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2011

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MPRA Paper No. 32093, posted 07 Jul 2011 19:29 UTC

DEPARTMENT
OF ECONOMICS

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Paper No. 11-09

Electronic copy available at: http://ssrn.com/abstract=1764268

Institutions First

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January 2011

Abstract

Chang (2011) raises doubts about the effects of institutions on economic development and questions the positive effects of entirely free markets based on secure private property rights. We respond by stressing that institutions structure the incentives underlying individual action, secure private property rights are indispensable for prosperity, institutions have a first-order effect whereas policies only have a second-order effect, successful institutional change comes from within a society, and given the status quo of developing countries first-world institutions are likely not to be available to them.

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For several decades economists have again been interested in the effects of institutions on economic development. The consensus is that well-protected private property rights are indispensible for economic development.[3] Chang (2011, 4) acknowledges that private property rights are essential for economic development. At the same time Chang (2011) raises doubts about the posited causal relationship running from institutions to economic development and questions the positive effects of entirely free markets based on secure private property rights. We respond to selected arguments made by Chang (2011) and maintain that in particular citizens of developing countries stand to benefit from less interference by their predatory governments.

Institutions structure incentives

As rules of the game, institutions structure incentives and affect the mechanism employed to transmit information. Individuals respond to incentives based on the information they have at their disposal. The institutional environment thus determines if people engage in productive, unproductive, or destructive behavior (Baumol 1990; Boettke and Coyne 2009). This is true for citizens of developed countries, citizens of developing countries, government officials, and members of the development aid community alike. Only if the institutional environment rewards productive behavior do people get to enjoy the benefits of economic development. In order to understand why some countries are rich and others are poor, why governments are effectively constrained in some places and not in others, and why some development policies fail and others succeed, an analysis of the incentives of the individuals involved is required. In other words, an analysis of the institutions is necessary. A growing empirical literature on the effects of institutions on development suggests that the better private property rights are protected the more

[3] For an account of the emergence of this consensus since the collapse of communism in the late 1980s, see Boettke, Coyne, Leeson, and Sautet (2005).

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economic development is enhanced (see, for instance, Acemoglu and Johnson 2005; Acemoglu, Johnson, and Robinson 2001, 2002; Scully 1988; Hall and Jones 1999; Rodrik, Subramanian, and Trebbi 2004; Shleifer 2009; Berggren 2003). In an environment where citizen's property is secured, citizens make long-term investments and can rely on capital markets and contractual arrangements to engage in complex trades. By realizing the benefits from widespread exchange they contribute to economic growth and development.

The first rule of development: secure private property

Besides suggesting that institutions affect economic development, empirical results indicate that while institutions that secure private property rights by preventing public predation are indispensible, state provision of contracting institutions are, in fact, dispensable (Acemoglu and Johnson 2005; Hay and Shleifer 1998; Williamson 2009). The evidence suggests that as long as private property rights are secure, contracting institutions are devised by the members of society in a decentralized fashion. Chang's (2011) concerns about negative effects of 'too strong' private property rights therefore appear to be unfounded. In a system of property rights that are secured from public predation, private parties find ways to prevent one another from engaging in private predation. In other words, citizens can contract around private predation, but they cannot contract around public predation. Further, in a system of secure private property rights alternative forms of ownership are free to evolve. Private property rights do not preclude communal ownership, which Chang (2011) argues can be more efficient than individual ownership in some situations, or any other form of ownership structure. Freedom of contract guarantees that individuals can enter any imaginable contractual relationship. Ostrom's work (see, for instance, Ostrom 2005) shows how communities can regulate the use of common

resources by devising rules that are diverse in form but have specific functions in common with and mimic private property rights. Various community-based systems of rules provide incentives for accountability and responsibility in resource use, just like private property incentivizes to economize on resources (Boettke 2010).

Institutions first, not policy first

Economists interested in the effects of institutions on economic development understand institutions to be the 'rules of the game' that apply to all citizens and in particular to the members of the body government. The foundational rules of governance, which determine how well-protected persons and property are, have a first-order effect on a society's prosperity. The policies pursued within the existing rules of governance or the political players involved only have a secondary effect on a country's development. The distinction made by James Buchanan (see, for instance, Buchanan 1987; Buchanan 2008; Brennan and Buchanan 1980) between a constitutional stage and a post-constitutional stage highlights the difference between rules of governance and policies. The foundation for secure citizens' property is laid on a deep institutional level – in Buchanan's terms on the constitutional level. The underlying rules of governance determine the long-term development of a society, whereas policies within the rule structure and personal characteristics of the political personnel only have secondary effects. Chang (2011, 4) conflates institutions – the rules of governance – with policies – the actions taken within the rules of governance. He argues that many 'institutions' that instilled economic development of the West were created after initial development occurred. He mentions democracy, modern bureaucracy, intellectual property rights, limited liability, bankruptcy laws, banking, central banks, and securities regulations. Chang enumerates policies, not institutions.

If institutions have first-order effects on the development prospects of a country, whereas policies only have second-order effects, lasting reforms with a considerable impact on a country's development can only be realized through systematic changes in the rules of governance. Only a change in the institutions of today's developing countries that makes private property rights more secure will allow their citizens to enjoy the benefits from widespread exchange and sustained economic development. A change in policies called for by Chang (2011) is not going to have the desired effects. Institutions rule, not policies.

Institutional change and institutional stickiness

Chang (2011) remarks that the relationship between institutions and economic development is not always the same. According to Chang (2011) the same 'dose' of some institution might be good for one country but bad for another and the same 'dose' of an institution can have varying effects in one country over time. We agree that the success of institutional change depends on the institutional status quo and the existing belief systems of the people. Institutional change that is introduced indigenously, i.e. homegrown by the citizens of a country, and evolves endogenously, i.e. results from the interaction of individuals and is not devised centrally by government, is most likely to persist over time. Endogenously evolved institutions are in this sense relatively 'sticky' because they are founded in the existing institutions and beliefs (Boettke, Coyne, and Leeson 2008). In contrast, institutions exogenously introduced by the domestic government are likely to be less sticky. Institutional change implemented by foreign government entities is least likely to stick, since members of foreign governments are unfamiliar with the indigenous institutions and beliefs.

The Western world has a long track record of failed attempts to save developing countries by either military means (Coyne 2006, 2008a, 2008b) or humanitarian means (Easterly 2002, Easterly 2009). The track record of domestic governments is similarly unimpressive. Since domestic governments of developing countries also neither have the requisite knowledge to engineer positive institutional change nor are likely to be of the benevolent variety, the most promising approach of the international community for contributing to the prosperity of the developing world is a marginal one (Easterly 2009). Supporting local individuals to make use of their time- and place-contingent knowledge, allowing indigenous institutions to evolve and eliminating trade barriers to provide citizens of developing countries to realize gains from international trade are feasible contributions of the West (Easterly 2006, Easterly 2009, Coyne 2008a).

Not feasible: first best governments in third world countries

Given the status quo of developing countries, the prospects of endogenous institutional change driven by the domestic population might not look very rosy. But realism is needed, not romance. Governments equipped with power to protect private property have to be constrained in order to prevent government members from abusing their power to predate on citizens. In countries where governments are not effectively constrained, government activity tends to favor members of the ruling elite, making increases in government involvement undesirable from the perspective of economic development (Leeson and Williamson 2009). That is the case in most developing countries.

Assuming a causal relationship running from economic development to institutions, Chang (2011) argues that resources should be used for policies "that more directly stimulate

economic development – be they educational expenditures, infrastructural investments, or industrial subsidies" (Chang 2011, 7). Chang (2011) envisions the governments of developing countries to engage in these activities. He has to assume that third world governments act like effectively constrained first best governments as known from the developed world. Such an assumption is most questionable. According to the Failed State Index 2010 (The Fund For Peace 2010), more than 20 percent (or 37 countries) of 177 countries considered worldwide are failing to provide basic government services and more than 50 percent (or 92 countries) are close to failing to do so. Under these circumstances first best governments are not part of the feasibility set for developing countries. The governments within the feasibility set of developing countries tend to be weak and failing, but strong enough to predate on their citizens (Leeson 2007). Any advice to developing countries based on the assumption that first best governments are available in the developing world is at least misguided, and at worst deadly.

Concluding remarks

Two concluding remarks are warranted. First, the underlying institutions of a society give rise to the observed pattern of social cooperation. In the presence of secure private property rights individuals pursue productive opportunities and contribute to the process of economic development. The failed experiments of socialism and development planning have forcefully demonstrated to us that the path to prosperity is paved by decentralized coordination of individual plans guided by market prices.

Second, institutions comprise the basic rules of society to which its members adhere when interacting with one another. These are not to be confused with the policies that are pursued within the existing system of institutions. Whereas variation in policies gives rise to

short-run fluctuations in economic activity, it is the basic institutions that determine the long-run economic performance of a society.

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