

Government

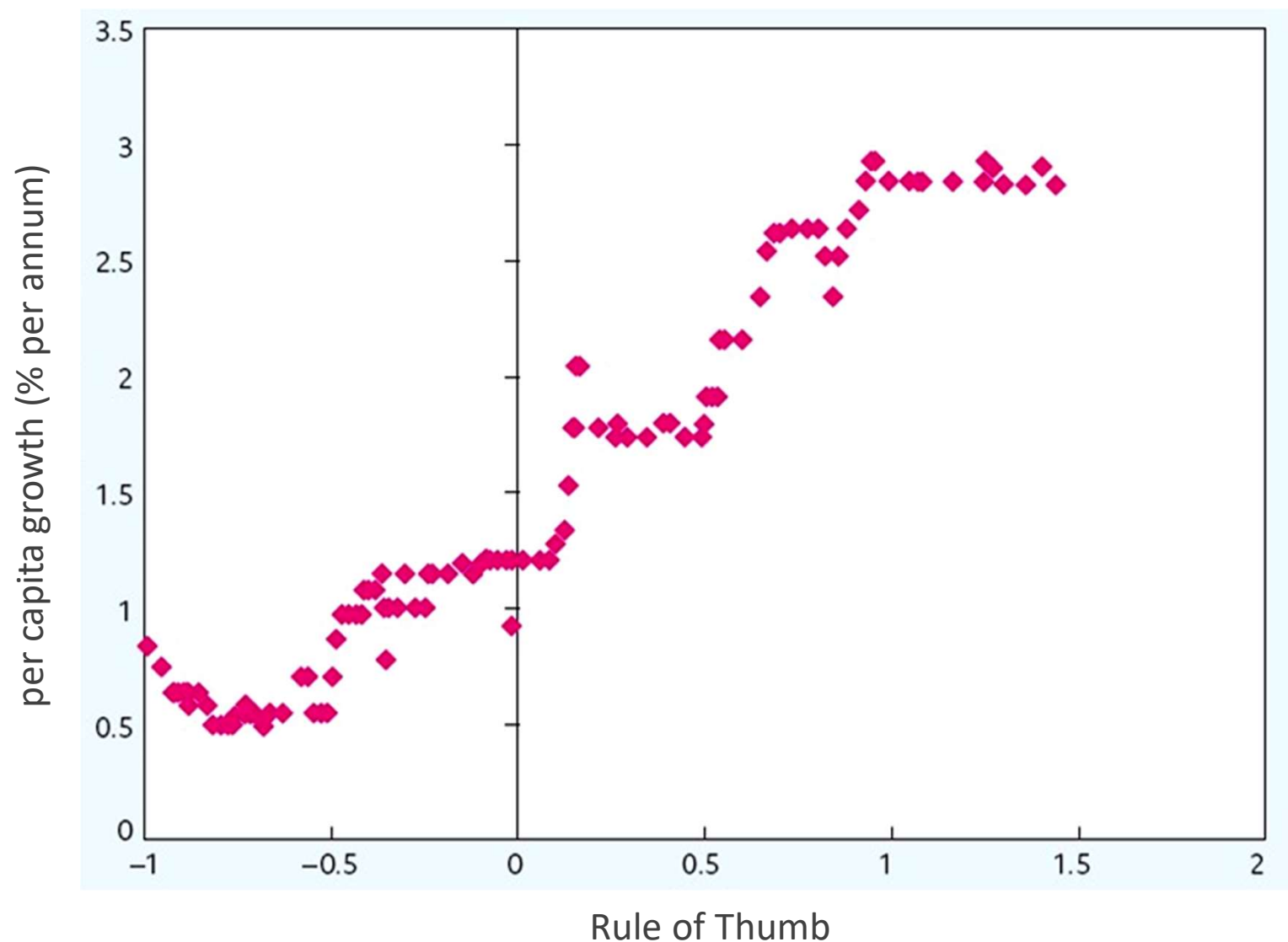
“Economic history is overwhelmingly a story of economies that failed to produce a set of economic rules of the game (with enforcement) that induce sustained economic growth”. [Douglas North].

“Don Peppe”

A cattle breeder told Diego Gambetta (the Sicilian Mafia, 1993, p. 15).

- “When the butcher comes to buy an animal, he knows that I want to cheat him [by supplying a low-quality animal]. But I know that he wants to cheat me [by reneging on payment].
- Thus we need ... Don Peppe [the Mafioso] to make us agree. And we both pay Peppe a commission.”

Rule of Law and Growth, 1960-1998



Role of government?

- Rule of law
- Property rights
- Market failures: externalities, public goods, imperfect competition, information failures, missing markets, stabilization, etc

A Taxonomy of Goods

	Rivalrous	Non-rivalrous
Excludable	Most conventionally marketed private goods.	Police protection, patented inventions, copyrighted material, subscription cable television programming.
Non-excludable	Parking spaces, public tennis courts, beaches, park benches, congested highways.	National defence, good weather, radio/television programming, internet, knowledge.

Government budget

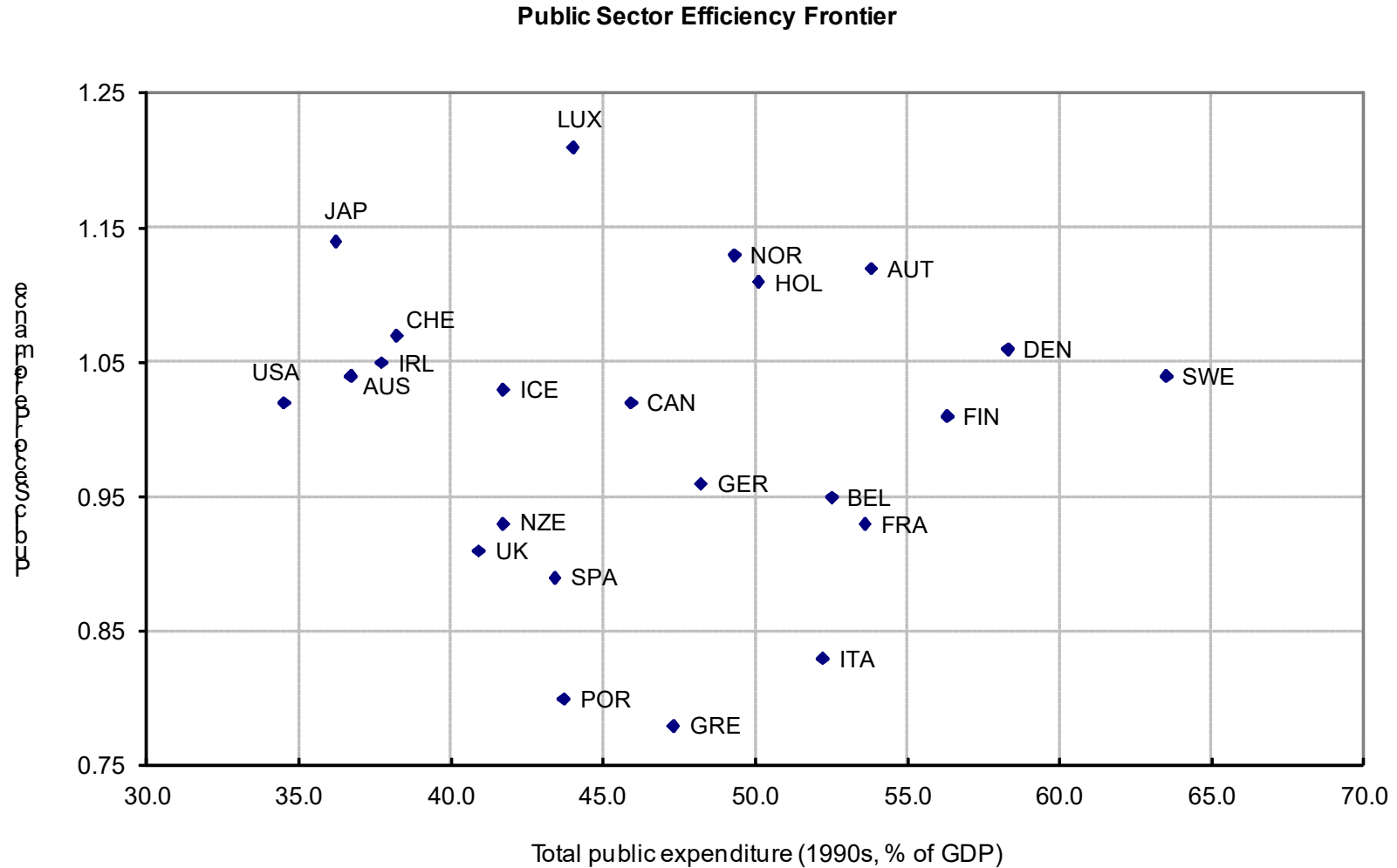
$$G = \tau(1 - \varphi)Y$$

- Only some fraction of the tax collection is converted into effective public provision
- The fraction φ is wasted

Government failures

1. *Limited information*: the optimal intervention requires a correct assessment by the government on the nature and the size of the market failure.
2. *Limited control over private market response*: the success or failure of programmes in the public sector depends not only on public actions but also on how the private sector responds.
3. *Limited control over bureaucracy*: bureaucrats don't face the same kind of pressures on them to cut costs that firms operating in competitive markets have.
4. *Limitations imposed by political processes*: even if the decision maker perceived the world as it really was, the political process through which decisions are made would make her deviate from the public interest.

Efficiency frontier



Optimal policy (intuitive)

- Private production function $Y = AK^\beta N^{1-\beta}$

- Public input: $A = \left(\frac{G}{Y}\right)^\eta$

- True production function: $Y = G^{\frac{\eta}{1+\eta}} K^{\frac{\beta}{1+\eta}} N^{\frac{1-\beta}{1+\eta}}$

- Getting prices right: $(1 - \tau^{GR})\beta = \frac{(r + \delta)K}{Y}$

- Golden rule:

- Max per capita consumption in steady state

$$\tau^{GR} = \frac{\eta}{\eta + 1} = \frac{G}{Y} \quad \left(\frac{G}{Y}\right)^{GR} = \frac{\eta}{1 + \eta}$$

Benevolent planner

- Steady state $y_t^* = A^{\frac{1}{1-\beta}} \left(\frac{s(1-\tau)}{n+\delta+\gamma} \right)^{\frac{\beta}{1-\beta}} e^{\gamma t}$

- Public input: $A = \left(\frac{G}{Y} \right)^\eta$
 $y_t^* = \left[\left(\frac{G}{Y} \right)^\eta \right]^{\frac{1}{1-\beta}} \left(\frac{s(1-\tau)}{n+\delta+\gamma} \right)^{\frac{\beta}{1-\beta}} e^{\gamma t}$

- Budget constraint:

$$G = \tau(1-\phi)Y$$
$$y_t^* = \left[(\tau(1-\phi))^\eta \right]^{\frac{1}{1-\beta}} \left(\frac{s(1-\tau)}{n+\delta+\gamma} \right)^{\frac{\beta}{1-\beta}} e^{\gamma t}$$

Benevolent planner

- Per capita consumption

$$c_t = (1-s)(1-\tau)y = (1-s)(1-\tau)[\tau(1-\phi)]^{\frac{1}{1-\beta}} \left(\frac{s(1-\tau)}{n+\delta+\gamma} \right)^{\frac{\beta}{1-\beta}} e^{\gamma t}$$

- The benevolent planner maximizes per capita consumption

$$\tau^{GR} = \frac{\eta}{\eta+1} = \frac{G}{Y}$$

$$\left(\frac{G}{Y} \right)^G = \frac{\eta}{1+\eta}$$

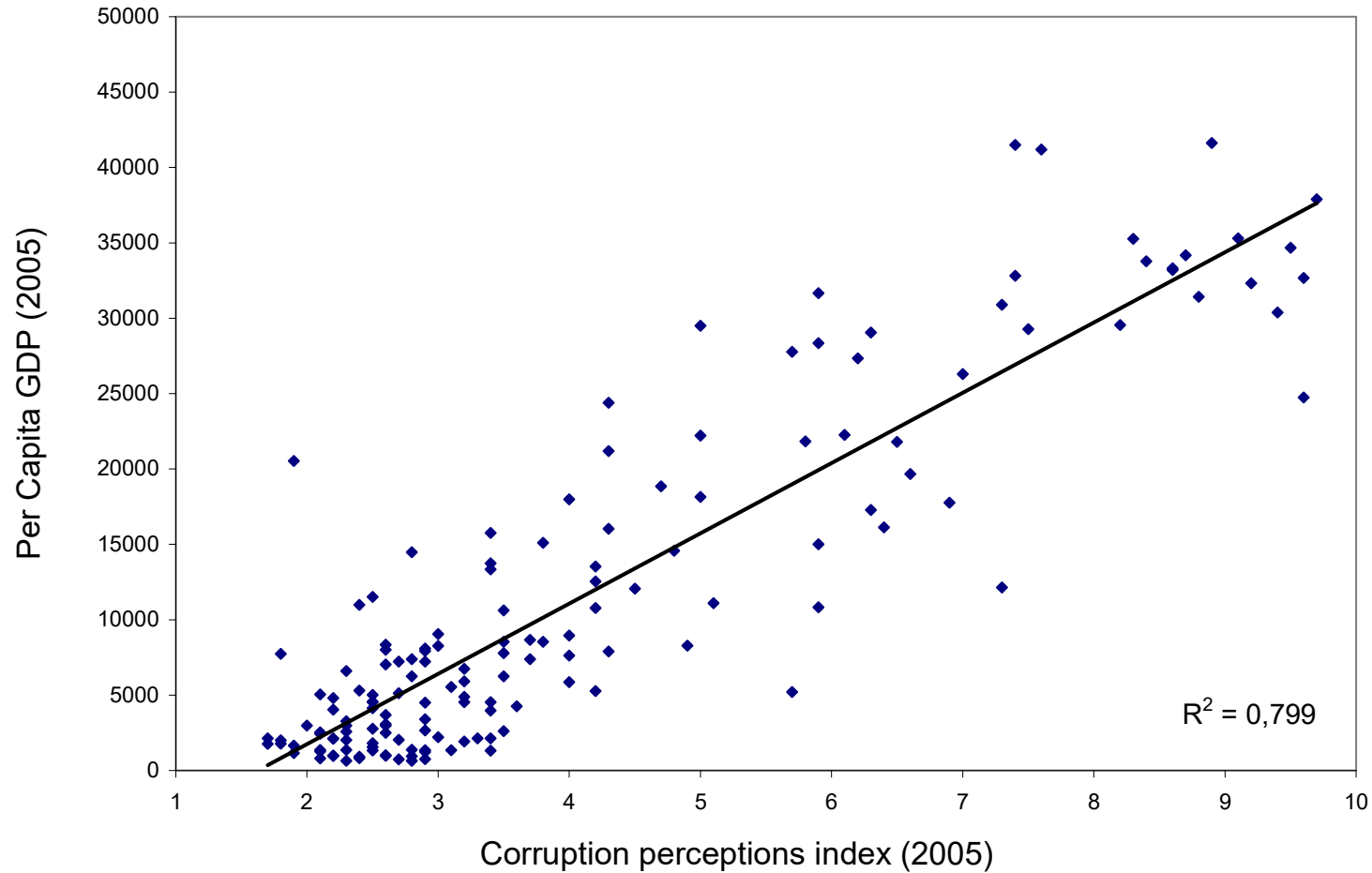
Corruption

“How deep is your love?” [Bee Gees]

Introduction

- So far, however, we have assumed that policies are designed and implemented by a benevolent planner whose interests are aligned with the social interest.
- In many countries, government officials are primary agents of diversion, seeking to maximize their own benefit through extortion, corruption fees or unduly appropriation of public assets.
- As a by-product, in societies with high levels of corruption, individuals tend to spend valuable resources in the search for fast money, instead of employing these resources in production and innovation
- In this chapter, we enrich the neoclassical growth model to examine the implications of corruption and rent seeking on economic performance.

Corruption perception index



Corruption

- An “act in which the power of public office is used for personal gain in a manner that contravenes the rule of the game”

Three necessary conditions:

- (i) the public official must have the authority to design or administer policies and regulations;
- (ii) this discretionary power must allow the extraction or creation of economic rents;
- (iii) the incentives embodied in political, administrative and legal institutions must be such that the official has incentive to use his discretionary power to extract or create rents.

Rent seeking

- Devoting potentially productive resources to persuade politicians and civil servants to take actions that generate income transfers or rents to particular individuals or groups in the society at the cost of the general interest
 - Organized lobbies
 - Bribery

Three models of corruption

- *Non-benevolent despot* (the kleptocrat)
 - empowered with perfect control over its bureaucracy uses his discretionary power with the aim to maximize his personal theft.
- *Decentralized corruption*:
 - a benevolent leader delegates discretionary power on a large-number of non-benevolent public officials which corruption activity cannot be coordinated
- *Generalized corruption*:
 - large-number of non-benevolent public officials
 - no benevolent planner.

Kelptocrat

- Maximizes theft

– Steady state: $y_t^* = \left[(\tau(1-\phi))^n \right]^{\frac{1}{1-\beta}} \left(\frac{s(1-\tau)}{n+\delta+\gamma} \right)^{\frac{\beta}{1-\beta}} e^{\gamma t}$

$$\Phi_t = \phi\tau Y = \phi\tau N \left[(\tau(1-\phi))^n \right]^{\frac{1}{1-\beta}} \left(\frac{s(1-\tau)}{n+\delta+\gamma} \right)^{\frac{\beta}{1-\beta}} e^{\gamma t}$$

- “solicitous of the victim’ prosperity”

$$\tau^K = \frac{\eta+1-\beta}{\eta+1} \quad \phi^K = \frac{1-\beta}{\eta+1-\beta} \quad \left(\frac{G}{Y} \right)^K = \left(\frac{G}{Y} \right)^{GR} = \frac{\eta}{1+\eta}$$

Dynamic considerations

- Trade-off
 - Extent of the theft
 - Probability of being displaced
 - Take then money and run
- Role for
 - Inter-temporal preferences
 - Political institutions

Political institutions

- How are leaders selected?
 - What are the limits to their power?
 - What are the mechanisms of control?
 - Separation of powers
 - Civil society
- *No natural gravitation*
- *Institutions influence the level of a country income and also its distribution among individuals and groups in the society*
 - *They only change when it becomes the interest of political elites to do so*

Decentralized corruption

- Tragedy of the commons
 - *Large number* of uncoordinated civil servants
 - Potential for extermination of the economy
- However:
 - Rent seeking (in an organized society) is time consuming
 - Under diminishing returns, this prevents extermination

The grease in the wheels argument

By providing bureaucrats a pecuniary incentive (speed money) corruption helps overcome the excess bureaucracy and red tape.

1. First best policy would be to address the rigidity itself.
2. Bribery is not equivalent to a competitive bid.
3. Bribery “contracts” cannot be enforced.
4. The society would be better off if the corresponding revenues were appropriated by the government
5. Corruption causes red tape, not the other way around

Comparative statics

- ***What happens when the effectiveness of rent seeking time declines?***
- ***What happens if the tax rate increases?***
 - A benevolent planner will opt to tax less (and hence to provide less public inputs) than in the case without rent seeking.

Copying with decentralized corruption

- Rules vs discretion
- Efficiency wages, checks and balances
- Optimal corruption is not zero

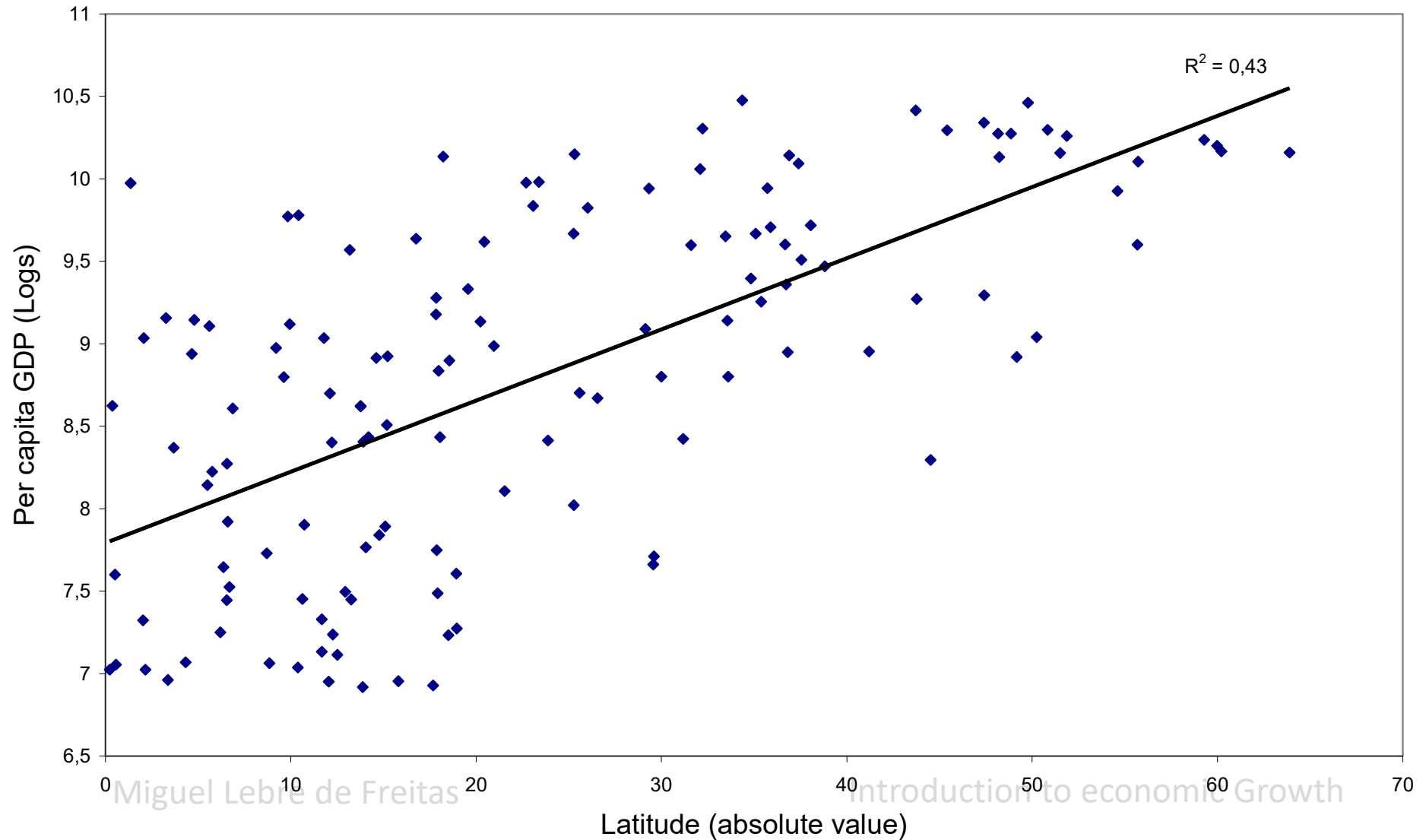
Generalized corruption

- Social norms: strategic complementarities
- When corruption is very high, the costs of being caught is low
- Institutions become dysfunctional
- Coordination game

Geography vs Institutions

“Variations in the economic performance across countries and regions (e.g, earlier industrialization in England than in China) reflect initial differences in geographical factors and historical accidents and their manifestation in variations in institutional, demographic, and cultural factors, trade patterns, colonial status, and public policy”. [Galor]

Per capita income and distance to equator



The geography hypothesis

- Agro-climatic conditions
 - The tragedy of the moriori
- Transport costs
- Disease
 - Productivity
 - Investment in human capital
- Geography still plays an important role in explaining the current location of economic activities, even though the underlying initial advantages of geography are no longer that important
 - Many great cities developed around arable land, natural defences or ports, even if these factors are no longer that important

Geography vs Institutions

- Geography hypothesis
 - Forces of nature
- Institution hypothesis
 - Human devised



in to economic Growth

Reversals of fortune

- “Natural experiment”: colonization of much of the world by Europeans, starting in the fifteen century.
 - This colonization transformed exogenously and abruptly the institutions in the colonized regions.
 - After the European colonization, many regions experienced “reversals of fortune”:
 - regions that were very rich and influent in the past, such as the Incas in America and the Mughals in India, became poor
 - regions that were poor, like Australia and North America, became rich.

Extractive vs Inclusive Institutions

- Europeans followed different colonization
 - “extractive institutions”:
 - slave plantations of the Caribbean, Congo and Central America.
 - Institutions were not designed to protect the property rights of the majority of citizens or to constrain the power of elites.
 - settler societies
 - Replication of European institutions in areas like in North America.
- The fact that countries that implemented settler institutions achieved higher economic performance than those that implemented extractive institutions provides, supports to the institutional hypothesis.

Why extractive?

European colonialists did not setup institutions for the sake of the society as a whole:

- In places where the climate and the soil quality made it more effective to produce crops using large plantations and where the disease environment was not favourable to European settlement, the colonialists established plantation systems based on slavery and erected political and legal institutions to protect the few landholders from the majority of the population.
 - In places where the climate and the soil quality made it more effective to produce using small scale farming, where most of the land was empty and with hospitable climate and germs, Europeans settled in large numbers and developed laws and institutions protecting property rights of the regular citizen and imposing constraints on the elites.
 - Europeans created settler societies wherever it was their interest to do so and “extractive” institutions wherever it was their interest too.
- Although the reversal of fortunes were triggered by major changes in the institutional setup, geography played a critical influence in shaping the quality of institutions



Dani Rodrik

[why do we have traffic lights ? - YouTube](#)

<https://youtu.be/mr5Gssaxl6g>

<https://youtu.be/ebkogYErN3Y>

<https://youtu.be/H2JFL1Sk21Y>

What's traffic in Hanoi and
St. Petersburg got to do
with institutional reform?