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KEYNOTE SPEECH

(Ignoring) the Prosperity Playbook

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ABSTRACT

Why are some countries poor? It comes down to good governance: secure property rights and policies that reduce transaction costs. In turn, this means the rule of law: limits on executive authority and a government that impartially enforces contracts, and thus abstains from picking winners. It also means a government that solves market failures. Yet the governments of developing countries often do the opposite. The proximate reasons are the endurance of state monopolies, policies that cripple the rural sector, and an over-dependence on natural resources. The deeper reason is rulers' need to raise revenues in short order to survive.

KEYWORDS
Development; financial repression; institutions; natural resource dependence; political economy; state capacity; transaction costs

I. Introduction

Why are some countries rich and others poor? When are policymakers more likely to indulge in myopic policies that mortgage future growth for short-term gain? How do countries get stuck in an underdevelopment trap?

In this article, I address these important questions, and begin by outlining the progress that modern political economy has made in explaining economic development.

I also document a perplexing puzzle: underdevelopment persists despite knowledge of a "prosperity playbook." The keys to economic progress have appeared in the pages of important journal articles, books, policy reports, and opinion editorials that have been widely disseminated. Yet policymakers often ignore this playbook. If anything, many have doubled down on policies explicitly frowned upon by political economists.

In this article, I also discuss a theoretical framework that makes sense of this paradox. Politicians in weak states deliberately pursue policies that exacerbate economic underdevelopment to raise revenues in short order and at low cost—a hat trick that proves necessary if they want to survive in office, often tantamount to avoiding exile, jail, or death.

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II. What is political economy and what is it good for?

Political economy straddles the intersection of politics and economics. It takes both power and markets seriously. Free markets do not tend to spring, like Athena, fully formed from Zeus's brow. Political economists argue that a host of public goods undergird exchange between strangers at long distances; strangers who may rarely interact repeatedly and find it difficult to reliably cultivate reputations. This has helped the political economy approach make great strides in explaining why some societies are more prosperous than others and how the surplus generated by exchange is distributed.

The political economy approach has made several concrete contributions. The most fundamental is the insight that the assignment and enforcement of secure property rights for ordinary citizens is the key engine of long-run growth. Similarly, institutions and policies that reduce the costs of transacting, and thus incentivize arms-length exchanges, are also critical—importantly, because lower transaction costs allow economic agents to unlock greater value from their assets, be they tangible or intangible (see Coase 1937; Haber, Razo, and Maurer 2003; North 1981, 1990; Williamson 1979).

Secure property rights provide both direct benefits and knock-on effects. They incentivize economic agents to save and invest, allowing them to internalize the returns to their efforts, usually in the form of streams of income associated with their assets. They underpin contracts, which can become more technical and sophisticated when property rights are well-defined, thus helping to extract more value from assets and exchanges. They also nourish financial systems, which pool savings and may, if properly designed, channel capital to its most efficient use. This is because secure property rights entail collateral that can back up loans, minority shareholders that do not steal from majority shareholders, and governments that do not expropriate banks from shareholders or steal deposits (Calomiris and Haber 2014; Haber, North, and Weingast 2008). In short, through both direct and indirect channels, secure property rights encourage specialization, increased gains from trade, and greater productivity.

In practice, this calls on several things to happen at once. The rule of law should prevail—not cronyism, corruption, and the will of the powerful. The government must enforce contracts fairly, and behave dispassionately when creating and implementing regulations, rather than pick winners and losers. Usually, this is a function of clear and strong limits on executive authority, and an impartial judiciary that strictly follows the law (North and Weingast 1989; Weingast 1997). In turn, this fosters widespread trust between strangers, who are barred from predating on each other, and trust in the government, which is barred from predating on citizens. In short, good governance is critical to prosperity.

In this vein, the government must also address market failures. These are a function of information asymmetries, coordination problems, and externalities.

The government must provide intellectual property rights to incentivize research and development and, hence, innovation. New ideas and inventions are a public good that will be underprovided if entrepreneurs fear that they will not be able to recover their fixed costs—that is, if other parties can simply steal their intellectual property, and thus incur only the variable costs associated with new ideas and inventions. In this way, insecure intellectual property rights deter new entrants into markets that would otherwise generate innovation (see Posner 2005).

Similarly, the government must underwrite a credit bureau that discloses borrowers' repayment histories. This will therefore make it more likely that lenders will overcome fears of moral hazard and adverse selection—thus increasing the supply of capital and reducing its price (Stiglitz and Weiss 1981). This is very important; besides patents, copyrights, and trademarks, widely available capital is another lifeblood of innovation, and thus development.

III. The puzzle of persistent underdevelopment

These ideas are quite straightforward. Often subsumed under the umbrella term "neo-institutional economics," they have been developed and honed over the last few decades, if not centuries (see Levi and Menaldo 2015). They have also been widely adopted by think tanks and non-governmental organizations, especially the World Bank. So it is perplexing that governments in underdeveloped countries have consistently ignored the recommendations put forth by political economists. Indeed, rulers such as Castro, Chavez, Kirchner, Mugabe, and Putin—to name but a few—seem to have adopted policies that do the exact opposite of what they should do if their goal is economic development.

First and foremost, governments in developing countries deliberately weaken property rights and increase transaction costs. For example, many Sub-Saharan African countries have failed to codify land rights. Recent governments in India and Bangladesh have expropriated healthy banks or forgiven the bad loans of politically influential borrowers—therefore reducing lenders' incentives to loan money to small businesses and the countryside.

And it goes beyond weakening property rights and disrespecting contracts. Governments across the developing world continue to violate the rule of law and foment mistrust, both directed against governments and as a wedge driven between citizens. Often this is through the flagrant abuse of executive authority; the incumbent governments in China, Russia, and Venezuela are three prominent examples. Or the government brazenly picks economic winners and losers by politicizing regulation. This might occur through non-competitive bidding processes to build public works that are rife with corruption, as well as patronage politics and crony capitalism. Recent scandals in Brazil, Indonesia, Malaysia, and South Africa are a testament to how widespread these practices continue to be.

Governments in the developing world also continue to allow market failures to fester. For example, China and India do not adequately protect intellectual property rights—despite the fact that they have signed international treaties that obligate them to do so. Or the state fosters segmented financial markets by creating regionalized monopolies and oligopolies, preventing banks from hedging against localized shocks—because loan portfolios are undiversified—and precluding credit from flowing across regions and thus from being put to its most efficient use.

IV. Gaining traction on the puzzle of willful underdevelopment

Ironically, the persistence of policies that contradict the insights about economic development furnished by political economy can also be explained by political economists. To see how, consider political economy's fundamental assumptions. Policymakers, like investors and consumers, are rational actors who optimize their preferences under constraints. Politics shapes markets that obey the laws of supply and demand, yet markets can be properly designed to produce the smooth and efficient allocation of resources or poorly designed, and distort investor and consumer behavior and thus derail this process. By aggregating individual choices, markets create patterns that represent real constraints on politics—yet they also create opportunities.

Political economists treat politicians as self-interested actors who pursue their own objectives. These objectives rarely coincide with those that a welfare-maximizing social planner would pursue. In other words, political economists relax the assumption that politicians are social-utility-maximizing robots. Instead, political economy takes politicians' preferences seriously, and assumes that politicians maximize power in the service of enriching themselves and their allies, or to advance ideological and partisan agendas. In some rare cases, it may even mean forwarding idiosyncratic preferences that have nothing to do with money or politics—such as stroking their own vanity or pursuing national glory. However, what political economy reminds us is that, even in those rare cases, politicians must gain and hold office if they want to satisfy their objectives.

Sometimes the best way for policymakers to accomplish this task is to undertake politically motivated market interventions. All too often, the deliberate rationing of inputs to the production process, as well as goods and services, creates distortions that can be used by politicians for political advantage. Private gain therefore comes at a social cost, in the form of reductions in consumer surplus and increases in deadweight losses.

Drawing on these building blocks, three main arguments have been put forth by a new generation of political economists for why economic underdevelopment persists despite widespread knowledge of how to arrest it. First, politicians' comparative advantage is often patronage, not economic stewardship. When institutions are weak, politicians compete based on clientilism, not programmatic policies. If politicians lack a reputation for delivering public goods or good policies, promises to reform are not believable (Keefer and Vlaicu 2007). Second, spoilers can block pro-development reforms. While the losers from better policies stand to lose rents and political power, any promises to compensate them are not credible (Acemoglu, Johnson, and Robinson 2005). Third, rents are the glue that holds society together. Developing countries are fragile and combustible; they are polarized between rich and poor or divided along ethnic lines, and the only effective way to tamp down conflict and violence is to create and distribute rents through powerful brokers who can keep peace (North, Wallis, and Weingast 2009).

While these are all helpful explanations, they fall short of explaining the puzzle of persistent underdevelopment. They fail to offer a unified theory that can explain patterns endemic to underdeveloped economies. These continue to be beset by large, informal sectors that are unproductive. They are also characterized by policies explicitly aimed at suffocating innovation and entrepreneurship. Moreover, they are marred by policies explicitly aimed at creating small and illiquid financial sectors (financial repression). The endurance of state-run monopolies and directed credit to state-sanctioned cartels is another problem, as are policies that cripple the rural sector and favor inefficient industries conglomerated in megacities teeming with slums. Finally, developing countries continue to overly depend on natural resources for employment, foreign exchange, and state revenues.

V. The fiscal roots of willful underdevelopment

I submit that these are all symptoms of an underlying syndrome. To understand why, consider the plight of a new ruler who comes to power in the average developing country. He probably obtained power via violence or subterfuge. He therefore immediately faces a lack of trust about his intentions and governing ability. Moreover, if said ruler wishes to survive in power, he must quickly raise revenues to pay the military, reward allies, and attack and deter his enemies. Yet it is eminently hard for him to do so when fiscal transaction costs are high because of an unproductive economy that is largely informal and plagued by credit market imperfections. That is, it is hard to do so when a ruler inherits a weak bureaucracy that cannot identify and verify tax obligations and monitor compliance, let alone punish evasion (see Menaldo 2016a, 2016b).

There is, however, a possible solution to this problem. A new, insecure ruler of a weak state may turn to the politicized regulation of the domestic economy. He may exchange monopoly rights for a share of the rents produced by rigging the market. Barriers to entry in the formal sector can be written into law or created by rationing and selectively distributing inputs to the production process. This can be accompanied by cheap credit created by financial repression in which so-called directed credit is funneled by state-owned or -controlled banks to monopolies and state-run firms (see Menaldo 2016a). It can also be accompanied by policies with an urban bias that tax the agricultural sector to subsidize a large and cheap labor force conglomerated in cities.

This is a self-enforcing strategy for raising revenues and currying political support. On the one hand, monopolists gladly comply with taxation in exchange for the government's enforcement of their monopoly rights. On the other hand, a ruler can share some of the rents produced by this system with supporters and tax some of the rents to fund the state (see Menaldo 2016a, 2016b).

Similarly, revenue-starved states with low capacity are more likely to specialize in the production and export of natural resources. Specifically, they are more likely to launch oil exploration efforts, goose the production of extant wells, export oil to a higher degree, tax it more heavily, and attract higher levels of capital in hydrocarbons (see Menaldo 2016b). While national oil companies have increasingly shouldered more of the heavy lifting to make this happen, private investors also continue to play a prominent role.

How do developing nations with insecure property rights that lack the rule of law manage to court foreign direct investment in natural resource sectors to generate hard currency and revenues? Investors exploit huge advantages in power, money, and information to protect their property rights in host countries across the developing world and recover their fixed costs at an accelerated rate; international oil companies increasingly engage in regulatory arbitrage to sidestep stringent regulations in their home countries, as well as higher taxes. In other words, they migrate to developing countries to exploit weak health, safety, and environmental standards, a cheap labor force with little-to-no rights, and weak fiscal bureaucracies.

Nevertheless, these weak states are often able to generate revenues and foreign exchange upfront. They do so in a variety of ways. This includes collecting predrilling fees and predrilling royalties, as well as bonuses, acre payments, and property taxes. It also includes acquiring an equity stake in oil projects or securing bilateral aid from countries such as China as an adjunct to signing hydrocarbon and mining contracts.

VI. Mexico: Posterchild of the willful underdevelopment syndrome

As an example of the symptoms associated with the underdevelopment syndrome outlined earlier, consider Mexico. It remains a relatively weak and revenue-starved state. It has also always been characterized by an over-reliance on natural resources, a chronically underdeveloped financial system due to financial repression, and inefficient oligopolies.

Mexico performs quite poorly on the "Indicator of Quality of Government" (IQG), the International Country Risk Guide (ICRG) derived index from the Political Risk Services Group (PSRG). While Mexico's average value on the IQG between 1984 and 2012 is 0.49—the variable is normalized to range from 0 to 1, with higher values indicating a stronger state—the average for the rest of the world during the same period, excluding Mexico, is 0.54, and the average for Latin America is 0.44. Worse yet, Mexico's score has steadily deteriorated over time—the maximum value it exhibits on the IQG, 0.56, is registered in 1984, the index's first year of coverage; in 2012, the last year of coverage, its score deteriorates to 0.44, the same value it exhibits in 1987.

It is therefore not surprising that Mexico has faced significant challenges when attempting to garner revenues. The state has had difficulty raising both ordinary and extraordinary revenues. Successive governments have found it inordinately hard to raise taxes on income, as well as other forms of direct taxation, and instead heavily relied on revenues from oil exports—a pattern that has lasted well into the 2000s (see Haber, Kline, Maurer, and Middlebrook 2008). Mexico's average total taxes (% GDP) between 1972 and 2010 are only 14.4 (% GDP), compared to 19.8 (% GDP) for the rest of the world (excluding Mexico); and the average for the rest of Latin America is 13.6 (% GDP), even though the majority of countries in the region are oil-poor. In other words, note that all of these figures include states' revenues from oil and other minerals.

Oil has helped patch over problems, to be sure, but it has not proven a panacea. After climbing to record levels on the heel of the two oil price shocks of the 1980s, the international oil price basically collapsed in the early 1980s. The upshot is that the share of Mexican government revenues attributable to oil tumbled 63% between 1983 and 2002 (see Haber and Menaldo 2011), from a high of 38.4 (% Total Revenues) to 14.10 (% Total Revenues). And the sharp rise in oil prices that began in 2001 and lasted until early 2014 did not really benefit Mexico all that much, as chronic underinvestment in oil exploration by PEMEX, the national oil company, has meant that Mexico has not been able to offset the steady depletion of Cantarrell, a supergiant offshore field in the Gulf of Mexico that accounts for the majority of its oil production.

Indeed, up until recently, Mexico's oil exports were a complement to a strategy of propping up big industrial firms that could be effectively monitored and taxed. It was directed credit to heavy industry, not oil, which was instead at the forefront of Mexico's post-revolutionary political economy. By 1936, private commercial banks were forced to lend a substantial part of their deposit base to the central bank. Also around this time, several development banks were created by the state. Nafin, which was tasked with financing Mexican manufacturing, quickly became the engine of directed credit. Often contravening its charter, Nafin allocated capital to politically connected firms. This was accomplished via medium- and long-term loans collateralized by firm shares, as well as by the provision of equity capital. The state also forced private commercial banks to lend a large share of their deposit base to industrial conglomerates.

Eventually, the central bank, the development banks, and the private banks got into the business of financing state-run enterprises. Over time, the state simply took over many companies entirely. By 1982, it owned over 1,000 firms. Many became insolvent after the sovereign debt crisis that hit Mexico that year, which was followed by the government's nationalization of the banking system. This only exacerbated financial repression. Consider that Mexico's average value of private credit (% GDP) between 1984 and 2011 was only 18.47; the average for the rest of the world during the same period, excluding Mexico, was 43.68; the average for Latin America, excluding Mexico, was 26.49.

Another set of pathological policies taxed agriculture to benefit urban consumers. Indirect taxes on agriculture were effectuated by policies that included price controls on foodstuffs and overvalued exchange rates. Taxes were also explicitly levied on some exported commodities such as coffee, sometimes via the use of marketing boards. As a consequence, Mexican agriculture became very unproductive and uncompetitive.

These policies only exacerbated the Mexican state's weakness. For decades now, the state's monopoly on the use of force and its control of territory has been seriously challenged. Beginning in 1994, a guerilla insurgency broke out in the southern state of Chiapas, led by the self-proclaimed Subcomandante Marcos. This took the federal government by surprise, pushing it back on its heels and forcing it into protracted, if not humiliating, negotiations with a group of ragtag rebels. That same year, the country was rocked by a series of high-profile political assassinations that took place in public and in broad daylight, respectively. First was the autocratic regime's handpicked succeeding candidate, Luis Donaldo Colosio, who was murdered during a campaign rally. Then, José Francisco Ruiz Massieu, the newly appointed secretary-general of the PRI, Mexico's ruling party, was assassinated on the streets of Mexico City.

While this seriously threatened political stability and order during the 1990s, democratization in 2000 did not spell an end to corruption, a weak rule of law, and Mexican citizens' chronic lack of trust in the government and bureaucracy (Haber, Kline et al. 2008). Both the fragile nature of the Mexican state and its institutional rot have been thrown into high relief in the aftermath of President Felipe Calderón's open declaration of war against the drug trade in 2006. Drug kingpins have reacted to this threat by waging a vicious war against each other and the Mexican government, coming to control huge swaths of territory, compromising the loyalty of state officials, and terrorizing local populations. In order to protect their drug corridors and consolidate market share, drug lords have bought off or murdered scores of federal and state politicians, police chiefs, army officers, and bureaucrats. Tens of thousands of civilians have lost their life during this ongoing conflict. Many have declared Mexico a failed state, including prominent officials within the United States government.

To make matters worse, consider the huge banking crisis that roiled Mexico in 1995, from which the country has still not fully recovered. This crisis was precipitated in part by unsound banking practices, including insider lending, which fed into an unsustainable credit boom. It caused significant pain. While average annual credit growth was 22.5% in the four years leading up to the crisis, over 50% of loans were non-performing at the peak of the crisis, and the largest one-month drop in deposits after a series of bank runs was 14% (Laeven and Valencia 2008; Haber, Kline et al. 2008).

The Mexican government then staged a huge intervention under the auspices of the PROCAPTE recapitalization program. FOBAPROA, Mexico's deposit insurance corporate, orchestrated a bailout program in which bank liabilities were sold to the government and transferred to a trust. This was hugely expensive; it carried a price tag of 46 billion dollars in 1995 (the cost of the loan purchases alone was 3.4% of GDP in 1995). While the output loss was ultimately 4.2% GDP, the fiscal cost (gross, % GDP) was a staggering 18.9% (see Laeven and Valencia 2008). By 1999, the total cost was 65 billion dollars, or 15% of GDP (see Haber, Kline et al. 2008, 116). Besides the huge cost this represented to average taxpayers, thousands of small businesses and middle-class debtors were pushed into bankruptcy (Laeven and Valencia 2008).

Mexico's chronic state weakness continues to be translated into financially repressive policies and financial underdevelopment. These policies benefit the government and a few politically connected insiders at the expense of broad financial development and consumer welfare. Despite the entry of foreign banks into Mexico's financial market after the crisis, the supply of credit remains anemic.

To be sure, Haber and Musacchio (2013) have shown that Mexico's historically high levels of financial instability and low levels of credit provision have been somewhat reversed since 1997, when the Mexican government allowed foreign banks to enter the market, and they have come to control almost 80% of total financial assets. By 2011, Mexico's level of private credit (% GDP) was still quite small, however, registering at 24.03%

compared to 34.64% for the rest of Latin America (the average excluding Mexico). Indeed, Mexico has fewer bank branches per person than its much poorer neighbor, Guatemala. And less than 7% of small businesses, which make up 95% of all Mexican firms, had access to bank credit in 2013 (The Economist 2015, 61).

This is not surprising. Financial deregulation only came about because Mexico was an extremely weak state that had been on the precipice of bankruptcy on the eve of these reforms, and was saved in the nick of time by a $20 billion dollar emergency loan made by the Clinton Administration. Haber and Musacchio (2013) and Calomiris and Haber (2014) argue that, in the aftermath of a massive bailout of the financial system that began in 1995, Mexican President Ernesto Zedillo crafted a "bank bargain" in which a few big foreign banks took over control of the financial system so that they could recapitalize Mexico's insolvent banks with real money. After they did so, however, formidable challenges remained, including a large informal economy and regulatory red tape.

Moreover, Mexico also continues to be characterized by crony capitalism in which a few politically connected firms dominate the commanding heights of the economy. Most market structures are oligopolistic. Government policy continues to produce rents that are shared between politicians and plutocrats, with a portion of these taxed to keep the Mexican state afloat.

VII. Key implications of my view of underdevelopment

What can we learn from the perspective fleshed out in this article? I have argued that a key cause of underdevelopment is chronic state weakness. Yet solving this problem is not straightforward. It is really hard to make weak states stronger because rulers care about their own survival and need to generate cash quickly; they do not have the luxury of waiting around for a broad tax base rooted in diversified economy to take hold. This is especially true if the beneficiaries of these investments are future incumbents; worse yet if they are current rivals who would bide their time and exploit the fiscal bounties associated with economic reform at a later date.

Another important implication is that interest groups are endogenous and expendable. Rulers strategically create monopolists and oligarchs to help them generate rents that can be taxed. Conversely, they are wont to throw these "key" allies under the bus when it is convenient—when they are no longer able to generate the precious rents that are needed for rulers to survive in office.

This article also suggests that the so-called resource curse, the view that countries with abundant natural resources suffer from a host of maladies, including weak state capacity, authoritarianism, the underprovision of public goods, and corruption and economic stagnation, is flawed. Rather, there is an "institutions curse." A legacy of weak state capacity and insecure property rights has impelled many developing countries to develop natural resources as a default sector in lieu of cultivating modern and diversified economies, and bad institutions have also condemned nations to suffer from ills unduly attributed to minerals and oil.

Finally, this article also intimates that if reforms come to a country beset with an institutions curse, these changes will often be the result of a crisis that makes the old rent generation system unviable. Yet reform may be tainted by the legacies of the past and probably not constitute a clean break—if anything, rents will simply be generated and shared in a different, but still development-retarding, manner. While some of the winners might change, the losers will continue to be average citizens.

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