Dani Rodrick. 2000. *Institutions for high-quality growth: what they are and how to acquire them?* National Bureau of Economic Research (NBER) working paper 7540 (February).

Importance of institutions

"All instances of successful development are ultimately the collective result of individual decisions by entrepreneurs to invest in risky new ventures and try out new things" (pp.1)

"The encounter between neo-classical economics and developing societies served to reveal the institutional underpinnings of market economies" (pp. 1-2).

"Hence, it became clear that incentives would not work or would generate perverse results in the absence of adequate institutions" (pp. 2).

Examples (pp. 2):

1) Russia: failure of price reforms and privatisation owing to the absence of adequate legal, regulatory and political apparatus.

2) Latin America: dissatisfaction with marker oriented reform due to little attention being paid to mechanisms of social security and safety nets.

3) Asia: financial crisis due to financial liberalisation running ahead of financial regulation.

These examples raise the questions "…which institutions matter and how to acquire them?" (pp. 2).

Definition of institutions: "…a set of humanly devised behavioural rules that govern and shape the interaction of human beings in part by helping them to form expectations of what other people will do." (pp. 3).

Perfect markets require the assignment of property rights, behavioural certainty and reinforcement of voluntary contracts. In other words: courts and law, a police force, a legislator, market ideology and accountability. (pp. 4)

Thus, (i) markets are embedded in non-market institutions; and (ii) non-market institutions not only serve the needs of the market – even if their existence is required for markets to work (pp. 4-5).

Examples (pp. 4-5):

1) Government goes well beyond the needs of the market – a police force, courts, law and legislator may be required for perfect market operation, but they are also required for many other aspects of the functioning of the society;

2) The same government required for the operation of free markets may impose restrictions on free market operations in pursuit of a larger social goal (example, regional policy).

Required institutions

Property rights – institutions for accumulation and innovation. Property rights refer to not only the ownership of the assets, but also, and mostly, the control over returns on the assets. Require a combination of legislation, private enforcement and traditions and customs. What constitutes greater public purpose that may limit private rights? (pp. 5)

Regulatory institutions – curbing of market failure: fraudulent and non-cooperative behaviour, transaction cost, incomplete information and coordination and capital market failures. Solutions are based on the theories of the second best, imperfect competition and principal-agent problem, and criticised under political economy analysis. (pp. 6-8)

Institutions of macroeconomic stabilisation - provision of environmental stability, involving fiscal, monetary and financial regulation. Which is the best set of institutions (ex, independent or controlled central bank)? Do they stabilise or are they irrelevant and predictable? Institutions are not independent of history. (pp. 8-9).

Institutions for social insurance – legitimisation of the market economy by making it compatible with social stability and cohesion. Developed through history – ex, West provides welfare through the fiscal system, while in the East lifetime employment and other firm level benefits ensure social security. Costs of social security (fiscal burden or labour market rigidities) may lead to cuts that increase social instability. (pp. 11)

Institutions of conflict management – coordination of social factions to reduce opposition to market adjustments (winners have gains limited, losers are not expropriated and pay-offs to non-cooperative behaviour are reduced). (pp. 12-13).

How to acquire these institutions (pp. 13-21)

Diversity

(i) there is no single mapping between the market and the set of non-market institutions required to sustain it;

(ii) no set of institutional arrangements must necessarily dominate another;

(iii) the existent set of institutional arrangements is just a sub-set of all potential institutional arrangements.

Modes of acquiring institutions

(i) blueprint – Washington consensus based on the US model of market economy – even so requires local expertise to make such institutions to work;
(ii) specific to local conditions and high degree of tacitness – risk of experimentation – gains from experience acquired elsewhere.
(iii) democratic participation whereby different interests are combined.

Where do you start? By defining what you want – a market economy; what institutions it requires; and how to develop them.

Democratic participation (pp. 21-32)

Democracy versus long-run growth – weak relationship with rates of growth, but less variation under democracy.
Question: does anything change?

Democracy versus short-term performance – decentralised decision-making reduces risk under imperfect information.
Questions: questioned by many that would argue that planning exists to deal with uncertainty, and that centralised planning exists to curb sub-goal problems? How much of central and decentralised decision-making is optimal?

Democracy versus resilience to economic shocks – lesser insulation of the authority higher levels of political access by non-elites results in lesser decline in the presence of shocks.
Questions: does conflict management require formal political democracy? How much of conflict management is attributable to relative bargaining power and social dynamics of bargaining of different social groups, irrespectively of formal political democracy?

Democracy versus distribution – more democracy leads to more equal income distribution.
Questions: how does one define more or less democracy? How do you measure income distribution? Equality is also consistent with lack of formal democracy as long as other factors are playing a role (example, China has the lowest Gini-coefficient in the World despite no formal, Western democracy at all; that has changed with changing ideology, political priorities and bargaining power of interest groups).

General questions: how do you define democracy? How do you measure it (which indicators) so that you can define “more”, “less” and “not at all”? How do you find out the causal relationship? How does one explain the acquisition of the institution of democracy in historical perspective.

Final comments (my comments)

Good points: institutions matter, reflect socio-economic conditions and history, and cannot be changed or acquired as if they are blueprints.

Bad points:

(i) *starting from wrong prepositions:* objective (a market economy – why?); meaning of market economy; market economy needing institutions but not being one; objective of the economy being efficiency;

(ii) *building of institutions* not seen from the point of view of specific political processes, but as a matter of choices as to how to maximise social welfare; the choices being influenced by customs and traditions (or history); or, in more mainstream words, by taste;

(iii) *markets are given institutions*, upon which, therefore, the historical process that applies to other institutions does not apply to markets. Hence, while non-market institutions can be influenced by political interests other than market efficiency, markets themselves are not;

(iv) *blueprints versus blueprints* – in the middle of the critique of blueprint institutions one can see blueprint definitions of markets, market dynamics and democracy, as well as the desire for blueprint acquisition of institutions, rendering the whole exercise incoherent;

(v) *avoidance of ultimate conclusion:* the main conclusion of such a study and critique should have been that the historical and socio-economic process that presides at the development of institutional arrangements, including markets, renders the goal of general market efficiency meaningless. However, such a radical conclusion, often approached, is always avoided by illogical deviations.