Economic Convergence: The Role of Institutions and Developed Countries

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Institutions undoubtedly play an important role in shaping an economy's growth prospects as they meander through economic development and the turmoils that accompany such evolution. Faria poses a simple question; what are institutions? This lays the foundation of this paper. It is from this simple question that identifies a success-harbouring institution. Democratic systems are discussed as a key element in promoting economic development. This ideology is then employed within the scope of EU institutions, and how such institutions have nurtured developing economies to bridge the disparities between nations in the bloc. Lastly, the failings of monocropping are discussed and how the developed world has shaped institutions in the developing world, for better or for worse.

I. Introduction

The role of institutions in economic development is a topic that has been discussed extensively in modern academic literature. Neo-classical economic theories have been replaced, such as the Harrod-Domar model of economic growth, which neglected a vital element; the importance of both formal and informal institutions that structure human interaction (North, 2003). These earlier models assume that functioning institutions do exist, which underpin all economic activity. Often, this is not the case in developing countries. This essay will focus primarily on the impact that institutions have on economic growth, examining; what institutions are, what determines whether institutions are 'good' or 'bad' and how these social and political infrastructures have developed in a historical context. Further, the influence that developed countries have had on institutional change in the developing world is discussed.

Literature focusing on explaining what institutions are, the key characteristics that strong institutions show and the influence of these on economic and social outcomes will be reviewed first. Following this, we will assess the impact of of the introduction of EU institutions to new members and look at why these may or may not have produced favourable outcomes. This case study will focus on Ireland and Portugal's development since joining. Discussion of the development aid given to Less developed countries (LDCs) will follow this European example, centring the analysis on the dos and don'ts of aid delivery and the key institutional factors in this equation. Finally, the actions of developed countries will be scrutinised, as we look at how a better understanding of institutional development is needed in order to improve aid efficiency and how we can modify our aid delivery to produce more favourable outcomes, before offering some concluding insights.

II. Literature review

What are institutions? Some philosophers, such as the architect Louis Kahn discuss in abstract terms the idea of institutions, suggesting that they exist to serve our very human will to be and to express (Lobell, 1979). Yet, he defines the "Houses of Institutions" as integral to societal function in the making evident this yearning, through the built environment. In our cities - the most advanced and complex expression of human endeavour - the silhouettes of Temples (the minaret of the Mosque/ the spire St. Patrick's Cathedral), Courthouses (the Four Courts), Universities (Trinity College), Stadia (Landsdowne Road), Financial Control (the Customs House), all delineate the functioning of a particular society and reinforce its workings. However, for this discussion, we will take a more formal, economic definition. Dani Rodrik, in his 2000 article "Institutions for high-quality growth: what they are and how to acquire them", gives a broad definition of institutions, as "a set of humanly devised behavioural rules that govern and shape the interactions of human beings". Taking these ideas, we can begin to understand the importance of institutions in determining economic outcomes, working as a sort of intermediary to reduce the costs (both monetary and non-monetary) of operation in all sectors of society, such as politics and business, but also education and more informal aspects of society. Institutions exist to reduce uncertainty. They provide a set of rules, both formal and informal (which may not always be easily defined) that incentivise and disincentivise certain behaviours, and if these institutions are suited to the environment, they allow us to interact in a concerted way (North, 2003).

When looking at literature on institutional development, it's evident how important they are in achieving sustainable growth. Hall and Jones' (1999) highlight the vital role institutions play in determining the long-run growth rates of an economy and explains that output per worker is to a great extent driven by institutions and social infrastructure. These ideas are reinforced by Cavalcanti and Novo (2005) who suggest that on average, in any developing economy a 1% improvement in institutions (measured using institutional indexes) will lead to more than a 5% increase in output per worker. These papers show just how fundamental institutions can be in achieving economic convergence in developing countries.

It is certain that stronger institutions will result in improved output, growth and economic outcomes. However, achieving these effective institutions has proved difficult for many economies. In order to comprehend how we can achieve this; we must first discuss what makes a 'high-quality institution' and which are the most important for growth. Rodrik (2000) outlines these as regulatory institutions, institutions of macro stabilisation, social insurance and conflict management. And, arguably most importantly, property rights. It seems quite intuitive that these institutions are needed to prevent fraud, protect control of returns to economic activity and promote social cooperation and trust. These are institutions that we can see clearly in almost all high functioning, efficient economies, but are often non-existent in less developed countries.

III. Participatory institutions

What are the factors that determine whether institutions form to promote or restrain economic development? Both Evans (2004) and Rodrik (2000) agree that participatory regimes are key in delivering strong institutions. That is to say that engagement in political discourse and the exchange of ideas in the public domain is a vital component of institutional development, so we should look to foster institutions that promote and improve individual's ability to choose. Democratic systems are shown to yield higher growth, more stable outcomes and improved wealth distribution, and an association between political participation and wages can be shown throughout the economy.

One example we can take is Porto Alegre in Brazil, where a deliberative democracy, in which citizens were given direct influence over decision making at a regional level, was introduced in 1989 in order to counter corrupt allocation of funds. In this example, we can see the positive impacts of increased political participation. Despite remaining growth neutral, the regions in which this deliberative regime was introduced showed major improvements in public services and infrastructure, higher human development and also gave those who partook in discussions financial and debating skills that they likely would not have otherwise acquired. These positive, real-world results show how participatory institutions can create an improved climate for development, giving non-elites a level of control over institutions and how resources are distributed. Alongside this, Porto Alegre is recognised as one of Brazil's greenest cities. It has seen improvements regarding environmental protection and sustainability practices, such as the city's particularly efficient public transport system. Protecting the environment and reducing our carbon footprint is one of, if not the greatest challenge facing society today, and one that in many ways global capitalism is failing to address ((Friant, 2019). Given that this has taken place in Brazil, a country notorious for corruption and political backwardness, the potential benefits of deliberative democracy in developing countries with similar issues are plain to see.

IV. EU Institutions

One way in which we can observe the direct impact of institutions on emerging economies is by looking at the development of smaller EU nations since they have joined. By joining the EU, a country is provided with membership

to strong, well established international institutions such as the ECB, the European Court of Justice and the European Parliament to name a few. Given the above discussion, access to these institutions should in theory give rise to improved economic growth and performance in new member states.
Ireland joined the EU alongside the UK in 1973, while Portugal joined later, with its Iberian neighbour, Spain in 1986. Both countries showed significantly lower levels of GDP per capita compared to the core European countries such as Germany and France prior to joining the EU. However, the rate at which they have converged to the European average has varied greatly, with Portugal remaining below the average still today. Of course, introduction into the European Union will have had immediate benefits for both countries economically and we see this particularly with the jump in Portugal's GDP in the years following 1986. The overall impact of European institutions will have taken time to become clear. Despite the influence of other factors, such as Ireland's favourable corporate tax rate that has attracted many of the world's largest multinationals to set up operations in this country, boosting employment and slightly inflating GDP figures, it is clear to see that EU membership and more specifically EU institutions have allowed for Ireland's output to grow almost exponentially through the 2000s and once again following the global financial crisis.

So how can we account for Portugal's sub-par growth trajectory compared to Irelands? Given that prior to becoming members of the EU both countries saw similar levels of per capita GDP, we should, in theory, expect to see similar progress from both countries, so why isn't this the case? Lains (2003) discusses how the overall influence of joining the EU on Portuguese growth was relatively small, pointing at investment in both human and physical capital as the main driver of growth around this period. Another analysis suggests that it is mostly institutional factors that have held back Portugal's long-run development, implying that Portugal has been unable to fully realise the potential benefits that EU institutions can offer (Amador, 2007).

V. Problems with 'Monocropping'

This brings us to the idea of Institutional monocropping, proposed by Evans (2004), which proposed the idea there is an 'optimal' way to organise our institutions to produce growth. That there is an ideal blueprint which can be followed and that we can expect the same results in different economies. This concept will be discussed further, particularly in relation to LDCs and the varying (mostly unsuccessful) results of simply importing an institutional blueprint and attempting to make these countries follow them. Returning to our discussion on Portugal, however, it seems clear that despite other factors at play, Portugal's economy and society has not been as suited to the European system as Ireland's. This is related, to a great extent, with Portugal's main industry being manufacturing of textiles and machinery, traditional areas that have not expanded greatly through technological progress, as well as the country's low capital to labour ratio (Amador, 2007). In comparison to Ireland, where progress has been facilitated through high levels of education, as well as the fact that Ireland is an English speaking country and its historic cultural ties (particularly with the United States), Portugal has been unable to welcome and develop new industries to the same extent. The main takeaway here is that what has worked in one country may not be as effective in the next. Understanding of local/ regional factors and the point at which an economy is at in its development is key when introducing new systems and regimes, and it seems that the European way of operating may not be entirely suited to Portugal, or at it has not enabled the Portuguese economy to flourish in the way it has for the Irish.

VI. Institutions and aid

Progressing our discussion, we can begin to look more specifically at the role played by institutions in the developing world and how we, as developed countries have influenced institutional development for better or worse in these countries, mostly through development aid. Before we discuss the interplay between institutions and aid, we must first look at the current state of global aid delivery and the factors that have historically reduced aid effectiveness.

In nominal terms, the level of Official Development Assistance (ODA) or aid has been increasing since the mid-nineteenth century, however, these figures did drop significantly following the global financial crisis. In Ireland, Irish aid (Ireland's official development aid programme) provided $976 (measured in 2018 USD) in developmental aid (which mainly focused on Africa), representing about .31% of GNI (OECD, 2020). Despite almost all developed countries across the globe allocating substantial sums of money to aid each year, the overall benefit of this to LDCs is still contested, with many authors arguing that aid delivery has generally been quite inefficient.

The way in which we deliver aid has been highly scrutinised, and in many cases fails to help the individuals towards whom it was initially directed. Inefficient aid delivery can occur for several reasons, the most prominent of which is the principal-agent problem. In democratic states, leaders and people in power are incentivised to deliver the aid that they receive to the intended beneficiaries as they need their support in order to remain in power. Unfortunately, it is often the case that poor countries, towards which aid is directed have the most undemocratic, corrupt regimes in place, and non-elites will have little to no political voice in these states. As such, ODA will often struggle to reach those who really need it. This is compounded by a total lack of transparency, both in the recipient country and sometimes in the donor agencies (in the form of a lack of data made publicly available), which prevents us from understanding how effective a given aid project is (Easterly & Pfutze, 2008). Other elements of aid delivery, such as avoiding these autocratic regimes and reduction in tied aid, food aid and technical assistance (which are considered the least effective aid channels) as well as increased aid specialisation to reduce transaction costs, must also be an area of focus for aid agencies if we wish to improve delivery (Easterly, 2007).

Research by Isham et. Al. (2005), which focused on the performance of aid-financed rural water supply projects, financed by varying donors in 49 LDCs across three continents, highlighted the important role that social and political institutions play in determining the success of aid projects, suggesting that favourable institutions have a significant impact on government efficacy. Analysis of aid projects financed by the World Bank agrees with this. It suggests that political institutions, particularly the civil liberties of citizens is a vital precondition for successful implementation of aid schemes, as it creates government accountability (Isham, et al., 1997). What does this information imply? Essentially, these studies show us that to achieve the most effective possible outcomes of aid delivery, we will need to offer it to countries that have strong enough institutions to make use of this monetary/non-monetary assistance. This poses a major problem, given that as previously mentioned, it is often the economies that need aid the most that will have the weakest institutions. How can we get around this issue? Should donors simply avoid giving aid to countries with sub-par institutions? This seems to be counterintuitive if the goal in aid delivery is to help with economic and social convergence of the worst-off. This suggests that we should first focus on helping to develop institutions in LDCs, so that future aid will be more effective. This has proven extremely difficult in practice and there are numerous examples where this has created unfavourable outcomes.

If we consider the failings of the Washington Consensus; a set of ten policy reforms proposed by British economist John Williamson in 1990 which focused heavily on institutional reform to harness the power of the free market in developing countries (Williamson, 2004). Mostly implemented in Latin America, the reforms were rushed and a period of significant and sustained economic turbulence followed in a number of these countries.

The Washington Consensus highlights the importance of understanding the factors at play that are specific to the economy where institutional change is needed and the major pitfalls of institutional monocropping and use of an institutional blueprint. It further reinforces the recommendations of Rodrik (2000, 2002) and Evans (2003) of promoting locally-driven, participatory institutions for stronger growth. Institutions are deep-rooted and not easily moved. Though maybe we can propose and build new formal institutions, it is the more informal norms and networks of power that will always govern how institutions function and these are significantly more difficult to see and understand, and as such, more difficult to modify. There is no cookie-cutter institutional framework that can be superimposed on any developing economy to promote growth and stability and make the country a stronger vehicle for aid.

Amongst these issues of institutional development, it is important to consider the biases in our perspective as developed countries and how much we know about optimizing these. Despite pushing for growth in LDCs, oftentimes the advice extended by international financial institutions are extremely biased towards an idealized neoliberal system, the benefits of which are highlighted policies and standards in place across LDCs, these countries should in principle increase their FDI attractiveness, be easier to trade with and in time reach similar levels of output as countries in the first world (Rodrik, 2002). The obvious bias in this sort of framework is that in turn, these institutions should benefit the developed economies, who will have new markets easily trade with, and often this is enforced through aid conditionality. As we have discussed, the reality is that this is seldom effective in practice. Following the failings of the Washington Consensus, an 'augmented' version of the paper was proposed, with a new and improved blueprint for LDCs to follow, highlighting just how little was learned about institutional development and the need for a total reshaping of perspective.

VII. Conclusion

Institutions are layered. Legislation designed to dictate behaviour and interaction often masks the reality that the informal will always hold power over societal outcomes. Change cannot blossom by imposing a template for individuals and the collective to follow. The restrictive approach used by international financial institutions in the past is clearly biased towards a neo-liberal approach; which suits the developed world. This has been shown to be an inefficient way to grow institutions. To promote institutional change that can truly improve outcomes both economically and socially and create institutions that are efficient in the local environment, a greater level of understanding of norms and mores, as well as trial, error and experimentation are necessary. Similarly, the failings of monocropping, and more specifically the success of participatory regimes also highlight issues we are still failing to deal with in the developed world, particularly in terms of climate change. The improvements discussed in Porto Alegre's level of climate action through deliberative democracy show how the developed world could learn in turn and benefit from allowing institutions to give people at all levels of society, not just the political elite, more of a voice in policy determination.

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