# Thicker Diagnostics

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Stevan Lee, Umar Salam, Mark Henstridge

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## Introduction

**The point of a Thicker Diagnostic is to integrate political, social and economic evidence to understand the issues that are limiting progress in a country, and to inform reform, policy and managerial choices. The thicker approach has strong implications for the selection of policy options at macro and sector level and for the use of evidence taken from other settings.**

At a macro level, development is about the massive differences between countries, especially in terms of material, economic performance and human welfare. At different times in history, the gaps between countries seem to be getting wider or narrower. In the 1980s, countries seemed to be diverging, by the 2000s, some convergence seemed to have set in. The gaps are still vast, with the United States 40-50 times richer, per capita, than poorer African countries like Malawi and Niger. Differences in natural endowments do not account for these huge gaps, especially in an age where capital and knowledge are so mobile. Therefore the common understanding is that there is something different about the way economies are working or interacting with other economies that is, or has been, holding back the poorer countries. At a macro level, diagnostics are about pin pointing these issues so solutions can be designed. A critical finding highlighted in this note is that **the causes of the problems** really matter, and will alter the effectiveness of proposed solutions to seemingly similar problems in different settings.

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### Growth theory and neoclassical diagnostics

Basic growth theory (Solow 1956) proposes a simple relationship between savings and returns to investment, implied by technology. This suggests that all countries should converge at a certain level of development, which is determined by technology, unless other factors are at play. Solow (and colleagues) know there are other factors at play. Endogenous Growth Theory proposes special endogenous features that produce increasing returns to investment in some countries, and therefore divergent outcomes across countries (Romer 1987)(Romer 1990). Another approach is to observe key exogenous features, which explain persistent gaps between countries (Barro 2012). The same models can show inequality between people as well as countries, and illustrates the issues which produce inequality within countries could also account for persistent differences between countries.

The Walrasian Competitive Equilibrium model provides a basis for the seminal type of “growth diagnostic” (Hausmann, Ricardo; Rodrik, Dani; Velasco 2006) (HRV). This equilibrium is a theoretical model of **optimal resource allocation**. The model is used by neoclassical economists as a workable approximation of a “healthy” economy in which producers make optimal investment and production decisions. In HRV Growth Diagnostics, the differences between an actual economy and the theoretical optimum point to constraints on investment and growth. The connection to growth theory is that if misallocations of resources are removed and technology is shared, then an economy should start to converge with more efficient global economies. In apolitical, neoclassical approaches like this, the causes of problems are treated as being exogenous. Policy is also exogenous, so **theoretically, policy can remove any misallocation of resources**. Optimal policy, however, is complicated by the secondary effects – the secondary reactions of prices and production levels within the equilibrium.

Ignoring the causes of economic problems is unsatisfactory for most economists, political economists and historians. Surely misallocations of resource aren’t simple errors or random accidents? There are approaches which attempt to extend economic analysis to take into account the **causes of problems.** There are also those that start with the political drivers and the economic implications of politics.

Approaches that address the causes of economic problems

The New Institutional Economics (NIE) explains how transaction costs or “institutions” might arise in a given political settlement and produce an economic performance which reproduces that political settlement (North 1991). This might continue for a long time, producing divergence between countries. There is some evidence of this (Robinson and Acemoglu 2012). However, NIE retains some apolitical characteristics. Although institutions are said to arise in and reinforce political settlements or social structures, they are still seen as costs (distortions) in a competitive economic system where the rules are the same for everyone, and in which there are no political groups.

Historians and political economists tend to approach analysis by starting with the political drivers. The premise that political groups must hold some sort of coalition in a political settlement and must therefore organise the economy in a way which preserves this settlement (in order to preserve their power). As in NIE, the institutions are “designed” by the powerful, but there is no assumption that they apply equally to all groups. Market power or transfers might be offered to one group at the expense of another. One way of describing this is that “rents” are created by institutions in a way which reinforces a political settlement (Khan and Jomo 2000).

There is a real issue which is that the greatest scholars of politics and history often are not too comfortable at linking their knowledge to economic policy and choices, at least not using “economics”. There are attempts by economists to combine economic and political approaches (Pritchett, Sen, and Werker 2017)(Bourguignon 2018).

In an attempt to explain the deeper causes of problems related to economic growth and political settlement it is noted that the deeper causes of policy emerge. Policy is a product of power and institutions and therefore in political and hybrid approaches, policy itself is endogenous – most of the time. **Therefore many of the problems causing suboptimal investment and growth are caused by policy.** A reversal of these policies would seem to be a good solution to encourage growth. However, the system has produced the problem-causing policies. An exogenous policy change or some other exogenous shock could be introduced to try and remove problems but secondary effects in the system would extend to policies, institutions, maybe political and social foundations. **One possibility is that the immediate impact of a policy change or intervention is neutralized by further adjustments to institutions and policy that it causes.** For example, a project provides services and credit for micro-enterprises to build them into larger, formal businesses. But the losers in this are the established firms who don’t like competition from new entrants, and they are politically connected. After initial successes, informal application of regulations makes sure the new entrants cannot thrive. This might look like institutional, petty corruption but as it helps powerful groups as well as petty officials, it sticks.

### Diagnostic Space, interactions and Thicker Diagnostics

**Whilst it is normal academic practice to highlight differences, contrast approaches, and draw attention to important distinguishing features, the novel process in this paper has been to focus on key commonalities.** The Diagnostic Space is introduced here as an arrangement of the building blocks of all the approaches discussed above (and more). Different approaches put different emphasis on different sets of features, but the underlying relationships between the features are similar. The HRV Growth Diagnostic occupies only the right two columns of the diagram, mainly just the relationship between private firms and production. The “current production equilibrium” is influenced of constrained by policies, regulations and limits. In HRV these constraints are exogenous.

Institutional or political economy approaches fill in parts of the two left hand columns, so that politics and institutions produce policy and regulation and they are no longer exogenous. This is a big difference. Policy changes might be amongst the external shocks that can disrupt this system, but existing policy is endogenous and part of the reaction of the system to shocks can be political, institutional and/or policy change.

#### Figure 1



In the complex Diagnostic Space, insights about equilibrium and interactions from simpler allocative efficiency models remain extremely relevant. In their Growth Diagnostic, HRV spend some time discussing the Theory of Second Best (Lipsey, R. G.；Lancaster 1956). In an economy, which is similar to the Walrasian Competitive Equilibrium, except for misallocations caused by one single distortion, then the removal of that distortion should produce a superior, optimal outcome. However, if there are multiple distortions, removal of one distortion does not necessarily produce a better outcome because of secondary effects. All prices and production levels are set simultaneously and a distortion that makes one level more efficient may also have secondary effects that make other levels less efficient.

In a much more complicated system where politics, social structures and institutions are introduced, secondary effects remain vitally important. An intervention or policy change will stimulate interdependent adjustments across the other features in the Diagnostic Space. An intervention will have one impact in one setting, and another impact in another setting where the background conditions are significantly different, because the secondary adjustments will also be different.

The purpose of the Thicker Diagnostic is to offer a practical way to fuse a wide range of political-economic, social, economic and technical approaches, in order to explore the deeper causes of persistent problems. And to use this fused approach to understand the likely impact of policy interventions. The thicker diagnostic should describe problems, but also their deeper causes. It should indicate sets of issues that are linked and that could be tackled together, and it should help the user to anticipate the secondary effects of policy and investment options – secondary effects which can include further institutional and/or policy changes, or even political and social changes.

The Thicker Diagnostic should alter the way evidence from other settings is used – there should be caution in using experimental evidence generated in significantly different settings, and certainly caution in interpreting this as evidence of “what works”. There may be a possibility to interpret externally generated evidence in terms of the immediate impact of an intervention, and to think through how this may work in a different setting.

## Growth Theory and a Thicker Set of Issues

### Growth theory and the differences between countries

|  |
| --- |
| Figure 2A |
|  |
| Figure 2B |
|  |
| Figure 2C |
|  |

Allocative efficiency is not the same as growth but growth theory is part of neoclassical economics where allocative efficiency is supremely important. The foundational neoclassical growth model is (Solow 1956). Solow shows that if countries share technology and efficient resource allocation, they should end up with similar economies whatever their starting point. Shared technology means a shared macro-production function, the equation that captures how the economy converts capital and labour into output. If every country has the same macro-production function then countries’ savings behaviour leads them to converge at the same point, *k\*,y\**, in Figure 2A. That’s the same level of income per capita.

Solow’s model is very simple, but it provokes debate about what is happening when we do not see convergence. It shows that if economies share technology and allocate resources efficiently, then rich and poor economies should converge over time. If this isn’t happening, then there are important omissions the model is not capturing. There are many options for what is left out of this model, which could explain why countries are not, as of the early 21st century, converging, or why countries are being held back from the “frontier” of economic performance.

One possible explanation for this divergence is that there is something about technology and its interaction with labour, which is not captured in the simple, decreasing returns production function. Endogenous growth theory proposes different functions, for example where technical progress or labour capability is itself a function of capital intensity, producing increasing returns over time. This might look like a macro-production function which produces more than one equilibrium level of investment and output e.g. Figure 2B, a low-income, low-capital path and high-income, high-capital path. Or a high-capital path with permanently accelerating labour productivity. Romer (1986) is perhaps the most famous version of this theory. It can explain apparently endless divergence between rich and poor countries, which in the late 80s seemed very useful since there was then a huge gap between OECD countries and the “third world”.

Another set of possibilities for explaining the lack of convergence could mean that countries do not share the same macro-production function at all. They may have different technology, and New Trade Theory explains how international trade and specialisation can make the production possibilities in trading countries different (Krugman 1986). Likewise, two countries may have the same technology, but key, persistent differences in other things which alter their production possibilities. These countries are represented in Figure 2C: **two countries with different macro-production functions rather than different spots on the same production function** – these two countries may grow at the same rate, but with a permanent gap in income level caused by the differences in macro-production function. Despite the massive variation in labour productivity and incomes in the world, there is some empirical evidence in favour of this “conditional convergence” (Barro 2012).

Where endogenous growth theories tend to pick out a pivotal endogenous variable, like learning, to explain multiple equilibria, conditional convergence allows for lots of differences between countries, including institutional differences. If the differences in the two macro-production functions in Figure 2C are to do with institutions, then a policy change or intervention which succeeds in disrupting institutions (and politics or social structures?) will shift the macro-production function itself, and permanently alter the gap between the two countries.

## The Diagnostic Space and the Thicker Diagnostic

### The Diagnostic Space and the purpose of the Thicker Diagnostic

The Diagnostic Space is a framework which focuses on key commonalities between diverse approaches. Figure 1 illustrates the ‘Diagnostic Space’ – the array of features which characterise a particular country or “development system” and the relationships between those features, the nature of which is strongly similar across a range of approaches. This becomes a framework for assembling evidence about those features and the causal relationships between the features. Crucially, every academic approach examined fits neatly into this space.

#### Figure 1 (repeated)



The space has four columns. On the right hand side of the diagram, there are producers and outcomes. The producers make some maximizing decisions about investment, employment and production which lead to a short-run equilibrium and a distribution of income (and changes in assets and technological experience). On the left hand side there is the political settlement and social structure, which design institutions. A lot of the approaches discussed in the introduction either focus on how political settlements and social structures produce institutional features, or how productive sector decisions are made, not (often) both. However, the intersection of the economic (right side) and political-economic (left side) approaches is through institutions; institutions are rules which constrain producers’ decisions and whilst they are designed on the left hand side, they have impact on the right.

An arrow pointing form right to left is a feedback loop, and there are two main ones in Figure 1. In the top right is a feedback loop related to industrial progress. This is not a feature of the basic neoclassical models but other economists often produce useful work on how industrial progress is working or being impeded (Sutton and Kellow 2011). The Thicker Diagnostic should certainly be able to absorb this sort of evidence. In this sort of analysis, production in a particular industry exposes firms to experience, develops technological and other capabilities which incrementally expand a county’s production possibilities. So the feedback loop goes from industrial outcomes back to producers. Like all feedback loops, this produces a path over time. If something is really bad for innovation of most firms are prevented from entering many industries, then industrial progress might be slowed as a consequence.

Another feedback loop is from outcomes back around to political settlements and social structures. Of course, from there this links to institutions and policy. These are the feedback loops that produce paths in political economy and mean that policy is endogenous.

The function of the Thicker Diagnostic is to arrange evidence from different types of analysis to complete a picture of the vital features, and their inter-relationships, in a particular setting.

### Hausmann, Rodrick and Velasco, Growth Diagnostics – resource allocation and the second best

In Growth Diagnostics (2005) and its various applications and elaborations, Hausmann, Rodrik and Velasco (HRV) set out an approach to diagnosing problems with the right side of the Diagnostic Space. Theoretically, HRV start with something like the Walrasian Competitive Equilibrium in mind and propose an approach to identify price distortions that point to major inefficiencies in resource allocation, which are impediments to investment and growth. In growth theory terms, this suggests that a poor country’s macro-production function will be shifted down by serious allocative inefficiencies, and that if these are removed, this function will shift up and a new, superior output and growth equilibrium will be found, akin to shifting from *F(X)* to *F(X’)* in Figure 2C. Their approach is designed to be extremely pragmatic and oriented to policy and programming needs – they are not too concerned about explaining historical developments.

Figure 3 **HRV principally focus on distortions in resource allocation that arise from private sector producers making production decisions subject to exogenous constraints**



In the Diagnostic Space, HRV are depicted in Figure 3 as being concerned with current investment, employment and production decisions of the private sector. This is just one, deeply coloured arrow in the system relating production to outcomes. Production decisions, and prices, are affected by “constraints” including policy and regulation, which are exogenous in this apolitical economic model. There is no “feedback”.

HRV include a discussion of the Second Best and general equilibrium effects or indirect effects – the very real possibility that in a highly distorted market, correcting one distortion with beneficial direct effects on resource allocation could also have indirect effects that undermine those gains or even generate a net outcome which is worse. This is represented by the coloured feedback arrow in Figure 3: prices are determined as producers make their choices. Changing one relative price changes all others. This is a vital general equilibrium effect which remains relevant even as information is added from the left hand side of the Diagnostic Space later. It is also a problem for HRV’s approach since it means that simply “fixing” one big distortion won’t necessarily produce a superior outcome. Their pragmatic solution to this is to target distortions with a very large direct impact – on the basis that with these, most adverse indirect impacts are less likely to spoil the benefits.

Whilst their theory is neoclassical and apolitical, in practice, HRV growth diagnostics did involve some attention to the deeper causes of the immediate problems identified, hence the pale red arrows on the left hand side of Figure 3. HRV know politics matters. However, by basing an approach on Walrasian General Equilibrium and Solow, they are treating the economy as a set of interacting, economic actors (individuals or firms) who are homogenous in all respects except possibly in their “initial” capital endowments, and who are all operating under the same rules as each other – any “distortion” affects all actors equally. There is also no attempt to endogenize institutional or policy reactive adjustments to change. These assumptions probably need to be dismantled if politics can be treated properly in the Diagnostic Space.

### Douglass North, New Institutional Economics, Acemoglu and Robinson

Douglass North won a Nobel Prize in 1993 for his approach to institutions and economics in economic history based on work which was built on transaction cost concepts conceived by Ronald Coase (Coase 1937). This gets called “The New Institutional Economics”. In Institutions, Institutional Change and Economic Performance (North 1991) describes how institutions are the deep, written or unwritten (formal or informal) rules which create the economic incentives which determine economic performance – they are seen as solutions to the problem of exchange, implying transaction costs. He discusses how these institutions may have political or social foundations, or indeed foundations in factor endowments (nature) which might generate deeply enduring institutions. The endurance of institutional differences between countries, rather than the convergence of institutions on a single set of normal or optimal institutions is of great interest to North because it produces path dependence and the possibility of divergence of economies based on institutional differences. This is like **F(X)** and **F(X’)** in Figure 2C, where **X** and **X’** are different sets of institutions.

In terms of the concepts discussed so far, North is suggesting historical political and social foundations for institutional features which are a lot like distortions in a Walrasian Competitive Equilibrium, which diminish allocative efficiency and the productive potential of a country which could account for a wide gap in the economic development of the country compared to one with different institutional features.

Figure 4 **The New Institutions Focuses on how institutions, or “transaction costs” alter the choices of private sector producers. These institutions arise in politics and the economic outcomes reinforce the political settlement, but there is less focus on how this works**



It is noticeable that whilst North’s institutions are grounded in politics, the impacts of the institutions are not experienced differentially by political groupings – all individuals have the same rights and there are no political groupings. This seem surprising given the intensely asymmetric and political institutions that North sometimes looks at, including the King of Spain’s restrictions on South American trade.

The later work, Violence and Social Orders (North, Wallis, and Weingast 2013), North gets more political and also comes closer to a predictive diagnostic by describing a typology of political settlements which is either open or limited-access. This implies two political groups, the elite and the rest. Consistent with earlier work, it is assumed that the ‘open access order’ is going to deliver an optimal resource allocation and that if this arises in a developing country, we can expect rapid economic convergence with rich countries. The open access orders use the threat of violence by the state to limit everyone else’s use of violence and to protect everyone’s rights. This contrasts with the three limited access orders where violence, or the threat of it, is used to convey stronger rights for elites in ways which distort and damage economic performance. Some ‘orders’ are clearly worse than others, one may give way to the next but there is nothing systematic about that – no theory of history. But the type of ‘order’ has clear economic implications, making this approach more predictive. For North, introducing three types of political settlement seems like adding detail, but it is also highly reductive – three specific types omits all the other types. In common with various other approaches, reducing the political settlement to a few types, risks blunting the accuracy of any predictions that might be made.

Acemoglu and Robinson (AR) have also made a seminal contribution to institutional economics, through their famous popular book Why Nations Fail (Robinson and Acemoglu 2012) and many academic articles (for example, (Acemoglu and Robinson 2017)). The chains of causality assumed by AR are extremely similar to those ascribed to North in Figure 4. Like North they use the framework to discuss historical episodes. Perhaps one of their main insights is that extractive institutions are likely to reinforce the grip of one type of regime – a relatively small elite that penalizes most of the population for its own benefit, whereas more inclusive institutions (similar to North’s ‘open access’ institutions) are more likely to reinforce the grip of another type of regime – a more accountable regime that governs more in the public interest – this is similar to NWW. So like North they are interested in enduring institutional differences and divergent paths. Also like North they can attribute the root cause of these differences to something completely exogenous, like ‘nature’. Once a self-reinforcing set of institutions and political settlement (or political and economic institutions) are established it might reproduce itself for a very long time – for several centuries, in fact – with no endogenous forces likely to disrupt the path. Something external may eventually disrupt it. As with North they look at 16th century Spain and its colonies compared to 16th century England and its colonies, as well as other examples.

AR make us think about path dependence and in an extremely reduced way, they offer an analysis of political factors from which they extrapolate development outcomes. One conclusion is that it is better for most people if institutions are more inclusive – but not necessarily better for the groups in charge which is why extractive institutions can be so persistent. Another implication is that institutions and policy have become endogenous. This explains the extreme persistence of institutional differences between countries in different dynamic equilibria or “paths”. Can a country change its path? This would appear to require an external disruption – even then, some external disruptions will be met by endogenous institutional and policy adjustments that restore a country to its path.

(Jean-Phillippe Platteau 2000) makes a very useful extension of North into social norms. There are social structures akin to political settlements but at a lower level. They produce institutions or “social norms” which put powerful limits on the opportunities of some social actors, which can be seen as resource allocation distortions. These are included in Figure 4.

### Pritchett, Sen and Werker

In Deals and Development (Pritchett, Sen, and Werker 2017)(PSW) seek a “unified growth theory” that uses a framework where the political settlement dictates institutions which generate economic outcomes – these are the familiar chains of causality from the Diagnostic Space. PSW is represented in the Diagnostic Space in Figure 5.

PSW use a framework with several elements that serves both to open up new dimensions and also reduce them to manageably small taxonomies. PSW define four types of political settlement. PSW also suggest that a country’s set of institutions can fit into one of four categories in the “deals space”, so there are multiple permutations of politics and deals space. Thirdly, they define four types of economic actors (in fact, types of producer), such that the goods and services they produce give them different access to rents in the ‘rent space’. So the type of political settlement and the position in the ‘deals space’ generates rents across different industries in the rent space.

PSW retain some of the apolitical tendencies of North and the taxonomies are too general to be very predictive. The type of political settlement does not predict the position in the deals space and a position in the deals space does not predict economic outcomes. There are no political groupings and although a “deals world” implies personalized contracts and rules of the game, the implications of asymmetric institutions are not discussed very systematically.

However, the “rents space” does move towards a more differentiated political economy analysis, compared with North. If political groups have different industrial interests, and perhaps ownership in some industries is protected or “closed access”, then institutions might shape “rents” across these industries in a political way. In other words, industrially asymmetric institutions may also be politically asymmetric. Where this is so, the Diagnostics Space suggests two types of feedback – industrial capability feedback, which alters the capability of firms. Also, political feedback which reinforces or alters the political settlement. Where these features have been important, a researcher following the PSW framework is likely to pick up on them.

Figure 5 **PSW follow North but with more focus on the rapid interactions between power, institutions, and economic outcomes. They also allow for institutions to be differentiated across industries, so there are both political and industrial feedback loops.**



PSW also addresses the authors’ preoccupation with episodic growth, and in so doing, provide interesting insights into how the features of different columns in the Diagnostic Space might interact sequentially. Any shock, in the type of political settlement, the position in the deals space (institutions) or indeed an exogenous technological change, leads to follow on impacts at all levels. PSW observe that institutions tend to move slowly whereas the growth rate is erratic and growth is often episodic. Growth episodes are characterized as symptomatic of adjustments to political-institutional and economic balance. This feedback happens fast enough to explain episodes of high growth. Where North and AR emphasize the endurance of institutional differences, PSW are more interested in the way perturbations in economic and political conditions may explain bursts of growth. They may trigger very strong growth conditions and a rapid growth episode, which further alters political conditions and the deals environment, often in a way that destroys the conditions for growth, such that the episode of growth contains the seed of its own termination. An example is a shock which produces a somewhat more open and orderly deals space position for a country in a country with closed access institutions. This boosts investment and growth and may start to erode the political settlement. However, plus or minus a few travellers, the old elite is likely to re-assert itself, with endogenous institutions tending back towards more personal deals and asymmetric rules, and this ultimately slows down investment and growth again. (In the rarer, more optimistic version, rapid growth produces a permanent political, institutional and economic shift.) This cycle is likely to last around 10 years, rather than AR’s 300 years. AR’s long “episode” also ends as the result of an exogenous shift rather than because of endogenous forces.

### Mushtaq Khan – political economy and development

Mushtaq Khan is a political economist and therefore his starting point is the left hand side of the Diagnostic Space. He is interested in how power is held and used in a country, how institutions, or the “rules of the game”, are organized to produce rents for the groups that are in power, or whose support is required by the regime. He is also often interested in the current dynamics of the political settlement, and not so taken with the idea of massive inertia in politics that characterizes NIE etc. Is the political economy producing prosperity and growth which is reinforcing the regime, or undermining it? Is the political economy undermining investment and growth but nevertheless reproducing the grip of the regime? This is an approach laid out in Rents, Rent seeking and Economic Development, (Khan and Jomo 2000) and more recently(Khan 2015).

For Khan, the politics of the management rents is absolutely critical to economic development. For him, the optimality of Walrasian Competitive Equilibrium is almost irrelevant: development is not about removing rents but about the difference between the management of rents which builds capabilities and investment, and that which traps a country in an immiserizing state.

Power is used to change the rules and generate rents for groups that are close enough to power. Rents arise in the economy, and there are various options for how they are generated. External events or endogenous dynamics might cause the position of different groups to alter and might also cause their grip on rents to alter, and of course rents have direct and indirect impacts on the rest of the economy. The timescale for these changes is much higher frequency than that of AR – Khan’s model allows for constant flux in power and rents. Although rents arise in markets, they are generated for particular groups – something not clearly dealt with by North or AR, so Khan’s institutions can be thought of as discriminating or “asymmetric” – applying differently to different groups. Khan’s rents result from the distribution of rights – different rights for different groups. Contrast North and AR’s tendency to see institutions as similar to classical economic constraints or transaction costs, which means they tend to assume that these rules apply equally to everyone.

Figure 6 **Khan puts far more emphasis on how complex politics produces institutions and rents for particular groups – the full economic impact of these rents is dealt with more vaguely**

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Khan’s approach can be clearly mapped onto the Development Space as in Figure 6. Strong on the left hand side of the diagram, and also strong on the feedback to politics. Khan does not treat rents in the same way as HRV and makes no attempt to model or quantify them in the same way. However, he is interested in whether rents are being managed in a way that produces developmental or anti-developmental outcomes. In acknowledging that rents can be learning or Schumpeterian rents – generating new techniques or innovation – or they can be monopoly rents leading to a deadweight loss and the entrenchment of political power. This is the substance of his critique of Anne Krueger and neoclassical economics in general – that they always regard rents as a negative. Because of the way he links rents to industrial policy, the “firm capability” feedback loop is coloured quite deeply in Figure 6.

### Bourguignon’s Economic Development and Institutions

The thicker diagnostic proposed in this paper joins long chains of effects right through the Diagnostic Space. Whilst it is possible to map the areas of interest of each of the included authors in a consistent way onto the layers of features in the Diagnostic Space, most authors do not attempt to analyse the long chains. PSW do this in a way, adding a lot of extra structure and add even more ideas about episodic growth. The thicker diagnostic is an attempt to fuse political and economic approaches to complete and then examine the chains.

Economic Development and Institutions (EDI) is a DFID -funded research project whose research directors are François Bourguignon and Jean-Philippe Platteau. The project scope extends to the far corners of the space described in Figure 7, with over 60 papers and an emergent EDI approach which is consistent with the North-like framework laid out above, although like other approaches, differs from or deepens that approach in places and for the project as a whole, encompasses variations in approach.

One research area in EDI is diagnostics, the aim of which is to provide a diagnostic toolkit as pragmatic as HRV’s “growth diagnostic” but which takes account of the origins and importance of institutions. This is in development, and had only been applied in a preliminary way in Tanzania, and then again in Benin as of October 2019.

Like other approaches discussed, the EDI diagnostic in Tanzania goes some way to marrying political, institutional and economic information and combining a more Khan-esque political economy approach with a more traditional economic approach to development constraints. It gathers some of the information that Khan might gather to establish the political and social forces underpinning institutions but also gathers some more HRV-like information about the symptoms of economic development problems. These are brought together in thematic essays which, ideally, are investigations of the causes of the symptoms identified, using chains of causality extremely similar to those in the Diagnostic Space.

Figure 7 **Bourguignon’s EDI diagnostic traces the full length of causal chains from politics through institutions through public and private production decisions to outcomes. There is strong awareness of the feedback to politics but also a strong emphasis on the interactions of features across the four columns.**

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Bourguignon is interested in general equilibrium in markets and the analogous interaction of institutions. An important path-finding paper in EDI (Torvik 2016) explains how the interaction of institutions is fundamental. A change in one institution will alter others, and the impact of the change will certainly be conditional on the background state of other institutional features. These diagnostics do list key “institutional weaknesses” but also acknowledge that institutions and policy are endogenous in this system. So any exogenous policy change or institutional reform will produce a reaction: secondary effects including in institutions.

HRV type studies are made use of in the identification of downstream problems and the EDI diagnostic does not repeat such a systematic exercise and does not confine itself to problems revealed by price distortions. At least in the preliminary study, the emphasis is on describing the insidious nature of key economic problems in a way which indicates the complexity of dealing with the institutional causes. Institutional weaknesses are identified but this does not carry an easy implication about the institutional reforms which are necessary.

### The second best and the implications for evidence in options appraisal

For a growth diagnostic like HRV, which hinges on economic efficiency, general equilibrium effects and the Second Best has some major implications. In fact, for the thicker diagnostic, there are linkages and interactions within and between layers of features. Between prices, between institutions, between prices and institutions etc. So the importance of the Second Best does not fade in the Thicker Diagnostic.

In a Walrasian competitive equilibrium, prices are endogenous. There can be an exogenous price change, for example, resulting from changes in international markets, but this produces a reaction in the system so that all or many other prices also change, as do the production and consumption levels of those goods and services. The analogy is, in Thicker Diagnostics and all the approaches that integrate political and economic analysis, institutions, policies and regulations are made endogenous. There can be an exogenous institutional change, for example, resulting from an international agreement, but as with all exogenous shocks, this will produce a reaction in the system across institutions and policy, and possibly also in social structures and the political settlement.

(Bourguignon 2018), (Torvik 2016) and colleagues show that altering one institutional feature changes the impact of other institutional reforms: the impact of institutional change is conditional on the starting point across all institutions, not just the institution to be changed. The classic example is the Sovereign Wealth Fund (SWF) for the safe keeping of assets derived from oil exploitation. In Norway, this works perfectly – but Norway has a particular set of background institutions. In Chad, a sovereign wealth fund was put in place but after a few years, it created a quantity of loot that may have been irresistible to the perpetrators of an attempted coup d’état, and was certainly irresistible to the President who raided it to fund efforts to defeat that coup attempt.

Endogenous institutions and policy has major implications for the use of evidence. The point of a diagnostic is to identify problems so that an evidence based approach can be taken removing the problems. “Second Best” shows why there is not much point in gathering data on the average impact of an intervention or a reform such as introducing a SWF – if external evidence were to be used in a decision about introducing a SWF then there would need to be data on the settings where SWFs had been more or less successful, and as much understanding as possible about why they had been unsuccessful in certain settings.

## Conclusions

This note has set out a review of approaches that attempt to explain development and growth. At a very high level, there is some consistency between very diverse approaches in terms of the broadest causal connections. Neoclassical economists often undertake apolitical analysis: the HRV Growth Diagnostic is an exercise in identifying allocative efficiency problems. There are also other approaches to identifying constraints on investment and growth which bring in other factors, for example innovation and the capabilities of firms. In their analysis, these economists ignore politics, and make policy exogenous. But all would accept that in reality, policy and institutions are set in a political way. Likewise, political experts do not generally attempt to analyse the economy in a way that rivals economists, but they do accept that power reproduces via the economy, at least partly.

The Thicker Diagnostic is a way of arranging diverse analysis and to bring together the political causes of institutions and policies, and the political and social consequences of economic outcomes. As with any development diagnostic, its purpose is to describe problems which undermine development of an economy or some part of that economy, help to rank the importance of those problems and to indicate where evidence based solutions should be found to address the problems.

The results is a thicker description of key development challenges and also of their causes embedded in political and social foundations. This may indicate an important set of issues that need to be tackled together, and the analysis also allows an anticipation of the secondary effects of a policy change or an intervention and therefore and anticipation of the reaction of the system to different options. As with an HRV diagnostic, further research and analysis may be required to fine tune the choices between options.

The Thicker Diagnostic will allow an anticipation of the reaction of the wider system to exogenous shocks: policy changes, transfers and investments, changes in technology, international markets or international agreements including trade agreements. Interventions and policy changes are deliberate exogenous shocks. So the Thicker Diagnostic can be used to identify some serious development problems and their causes and also to anticipate the impact of options for tackling those problems. For a given problem and proposed solution, the conclusion may be:

* The candidate intervention or policy change will fail to disrupt the system and have no lasting impact, because the system will produce a combination of countervailing formal and informal institutional and policy changes that will neutralize the impact of the intervention;
* Alternatively, it may seem likely that the candidate intervention or policy change can be made to “stick”, and will disrupt the system causing adjustments not just to the immediate targeted economic outcomes but also in political and social structures, institutions and policies – these might be minor adjustments or theoretically, could snowball into something with much wider impact;
* The Thicker Diagnostic analysis will show up potential blocking groups that might help neutralize an intervention – understanding these might indicate a set of complementary interventions which might help the central intervention or policy change to “stick”;
* In special cases, the Thicker Diagnostic might allow a more accurate subsequent evaluation of the full impact of a set of interventions which is revelatory – i.e. the existing regime changes its calculus as a result of the new information such that the endogenous adjustment and policy change occurs, which of course sticks. In this case, the information is disruptive and no further external intervention is required.

Just as with the HRV growth diagnostic, the basic diagnostic exercise will not produce fine-tuned policy recommendations, but it will give a good indication of what the objectives of policies or interventions should be and of the design challenges that will need to be met.

The Annex below shows some worked examples of Thicker Diagnostics, introducing the Diagnostic Space Matrix.

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## Annex: How To Do a Thicker Diagnostic

This Annex shows how a Thicker Diagnostic is performed. The process is intended to be undertaken at country level, although it should be possible to adapt the diagnostic to focus on particular issues and even a single sector like education, or a subdivision of a country like a region or a city. The exercises should be possible without major data generation or survey work, rather, by basing conclusions on a wide range of existing evidence. In countries which are particularly under-researched it would be possible to generate missing parts of the data. However, in this approach, there is no complete set of data which is required. Rather, new information can always usefully be added.

The key steps are:

- assemble information on right-hand features: producers, efficiency and capabilities;

- assemble information on left hand features: the social structure and strong social norms, the political settlement and important interests, rents and limits which the political settlement relies upon;

- arrange these features in the diagnostic space and/or DS matrix;

- match right and left hand features through the intersection of institutions. Allow for institutions to have asymmetric impact on different industries or on different sets of producers associated with political groups, or social groups like ethnicities and gender;

- identify important, long chains of direct causality from left to right, and also consider important interactions within or reaching back left across columns which might be reinforcing feedbacks;

- use the deeper understanding of the causes and persistence of problems for options appraisal and to frame further investigations.

The thicker diagnostic can make use of any or all of the information of the type generated in the approaches discussed and other diagnostic exercises like the World Bank Systematic Country Diagnostics.

## Right Hand Information

Right hand information is to be converted into features under the heading private or public producers and outcomes which derive from the production process or from the income and wealth generated by the production.

On producers, it would be good to use firm census or enterprise survey information, or similar, to characterize the population of firms, for example according to age, size and broad industry. “Left Hand” information may reveal that institutions and regulations treat firms in different industries, or possibly firms with different ownership, differently. If this is the case then it will be useful to describe private producers according to the groups of producers that are facing different “rules of the game”. IN most developing countries, there should at least be a distinction between formal and informal enterprises and this will very often match a distinction about size: large formal firms and informal micro-enterprises. In each setting there might be more relevant, local categorizations of producers.

Public producers, including parastatals but also public sector service delivery operations run by civil servants, also need to be categorized. As with firms, the amount of detail needed might depend on “Left Hand” information about where some parts of the public sector are differently incentivized of captured compared to other parts.

The results of an HRV type study which examines imbalances and price distortions at macroeconomic level, in factor markets and in other markets, will be almost indispensable for the Thicker Diagnostic. These distortions occur somewhere in the space between the “producer” and “outcome” columns but have direct consequences in terms of levels of production and prices in the outcome column.

It could be left out but ideally, the Thicker Diagnostic should make use of any information about the productivity and capability of producers and how this is explained. The “outcome” pattern of production may generate capabilities that feed back into the production possibilities in the economy. This could include enterprise survey statistics about the size structure and age of firms and the amount of reported innovation and productivity growth across enterprises, or other available assessments of technological advancement, innovation and spillovers. Information on the diversity of production and any ongoing transformation in the pattern of growth also helps with inferences about firm capability. If there is an Enterprise Map, eg (Sutton and Kellow 2011) or similar and/or Qualitative study on innovation, eg (Voeten, Achjar, and Utari 2016), so much the better. If there are detailed studies of skills and the labour market, also, so much the better.

“Outcomes” goes beyond production and income to include changes in assets and wealth. This could include savings and investments (or absence thereof) in productive capital. Information from national accounts may suffice unless there is an interesting feature that needs to be brought out – for example, is there a drastically different capital intensity in one group of firms compared to another? Human capital, resulting from public and private investment, should also be included and there is likely to be a wealth of reports on service delivery and progress with human capital: Public Expenditure Reviews etc. Social norms are often relevant in the accumulation of human capital. It might also include changes in the prices of assets linked to their associated income potential, rather than simply capital generated from savings- these can be important determinants of wealth. For example, the price of urban land can be very policy sensitive, and it may be interesting to be aware which political or social groups possess the urban land that is rising in price.

## Left hand Information

Left hand information is also to be arranged across two columns under the headings Foundation (political settlement and social structure) and Institutions. What is needed is information about the key political groups or actors who have power, and also those who want it, how they hold that power and what they do to hold onto it. Likewise there should be information on key elements of the social structure, who has power at a social level and how social norms reproduce that structure.

The results of a Khan type study or another serious political settlements analysis that identifies political groups, the rents they require and the measures they take/ institutions the create in order to achieve this. Failing such an integrated report, and even if there is one, information can be gathered from histories and political accounts to help form a good description of the political settlement: who are the major political actors? what are their interests? how is power balanced? What institutional features are created to maintain this settlement?

A review of critical social norms including gender based norms, and their impacts. Authoritative reports on poverty, like World Bank poverty assessments, will often contain this sort of information. There is often material specifically on gender based constraints and norms.

More targeted topical modules or ‘deep dives’ require more detailed upstream information as well as more detailed technical and downstream information. In an example of a skills shortage constraining growth caused by underinvestment in human capital and bias against girls, the top level upstream information might link underinvestment to some political cause and might link the bias against girls to gender norms about education and restricted labour market participation. A deeper dive to inform an actual reform programme would need deeper downstream information but also more detailed knowledge about how institutions impact the public sector within education and how gender norms specifically impact girls’ access to education and the returns to human capital for women and girls.

### External factors

The impact of exogenous shocks is beyond the scope of the core diagnostic but the framework could be extended to think about such issues. Potentially, exogenous changes could have a major disruptive impact on the deterministic path set up by the layers of exogenous features in the diagnostic space. These could include technological change, large movements in international prices and/or trading conditions, natural phenomena like diseases or climate change, conflict or changes in countries with an important relationship.

An important consideration is whether the country (/sector/city) is steady in its dynamic equilibrium or whether it is already adjusting to major external shocks at the time of study. For example, conflict or post-conflict countries, or countries with a recent change of regime may be adjusting to a new political settlement and therefore in flux. This is important to know and if it’s true, it would be great to try and understand the main direction of that adjustment.

### Synthesis and analysis

Synthesis and analysis involves a matching of upstream and downstream evidence to generate preliminary ‘long chains’ of effects. Then, consideration of interactions to spot critical reinforcing endogeneities and to refine the long chains. Finally, using these refined long chains it should be possible to assess policy options and packages of policy options may be implied.

This may best be illustrated by two real world examples. A Thicker Diagnostic of India, biased strongly towards human development issues. Also a Thicker Diagnostic of Nepal, which was undertaken very rapidly using secondary sources only.

## Example: India Thicker Diagnostic

To illustrate the synthesis and analysis process, a highly stylized and simplified version of an India diagnostic is used. This is a summary of a much larger report prepared in early 2019.

#### Right Hand Information:

In terms of market distortions, reviewed material shows that India’s economy is strongly dual, with pronounced differences between formal and informal sectors. The formal sector has a small number of large, old, highly capitalized firms and few younger, smaller firms. There is a huge tale of tiny informal firms with much less capital and labour productivity. Across the literature, the “missing middle” is linked to a closed access business environment where regulation is enforced in an asymmetric way to generate barriers to entry.

In terms of capabilities, the missing middle is important in that it deprives India of a channel for innovation and the accumulation of firm capability. In addition, it is clear that India has much worse human development indicators than its income status would predict. This is partly due to very low levels of public subsidy in education and especially health.

#### Left Hand Information:

In very crude and reduced terms, the literature on India’s political economy reveals an historic ‘elite bargain’ which protects the interests of elite actors connected to power. This creates protectionism and other market distorting institutions.

The elite bargain makes politics a high stakes game, and democratic elections mean that it is worth elites engaging in a transactional or “clientelist” politics to gain power. This creates a strong bias in favour of the public sector distributing private goods, rather than public goods.

Another striking feature of India’s political and social foundations is very strongly disempowered groups as a result of strong social norms. This causes household discrimination against women and girls including over education and nutrition. It generates discrimination in service delivery including form women, lower castes and tribes. And it involves widespread labour market discrimination, effectively restricting the participation of large groups from whole areas of the job market.

#### Matching and Interactions:

This part of the process can make use of the Diagnostic Space Matrix (DSM). This is a way of organizing key features of the system under diagnosis and for recording investigations about short causal connections in that system. Each feature is included as a determinant (row) and a dependent (column), and features are grouped together. North-East of the long diagonal are impacts of left-hand features on features to their right, in the Diagnostic Space. South-West of that diagonal are “feedback” impacts of right-hand features back into features on their left.

Key features identified in right and left hand information are inserted into the DSM. These include elite groups and highly disempowered groups; sets of institutions that enforce the elite bargain/ protection of elite businesses; sets of institutions that constitute election winning clientelism; social norms which discriminate against women, girls and lower castes and tribes. The “Missing Middle” is visible under producers as two groups of firms – large, elite-owned formal firms and informal micro enterprises. Finally, key outcomes are included.

The DSM is used to explore long chains of causality and reinforcing feedbacks through the diagnostic space. If a feature in a row is a determinant of another feature in a column, an arrow, “↗” is placed in the corresponding cell. Above the diagonal (top left to bottom right), an arrow shows a relatively simple linear link between a more upstream and a more downstream feature. Below the diagonal, arrows show more complex endogeneities. At the bottom left is the “feedback” loop, from outcomes back to political and social foundations.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **INDIA THICKER DIAGNOSTIC**  **DIAGNOSTIC SPACE MATRIX** | | | Elite Groups: self-protective elite bargain | | Elite Groups: election-winning clientelism | | Highly disempowered groups | | Closed access business institutions: asymmetric regulation, corruption, barriers to entry | | Institutional bias towards public provision of private goods instead of public goods | | Social bias against investment in HD of women and girls | | Small number of highly capitalized, elite owned formal firms | | Many under-capitalized, informal microenterprises and farms | | Low public and private investment in human capital | | Low demand for urban labour | | Subsidized rural wage and a low supply of urban labour | | High returns to capital in the protected formal sector |
| **POLITICAL SETTLMENT AND SOCIAL STRUCTURE** | Elite Groups: self-protective elite bargain | |  | | **↗** | |  | | **↗** | |  | |  | |  | |  | |  | |  | |  | |  |
| Elite Groups: election-winning clientelism | | **↗** | |  | |  | |  | | **↗** | |  | |  | |  | |  | |  | |  | |  |
| Highly disempowered groups | |  | |  | |  | |  | |  | | **↗** | |  | | **↗** | |  | |  | |  | |  |
| **INSTITUTIONS AND SOCIAL NORMS** | Closed access business institutions: asymmetric regulation, corruption, barriers to entry | |  | |  | |  | |  | |  | |  | | **↗** | | **↗** | |  | |  | |  | |  |
| Institutional bias towards public provision of private goods instead of public goods | |  | |  | |  | |  | |  | |  | | **↗** | |  | | **↗** | |  | |  | |  |
| Social bias against investment in HD of women and girls | |  | |  | |  | |  | |  | |  | |  | |  | | **↗** | |  | |  | |  |
| **PRODUCERS** | Small number of highly capitalized, elite owned formal firms | |  | |  | |  | |  | |  | |  | |  | |  | |  | | **↗↗** | |  | | **↗** |
| Many under-capitalized, informal microenterprises and farms | |  | |  | |  | |  | |  | |  | |  | |  | |  | | **↗↗** | | **↗↗** | |  |
| **OUTCOMES** | | Low public and private investment in human capital | |  | |  | | **↗** | |  | |  | |  | |  | |  | |  | | **↗** | | **↗** |  |
| Low demand for urban labour | |  | |  | | **↗** | |  | |  | |  | |  | |  | |  | |  | | **↗** |  |
| Subsidized rural wage and a low supply of urban labour | |  | |  | | **↗** | |  | |  | |  | |  | |  | |  | |  | |  |  |
| High returns to capital in the protected formal sector | | **↗** | | **↗** | |  | |  | |  | |  | |  | |  | |  | |  | |  |  |

In the DSM and the Diagnostic Space, pink arrows show how the elite bargain produces the closed access business environment (matching) which in turn produces the “Missing Middle”, or lack of small and medium sized, young formal sector firms. This undermines both economic efficiency and firm level capability development. An important inefficiency is that it supresses urban or ‘modern sector’ labour demand. This is a long chain of effects.

The blue arrows show a different long chain, from social disempowerment to low investment in human capital/ human development. This is reinforced by low public investment in human development (which is part of the other long chain). There are important reinforcing endogeneities in the second long chain, which show up as blue arrows below the diagonal. Social discrimination in service delivery, and also in the labour market, reinforces household level bias (and social norms). This reinforcing endogeneity causes the long chain to be labelled a “trap”, the “low human capital rural trap”.

Note that clientelism feeds both these long chains. Underinvestment in infrastructure and skills reinforces the 2missing middle” and underinvestment in human development, and entitlement programmes focused on rural areas, reinforce the “low human capital rural trap”.



#### Policy Choices:

This very compressed version of a thicker Indian diagnostic suggests that policy should address the missing middle and low levels of human development. But the diagnostic does not need to be thicker in order to highlight these issues – these are just the important downstream problems for economic efficiency and capability.

However, the stylized knowledge about the long chains results from the thickness of the diagnostic and these have strong pointers to policy.

On the missing middle – this appears to result from deep political bias against competition in order to generate easy rents for some groups with a lot of political influence. This suggests that a whole battery of technical fixes like business training or better finance for MSMEs might not make much difference because the barriers to entry are quite purposeful and institutions are likely to adapt to preserve those barriers should technical measures like training and credit start to weaken them.

A problem with deep political and institutional roots is hard to solve with any technical fix. A first port of call for policy makers facing such a problem would be to look at evidence of “what works” in similar settings – other places where a powerful private interests have created a distorted business environment. A possible alternative course of action could be to persuade the historic beneficiaries of the bias against competition that parts of the ‘missing middle’ are no longer to their advantage – for example, the cost of intermediate supplies and services are raised by the absence of organized and efficient smaller firms. In the modern world, it isn’t efficient for large companies to internalize every part of the value chain. If the problem is politically rooted, perhaps a politically rooted solution could be brokered by suggesting that special efforts should be made to improve the business environment for new entrants in intermediate goods and services. (Such a policy would need a lot more work but the diagnostic points in this direction.) The diagnostic, at minimum, re-frames the discussion about the missing middle.

On the low human capital trap, a ‘thin’ diagnostic might point to greater public investment in health and education services. The thicker diagnostic conveys the historic failure to do this and its deeper institutional and political underpinnings: so increased funding might be hard to generate. It also draws attention to layers of reinforcement caused by very slow-to-change social norms: so increased funding for public service might not actually break through the low human capital trap in any case because there would be still social bias against investing in women and girls and against providing proper services to low status groups.

Once again, the first port of call in a search for solutions should be a sift of evidence for what works in similar conditions. It is possible that the low human capital rural trap is more special to India than the type of missing middle found in India and elsewhere. Some policies that suggest themselves include:

- Education, nutrition and health services targeted solely at disempowered groups, possibly with additional rewards for enrolment in these services

- Service delivery through the private sector financed from direct subsidies to disempowered users – to empower those users in the face of service delivery discrimination

- Simultaneous action to open labour markets: quotas and subsidies might be justified in order to break down social norms and household attitudes.

These sorts of policy require strong political backing. This isn’t an impossibility in India because disempowered groups are very large and have a long history of using democracy to claim rights. Also, if the low human capital rural trap is seriously undermining future growth prospects it is not in elite interests. There have been elite-poor alliances in India before, it’s just that they have tended to revolve around the distribution of private goods and subsidies instead of human capital. Policy advisers doing diagnostics can’t make these political changes or deals but they could highlight winners and losers from different reform options. The diagnostic can certainly frame further analysis of these options.

## Example: Nepal Thicker Diagnostic

This example was prepared very rapidly, in a couple of days, and therefore it represents distinctly preliminary findings – the previous example benefitted from fieldwork and sense checking interviews. This rapid study of Nepal was made possible by excellent right and left hand information from secondary sources:

*Asia Foundation 2017, Political Economy Analysis of Local Governance in Nepal;*

*Asia Foundation 2014, Political Economy Analysis of Electricity Tariff Restructuring in Nepal;*

*Magnus Hatlebakk for Norwegian Ministry of Foreign Affairs 2017, Nepal, a political economy analysis;*

*MCC 2014, Nepal Growth Diagnostic;*

*ODI for DFID 2014, Structural economic transformation in Nepal, A diagnostic study submitted to DFID Nepal;*

*Roy and Kahn 2017, Nepal’s Political Settlement and Inclusive Growth: Not Quite Business as Usual;*

*World Bank 2018, Systematic Country Diagnostic.*

#### Right Hand Information

Several growth diagnostics identified major excessive costs which were causing the misallocation of resources.

The supply of electricity is inadequate to meet demand, creating a major distortion. There are IPPs but further private investment is deterred by pricing policy. Public investment has not supported expansion by the National Electricity Authority (NEA) and the NEA has not found a stable way to promote private investment – there are disputes with the price regulator ETFC, which in the past has suspected NEA of inefficiencies and corruption. MCC, ODI and WB all see this is an important economic constraint, and WB sees it is a missed industrial opportunity, because Nepal has so much hydro potential – it could be exporting.

Transport costs are high and customs arrangements are difficult. This is partly because of a bureaucracy that has failed to prioritize road investment for a long time (probably public procurement leakages). A second cause of high transport costs are that regulators permit anti-competitive arrangements in productive sectors, notably around trade and trucking. The existence of trucking syndicates feeds into transport costs. The existence of organized trading (smuggling) syndicates is one reason why customs are made so difficult for outsiders to navigate.

The “business environment” is difficult for most potential businesses, so there is a small, uncompetitive formal sector with sluggish growth and low capabilities, 96% of workers are in the informal sector which has grown, in services, but where labour productivity is very low.

In terms of outcomes, these significant costs for business hold back investment and formal sector employment. Low labour demand reduces the returns to investment in human capital, where public investment is also low. The result is mass migration of unskilled workers and by 2016, remittances that are worth 30% of GDP (see below).

A non-standard issue in Nepal is the impact of migration and remittances. This is a consequence of sluggish growth and low labour demand (1.). A good impact of it is that it largely explains why Nepal has made great progress in poverty reduction in the last decade despite sluggish per capita growth by LIC and regional standards. Remittances have swollen to 30% of GDP and are quite evenly spread across households in different parts of the income spectrum: they support consumption in poor households and of course they support demand for non-tradeables and imports across the economy.

Where foreign exchange earnings support demand for non-tradeables goods, the exchange rate always strengthens. Khan sees this is a rent, and some insider groups do benefit from it, but it can also be seen as a side effect of very high remittance income, it is like the Dutch Disease created by migrants instead of oil. ,

A high level of remittances allows a large trade deficit and the capacity to import can only have reinforced some elite groups interest in syndicated trading/smuggling operations. Remittances make imports cheap, but rent-extracting importers reduce the advantage of this for businesses and consumers alike.

#### Left Hand Information

Like India, Nepal has deep regional, ethnic and caste related inequalities some of which are entrenched by social norms. Combined with closed access politics for many years this produces very unequal service delivery across regions and groups and very unequal human development outcomes: basic school completion is quite low by international standards but for Dalits, for example, it is about 5%, which is extremely low.

A closed access political system which generates patronage and corruption in the bureaucracy. In Nepal, reports are of ubiquitous promotion of private/political interests by parts of the bureaucracy, but in quite an uncoordinated way, in small/individual deals.

A key feature of Nepal is that the closed access political settlement is not stable, it has been thoroughly undermined by civil war and more than ten years of negotiated peace in which politics has become much wider access. The new political settlement is not yet stable either but many sources agree that the way it stabilizes is fundamental to future development prospects. There is a lot of focus on how devolution works out. Mushtaq Khan suggests that if the provincial level is given a lot of power and resource, this could easily tip into identity based provincial politics with clientelism to distract/divert the wider political appetites, along with unstable national coalitions unable to improve conditions for growth very much. Alternatively, if a more stable national coalition (CP-UML-??) emerges and pushes more power and discretion to a lower level of local government, perhaps quite a stable, developmental shift can occur, accommodating the wider participation in politics.

In reality, we seem to be seeing a mixture of these types of devolution so the final outcome is still uncertain. Nepal may not be steady in its dynamic equilibrium, and this is an important consideration in all policy choices.

#### Matching and Interactions:

Key features have been arranged in a Diagnostic Space Matrix below. The interactions are also displayed as arrows in the diagnostic space below that.

A lot of the solid red arrows represent a rather familiar phenomenon in developing countries. A closed access political system which generates patronage and corruption in the bureaucracy. In Nepal, reports are that private/political interests are promoted by parts of the bureaucracy in quite an uncoordinated way, in small/individual deals. Gold arrows relating to anti-competitive rents in the trucking and trade sectors reinforce high transport costs and the limited scale of the formal sector. The dotted “feedback” arrows show that the high level of migration and remittances reinforces the lucrativeness of the trucking and trade (smuggling) businesses by boosting demand for imports, and also strengthens the exchange rate further undermining the competitiveness of formal sector, export oriented businesses.

The blue arrows show that the new political settlement has the potential to be disruptive to some of the deeper causes of infrastructure problems and the poor, anti-competitive business environment as well as service delivery problems. This is uncertain.

#### Policy Choices

There was no policy work undertaken connected to this rapid diagnostic but a number of clear issues do suggest themselves as a result of the analysis.

Attempts to tackle transport costs by investing in roads, or border posts are likely to be blocked or will yield returns to the wrong actors if nothing is done to prevent the transport and import/export industries being run as rent generating, closed access businesses. The best technical solution in transport and trade might be to break up syndicates and to reduce trade protection. But this would generate losses for powerful actors so would likely be blocked without some serious compensatory measures.

There should be a lot of caution about trying to prevent migration, since it is responsible for poverty reduction in recent years. The incentives for migration would diminish if there was employment in alternative industries, but these alternative industries won’t be much helped by forcing more unskilled labour back into the Nepali labour market.

The rents from transport and trade have squeezed trade and competitiveness and helped to create the migration for work pattern in Nepal – these phenomena reinforce each other.

It is conspicuous in some of the literature that Nepal has massive untapped natural rent in the form of hydroelectric power potential and virtually unlimited market access in India– there is an impasse on mobilizing investment resources to exploit this. Unlike transport and trade, it is hard to see why unblocking the bureaucratic stranglehold on power investment in Nepal causes major losses for connected people- maybe it does, and this needs to be investigated more. The Hydro sector could generate rents that don’t damage economic performance and these could be used to make sure losers from power sector reforms are compensated. They may even allow compensation of losers from other sets of reforms.

It is spotted already but the decentralization process in Nepal is a playing out of the new political settlement and could have impact on a lot of issues. One option is to decentralize the power to generate rents in the economy, and damage economic performance, as is being done now. Another option is to re-build support for the political settlement which is less reliant on these rents – however, if there are powerful losers, something might need to be done to compensate them.

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| **Nepal rapid/thick diagnostic** | | | **DEPENDENTS** | | | | | | | | | | | | | | | |
| Residual closed-access politics, with strong opposition and short time horizon regimes | Emergent shift to more stable coalition with more open access to power | Devolution – political settlement not settled | Historically disempowered regions, ethnic groups, castes | Patronage and corruption commonplace in bureaucracy – not very coordinated | Syndicates in key sectors including import/export and trucking | Inequality/discrimination in service delivery, possibly improving | Small formal sector, low capability investment and NEA behaviour | Very large informal sector, even lower capability t and trade arrangements | HD service delivery at best unequal, possibly improving informal sector, even lower capability | Hi costs of electricity due to low public investment and NEA behaviour – can it improve? | HI costs of transport due to low public investment and trade arrangements – can it improve? | Strong exchange rate damages competitiveness and stunts firm capabilities | Low labour demand, low human capital produces high levels of migration and remittances | Poverty reduction with sluggish growth | Unequal HD and unequal opportunities despite poverty reduction |
| **DETERMINANTS** | **POLITICAL AND SOCIAL SETTLEMENT** | Residual closed-access politics, with strong opposition and short time horizon regimes |  |  |  |  | **↗** | **↗** | **↗** |  |  |  |  |  |  |  |  |  |
| Emergent shift to more stable coalition with more open access to power |  |  |  |  | **↗** |  | **↗** |  |  |  |  |  |  |  |  |  |
| Devolution – political settlement not settled… identity politics or developmental state? |  |  |  |  | **↗** |  | **↗** |  |  |  |  |  |  |  |  |  |
| Historically disempowered regions, ethnic groups, castes |  |  |  |  |  |  | **↗** |  |  |  |  |  |  |  |  |  |
| **INSTITUTIONS** | Patronage and corruption commonplace in bureaucracy – not very coordinated – improve? |  |  |  |  |  |  |  | **↗** |  | **↗** | **↗↗** | **↗↗** |  |  |  |  |
| Syndicates in key sectors including import/export and trucking |  |  |  |  |  |  |  | **↗** |  |  |  | **↗** |  |  |  |  |
| Inequality/discrimination in service delivery, possibly improving |  |  |  |  |  |  |  |  |  | **↗↗** |  |  |  |  |  |  |
| **PRODUCERS** | Small formal sector, low capability |  |  |  |  |  |  |  |  |  |  |  |  |  | **↗↗** |  |  |
| Very large informal sector, even lower capability |  |  |  |  |  |  |  |  |  |  |  |  |  | **↗↗** |  |  |
| HD service delivery at best unequal, possibly improving |  |  |  |  |  |  |  |  |  |  |  |  |  | **↗↗**  **↗** |  | **↗↗**  **↗** |
| **OUTCOMES** | Hi costs of electricity due to low public investment and NEA behaviour – can it improve? |  |  |  |  |  |  |  | **↗↗** | **↗↗** |  |  |  |  |  |  |  |
| HI costs of transport due to low public investment and trade arrangements – can it improve? |  |  |  |  |  |  |  | **↗↗** | **↗↗** |  |  |  |  |  |  |  |
| Strong exchange rate damages competitiveness and stunts firm capabilities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Low labour demand, low human capital produces high levels of migration and remittances | **FEEDBACK**  **OUTCOMES TO POLITICAL AND SOCIAL SETTLMENT** | | | |  |  |  | **↗↗**  **↗** | **↗↗**  **↗** |  |  |  | **↗↗**  **↗** |  | **↗↗** |  |
| Poverty reduction with sluggish growth |  |  |  |  |  |  |  |  |  |  |  |  |
| Unequal HD and unequal opportunities despite poverty reduction |  |  |  |  |  |  |  |  |  |  |  |  |

#### Nepal Diagnostic Space

