

Institutional Arrangements and Economic Growth

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What (almost) all economists agree on:

- The central importance of *economic growth* in determining economic performance (including poverty reduction) in the developing world
- The central importance of *domestic* policy choices in determining economic outcomes in the poor nations
- The central importance of a *market-friendly, outward-oriented, budget-balance-consistent* policy orientation in generating economic growth

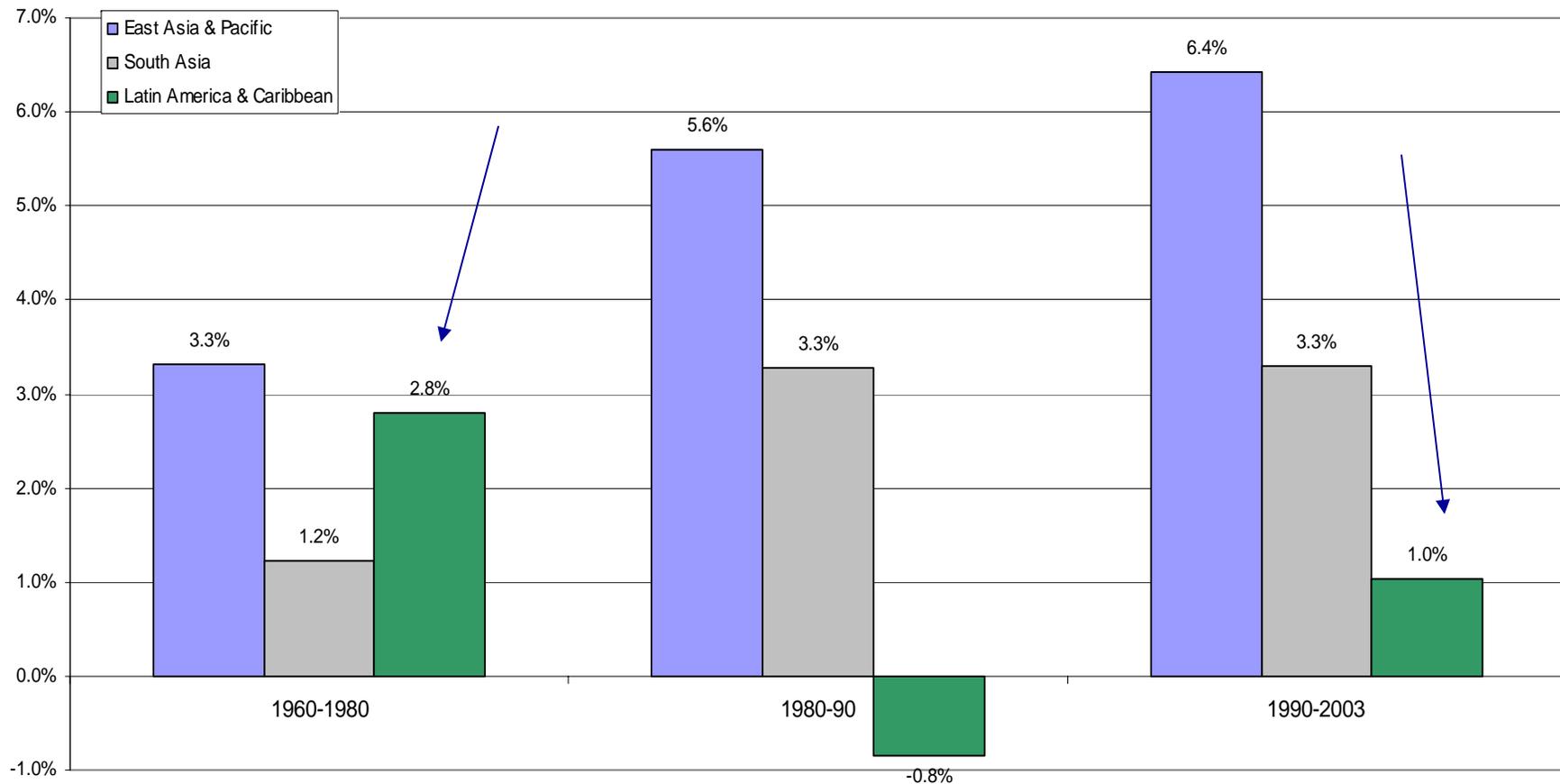
The challenge is to translate this into a concrete policy agenda

- And here the track record of the profession has not been outstanding

Puzzling economic outcomes:

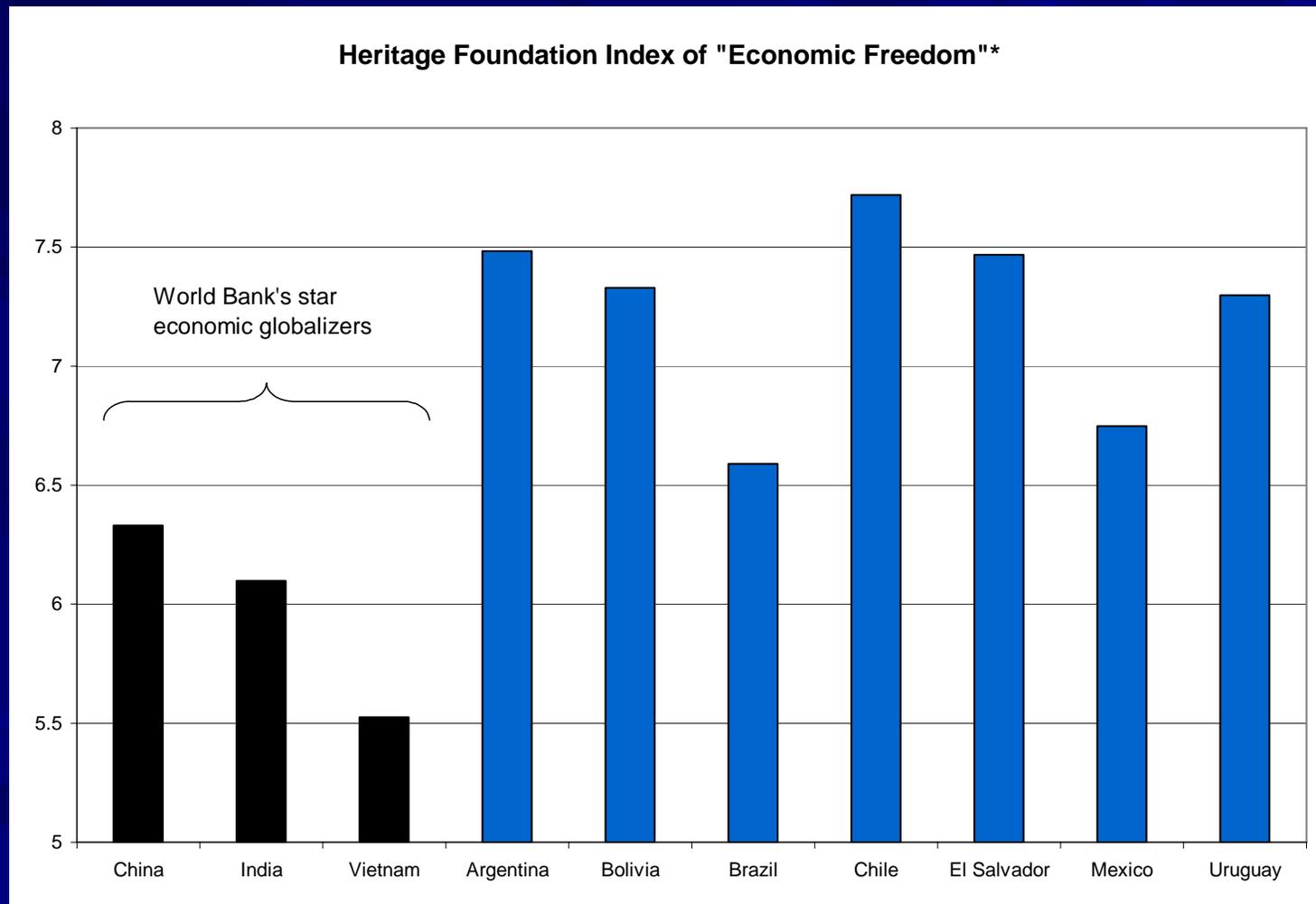
Exhibit 1: Countries that adopted the standard reforms have done poorly (measured against not simply other regions, but also their own past performance)

Economic growth across regions, by time periods



Puzzling economic outcomes:

Exhibit 2: Countries that have benefited the most from integration in the world economy are countries with non-standard policies



*The index is a composite quantitative measure of “the 10 key ingredients of economic freedom such as low tax rates, tariffs, regulation, and government intervention, as well as strong property rights, open capital markets, and monetary stability.”

Towards a resolution:

There are some general principles of “good policy”

All successful countries have

- provided effective property rights protection and contract enforcement
- maintained macroeconomic stability
- sought to integrate in the world economy
- ensured an appropriate environment for productive diversification and innovation
- provided effective prudential regulation of financial intermediaries
- maintained social cohesion and political stability
- ...

But these general principles do not map directly and uniquely into specific policies

Easier to specify *functions* that good institutional arrangements perform than it is to specify the *form* they must take.

“I would suggest that the rate at which countries grow is substantially determined by three things: their *ability* to integrate with the global economy through trade and investment; their *capacity* to maintain sustainable government finances and sound money; and their *ability* to put in place an institutional environment in which contracts can be enforced and property rights can be established. I would challenge anyone to identify a country that has done all three of these things and has not grown at a substantial rate.”

-- Larry Summers (2003)

Ability to do x, capacity to do y does not amount to a policy agenda.

The multiplicity of institutional forms: a Chinese counterfactual

problem

Low agricultural productivity

Private incentives

Fiscal revenues

Urban wages

Monopoly

Enterprise restructuring

Unemployment

solution

Price liberalization

Land privatization

Tax reform

Corporatization

Trade liberalization

Financial sector reform

Safety nets

And so on...

How China did it instead

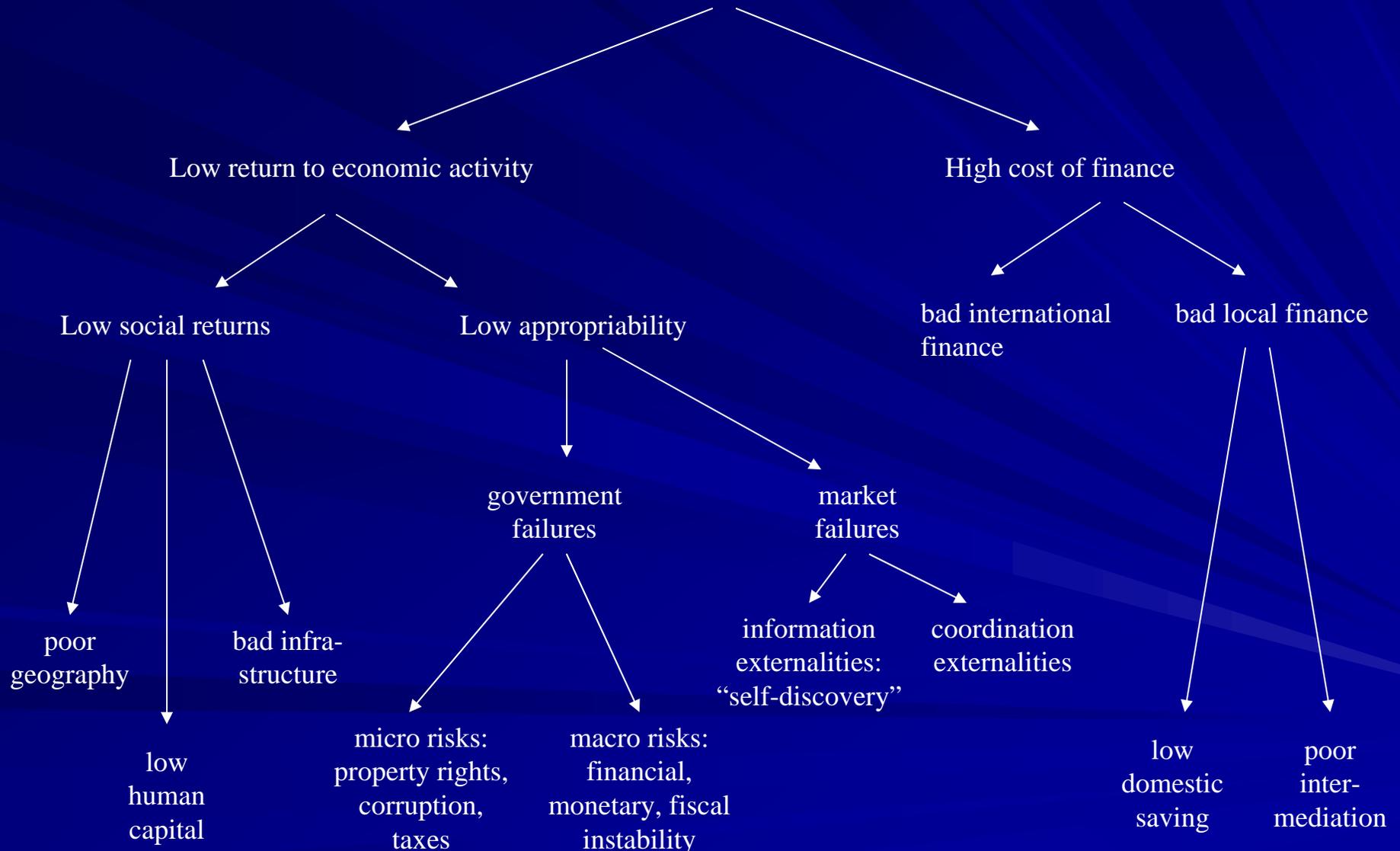
- Pragmatic, often heterodox solutions to overcome political constraints and second-best complications
 - Two-track pricing insulates public finance from the provision of supply incentives
 - Household responsibility system obviates the need for ownership reforms
 - Township and village enterprises provide effective control rights when courts are weak
 - Special economic zones provide export incentives without removing protection for state firms
 - Federalism, “Chinese-style” generates incentives for policy competition and institutional innovation

- Strategic and sequential approach targeting one binding constraint at a time
 - First agriculture, then industry, then foreign trade, now finance...

- Remaining institutional challenges
 - Especially with regard to political democracy and the rule of law

A diagnostic approach to stimulating economic growth

Problem: Low levels of private investment and entrepreneurship



General lessons

- Binding constraints to growth differ across countries and over time
 - clear evidence that growth is unlocked in a large variety of ways
 - different strokes for different folks: CHN was constrained by poor supply incentives in agriculture; BRA is constrained by inadequate supply of credit, SLV by inadequate production incentives in tradables, ZAF by inadequate employment incentives in manufacturing, ZWE by poor governance ...

- Relaxing binding constraints requires well-targeted reforms that are cognizant of prevailing second-best and political complications
 - selectivity instead of a laundry list
 - pragmatism in lieu of “best practice” and rules of thumb

- Over time, strengthening institutional underpinnings is critical
 - institutionalizing “diagnostics”
 - building resilience to external shocks
 - institutional reform is key, but to *sustain* rather than *ignite* economic growth