Policy for Development
Aims of Public Policy Lecture

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The tradition to thinking about public policy starts with the First Theorem of Welfare Economics.

There is an underlying equilibrium, characterized by preferences, technology, factor endowments, but something interferes with Pareto Optimality; monopoly, externalities, public goods and various types of market failures.

The presence of these failures motivates policy and, theory of the second best notwithstanding, it also gives specific ideas about what the policy should looks like – regulate the monopoly, tax the negative externality, promote competition, etc.

A vision brilliantly articulated by Francis Bator in his 1958 paper “The Anatomy of Market Failure” one of my favorite papers when I was an undergraduate at the LSE.
The Implicit Structure

- The underlying vision is one where all the basic elements are in place to generate efficiency, even prosperity since it is natural to associate this with an efficiency allocation of resources, but there are just a few problems.
- What are these elements?
- They are the familiar implicit structure of neoclassical economics: well defined and enforced property rights, markets and market processes, exchanges which are costlessly enforced etc.
- It’s clear that many societies don’t have these elements in place. (and Bator was well aware of this!)
Incomplete Property Rights in Colombia

Note: Proportion of land without formal title or registration. Average between 2000 and 2009.
Source: Instituto Geográfico Agustín Codazzi (IGAC).
The Northian Program

Implications for Policy?

- Douglass North developed an agenda that the real problems of development were not the type of market failures Bator identified, but failures in the institutional structures he assumed.
- Nevertheless, this led to a conceptual approach to policy that was not so different from that started by A.C. Pigou’s *Economics of Welfare*, culminating (via Paul Samuelson) in Bator’s great paper.
- Instead of focusing on solving problems of market failure, instead we focus on the underlying institutions: introduce well-defined property rights where none exist (Hernando de Soto, Erica Field), create institutions that can help guarantee the security of property rights.
- Indeed, the Colombian government’s “Rural Mission” has just this year announced the policy priority of giving every Colombian written title to their property.
Yet one of the implications of North’s work was is that it is likely that the institutional problems which North and his successors identified are part of an equilibrium which looks very different from that implicit in Bator’s model.

For example in his great book with Robert Thomas, *The Rise of the Western World*, North emphasized the political underpinnings of successful institutional change.

If institutions are a collective choice then this raises a set of policy issues which are more complex than just “give every Colombian written title to their property”.

So the policy implications might actually be rather different.
Policies and Institutions are Embedded in Society

- A more recent wave of research that has started to look beneath institutions and institutional failures and more squarely at society.
- This literature has taken issue with the model of human behavior that Bator assumed and instead borrowed from anthropology the idea that humans are embedded in societies with “culture” and behave pro-socially, exhibit trust towards each other, and cooperate in ways that are not individually rational with neoclassical preferences.
- Early evidence of this was provided by the ultimatum and dictator games and extended by trust and public goods games.
Many scholars who work in this tradition focus on the fact that these findings show that the traditional model of ‘homo economicus’ does not accurately describe how real people behave.

I think this is right, but I’d like to emphasize another aspect: it shows that we have to take seriously the notion of a ‘society’ of people with interlinked preferences and where the underlying nature of society, for example the extent to which people cooperate with each other and trust each other, might be critical to the overall functioning of the economy.

It is natural to model such a society in terms of a social network and network ideas have proved very fruitful in this context.
The Social behavior of US Senators and Cows

An Implication of the Networked World

Multiple Steady-States

- This literature is rife with strategic complementarities and contagion.
  - If your friends are obese, you are much more likely to be obese,
  - if your friend commits suicide, you are much more likely to do so,
  - but if you friends and happy, cooperative and trusting, then that spreads too.

- This suggests that there may well be multiple steady-state equilibria and that societies can get trapped into very inefficient equilibria.

- It is quite ironic that a literature motivated to show that individuals are much more cooperative and pro-social than ideas about “free riding” would imply, ends up positing a world that can be characterized by very inefficient equilibria.
The Moral Basis of a Backward Society

- This is certainly borne out by a great deal of ethnographic literature and it coincides with my personal experience in developing countries.
- Let me illustrate this with a famous example, Edward Banfield’s 1958 book *The Moral Basis of a Backward Society* which is an ethnography and theory of the poverty of a southern Italian village. Banfield says

  “This book is about a single village in southern Italy, the extreme poverty and backwardness of which is to be explained largely . . . by the inability of the villagers to act together for their common good . . . this inability . . . arises from an ethos – that of “amoral familism” – which has been produced by three factors acting in combination: a high death rate, certain land tenure conditions, and the absence of the institution of the extended family.” (p. 10)
Amoral Familism

- Banfield’s advanced the following hypothesis

  "The Montegranesi act as if they were following this rule: Maximize the material short-run advantage of the nuclear family; assume that all others will do likewise."

- Someone who behaves like this is an ‘amoral familist’.
- Banfield portrays Montegrano as trapped in a very inefficient low-level Nash Equilibrium (a bit like the Prisoner’s Dilemma).
- This non-cooperative behavior filters up to the way institutions work, particularly political institutions and the state.
These underlying social equilibria interact with institutions.

In Colombia they recently instituted a law to force Ministers to reveal their assets. They grudgingly produced declarations that are obviously false. When I asked one of my Colombian collaborators Leopoldo Fergusson, why nobody was complaining about this (e.g. the media) he replied

"tienen rabo de paja" (literally: “they have backsides of grass”).

The meaning of this (somewhat colloquial phrase!) is that nobody blames anybody else because everyone is guilty of something so you’d better shut up in case criticism comes back to bite you.

So there is an underlying social norm of keeping your mouth shut in case someone starts blaming you that makes the institutional change meant to improve transparency largely ineffective.
Changing the Equilibrium

Implications for Policy

- This research suggests that policy for development might not involve Bator style improvements on some basically functional equilibrium. It might involve actually moving the whole equilibrium.

- But maybe this is the same thing? Couldn’t it be that policies that improve locally on the efficiency of an equilibrium, are the same policies which help to push the equilibrium towards something much better?

- This is possible, but if you look at the litany of failures of “policy reform” you see that dysfunctional equilibria can be very stable to perturbations even if on their own these seem sensible policies.

- I will illustrate this with a couple of examples from my own research with Daron Acemoglu, Simon Johnson and Pablo Querubín (“When Does Policy Reform Work? The Case of Central Bank Independence” Brookings Papers on Economic Activity, Spring 2008, 351-417.)
The See-Saw Effect

The Case of Zimbabwe

Note: Annual Inflation Rate corresponds to the annual variation in the consumer price index reported in the International Financial Statistics (IMF). Vertical line shows the year of Central Bank reform taken from Polillo and Guillen (2005).
The See-Saw Effect

COLOMBIA

Annual Inflation Rate = 
Government Expenditure as % of GDP

ARGENTINA

Annual Inflation Rate = 
Government Expenditure as % of GDP
Perturbing Equilibria

- This stability of low-level equilibria is very different from the conclusions of a related literature which emphasizes how they are driven by ‘coordination failures’.

- Models of social interactions often have a “tipping point” property in the sense that there are multiple steady-states driven by some motive to conform to a particular social norm. If people can re-coordinate, it is easy to switch from an inefficient norm to a more efficient norm.

- One of the supposed social norms which fits this model is that of female genital mutilation (originally proposed by Gerry Mackie). Seems to be a clear example of socially inefficient norm.

- Yet the recent research shows that the distribution of this norm across villages in Sudan is not consistent with this model (though of course there could be a lot of heterogeneity driving this empirical pattern).

- Not much room for ‘nudges’!
A Tipping Point?

Charles Efferson, Sonja Vogt, Any Elhadi, Hilal el Fadil Ahmed and Ernst Fehr (2015) “Female Genital cutting is not a Social Coordination Norm,” Science, 25 September,
What are the Entry Points?

- So maybe we need new ways of thinking about how to disrupt low-level equilibria and push society to a different steady state.
- One thing we could ask ourselves is what sort of entry points there are and which might be the more effective. It could be that it’s more effective to try to change the way society works and then this will spread up to institutions or vice versa?
  - Evidence that creating institutions that induce cooperation then leave a legacy of cooperativeness when the institutions are removed (Peysakhovich and Rand (2016) “Habits of Virtue,”)
  - Evidence that cooperative behavior spreads in networks (Fowler and Christakis (2010) “Cooperative behavior cascades in human social networks,”)
  - Targetting influential people in networks helps to spread particular forms of behavior (Kim, et. al. (2015) “Social network targeting to maximise population behaviour change,”)
- Most likely, one has to work on all margins at the same time.
Let me use an example of successful institutional and social change to discuss this: the transition of the US South. I’ll do this through the lens of Gavin Wright’s great book *Sharing the Prize*.

In the 1940s the US South was poor, with intense discrimination and segregation (lack of cooperation?), history of underinvestment in public goods, low urbanization, backward industry.

Transformed by: collective action of the Civil Rights movement, out migration of African Americans, and technical change (mechanization of cotton picking). It also came in the context of outside enforcement of institutional changes by the federal state: Brown versus Board of Education, US Marshals enforcing desegregation.
The Convergence of Black Wages

![Graph showing the convergence of Black wages in different regions from 1950 to 2000.](image)

Figure 4.5 Median black male income by region, 1953–2000.

Figure 4.6 Median male income in the South by race, 1953–2000.

“Laws and force cannot change a man’s heart”

- So said President Eisenhower in the context of Brown versus Board of Education. But they did...
- As Martin Luther King Jr. put it

“It may be true that the law cannot change the heart but it can restrain the heartless.
It may be true that the law cannot make a man love me, but it can keep him from lynching me and I think that is pretty important, also.”

- Role of outsiders, like Gavin Wright and Dr. Richard L. Pearson, in shifting the equilibrium.
Pareto Improving?

- Return to Gavin Wright's title: *Sharing the Prize*.
- It’s pretty easy to be skeptical that development is Pareto improving.
- Different social equilibria no doubt have important consequences for distribution and under-development is not just a big coordination failure, people benefit from low-level equilibria.
- I think that’s right locally, but as one Mexican businessman said to me

  “leave aside Carlos Slim, who do you think is richer, a Mexican monopolist or the guys running Samsung and Hyundai? How rich do you think you can really get with the beer monopoly in Yucatan?”
A lot of work on the political economy of development, including my own, emphasizes a lot the political economy of domestic equilibria.

Though in principle foreign aid etc. can create incentives to change this I think the evidence largely shows that such aid has been ineffective in promoting development.

Countries that have grown rapidly in the last 50 years, Botswana, China, India, Mauritius etc. have done so because their domestic political equilibrium changed.
A Role for Outsiders

- But the evidence I discussed today also emphasizes the role of outsiders. As Banfield pointed out when considering how Montegrano might change

“Clearly a change in ethos cannot be brought about by the deliberate choice of the people of Montegrano. It is precisely their inability to act concertedly in the public interest which is the problem” (p. 164)

- Recall the role of outsiders in changing the US South.
- A folk wisdom amongst trade union activists seems to be that firms never spontaneously unionize. Unionization needs to be precipitated from outside to disrupt the existing equilibrium in the firm.
A New View for Development Policy

- So if you think about under-development as being caused by societies being trapped into dysfunctional equilibria the right way to think about development policy is in terms of what interventions are needed to move from one equilibrium to another.

- There is an affinity with early models of development in the 1950s, for example Myrdal’s 1957 *Economic Theory and Underdeveloped Regions* which also viewed poor societies as trapped in low-level equilibria, but the mechanisms I have discussed today and the likely solutions are radically different.

- This is not the way that development policy has been or is considered, which is more like Bator’s model.

- The argument is that development policy should look more like the role of outsiders in the changing of the South or trade union activists unionizing a firm.
A Final Radical Thought

- At this point we’ve moved along away from Bator’s influential synthesis of the motivations for public policy.
- I argued that one may have to think very differently about policy if you are trying to change the equilibrium in an under-developed country.
- It may also be the case that if you can induce a transition to a better equilibrium then policy will to an extent take care of itself because the basic structure of incentives and feedbacks from society are highly functional.
- I hesitate to push this claim however speaking in a city where the murder rate has increased by over 50% this year!