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SECOND-BEST INSTITUTIONS

Dani Rodrik

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Dani Rodrik, Harvard University and CEPR

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Centre for Economic Policy Research
90–98 Goswell Rd, London EC1V 7RR, UK
Tel: (44 20) 7878 2900, Fax: (44 20) 7878 2999
Email: cepr@cepr.org, Website: www.cepr.org

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ABSTRACT

Second-Best Institutions

The focus of policy reform in developing countries has moved from getting prices right to getting institutions right, and accordingly countries are increasingly being advised to move towards "best-practice" institutions. This paper argues that appropriate institutions for developing countries are instead "second-best" institutions - those that take into account context-specific market and government failures that cannot be removed in short order. Such institutions will often diverge greatly from best practice. The argument is illustrated using examples from four areas: contract enforcement, entrepreneurship, trade openness, and macroeconomic stability.

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Dani Rodrik
John F. Kennedy School of
Government
Harvard University
79 Kennedy Street
Cambridge, MA 02138
USA
Email: dani_rodrik@harvard.edu

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SECOND-BEST INSTITUTIONS

Dani Rodrik*
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The focus of reforms in the developing world has moved from getting prices right to getting institutions right. This reflects the recognition that markets are unlikely to work well in the absence of a predictable and legitimate set of rules that support economic activity and dispense its fruits. “Governance reforms” have become the buzzword for bilateral donors and multilateral institutions, in much the same way that liberalization, privatization and stabilization were the mantras of the 1980s.

But what kind of institutions should reformers strive to build? It is easier to list the functions that good institutions perform than it is to describe the shape they should take. Desirable institutions provide security of property rights, enforce contracts, stimulate entrepreneurship, foster integration in the world economy, maintain macroeconomic stability, manage risk-taking by financial intermediaries, supply social insurance and safety nets, and enhance voice and accountability. But as the variety of institutional forms that prevail in the advanced countries themselves suggests (Richard Freeman 2000, Peter Hall and David Soskice 2001), each one of these ends can be achieved in a large number of different ways (Dani Rodrik 2007).

Furthermore, developing nations are different from advanced countries in that they face both greater challenges and more constraints. That this may require “appropriate” institutions differing from those that prevail in rich countries is an old theme that goes back at least to Alexander Gerschenkron (1962). This theme has been picked up in a number of recent analyses. For example, Daron Acemoglu *et al.* (2006) argue that countries that are distant from the global

* John F. Kennedy School of Government, Harvard University, Cambridge, MA 02138 (dani_rodrik@harvard.edu).

technology frontier, and where the main challenge is stimulating investment rather than innovation, may benefit from institutional arrangements that privilege incumbent firms over entrants because these generate the rents that finance the requisite investments. Yingyi Qian (2003) has ascribed China's success to the adoption of a variety of transitional and heterodox institutions that managed to provide efficient incentives while maintaining the rents of those who are politically powerful. Avinash Dixit (2004) has argued that self-enforcing governance arrangements can be more efficient than formal institutions in early stages of economic development in light of the large fixed costs of setting up the latter. Simeon Djankov *et al.* (2003) conceptualize institutions as a spectrum that runs the full gamut between private ordering (with no room for public enforcement) to state ownership (with no room for private enterprise), and argue that the appropriate choice depends on a society's initial conditions.

Yet this literature appears to have had very little impact on operational practices. The type of institutional reform promoted by multilateral organizations such as the World Bank, IMF, or the World Trade Organization is heavily biased towards a best-practice model. It presumes it is possible to determine a unique set of appropriate institutional arrangements *ex ante* and views convergence towards those arrangements as inherently desirable. One of its apparent virtues is that it enables cross-national comparisons and benchmarking: institutional performance can be measured by, say, counting the number of days it takes to register a firm in different countries or settle a commercial dispute in courts. This approach is grounded in a first-best mindset which presumes the primary role of institutional arrangements is to minimize transaction costs in the immediately relevant domain--without paying attention to potential interactions with institutional features elsewhere in the system.

I shall argue that dealing with the institutional landscape in developing economies requires a second-best mindset. In such settings, a focus on best-practice institutions not only creates blind spots, leading us to overlook reforms that might achieve the desired ends at lower cost, it can also backfire. I will elaborate on this point using illustrations from four areas: contract enforcement, entrepreneurship, trade openness, and macroeconomic stability.

I. Courts and contract enforcement

Consider the legal environment in which firms operate in most countries of Sub-Saharan Africa. Even though there are commercial laws on the books that govern the settlement of contractual disputes, courts are highly inefficient, costly to use, and potentially corruptible. Firms therefore rarely resort to them in practice. When Ghanaian firms were asked whether they would go to court following a dispute with a supplier or a client, fewer than 10 percent answered in the affirmative (Marcel Fafchamps 2004, Table 4.5). Lacking legal recourse, firms resort instead to relational contracting: they build long-term, personalized relationships with their suppliers or consumers, and sustain cooperation through repeated interaction. In addition, they screen potential business partners by gathering information about them, inspect goods on delivery prior to payment, and are often willing to renegotiate when contract terms are not fulfilled (Fafchamps 2004).

This brief description of the contracting environment suggests that a weak judiciary imposes significant costs on doing business in Africa. It is only one short step to conclude that a package of judicial reforms—aimed at strengthening the capacity, autonomy, and honesty of courts—is an important priority for the region.

But now consider the situation in Vietnam, where the private sector has been booming and the economy has been growing at 8 percent a year. The legal environment is, if anything, in worse shape there than it is in most of Africa. In their surveys of firms, John McMillan and Christopher Woodruff (1999) found that there was little confidence in the courts and very little resort to them. Firms relied instead on relational contracting, just as in Africa. The strategies were in fact quite similar: build long-term relationships based on trust, demand immediate payment, screen out unreliable firms, and renegotiate when things run into trouble.

Why is relational contracting able to sustain so much more economic activity in Vietnam than it does in African settings? I don't know. But we can nonetheless draw some implications from this comparison. First, even if the formal system of contract enforcement is weak, the contracting environment can still be conducive to high growth in the presence of informal substitutes. Obviously, the legal system has (so far) not constrained the growth of Vietnam's private sector. Second, the knee-jerk reaction that the apparent weakness of courts in Africa requires an immediate remedy in the form of judicial reform may well be misplaced. Since relational contracting in Africa has so many of the same features of that in Vietnam, perhaps it is not the inadequacies of the legal system that constrains Africa's growth either.

Third, and more intriguingly, an effort to strengthen judicial (third-party) enforcement can easily do more harm than good in the presence of relational contracting. Imagine that some of the firms begin to think that they can rely on courts and therefore don't care about the reputation of the suppliers that they work with. Since suppliers that cheat now have an improved outside option, the discipline that prevents opportunistic behavior in relational contracts is undermined (Dixit 2004, chap. 2). This raises transaction costs for firms that continue to regard courts as ineffective.

Thinking in these second-best terms also suggest avenues of reform that may have been easily overlooked. Perhaps it is more effective to enhance relational contracting—for example by improving information gathering and dissemination about the reputation of firms—than to invest (at the current stage of a country’s development at least) in first-class legal institutions. Perhaps early efforts at reforming formal contract enforcement institutions should focus on specific categories of firms that do not have access to relational contracting—foreign firms or new firms—instead of targeting all firms across the board.

II. Entry regulations and entrepreneurship

Entrepreneurship can be suppressed for a variety of reasons. Entry costs may be high, property rights may not be well protected, the contracting environment may be poor (either because relational contracting does not work well or the courts are ineffective), or the perceived returns may be low. The World Bank’s Doing Business Surveys and Investment Climate Assessments focus on some of these impediments while neglecting others, potentially skewing institutional reform strategies. In particular, costs associated with the regulatory and legal regimes figure prominently, while costs relating to relational contracting or market imperfections are entirely absent.

Consider entry regulations. Licensing and registration requirements that raise the cost of entry reduce competition and generate rents for incumbents. In one view the world, this is an unmitigated bad because it generates static inefficiencies and possibly also undermines productivity growth over time through the dynamics of entrepreneurial selection. In a first-best world, that would be the end of the story. But in a second-best world, rents can be useful to stimulate entrepreneurship. In fact, rents may well be a *necessary* condition for adequate levels of entrepreneurship to emerge in non-traditional economic activities.

This point is made in Ricardo Hausmann and Rodrik (2003) using a particular model of entrepreneurship that may be particularly relevant to developing countries. In this model, entrepreneurs provide a cost-discovery function: by engaging in new economic activities, they help map out the underlying cost structure of the economy, providing valuable information to other entrepreneurs about what can be produced profitably and what can not. This kind of informational spillover implies that the requisite level of entrepreneurship is generically under-supplied in competitive situations. In fact, under free entry, the incentive to engage in cost discovery is eliminated totally: if I discover, say, that pineapple canning is a profitable economic activity my profits are quickly socialized through imitative entry, while if I discover that it was a mistake to invest in that activity, I bear the losses in full. There needs to be some rents in equilibrium, maintained through entry restrictions or other means, for entrepreneurship of this kind to be provided at all. Bailey Klinger and Daniel Lederman (2006) provide some evidence that entry barriers may indeed promote new export activities.

More generally, rents play a useful role in sustaining long-term relational contracts of the sort discussed in the previous section. When entrepreneurs do not earn rents which they can share with their suppliers, they have no carrot with which they can induce “honest” behavior on the part of the latter. And when creditors earn no rents, they have little incentive to monitor borrowers and improve project selection (Thomas Hellman et al. 1997). The paper by Acemoglu et al. (2006) I referred to earlier emphasizes the growth-enhancing role of such rent-sustained relationships early in the development process. In all these settings, a moderate amount of entry restrictions helps because foregone efficiency gains are more than offset by improvements in dynamic incentives.

These considerations suggest that a single-minded effort to reduce entry regulations may not only fail to produce the intended effects, it can also backfire when the binding constraint is expected returns that are too small rather than inadequate competition. Appropriate reform strategy requires having a good fix on the binding constraint.

III. Import liberalization and global integration

Suppose you want to open yourself up to international trade and integrate into the global economy. The textbooks (and the WTO) suggest you accomplish this by eliminating quantitative restrictions and other administrative measures on trade and by lowering your import tariffs.

But a striking feature of the global experience with trade liberalization over the last half century is that the most successful globalizers among developing countries adopted institutional arrangements that look quite different. South Korea and Taiwan instituted a regime of export subsidies in the 1960s, highly differentiated by product and targeted at non-traditional exports. Southeast Asian countries like Malaysia and Thailand relied heavily on export-processing zones, as did Mauritius, a rare African globalization success story. China relied on a combination of export incentives and Special Economic Zones. In none of these countries did tariff cuts on imports play a significant role in fostering outward orientation early on. Chile is perhaps the only case that fits what most economists and policy advisers would consider “best-practice” in trade liberalization.

What is going on here? One could argue that the manner in which outward orientation is achieved is immaterial since export promotion is the same as import liberalization (thanks to the Lerner symmetry theorem). But this argument overlooks the highly specific nature of the export incentives provided by the Asian countries, and in any case only further highlights the puzzle of why these countries did not choose the much simpler route of import liberalization.

An important feature of these alternative paths to global integration is that they generate supply incentives at the margin for new tradable activities, without removing protection for existing activities. That in turn has two advantages, one having to do with efficiency and the other with political economy. The efficiency reason is that the Asian model of liberalization protects employment in the transition to the new long-run equilibrium. When new export oriented activities are slow to arise—due either to overvalued exchange rates or to market failures that hinder supply incentives for non-traditional products—import liberalization may result in workers in previously protected industries being displaced and transferred into even less productive activities such as informality or unemployment. Indeed, Latin America's poor economy-wide TFP performance and its expanding informality during the 1990s can be ascribed in part to the conventional program of import liberalization that was administered in the region. Export subsidies, EPZs, and SEZ instead create new opportunities at the margin, while minimizing the squeeze on import-competing activities.

The political economy advantage is now easy to see. The sequential, marginal nature of the Asian model of liberalization blunts the adverse impact on the firms in import-competing sectors and therefore removes an important obstacle to trade reform. For example, the Mauritian EPZ enabled an export boom in the midst of a highly protected domestic economy and despite the political power of import-substituting industrialists who would never have allowed across-the-board import liberalization at the time.

The lesson here is that a particular economic objective—outward orientation—can be achieved through a number of different institutional designs, and sometimes it is worth doing things in an unorthodox, round-about way if this will serve to relax other constraints elsewhere in the system.

IV. Credibility of monetary policy and economic performance

One of the most striking institutional innovations in the developing world in the last two decades has been the spread of independent central banks operating under strict rules. Given the experience with high inflation and macroeconomic instability in the 1970s and 1980s, it is easy to understand the appeal of these reforms. Central bank independence removes monetary policy from the day-to-day control of politicians and therefore enhances credibility of anti-inflationary policies. Along with much improved fiscal policies, it has no doubt contributed to the return of macroeconomic stability in Latin America and other parts of the world suffering from high inflation. Together with inflation targeting and flexible exchange rates, it now defines the best-practice in monetary policy towards which the IMF goads countries under its influence.

But such institutional arrangements begin to look like a worse bargain when low inflation is no longer the over-arching goal of monetary policy, and in particular when currency competitiveness becomes a serious concern. The cross-country evidence is highly suggestive with regard to the growth benefits of currency undervaluation (Rodrik 2008), and it is telling that few of the central banks in Asia are independent. As many governments are finding out, it is very difficult to get the central bank to respond to currency concerns when it has been locked into a price-stability objective and when its responsiveness to the government has been diminished through independence.

Argentina's convertibility experiment during the 1990s illustrates in extreme form both the benefits and costs of institutional lock-in. The convertibility law was an ingenious institutional innovation through which the government was able to relax the most binding constraint at the time: the lack of policy credibility on the monetary policy front. The plan worked as long as the constraint remained unchanged. But once the binding constraint became

lack of competitiveness, following the Asian financial crisis and the Brazilian devaluation in particular, rigid rules that prevented currency depreciation became the problem rather than the solution. Ultimately, neither convertibility nor central bank independence survived the ensuing crisis. As Alejandro Neut and Andres Velasco (2003) show, pre-commitments can actually undermine credibility when unforeseen circumstances render flexibility desirable ex-post.

The lesson here is that institutional rigidity pays off when lack of credibility and time inconsistency are the main problems of the day, but that it can eventually become a drag on growth. No single set of best practices will serve the needs of all countries at all times.

V. Concluding remarks

Governments can learn a lot by looking at what works and doesn't in other settings. Codifying this experience is no doubt a useful exercise. But real-world reformers operate in a second-best environment of their own, which means they need to keep an eye on how proposed solutions affect multiple distortions. Sometimes binding constraints will lie elsewhere and they need to guard against adverse interactions with other distorted margins. At other times, there will be multiple ways of removing a constraint, some of which may be politically much more feasible than others. Finally, the nature of the binding constraint will change over time, requiring a change in focus as well. Best-practice institutions are, almost by definition, non-contextual and do not take account these complications. Insofar as they narrow rather than expand the menu of institutional choices available to reformers, they serve the cause badly.

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