



The Ronald Coase Institute

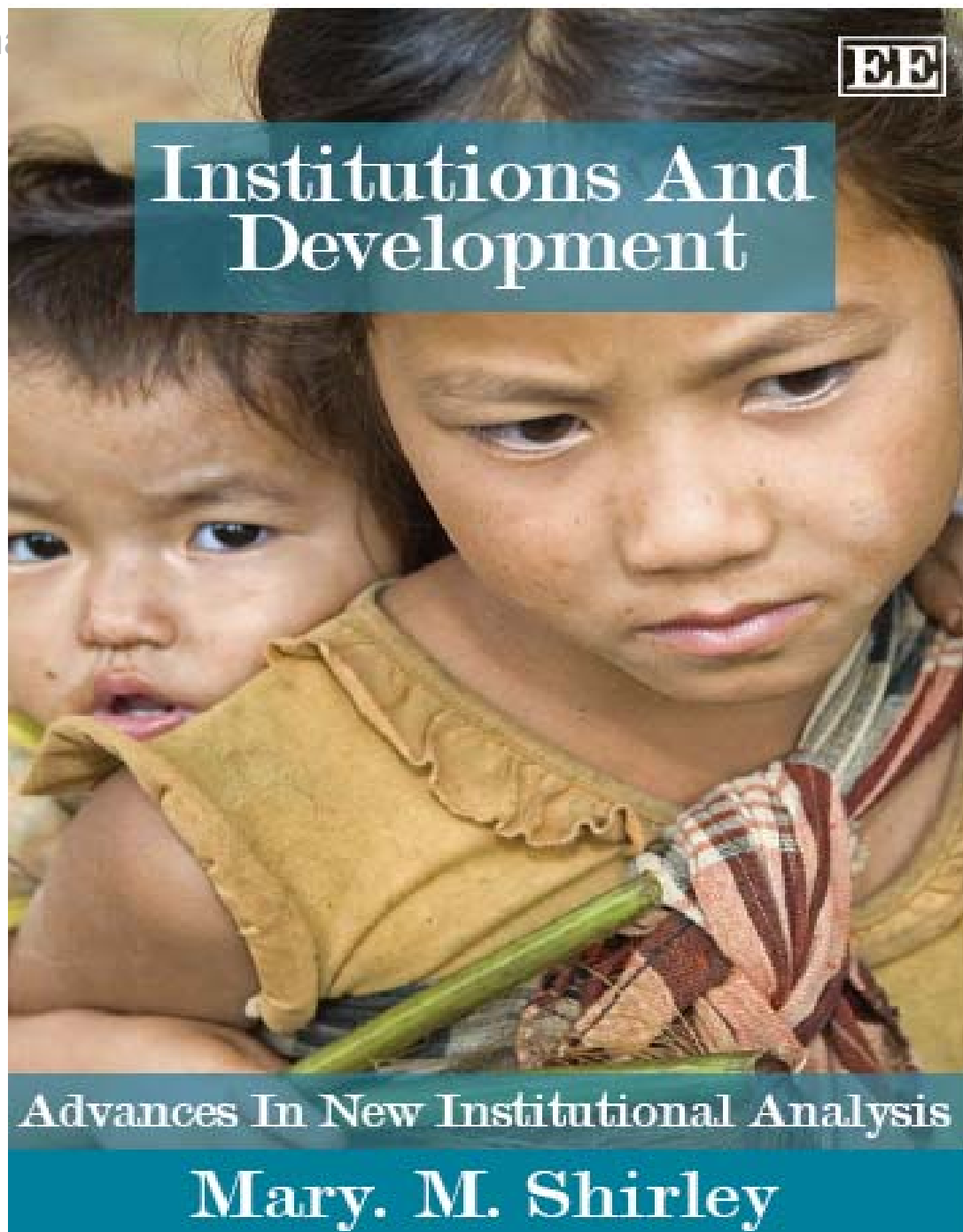
# Institutions and Development

Mary M. Shirley

President, The Ronald Coase  
Institute



The Roman



# Institutions And Development

Advances In New Institutional Analysis

Mary. M. Shirley

Elgar, 2008

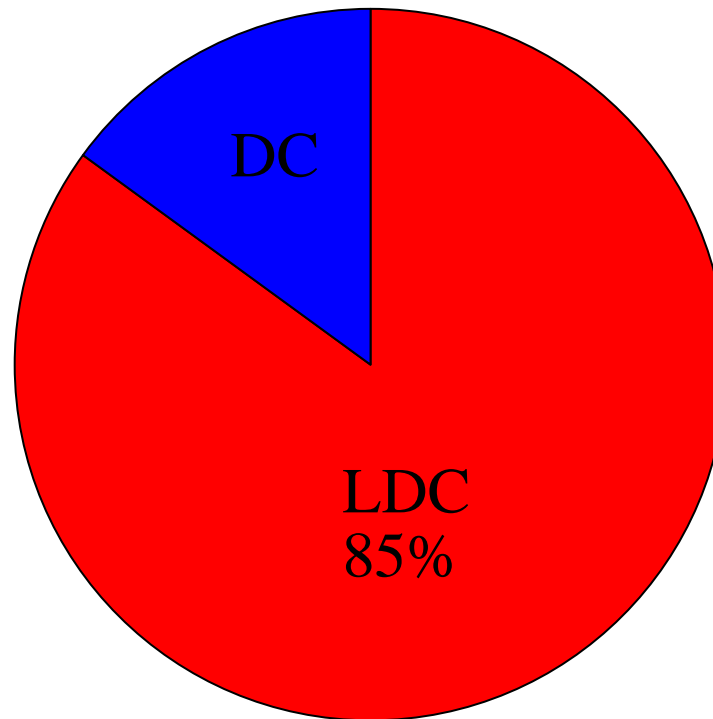


# Questions

1. How do institutions affect development?
2. Can foreign aid improve institutions?
3. Can foreign aid avoid institutions?
4. What can be done?



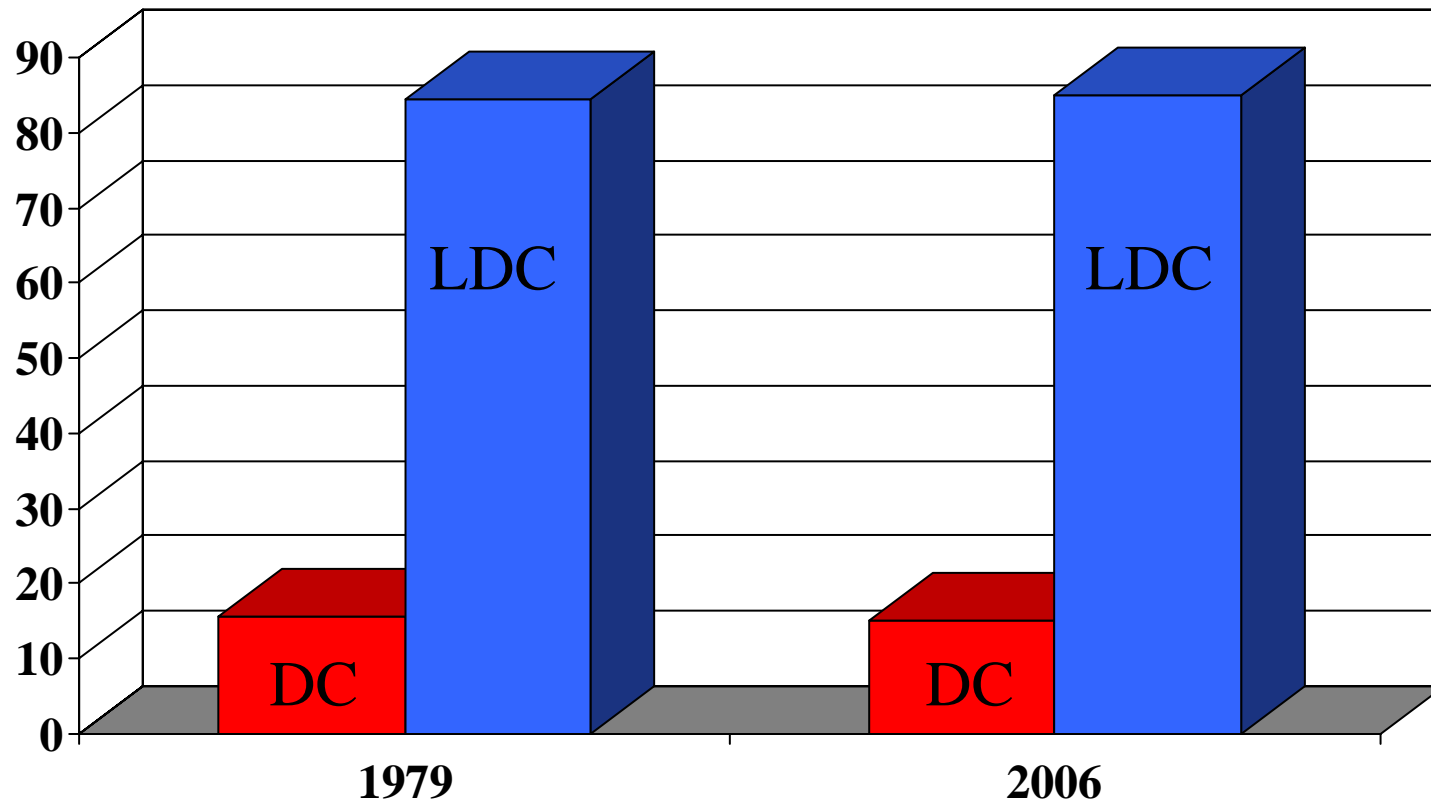
# Most of world's population lives in less developed countries



World Bank, DC = >\$11,115 GNP p.c. PPP in 2006

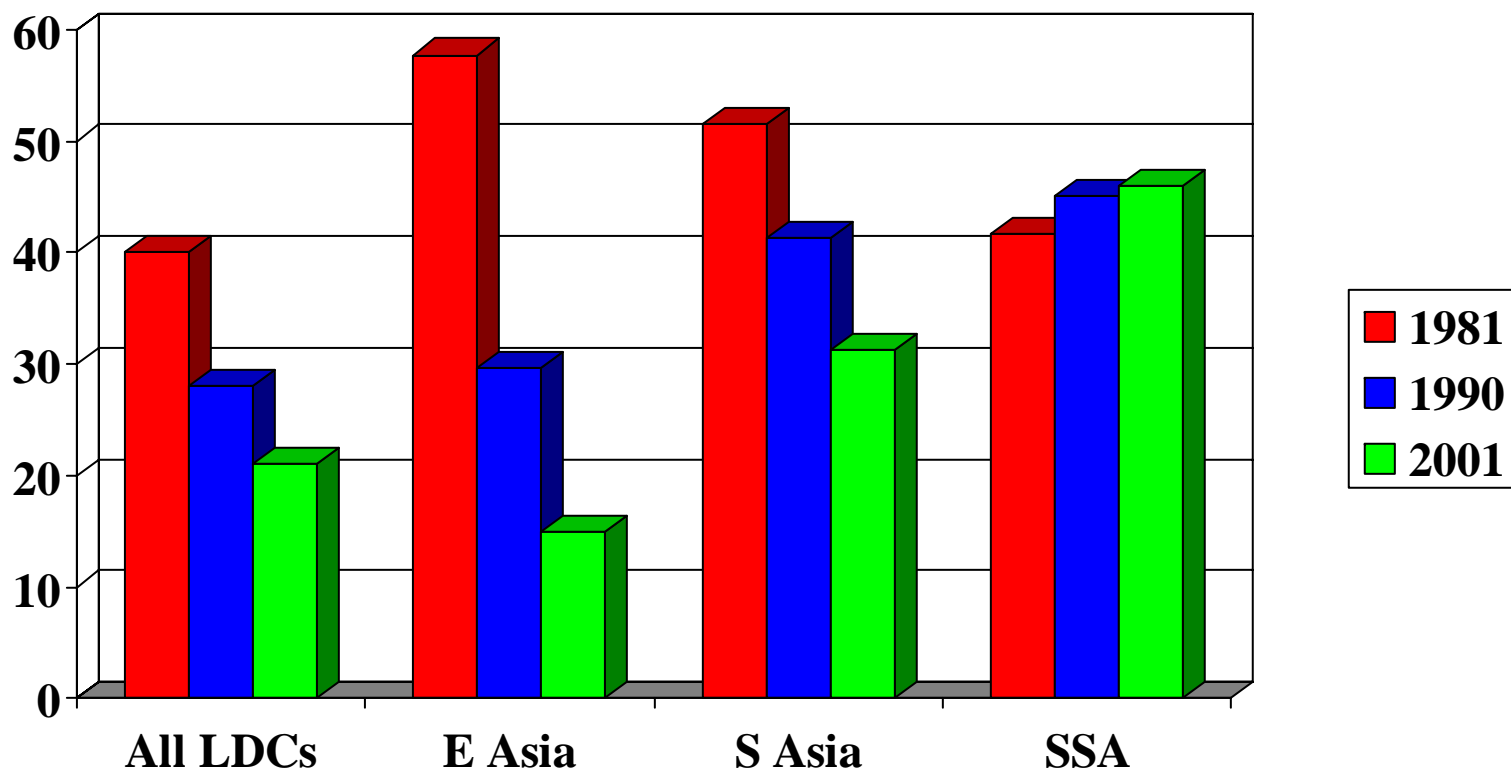


# This has changed little





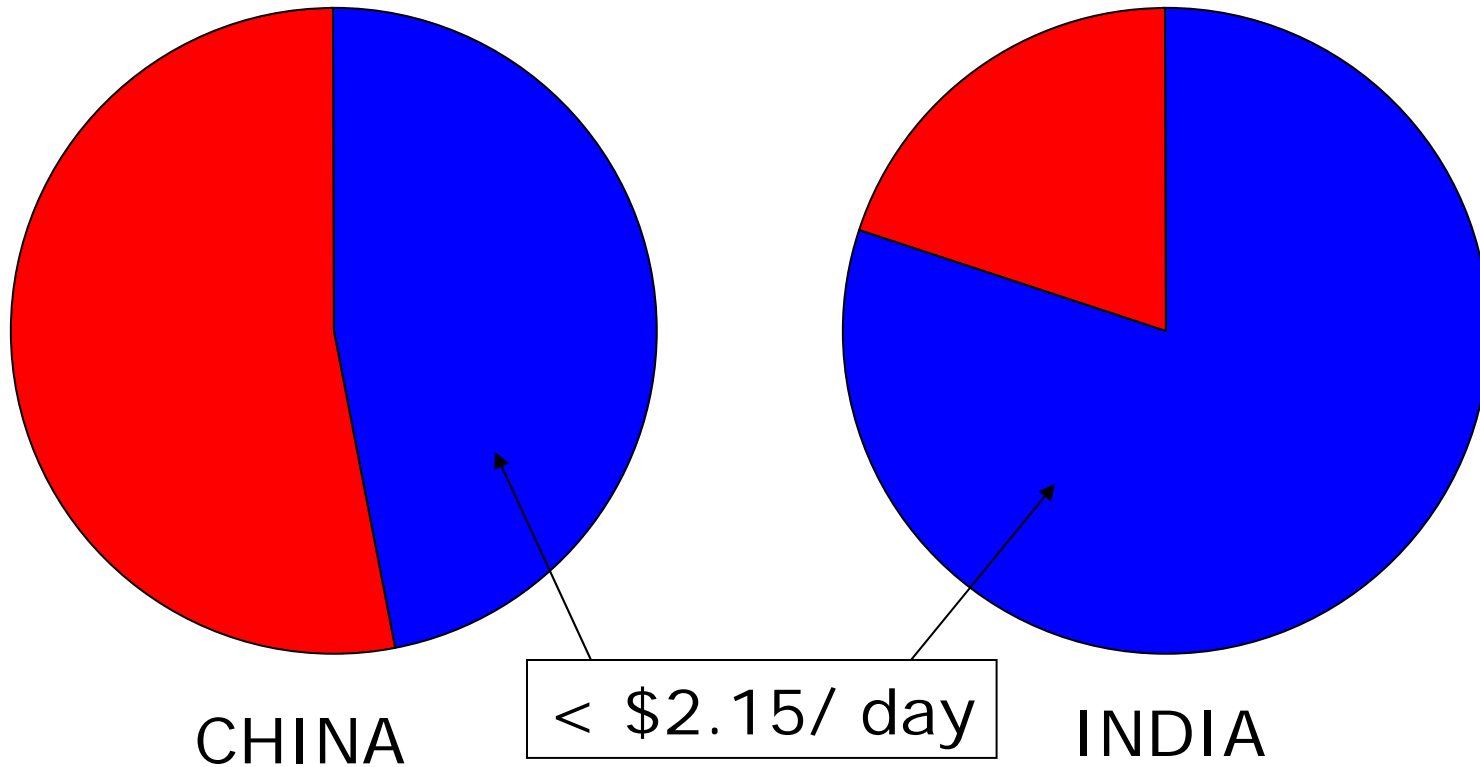
# Population in Extreme Poverty Has Declined\*



\*% pop. in hh w/<\$1 per day (1993 PPP) per capita income. Chen & Ravallion, 2004



# Still many poor people



Chen & Ravallion (2004)



The Ronald Coase Institute

# AID community is large



21 multilaterals



36 large bilaterals



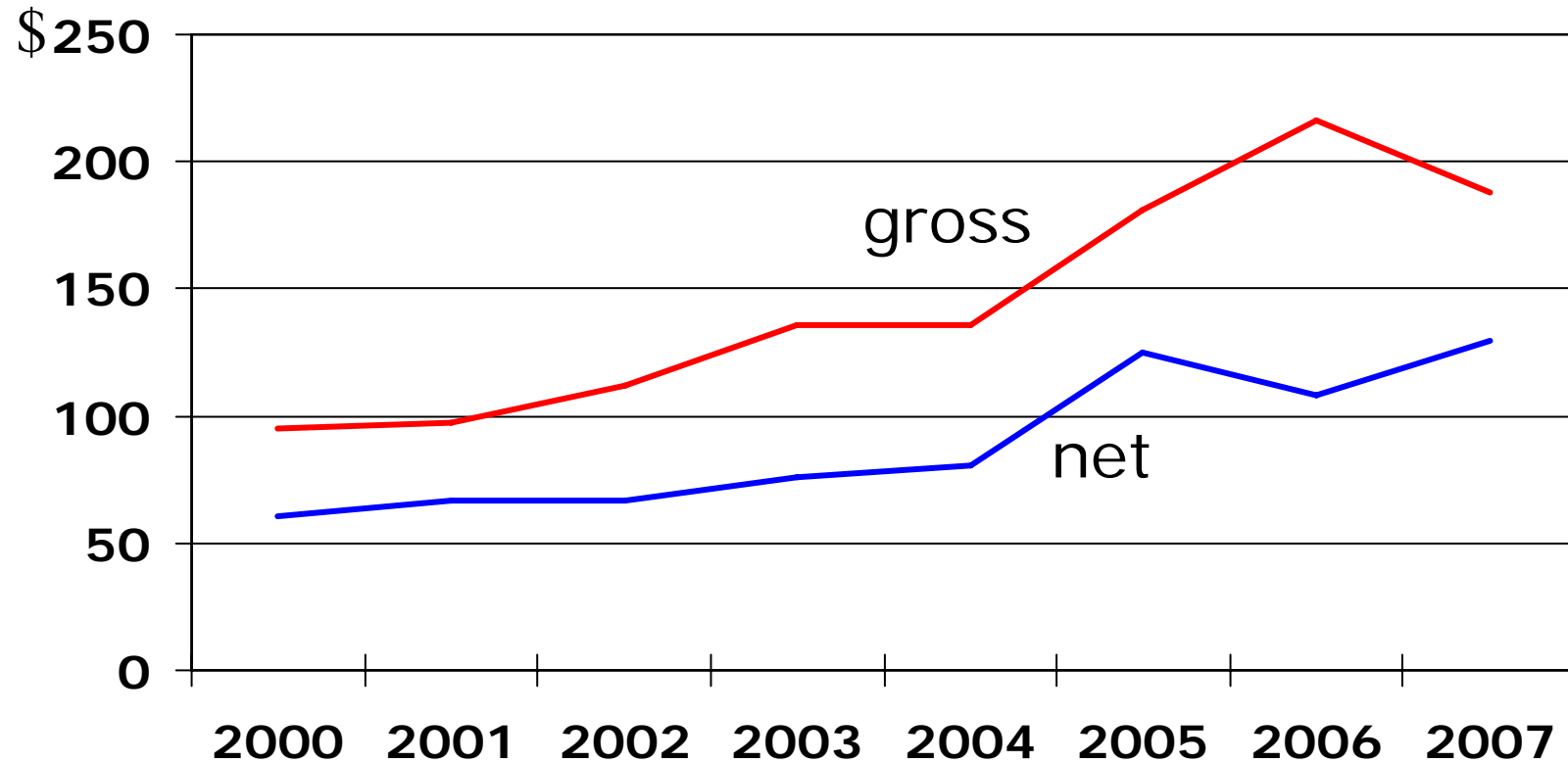
17, 428 internt'l NGOs





The Ronald Coase Institute

# Foreign aid is large & growing (\$billions)



Based on data from OECD 2009



The Ronald Coase Institute

# What Kinds of Institutions Are Needed for Development?

**Encourage  
exchange** by  
lowering  
transaction  
costs



## Institutions that reduce transaction costs

- Contracts & enforcement mechanisms,
- Commercial rules, laws
- Norms (trust, shared values, etc.)



# Institutions Needed for Development

**Encourage  
exchange** by  
lowering  
transaction  
costs

Direct the  
power of the  
state toward  
**protecting  
property &  
individuals,**  
not exploiting  
them



The Ronald Coase Institute

# Institutions that control the state

- Constitutions, electoral rules, federalism
- Political checks & balances
- Norms (civic mindedness, probity, rule of law, etc.)



# Institutional frameworks

1. Durable (usually)
2. Endure because powerful people benefit
3. Changes idiosyncratic & experimental (usually)



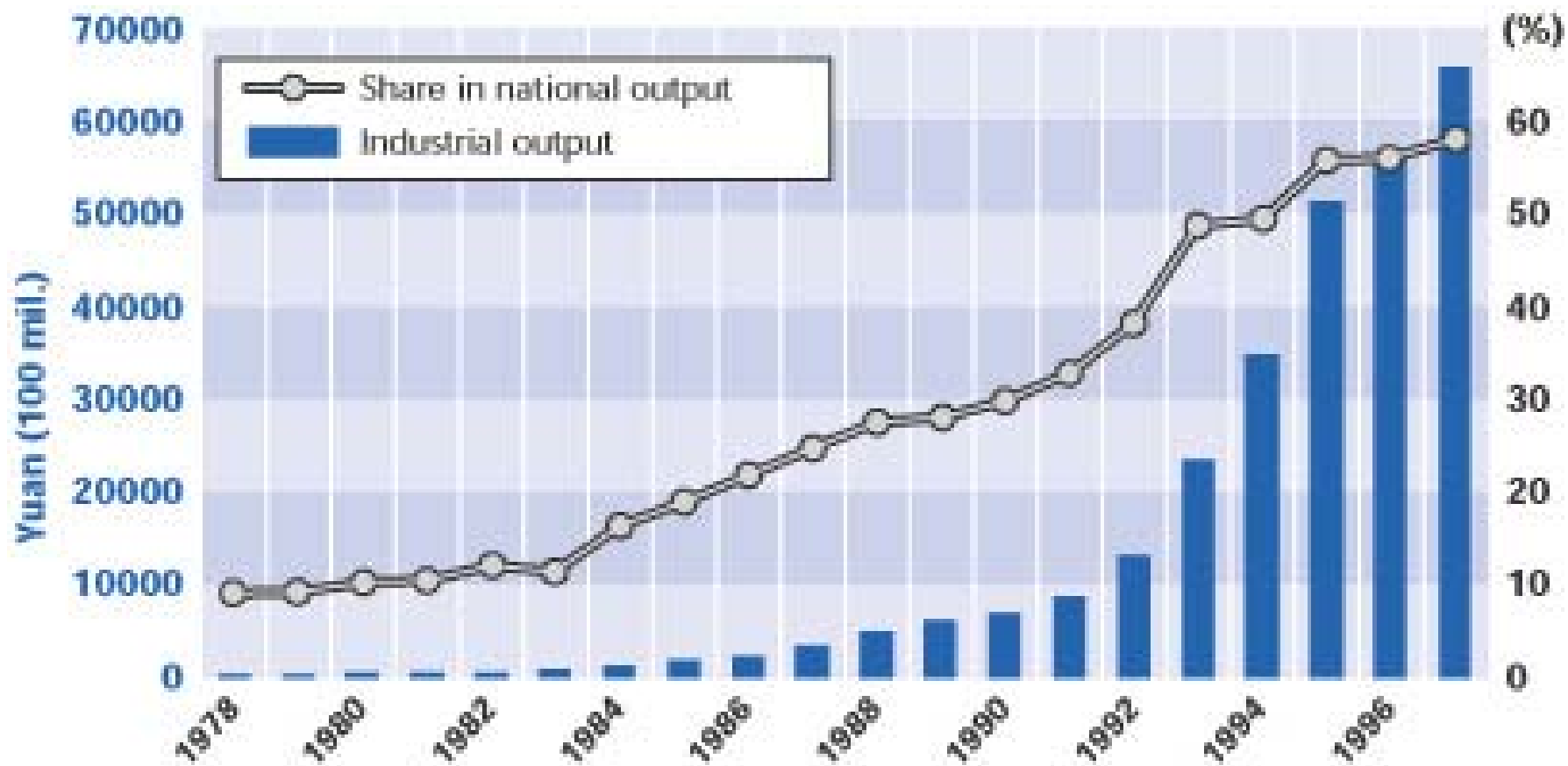
The Ronald Coase Institute

## E.G. idiosyncratic change: China's TVEs

- State owned enterprises run by private investors
- Overseas Chinese ties to village substitute for secure property rights
- Regular payments of profit shares to government officials



## TVEs



Wei Zou, "The Changing Face of China's Rural Enterprises," *China Perspectives* #50, Nov. – Dec., 2003





The Ronald Coase Institute

“Capitalism with a red hat”





The Ronald Coase Institute

# Can aid improve institutions?





The Ronald Coase Institute

Focus is aid for economic  
development, not  
humanitarian aid



The Ronald Coase Institute

Can development aid  
promote growth?



## Rajan & Subramanian, 2005 examine aid and growth

- 10, 20, 30, 40 time periods
- Only aid directed at growth
- Only countries with good policies
- Different regions, areas



Rajan & Subramanian, 2005  
find no statistically robust  
association between aid &  
growth



# What about aid and institutions?

- No effect on institutions (see cites in Burnside & Dollar 2004)



# Evidence aid can **harm** institutions

- Associated w/ **lower bureaucratic quality, corruption, less rule of law** (Knack 2000)
- **Increased rent seeking** (Economides 2004)
- **Rent seeking, corruption, waste** (Bauer 1991, Kanbur 2000, Easterly 2002)





# Evidence aid **harms** institutions

- Associated with **slower adoption of market oriented reforms** (Heckelman & Knack 2005)
- **Negative association with democracy** (Djankov et al, 2006) & **transition to economic freedom** (IMF 2005)



# Cross Country Regressions

- Reverse causality
- Problems in establishing causal relationships
- But – can rule out hypotheses consistently rejected in most specifications



World Bank's evaluation department judged its projects to improve public administration, rule of law, etc. in Africa to be **“largely ineffective”** (2005)



# Why?

- Samaritan's Dilemma (Buchanan 1977)
  - Payoff highest to Samaritan if Samaritan provides aid and beneficiaries respond by exerting higher effort



# Why?

- Samaritan's Dilemma (Buchanan 1977)
  - Payoff highest to Samaritan if Samaritan provides aid and beneficiaries respond by exerting higher effort
  - Payoff highest to beneficiaries if they get aid without increasing effort



# Why?

- Moral hazard:  
“...aid helps to ensure incompetent governments from the results of their actions, thus weakening their incentive to find alternative revenue sources or better policies.” Ostrom, 2002



## Why?

Mismatch between  
characteristics of aid  
agencies &  
characteristics of  
institutions



# Institutions vs. Aid

## Institutional framework

- Deep rooted & usually durable





# Institutions vs. Aid

## Institutions

- Deep rooted & usually durable

## Aid

- Three year projects
- Policy, organizations, sector rules
- Staff rotates
- Rewards for approval



The Ronald Coase Institute

# Institutions vs. Aid

Institutions

Supported by  
powerful



# Institutions vs. Aid

## Institutions

- Supported by powerful

## Aid

- Requires permission government
- Aid incentives to cooperate
- Revolutionaries would be asked to leave



# Institutions vs. Aid

## Institutions

Changes are  
often  
idiosyncratic  
&  
experimental



# Institutions vs. Aid

## Institutions

Changes are often idiosyncratic & experimental

## Aid

- Focus on Western best practice, not TVEs
- Rapid
- Defensible
- Benchmarks



The Ronald Coase Institute

# pro forma reforms



# Performance Contract

SOE ←

Government



AID GIVER

Promises:

- ↑ productivity
- ↑ profitability
- ↑ investment
- ⊕ other targets

Promises:

- autonomy
- bonus
- punishment



The Ronald Coase Institute

# Performance Changes After the Introduction of Contracts

Number of state-owned enterprises



Return  
on assets

Shirley & Xu, 1998

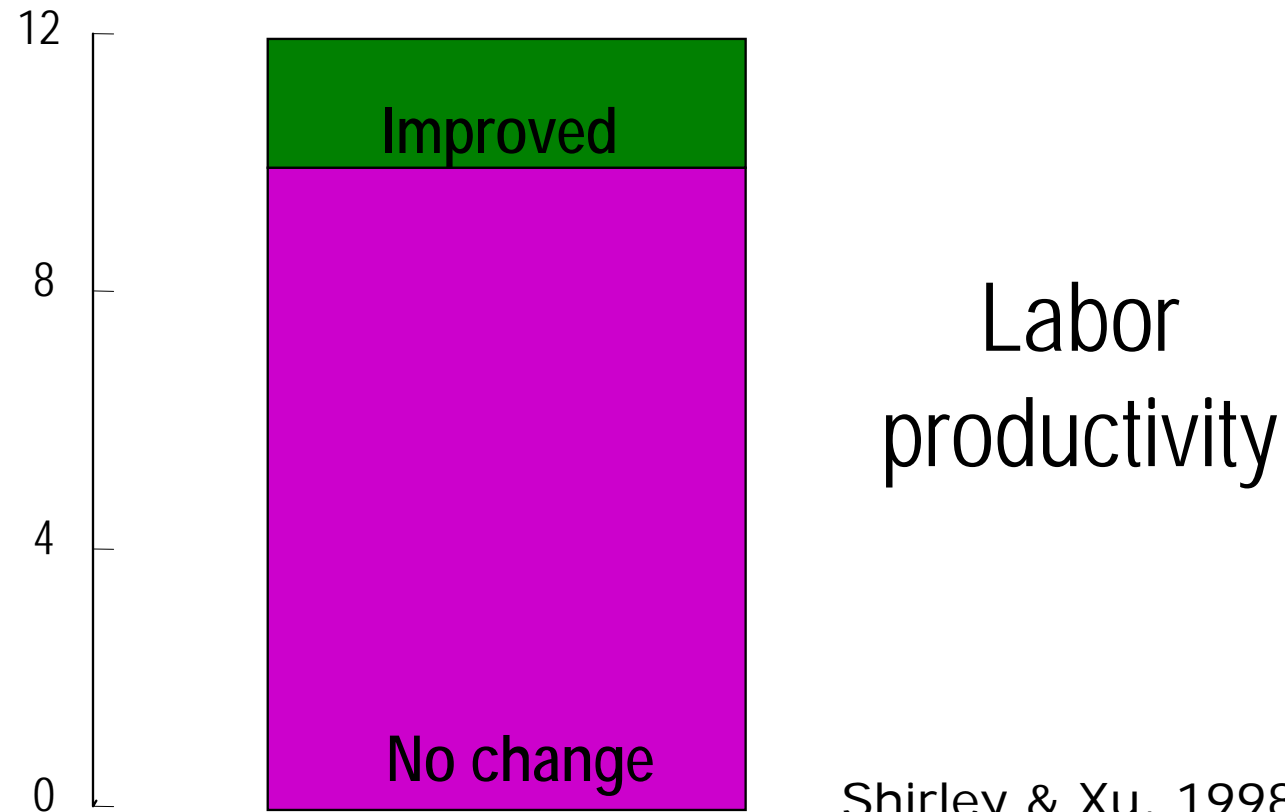




The Ronald Coase Institute

# Performance Changes After the Introduction of Contracts

Number of state-owned enterprises





# Performance Changes After the Introduction of Contracts

Number of state-owned enterprises



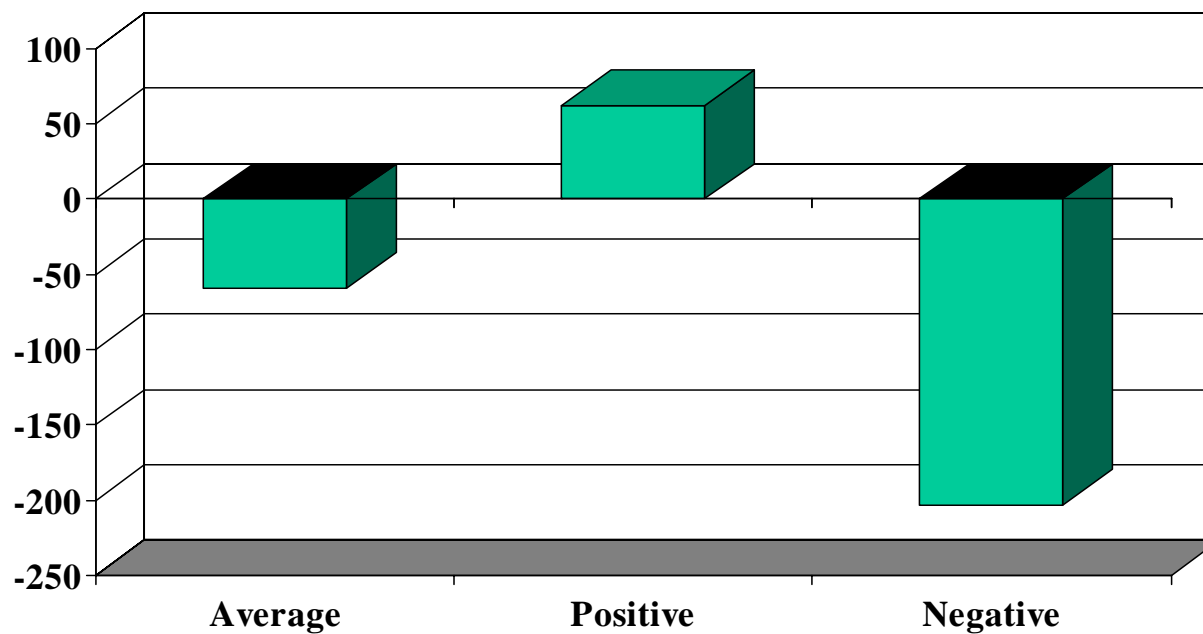
Total factor productivity

Shirley & Xu, 1998



## No Significant Positive Correlation with TFP in over 500 Contracts

Graph 7: Effects of Performance Contracts on Total Factor Productivity in Chinese State Owned Enterprises



Shirley & Xu, 2001



# Why such poor results?

- Weak targets
- Government renegeed:
  - No bonuses
  - No punishments
  - No autonomy



# Why performance contracts?

Aid staff liked:

- Tangible action
- Tangible “success”
- Projects possible w/o privatization or layoffs, closures



# Why performance contracts?

Aid staff liked:

- Tangible action
- Tangible  
"success"
- Projects  
possible w/o  
privatization

Government liked:



# Why performance contracts?

Government liked:

- Easy action
- Easy “success”
- Aid w/o political costly actions:  
layoffs, closures,  
privatization



Bottom line:  
Fundamental changes  
in deeply rooted  
institutions do not  
happen because of  
outsiders' money or  
pressures





The Ronald Coase Institute

Can aid avoid damaging  
institutions?



# Problems

1. Measuring reform in institutions
2. Combating incentive to “move the money”



The Ronald Coase Institute

# E.G. US Millennium Challenge Account

Created 2002

Assists only 61 poorest countries  
that rank in top half on:



The Ronald Coase Institute

# E.G. US Millennium Challenge Account

Control of corruption, and on:



The Ronald Coase Institute

# E.G. US Millennium Challenge Account

Control of corruption, and on:  
Governance

- Political rights
- Rule of law
- Effective government



The Ronald Coase Institute

# E.G. US Millennium Challenge Account

Control of corruption, and on:  
Governance

Investing in health, education

- Immunization, completion rates
- Expenditures



The Ronald Coase Institute

# E.G. US Millennium Challenge Account

Control of corruption, and on:  
Governance

Investing in health, education

Economic policies

- Inflation, trade & fiscal policy
- Regulation
- Business environment



<b>Dimension</b>	<b>Performance Criteria</b>
<b>Governing Justly</b>	<ol style="list-style-type: none"><li>1. Civil liberties</li><li>2. Political rights</li><li>3. Voice and accountability</li><li>4. Government effectiveness</li><li>5. Rule of law</li><li><b>6. Control of corruption</b></li></ol>
<b>Investing in People</b>	<ol style="list-style-type: none"><li>1. Immunization rates</li><li>2. Public expenditures on health</li><li>3. Primary education completion rate</li><li>4. Public expenditures on primary education</li></ol>
<b>Promoting Economic Reform</b>	<ol style="list-style-type: none"><li>1. Inflation rate</li><li>2. Cost to start a business</li><li>3. Days to start a business</li><li>4. Trade policy</li><li>5. Regulatory quality</li><li>6. Fiscal policy</li></ol>





## **Institutional Criteria**

- **Civil liberties**
- **Political rights**
- **Voice and vote**
- **Government effectiveness**
- **Rule of law**
- **Control of corruption**
- **Days to start a business**
- **Regulatory quality**



# Problems

- Abstract – “rule of law”



# Problems

- Abstract – “rule of law”
- Outcomes – government effectiveness



# Problems

- Abstract – “rule of law”
- Outcomes – government effectiveness
- Static – governance



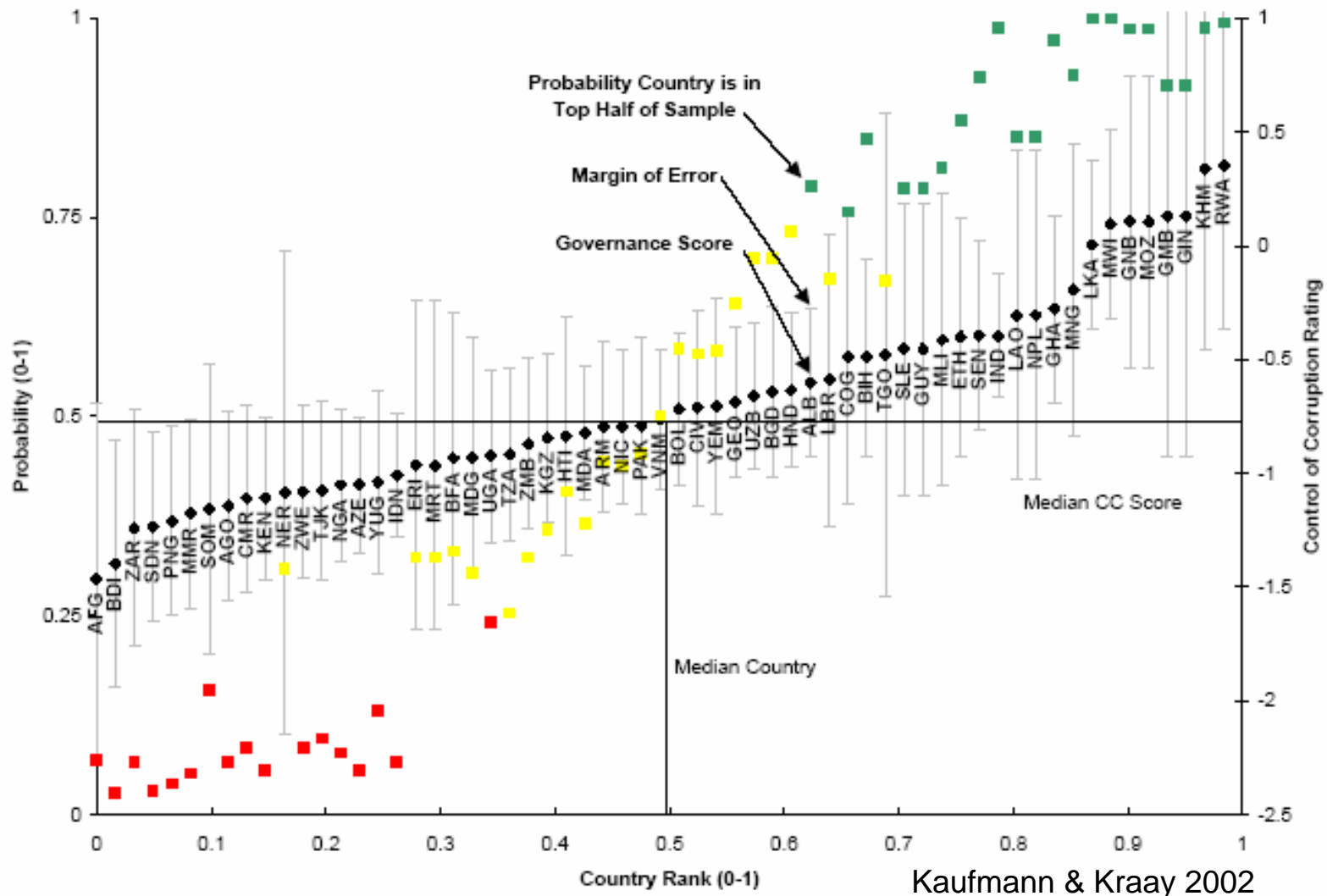
# Problems

- Abstract – “rule of law”
- Outcomes – government effectiveness
- Static – governance
- Margins of error



# Impossible to say w/90% certainty where 51 of 61 countries rank

Figure 1 – Margins of Error and Governance Rankings





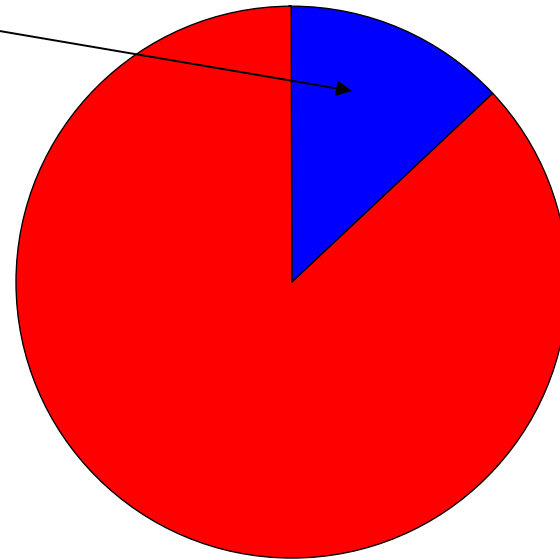
# What should we measure?

Whether a country is improving  
**its** institutional framework in  
ways critical to **its** success



# Few countries

By June 2007 MCA  
had agreements  
with only 8 of 61  
countries

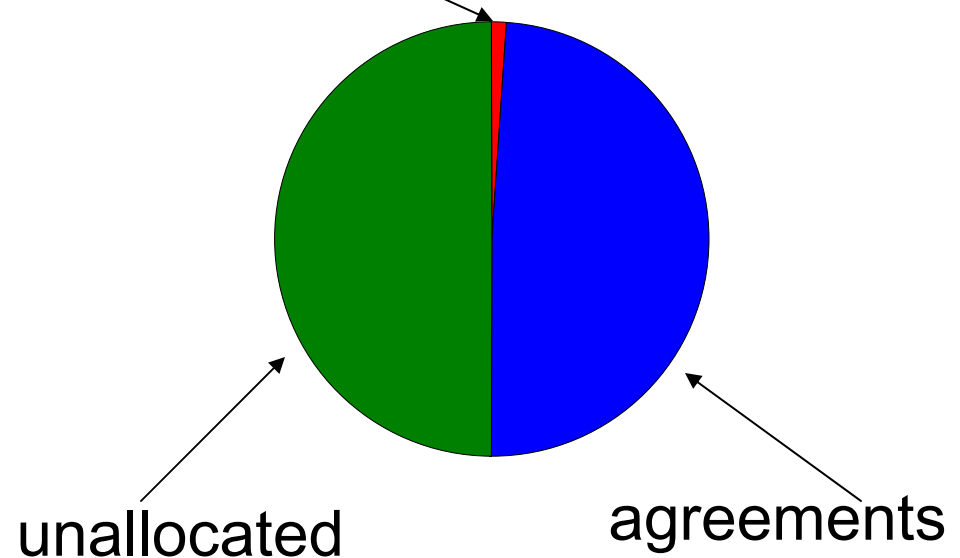






# Little disbursed

By June 2007: \$71 million disbursed out of \$3 billion for 8 countries with agreements (\$6 billion total to MCA)

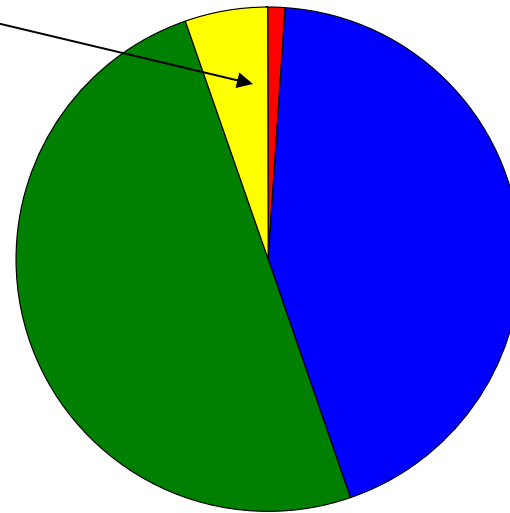




The Ronald Coase Institute

# New category created to “move the money”

13 “threshold  
countries”  
allocated \$310  
million





The Ronald Coase Institute

What can be done about  
damaging institutions?



Societies cling to blatantly  
damaging institutions  
even when faced with  
crisis, but...

Institutional frameworks  
do change



**Ideas and learning** are powerful forces in overcoming beliefs and norms that inhibit change in institutional frameworks (North)



Critical mass of well  
trained scholars in  
receptive circumstances  
(Shirley and Soto, 2007)



# Case studies

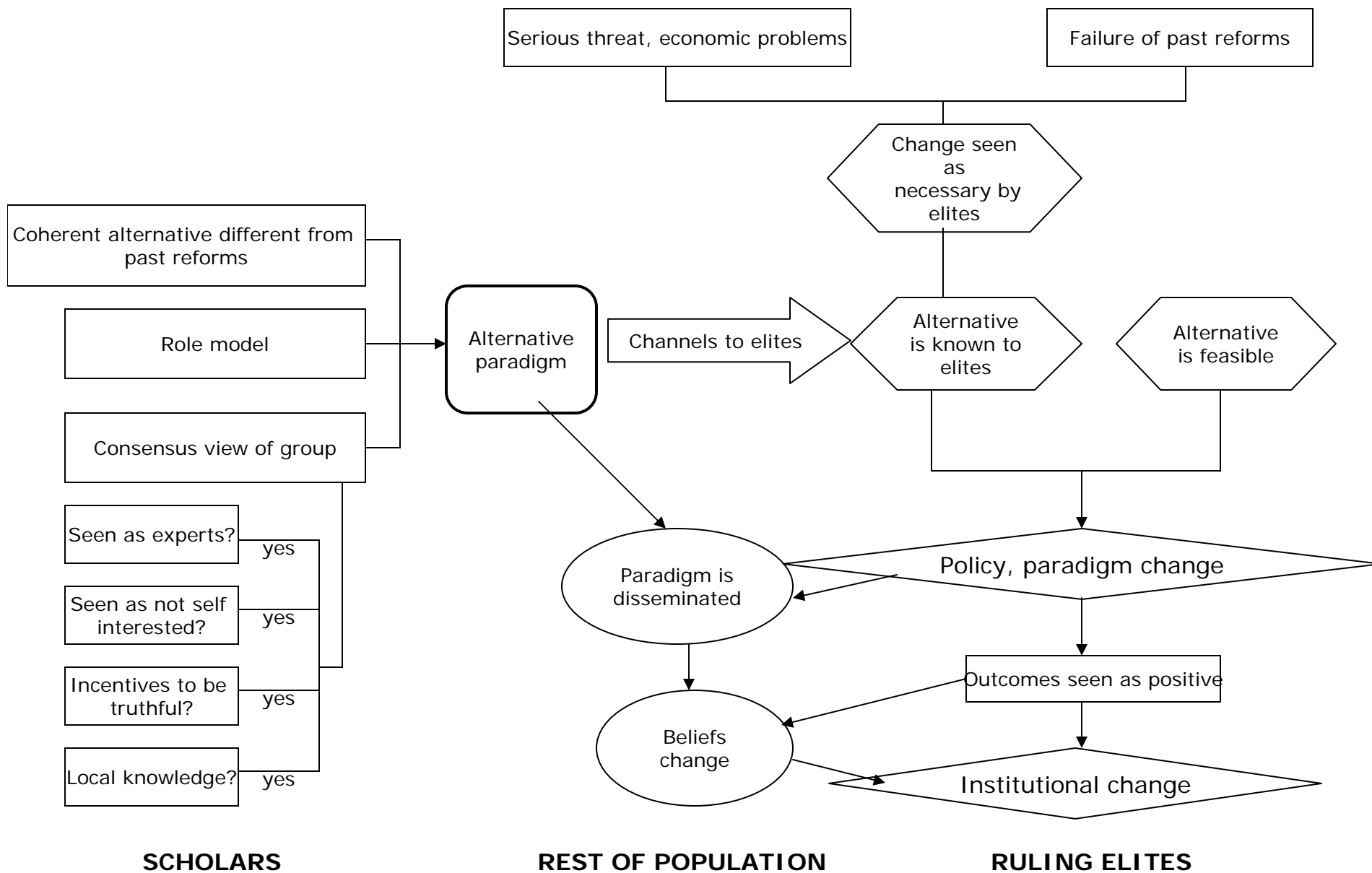
1. Chile: 1975
2. China: 1993
3. Korea: 1980
4. Taiwan: 1958-61/1986
5. Argentina: 1991
6. Indonesia: 1966/1983

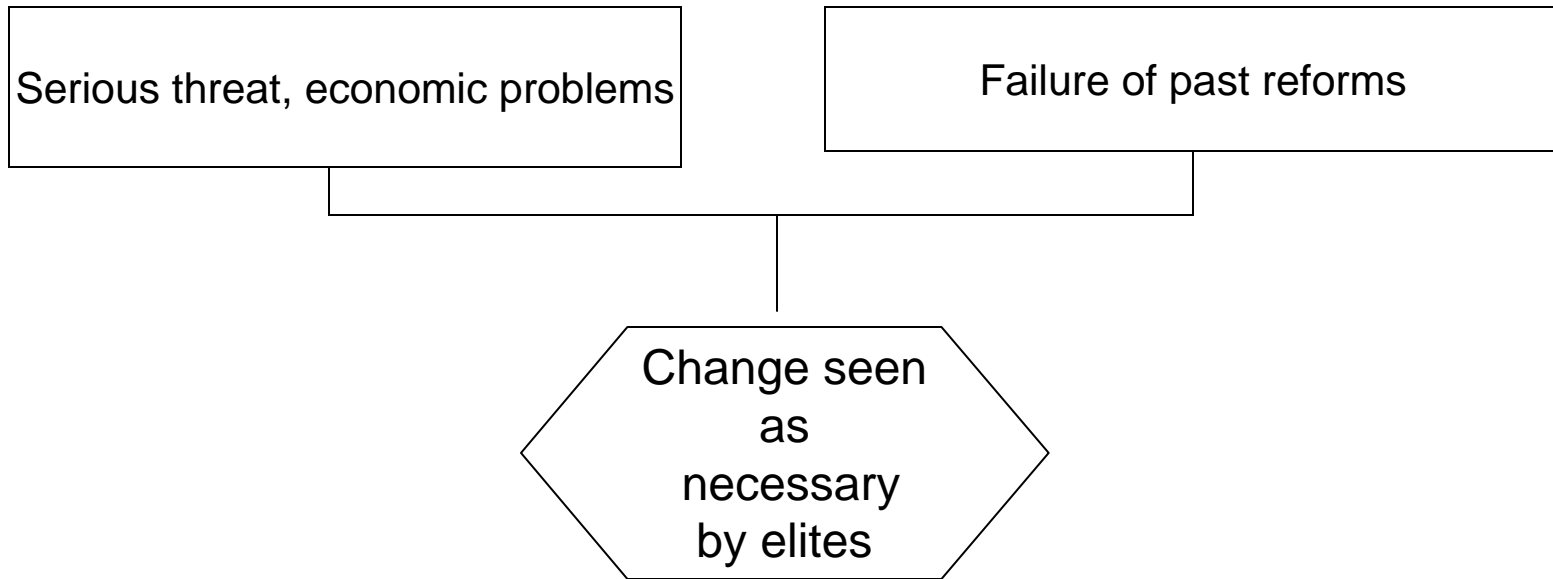


## Case studies

1. Chile: 1975 Chicago boys
2. China: 1993 "Socialist Market Economy"
3. Korea: 1980 EPB economists
4. Taiwan: 1958-61/1986 S.C. Tsiang, T.C. Liu, others
5. Argentina: 1991 Cavallo boys
6. Indonesia: 1966/1983 Berkeley mafia









The Ronald Coase Institute

## Scholarly group with alternative paradigm

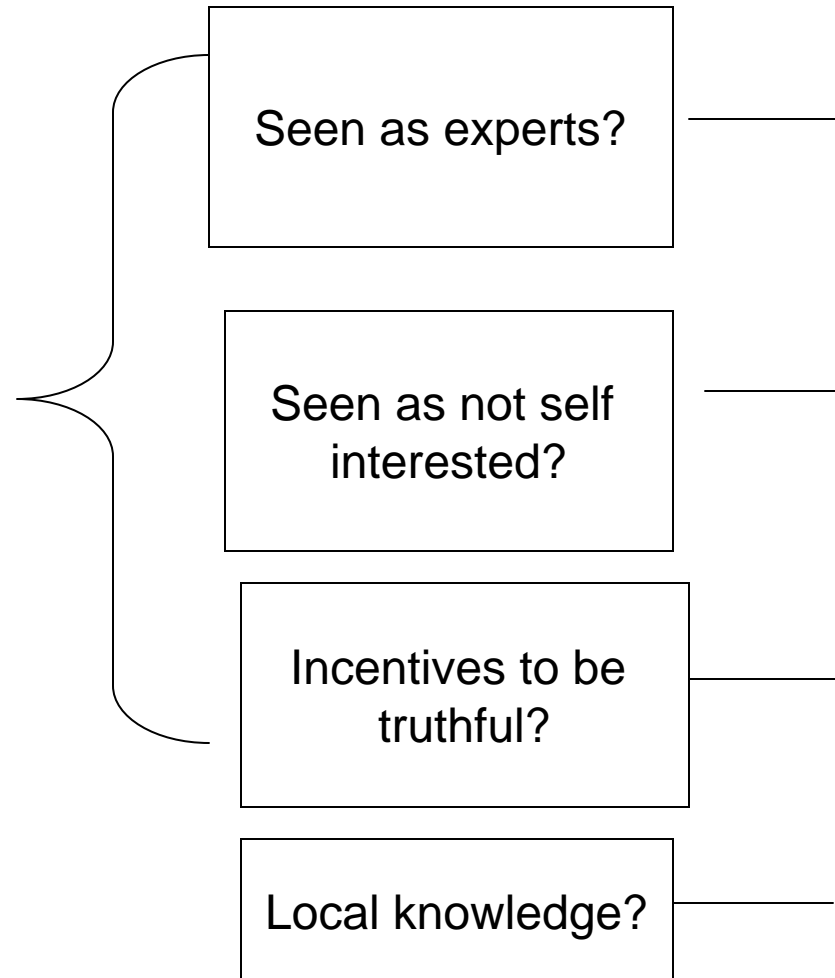
Coherent alternative different  
from past reforms

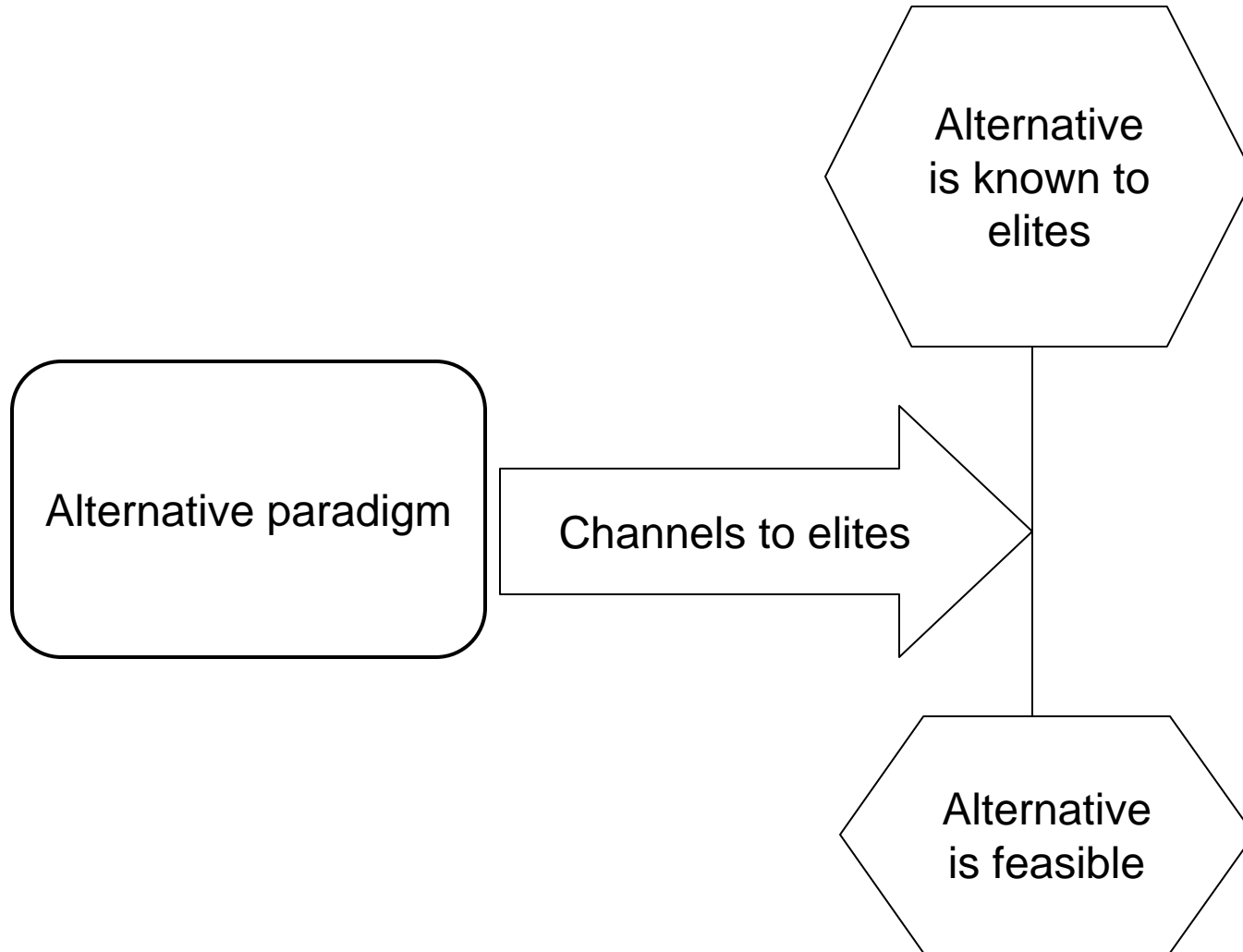
Consensus view of group

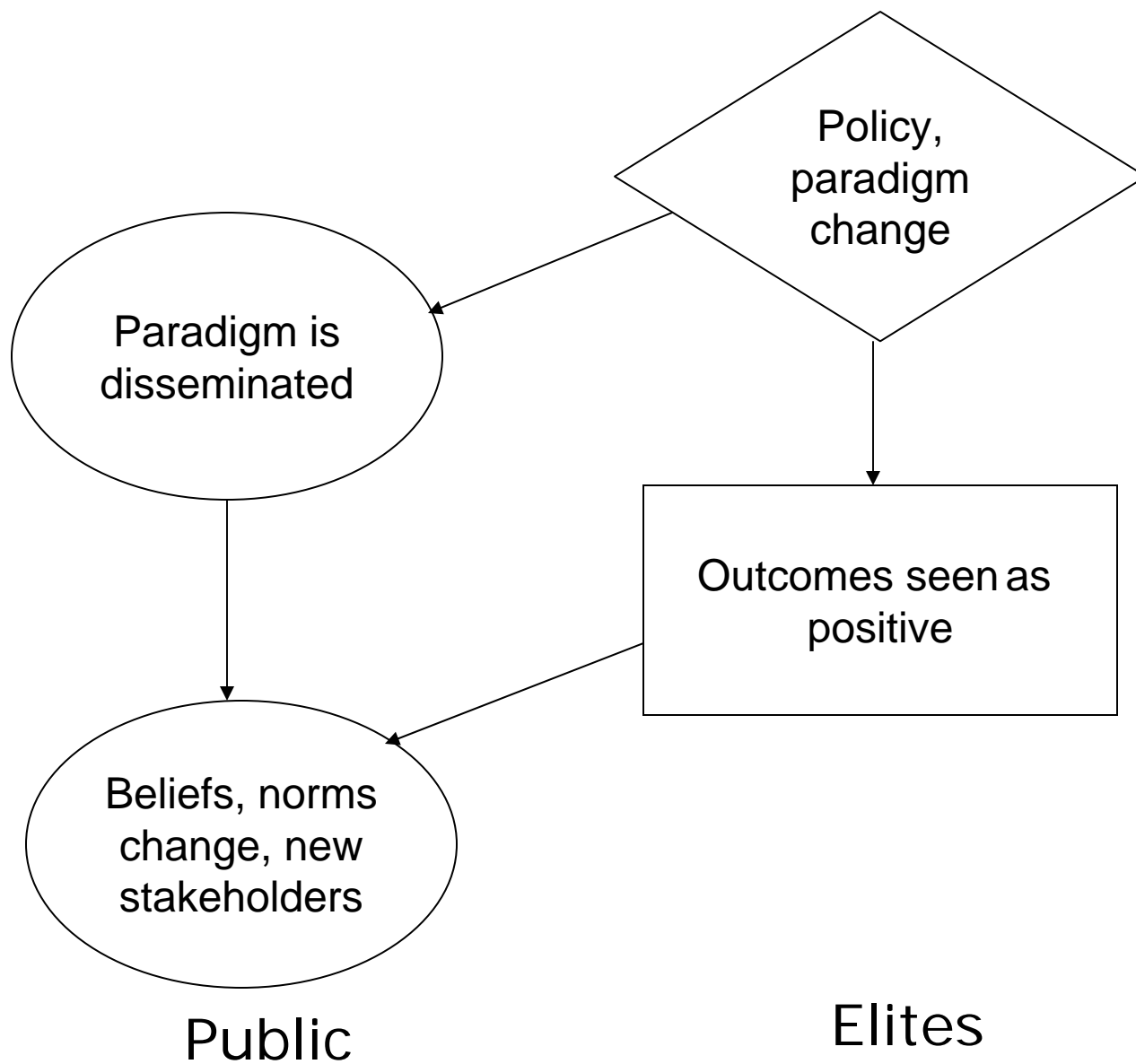


## Scholarly group with alternative paradigm

Lupia &  
McCubbins









## Scholars in receptive circumstances:

- **Identified** barriers to reform
- **Persuaded** policy makers to adopt new paradigms and policies
- **Informed** public debate, contributing to changes in beliefs



# Conclusion

- To develop countries need institutions that lower TCs and protect property and individuals





# Conclusion

- To develop countries need institutions that lower TCs and protect property and individuals
- Aid cannot strengthen – and may undermine – such institutions



## Conclusion

- To develop countries need institutions that lower TCs and protect property and individuals
- Aid cannot strengthen – and may undermine – such institutions
- Aid cannot avoid institutions



The Ronald Coase Institute

# Build Intellectual Capital

Local scholars provide ideas and analysis that can raise the potential for institutional change.





The Ronald Coase Institute

Find out more at [www.coase.org](http://www.coase.org)





## References

- Bauer, Peter (1991). *The Development Frontier: Essays in Applied Economics*. London: Harvester Wheatsheaf.
- Buchanan, James M. (1977). 'The Samaritan's Dilemma,' in *Freedom in Constitutional Contract*. James M. Buchanan ed. College Station: Texas A&M University Press.
- Burnside, Craig and David Dollar (2004). 'Aid, Policies, and Growth: Revisiting the Evidence.' World Bank Policy Research Working Paper 2834: Washington, D.C.
- Chen, Shaohua and Martin Ravallion (2004). 'How Have the World's Poorest Fared since the Early 1980s?' World Bank Policy Research Working Paper 3341: Washington, D.C.
- Djankov, Simeon, Jose Garcia Montalvo, and Marta Reynal-Querol (2006). 'The Curse of Aid.' Working Paper March, 2006. Available at SSRN:<http://ssrn.com/abstract=893558>.



- Easterly, William (2002). *The Elusive Quest for Growth. Economists' Adventures and Misadventures in the Tropics.* Cambridge, MA: MIT Press.
- Economides, George, Sarantis Kalyvitis, and Apostolis Philippopoulos (2004). 'Do Foreign Aid Transfers Distort Incentives and Hurt Growth? Theory and Evidence from 75 Aid-Recipient Countries.' CESifo Working Paper Series No. 1156: Munich.
- Heckelman, Jac and Stephen Knack (2005). 'Foreign Aid and Market-Liberalizing Reform.' 33. World Bank Policy Research Working Paper 3557: Washington, D.C.
- International Monetary Fund (2005). *World Economic Outlook, September 2005: Building Institutions.* Washington, D.C.: International Monetary Fund.
- Kanbur, Ravi (2000). 'Aid, Conditionality and Debt in Africa,' in *Foreign Aid and Development: Lessons Learnt and Directions for the Future.* Fred Tarp ed. London: Routledge.
- Knack, Stephen (2000). 'Aid Dependence and the Quality of Governance: A Cross-Country Empirical Analysis.' 38. World Bank Policy Research Working Paper 2396: Washington, D.C.



The Ronald Coase Institute

Kaufmann, Daniel and Aart Kraay (2002). 'Governance Indicators, Aid Allocation, and the Millennium Challenge Account.' The World Bank Institute Working Papers Series: Washington, D.C.

Millennium Challenge Corporation (2006). 'Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in Fy 2006.' September 8, 2006, available at: [www.mca.gov/about\\_us/congressional\\_reports/FY07\\_Criteria\\_Methodology.pdf](http://www.mca.gov/about_us/congressional_reports/FY07_Criteria_Methodology.pdf).

OECD, DAC (2009). 'Statistical Appendix of the 2008 Development Cooperation Report.' OECD, DAC available at [www.oecd.org/dac/stats/dac/](http://www.oecd.org/dac/stats/dac/): Paris, France.

Ostrom, Elinor, Clark Gibson, Sujai Shivakumar, and Krister Andersson (2002). 'Aid, Incentives, and Sustainability: An Institutional Analysis of Development Cooperation.' Swedish International Development Cooperation Agency. SIDA Studies in Evaluation: Stockholm, Sweden.





- Rajan, Raghuram G. and Arvind Subramanian (2005). 'Aid and Growth: What Does the Cross-Country Evidence Really Show?' International Monetary Fund, Research Department Working Paper WP/05/127: Washington, D.C.
- Shirley, Mary M. and L. Colin Xu (1998). 'Information, Incentives and Commitment. An Empirical Analysis of Contracts between Government and State Enterprises.' *Journal of Law, Economics and Organization*, 14:2, pp. 358-78.
- Shirley, Mary M. and L. Colin Xu (2001). 'Empirical Effects of Performance Contracts: Evidence from China.' *Journal of Law, Economics and Organization*, 17:1.
- Shirley, Mary M. and Jessica Soto (2007). "When Do Local Economists Affect Institutional Change?" Unpublished working paper; see Shirley (2008) chapter 7.
- Shirley, Mary M. (2008). *Institutions and Development*. Cheltenham, UK and Northampton, MA: Edward Elgar, 2008).  
[http://www.e-elgar.com/bookentry\\_mainUS.lasso?id=12524](http://www.e-elgar.com/bookentry_mainUS.lasso?id=12524)





The Ronald Coase Institute

World Bank (2005). *Capacity Building in Africa. An OED Evaluation of World Bank Support*. Washington, D.C.: The World Bank, Operations Evaluation Department.

World Bank (various). *World Development Report*. Washington, DC: The World Bank.

Zou, Wei (2003) "The Changing Face of China's Rural Enterprises," *China Perspectives* #50, Nov. – Dec.