ECON 672: Economics of Development

Week 13: Institutions, implementation, and political economy

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Institutions as Cause and Consequence of Development

Similar to health and education, **institutions** are both an outcome and determinant of development: are states poor because they are corrupt or corrupt because they are poor? Or both?

> *We thus face a fundamental development paradox: the state is most prone to failure precisely where it is most needed. — de Janvry & Sadoulet, p. 518*

de Janvry & Sadoulet on Institutions and Development

The roles of resources, geography, technology, and institutions are more a matter of balance and complementarities than of substitutions. Recognizing the role of institutions in development is certainly not new, but greater emphasis and better understanding have recently been given to the subject with theoretical developments in new institutional economics (NIE) (North, 1990) and empirical analyses trying to more rigorously identify the direction of causalities between institutional choices and development outcomes (as in Acemoglu et al., 2002).

— de Janvry & Sadoulet, p. 503

Banerjee & Duflo on the View from Below

The main lesson from Acemoglu and Robinson's historical analysis [...] is that bad institutions are very persistent, and there may be no natural process to eliminate them. We share their skepticism both about the danger of a strategy to impose institutional change wholesale from outside and about the hope that things will eventually fix themselves if we leave people alone. Where we part with them is in continuing to be optimistic: In practice, we do see a lot of significant institutional changes happening, at the margin, in the absence of an outside invasion or a full-scale social revolution. [...] To really understand the effect of institutions on the lives of the poor, what is needed is a shift in perspective from INSTITUTIONS in capital letters to institutions in lower case—the "view from below."

— Banerjee & Duflo, p. 260

The Role of Institutions

Role of institutions: provide rules and conventions to codify social interactions and constrain uncertain individual behavior

- Micro to macro
- Economic, social, and political
- Formal and informal
- Improve markets and address market failures (AI, AS, MH)

Laws, contracts, markets, churches, family norms, Peace Corps, codes of conduct, ethics, etc.

Transaction Costs, Efficiency, and Equity

Market failures arising from **transaction costs** create both inefficiency *and* inequality; "non-separability between efficiency and equity" (de Janvry & Sadoulet, p. 507)

- Credit and interest rates
- Insurance and risk management
- Labor and efficiency wages
- Land rental and vacancies
- Pricing bands on agricultural commodities

See de Janvry & Sadoulet pp. 510–512 for specific applications to sharecropping contracts; we will model these explicitly in ECON 673.

Banerjee & Duflo on Bertrand et al. (2007)

A study of the allocation of driver's licenses in Delhi showed that knowing how to drive did not really make it more likely that someone would actually get a driver's license, but being willing to pay more to get it fast did. Delhi effectively has a free market in driver's licenses, and that's exactly what we do not want. The challenge is how to get the state to do the job when avoiding the free market outcome is precisely the goal.

— *Banerjee & Duflo, p. 260*

Why Good Institutions May Not Emerge

Why might good institutions not emerge?

- Local efficiency, social inefficiency
- Efficiency without equity
- **Path dependence**
- Lack of commitment devices
- Uncertainty about (distribution of) gains
- Loss of relative status
- Coordination, hold-up problem, procrastination, side-selling

Banerjee & Duflo on Top-Down Reform

The central problem, [Easterly] rightly points out, is that it is easier to take over a country than to know how to make it run well. [...] Institutions need to be tailored to the local environment, and therefore any top-down attempt to change them would probably backfire. Reform, if possible at all, must be gradual, and must recognize that existing institutions are most likely there for a reason.

— *Banerjee & Duflo, p. 258*

Political Economy and the State

How do we analyze **political economy** and the role of the state as a particular institution?

- Positive analysis of policy: origin and impact
- Normative analysis of policy: ideology and feasibility

de Janvry & Sadoulet on the Role of the State

The state in particular has a fundamental role to play in compensating for market and civil society failures. If the state is effective in both its intrinsic functions and in its compensatory roles, development outcomes are more likely to be achieved; but the state can also fail. In this case, inefficiencies and deficits in development outcomes will result. Many potentially good policies will not be implemented and many bad policies and bad practices, such as abuse of power and corruption, will be. Clearly, a well-functioning state is key for development, especially if market and community failures are pervasive, as is typically the case at early stages of development. However, a well-functioning state is itself a product of development.

— *de Janvry & Sadoulet, p. 518*

Theories of the State and Political Economy

Theories of the state and political economy:

- Many good policies are not implemented while bad policies remain in place
- Market failures and policy responses to them are the product of a particular political equilibrium based on costs and benefits; changing these may require reaching a new equilibrium
- Political feasibility governs policy; a good policy that cannot be enacted is not a viable solution
- Some political actors are motivated entirely by self-interest, but may still enact policies with positive spillovers at the margin
- "Good government" is not a guarantee of good policy; "bad government" does not necessarily preclude good policy

Banerjee & Duflo on Institutions in Practice

Although there is scope for improvement in accountability and corruption even within the framework of generally "bad" INSTITUTIONS, there is, conversely, no guarantee that good INSTITUTIONS necessarily work well in practice.
— Banerjee & Duflo, p. 264

The Functionalist State

The **functionalist state** view puts the state as a central social planner, solving issues like externalities, economies of scale, asymmetric information, coordination failure, market failures, and similar.

If existing (free) markets are inefficient, the state can increase efficiency with its intervention.

The state might thus craft policies (with importance weights w_i) such that total social welfare is maximized given a budget B:

$$\max_{policy} \sum_i w_i \Delta u_i = \sum_i w_i (\Delta CS_i + \Delta PS_i) + \Delta B \text{ with } \sum_i w_i = 1$$

Functionalist Policies

What might these functionalist policies look like?

- Import and export controls, e.g. tariffs
- Industrial subsidies or targeted taxes
- Forced national saving to boost investment
- Public investment in infrastructure
- State-led planning and coordinated public investment

The Pluralist State

The **pluralist state** view puts the state as a mediator of competing stakeholder groups' interests. Such coordination and cooperation may be simple in smaller groups, but much more challenging in larger populations.

> *Incentives for voluntary collective action disappear as monitoring of effort in the provision of a collective good becomes impossible and there is a strong incentive to free-ride. Formalized systems of governance need to emerge to enforce cooperation. — de Janvry & Sadoulet, p. 524*

Failed and Weak States

We might particularly focus on development in **failed or weak states**, such as military dictatorships or juntas. These states are primarily focused on the short-term goal of remaining in power and are generally corrupt and predatory, making development difficult to achieve and sustain.

However, increasingly, these weak or failed states are the site of large shares of remaining extreme poverty, motivating ways of delivering "good aid in hard places".

The Corruption/Compliance Game

Of particular concern might be **corruption**, "the abuse of entrusted power for private gain" (Transparency International). We could model such corruption, bribery and enforcement between a state authority and private agent, with a corruption/compliance game:

Table 1: Generic corruption/compliance game, payoffs listed as (official, agent); de Janvry & Sadoulet, Figure 21.6

Official	Agent complies	Agent violates
Enforce	$S,\ 0$	$S + \lambda F,\ V - F$
Ignore	$(1-\mu)S + B,\ -B$	$(1-\mu)S + B,\ V - B$

$S =$ salary; $F =$ fine; $\lambda =$ official's bonus share of the fine; $V =$ agent's gain from violating; $B =$ bribe; $\mu =$ probability the official is caught and dismissed. We assume $V > B$ and $V < F$.

Equilibria of the Corruption/Compliance Game

The agent complies when the official enforces ($0 > V - F$) and violates when the official ignores ($V - B > -B$). The official's best response depends on the salary S:

- $S > \frac{B}{\mu}$: Enforce is dominant, so the unique Nash equilibrium is (Enforce, Comply)
- $S < \frac{B-\lambda F}{\mu}$: Ignore is dominant, so the unique Nash equilibrium is (Ignore, Violate)
- $\frac{B-\lambda F}{\mu} < S < \frac{B}{\mu}$: the official enforces only against violators, while the agent violates only when ignored; there is no pure-strategy Nash equilibrium[1] but *behavior cycles*

Corruption is thus most likely with low salaries S, high bribes B, and low vigilance μ.

[1] This range of parameters would produce a unique mixed-strategy Nash equilibrium, as in the standard inspection game (Ishikawa & Fontanari, 2025).

Fighting Corruption

How, then, to reduce sure corruption (Ignore, Violate)?

- Increase public reporting (e.g. Reinikka & Svensson, 2004) to increase public information and accountability (I better understand the benefits I am supposed to be receiving)
- Increase top-down monitoring through audits (e.g. Olken, 2007) to raise μ (corrupt officials are more likely to be caught and dismissed)
- Increase salaries S of public officials to reduce the incentive to accept bribes (I am paid enough to not be tempted by bribes)
- Increase fines F and/or the share λ of fines that enforcing officials receive as a bonus to reduce the incentive to accept bribes from violators

Limiting Rent-Seeking

Strategies for limiting rent-seeking more broadly:

- Increase state autonomy and reduce dependency on funds from lobbies or limit lobbying activities more broadly
- Scale down the predatory state (limit public ownership, introduce transparent and enforceable rules and standards, discipline bad actors, shift to reliance on market forces)
- Use policy instruments less prone to outside influence, even if they are second-best in efficiency (e.g. tariffs over subsidies)
- Promote cooperative over redistributive solutions (e.g. allow officials to seek re-election so that they value their reputation; Ferraz & Finan, 2011)
- Increase effectiveness of policymaking (e.g. commitment through rules, delegation, state variables, reputation, or reduced flexibility)

5-minute Break

Olken (2007)

Randomly selected presenter: **Toni**

1. What is the research question?
2. How do the authors answer it?
3. What do they find?
4. Are you convinced by the design and results?
5. How does the paper connect to our other readings?

Banerjee & Duflo on Olken (2007)

Our colleague Benjamin Olken hired teams of engineers to excavate a tiny bit of road in 600 or so villages to figure out how much material had actually gone into the road's construction. The cost estimate was then compared with what was reported. Another team interviewed some of the people who were reported to have worked on the project about how much they had actually been paid. Theft was rife: 27 percent of the wages reported to have been paid had somehow vanished, and so had 20 percent of the materials. To make matters worse, the money was only one part of the waste. The roads that were built were still the same length (otherwise the theft would be too obvious) but the missing materials meant that they were built less well, and therefore more liable to be washed away by the next rains. In an effort to fight corruption, government officials in charge of the program told the village leaders that the building programs would be audited, and the results would be made public. The government did not hire especially honest auditors—they worked within the existing system. Yet, Olken showed that the threat of audits reduced the theft of wages and materials by one-third, compared to the villages where audits were not conducted (the villages where audits were conducted were randomly selected). [...] Top-down monitoring is not a particularly new idea. But audits and decoys seem to be effective, presumably because once the information is out there, there is some chance that it will be used to punish the offenders. A few people within the system who believe in fighting corruption may be enough.

— Banerjee & Duflo, pp. 262, 264

de Janvry & Sadoulet on Olken (2007)

How to control corruption in public expenditures? Using an RCT approach, Olken (2007) compared two alternative approaches to reducing corruption in 608 village road construction projects in Indonesia: a top-down approach using external monitoring by government auditors; and a bottom-up approach using community monitoring. In the top-down treatment, audits by Jakarta accountants were increased from 4 percent to 100 percent of the projects. In the bottom-up treatment, increased grassroots participation was induced by sending invitations to village meetings and distributing anonymous comment forms to collect villagers' opinions. The measure of corruption was very precise, taking samples of construction materials to detect the use of cheap sand in place of expensive crushed rock in road building and estimating the cost of the discrepancy. Comparing construction costs with the two materials showed that on average 29 percent of funds were stolen in control projects. The top-down audits approach proved to be much more effective at controlling corruption, reducing the discrepancy between official project costs and actual spending by 8 percentage points, or 28 percent—a large effect. Increasing grassroots participation in monitoring had, by contrast, little average impact, reducing missing expenditures only in villages with good cooperation and no elite capture. Olken concluded that traditional top-down monitoring can play an important role in reducing the cost of corruption, even in a highly corrupt environment.
— de Janvry & Sadoulet, p. 537

Group Discussion

Bringing together our lecture material and academic article, I have prepared the following suggested discussion questions:

- What do Banerjee & Duflo mean by "*good politics may or may not be necessary for good policies; it is certainly not sufficient*"?
- How do the cases of market failure we have studied (insurance, credit, labor) also relate to institutions?
- If corruption and other rent-seeking activities create such large social costs, why are they so common? How can we address these issues in practice?

Roadmap

Looking Ahead to Week 14

What do we have on the horizon before next Tuesday?

- Our **Draft Presentation Slides** and **Draft Final Paper** assignments will be due on Friday at 6pm
- My office hours for ECON 672 will be held Tuesday before class, 12:15-2:15pm in MCL 108 or virtually by appointment
- Our fourteenth topic will be *Social programs, targeting, and cash transfers*. Our textbook reading will be Chapter 14. Our *Poor Economics* reading will be the "Social Transfers and Labor Markets" section of Chapter 11. Our required journal article will be Egger, Haushofer, Miguel, Niehaus, & Walker (2022), "General Equilibrium Effects of Cash Transfers," Econometrica.
- Our **Weekly Reading Response** assignment for this paper will be due Tuesday at 2:40pm before class. One student will be randomly selected to **present their response** to the class in 5-8 minutes.