

Great Changes in the World and in Economics Corruption, Development and Institutional Design

Introduction

The Fourteenth World Congress of the International Economic Association took place in Marrakech between August 29 and September 2 2005. The main themes of the Congress were “New Trends in Economics” and “Understanding the Great Changes in the World”. These two volumes published by Palgrave present to the reader the presidential address by János Kornai, most of the distinguished invited lectures (by Yingyi Qian and Jinglian Wu, Timur Kuran, Edmund Phelps and Philippe Aghion) and many of the papers presented at the different invited sessions organized by Masa Aoki (Mechanisms of Institutional Change, Herbert Gintis (The Implications of Experimental Economics For Economic Theory), Mustafa Nabli (Is Democracy a Binding Constraint for Economic Growth in the Middle East and North Africa Region?), Susan Rose-Ackerman (Trust and Distrust in Post-socialist Transition), Jan Svejnar (15 Years of Post-Socialist Transition), Oded Stark (The New Economics of the Brain Drain: Analytics, Empirics, and Policy) and Claude Menard (Institutional Design and Economic Performance).

There have been many changes both in the world and in economics around the turn of the millenium. A fundamental change has been the end of the cold war and the post-socialist transition in Central and Eastern Europe, China and Vietnam. Countries like China and India have engaged on an impressive growth path. Globalization has continued to unravel with goods, capital and people moving more freely around the globe. With 9-11 and the Iraq war, but also Chechnya, Kosovo, Afghanistan and the continued conflict in the Middle East, new concerns have arisen about fault lines of conflict in the twenty first century. Simultaneously, the spread of democracy continues throughout the world. Spectacular advances in information technology are affecting the technology of production and the organization of firms as well as communication channels in general but are also triggering social and cultural changes that we are only beginning to grasp. Many other profound changes have also been taking place. The world in 2007 is completely different from the world even twenty or thirty years before.

Several of these important changes in the world have been concomitant to changes in economics. This is not surprising. Some of the changes in economics have been brought about by important changes in the world. The large-scale economic transition from socialism to capitalism has contributed in a significant way to put institutional economics firmly in the mainstream. The large output fall and strong subsequent variation in macroeconomic performance across countries came quite unexpected to the mainstream of the profession who thought that liberalization, stabilization and privatization should put these economies on a virtuous growth path. Economists started taking very seriously the idea that the dismal performance of the Russian economy and of most of the Former

Soviet Union economies in the nineties could be attributed to institutional failures. The transition experience convinced a large part of the economics profession of the importance of institutions as the underpinning of a successful market economy. The Marrakech Congress is a good reflection of the current strength of institutional economics as various distinguished lectures and invited sessions related to institutional issues. The themes of the Congress also reflect an attempt to enrich the analysis of institutions by looking at *systems of institutions*, i.e. by studying the different institutions forming an economic system (political, legal, cultural, social,...) and analyzing the interactions between institutions. Another important change in economics is the increasing success of behavioral economics. The standard model of rationality is being put into question as several of its core components are contradicted by a large body of work in psychology. Models of behavioral economics or of economics and psychology are introducing changes to the standard assumptions of *Homo Oeconomicus* and deriving new predictions about economic behavior. More and more evidence is produced by experimental economics about individual and group behavior, testing standard assumptions about rationality but also about game theory. The results of these experiments leads to the formulation of new assumptions and behavioral models. These are only some visible examples of changes in economics but, of course, many other changes have also been taking place in many different fields.

The two main themes -- „Understanding the Great Changes in the World” and „New Trends in Economics” -- are the *Leitmotifs* of both volumes containing the papers of the Marrakech congress. Each paper is reflecting either one of the main themes, or both. Most papers in the present volume are dealing with three important issues: corruption, development and institutional design.

Corruption, rent-seeking and governance are obviously important issues in research on institutions. Jana Kunicova and Susan Rose-Ackerman analyze the effect of political institutions on corruption. They distinguish between three types of electoral rules: 1) plurality, 2) proportional representation (PR) with open list and 3) proportional representation with closed list. They argue that under PR, there are more collective action problems for voters and opposition parties to solve in monitoring incumbents. Indeed, voting districts are smaller under plurality rule which give voters more incentives to monitor politicians. Also, opposition politicians have more incentives to monitor incumbents under plurality rule because there is clear alternance of governments whereas under PR, there usually are coalition governments with changing alliances. On top of that, closed list PR shelters corrupt politicians from punishment by the electorate. These hypotheses are confirmed by cross-country regressions which also show that presidential countries are more corrupt as well as countries with a federal structure.

In Russia, president Putin has tried to fight corruption and to increase the centralization of government. Evgeny Yakovlev and Ekaterina Zhuravskaya evaluate the changes that have been taking place between the Yeltsin and the Putin administration. They focus in particular on state capture, i.e. successful influence activities of oligarchs within the state

apparatus. As a consequence, firms without political influence stagnated and their overall productivity, sales and investments declined. It had a negative effect on tax collection and on regional small business. What has changed since Putin's selective crackdown on oligarchs? They find no significant change in measures of capture and on the negative economic effects of capture. Similarly, in 1999 a law was passed to restrict tax breaks to enterprises which were one of the most popular forms of preferential treatment for enterprises. They find that the reduction in tax breaks was offset by an increase in preferential subsidies and loans. They also find that enterprises belonging to the federal government have become the most powerful lobbyists.

Mustafa Nabli and Carlos Silva-Jauregui analyze the relationship between democracy or its deficit in the MENA (Middle East and North Africa) region. There is no question that democracy has lagged behind in the MENA region. There is a persistent democracy gap. Contrary to what can be observed in the rest of the world, there is no correlation in the MENA region between the level of income and progress in democracy. The rich oil-exporting countries in particular have among the lowest democracy scores. Per capita income growth in the MENA region has also been low, though not as low as Sub-Saharan Africa. However, the general literature on the link between democracy and growth is not very conclusive and many of its results are either fragile or conditional. While there has been little democratic progress in MENA countries there has been progress in human development, in particular in education and health. They discuss a battery of governance indicators and conditions for good governance under democracy. Countries like Iraq, Lebanon and Syria that are more fragmented have worse initial conditions for good governance. Oil producing countries usually have worse governance indicators. The authors are skeptical that good governance may come out of non democratic regimes. On the other hand, obstacles to reform are numerous and political economy factors would tend to favor the status quo. One must look for reforms such as more economic openness, less clientelism, improvements in the legal framework that could create a virtuous circle in favor of democratic progress.

The transition countries have obviously been the ones that have experienced the most institutional changes with varying results. Klara Sabirianova, Jan Svejnar and Katherine Terrell compare the experience of the Czech republic and Russia in terms of economic convergence and catching up with the technological frontier where the latter is measured by the estimated efficiency of the top third of foreign firms operating in a country. They found that the distance to the frontier is larger for domestic firms in Russia compared to the Czech republic but that it has not decreased and has even increased during some periods. They also test for spillover effects of foreign direct investment. They find that in industries with a greater share of foreign firms, domestic firms are falling behind more than in sectors with a smaller foreign presence. However, in the Czech republic this effect becomes weaker over time. Interestingly, they do find positive spillovers but on foreign firms only.

Entrepreneurship is a key factor for successful performance of an economy. It is a topic that has been underresearched by economists. Simeon Djankov, Yingyi Qian, Gérard Roland and Ekaterina Zhuravskaya present the results of a pilot study on Chinese

entrepreneurs as part of a broader international research initiative on the topic. They surveyed entrepreneurs and non entrepreneurs sharing the same age, gender and education distribution as entrepreneurs. They found that, controlling for these characteristics, entrepreneurs were more willing to accept a risk-neutral gamble. The major difference they found in terms of family background is that entrepreneurs have nearly three times more entrepreneurs in their family or among their childhood friends. They are more driven by greed and have different labor-leisure preferences than non entrepreneurs. These variables are highly significant in different regressions. Entrepreneurs are also more optimistic about the business environment than non entrepreneurs.

Oded Stark had organized a session in immigration policies, an increasingly important policy issue on most continents. In a paper with Simon Fan, the phenomenon of “educated unemployment” is analyzed, i.e. voluntary unemployment by highly skilled workers who prefer to wait and search for a job offer from a foreign country rather than settling for a domestic job. They show that besides the brain drain usually mentioned in relation to highly skilled workers there is a “brain gain” related to the incentives of individuals to acquire higher education. This brain gain may have negative effects in the short run, the phenomenon of “educated unemployment” but in the long run the brain gain and the higher level of human capital in the economy can generate sufficient positive externalities so as to generate an economic takeoff. In a joint paper with Alessandra Casarico and Silke Uebelmesser, the choice of the optimal immigration policy is analyzed in a situation where there is asymmetric information about the skill of migrant workers and the destination country can tax migrants. They find that there is a dynamic trade-off between selecting high skill migrant workers who will pay more taxes and incentives of potential migrants to invest in skill acquisition. A relatively open immigration policy of a destination country may affect positively the incentives to invest in skill acquisition in the home country and thus benefit the home country despite a brain drain effect. Another paper by the same authors together with Carlo Devillanova generates the same effect in a framework where agents are homogeneous and migration policies are set in a non cooperative way.

In a joint paper with Steve Boucher and Edward Taylor, evidence is provided in favor of the “brain gain” effect. They find indeed using data from Mexico that villages of migrants have a higher average level of schooling than other villages. Moreover, the emigrating workers in general have higher skills than the domestic workers. However, these findings are valid for migration within Mexico. Migration from rural Mexico to the US does not have however positive effects on schooling in the villages of migrants.

The complementarities between institutions is a key factor in understanding regulatory issues. Claude Menard analyzes the case of water utilities. In the eighties, economists recommended privatization of utilities in order to reduce or eliminate politicized interventions. Other axes of reform were a) to dismantle monopolies as much as possible in order to induce competition, b) to allocate exploitation rights via competitive auctions and c) to establish a monitoring framework and an optimal design of a regulation system. In line with the Washington consensus, there was the belief that a “one size fits all”

approach to this problem would be fruitful. However, institutionalist thinking emphasizes the importance of the institutional endowments and the cross-country differences in human resources available to implement recommended reforms. Institutional endowments are critical because regulation is a governance issue. In the case of water utilities, since water must be provided to all citizens, depolitization may not be avoided and must try to design the best regulation system that fits local conditions of developing countries.

Regulations and institutional design are also the object of the paper by Luis Andres and Stephane Straub who focus on the performance of infrastructure companies. Using data on more than thousand concession in Latin America between 1980 and 2000 they examine the impact of aggregate measures of regulatory quality on the divergence between the internal rate of return and the average cost of capital. There is a significant impact of overall regulatory quality. Similarly, the presence of independent regulators has a negative impact on contract renegotiation and regulators appear to act as a barrier against opportunistic behavior by governments, especially in environments of weaker governance. They find that price cap schemes lead to more contract renegotiation. Also, autonomous regulatory bodies are associated with reductions in the number of employees.

Finally, Richard Green analyzes the evolution of the energy sector in the UK which has changed very much since the privatization policies of the early eighties. He emphasizes the strong learning component associated to institutional changes. Efforts to introduce competition in the privatized gas industry did not work right away. British gas initially behaved like a price-discriminating monopoly and managed to keep out entry by not committing to a price schedule for the use of its pipelines and by giving itself the opportunity to renegotiate with customers who would be targeted by competitors. A rule had to be imposed restricting it from buying more than 90% of gas supplies. Even so, competition initially remained marginal at best. The firm had to be split up in parts, a process that took a few years. Many changes were also operated to the setup of regulatory institutions to avoid collusive tendencies (regulatory boards instead of individual regulators) but also excessive rigidities. It was found that important gains can be made by transparency in regulation.

Other topics that were the object of invited session are published in the first Congress volume. These two volumes should be seen as a whole. All in all, we hope that the selection of papers in these volumes will give the readers a snapshot of recent trends in economics and how they reflect important changes taking place in the world.

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