Why institutions are so important for growth

OPEN SKY

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IN 1900, Argentina looked like a promising country with respectable growth. It was queueing to be an industrialised country like many other western European nations. However, financial markets, the legal system, stock exchange, and the central bank were not ready with up-to-date regulations and, more importantly, their enforcement. Argentina turned out to be unfortunate for not being able to keep the pace of other European nations which had better institutions in place. Argentina's per capita income is now USD 14,000, far below the mark of USD 40,000 which it should have enjoyed right now like its other comparable European peers.

Ivory Coast and Mexico had similar periods of promising growth even until the end of the 1970s, but both of them soon plunged into zero or negative growth. Ivory Coast was a role model to many African countries, but the country failed to understand that its institutions, such as the public administration, property rights, and law enforcement, must be ahead of African standards. Abidjan, its economic capital, is slightly less congested than Dhaka, reflecting a failure of street discipline. After independence in 1960, Ivory Coast (Côte d'Ivoire) grew almost at 10 percent for the first 20 years – the highest of Africa's non-oil exporting countries. But average growth since the early 1980s until now has remained in the doldrums of 2 percent or so.

A once growth champion can thus turn into a case of growth disaster, alerting us that growth may cascade down like spring water anytime if the society fails to build adequate institutions. There are many stories in the world to remind us that we should fix our institutions at a faster pace to keep our growth going. Otherwise, challenges, as faced by countries like Argentina, Mexico, or Ivory Coast won't be a surprise. It is imperative to clarify first what the term 'institutions' means.

The term, 'institutions,' has different meanings in different disciplines. But when we speak of it in relation to growth, we usually refer to the definition of institutional economics. Although 'institutions' and 'organisations' may appear the same, in reality they aren't. Institutions are a set of consistent rules that shape the behaviour of organisations and individuals in a society. They can be formal, such as constitutions, laws, regulations, contracts, and procedures. Norms, values, and traditions are informal institutions. Since values, traditions, and laws are often interwoven, institutions give us a much bigger width and depth than a simple set or rules.

There are four key sectors such as finance, education, justice, and public administration, where institutions play the most effective role in promoting growth in a society. If a rule is broken, it's often both an institutional and organisational failure. Dhaka is a thriving city representing 35 percent of the country's GDP. Different studies state that Dhaka's mobility impediments owing to traffic congestion are taking a toll of USD 1 to 3 billion from the nation's potential income. Thus, we are losing almost 1 percentage point of growth each year. This is partly an infrastructural constraint and heavily an institutional problem, because rules aren't there. Laws aren't enforced even if they are there. Defective institutions are in place. A recent report by Brac's Institute of Governance and Development states that 40 percent of Dhaka's traffic jam can be removed without any engineering effort, but by enforcing street laws.

Opening an organisation isn't enough to ensure proper institutions – just like opening the Board of Investment didn't guarantee enough comfort to foreigners to jump into Bangladesh. The newly formed Bangladesh Investment Development Authority ((BIDA) has taken a different approach. It is examining why Bangladesh's position in the ease of doing business is so poor - 176 out of 190 countries. The target BIDA has taken is to bring down the number to at least 99. Here the authority is directly addressing the institutional problems that are actually preventing foreigners to flow in. And that is how a nation can build institutions.

The medicines of growth economics, as suggested in textbooks are not new, but they don't work without institutions. Imagine a case where a patient with physical injuries approaches two different physicians separately. Doctor A prescribes antibiotics and pain relievers. Doctor B emphasises on therapy but prescribes lesser antibiotics and pain pills. Who is better is hard to say, but Doctor B appears to have kept the patient's less medicated recovery and therefore long-term welfare in mind. Institutions provide long-term sustainability of growth to a nation. Otherwise, growth gets out of steam at some point.

When there is no good rule to drive in the street, there is a legal gap. But when the law is there without any regard from the public, there is an enforcement gap. These two gaps must be filled before defining institutions. When we see vehicles of some powerful officials being driven on the wrong side of the road, it sends a signal to many that institutions are not in place. Institutions mean laws not in books but in real action.

Bangladesh has investment opportunities as well as a bundle of fiscal and monetary policies which are, at least in theory, no less accommodative than those in Vietnam. Then why is Vietnam attracting FDIs equivalent to 5 percent of its GDP while ours is less than 1 percent? Simply put, institutions in Bangladesh are not as well-prepared and accessible as they are in Vietnam. It's high time to look at improving institutions for Bangladesh just to make sure that we want to maintain this growth momentum. Bangladesh can't afford the similar fate of growth as experienced by Ivory Coast, Mexico, or Argentina.

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