# I Setting the Stage

# 1 The Development Puzzle

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## 1.1 Background

Beginning with the second half of the twentieth century, the average growth of income per capita in the world, at the annual rate of almost 2.5 percent, has been unprecedented by historical standards. In particular, economic growth has been much more rapid than in the United States in the half century between the Reconstruction and World War I (Maddison 2001). This overall extraordinary performance, however, hides a considerable variation in growth rates across countries as pointed out in several studies (e.g., see Pritchett 1997; Easterly and Levine 1997; Ndulu and O'Connell 1999). Thus the average growth rate of income per capita in East Asia and the Pacific in the period 1960 to 2004 was a remarkable 4.9 percent; among OECD countries it was 2.7 percent, but just about 0.5% in sub-Saharan Africa.[1] The examples of rapidly developing Korea and Taiwan since 1960s, the growth spurts in China since the late 1970s, and more recently, India, show that the adage "the rich (countries) stay rich, while the poor stay poor," need not hold in the absolute; staying behind is not a sealed fate. Yet the persistent underdevelopment in much of the world is troubling. Further Artadi and Sala-i-Martin (2003) document that the disappointing growth performance of sub-Saharan Africa is accompanied by an increase in inequality, and Kraay (2006) shows that economic growth is the most direct route out of poverty. Low growth rates therefore directly translate into desperate human conditions: extreme poverty and hunger, high infant mortality and low life expectancy, poor infrastructure and inability to cope with natural disasters, devastating conflicts and civil wars that inflict death and sow despair. These twin observations—an increasing pace of aggregate development and the unequal incidence of its benefits across countries and regions of the world—constitute some of the fascinating and pressing puzzles researchers have tried to grapple with.

When trying to understand the causes of development, the neoclassical economists of the post–World War II period traditionally looked for narrowly defined "economic" factors such as the accumulation of physical factors and resource endowments. Investment, in particular, was viewed as a key factor in boosting economic growth. Then there came the recognition that with diminishing returns to scale in production, the neoclassical view cannot possibly explain the existing gross differences in economic performance. This led to Solow's emphasis of the importance of technological progress as a source of long-run growth. Assuming free flows of technology, however, this theory has a problem in explaining persistent—and even growing—differences in growth performance across countries. Consequently the endogenous growth theories of the 1980s have drawn attention to the process of technological advance and of human capital accumulation. This literature focused on spillover effects pertinent to knowledge acquisition, and the resulting allocation inefficiencies were viewed as obstacles to development. Policies in the relevant areas of education, research, and innovation have become to be considered the means to achieving adequate levels of growth and development. Even more recently the profession seems to have recognized ever more acutely that political, social, geographical, and even historical factors cannot be ignored when trying to make sense of development. These factors, while potentially having an independent effect, are also likely to play an important role in shaping the accumulation of the production factors deemed crucial for development in the earlier literature. The shift in emphasis was also partly motivated by multiple country experiences that have been inconsistent with the established growth paradigms. For instance, achievements in the area of education are in themselves insufficient to guarantee economic progress, and the impact of human capital investment arguably depends on other institutional aspects—as is evidenced by the performance of east European countries under the communist regime. Similarly the relationship between actual physical investment and economic outcomes need not be a very close one, and it depends on the type of investment and the environment in which it takes place (Artadi and Sala-i-Martin 2003).

The recent report on *Prospects for the Global Economy* by the World Bank (2005) also confirms the picture according to which the high-income countries outperformed, whereas most developing countries, and in particular, sub-Saharan Africa, strongly underperformed in the 80th and 90th in terms of their growth rates compared to GDP growth rates in the world. The data show that this trend has reversed in the first half of the current decade, and the report's authors expect that developing countries will outperform the high-income countries and conjecture that even sub-Saharan Africa will have an annual growth of GDP of 1.6 percent. However, their account of the income distribution draws a gloomy picture of the current state of the world (see table 1.1).

This cursory review illustrates the frustrations of empirical growth analyses based on estimating a neoclassical production function—which tends to leave much of growth performance across countries unexplained by the standard production factors. This major challenge has haunted the researchers of development ever since the issue came to grab their attention. While the large unexplained, "residual" variance has been recognized since Solow's seminal work, its traditional interpretation tended to focus on technology and innovation. More recently some scholars—guided by the insights of economic historians (see North 1990)—have instilled in the residual a much broader interpretation as being related to a society's institutional quality (see Acemoglu et al. 2002; Hall and Jones 1999). In the evolution of developmental thought, political factors came to be seen as one of the factors reflecting and shaping this quality. In this view, political and economic forces interact in determining the societal outcomes.[2] In a related vein, rich models of political economy and their application to development-related issues such as corruption, comparative politics, the size, composition and structure of government have emerged from this research program. They allowed opening the black box of policies formation and how it is affected by the nature of political and social institutions. The study of the role of political institutions in the development process has been picking up momentum in recent years addressing issues such as the nexus of democracy, inequality, and growth; political obstacles to development-enhancing policies; weak institutions and corruption; social capital; political instability; and the political economy of trade openness. In many cases this was not just a reflection of academic curiosity but a response to and an interpretation of pressing developmental issues.

The chapters in this volume address some of the issues above. While by all means not exhaustive of the vast area of research in the political economy of development, they make a representative sample of topics

**Table 1.1**
Regional breakdown of poverty in developing countries

| | Millions of people living on | | | | | |
|---|---|---|---|---|---|---|
| | Less than $1 per day | | | Less than $2 per day | | |
| Region | 1990 | 2002 | 2015 | 1990 | 2002 | 2015 |
| East Asia and Pacific China | 472 | 21 | 14 | 1116 | 748 | 260 |
| *China* | *375* | *180* | *11* | *825* | *533* | *181* |
| *Rest of East Asia and Pacific* | *97* | *34* | *2* | *292* | *215* | *78* |
| Europe and Central Asia | 2 | 10 | 4 | 23 | 76 | 39 |
| Latin America and Caribbean | 49 | 42 | 29 | 125 | 119 | 106 |
| Middle East and North Africa | 6 | 5 | 3 | 51 | 61 | 40 |
| South Asia | 462 | 437 | 232 | 958 | 1091 | 955 |
| Sub-Saharan Africa | 227 | 303 | 336 | 382 | 516 | 592 |
| **Total** | **1218** | **1011** | **617** | **2654** | **2611** | **1993** |
| *Excluding China* | *844* | *831* | *606* | *1829* | *2078* | *1811* |
| | Percentage of population living on | | | | | |
| | Less than $1 per day | | | Less than $2 per day | | |
| Region | 1990 | 2002 | 2015 | 1990 | 2002 | 2015 |
| East Asia and Pacific China | 29.6 | 14.9 | 0.9 | 69.9 | 40.7 | 12.7 |
| *China* | *33* | *46.6* | *1.2* | *72.6* | *41.6* | *13.1* |
| *Rest of East Asia and Pacific* | *21.1* | *10.8* | *0.4* | *63.2* | *38.6* | *11.9* |
| Europe and Central Asia | 0.5 | 3.6 | 0.4 | 4.9 | 16.1 | 8.2 |
| Latin America and Caribbean | 11.3 | 9.5 | 6.9 | 28.4 | 22.6 | 17.2 |
| Middle East and North Africa | 2.3 | 2.4 | 0.9 | 21.4 | 19.8 | 10.4 |
| South Asia | 41.3 | 31.3 | 12.8 | 85.5 | 77.8 | 56.7 |
| Sub-Saharan Africa | 44.6 | 46.4 | 38.4 | 75 | 74.9 | 67.1 |
| **Total** | **27.9** | **21.1** | **10.2** | **60.8** | **49.9** | **32.8** |
| *Excluding China* | *26.1* | *22.5* | *12.9* | *56.6* | *52.6* | *38.6* |

Source: World Bank, 2005, Prospects for the Global Economy 2006: Economic Implications of Migration and Remittances, p. 9.

and approaches that are used in the literature. In particular, an exciting feature of much of the recent work is the methodological variety employed to seriously tackle and thoroughly understand the interaction between political, social, institutional, and economic factors in development. Thus the methodologies employed in the chapters range from carefully formulated mathematical models to statistical analyses of cross-country and panel data, from survey data analyses to subtly designed randomized policy experiments. This wealth of sometimes complementary, sometimes competing approaches should, so we hope, contribute to our better understanding of this complex area of research.

Many features of a society can possibly be included as ultimate determinants of economic development; among them, a few can be singled out as being of some significance: the *structure of governance*, the *quality of a country's governing bodies, including the degree of property rights protection*, and the *social norms* that govern collective decision making. The analyses in this book contribute precisely to these three features, which we will now discuss in some more detail. The focus on these areas implies, inter alia, that other equally important issues within the general domain of the political economy of development remain outside the scope of this volume.

## 1.2 Book Themes and Organization

### *Governance Structure*

The division of responsibilities among various levels of government is an important issue, both in developed and developing countries, and as such this issue has received much attention in the literature. Early work, driven by Tiebout's (1956) insights and motivated primarily by intergovernmental relationship in industrialized countries, focused on the potential advantages of decentralized government structure as the means to allow local preferences to express themselves (Oates 1972). Riker (1964) emphasised the importance of clearly delineated responsibilities. More recent work on the political economy of federalism considers whether a federal structure increases or decreases the scope for making politicians accountable for their policy decisions, and how federal structures affect the process of evaluation and selection of politicians with respect to their competence or ability. Intuitively, for instance, competition among local communities is viewed as leading to superior decision making relative to centralized government, which could be subject to pressures by interest groups and thus state capture. However, the theory results on accountability paint a more complex picture, and the policy recommendations that result from this literature are not clear-cut.[3]

Decentralization has been claimed more generally to be an important variable factor for improving political accountability also by political scientists (Weingast 1995; Qian and Weingast 1997), and the World Bank has routinely promoted decentralization as a desirable direction of policy reform. More recent research, however, generates a much deeper and nuanced view of the relationship between decentralization and development. Motivated by the comparison of China's economic achievements with Russia's failure, some have argued that the quality of government, namely its ability to commit, is a key factor in explaining the success of decentralization. Jin, Qian and Weingast (2005) compare China and Russia and conclude that there is a positive relationship between credible financial incentives given to the lower level governments and local economic performance. Similarly Qian and Roland (1998) attribute performance differences to weak incentives of local governments to be efficient in the centralized structure. Because many developing countries (Brazil, China, India, Russia) happen to have a federal, multiple-layer governance structure, issues of economic and political decentralization, its fiscal aspects vis-à-vis administrative control and accountability, have featured prominently in recent years.

Vertical decentralization gives some scope for uncoordinated behavior or strategic rivalry between different tiers of government, and this is a potentially important source of serious inefficiencies of federalism. This holds, in particular, in the context of developing countries that are characterized by institutions that are too weak for correcting for such incentives. Some of these problems have been highlighted, for example, by Treisman (1999a) and Cai and Treisman (2005) and Kessing, Konrad, and Kotsogiannis (2006). Many of the advantages of decentralization emerge in a theory where a benevolent government or a government directly responsive to voter's preferences is assumed. Some more recent research, focusing more narrowly on the experience of developing countries, with either weaker mechanisms for disciplining government or less benevolent government, suggests, in contrast, that decentralization may result in a "local capture" and may perform less well than a centralized government for other reasons.[4]

While theoretical debates on the advantages and deficiencies of decentralization versus central government structure has been in full swing, there have been relatively few empirical tests of the theoretical arguments.[5] Three chapters in the volume purport to fill this vacuum by dealing empirically with this issue. **Gennaioli and Rainer** (chapter 2) set to test the economic advantages of decentralization in the context of sub-Saharan Africa, focusing on the provision of public goods such as education, health, and infrastructure. Their identification strategy is based on using the pre-colonial degree of decentralization. They find that countries that had a more centralized government structure at that stage do better in terms of public goods provision than decentralized countries. Their interpretation of these findings is that centralization may undermine local capture and lead to better accountability.

**Khemani** (chapter 3) focuses on intergovernmental relationship in India and accomplishes two objectives. First, she provides an indirect test of the soft budget constraint hypothesis using a panel data of 15 Indian states. She finds that when the national government and a state government are controlled by the same party, the state tends to have a larger budget deficit than otherwise; the interpretation of this finding is that this occurs in anticipation of a future bail out. Additionally Khemani argues that relegating fiscal authority in this regard to an independent agency tends to alleviate the problem. The recent Indian experience with such an independent authority seems to support such policy.

**Kremer** (chapter 4) examines this same issue in the context of the Kenyan education systems. In Kenya, teachers are hired by the central government, but many other educational choices such as decisions on school constructions are made locally. Kremer finds that this system is inefficient, generating in particular an excessive school building with small classes as well as overspending on teachers at the expense of non-teacher inputs so that the resulting school fees are excessively high. He argues that the absence of alignment in incentives at the central and the local levels caused the Kenyan educational system to stagnate, despite some features which are considered as potentially enhancing its quality such as parents' ability to exercise school choice. Kremer also reports on the results of a donor intervention that helped improve the allocation of educational funds and argues that allocative distortions, not necessarily low level of spending on education, have been the main culprits behind the failures of the school system in Kenya.

### *Institutional Quality, Property Rights, and Appropriation*

The quality of institutions, their stability, transparency, predictability, enforceability of rules, and the ability to commit are also likely to influence—directly or indirectly—economic performance, and the recognition of its importance for development came to the fore in some recent writings.[6] A key aspect in this context is corruption and a large research program evaluates the direct and indirect consequences of corruption (Aidt 2003), typically based on data that describe corruption as a subjectively assessed rather than an objectively measured variable. The effect of such corruption measures on growth is typically considered to be negative in general, and also specifically for the performance of African countries.[7]

The contribution by **Vicente** (chapter 5) considers a so far neglected cause of corruption: a country's stock of natural resources. As is well known, a country's natural resource wealth may retard rather than promote economic development. Sachs and Warner (1997) report a negative and robust correlation between GDP growth and natural resource wealth of a country and between growth and the share of natural resource exports in GDP and these stylized facts illustrate what is sometimes called the "natural resource curse." Several explanations for this phenomenon have been discussed. Torvik (2002) and Mehlum, Moene, and Torvik (2006) emphasize the role of rent-seeking activities and the importance of the institutional setup, which explains why the natural resource curse is more likely to show up in a country with weakly developed institutions. Empirical work suggests that resource wealth may interact with the development of institutional quality.[8] Vicente constructs an analytical model of a repeated interaction between a country's elite and its population, where the former determine the level of corruption and the latter can possibly revolt. This framework enables the author to study the effect of a windfall in natural resources on corruption incentives. Vicente also presents, consistent with the model's analysis, some tentative empirical evidence on the positive relationship between natural resource windfalls and corruption.

In the context of African (laggard) development, several scholars drew our attention to the detrimental effects of violent conflict. Much of this work concentrates on the conflict between various social groups for political leadership and how it can potentially be mitigated.[9] The impacts of social pressure, peer groups, religious and ethnic factors in shaping political identities and thereby economic outcomes, have increasingly come into play in recent research.[10]

In this context, causal factors of violent conflicts have attracted researchers' attention (Collier and Hoeffler 2004).[11] The relationship between political stability and the governmental incentives to promote economic prosperity and growth is most likely a key issue for understanding the poor growth performance of many developing countries. Olson (1993) and McGuire and Olson (1996) compared the incentives of a political leader to use current revenue for investments in public goods or to delay the extraction of rents to those of the owner of a business company. Incentives to invest are there only where there are expectations of reaping the benefits from such investment, which suggests a positive relationship between political stability and a country's economic development. However, as reported in Robinson (1999) there is a large number of dictators who were in office for a very long period of time and, at the same time, extracted revenue but disinvested in infrastructure and other public investment goods; the list of examples includes the Somoza family in Nicaragua who governed from 1937 to 1979, Ferdinand Marcos in Philippines, who governed from 1965 to 1986, the Duvaliers who ruled in Haiti from 1957 to 1981, and Mobutu who ruled in Zaire from 1965 to 1997. These cases either falsify the theory or show that the observed office duration of country leaders is a poor indicator of political stability. Konrad (2002) considers a theoretical explanation whereby the effort required to fend off contenders and the resulting expected tenure are endogenous to country leaders' investments in the development of his country. Country leaders typically have an incumbency advantage when competing with rival contenders, and the size of this incumbency advantage may determine a certain upper prosperity threshold that may not be surpassed for an incumbent leader to stay in office. Accordingly, institutions that determine the size of incumbency advantages turn out to be key factors for economic development.

Two contributions in this volume relate to appropriation conflict. As discussed, empirically, poor countries seem to be the countries in which property rights conflict between private investors and government representatives is most pronounced. **McBride and Skaperdas** (chapter 6) provide an important explanation why this is a consequence of countries' income levels. They show how violent conflict is more likely to emerge in low-income countries. If the future is bright and resourceful compared to the present situation, it may be valuable for opponents to avoid enduring conflict and to fight things out in the present. Accordingly, violent conflict is more likely to emerge in countries with rival political forces when the national income of the country is still low. In richer countries, the cost of conflicts that occur today is higher, and the cost is less likely to be justified by the savings in future, enduring conflict.

The second contribution focuses on the potential appropriation conflict between government officials and agents in the private sector. Work that traces back at least to the analyses on the expropriation waves in the 1960s and 1970s drew attention to the possible relationship between an investor's chances to recover at least a major share in the returns in his investment and his unwillingness to undertake the investment if he cannot expect to recover a reasonable return.[12] The holdup problem in foreign direct investment, by which the ex post incentives of the host government to extract rents or to expropriate deter the investor to make use of investment opportunities that could generate considerable rents, has attracted considerable interest in the literature.[13] To a large extent this literature essentially assumes that it is up to the decision of the government whether an investor can keep the returns on his investment, or whether these are partially or fully confiscated. A central question is then what are the conditions under which repeated interaction—for instance, in terms of repeated decisions about the re-investment of depreciated capital—can sustain tacit collusion. Indeed, as becomes clear from considering particular cases and going into the deeper structure of expropriation cases, it turns out that this view is probably too simplistic. An extensive body of work shows that appropriation and the allocation of assets or returns of assets is the outcome of a conflict between different parties.[14]

**Wärneryd** (chapter 7) uncovers an important information aspect in such appropriation conflicts that feeds back on individuals' investment incentives and particularly applies to developing countries. An investor who anticipates that he must defend the returns of his investment against shareholders or other stakeholders and who can increase the uncertainty about the actual value of the returns of his investment will benefit from pursuing such a policy, even if this policy reduces the expected gross returns of his investment. This trade-off emerges only if the investor has to fight for protecting the returns of his investment from appropriation. Hence the trade-off emerges only in states in which investors are not well protected from attempts to confiscate the investment returns.

### *Norms and Culture*

Social characteristics such as social norms, identity, and trust have for some time featured as relevant for economic performance.[15] More recent literature documents this empirically, identifying robust economic effects of these "softer" factors.[16] Two chapters in this volume tackle these effects from different perspectives.

**Chen** (chapter 8) focuses on the relationship between religious intensity and social violence. Using the differential effect of the Indonesian financial crisis across regions as an identifying variable, he illustrates an increase in both, depending on the region's vulnerability. He then goes on to argue for a causal effect from religiosity to social violence. In other words, the intensity of religious sentiments seems to have increased in Indonesia in response to the financial crisis and, in turn, to have caused an increase in social violence. The availability of social insurance acted, however, to mitigate this effect. One of the chapter's conclusions therefore is that people tend to resort to deeper religious identification and religious extremism in times of crisis, especially in the absence of a well-organized social insurance scheme.

**Shayo** (chapter 9) sets to study the determinants of identification with one's nation and its effects on attitudes toward redistribution using the data from several surveys of individual attitudes in most of the world's countries. He finds that income is negatively related to the intensity of such identification, so the poor are more likely to identify with the nation than the rich. Moreover national identification reduces the support for income redistribution. The chapter provides one argument why redistributional demands by the poor are often quite limited: while fiscal considerations would appear to cause an increase in these demands, social dimensions seem to moderate them.

### *The Organization of the Volume*

While the issues above form just a relatively small subset of the relationship between political, social and economic factors in development, each constitutes an important research area with well advanced literature both theoretical and empirical. The growing data availability both at a macro, country level and at a micro level of individual or small aggregate units has led to a mounting insistence on measurability of theoretical concepts and on making them ever more operational. Consequently the volume is organized around the themes reviewed above. It begins with the section on governance structure (Gennaioli and Rainer, Khemani, and Kremer), continues with the section on institutional quality and property rights (Vicente, McBride and Skaperdas, and Wärneryd), and concludes with the section on social and cultural norms as the main driving forces for development (Chen and Shayo).

The issues being vast and the literature evolving fast, it is impossible to expect from a volume like this to do full justice to the existing body of work and the variety of approaches pursued, all the more to solve the development puzzle. A more modest aim is to stimulate a discussion and, perhaps, provide a fertile ground for further work. Indeed our hope is that this collection will be useful both for continuing academic efforts in the area of economic development as well as to its many dedicated practitioners.

## Notes

1. Calculations based on World Development Indicators.

2. See Acemoglu (2005) for an example of this approach.

3. For instance, Besley and Case (1995), Seabright (1996), Hendriks and Lockwood (2005).

4. See Bardhan and Mookherjee (2006), Blanchard and Shleifer (2001), Treisman (1999b, 2000a).

5. See, for instance, Kessing, Konrad, and Kotsogiannis (2007) for a discussion and empirical evidence regarding the detrimental role of vertical decentralization for countries' ability to attract foreign direct investment.

6. For instance, Acemoglu et al. (2002), Hall and Jones (1999), and Rodrik et al. (2004).

7. See Mauro (1995) for an example of the former, and Gyimah-Brempong (2002) for the latter. Gyimah-Brempong (2002) estimates the direct and indirect effect of an increase in the corruption index by one unit to cause a reduction in the growth rates of GDP in a large set of African countries by three quarter to 0.9 percentage points per year.

8. Sala-i-Martin and Subramanian (2003) and Bulte, Damania, and Deacon (2003).

9. Easterly and Levine (1997), Collier (2000), and Collier and Hoeffler (2004).

10. Akerlof and Kranton (2000), Alesina et al. (1999), Barro and McCleary (2003).

11. A key insight emerging from this work is that the relationship between conflict and fractionalization is unlikely to be monotonic, or even linear (Collier 2001). Two large ethnic groups may struggle much more forcefully with each other than a much more fractionalized country.

12. Andersson (1991) contains an empirical account on confiscatory taxation and nationalization.

13. Examples are Eaton and Gersovitz (1983), Cole and English (1991), and Thomas and Worrall (1994).

14. For instance, Grossman and Kim (1995), Hirshleifer (1995), Müller and Wärneryd (2001), and Skaperdas (1992, 2003).

15. See Adelman and Morris (1967).

16. Thus Zak and Knack (2001) find that trust enhances growth prospects; Easterly and Levine (1997) emphasize the significance of ethnic cleavages in explaining poor economic performance of African countries; Hall and Jones (1999) develop measures of social infrastructure that they find extremely relevant for economic growth across countries.

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