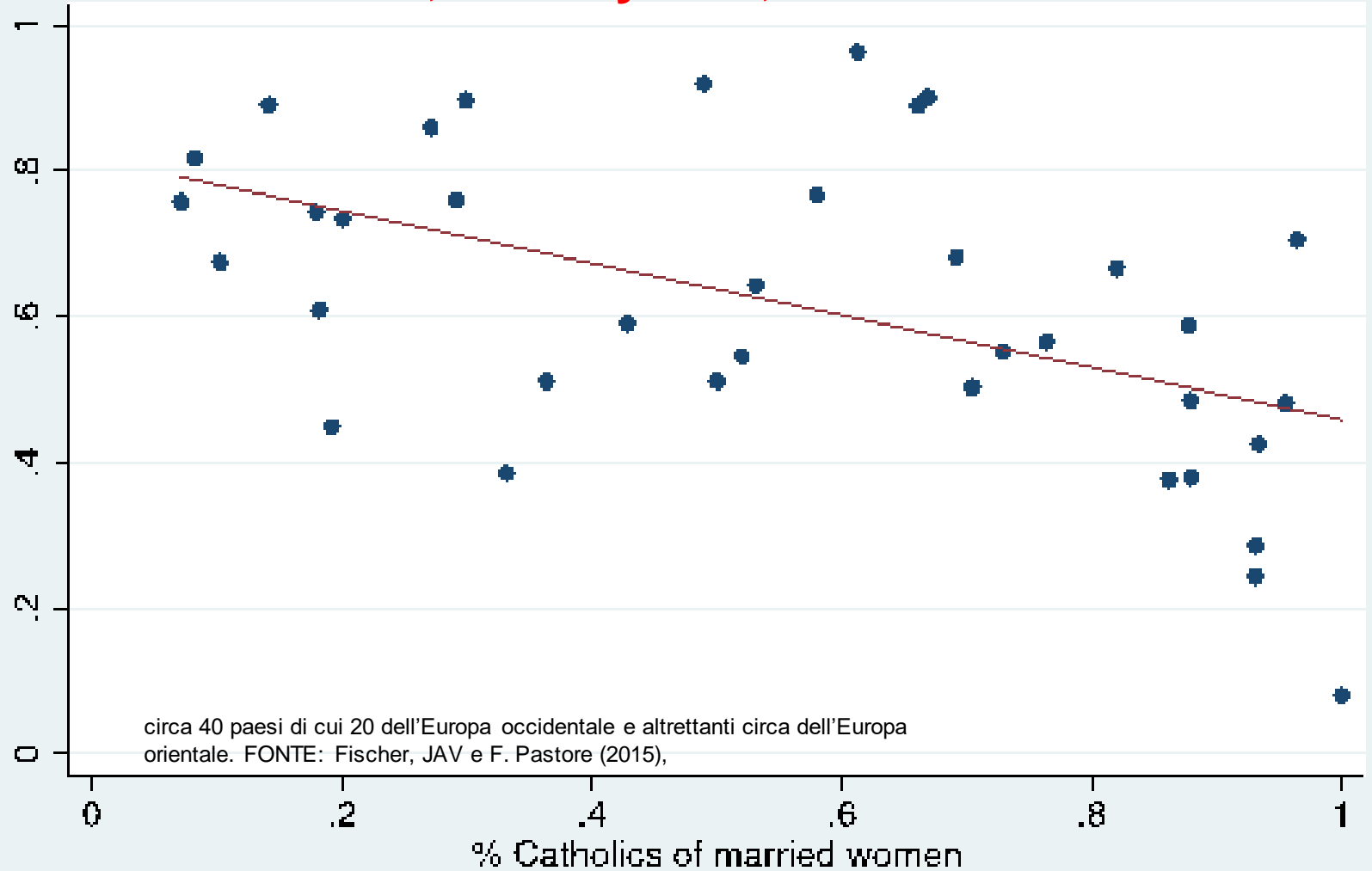
Religion and religiousness

- Theoretical foundations
 - Secularization hypothesis
 - Market or supply side forces hypothesis
 - greater state regulation of religion may decrease the efficiency

Data: World Value Survey, Gallup Millenium Survey, International Social Survey Programme

- Findings:
 - For given religous belief, increases in church attendance tend to **lower** growth

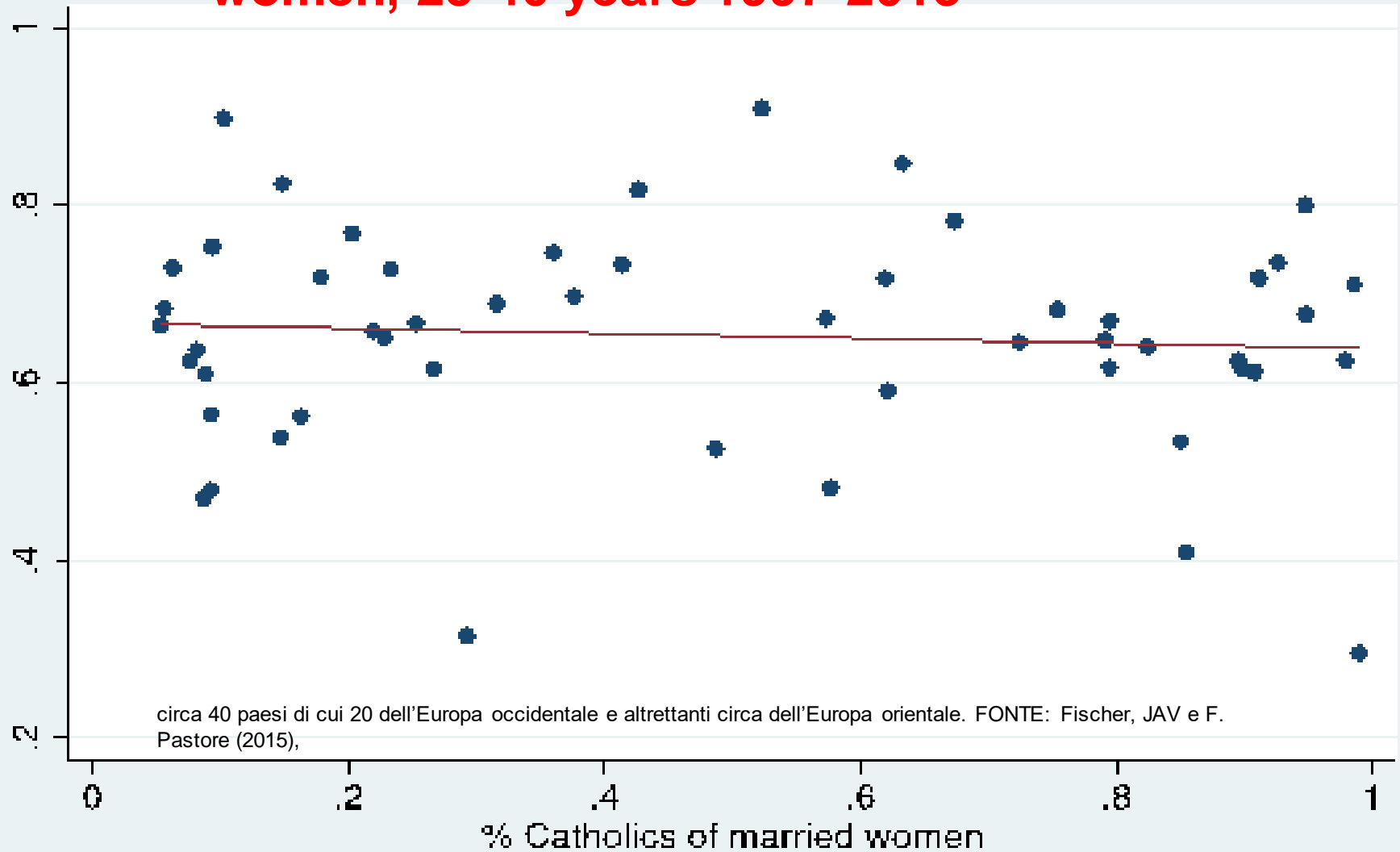
Religion and Female employment, married women, 25-40 years, 1981-1996



• % employed of married women

— Fitted values

Religion and Female employment, married women, 25-40 years 1997-2013



circa 40 paesi di cui 20 dell'Europa occidentale e altrettanti circa dell'Europa orientale. FONTE: Fischer, JAV e F. Pastore (2015),

• % employed of married women

— Fitted values

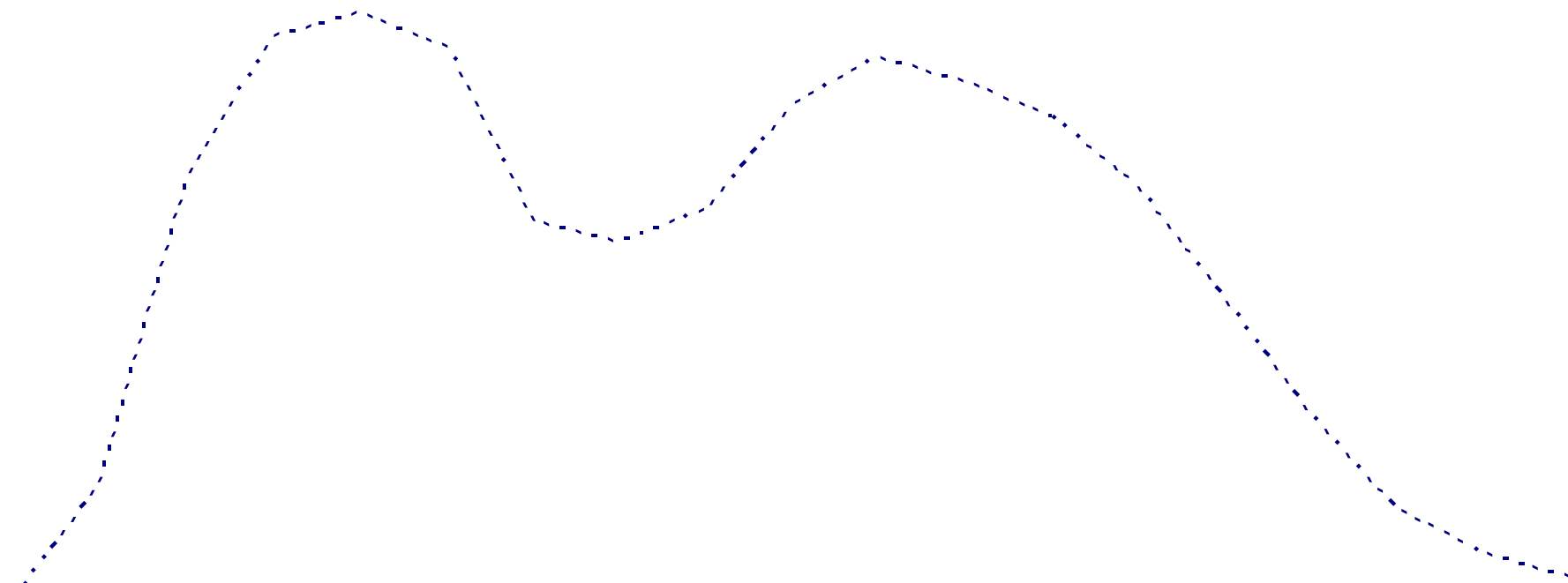
Cultural issues

- The theory of human development: A cross-cultural analysis (C. Welzel, R. Inglehart, H-D. Klingemann)
- Foundations
 - Socioeconomic development, emancipative value change and democratization

Emancipative values linked to people's available resources

Effective democracy linked to emancipative mass values

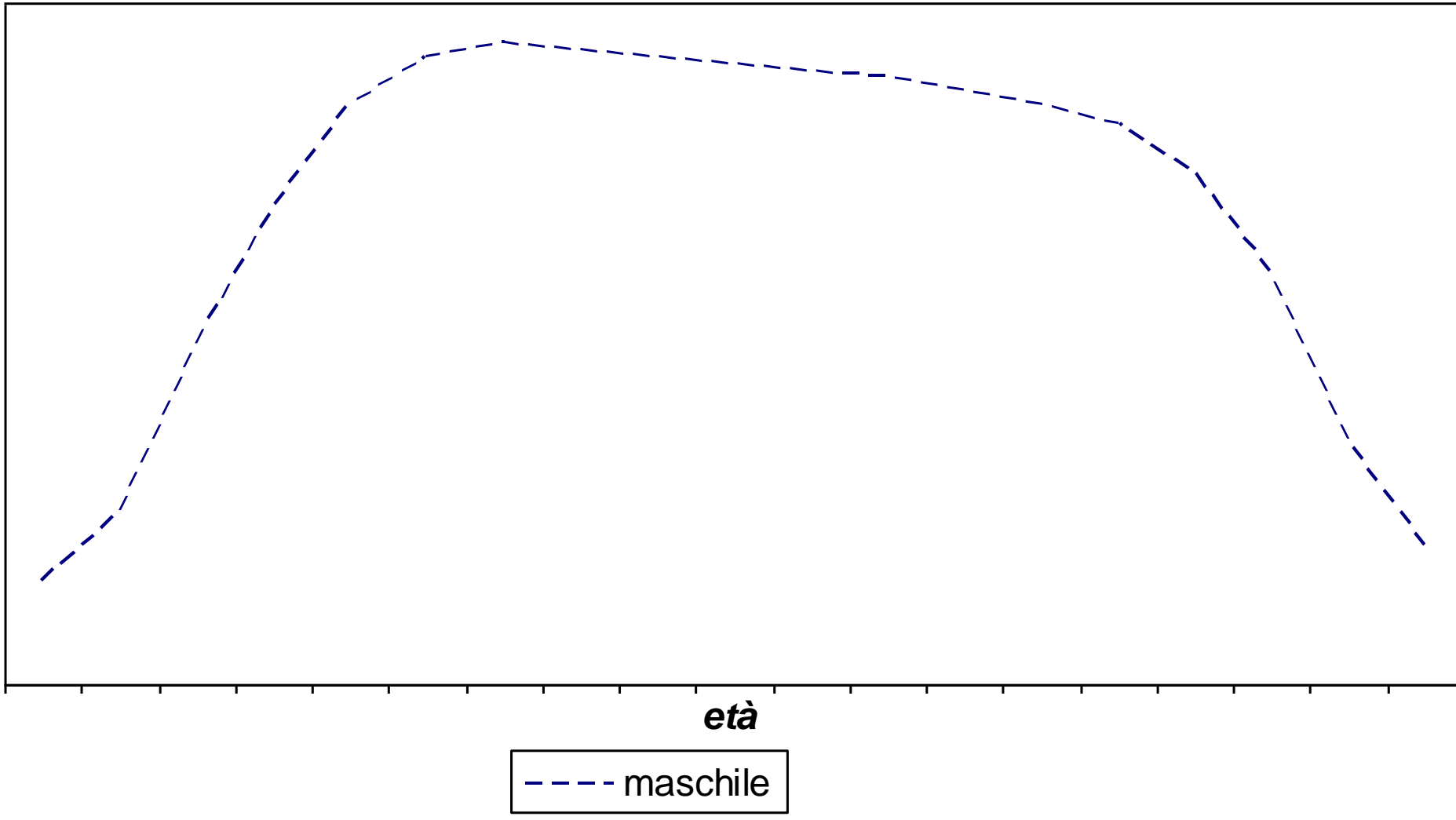
Modelli di partecipazione femminile al lavoro per età



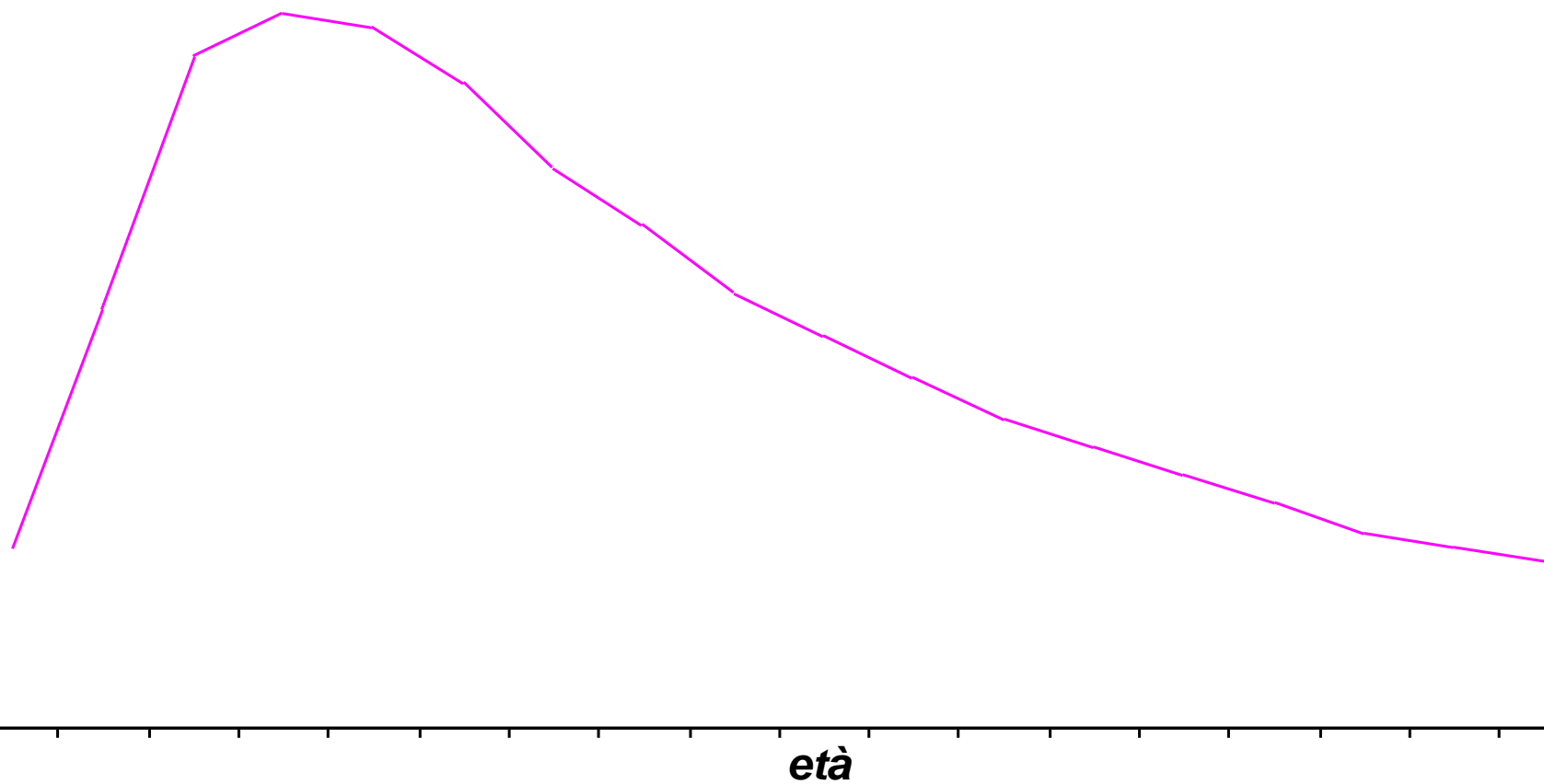
età

..... femminile: Europa - centro nord

Modelli di partecipazione maschile al lavoro per età



Modelli di partecipazione femminile al lavoro per età



— femmine: Europa -sud

Freedom?

- Individuals have economic freedom when:
 - property is protected
 - no arrangements that restrain the realization of gains from economic activities
- Sources of data:
 - Heritage Foundation/Wall street Journal (10 elements)
 - Fraser Institute (17 elements)
- Issues to be addressed:
 - Lack of sensitivity analysis
 - Link between economic freedom and economic growth depends on the measure used
 - No studies found that economic freedom does not influence growth

Questions

- People say: “institutions matter.”
- Great!
- But, if institutions are nothing more than codified laws, organizations and other such explicit, intentional devices, why can't badly-performing economies design (emulate) “good” institutions and implement them?
- because they do not change so easily ...and they are informal...

How do institutions change?

“history matters” for development.

Institutions: a difficult definition

- Moreover the definition of institution and the effects that they can cause on development are not equally shared by economists.
- The same definition of economic institutions is often contrasting and it varies according to the various schools of economic thoughts and the various theoretical approaches.

Old Institutional Economy

1. The **Old Institutional Economy (OIE)** rejects the concept of a rational individual (*methodological individualism*) who maximises his own benefit and emphasises the role of the habits, behavioural rules and social rules as the basis of the human action. The OIE develops an alternative concept of economic behaviour that finds its own origins in the institutions. The institutions are the rules according to which enterprises and consumers “satisfy” and not “maximise” respectively their own return and utility. For this institutional approach of economics “*institutions matter.*” The institutions are not necessarily created to be socially and economically efficient; conversely they are created to serve and to preserve the interests of some social clusters and to create new rules. Institutions, therefore, can be said to be efficient as long as they are committed to their original aims.

New Institutional Economics

2. The second approach is the **New Institutional Economics (NEI)**. Libecap (1998) claims that “the new institutional economics retains its general attachment to neoclassical economics with its emphasis on individual maximization and marginal analysis, but with attention to transaction costs, information problems, and bounded rationality” According to North “the institutions (...) represent the way through which economies face the Market failures.” Nevertheless, North rejects the assumption of efficient institution and he highlights the vital role of power clusters and lobbies upon the institutional agreements. The most important role of Institutions is that of reducing the uncertainty in order to determine a steady framework of social relations.

the neoclassical theory

3. Finally, in the *pure* paradigm of the **neoclassical theory** there is no allocation mechanism different than the market. The only institution admitted is the market where the price is determined. This allocation does not involve equity, norms or behaviour, cultural differences and the institutions are exogenously given, i.e. they are not involved in the economic analysis. In the neoclassical theory with perfect information the allocation is *price-guided*, the transaction cost is zero. Hence, the institutions (apart from the market) are not useful, instead they inhibit the economic performance.

CENTRAL DILEMMA

- The main problem in the institutional economic analysis is to establish what is the fundamental paradigm of the economic choices between the two:

1. **INSTITUTIONS → PREFERENCES → MAXIMIZATION → CHOICES**
2. **INSTITUTIONS → CHOICES**

NEI and OIE

- The NEI seems to be oriented towards the 1° paradigm, on the contrary the OIE towards the 2°.
- In the 1° case the neoclassical approach, although revised, can still work, through the introduction of **transaction costs** that eliminate negative externalities (Coase 1937).
- On the contrary, in 2° the case, economic institutions are rules and behavioral patterns that not only create the preferences but also abolish the maximizing mechanism, replacing it with a model where agents are not guided by prices but their actions are **determined** by institutions (Matzner 1993).

Transaction Costs

- Transaction costs are the costs to make an exchange, to transfer the propriety, to start an activity, to protect one's own business, to gather information, to change or to preserve the actual institutional framework, etc.
- Transaction costs, certainly, do not involve only the financial expenses but also time and all resources required to pursuit goals.
- These resources could be private or public resources and their measure is not only in economic terms but as well in social terms.

NEI position on institutional change

- The theory of the institutional change in the NEI is based on a fundamental assumption: the institutions reduce the costs of transaction, and the agents would use the institutions in order to diminish the costs of transaction (North 1990).
- The firms react to the change of the relative prices modifying their productive methods. To the new prices and with the new techniques, old institutions could not be longer suitable to diminish the costs of transaction (North 1990), therefore the institutions will change.

Formal institutions

Formal institutions are generally defined as the law sphere, with constitutions, regulations and organisations. There is a direct connection between formal rules and a political economy framework such as governance, property rights, and judiciary system. Thus, reinforcing of the formal institutions is guaranteed by the legal system.

Informal institutions

They are a set of **social norms**, conventions, moral values, religious beliefs, traditions and other **behavioural norms** that have passed the test of the historical time and that determine the individual behaviour.

The informal institutions can be called *the Old Ethos* or *the Carriers of History*. These informal rules are part of the dynamic evolution of a community and heritage of its culture. In addition these rules or institutions are self-reinforcing in course of time through mechanisms such as imitations, traditions and other forms of teaching.

They also serve as sanctions that facilitate the self-reinforcing process such as: community membership, fear of expulsion, reputation and fear to be the only one not to respect the rules.

There is an inbuilt threat in this *Hobbesian type Competition* which allows the respect of the rules because otherwise the social relationships will become *violent*. (Solow R., 1994)

A normative system

- This highlights the complexity of a normative system that is characterized by one formal dimension and one informal dimension, each with the own characteristic
- Hence, Institutions are “*a set of social rules that structure social interactions*” (Knight, 1992:2)

A complex framework

	Formal rules	Informal rules
Conformity	Legal sanctions	Social obligation
Reinforcing	Legal incentives	Reputation
Motivation	Functionality	Orthodoxy Prevalence
Tools	Law, organizations, constitutions	Tacite conventions, social norms, habits
Legitimacy	Judicial- state	Cultural-traditional

Formal/informal

- Hence it is needed to overcome the distinction between formal institutions and informal ones. Otherwise will prevail a misleading idea, on the effective state of the institutions, whereas there is a change of formal rules with a persistence of previous behavioral patterns (or vice versa) (examples abound ...). Both Formal and informal Institutions can determine the behavior of the agents and of the organizations in pursuit their aims.

What is an “institution” then?

- Arrangements that coordinate the behavior of individuals in society.
- Institutions are sets of regulatory norms.
- An institution is a stable, valued, recurring pattern of behavior.

Where do we see “institutions”?

1. Is family an institution?
2. Friendship?
3. Love?
4. Marriage?
5. School?
6. Exam?
7. Market?
8. Firm?
9. Contract?
10. Polls (voting)
11. Political party?
12. Constitution?
13. Exchange rate regime?
14. Central bank independence?
15. Currency?
16. Theatre?
17. Literature?
18. Cinema?
19. Cinematography?
20. Poverty?
21. Social stratification?
22. Casta system in India?

ONLY IF...An institution is a stable, valued, recurring pattern of behavior.

Example of category of economic institutions

- Trust
- Information
- Property rights and Privatizations
- Rent-seeking, Groups of pressure and lobbies
- Bribe/corruption
- Reputation and Values
- Mechanisms of selection,
- Competition and cooperation
- Intermediary
- Bureaucracy
- Organizations
- Laws and constitutions
- Industrial relations

There has to be reciprocity

The important conclusion

- Social agents
 - generate,
 - influence
 - and support institutions.

BUT

- Institutions create social agents.

A good institution must survive a dual test of “making sense” and “being fit” for its mission.

State and Market

- A concept that must be clarified is that the economic institutions are not external ties that hinder economic growth and do not refer to a contraposition between State and Market.
- They are on the contrary the mechanism of operation of the economic processes, the modalities of realization of the exchanges (Fadda 1999, p.98).

Markets require non-market institutions to work well

- a. Markets are not self-creating
 - i. Property rights
 - ii. Contract enforcement

- b. Markets are not self-regulating
 - i. Regulatory authorities
 - ii. Correction of market and coordination failures

- c. Markets are not self-stabilizing
 - i. Monetary, fiscal and currency arrangements

- d. Markets are not self-legitimizing
 - i. Political democracy
 - ii. Social insurance
 - iii. Redistribution

Long term economic development forces

(Maddison 1995)

- institutions
- natural resources
- demographic development
- labor supply
- human capital
- technological progress
- structural Changes (consumption, occupation, parity, agriculture etc)
- international Commerce,
- channels and international ways of communication

Different "style of Capitalism"

- Appropriated economic institutions equal for all countries do not exist, but every country has its own "style of Capitalism" (Rodrik 1999)

Washington Consensus revival

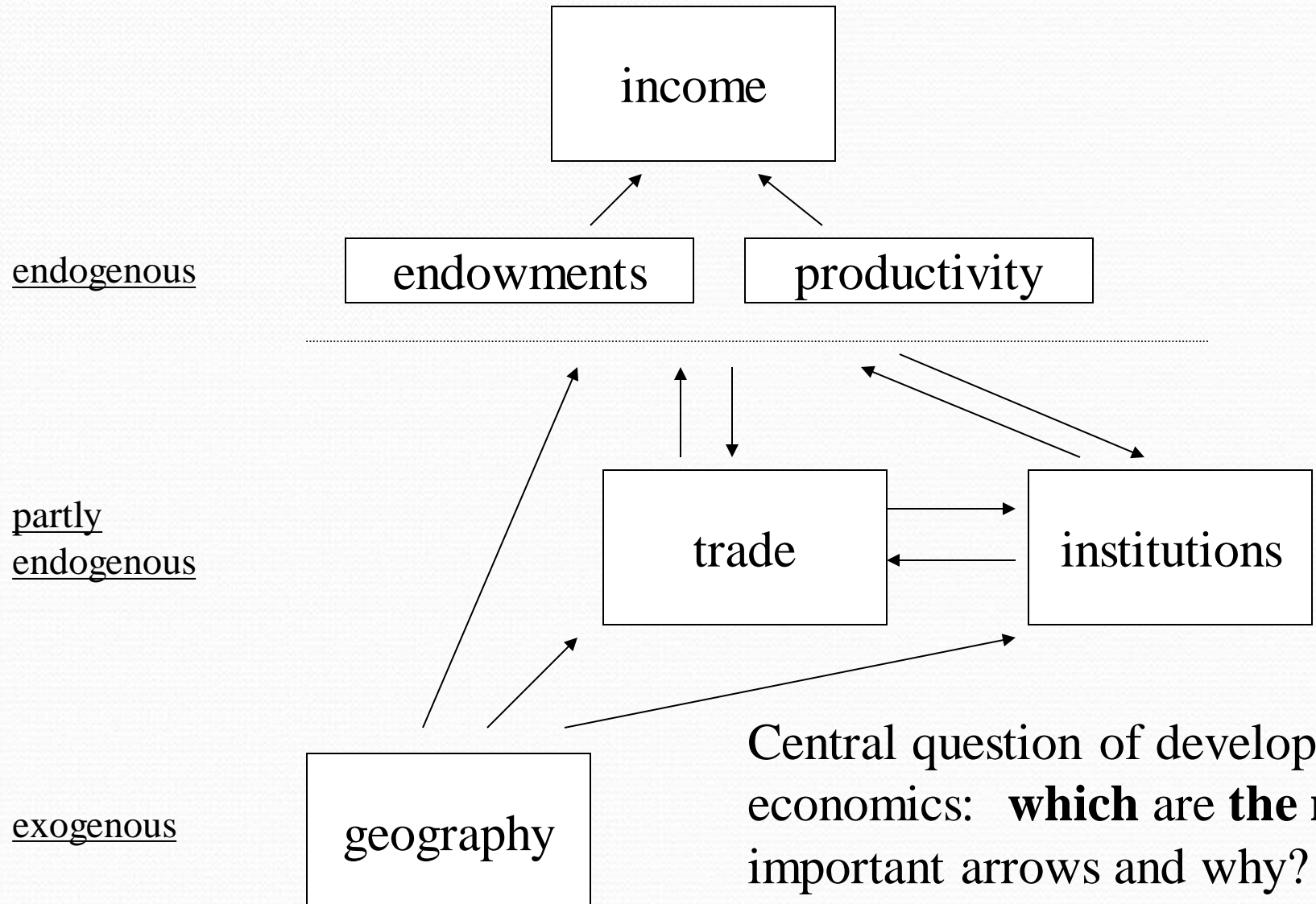
1989: Original Washington Consensus	2000: “Augmented” Washington Consensus the previous 10 items, plus:
<ol style="list-style-type: none">1. Fiscal discipline2. Reorientation of public expenditures3. Tax reform4. Financial liberalization5. Unified and competitive exchange rates6. Trade liberalization7. Openness to FDI8. Privatization9. Deregulation10. Secure Property Rights	<ol style="list-style-type: none">11. Corporate governance12. Anti-corruption13. Flexible labor markets14. WTO agreements15. Financial codes and standards16. “Prudent” capital-account opening17. Non-intermediate exchange rate regimes18. Independent central banks/inflation targeting19. Social safety nets20. Targeted poverty reduction

Disappointments of the Washington Consensus

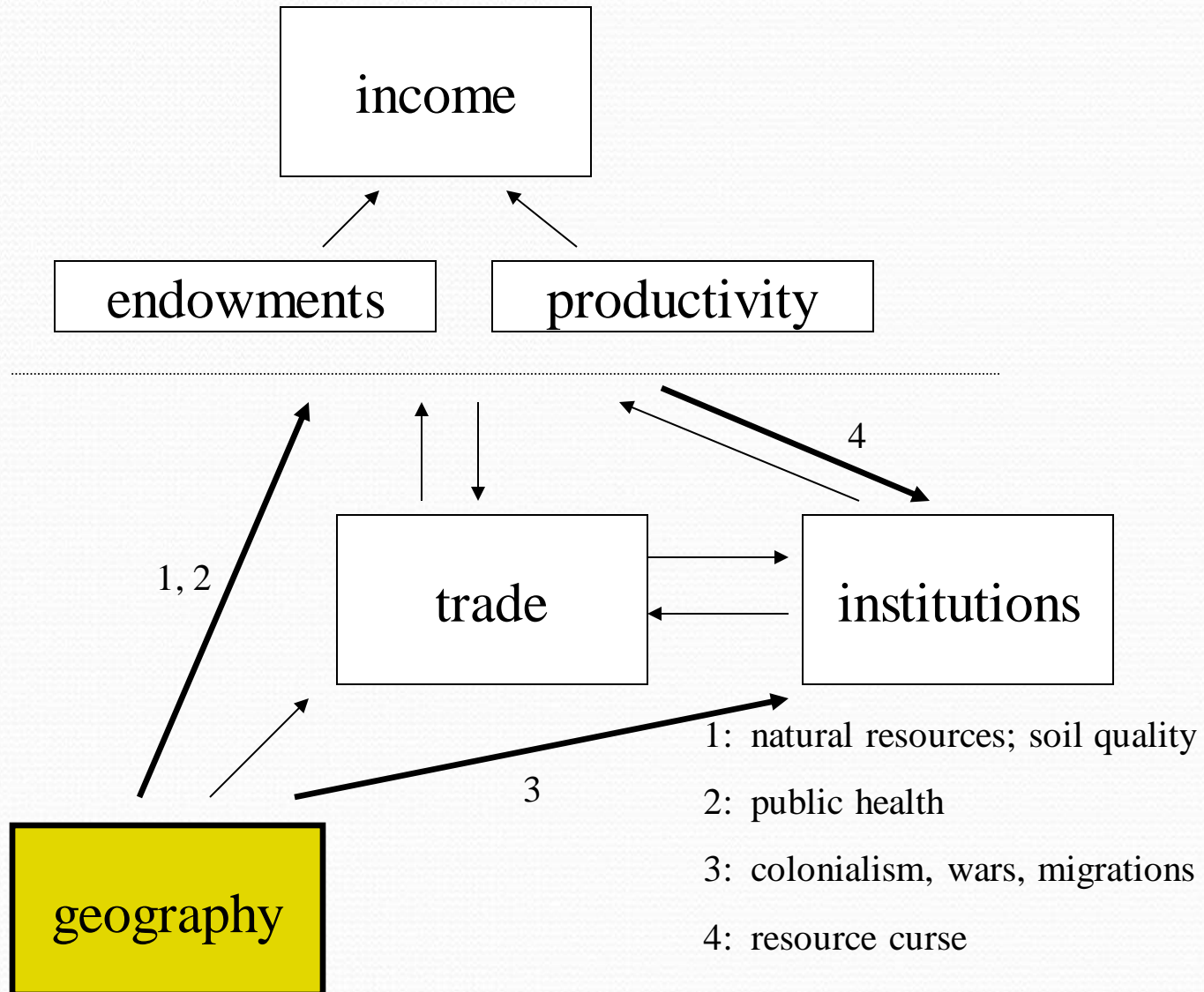
- Latin America: Only 3 countries have grown faster during the 1990s than in the 1950-80 period (and one of those 3 was Argentina!)
- Countries in transition: Real output below 1990 levels in all but four former socialist economies; poverty rates higher
- Sub-Saharan Africa: Results remain very disappointing, and far worse than those obtained prior to the late 1970s
- Widening income gaps:
- Frequent and painful financial crises: Mexico, East Asia, Brazil, Russia, Argentina, Turkey.

All of development economics

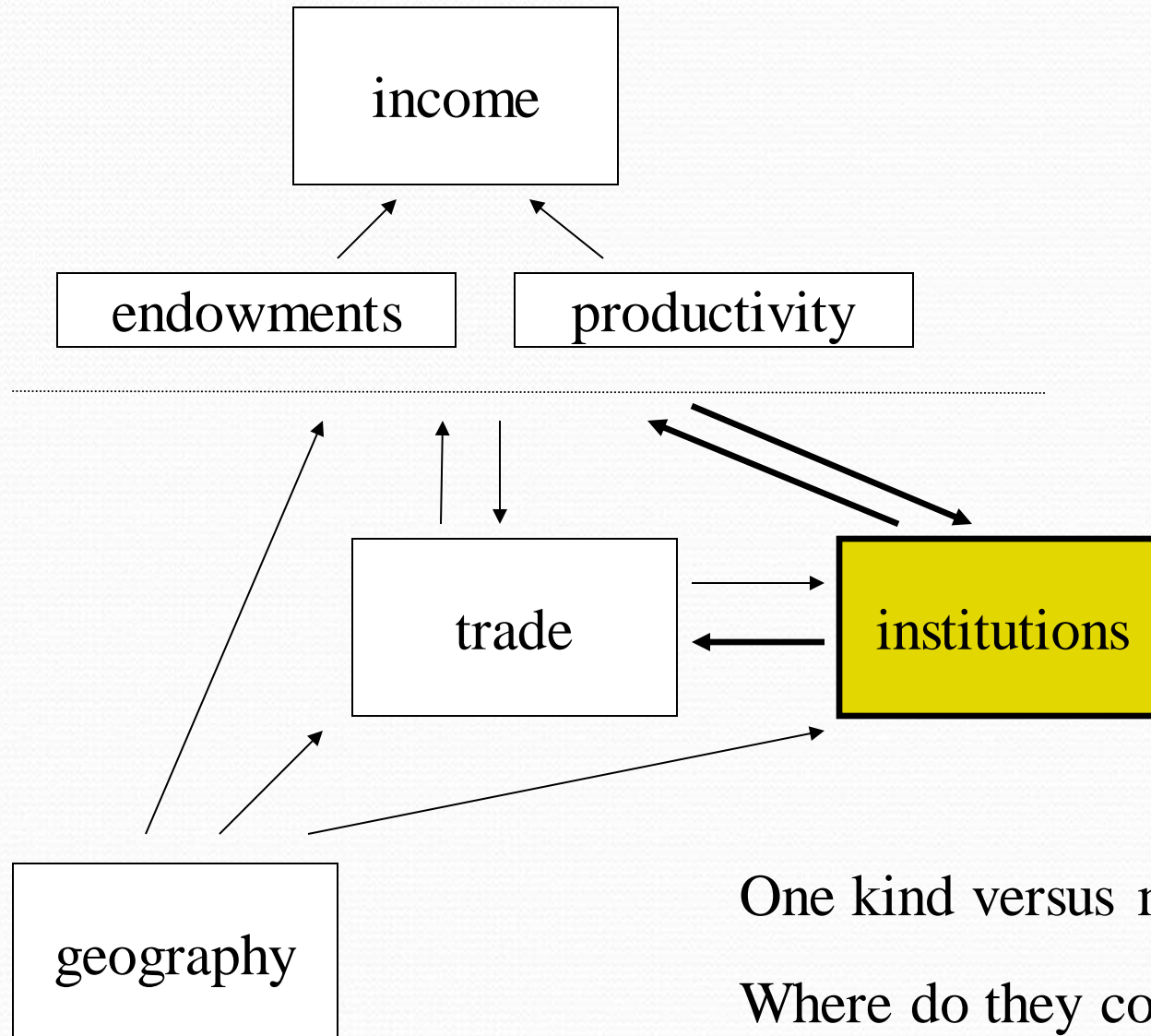
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Geographical determinists claim that...



.... While the institutionalists prefer



One kind versus many?

Where do they come from?₅₀

Determinants of wealth

$$\log y_i = \mu + \alpha \text{INS}_i + \beta \text{INT}_i + \gamma \text{GEO}_i + \varepsilon_i \quad (1)$$

$$\text{INS}_i = \phi + \lambda \text{INT}_i + \psi \text{GEO}_i + v_{\text{INS}_i} \quad (2)$$

$$\text{INT}_i = \varphi + \theta \text{INS}_i + \omega \text{GEO}_i + v_{\text{INT}_i} \quad (3)$$

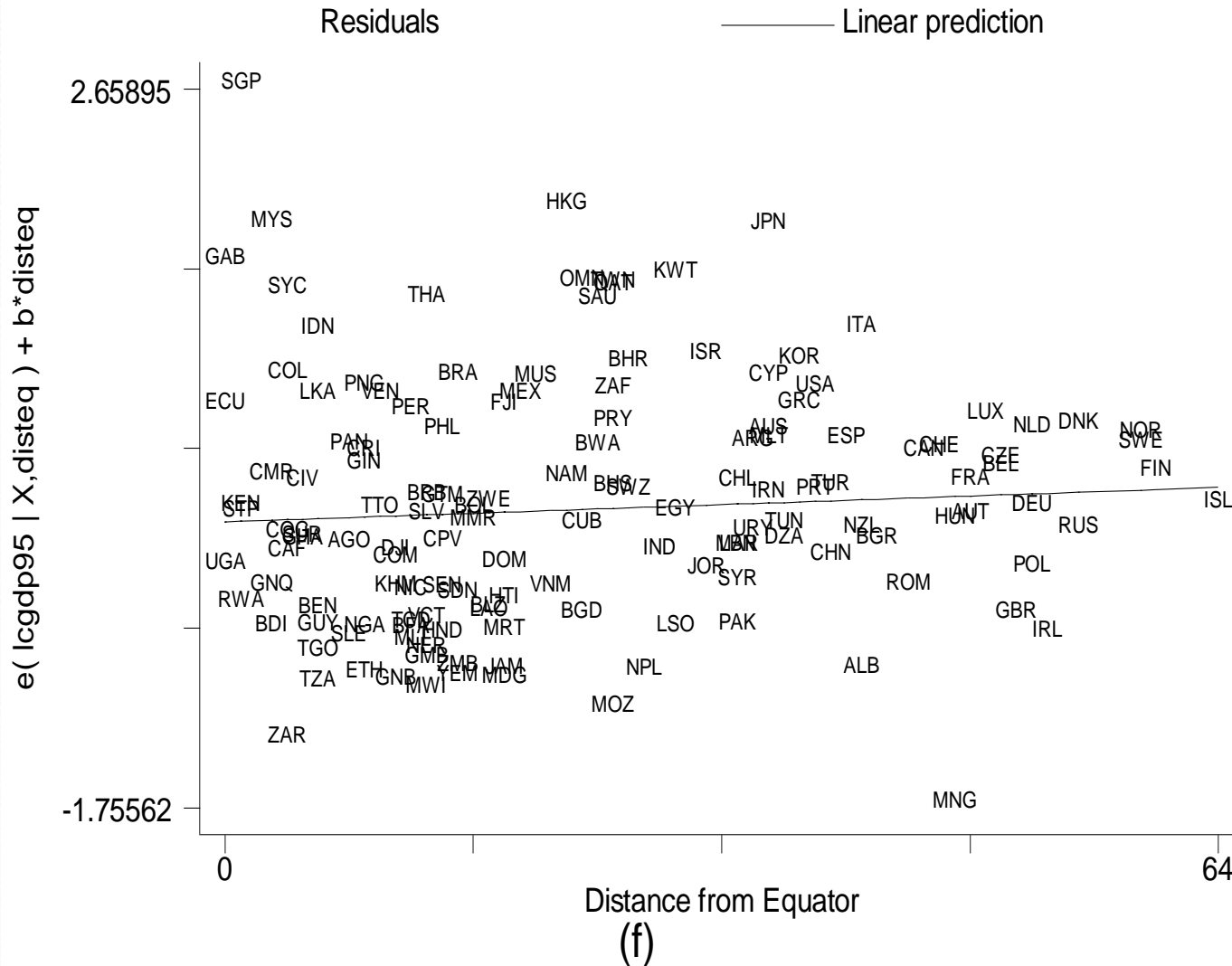
Some seminal work

- Frankel and Romer (1999)
- Hall and Jones (1999)
- Acemoglu, Johnson, Robinson (2001)
- Dollar and Kraay (2002)
- Alcalá and Ciccone (2002)
- Easterly and Levine (2002)

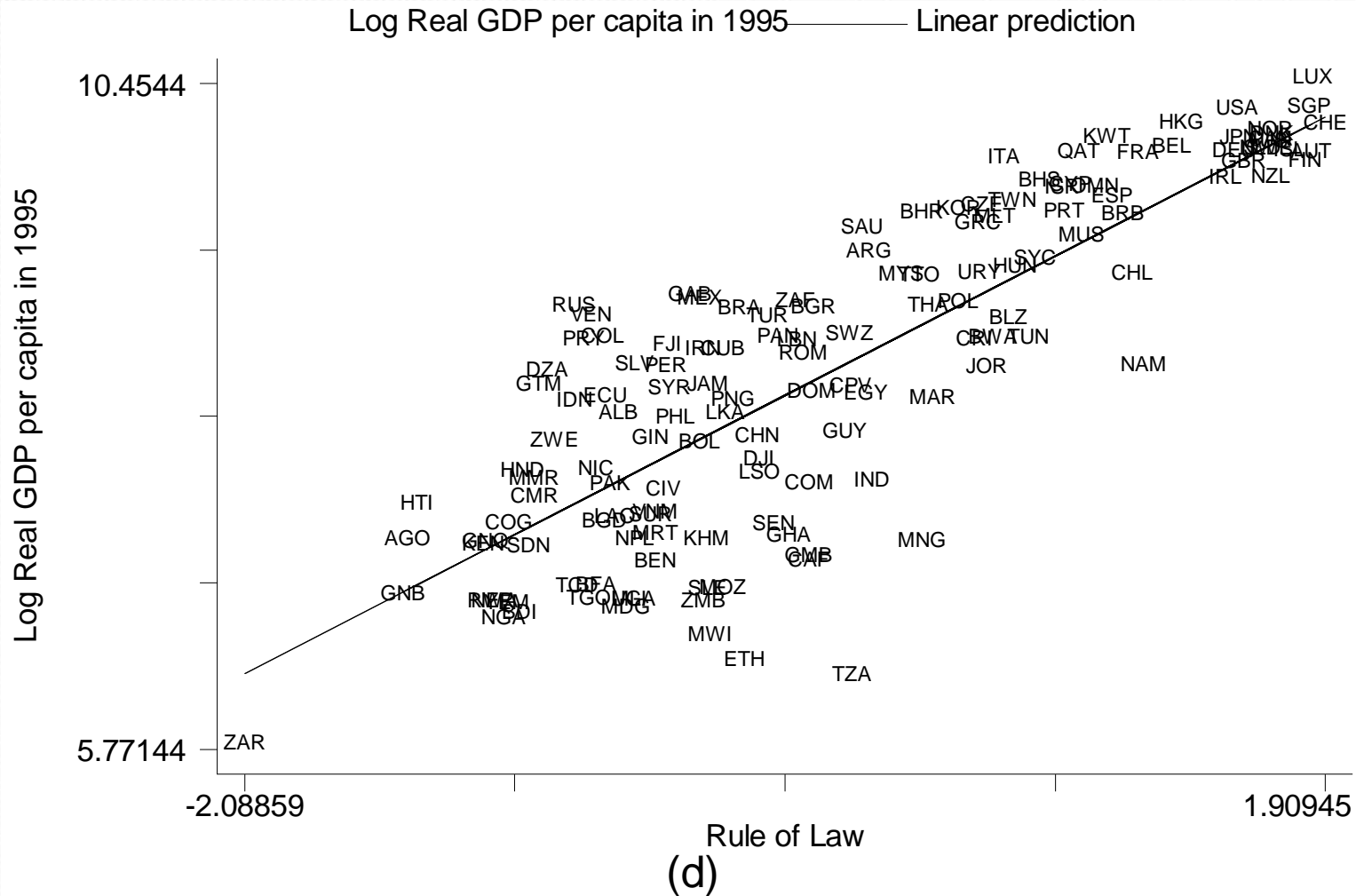
Basic implementations into empirics

theoretical concept	empirical proxy	instrument
geography	distance from equator, mean temperature, etc.	--
integration	trade/GDP ratio	predicted trade share constructed from a bilateral gravity equation (Frankel and Romer, 1999)
institutional quality	survey of investor perceptions regarding protection of property rights, rule of law, etc.	mortality rates among 19 th century European settlers (Acemoglu et al., 2001)

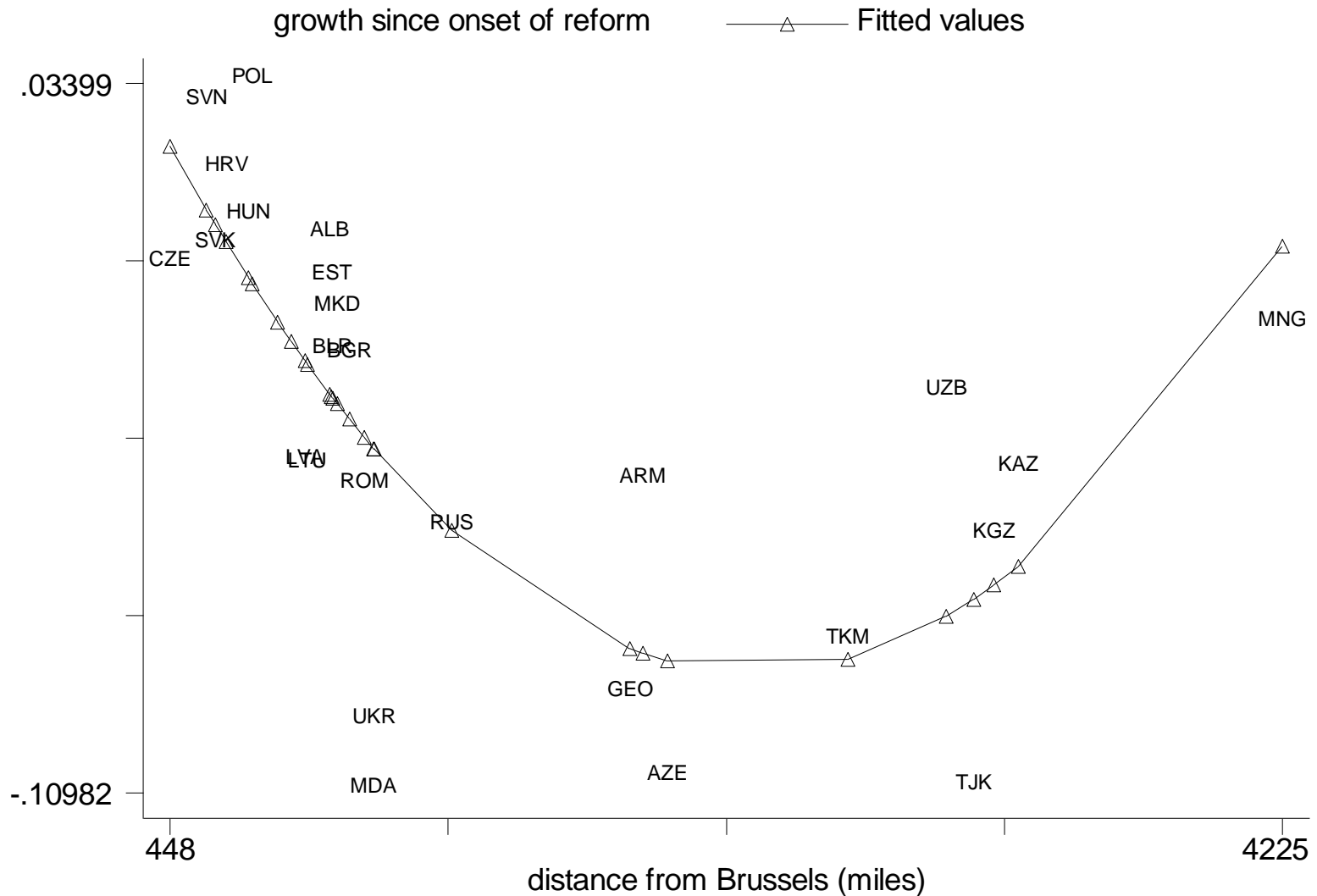
Distance from equator



Rule of Law



Growth and distance from Brussels



„Reform” and distance from Brussels

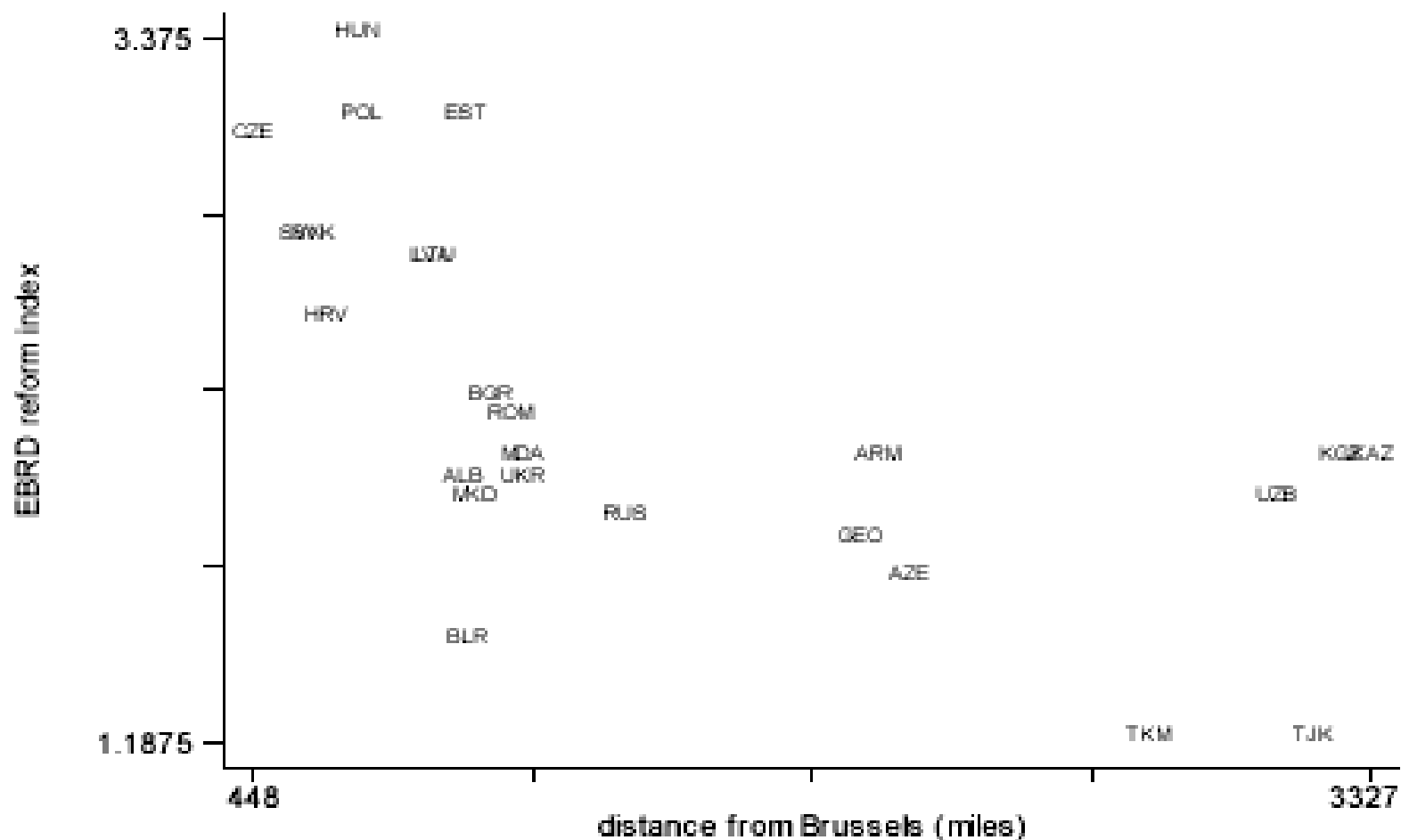


Figure 6: Relationship between "reform" and distance

Voice and accountability and distance from Brussels

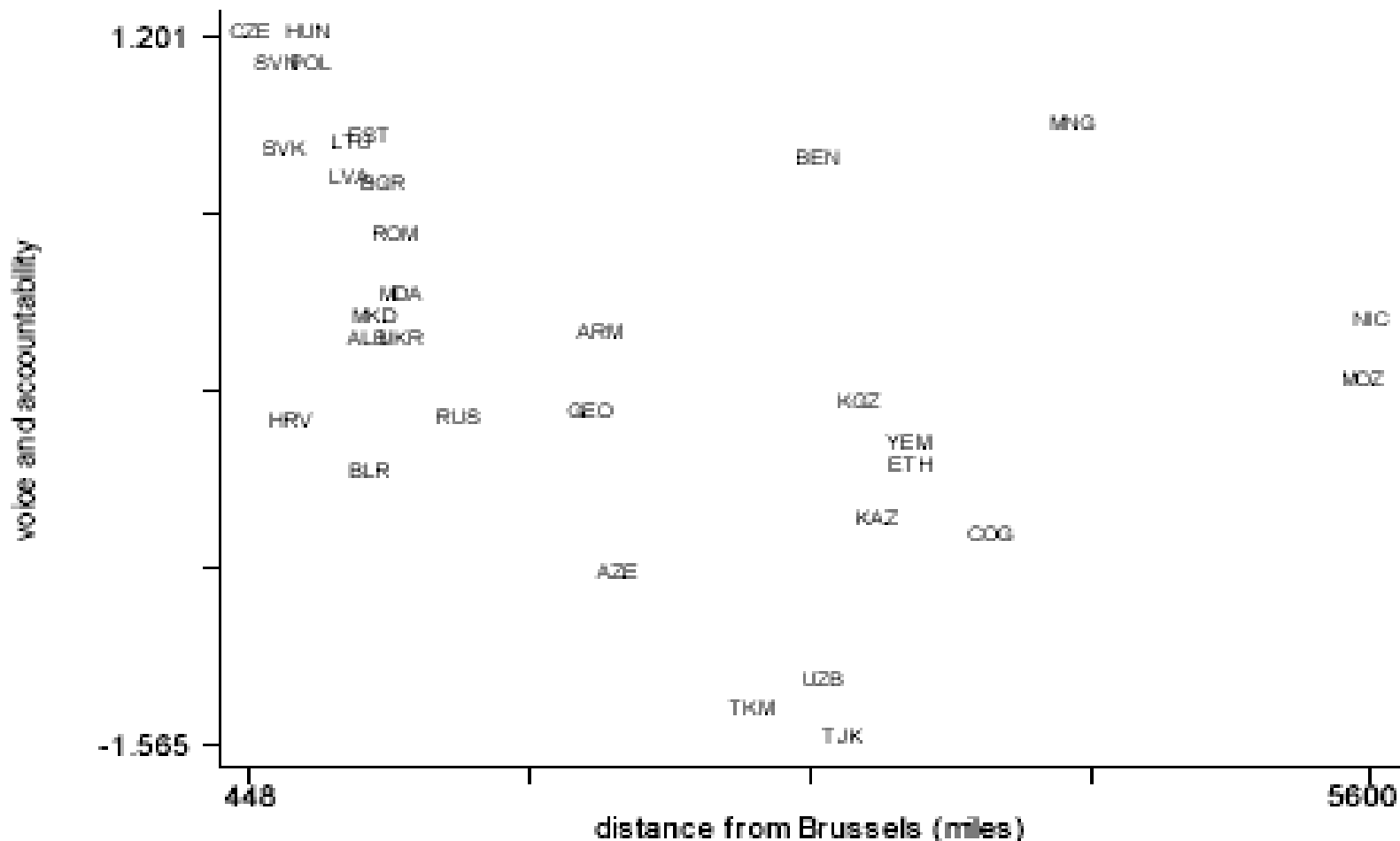


Figure 7: Relationship between voice and accountability and distance

Control of corruption and distance from Brussels

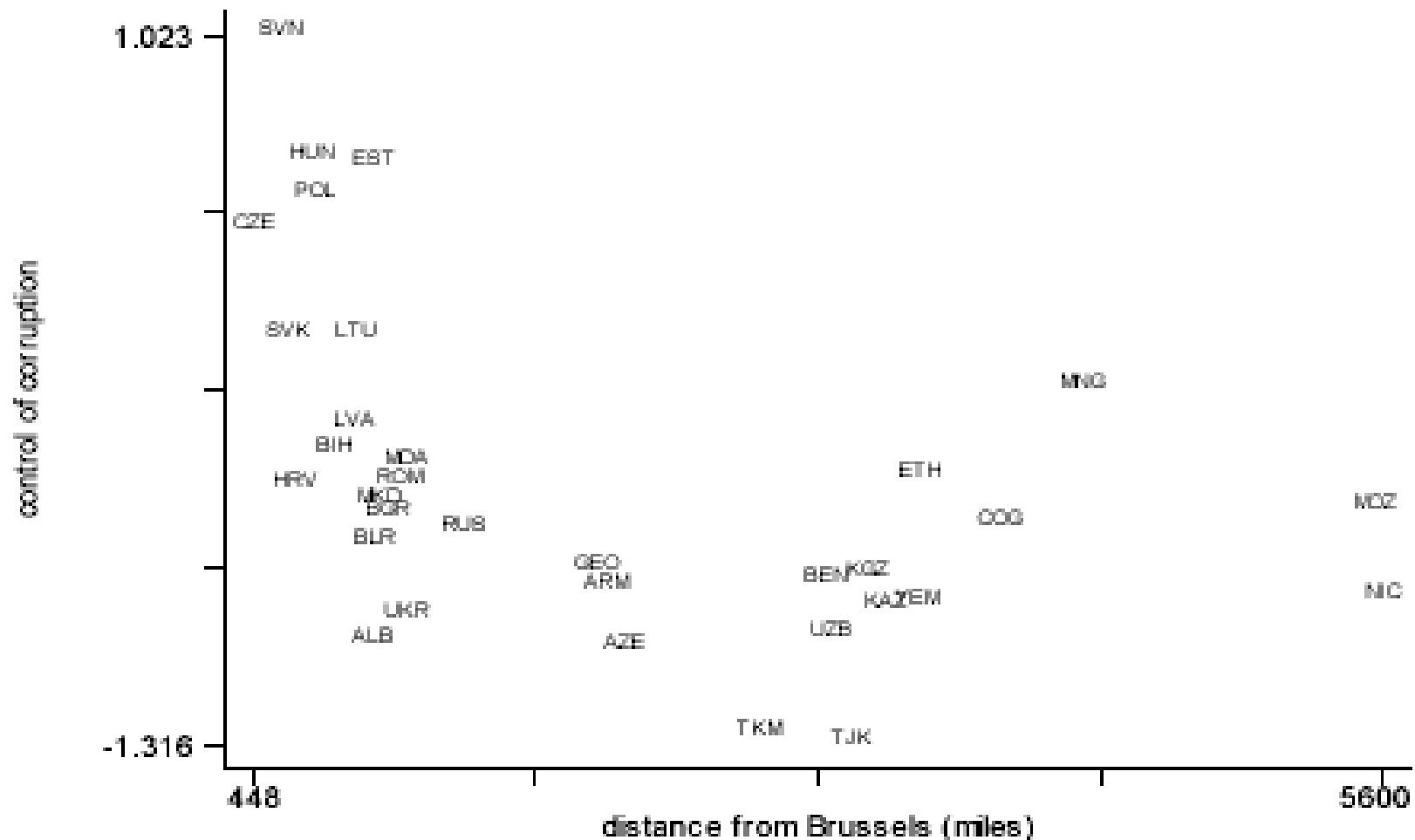


Figure 8: Relationship between control of corruption and distance

Economic development = institutional change

Since "institutions matter" is crucial to implement institutional policies. Hence, the problem is to implement appropriate institutions that bring about economic development. Development is defined by institutional economists as a process of "institutional change and economic growth" (Toye 1995).

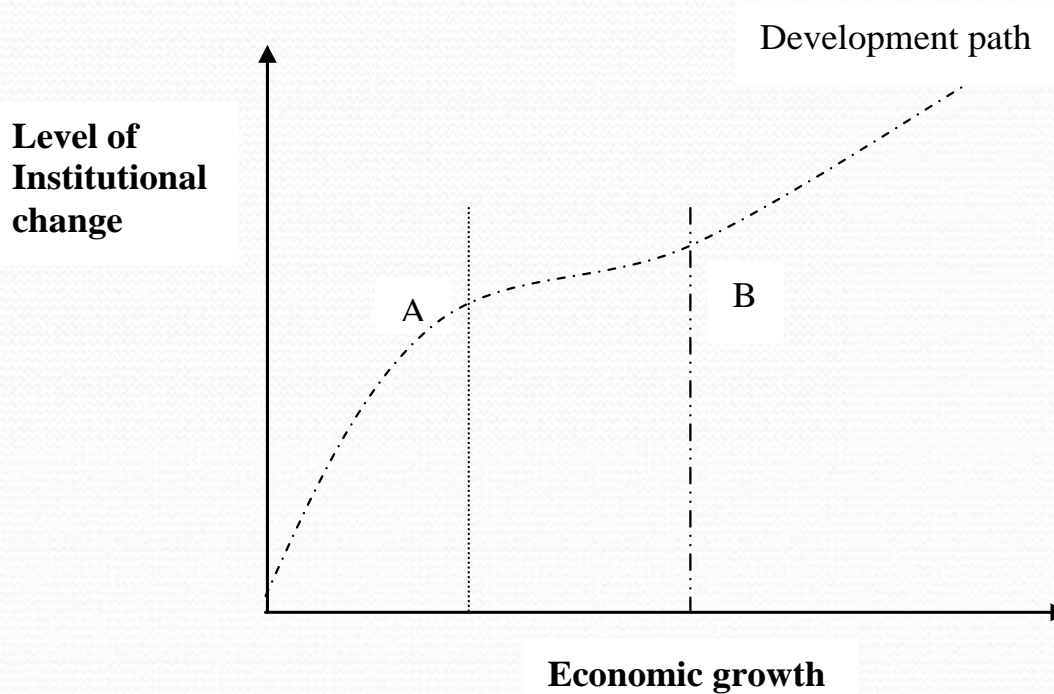
However, since institutions are "standardised behaviour patterns" then in order to change institutions those behavioural models must change, breaking off old rules, social norms and routines that impeded a development process before (Kuznets, 1965)

Kuznets says

“The transformation of an underdeveloped in developed country is not merely the mechanical addition of a stock physical capital: it is a thoroughgoing revolution in the patterns of life and a cardinal change in the relative powers and position of various groups in the population.... The growth.... must overcome the resistance of a whole and complex of established interest and values”. (1965, p.30):

Variety of trajectories of development

Figure 1



Note: during the first period, from the origin to the point A, the speed of institutional change is faster than the speed of economic growth. In the second period, from point A to B, the economic growth is faster than the speed of the institutional change. In other words, economic growth follows the institutional change.

institutional change (OIE)

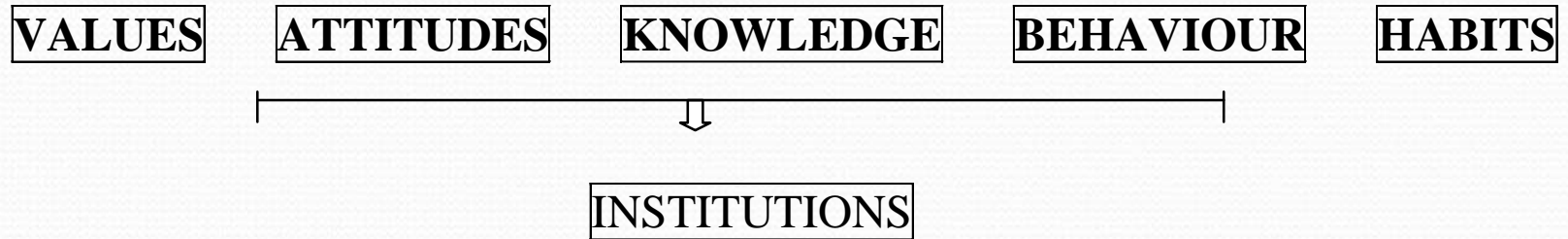
- *The institutional change is a slow process, and it starts (because institutions are not longer efficient) when the technological or environmental conditions permit for such a change, or the aims of dominant groups support the change or still when power relations among the social groups change*

4 paths of Institutional Changes (OIE):

1. Technology → formal and informal change → new behaviours and habits.
2. By design → formal change → new behaviours and habits → informal change.
3. Change in the values → new behaviours and habits → informal change → formal change.
4. Revolution → formal change → informal change.

Concluding remarks

Institution formation



Variety of institutions

- The economic institutions vary from country to country, from the various social contexts and they do not have, generally, a model towards which they converge, in the sense that in some contexts some institutions can be present/useful/efficient in others not, and also where they are similar, it is not said that they carry out the same function or they have the same effects (North 1990).
- Examples abound...

Examples

- Agents reactions to fiscal pressure in Scandinavian countries and in Mediterranean countries
- Agents reactions to public concessions (for taxi drivers, for shops, for corporation such as notary, layer, solicitors, etc)
- Cooperation within Italian industrial districts
- Adverse Selection within silicon valley
- Hidden agreements (i.e oil cartel etc)
- Italian dualism, which is an industrial, institutional and behavioral dualism

Appropriate institutions

- Every country chooses the economic institutions that thinks are more appropriated for the domestic context, considering the numerous differences that can exist within the same economic system (Rodrik 1999).
- The Italian districts case is just an example and an interpretation of such a diversity of local governance, local development, and networking between economic agents.

Appropriate institutions (2)

- In the same way the phenomenon of the Italian dualism between north and south shows that those same institutions do not have the same effect (Graziani 1998).

Appropriate institutions (3)

- Or still, the phenomenon of familiar Capitalism in some countries of the south east Asian show, in other terms, another variety of capitalism dramatically affected by informal rules. (Hirschman, 1990)

Appropriate institutions (4)

- In Germany or other Asian countries such as South Korea and Japan there is a strong link between banks and the firms, a particular institutional framework and a particular partnership between state and market which have allowed the creation of a successful model of development specific with informal rules of those countries (Rodrik 1999).

Appropriate institutions (5)

- In LDCs strategies of "Imports Substitution" (IS) or of "Exports Promotion" (EP), and all the connected institutions (subsidies to the exports, customs duties, aids of State, credits to the exports, etc) have been working in the same period, in the same countries but not in others although countries were in the same category of LDCs (Meier 2000).

Varieties of capitalism and welfare systems

Characteristics Models (leader country)	Competition	Economic Regulation	Main Economic Actors	Relationship between public and private actors	International Economic Relation	Taxation
Anglo-saxon model (USA, UK, Ireland)	Promoting free competition	Deregulation, withdrawal of the State from the Economy	Firms, Corporations, Markets,	Residual public sector: Market-oriented	Global competition	Low taxes, no or little progressive rate
Corporatist model (Germany)	Balancing Cooperation and Competition	Decentralized	Tripartite structures (business clubs, Trade unions, government)	Public-private partnerships	Protection of strategic sectors in an open economy	High taxation to finance Welfare State
Dirigiste model (France)	State Control, regulated competition	National Accumulation and Regulation Strategy	Private and Public sectors	Public-private partnerships under State guide	Protectionism	High Taxes and Collective Recourses
Social Democratic model (Scandinavian countries)	State controlled liberalization and competition	Knowledge and innovation as economic guide for regulation	Public and Private Firms and Ethic Corporations	Public-private partnership in order to realize Social Cohesion	National Actors, moderate free competition, open economy	High wages, career perspective, High and progressive tax rate
Socialist markets (China, Vietnam)	Balancing between forms of liberalization and free competition	State Regulation and innovation	State or municipal owned firms, semi-private firms, private foreign firms. Public Authorities	Public and private actors with more emphasis on collective goals	National strategies in a global context, reasonably free trade	Distributive policies, collective services, equalitarian principles.