

Why the 'right' institutions might fail*

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Abstract

The paper argues that there is a bi-directional relationship between the quality of institutions and the quality of leaders. Institutions are as good as the people who run them and people are as good as the institutions within which they operate. However, the infinite regress problem of 'who monitors the monitor' implies that we cannot design institutions with perfect checks and balances. Therefore, the 'right' institutions might fail to produce the desired results because the quality or character of the people running them is very poor. While we focus on the character of leaders, we, nevertheless, argue that differences in inter-country socio-economic performance need not stem from differences in the *endowments* of integrity or moral character of their populations. On the contrary, two societies could have the same endowment of integrity within their populations but one society might perform better because it has a better process of *selecting* good-quality leaders. We, therefore, argue that the selection process for leaders or politicians is very important for socio-economic performance.

Keywords: critical mass, growth, institutions, leaders, politicians, selection.

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1. Introduction

Since the seminal works of Nobel Laureates Ronald Coase and Douglas North, the buzzword for more than two decades has been *institutions*. Most development experts believe that growth can be achieved by putting in place the “right” institutions. Will democratic institutions necessarily produce economic prosperity and eliminate poverty? The experiences of countries like Ghana, Nigeria, India, Argentina, etc suggest that this question does not lend itself to an unequivocal answer.

An April 2006 article by Moisés Naím in *Foreign Policy* quotes François Bourguignon, the chief economist at the World Bank as saying “We do not really know what causes economic growth ... We do have a good sense of what are the main obstacles to growth and what are the conditions without which an economy cannot grow. But we are far less sure about what are the other ingredients needed to create and sustain growth.” In this piece, we will argue that the missing ingredient is the quality of leaders.

In what follows, we refer repeatedly to the notion of good values. It is important to note that a given culture may have its own definition of good values. There need not be a consistent and universal definition of good values. In this piece, we use good values to denote behavior that produces, what we call, growth institutions.

There is a long standing debate on whether nurture (i.e., institutions) as opposed to nature (i.e., people, geography) determines socio-economic outcomes. Diamond (1997), Easterly and Levine (2003), Sachs (2003) are among the notable authors who emphasize the role of geography (e.g., ethno-linguistic diversity, climate) in the determination of socio-economic outcomes.¹ North (1990), and Acemoglu et al. (2001, 2002) and Rodrik (2003) emphasize the role of institutions (e.g., rule of law, property rights, democracy). Besley (2005, 2006) and Caselli (2004) focus on the quality of politicians. To the extent that we argue that people are as good as the institutions within which they operate, we could, arguably, put the quality of politicians in the category of institutions.

Economists have typically found institutions to be more appealing in explaining economic performance than using the character or the morality of leaders and politicians. This stems from the economic methodology of explaining outcomes by appealing to changes in prices and incomes (i.e., constraints) as opposed to using changes in peoples’ tastes or preferences. The *locus classicus* of this viewpoint was forcefully espoused by the Nobel Laureates Gary Becker and George Stigler in their 1977 paper in the *American Economic Review* titled “De Gustibus Non Est Disputandum”, which literally means that tastes should not be disputed. In this methodology, there is no point in arguing about tastes, character, morality, or preferences.

However, the rise of bureaucratic and political corruption in developing countries like Ghana, Nigeria and Zaire since the 1970s called into question the over-emphasis on institutions as the main predictor of economic performance. Even so, some

¹ However, Easterly and Levine (2003) found that geography matters only through institutions. Hence, their result could be seen as a compromise between the two camps.

institutionalists will argue that corruption can be significantly reduced by putting the ‘right’ institutions in place. This view point is correct but one has to recognize that institutions are run by human beings. It is human beings who have to put the supposedly ‘right’ institutions in place. Indeed, the burgeoning field of behavioral economics – which combines insights from psychology and economics - has now made it more fashionable to use moral concepts like fairness, greed, and patience (i.e., time preference) in explaining economic behavior.

This article is related to some recent ideas in economics by Caselli and Morelli (2004) and Besley (2005, 2006). As in Caselli and Morelli (2004) and Besley (2005), one could imagine the quality of leaders or politicians as a mix of competence and character. In what follows, we take the competence dimension as given and focus on the character dimension. However, we shall argue that character is not exogenous but is endogenous. In particular, we shall argue that while people affect the quality of institutions, the character or values of the citizens of a country is also affected by the quality of institutions.

While we focus on the character of leaders, we, nevertheless, argue that differences in inter-country socio-economic performance need not stem from differences in the *endowments* of integrity or moral character of their populations. On the contrary, two societies could have the same endowment of integrity within their populations but one society might perform better because it has a better process of *selecting* good-quality leaders. We, therefore, argue that the selection process for leaders or politicians is very important for socio-economic performance. This point is forcefully and well presented in Besley (2005).

The main argument is presented in steps. In the next section, we argue that it is impossible to design an institution with perfect checks and balances. This inability implies that we have to trust some people to do the right thing, even when they are not monitored. This requires leaders with integrity and commitment to the public good. Section 3 then argues that a critical mass of such leaders is required to produce good-quality institutions and results. We also argue that there is a bi-directional relationship between the quality of institutions and the quality of leaders. That is, institutions are as good as the people who run them and people are as good as the institutions within which they operate. Section 4 gives policy recommendations and section 5 concludes the paper.

2. Inability to design institutions with perfect checks and balances

It is important to note that we cannot design an institution that perfectly monitors everyone. We will necessarily run into the infinite regress problem of “who monitors the monitor?” For example, who monitors supreme court judges appointed for life? And if they were not appointed for life, that would also have its own shortcomings because they will not be independent of the executive branch of government. So somehow, we may

have to appoint supreme court judges for life, hope that they do the right thing, and not be driven by special interests.

Similarly, we cannot design a system that completely monitors the president of a country to deliver good economic results, even in a democracy. Consider a world in which (i) voters may lack information, (ii) political parties may have strongholds over certain electoral regions much akin to brand loyalty in oligopoly or monopolistic competition (iii) politicians may come from a very low quality pool akin to competition among similar firms with very high unit costs. For example, the two leading political parties in a country may both be bad with marginal differences between them (iv) voters may have non-monetary/non-economic preferences (tribalism, abortion, homosexuality, ideology, etc) and (v) voter turnout may be low because each voter believes that his vote will not make a difference or has become cynical of politics.

Given one or several of the above conditions, an incumbent political party with a bad economic record could still be victorious in the next election. Therefore, democratic institutions need not enhance economic growth nor discipline an incumbent leader to deliver very good economic outcomes.²

Given that we cannot design a system that monitors everybody because we necessarily run into the infinite-regress problem of “who monitors the monitor?”, a critical mass of people with integrity is necessary. The complementary roles of institutions and the quality of leaders was noted by the great American political scientist, Vladimir Orlando Key when he remarked that

"The nature of the workings of government depends ultimately on the men who run it. The men we elect to office and the circumstances we create that affect their work determine the nature of popular government. Let there be emphasis on those we elect to office."

In the Federal Papers, LVII, a similar point is made by James Madison, the fourth president of the USA and primary author of the constitution, when he wrote that

"The aim of every political Constitution, is or ought to be, first to obtain for rulers men who possess most wisdom to discern, most virtue to pursue, the common good of society; and in the next place, to take the most effectual precautions for keeping them virtuous whilst they continue to hold their public trust."

Caselli and Morelli (2004, 775) note that "... bad rules are as likely to be the consequence, as the cause, of bad politicians."

Finally, Besley (2005, p. 45) makes the point poignantly when he notes that "... if the control of politicians through elections is limited, then improving the quality of

² The debate on whether political markets or democracy leads to efficient outcomes is the basis of differences between the Virginia and Chicago schools in public choice. For a discussion and analysis of the two view points, see Coate and Morris (1995).

government requires an increase in the honesty, integrity, and competence of those who are elected.”

3. The critical mass of good leaders and path dependency

Imagine that we have a bunch of good people (leaders) who will do the right thing, no matter what. These people do not need punishment, checks and balances, etc to do the right thing. Think of them as people who are sufficiently committed to the common or public good. These people have a high moral cost of acting against the public interest. If we have a critical mass of these good people who are willing to stay in the country, then the institutions run by them will work very well. As noted by Caselli and Morelli (2004, 775), “[I]n a country in which a majority of office holders is of high quality, we would expect institutions leading to bad policies, or bad future quality, to be removed.”

Let us refer to an institution that is conducive to economic prosperity as prosperity-enhancing. Note that the institution may be conducive to prosperity but need not actually produce prosperity. To produce prosperity, we need a critical mass of people with the right mindset (good leaders). Therefore, good leaders (right mindset) plus prosperity-enhancing institutions will produce prosperity. For want of a better term, let us refer to this as growth institutions.

Over time, children are born into these well-functioning and growth institutions (society). They observe these growth institutions and some of them imbibe the good values inherent in them (i.e., the growth institutions). These values may be the respect for the rule of law, property rights, and contracts, obeying the police, driving carefully, waiting your turn in a queue, accommodating divergent views, demanding accountability from government, paying your taxes, despising bribery, corruption, and nepotism, developing a curious mind, etc. So the good values inherent in the growth institutions might socialize some people and affect their mindset. In the process, the system produces some people with a high moral cost of acting against the public interest. But there will also be others who grew up in these institutions (society) but have a low moral cost of acting against the public interest. For these people, it is the threat of punishment that will deter them from wrong doing. Now there will be two types of people whose actions are observationally equivalent but are, however, driven by different motivations. There are those who obey the good laws of the land because they have a high moral cost of being social deviants which stems, in part, from observing the good values inherent in growth institutions as kids. Then there is another group with a low moral cost but nevertheless obeys the law, because of the threat of punishment. Almost everyone may appear to be on auto-pilot as far as good citizenship is concerned but the same actions are driven by different considerations.

Clearly, growing up in good, well-functioning, and growth institutions can affect the mindset of people in a way that sustains these institutions. Growing up in dysfunctional and anti prosperity-enhancing institutions can also have a similar effect on people’s

mindset. We are the products of what we see and are taught at home and in school as children and adults. The point is that existing institutions reinforce each other and persist for a long time. Indeed, Caselli and Morelli (2004) find that bad out-going politicians sow the seeds for bad incoming politicians. Result 3 in their paper states that “[T]he competence of the elected body... can be increasing in the competence of the outgoing body...” This reinforcement or persistence of outcomes is usually referred to as *path dependency*.

The preceding discussion suggests that there could be *multiple equilibria* which means that a society could either be in a good equilibrium or a bad equilibrium. To be sure, path dependency is only interesting when there are multiple equilibria. The phenomenon of multiple equilibria in situations of social interaction is common and was first noted by the Nobel laureate Thomas Schelling. Recently, Caselli and Morelli (2004) have noted that the movement from a bad equilibrium to a good equilibrium involves a *critical mass* of men and women noted above. Caselli and Morelli (2004, 774) note that “[T]he coordination problem is not so much to find a few good men and women to run for a specific office, but to find an enormous number of them to run for the galaxy of elective positions ...”

The Nobel laureate, Robert Aumann, showed that growth institutions can be achieved, even if everyone has a very low moral cost of acting against the common good. However, the conditions under which this result – called the Folk Theorem - is possible are very stringent and therefore are unlikely to be met in the real world. In particular, everyone must be sufficiently patient and have a very long planning horizon. The result also hinges on everyone else simultaneously choosing a punishment strategy, if one person engages in an anti-prosperity behavior. This kind of coordinated behavior is impossible in a country with millions of people.

The discussion implies that the transition from one institution to another can be very difficult since the people were originally influenced by and have a mind set that is consistent with the old institution. Their mind set may not be consistent with the new institution. For example, how can you expect fifty-year olds who have witnessed and practised dictatorships all their lives to suddenly embrace democratic ideals and principles, even if you put such institutions in place? And this dictatorship was observed and practised by these fifty-year olds not only at the national level but also in their domestic households, where ideas were not freely debated and orders by parents were not supposed to be explained, let alone, questioned. Hopefully, the younger ones are more likely to embrace such democratic principles or any principles stemming from new institutions. However, the likelihood of this happening is much higher if they observe well-functioning and prosperity-enhancing institutions. But this might take a long time, given that the new institution is currently being run by the people with the old mindset. Therefore, the new institution might take a long time to produce prosperity, although in principle, it ought to do so.

4. Policy recommendations

From a policy stand point, it is not sufficient to put in place the ‘right’ institutions. This has to be augmented with teachings of the virtues of good citizenship, patriotism, and acting in the interest of the common good. A natural starting point is the re-orientation of elementary and secondary school curriculum to reflect the history of the country, growth-enhancing values, and the benefits of co-operative behavior. The nation should also honor those who have served honestly and selflessly in public service. This will encourage others to aspire to attain such virtues. On this point, Besley (2005, p. 59) opines that “... economists and other social scientists should pay more attention to the origins of civic virtue and the possibility of increasing the number of trustworthy public servants. While economists often resist the idea that values can be or should be taught, their importance is manifest in the operation of public and private institutions – from Watergate to Enron.”

What is being advocated here should not be interpreted as a call for brainwashing, indoctrination, or propaganda. Indeed, kids and adults learn better from observation. So if what the leaders and teachers of the nation preach is inconsistent with their actions, no amount of education or preaching will be effective. As noted in the text, people are the products of what they observe in the institutions within which they grow.

Since actions speak louder than words, a more effective policy requires an improvement in the selection mechanisms of political leaders. As noted above, the importance of selection has been pointed out and discussed in Besley (2005, 2006). Also the quotes in section 2 attributed to James Madison and Vladimer Key emphasize this point. There is the need to expose the past and bad anti-growth actions of prospective and incumbent leaders. This requires a vigilant, competent and truthful media. The freedom of the press and media is a necessary, but not sufficient condition, in this respect. Decentralization of fiscal and political power which allows the selection of leaders within smaller electorates also improves the selection process because voters are more likely to be actively involved, demand information and accountability, and engage in less free riding in smaller electorates.³

The focus on selection of leaders is important because it frees us from the problem of explaining differences in socio-economic performance based differences in the *endowments* of integrity or the moral character of the population. Two societies might have the same endowment of integrity within their populations but one society might perform better because it has a better process of selecting good-quality leaders. A good selection process should also make public service and politics attractive to good-quality citizens. Hence a good selection process must not only focus on the demand for good-quality leaders but also on the supply of such leaders.

On the issue of selection, it is important to note that most countries in Africa and Latin America have suffered from a very bad selection process (i.e., military coups). Coups must be avoided because in the end they typically make things worse. No matter how bad

³ The benefits of decentralization have been recently documented in Fisman and Gatti (2002) and Faguet (2004).

things are in a democracy, if a country is patient enough, there is a higher likelihood of a better informed and sophisticated electorate over time which is more likely to produce high-quality politicians and thereby yield better results. While we have taken the competence of leaders as given, we wish to indicate that coups produce leaders who may not be different in their lack of commitment to the public good but these leaders are invariably less technically competent. A well-established democracy with better informed voters is more likely to produce leaders who are both technically competent and are committed to the public good.

5. Conclusion

While the analysis suggests that institutions do affect the mindsets of people and the mindsets of people do affect the performance of institutions, it does not and cannot explain the initial endowment or evolution of institutions and qualities of leaders. It also does not explain why some growth institutions produce extreme inequalities in the distribution of income.

To conclude, we note that institutions are as good as the people who run them and people are as good as the institutions within which they operate. And do not be surprised if a country like Ghana has prosperity-enhancing institutions without producing growth or produces very little growth. The missing part of this jigsaw puzzle is the critical mass of leaders with the right mind set. We cannot design institutions that monitor everyone. Who monitors the ultimate monitor? It is their own conscience, values, and commitment to the common good that monitors them. Of course, they might have other values that are culturally acceptable and are not necessarily inferior to the values of other cultures. That is fine, so long as we understand that not every set of values yields growth institutions. Young democracies like Ghana can improve on their economic performance and achieve growth institutions by improving the process of political and bureaucratic selection.

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