

Institutions, quality of government and regional cohesion

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Introduction

- ▶ **Do institutions matter for economic development?**
- ▶ **The link between institutions and economic development has traditionally been overlooked**
- ▶ **Traditional approaches and policies to spurring economic development were based on:**
 1. Greater investment in the stock of physical capital (neoclassical)
 2. Endogenising innovation, technology, and physical capital (endogenous growth)
 3. Agglomeration, externalities, and distance (new economic geography)
- ▶ **This system tended to work in the past**
 1. National intervention in the postwar period had coincided with growth and a reduction in disparities
 2. The first two approaches informed the European regional development effort during the reform of the Structural Funds

Do traditional approaches still work?

▶ These approaches, however, seem today less capable of explaining economic growth and development

1. Regional convergence in Europe shifted to stability
 - Cross-country convergence
 - Intranational divergence
2. Growth in the residual factor
3. Disagreement among independent studies about the returns of the European regional development effort

▶ Institutions being rediscovered

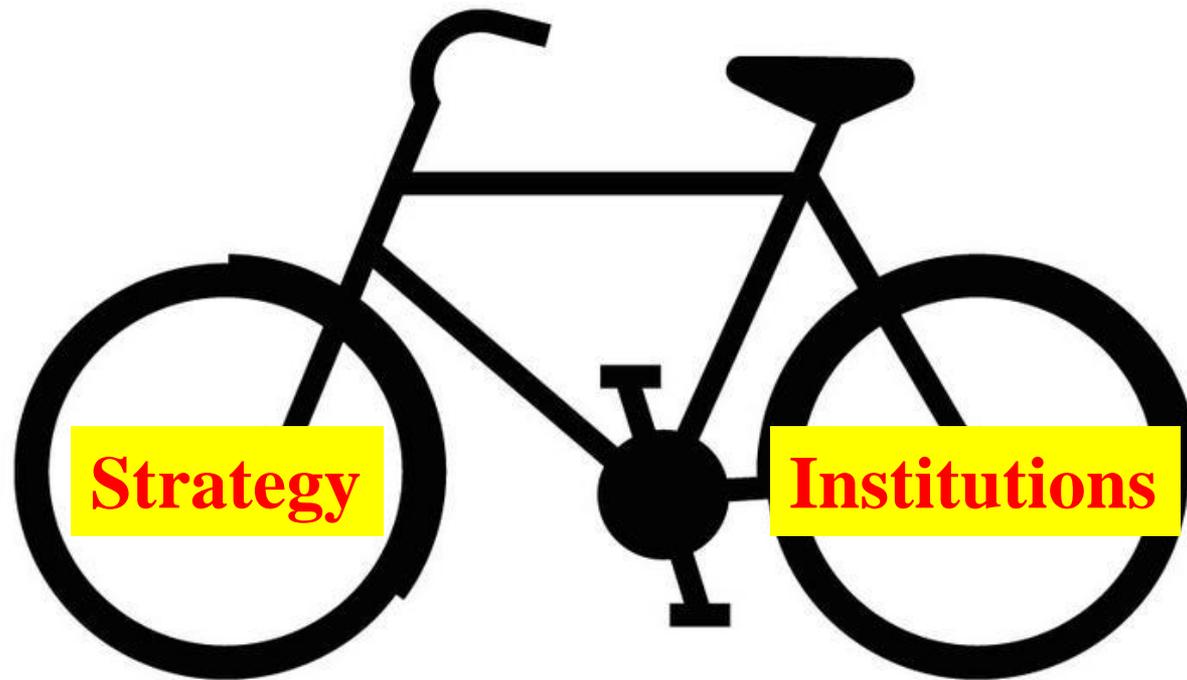
1. Work by sociologists, geographers, and some economists since the mid-1980s
2. Becoming mainstream in economics
 - ‘Institutions matter’ (Hall and Jones, 1999; Rodrik et al, 2004)
 - Research now trying to understand which institutions matter
 - Some institutional arrangements are more appropriate than others, depending on the circumstances (Aghion and Howitt, 2006)

The role of institutions in development

- ▶ **Across the world development policies seem to be becoming less effective**
 1. Neoclassical orthodoxies regarded as inadequate and perhaps providing imperfect interpretations of regional development (Yeung, 2000)
- ▶ **Growing attention has been paid to other factors and, especially institutions**
- ▶ **Belief that different local institutional arrangements are key to our understanding of development**
 1. Emphasis on social capital (Putnam, 1993, 2000)
 2. On institutional thickness (Hudson, 1994; Amin and Thrift, 1995)
 3. Learning regions (Morgan, 1997)

How is development achieved?

- ▶ Through a balance between strategies and institutions



Why local and regional institutions?

► National institutions are often considered as:

1. Too remote to be able to respond effectively and rapidly to local and regional needs of collective goods.
2. Too rigid and distant to be capable of articulating the negotiating bodies or agencies through which the interaction of local economic and social actor is achieved and networks are set

Integrating institutions in development

- ▶ **Developing and improving institutional capacity is therefore increasingly regarded as key for development**
- ▶ **There is a need to integrate institutions in development strategies**
- ▶ **But this is easier said than done**
- ▶ **Several factors limit the integration of institutions in development strategies**

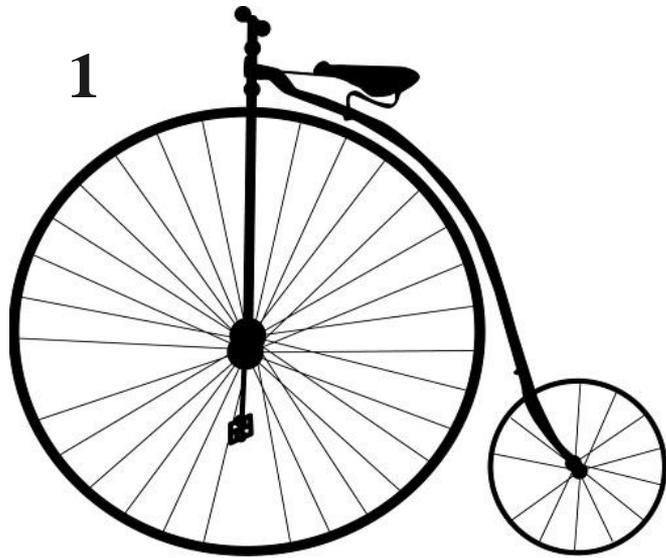
Key problems

- ▶ **Measuring institutions is difficult and controversial**
 1. Local institutional constructs tend to be intangible (Fine, 2000)
 2. Identical formal institutions may yield very different economic returns in different contexts
- ▶ **Efficient institutions are context- and geography-specific**
 1. What is solid and efficient in one region may not be so in another
 2. There is a need to integrate institutions in development strategies
- ▶ **The effectiveness of institutions changes with time**
 1. What are 'good' institutions in one period may no longer be appropriate in another (Storper, 2005)
 2. Institutions need to adapt (institutional migration)
- ▶ **Institutions are extremely resilient to change**
 1. Persistence of family structures (Duranton et al., 2009)

Key problems (II)

- ▶ **Identifying the right mix of institutions is problematic**
 1. More than the density of institutions...
 2. It is the quality of institutions
- ▶ **Endogeneity between institutions and development**
 1. Direction of causality difficult to predict
- ▶ **Endogeneity between institutions and other constituents of growth**
 1. Institutions may hide the effect of other factors and especially human capital (Glaeser et al., 2004)

What do we often have?



3



What do we often have?

- ▶ **Mimicking of policies developed elsewhere**
- ▶ **With no prior adaptation to local conditions**
- ▶ **In settings of inadequate institutions**
 1. Prevalence of individual over collective interests
 2. Rent-seeking
 3. Impacted information problems and free-riding
 4. Insider-outsider problems
 5. Inefficient systems

Big ambitious strategy



Inadequate local institutions

So, what do we do?

- ▶ **While institution-building is essential for development...**
- ▶ **‘One size fits all’ institutional intervention is likely to be counterproductive**
- ▶ **Institutional component of development policies needs to be region specific**
 1. Policies need to adapt to place-bounded institutions
 2. And to understand local conditions
- ▶ **Does this mean going from ‘one size fits all’ to ‘tailor made’?**
 1. No, excessive ‘tailor made’ will be difficult to implement and monitor
 2. Need to define clear guidelines in terms of development strategies and types of institutional intervention:
 - Guidelines for capacity building
 - Guidelines for increasing participation
 - Guidelines for increasing transparency and accountability
 - Guidelines for minimising corruption
 3. Leaving sufficient leeway for adaptation to local conditions

How does this work in practice

- ▶ **Good institutions are essential...**
- ▶ **But so is the existence of a good policy**
- ▶ **Both factors very often go hand in hand...**
- ▶ **But you can have one without the other**
- ▶ **Present the case of how institutional (government quality constraints) have limited the impact of the European Regional Cohesion policy**

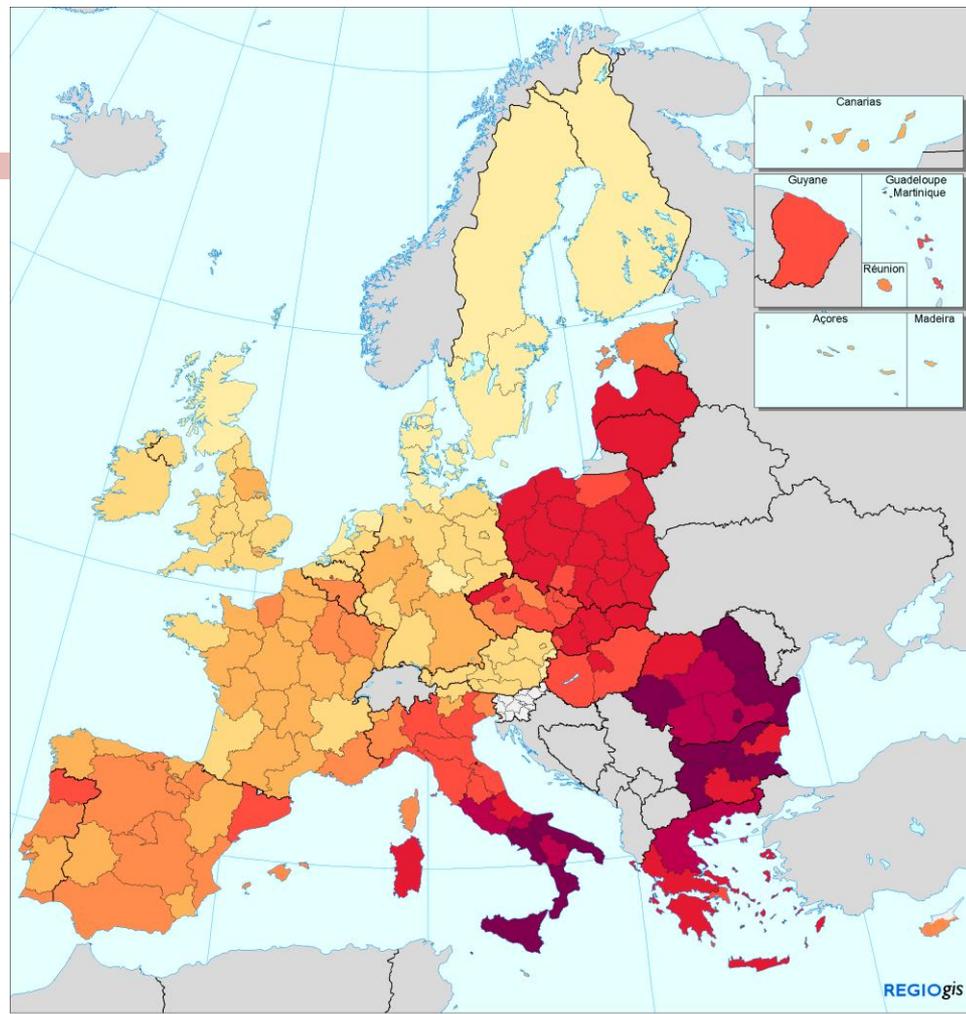
Quality of government and cohesion in the EU

- ▶ **The EU, the area of the world with the largest regional development, has come to this realisation after 25 years of strong intervention**
 1. The presence of weak governmental institutions
 - Weak rule of law
 - Corruption
 - Low quality of bureaucracy
 - Weak or unstable electoral institutions
 2. May undermine the assimilation of funds
 3. And affect the potential returns of the European Cohesion effort
- ▶ **But little empirical evidence of the extent to which quality of government may affect the returns of public policies**

Measuring the quality of government

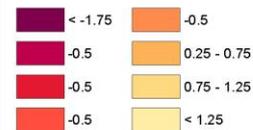
- ▶ **This type of analysis has been constrained by problems measuring the quality of government**
 1. Increasing data at national level
 2. But virtually nothing at a regional level, from a comparative perspective
- ▶ **Recent study by the by the Quality of Government Institute at the University of Gothenburg (QGI, 2010)**
 1. Development of a Quality of Government (QualGov) Composite Index
 - Rule of law
 - Corruption
 - Quality of the bureaucracy
 - Democracy and the strength of electoral institutions
 2. Survey data (2009) from some 34,000 respondents (and 2013, 82,000 respondents)
 3. 18 EU countries, 172 regions

Quality of Government (QoG) Index



European Quality of Government index, 2009

Standard deviation, range from poor quality (negative) to high quality (positive)



Note: EU = 0

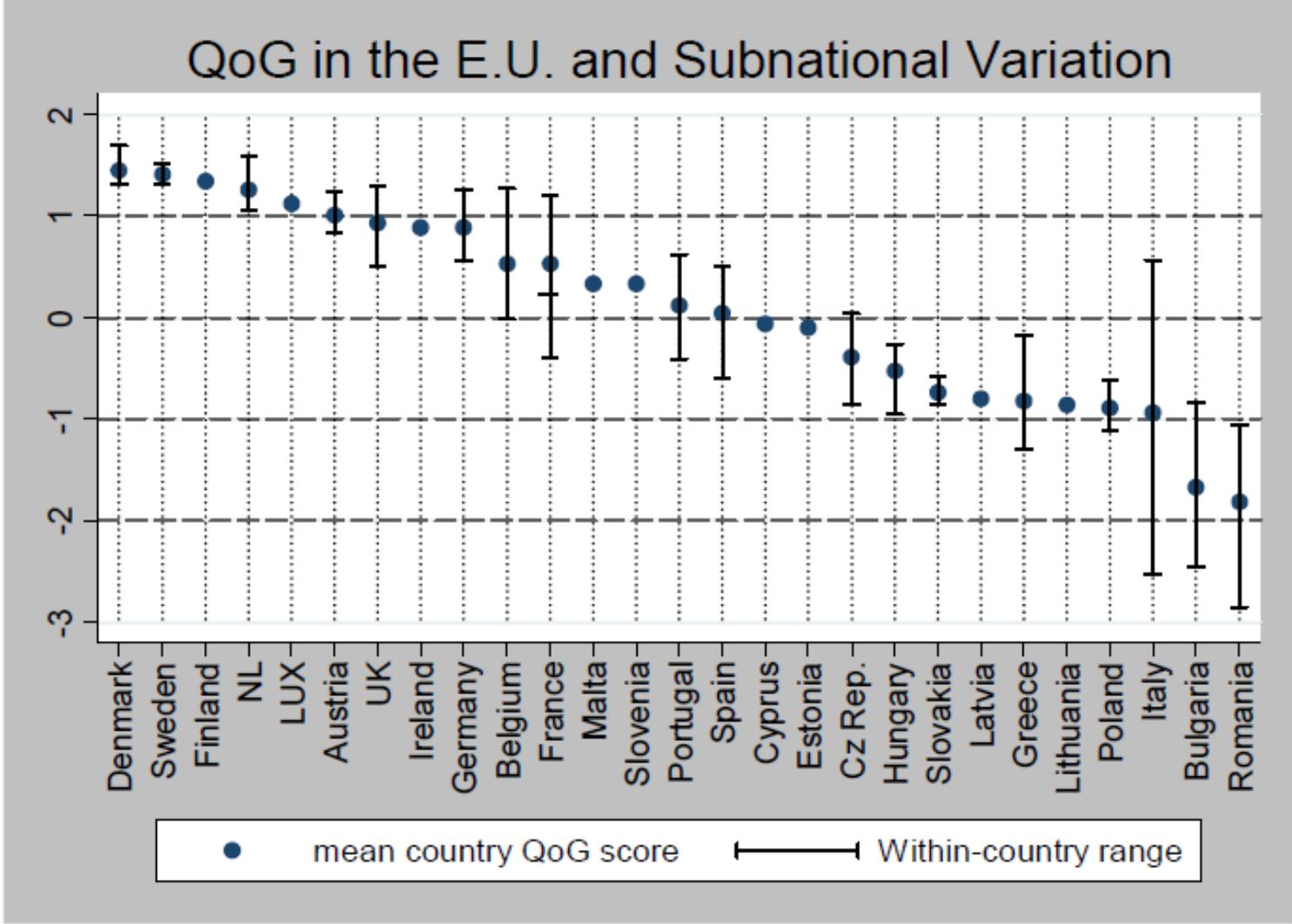
Source: World Bank and regional quality of government survey

0 500 Km

© EuroGeographics Association for the administrative boundaries

Source: Quality of Government Institute 2011

Big within- and cross-country differences



Source: Quality of Government Institute, 2010, p. 41

Model

$$\Delta y_i = \alpha + \beta y_i + \delta Cohesion_i + \phi QGov_i + \gamma Cohesion * QGov_i + \boldsymbol{\varphi} \mathbf{X}_i + v_i$$

► Where:

1. Δy is the average annual growth of real GDP per capita of region i over the period 1999-2005;
2. y_i is the GDP per capita in the previous period;
3. *Cohesion* represents the expenditure per capita in cohesion in region i by the EU in any given year;
4. *QGov* is a composite indicator of the quality of government in any given European region, collected by the Quality of Government Institute at the University of Gothenburg;
5. *Cohesion*QGov* is the interaction between the previous two variables;
6. \mathbf{X} denotes a vector of control variables
 - Level of education and training of the adult population
 - Infrastructure endowment
 - Levels of employment
 - Agglomeration effects
7. v is the corresponding disturbance term.

Investment, QoG and regional growth

Dep. Variable	(1)	(2)	(3)	(4)	(5)	(6)
GDP pc growth	2-way FE	2-way FE	2-way FE	2-way FE	GMM-sys 4 to 7 lags	GMM-sys 4 to 5 lags
In GDPpc	0.00119 (0.00848)	0.00693 (0.00976)	0.000756 (0.00878)	0.000780 (0.00877)	-0.0332*** (0.00892)	-0.0328*** (0.00951)
Cohesion expenditure pc	3.16e-05** (1.15e-05)		3.05e-05** (1.20e-05)	3.10e-05** (1.24e-05)	4.44e-05** (1.84e-05)	5.25e-05*** (2.03e-05)
Quality of government		0.00384 (0.00277)	0.00380* (0.00217)	0.00392 (0.00243)	0.00137 (0.00510)	0.00178 (0.00513)
Cohesion exp x quality gov				-9.94e-07 (1.04e-05)	1.07e-05 (1.85e-05)	1.29e-05 (2.11e-05)
Time controls	Yes	Yes	Yes	Yes	Yes	Yes
Country controls	Yes	Yes	Yes	Yes		
Observations	972	1,017	972	972	1,125	1,125
R-squared	0.261	0.238	0.264	0.264		
No. of countries	18	18	18	18	18	18
p-value of Hansen test					0.353	0.006
Instruments					173	124

Robust standard errors in parentheses

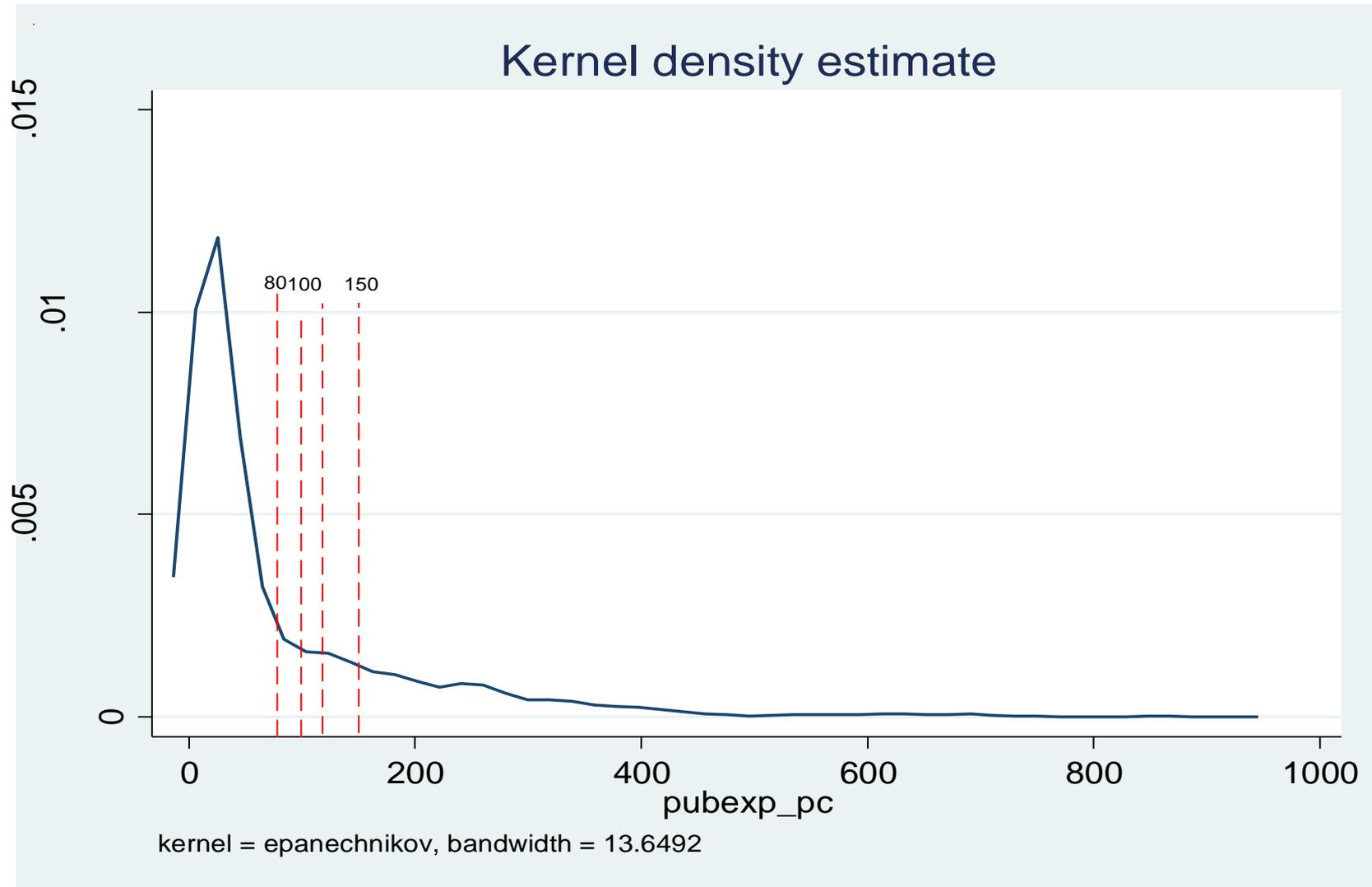
*** p<0.01, ** p<0.05, * p<0.1

Investment in Cohesion has a positive and significant association with economic growth

Regardless of the local and regional quality of government

Interaction between both factors not relevant

Unequal distribution of Cohesion expenditure



Using a threshold of €100 per head

Dep. variable	(1)	(2)	(3)	(4)
GDP pc growth	2-way FE	2-way FE	2-way FE	2-way FE
ln GDPpc	-0.0494** (0.0207)	-0.0116 (0.0157)	-0.0603** (0.0202)	-0.0621** (0.0197)
Cohesion expenditure pc	2.12E-05 (1.69E-05)		1.41E-06 (1.56E-05)	1.72e-05** (6.58E-06)
Quality of government		0.0136** (0.00514)	0.0125*** (0.00336)	0.0225*** (0.00633)
Cohesion exp x quality gov				-4.39e-05** (1.50E-05)
Time controls	Yes	Yes	Yes	Yes
Country controls	Yes	Yes	Yes	Yes
Observations	218	263	218	218
R-squared	0.336	0.379	0.355	0.355
No. of countries	10	14	10	10

Above €100 of expenditure per person, per annum, investment in Cohesion ceases to be significant

Whereas quality of government becomes fundamental

And the interaction between both variables is significant, but close to 0

Using different thresholds

The returns of greater cohesion expenditure weaken as the threshold increases

While the impact of the quality of government becomes more and more important fundamental

As does the interaction between expenditure and quality of government

Dep. Variable	(1)	(2)	(3)	(4)	(5)
GDP pc growth	No threshold	>80€	>100€	>120€	>150€
In GDPpc	0.000780 (0.00877)	-0.0472** (0.0182)	-0.0621** (0.0197)	-0.0816*** (0.0240)	-0.0729*** (0.0221)
Cohesion expenditure pc	3.10e-05** (1.24e-05)	1.71e-05*** (5.21e-06)	1.72e-05** (6.58e-06)	2.54e-05* (1.17e-05)	1.48e-05 (1.65e-05)
Quality of government	0.00392 (0.00243)	0.0186** (0.00611)	0.0225*** (0.00633)	0.0258*** (0.00627)	0.0315*** (0.00721)
Cohesion exp x quality gov	-9.94e-07 (1.04e-05)	-4.07e-05** (1.51e-05)	-4.39e-05** (1.50e-05)	-5.49e-05** (2.01e-05)	-6.83e-05*** (1.94e-05)
Time controls	Yes	Yes	Yes	Yes	Yes
Country controls	Yes	Yes	Yes	Yes	Yes
Observations	972	252	218	193	165
R-squared	0.264	0.342	0.362	0.350	0.346
No. of countries	18	11	10	10	10

Impact on growth at different thresholds

Impact on growth of one standard deviation increase

	>80€	>100€	>120€	>150€
Increase in structural fund expenditure	1.93	1.68	1.59	1.50
Increase in quality of government	6.94	6.93	5.63	6.89

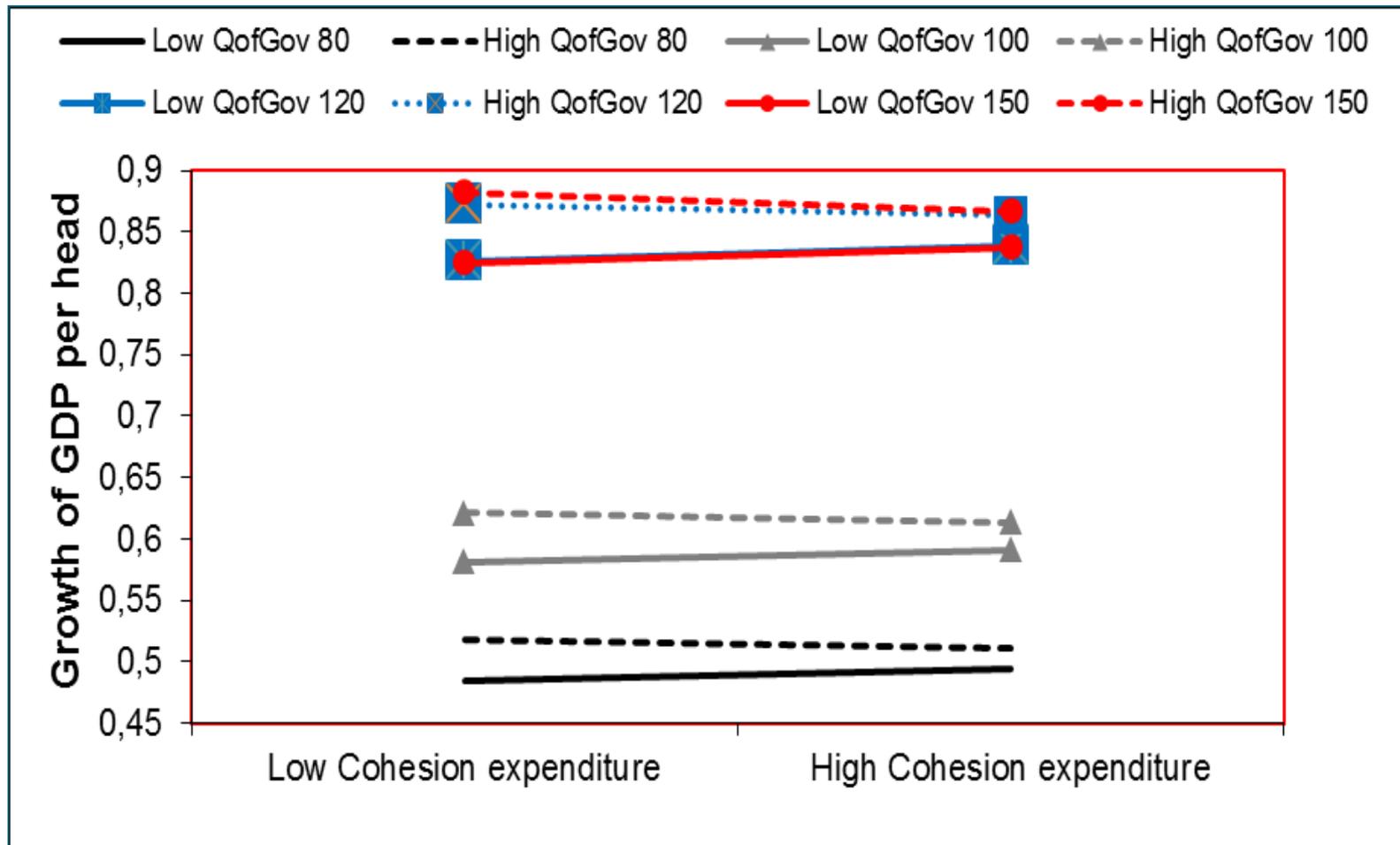
Impact of increase in quality of government is significantly greater than that of pouring additional funds above €80

The economic returns of investing more in cohesion in Europe stop at €120

Above €80, regions with a higher quality of government perform significantly better at the same level of cohesion expenditure than those with a lower quality of government.

In order for greater cohesion investment to overtake the advantages of quality of government, EU cohesion budget would have to be multiplied 2.7 times

Graphic interpretation of the analysis



Strategies of gain and strategies of waste

- ▶ **There is a fine line between generating strategies of gain and strategies of waste**
 1. It will depend on how successful a strategy is in embedding economic activity within a certain territory
 2. The more adequate the diagnosis and the design of the strategy, but also the better local institutions, the greater the chances of medium and long-term success
- ▶ **But the risks of relying on one policy instrument are significant...**
- ▶ **making strategies of waste more prevalent than strategies of gain**

Strategies of gain and strategies of waste (II)

► Reasons for the prevalence of strategies of waste

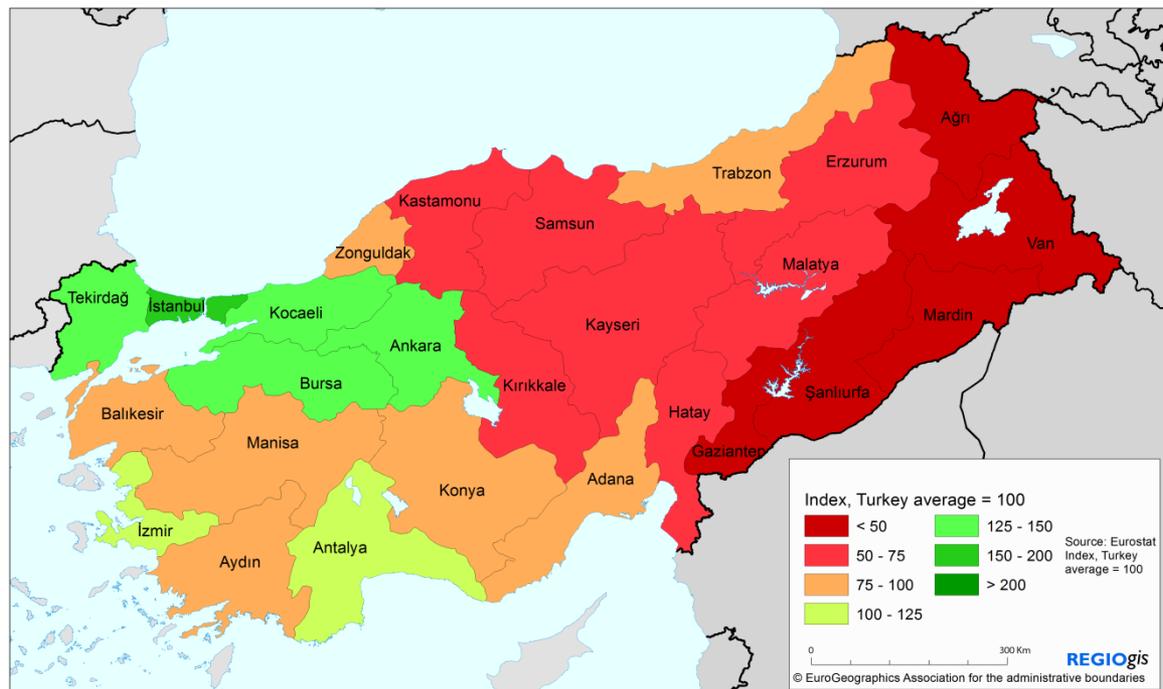
1. Based on the difference between public opinion and political cycles and economic development cycles
 - Economic development is a medium and long term task...
 - Public opinion and political cycles are very short term and short term respectively.
 - Decision-makers will look for short-term public support, and visibility
 - Decision-makers will look for easy (if unimaginative) strategies
 - Decision-makers will look for legacy
 - The development of the civil society will act as a filter

Strategies of gain and strategies of waste (III)

- ▶ **Emphasis on simple, highly visible, short-term and transferable strategies**
 1. Infrastructure
 2. FDI
- ▶ **To the detriment of medium and long-term more balanced and tailor-made strategies**
- ▶ **And of greater emphasis on the quality of local institutions**

What is in it for Turkey?

Turkey: GVA per head, 2008



► Important territorial disparities in Turkey

1. Untapped and unused economic potential
2. Economic risk
3. Socio-economic and political risk

What is in it for Turkey? (II)

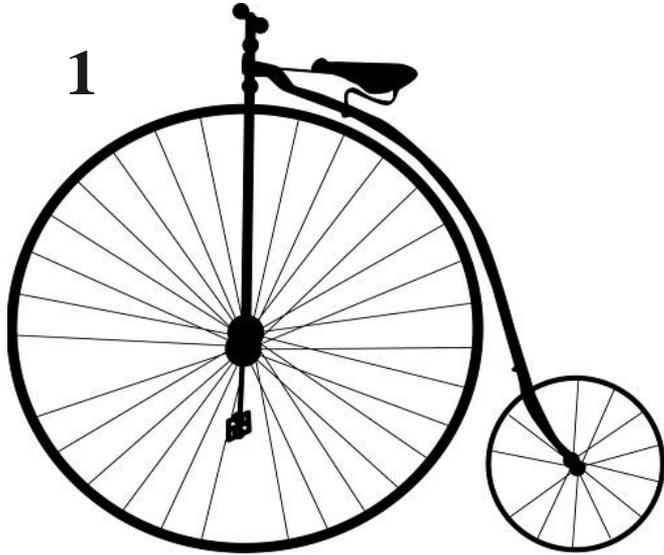
- ▶ **Need to stimulate growth, specially in lagging-behind regions**
- ▶ **But institutional quality problems**
- ▶ **... But limited resources**
- ▶ **Need to make the most of scarce resources**
 1. Tackling institutional problems at the same time as applying adequate development strategies
 2. Will increase the returns of any policy
 3. And reduce the monetary cost of intervention

Conclusions

- ▶ **Both traditional public investment and institutions make a difference for regional economic growth**
- ▶ **The greater the level of expenditure and the better the quality of the local institutions, the higher the economic returns of public expenditure on cohesion**
- ▶ **Institutions strongly mediate the returns of any development effort**
- ▶ **And, in many regions, greater levels of public investment expenditure would only lead to a marginal improvement in economic growth, unless the quality of local institutions is significantly improved**
- ▶ **There are no shortcuts: throwing a greater amount of funds will not do the trick, unless institutions improve.**

Change from this...

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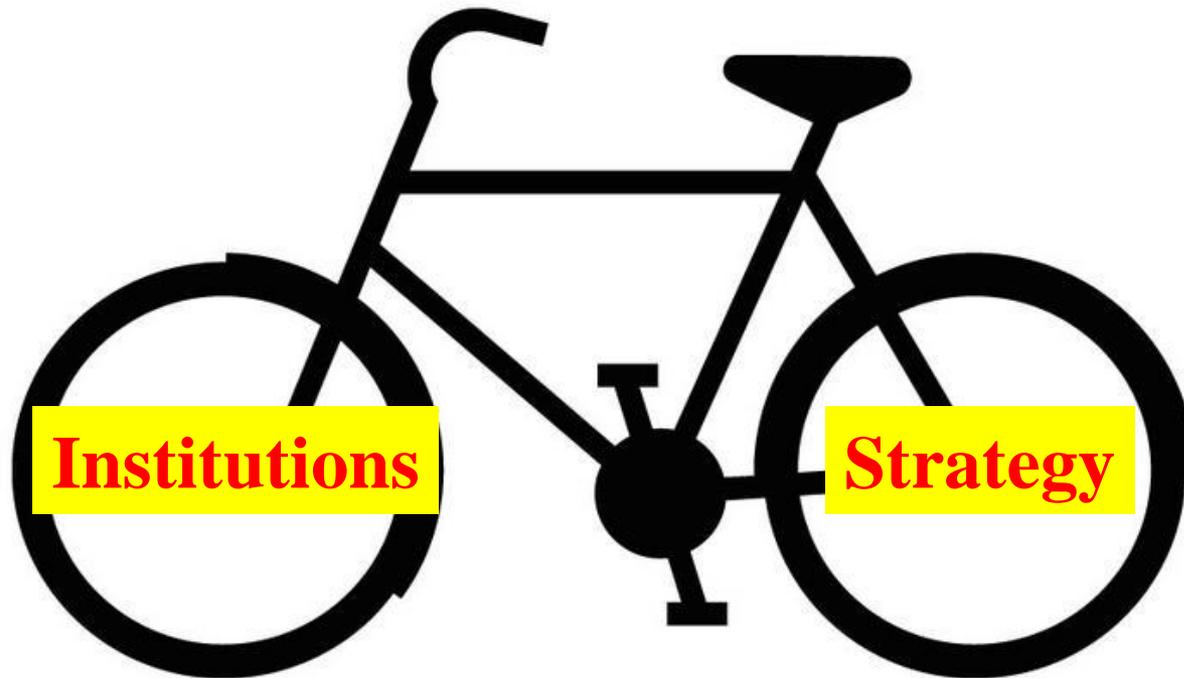
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To this



Thank you!

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and regional cohesion**

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More information and research:

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