Economic Structures, Institutions and Economic Performance

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The Argument

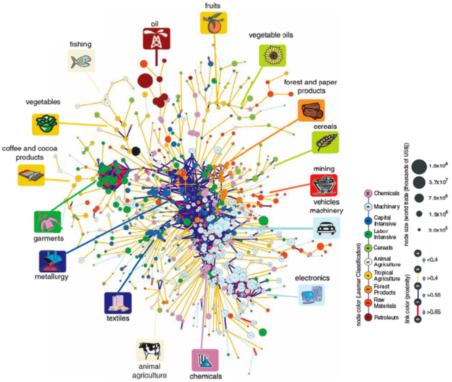
- Economic Structures are the Fundamental cause of long run growth
- What do we mean by Economic or Productive Structures? Aggregate representation of a country's technological capabilities or at the micro level, the technological content of goods/services produced
- Economic Structures matter for:
  - rate of technical change
  - distribution of income
  - direction of political transition
  - how institutions perform — "inclusive" institutions for instance and
  - the type of market structure under which goods/services are produced

Economics of High Tech-Productive Structures

- Sustainable growth is observed when an economy's productive structure is composed of commodities with increasing returns
- Why are economic activities with increasing returns so important?
  - Firstly, they are produced under varying degrees of imperfect competition and this has a number of growth enhancing effects.
    - Prices, wages and profits are elevated for longer periods when compared to economic activities produced in highly competitive industries.
    - This sustains aggregate demand and serves as a robust source of internal growth.
    - More conducive for innovation and technical progress.
  - Higher income and price elasticity of demand in export markets
  - Greater scope for product diversification

Structural Change

- Institutions of Production (industrial policies) vs. Institutions of Exchange (property rights etc)
- Differences in economic performance lie in the different patterns and rates of structural change, not in the differences in ("inclusive") institutions.



Economic Structures and Institutions

We make two claims:

Proposition 1

There is bi-directional causality between economic structures and institutions

Proposition 2

The type of economic structure determines the performance or efficacy of formal institutions.

Proposition 1

- IMF structural adjustment programs
- Discovery of gold or oil
- NIE studies only one direction of causation, from rules to consequence
- Robinson Crusoe — limited liability and independent central banks

Economic Structures and Institutions cont'd

Proposition 2

- Enforcing institutions are not costless — returns from private contracting must be sufficient to cover costs — only likely in high tech economic structures
- Think of why consumer protection codes, private property rights, fire regulation etc. are inadequately enforced in countries with low tech structures. Economic activities are largely undertaken and regulated through **informal** means
- In short, societies cannot simply download the "best" institutions and expect these to work.
- If "inclusive" institutions are important to growth and economic structures determine how these are enforced — then economic structures are the fundamental cause of growth

Economic Structures and the Allocation of Talent

- A given economic structure has a given structure of occupational rents that determines the structure of the labour market
    - Think of FIRE economies and the demand for financial entrepreneurs
- Occupational rents serve as a source of *de facto* political power that can be transformed into *de jure* political power
    - Think of financial entrepreneurs buying politicians
- An equilibrium emerges among economic structure, institutions and political power
    - Financial entrepreneurs buy politicians to maintain the FIRE economy.
    - The same holds in the developing country context, there are winners even in low tech economic structures
- The equilibrium explains both structural and institutional rigidities

Economic Structures and Political Transitions

- AR (2006) Land and Capital intensive economic structures — low and high tech economic structures
- Modernization hypothesis — per capita income is NOT economic structure
- Critical Junctures hypothesis
- Democratic vs. oligarchic property rights and technological progress
- Economic structures determine technical change through economic and political channels

A Simple Model

Figure 1: Schematic of Economic Structures, Institutions & Economic Performance

$$\text{economic structure}_t \Longrightarrow \underset{\text{distribution}_t}{\text{income}} \Longrightarrow \left.\begin{array}{r}\text{de facto}_t\\ \text{de jure political power}_t\end{array}\right\} \Longrightarrow \text{institutions}_t$$

$$\text{institutions}_{t+1} \Longrightarrow \text{economic structure}_{t+1} \Longrightarrow \text{economic performance}_{t+1}$$

Evidence

- No shortage of empirical support — see HJC, Rodrik, Reinert, Wade, Mazzucato etc

A USA CASE

- Central story: 2008 financial crisis is the outcome of a growth reducing structural change that was papered over by cheap credit and a housing bubble.

Evidence cont'd

Agrarian US — 1900s

- Expanded cultivation and exogenous shocks led to a collapse in agricultural prices and incomes
- Predictably, a fall in agricultural employment — this altered the distribution of occupational rents against rural labour
- This worsened already high inequality and allowed economic elites to bargain for tax cuts etc
- These deflationary effects were temporarily countered by WWI and high inequality and forced savings created a large pool of loanable funds
- The newly emerging industrial sector could not absorb all excess savings
- Cheap credit and a debt induced growth model solved this problem — great depression

Evidence cont'd

Golden Age US

- WWII completed the industrial transition and put an end to the great depression
- The Fordist regime strengthened the middle class and reduced de facto influence of elites — tax rates on the rich increased
- The high tech economic structure ensured wages grew in line with productivity
- Marshal Plans I and II also promoted growth enhancing structural change

Evidence cont'd

Great Recession US

- De-industrialization altered occupational rents against industrial labour
- With the rise of inequality, de facto power of elites increased
  - lower taxes, de-unionization, financial deregulation and other policies to weaken industrial labour
- No WW or Marshall Plan to compensate for the emerging deflationary effects — old strategy of cheap credit was followed — great recession

Conclusion

- Direction and rate of structural change are the fundamental determinants of growth
- Structural change affects growth through the changes in the distribution of income and its corresponding effects on political institutions
- The case study demonstrates that economic structures and institutions reinforce each other
- Unmanaged structural changes create high inequality and deflationary effects that are likely to be papered over by credit booms and financial bubbles