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Institutions-Economic Development Nexus: Setting the Cart before the Horse for Developing Countries

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Abstract

The developing countries are under pressure from the developed countries and their allied institutions (World Bank, International Monetary Fund and World trade organization) to adopt good institutions if they are to develop. These good institutions include good bureaucracy, democracy, strongly protected private property rights, intellectual property rights, an independent judiciary, transparent market oriented corporate governance and an independent central bank. The reason for the forced adoption is premised on their belief that poor-quality institutions in the developing countries inhibit their economic development. This paper therefore critically examines this dominant discourse on the relationship between institutions and economic development, and contends that institutions that promote market freedom and strongly protect property rights including intellectual property right are not the best for economic development. It argues that the developed countries did not attain their developmental status through these institutions that they coerced developing countries to adopt. Historical evidences show that most of the developed countries attained their developmental status enroute infant industry protection, export subsidies, public owned enterprises, and other forms of government interventions which they now frowned at. Thus, the paper concludes that institutions-economic development nexus is tantamount to setting the cart before the horse.

Keywords: *Institutions, Economic Development*

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Background to the Study

Developing countries are coerced by the developed countries, and the international development policy establishments they control, to adopt a set of good policies and good institutions to enable them develop. This forced adoption is premised on the ground that poor-quality institutions are the root cause of underdevelopment of developing countries. These institutions include; democracy, good bureaucracy, strongly protected private property rights (including intellectual property rights), an independent judiciary, financial institutions (including apolitical Independent Central Bank) and transparent and market oriented corporate governance (Chang, 2001). To actualize their drive towards the adoption of these institutions, the International Monetary Fund (IMF) and the World Bank have begun to impose many governance related conditionalities, which require as a precondition for borrowing, the borrowing country adoption of better institutions that improve governance (Kapur and Webber, 2000).To worsen the situation for the developing countries, many developed country governments began to attach governance conditionalities to their bilateral aids; what a tragedy.

Given, the role played by World Bank, International Monetary Fund and World trade organization in promoting institutions many see them as willing tool with which the developed countries press home their interest and pry open developing countries market. They imposed on developing countries standard policy packages that are considered to be universally valid by the developed countries, without carefully taking into consideration in their designed peculiarity of each developing country (Chang, 2007). These policy packages have resulted to poor results with its attendant consequences. What the developed countries and its allied institutions have forgotten is that institutions cannot operate in a vacuum but interact with other institutions. So, if the developing countries import the new institutions forced on them by developed countries and their allied institutions, there is tendency of malfunctioning because of their incompatibility with the local institutions.

History show that today's developed countries acquired most of the institutions the developing countries are made to believe to be the prerequisites for economic development after, and not before, their economic development, democracy, modern day bureaucracy, intellectual property rights, central bank and so on (Chang, 2002a). To be précised the Anglo-American countries, whose institutions the World Bank and its allied consider to be the global standard, themselves did not have most of these institutions in their earlier stages of development, they acquired most of them only after they became rich (Chang, 2005).

It is against this background that this paper contends that the dominant view on institution – development nexus is like setting the cart before the horse. To achieve the objective of this paper, we adopt the historical methodological approach, which is the methodology of the German Historical School of economics in many continental European countries. The justification for this approach is that it helps us to discuss current issue with the help of history. This will help us to unveil some of the mysteries behind the development of the developed countries and the institutions they imposed on the developing countries. The rest of the paper is divided into five sections. Section two is conceptual clarification while section three takes care of the historical antecedent of the developed countries. Section four contains learning the right lesson from history, while section five concludes the paper.

Conceptual Clarification

Institutions

There is a major difficulty involved in the study of institutions – economic development nexus. This difficulty emanates from lack of consensus on the definition of institutions. Given this difficulty it will be more frustrating for a consensus to be reached on what these institutions are supposed to do, as to promote economic development. When we have differences over the exact definition of what institutions is, then describing the role of institutions in economic development will be tantamount to that of a blind man describing an elephant. However, North (1990) defined institutions as the rules that govern the game in a society or the humanly devised constraints that shape human interaction. So, in this paper we define institutions as the product of the interaction within a system that helps to shape the behaviour and action of the people for peaceful coexistence.

Development

For the purpose of this paper, we adopt the definition of development given by Akpakpan (1987 and 2011) and modified by Wilson (2003). According to them, development is a process of improvement in the various aspects of life of the society, usually manifested in the occurrence of desirable changes such as:

(i) An increase in the capacity of the society to produce and distribute needed goods and services;
(ii) A reduction in the level of unemployment;
(iii) A reduction in the level of absolute poverty, i.e. a reduction of the proportion of the population living below the poverty line,
(iv) A reduction in the level of economic and social inequalities,
(v) An increase in real output of goods and services, i.e. economic growth,
(vi) A rise in the levels of social and political consciousness and political participation,
(vii) An improvement in the quality of services,
(viii) An improvement in the quality of life, as measured by access to clean water, adequate health services and decent accommodation, and
(ix) A reduction in pollution or environmental degradation.

The central thesis in the definition of development adopted in this study is that an increase inthe capacity of a society to produce and distribute needed goods and services needed by its citizens clearly define development and it is the dividing line between developing and developed countries. Therefore, the question begging for an answer is, will the adoption of these institutions enhance the capacity of the developing countries in the production of goods and services needed by their citizens given their peculiarities?

Historical Antecedent of the Developed Countries

The central thesis of this paper is that today's developed countries did not acquire their developmental status through the policies and institutions that they now coerce the developing countries to adopt. Evidence abound that most of them attained their developmental status through, infant industry protection, subsidies, government involvement in the economy to mention but a few which they now frowned at as bad policies. The historical lesson from the historical expedition of some of these selected countries will help to drive home our argument and further buttress the fact that institution – economic growth nexus as recommended by the developed countries is indeed like setting the cart before the horse. Below is a country by country analysis or country's specific analysis to drive home our position. The for choosing these countries is that they are the early comers and do not experience any institutional constraint. Britain initiated the industrial revolution from the proceeds gotten form the infant industry protection. America a colony of Britain follow the line of Britain and achieve development without any institutional constraint, so also Japan. Korea is chosen because it ignores the institutional constraint and patterned her economy in line with that of the first comers.

Britain

List (1885) argues that Britain was actually the first country to perfect the act of infant industry promotion, which according to him was the propelling force behind most country journey to development. List summary of the British road to industrial success is worth quoting at length as to substantiate this fact of history. As he succinctly put it:

Having attained to a certain grade of development by means of free trade, the Monarchies (of Britain) perceived that the highest degree of civilization, power and wealth can only be attained by a combination of manufactures and commerce with agriculture. They perceived that their newly established native manufacturers could never hope to succeed in free competition with the old and long-established native manufactures of foreigners (the Italians, and Hansards, the Belgians and the Dutch)… hence the sought, by a system of restrictions, privileges and encouragements, to transplant on to their native soil the wealth, the talents and the spirit of enterprise of foreigners. P. 39

The above, clearly define the characterization of British industrial development which is fundamentally at variance with its stance as a propagator of free-trade or free-market economy and institutions. This behaviour of Britain is tantamount to climbing to greatness with a ladder and then turns to kick the ladder away.

Defoe (1728) in his book, "A plan of the English Commerce" described how the Tudor monarchs especially Henry VII and Elizabeth I, used protectionism, subsidies, distribution of monopoly rights, government-sponsored industrial espionage and other means of government intervention to develop England's Woolen Manufacturing Industry which was Europe's high technology industry as at that time. Prior to that time Britain had been a backward (underdeveloped) economy that centred on exports of raw wool as a major source of foreign earnings. As of then, Woolen Manufacturing Industry was well developed in Belgium and the Netherlands, known as of then as the Low Countries. Britain exported raw wool to these countries and imported finished clothes from them. According to Defoe (1728), Henry VII was not comfortable with this trend because Britain exported the raw wool to these countries and imported cloth at a very high price. In trying to reverse this ugly trend, Henry VII increased the tax on raw wool export in order to discourage the exportation of raw wool. After a while he banned the export of raw wool to these countries (Belgium and the Netherlands) as to encourage the processing of the raw wool at home (Britain) and to promote the value chain for his country.

Dafoe (1728) reiterated that Henry VII did not know how long it would take Britain to catch up with her sophisticated competitors in Belgium and Netherlands. King Henry VII raised export duties on raw wool only when Britain's infant industry was established enough to handle the volume of wool produced. He quickly withdrew his ban on raw wool exports when, he realized that Britain Industry cannot single handedly process all the raw wool it produced. Elizabeth, I after 100 years of Henry VII, reign continued with Henry's VII import substitution industrialization policy; this policy continued until Britain developed the sufficient capacity to process her wool production. Queen Elizabeth I then reintroduced total ban on raw wool export. This policy enactment (raw wool export ban) drove the competing manufacturers in Belgium and the Netherlands out of business because they were deprived of their source of raw materials for their industries.

But for this policy put in place by Henry VII and continued by Elizabeth I, it would have been impossible or very difficult for Britain a major raw material (wool) producer to have transformed itself into European centre of the high-technology industry. Wool manufacturing then became Britain's most important export industry that provided the country with much foreign earnings. It was the earnings from this industry that enable Britain to finance the massive import of raw materials and food that fed the industrial revolution (Chang, 2007).

Brisco (1907) stated that Walpole in 1721 enacted a legislation aimed at protecting British manufacturing industries from foreign competition, subsidized them and encouraged them to export. Tariffs on imported foreign manufactured goods were significant raised to about 60 percent, while tariff on raw materials used for manufacturing were lowered or even dropped altogether; manufacturing exports were encouraged by series of measures, including subsidies.

Walpole's protectionist policies continued for a century, and this helped British manufacturing industries to catch up with those from Belgium and Netherlands and finally forge ahead of them in the continent. Britain remained a highly protectionist country until the mid-19th century. In 1820, Britain's average tariff rate on manufacturing import was 45 to 55 percent, compared to 6 to 8 percent in Belgium and Netherlands, 8 to 12 percent in Germany and Switzerland and about 20 percent in France (Chang, 2007). Wadpole banned the construction of new rolling and slitting steel mills in America, thereby compelling Americans to specialize in low value-added pig and bar iron, rather than high value-added steel products. Britain banned cotton textile import from India (Calicoes), which were then superior to the British ones. In 1699 it banned the export of woolen cloth from its colonies to other countries (the Wool Act), destroying the Irish woolen industry and stifling the emergence of woolen manufacture in America (Chang, 2007). The above historical antecedent buttress the fact that it was not the free market but government intervention through protection (infant industry), subsidies and outright ban that helped to develop the British woolen manufacturing which served as the spring board for industrial revolution.

To show the double life of Britain, by the end of the Napeolenic wars in 1815 forty years after the publication of the Wealth of Nations, by Adams Smith, British manufacturers were firmly rooted as the most efficient in the world, except in a few limited areas. British manufacturers correctly perceived that free trade was now in their interest and started campaign and also called for the abolition of the corn laws to enable them have access to cheaper food (Chang, 2007).

United States of America
Bairoch (1993) in his book "Economics and World History – Myths and Paradoxes" pointed out that Hamilton in 1791 submitted his report on the subject of manufacturers to the US congress. He contended that a country needed a big programme to develop its industries. The centre thesis in his argument was that a backward country like the US should protect its industries in their infancy from foreign competition and nurture them to a point where they could stand on their own feet. Hamilton in his report proposed series of measures to achieve the industrial development. These ranged from: (i) protecting duties (tariff), (ii) prohibition of rival articles (import ban) (iii) prohibition of the exportation of the raw materials of manufactures (export ban on industrial input), (iv) pecuniary bounties (subsidies), (v) premiums (special subsidies for key innovation), (vi) exemption of the materials of manufacturers from duty (import liberalization of inputs); (vii)draw backs of the duties which imposed on the materials of manufacturers (tariff rebate on imported industrial inputs), (viii) the encouragement of new inventions and discoveries, at home, etc.

Based on Hamilton report, the US government raised tariffs from 12.5 percent to 25 percent; it was later raised to 35 percent and in1820 the average tariff rate was 40 percent (Chang, 2007). Thus, Hamilton provided the blueprint for American economic policy until the end of Second World War. Abraham Lincoln the 16th President of America raised industrial tariff to their highest level in the history of America. Tariffs on manufactured imports remained at 40 to 50 percent and were the highest in any country. Apart from the consolidation of the tariffs policy, Abraham Lincoln saw the passage of the Morill Act. This Act established the 'land grant' colleges, which helped to boost the country's research and development (R&D) capabilities, which subsequently became the country's most important competitive weapon (Chang, 2007). The US adopted voluntary export restraints against successful foreign exporters (e.g. Japanese car companies); and quotas on textile and clothing imports through the multi-fibre agreement; agricultural subsidy and anti-dumping duties (where dumping was defined by the US government in a way that was biased against foreign companies).

Japan

Japan Ministry of International Trade and Industry launched an industrial development programme that has now become a legend in Japan. Imports were highly controlled in Japan through government control over foreign exchange. Exports were promoted through subsidies in order to maximize the supply of foreign currency needed to acquire better technology. The Japanese government protected their infant industries and channeled subsidized credits into key sectors through directed credit programmes; it also regulated foreign investment by transnational corporation. Foreign investment was banned in most key industries. Even when it was allowed, there were strict ceilings on foreign ownership, usually a maximum of 49 percent. Foreign companies were mandated to transfer technology and buy at least specified proportions of their inputs locally (what is referred today as local contents requirement). Japanese government also regulated the inflow of technologies, to ensure that obsolete or over-priced technologies were not imported (Chang, 2007; 2005; and 2002).

Toyota Company started as a manufacturer of textile machinery (Toyoda Automatic Loun) and later moved into car production in 1933. To encourage the newly established company, Japanese government kicked out General Motors and Ford in 1939 and bailed out Toyota with money from the Central Bank of Japan in 1949. The fact remained that, had Japanese government followed the free trade economist strait jacket recommendation, there would not have been Lexus. Toyota would at best, be a junior partner to some western car manufacturers, or worse, have been wiped out.

Korea

For Korea to attain to its present status, the government has to nurture some key industries. The selected industries were supported through tariff protection, subsidies and other forms of government interventions. The Korean government owned all the banks, and this enabled the government to direct credit to the much-needed sectors. Some big projects were undertaken directly by the government (stated-owned enterprises); the steel maker POSCO was owned by the government (Chang, 2007).

The Korean government has control over the scarce foreign exchange; the government ensured that the hard-earned foreign earnings were judiciously used in the pursuance of the country industrial policy. The government controlled foreign investment in certain sectors and shut it completely in other sectors based on their national development plan. The government encourages reverse engineering and overlooks pirating of patented products.

Learning the Right Lesson from History

The historical antecedent x-rayed point to the fact that the developed countries in their early stages of development used some mixture of protection, subsidies, regulation and state-owned enterprises in their economies. The sad thing is that these developed countries are now rewriting their history to suit their present goals and aspiration. This is in line with Chang (2007) assertion that, history is written by the victor and it is human nature to re-interpret the past from the point of view of the present. As a result, the rich countries have over time, gradually and subconsciously, rewritten their own histories to make them more consistent with how they see themselves today, rather than as they really were.

Conclusion

The developed countries do not follow the path way they are now recommending for the developing countries. They attained their developmental state through some mixture of protection, subsidies and the used of state-owned enterprises. These policies and measures are now being frowned at by the developed countries and they turn themselves to promoters of market economy without recourse to its attendant effect on the developing countries. In the developing countries the compensation mechanism is weak or non-existent; therefore, there is greater need for state owned enterprises. To worsen the situation of developing countries is their weak capital markets, weak regulatory and taxation capabilities. Thus, adopting these institutions without recourse to their peculiarity and their inherent weaknesses will make matter worse for the developing countries and frustrate their developmental stride. Thus, this paper concludes that institutions – economic development nexus, the dominant discourse in the literature is tantamount to setting the cart before the horse and it is an impossible mission given the attitude of the developed countries and their allied institutions. The paper therefore suggests that the developing countries should be allow to chart their course of development without these institutional constraints. The developing countries should protect their infant industries, regulate the inflow of foreign direct investment into their countries and the type of technology imported into their countries.

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