SITE Academic Conference

"Institutional Challenges in Emerging Economies"

September 2-3, 2013

Report

"The Beginning of a New Tradition"

Institutions matter for economic outcomes. They influence the business environment firms operate in, the efficiency of markets that determine the allocation of capital and labor, the quality of public service delivery and the ability of citizens to hold their politicians accountable.

The constraints that bad institutions put on development are most clearly shown in emerging economies. Institutions in these countries differ from those in the developed world, possibly rendering traditional economic insight inapplicable. Therefore, it is important to understand the challenges that arise due to the specific institutions of emerging economies.

On September 2-3, 2013, the Stockholm Institute of Transition Economics held an academic conference aimed at discussing the key challenges of institutions and institutional reform in developing and emerging economies. 22 researchers from Sweden, Europe and the US came together to discuss their ongoing research on issues ranging from improving access to financial markets for the poor, the allocation of talent, and the impact of informal institutions like religious practice, to fighting corruption and institutional reform.

The program of the conference was specifically designed to bring together economists of very different fields to ensure that both micro and macroeconomic insights could be discussed. It was also composed with the idea to hear different methodological perspectives of research carried out in field experiments, as empirical studies drawing on historical data, but also from a theoretical standpoint. The keynote speaker David Laitin from Stanford University took the debate one step further, stressing the importance to connect academic research to policy advice.

This conference marks the beginning of a new tradition at SITE. With our annual academic conferences we hope to provide a regular platform for academic debate as a key input into policy analysis and advice. We would like to thank our sponsors from Riksbankens Jubileumsfond and Vetenskapsrådet for their generous support to make this event possible.

Torbjörn Becker, Director of SITE

Session 1: Access to Finance

Emily Breza from Columbia GSB opened with describing the results from a field experiment she conducted together with her coauthor Arun Chandrasekhar to explore two interventions that might help individuals to increase their savings balances. Emily argued that in rural India, the formal financial sector has extensive geographical reach. The density of local bank branch offices is high, and they offer savings accounts with no or very little fees. Yet, rural households appear to save inadequately. Instead of a lack of opportunity, the literature has quoted behavioral biases such as inattention, time inconsistency and temptation as underlying causes. In her project, Emily and her coauthor explore whether savings monitors can help overcome these problems. They designed a financial product based on the business correspondent model, which includes frequent reminders, assistance in opening an account, and the setting of a six-month savings goal. They then measured the effectiveness of adding a peer monitor to this basic bundle and tested whether the local social network can help to increase the penetration of the formal banking system. In the study that was carried out in 60 villages located in Karnataka, India, they find that the business correspondent component had at most a modest effect on savings accumulation. Individuals in the treatment group had a low rate of achieving their established long-run savings goals. However, adding a monitor from their peer network had a large effect on goal attainment. The results suggest that incorporating social networks into financial institutions might be useful to alter the low savings rates in emerging countries.

This point of view was reinforced by **Konrad Burchardi from IIES**, who gave the formal discussion. He argued that this project stresses the potential of social collateral in solving internal agency problems. He questioned, however, how this approach could be implemented beyond the framework of the study, and whether the effect would still be as strong once peer monitoring has become common practice and is potentially internalized by the savers and subsequently subject to the same behavioral biases. Other conference participants raised doubts as to whether the payment scheme used to incentivize the monitors was giving rise to socially suboptimal behavior (e.g. gaming the system, or increased pressure to safe beyond the optimal point). Emily reported that indeed any incorporation of the social network needed to be monitored and required intervention to obtain the socially optimal results.

The second presentation was given by **Simone Schaner from Dartmouth University**. Simone argued that individuals may face demands on their savings from others, making formal savings accounts less attractive the cheaper they are to access. Too much liquidity could worsen for example a woman's ability to save long-term when her bargaining power within the family is low. The easy access to her savings could make it harder for her to object demands from her husband or other family members. To study whether such effects could explain the low rates of savings in formal accounts despite their wide availability, Simone set up a field experiment in Kenya. In the randomized trial, she offered free ATM cards to a subset of newly opened bank accounts, which substantially reduced the cost of accessing savings in these accounts. She finds that subsequently, the cheaper accounts are predominantly used by men or couples, but that reducing the access fees had a negative effect on women's savings in these accounts. The results suggest that indeed the intra-household bargaining structure might account for low usage of very liquid savings vehicles. Simone further tests this hypothesis by proxying the bargaining power of husbands and wives with demographic characteristics and finds that both men and women with below-median bargaining power exhibit negative response rates to the reduced fees. This study highlights that very different underlying cultural and societal structures might render an a priori positive institutional reform ineffective in developing economies.

Maria Perrotta Berlin from SITE, who formally discussed this paper, raised doubts as to whether the study adequately measured who exactly increased or decreased the usage of savings accounts, because other available savings vehicles had not been taken into account. She noted that it might simply be the case that the offered experimental accounts did not meet the needs of the population for some non-studied reason. Furthermore, Maria pointed out that it was unclear whether an increase of the savings rate through increasing liquidity was the socially optimal objective. Maria agreed, however, that the studied differential effects on men and women pointed to an underlying effect that warrants further investigation, if one takes as given the premise of trying to increase the use of formal savings accounts. Other conference participants asked whether the results were of any longer-run relevance. Simone pointed out that she indeed found effects of her intervention three years later, and that the study was still running to confirm any further impact.

Session 2: Informal Economy and Corruption

Mauricio Prado from Copenhagen University presented a theoretical investigation into the institutional challenges faced by firms and workers which lead to them operating and working informally. He argued that the answer to the question of why firms and workers become informal boils down to a cost-and-benefit analysis. He therefore aimed to understand what the main determinants of the costs and benefits to informality are and how they interact. In particular, the study uses a heterogeneous firm and agent model of an open economy, and considers the level of taxes and tariffs as well as the degree of enforcement, paired with regulation that might increase or decrease productivity of firms in the formal sector. Based on his model, Mauricio concluded that for emerging economies, the main factor driving informality is socially inefficient regulation rather that too little enforcement or too high taxation.

Jens Prüfer from Tilburg University offered his remarks on the paper. He criticized that the main result might be driven by the assumption that regulation is purely inefficient. While as a stylized fact this might be true, a theoretical model that claims regulation is bad must at least allow for the possibility that some regulation might be desirable. Jens argued that this is particularly true in emerging markets where the environment is generally thought of as too little rather than too much regulated. Moreover, regulation might be a direct determinant of whether someone works in the formal or informal sector for example by providing work permits, rather than just through the incentive effects considered in the model. Lastly, Jens questioned whether the very stylized general equilibrium framework chosen by Mauricio was the appropriate toolkit to model institutions, especially in developing countries where market imperfections play a large role.

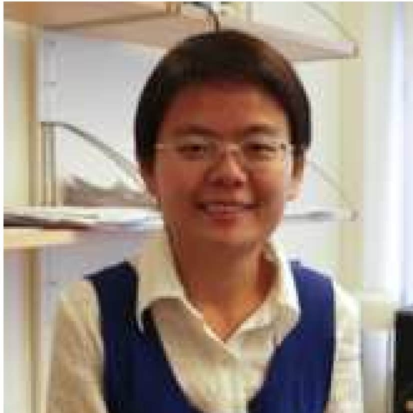
Stephan Litschig from Pompeu Fabra continued with a presentation about judicial presence and rent extraction. Together with his coauthor Yves Zamboni, Stephan used a unique dataset from Brazil to ask whether corruption in local governments was larger or smaller in districts that had a

court and police. Theoretically, the physical proximity of prosecutors and judges could have ambiguous effects on corruption: On the one hand, they might deter local politicians from corrupt actions. On the other hand, they might also be more easily captured themselves and not be able to control and prosecute independently. In their study, Stephan and Yves found that the former effect prevailed in the Brazilian context. Fewer irregularities were noted in counties that had a court as opposed to counties that were served by a neighboring court. However, the authors found no effect on the intensive margin of corruption, i.e. conditional on an irregularity being recorded, the size of the offense was not smaller when prosecutors were physically located in the county. Moreover, the authors estimate that judicial presence reduces rent extraction only for first-term politicians. The results suggest that checks and balances do work through physical presence in Brazil.

Giancarlo Spagnolo from SITE offered his remarks on the study. He suggested that the effect was one of deterrence, and that the same should then hold for other crimes that are not related to corruption. He argued that the study could be extended in that way as a robustness check. Along these lines, Giancarlo noted that a large body of literature on Law and Economics was also relevant but not taken into account in the paper. Moreover, Giancarlo urged the authors to develop a general classification system of recording irregularities, in order to help a consistent measurement of corruption.

Session 3: Gender and Religion

The third session started with **Andreas Madestam from Stockholm University** talking about whether there was a gender bias in lending. Together with two coauthors, Andreas investigated the credit conditions for borrowers at a commercial micro-lender in Albania. He argued that both male and female officers were biased against borrowers of the opposite gender. Andreas showed evidence that borrowers whose cases were handled by an officer of the opposite sex faced higher interest rates, were given smaller loans and were subsequently less likely to return to the bank for a follow-up loan. Such discrimination is likely socially inefficient and detecting it is a first stage to implementing better standards. Andreas argues that such gender biases are especially severe in emerging markets were competition between lenders is low, and borrowers already face large obstacles to receiving loans.



In her formal discussion, **Ruixue Jia from the University of California, San Diego** suggested that the study should distinguish between a true behavioral bias and an information asymmetry. She outlined a theoretical model that could inform a more detailed estimation. Moreover, Ruixue raised the question of whether the lending outcome must necessarily be judged as inefficient, as suggested by Andreas. Other conference participants pointed out that the presented results are only valid if the bias is going in the same direction for men and woman, because the estimates represent the sum of both gender effects and could potentially cancel out. Andreas acknowledged this critique on the methodology, but argued that the qualitative findings would not be altered.

David Yanagizawa-Drott from Harvard University followed, presenting a project that aims at quantifying the economic effects of religious practice. David and his coauthor Filipe Campante study Ramadan, using variation in the length of the fasting period due to the rotating Islamic calendar. David showed that longer fasting has a negative effect on output growth in Muslim countries but at the same time increases subjective well-being among Muslims. He argued that these results are primarily associated with individuals choosing to move out of the formal sector and into self-employment, rather than with direct effects of fasting on labor productivity. Moreover, the results of his research suggest that Ramadan affects Muslims' relative preference regarding work and religiosity, suggesting that this mechanism also operates via changing beliefs and values.

Andreas Madestam from Stockholm University discussed this paper. He noted that the paper documented effects of fasting rather than religious practice, and so cannot easily be generalized to yield conclusions about the general effect of religion on economic outcomes. Moreover, since the results appear to come mainly from substitution of formal work, he suggested that one should see a difference depending on how rigid labor markets are. In some countries or sectors it might not be easily possible to adjust along the employment margin. Andreas, as well as other conference participants, pointed out that the results might also be in part driven by a seasonal effect. In the years where Ramadan coincides with longer days (more daylight), it might also coincide with Harvest season, which sees higher demand for labor. The decreased productivity due to fasting could then explain lower growth rates, but also higher satisfaction.

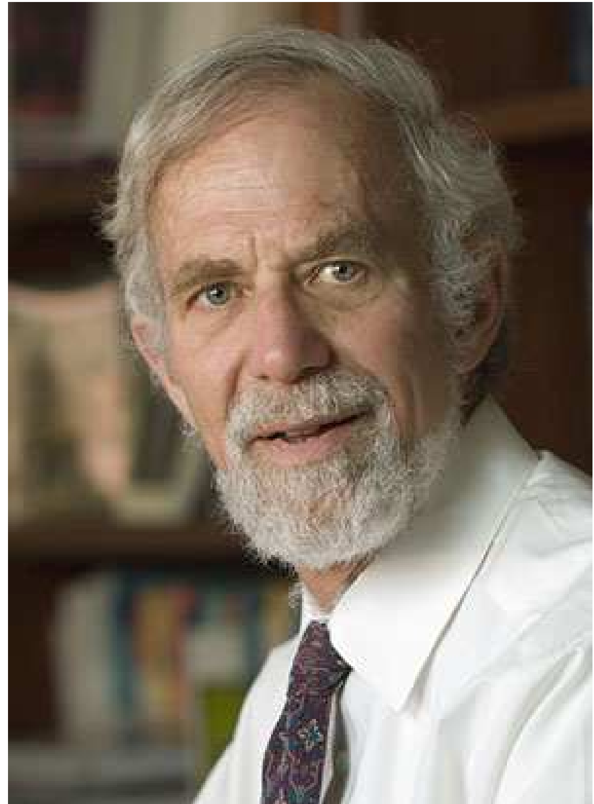
Session 4: Education and Human Capital

In the final session of the first conference day, **Leonid Polishchuk from the Moscow Higher School of Economics** talked about institutions and the allocation of talent. Comparing the educational choices of students in the Ukraine and Poland, he argued that the underlying institutional differences between these countries are a key determinant of how many students chose to study science versus law. He argued that stronger institutions make young Poles confident in the ability to earn good rates of return to their skills, knowledge and innovations in modern technologies, whereas young Ukrainians believe that law degrees would better equip them for an institutional environment where the rule of law is feeble and corruption and rent-seeking are prevalent. Leonid then offered a theoretical model that reflects this mechanism and predicts that more talented individuals are particularly sensitive in their career choices to the quality of institutions. Together with his coauthor Timur Natkhov, Leonid tested these predictions on a sample of 95 countries and reported a strong positive correlation between the quality of institutions and graduation of college students in science. The results of this study suggest a new channel by which better institutions might increase human capital, and therefore provides a new link between institutions and macroeconomic performance.

Ina Ganguli from SITE offered comments on this paper. She first mentioned many more data sources that the authors could consider for future research. She noted in particular that the field of study as a proxy for productive versus rent-seeking activities in society might be misleading, since the use of undergraduate degrees differs greatly in different countries. Ina also pointed out that the model as well as the empirical analysis did not take into account any dynamic effects, and suggested a further analysis using different cohorts of students. Other conference participants raised the concern that graduates from the Ukraine and Poland faced very different demands for labor, given that Polish citizens could move freely in the European Union, whereas Ukrainian students had to find jobs locally. Along these lines Ina suggested that migration and other effects from globalization should be taken more seriously in the study.

Institutions and Development: Limits to Identification

Keynote Address by David Laitin, Stanford University



At the end of the first conference day, David Laitin of Stanford University offered a keynote address. David is the James T. Watkins IV and Elise V. Watkins Professor of Political Science. During his career he has conducted extensive field research in developing countries as well as survey and experimental studies on language, culture and politics.

In his talk, he addressed the question of what policy advice researchers can offer based on current research in development economics. He started by addressing both the in his view revolutionary impact of the relatively new methodology of using randomized trials as well as its critiques prevalent in the development economics community.

Offering his own point of view in this debate, Laitin urged that research on economic development needed to assess the degree to which the identified cause addresses the underlying macro problem that motivated the research in the first place. He raised the concern that much of the currently published research focusses on very specific questions and has therefore only very limited external validity. He argued that with the focus on statistical significance many research findings get blown out of proportion. Quoting three examples in recently published articles, he showed that while the cited effects can appear quantitatively large, putting results in the macro perspective often shows that they might only lead to insignificant improvements. Such over-estimation then gives misleading input into the political cost-benefit analysis, thereby undermining sound policy advice.

Moreover, Laitin stressed that better direct data on institutions is needed in order to study the mechanisms by which these institutions work. At the end of his talk, he argued that future research needs to move beyond the static models currently used, in order to provide theoretical intuitions of why any innovation in institutions would be self-reinforcing.

Session 5: Political Economy

The second conference day started with a session on Political Economy. **John Morrow from LSE** presented his theory of the political economy of inclusive rural growth. Together with his coauthor Michael Carter, he developed a model that aims at explaining why shared growth policies have led to the so called East Asian Miracle but have not been implemented elsewhere. He examined the structure of political competition between parties that offer different amounts of tax-financed public goods and could convince uninformed subsistence voters by persuasive messaging. Morrow explained that such structures could lead to both vicious and virtuous cycles of political-economic outcomes, since the support for public goods depends on technology adoption, which in turn depends on the credible level of public good provision. He argued that in societies with high initial inequality, a policy that provides positive amounts of public goods from which all parts of society could benefit (i.e. an inclusive growth strategy) is unlikely to succeed over one that offers zero public goods. The results of this study therefore stress the importance of the underlying conditions in terms of inequality in a society for the success of growth policy.

Teodora Borota from Uppsala University offered formal remarks on the presentation. She pointed out that the model was static and therefore not necessarily suited to the analysis of an inherently dynamic process of sustaining inclusive policies in a game of political competition. She also noted that the interpretation of some of the modeling choices was unclear. In particular using only one statistic of inequality instead of the whole distribution might lose important insights as to when exactly an inclusive policy is sustainable in equilibrium. Teodora asked whether other government policies, like alternative tax regimes, might correct for the drawbacks of an unequal society. Lastly, she question whether the East Asian Miracle was indeed a consequence of rural growth rather than fast growth and associated migration to industrial areas – a channel absent from the presented model.

Camilo Garcia from the University of Pennsylvania followed, presenting a network approach to the political economy of state capacity. Together with his coauthors Daron Acemoglu and James Robinson, he studied the direct and spillover effects from local state capacity on economic outcomes in Columbian municipalities. Contrary to Stephan Litschig's presentation on the first conference day, he argued that the determination of how large state presence is in any given municipality is not exogenous, but rather determined in a network game in which each player anticipates the choices and spillover effects created by the neighboring local governments. Camilo stressed that these effects needed to be taken into account when attempting to estimate the effect of institutions on economic outcomes. In his estimation, when taking the endogenous determination of institutions into account, the effects of state presence on prosperity turns out to be quite large, suggesting sizable returns to institutional development.

Elena Paltseva from SITE led the formal discussion. She pointed out that the number of state employees might not be a good measure of state capacity, since it doesn't necessarily reflect efficiency of a given government agency. Moreover, some of the resulting prosperity in a municipality with many government employees might be a direct effect of people employed by the government having a more stable and higher income, rather than due to favorable effects of institutions on economic activity that the authors intended to measure. Elena also mentioned that the policy implication from the study's results would be a strong case for complete centralization; she suggested that such strong results were guided by the modeling choice of not having any cost to centralization rather than the underlying data.

Session 6: Institutional Reform

Tim Willems from Nuffield College offered a theoretical study on learning dynamics and the support for economic reforms. In particular, he argued that the timing of revealing which parts of the population gain from a proposed reform might matter greatly for the political success of such reform, irrespective of whether they are indeed favorable for society overall. Together with his coauthor Sweder van Wijnbergen,

he finds that reforms can lose public support if too many reform winners are announced early on, because it negatively biases the believes of the remaining population and might swing their votes against the policy. Tim showed that his model suggests economic reform implementation to be most successful if done in a sequence of areas as opposed to the whole country at once. He cited Chinese special economic zones as evidence that such strategies can be successful in practice.

Tom Cunningham from IIES remarked in his formal discussion that the model might not actually fit the presented data too well. Instead of reforms being reversed, as in the theoretical model presented, reforms often stall. Initial steps are enacted, often with good economic outcomes, but reforms later lose support. Tom offered an alternative explanation, suggesting that there might be diminishing returns to reforms. He pointed out that it was unclear in the presented examples whether the reforms should have continued or whether they were stopped at the socially optimal moment. Tom also noted that the general implication of the study was quite radical: When taking as given that the complete reform is welfare improving, then no communication about who wins and who loses is the best policy. This seems to be in stark contrast both with reality and with other literature on the topic.

The last presentation of was given by **Daniel Keniston from Yale University**. He presented a field experiment aimed at testing whether institutions could be reformed from within. To that end, Daniel and four coauthors experimented with reforming some aspects of police organization in Rajasthan, India, in order to improve police performance as well as the public's perception of the police. He reported that training as well as an improvement in the incentive and transfer structure at the tested police stations improved police performance. Other interventions, like placing community observers in the police station, however, showed no effect. The authors interpret this result as showing that reforming an institution like the police works better if the measures are implemented top-down, rather than relying on sustained cooperation in the local offices.

Anders Olofsgård from SITE noted that the paper nicely illustrated some of the difficulties in reforming institutions, but that it did not address any general mechanism for institutional reform. He argued that the interventions used here were very specific to the problems at hand for the police in Rajasthan, so that the results were not necessarily applicable to other institutional circumstances. Moreover, Anders questioned whether the experiment did indeed say anything about endogenous institutional change, as it was still implementing reforms through an exogenous driving force (the researchers). Lastly, Anders pointed out that the main improvements the study recorded were about the public's perception of the police, rather than actual performance improvement – an outcome not necessarily optimal from the point of view of dynamic reform incentives. In the discussion that followed, Daniel and other conference participants agreed that this study was a small step into the terrain of reforming institutions, but that much longer evaluation periods as well as broader studies were needed to draw any general policy conclusions.

List of Presenters and Discussants

Teodora Borota	Uppsala University
Emily Breza	Columbia GSB
Konrad Burchardi	IIES, Stockholm University
Tom Cunningham	IIES, Stockholm University
Ina Ganguli	SITE
Camilo Garcia	University of Pennsylvania
Ruixue Jia	University of California, San Diego
Daniel Keniston	Yale University
David Laitin	Stanford University
Stephan Litschig	Universidad Pompeu Fabra
Andreas Madestam	Stockholm University
John Morrow	London School of Economics
Anders Olofsgård	SITE
Elena Paltseva	SITE
Maria Perrotta Berlin	SITE
Leonid Polishchuk	Higher School of Economics, Moscow
Mauricio Prado	University of Copenhagen
Jens Prüfer	Tilburg University
Simone Schaner	Dartmouth University
Giancarlo Spagnolo	SITE
Tim Willems	Nuffield College, Oxford University
David Yanagizawa-Drott	Harvard University

List of Participants

Anna Aevarsdottir, Stockholm University
Jose Araujo, KTH Stockholm
Sara Babiker, SSE
Torbjörn Becker, SITE
Michael Bekele, SSE
Martina Björkman Nyqvist, SSE
Andreas Born, SSE
Landing Ceesay, St.Thomas Institute, Gambia
Jun Chen
Elena Damm, SSE
Gun Eriksson Skoog, Nordic Africa Institute
Eleonora Freddi, SSE
Maren Frömel, EUI Florence
Niklas Gallenschütz
Mats Hårsmar, Nordic Africa Institute
Emma Hutchison, SSE
Nina Jalava
Yanming Kan, SSE
Musa Kandeh, St.Thomas Institute, Gambia
Aziz Kamirov, WIDER, UN University
Shuhei Kitamura, IIES Stockholm University
Nils-Petter Lagerlöf, NYU
Chloé Le Coq, SITE
Yuan Li, SCERI, SSE

Zihao Liu
Sutian Ming
Susanne Oxenstierna, FOI
Giovanni Palmioli, SSE
Erik Prawitz, IIES Stockholm University
Riikka Savolainen, Aalto University
Jenny Simon, SITE
Gloria Soto Galvez
Miri Stryjan, IIES Stockholm University
Halia Vallandares, Mount Royal University
Gryte Verbusaityte, SSE
Johanna Wallenius, SSE
Mikael Wendschlag, Uppsala Universitet
Qing Xia
Emmi Östlund

Sponsors