Preface

THE INSTITUTIONAL DIAGNOSTIC PROJECT

This study of Mozambique is one of four case studies in a research project whose final aim is to devise a methodology that would establish an 'institutional diagnostic' of economic development in a particular country. The objective of such a diagnostic is to identify the institutional factors that may slow down development or reduce its inclusiveness or sustainability, the reforms likely to overcome these weaknesses, but also the political economy that may prevent or facilitate such reforms. These diagnostics must thus rely on a thorough review of economic development and institutional features of countries under analysis, which is the content of this volume on Mozambique. As a preamble, the following pages offer a general description of the whole diagnostic project.

'INSTITUTIONS MATTER'

'Institutions matter' became a motto among international development agencies in the late 1990s, when it became clear that structural adjustment policies – themselves based upon the so-called 'Washington Consensus' – and their emphasis on markets were not delivering the growth and development that was expected. The slogan sounded a note of disappointment for those liberalist reformers, sometimes jokingly called the 'marketeers', who promoted the reliance on market mechanisms and the pre-eminence of private actors in order for developing countries to get out of the crises of the 1980s and restore long-run growth. Giving more space to the market was probably justified from a theoretical point of view. Practically, however, it was another story. What the marketeers had not fully realised was that a well-functioning market economy requires regulating institutions, public goods, and non-market services

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which most often were missing or deficient in the economies being considered. Under these conditions, liberalising, privatising, and deregulating might in effect prove counterproductive without concomitant institutional changes.

Nowadays, the 'institutions matter' slogan appears as a fundamental truth about development, and it is indeed widely shared by the development community, including international organisations. Equally obvious to all is the complementarity between the market and the state: the economic efficiency expected from the former requires some intervention by the latter through adequate policies, the provision of public services, and, more fundamentally, institutions able to impose rules constraining the activity of various economic actors, whether public and private. Practically, however, the institutions of a country are the outcome of history and specific events or circumstances. Therefore, they are not necessarily well adapted to the current economic context and to the modern development challenge. This raises the issue as to how existing institutions can be reformed.

That 'institutions matter' has also long been evident for those academic economists and political scientists who kept stressing that development is the outcome of the joint and interactive evolution of the economy and its institutional set-up, with the latter encompassing not only state and political agencies but also cultural and social norms. As a matter of fact, the study of the role of institutions has a long history in the development economics literature, from the very pioneers of the discipline in the post–Second World War years and their emphasis on development as a structural and cultural transformation, as for instance in the writings of Peter Bauer, Albert Hirschman, Arthur Lewis, or Hla Myint, to the New Institutional Economics as applied to development issues, in particular with the work of Douglass North, to the Institutional Political Economy approach put forward nowadays by social scientists like Mushtaq Khan, and to the more formalised school of Political Economics pioneered by Daron Acemoglu and James Robinson.

HOW INSTITUTIONS MATTER IN DEVELOPMENT POLICY TODAY: THE ROLE OF 'GOVERNANCE'

Faced with the disappointing performances of the so-called 'Washington Consensus', which governed the market-oriented 'structural adjustment' policies put to work in developing countries at the time of the macroeconomic crisis of the early 1980s, international organisations and bilateral development agencies switched to what was called the 'post-Washington Consensus'. This extended set of principles were seen as a way of compensating for the neglect of institutional considerations in the original set of policies. Market-oriented reforms had thus to be accompanied by other reforms, including the regulation of various sectors, making government more efficient, and improving human capital formation. Most importantly, however, emphasis was put on good governance as a necessary adjuvant to market-led development, especially in its capacity to protect property rights and guarantee contract enforcement. With time, governance then became a key criterion among donors for allocating aid across low-income countries and monitor its use.

It is fair to say that, practically, governance is defined and evaluated in a rather ad hoc manner, based on some expert opinion, firm surveys, and some simple economic parameters like the rate of inflation or the size of budget deficit. The relationship with the actual nature and quality of institutions is thus very indirect. This still seems the case today, even though the recent World Development Report by the World Bank, *Governance and the Law*,[1] intends to go deeper by showing how governance, or policymaking in general including institutional reforms, depends on the functioning of institutions, the role of stakeholders and their relative political power. Practically, however, there remains something rather mechanical and schematic in the way institutions are represented in this report, which is actually more about effective policymaking than on the diagnosis of institutional weaknesses and possible avenues for reform.

If there is no doubt that institutions matter for development, the crucial issue is to know how they matter. After all, impressive economic development achievements have been observed despite clear failures in particular institutional areas. In other words, not all dimensions of governance may be relevant at a given point of time in a given country. Likewise, institutional dimensions that are not included in governance criteria may play a decisive role.

There is admittedly limited knowledge about how institutions affect development, how they form, and how they can be reformed in specific contexts. Despite intensive and increasing efforts over the last few decades, the challenge remains daunting. The difficulty comes from the tight imbrication of the way the quality of existing institutions affects the development process, including policies, the political economy context which conditions possible institutional reforms, and the influence that the pace and structure of development exerts, directly or indirectly, on the dynamics of institutions.

SEARCHING FOR EVIDENCE ON THE RELATIONSHIP BETWEEN THE QUALITY OF INSTITUTIONS AND DEVELOPMENT

Three approaches have been followed to help in the identification of development-hindering or -promoting institutional features, and of their evolution over time, whether autonomously or through discretionary reforms. All three approaches have their own drawbacks.

The first approach consists of historical case studies. These are in-depth studies of successful, or unsuccessful, development experiences, and their causes and processes as they unfolded in the historical past or in the

[1] World Bank (2017).

contemporary world. The formation and success of the Maghribi trading networks in eleventh-century Mediterranean basin, the effects of the Glorious Revolution in Britain, the enactment of effective land reforms in Korea and Taiwan after the demise of the Japanese colonial rule, and the implementation of the Household Responsibility System in rural China – all these are examples of institutional changes that led to vigorous development, whether state-led or resulting from decentralised initiatives triggered by external factors. On the other hand, violent fights for the appropriation of natural resource rents in several post-independence African states illustrate the opposite course of blocked development under essentially predatory states. Studying such events is of utmost interest insofar as they highlight rather precise mechanisms susceptible of governing the transformation of institutions, often under the pressure of economic and other circumstances, sometimes prompting and sometimes hampering development. In their best-selling book *Why Nations Fail*, for instance, Acemoglu and Robinson (2012) masterfully show the role of institutions in several historical and contemporaneous experiences of sustained or failed development. In particular, they stress the critical role of inclusive institutions as compared with predatory ones, and most importantly the role of favourable political conditions in changing institutions and sparking off development. The most serious problem with this approach, however, is that the experiences thoroughly analysed in the history-based empirical literature are rarely transferable in time or in space and are not necessarily relevant for developing countries today.

Under the second approach are cross-country studies pertaining to the contemporaneous era. It relies on indicators that describe the strength of a particular set of institutions or a specific aspect of governance in a country: protection of property rights, nature of legal regimes, extent of democracy, strength and type of controls on the executive, and extent of corruption, the issue being whether there is a correlation between these indicators and gross domestic product (GDP) growth or other development outcomes. These institutional and governance indicators are generally based on the opinion of experts in various areas evaluating, on a comparative basis, countries on which they have specialised knowledge. They are thus based on largely subjective grounds and lack the precision needed for statistical analysis. If correlation with development outcomes is sometimes significant and often fit intuition, the use that can be made of them is problematic as they essentially refer, by construction, to an abstract 'average country' and may be of little use when focusing on a particular country. Most importantly, they say nothing about causality and still less about the policy instruments that could improve institutions under consideration. Corruption is generally found to be bad for development, but in what direction does the causality go? Is it true in all countries and all circumstances? What about the cases where corruption 'greases the wheels' and reintroduces economic efficiency in the presence of too stringent administrative constraints? And, if it is to be curbed, what kind of reform is likely to work?

Cross-country studies are a useful approach provided that it is considered as essentially exploratory. They need to be complemented by more country-specific analyses that can detect causal relationships, shed light on dynamic processes at play in key sectors of the economy as well as on their interactions with institutions and the political arena, and inform on potential ways of conducting reforms.

The third approach exploits the fact that some sorts of institutional weaknesses or strengths are readily observable, such as the delivery of public services like education or healthcare. For instance, the absenteeism of teachers in public schools reveals a breach of contract between civil servants and their employers and/or a monitoring failure by supervisors. There are ways of incentivising teachers so that they show up in school, and numerous experimentations, rigorously evaluated through randomised control trial (RCT) techniques in various community settings, have successfully explored the impact of such schemes in various countries over the last two decades or more. Identification of similar institutional weaknesses at the micro level and experimentation of ways to remedy them have sprouted up in the recent past, so much so that the field has become the dominant subject among researchers in development economics. Inspired by the RCT methodology and its concern with causality, a new economic approach to history has also blossomed in the last decades. This literature exploits so-called 'natural experiments' and intends to assess the impact of institutional changes that exogenously emerged in particular geographic areas in the past, the outcomes of which can still be observed and compared to otherwise similar neighbouring regions today. These outcomes can be of an economic, a social, or a political nature.

A major limitation of the third approach is that it generally addresses simple cases that are suitable for experimentation. Identifying more macro-level institutional failures and testing appropriate remedies through the RCT method is much less easy, if not impossible. In addition, successful testing of reforms susceptible of correcting well-identified micro-level institutional failures does not mean that the political will exists, or an effective coalition of interest groups can be formed, to fully correct the detected inefficiency. Thus, in the above example of teachers' absenteeism, there is no guarantee that the state will systematically implement the incentive scheme whose impact has been shown to be the best way to improve school performances. The institutional weakness may thus not be so much in the breach of contract between teachers and their public employer as in the incapacity of the latter to design and implement the right policy. As this example shows, an in-depth understanding of macro-political factors is needed to reach a proper assessment of the feasibility of reforms and the conditions required for their successful implementation.

The above empirical approaches leave a gap between an essential macro-view of the relationship between institutions and development, whether it consists of stylised historical facts or cross-country correlations between GDP growth and governance or institutional indicators, on the one hand, and a micro-perspective on institutional dysfunction (e.g., the observation of absenteeism of civil servants or corrupt tax inspectors) and possible remedies, on the other hand. Also note that, in most cases, these approaches permit to identify relationships between institutional factor and development outcomes but not the mechanisms responsible for them. In economic modelling parlance, they give 'reduced form' rather than 'structural' evidence about the institution–development nexus. Filling this twofold gap requires a meso-approach based, as much as possible, on structural analysis conducted at intermediate levels of the social and economic structure of a country, including economic or social sectors as well as key groups of actors and official decision-making or monitoring entities.

Awareness of these drawbacks of the standard analysis of the relationship between institutions and development and, therefore, of the need for a more structural, sectoral, and political economy approach to that relationship has motivated the exploratory research undertaken within the present Institutional Diagnostic Project.

INSTITUTIONAL DIAGNOSTIC AS A NEW APPROACH TO INSTITUTIONS AND DEVELOPMENT

The Institutional Diagnostic Project research programme aims at developing a methodology or, better said, a framework that allows the identification of major institutional weaknesses or dysfunctions that block or slow down economic growth and structural transformation, and/or make them non-inclusive and non-sustainable, in a given country at a given stage of its development process. The diagnostic is also intended to formulate a reform programme and point to the political stakes involved in its implementation. In other words, it should contribute simultaneously to a better understanding of the specific relationship between institutions and development in the country under consideration, to a more complete stocktaking of policies and reforms likely to improve the development context, and to characterising the political barriers that might obstruct these reforms. It is a country-centred approach that differs from historical case studies, in the sense that the focus is not on a particular event, circumstance, or episode in a country but on the overall functioning of its economy and society. It also goes beyond the mere use of governance or institutional indicators that appear much too rough when dealing with a specific economy. On the other hand, it makes use of microeconomic evidence on institutional weaknesses and dysfunction in a country and, when available, on whatever lesson can be learned from experimental works that may have been conducted in the area concerned. It thus makes use of the various methodological approaches to the study of the institution–development relationship but goes beyond them by embedding them in essentially a structural approach adapted to the particulars of a country.

A priori, it would seem that institutional diagnostics should resemble the 'growth diagnostics' approach developed by Hausmann, Rodrik, and Velasco[2] some 15 years ago to identify the binding economic constraints to economic growth. The resemblance can only be semantic, however. Practically, if the objective is similar, the difference is huge. Most fundamentally, the growth diagnostics approach relies explicitly on a full theoretical model of economic growth based on the accumulation of means of production and innovation in the private sector, the availability of infrastructure, financial facilities, the control of risk through appropriate insurance mechanisms, and the development of human capital. Constraints in one of these dimensions should logically translate into a high relative (so-called) 'shadow' price paid for that resource or that facility that is the actual cost paid by the user of that resource which may differ from its posted price. The observation of those prices should then allow the analyst to identify the constraints most likely to be binding. No such model is available, even implicitly, in the case of the relationship between institutions and development: there is no shadow price easily observable for the availability of a fair and efficient judiciary, an uncorrupted civil service, an effective regulatory agency, or a transparent budget. Another, more heuristic approach needs to be developed.

In the exploratory attempt of the Institutional Diagnostic research programme, we decided to avoid designing a diagnostic framework *a priori*, testing it through application to various countries, and then revising it progressively in the light of accumulated experience. Instead, our preference went to a more inductive approach consisting of exploring the relationship between existing institutions and the development process in a limited number of countries. On the basis of these in-depth country case studies, the idea is to draw the contours of an institutional diagnostic framework destined to be applied to other countries. The purpose of this framework is to identify pivotal and dysfunctional institutions, understand the causes of the dysfunction, and suggest feasible ways of correcting them in the particular social and political context of a country. In short, the elaboration of the diagnostic methodology has proceeded quasi-heuristically, from a few exploratory yet detailed attempts to understand the role and the dynamic of major institutions in a country, as well as their interactions with the local environment, including the society, the polity, and the geography.

A requirement of the UK Department for International Development, now the Foreign and Commonwealth Development Office, which funded this research project, was to focus on low-income and lower middle-income countries. Accordingly, and in view of available resources, the four following countries were selected: Bangladesh, Benin, Mozambique, and Tanzania. The rationale for this choice will be provided in the individual case studies. At

[2] Hausmann et al. (2005).

this stage, it will be sufficient to emphasise that, taken together, these four countries exhibit the diversity that is needed in such an exploratory exercise, diversity being understood in terms of geography, population size, economic endowments, historical and cultural legacy, or development strategy. Despite that diversity, however, the fact that they often face similar economic and institutional challenges in their development suggests that there may be common lessons to be drawn from the in-depth study of these challenges.

STRUCTURE OF CASE STUDIES

Before presenting the structure of the case studies, it is worth defining more precisely what is meant by 'institutions'. In the present research programme, we use a definition derived from North (1990), proposed by Baland et al. (2020: 3) in the recently published *Handbook of Institutions and Development*:

> (Institutions are defined) as rules, procedures or other human devices that constrain individual behaviour, either explicitly or implicitly, with a view to making individual expectations about others' behaviour converge and allowing individual actions to become coordinated.

According to that definition, laws and all that they stipulate are institutions, insofar as they are commonly obeyed. Even though often appearing under the label of governance, democratic elections, the control of the executive, or the functioning of public agencies are institutions too. But this is also the case of customary law, even unwritten, or common cultural habits. Institutional failures correspond to situations where a law or a rule is not operating and contraveners are not punished. Actually, this situation may concern large groups of people such as when, for instance, several laws coexist, or a law cannot be enforced on the whole population for lack of resources. The formal production relationship between employers and employees or between firm managers and the state through tax laws are institutions that govern modern companies in developing countries, but the existence of informal production sectors results from the inability of the state to have labour and tax laws enforced throughout the whole production fabric, especially among micro and small enterprises. Yet, implicit rules govern the relationship between informal managers, their clients, and people who work for them. As such, production informality may thus be considered as an institution in itself, which coexists with formal labour laws. The concept of institution also applies to laws and customs that rule social and family life. Here too, informal institutions are when, for example, religion or tribal tradition dictate behavioural rules that differ from secular laws, for instance in areas like marriage, divorce, or inheritance. However, note that, because the focus is on economic development, most institutions or institutional weaknesses considered in the Institutional Diagnostic Project generally refer to those likely to have a significant impact on the economy.

Equipped with this definition, the in-depth study of the relationship between institutions and development in a country and the identification of institutional impediments to long-term inclusive and sustainable development will proceed in three steps. The first one is 'mechanical'. It consists of reviewing the economic, social, and political development of a country, surveying the existing literature, and querying various types of decision-makers, top policymakers, and experts about their views on the functioning of institutions in their country. The latter can be done through questionnaire surveys or through focused qualitative interviews. Based on this material, some binding 'institutional weaknesses' on economic development may be identified and hypotheses elaborated regarding their economic consequences and, most importantly, their causes.

This direct but preliminary approach to the institutional diagnostic of a particular country is also expected to point to several thematic areas where critical institutions seem to be at play. Depending on the country considered, some of the areas obviously deserving scrutiny are the following: modalities of state functioning, that is the bureaucracy and the delivery of basic public goods like education; tax collection; economic regulation and the relationship between private business and political power; land allocation system and property rights; decentralisation, and so forth.

The second step consists of a thorough analysis of these critical areas in order to precise the *modus operandi* of relevant institutions and the sources of their inefficiencies, the ways of remedying the situation, and the most important challenges posed by the required reforms. Are the observed institutional inefficiencies caused by a lack of competent civil servants, their tendency to shirk or get involved in corrupt deals, the excessively intricate nature of the law or administrative rules or their undue multiplication and their mutual inconsistency, or else the bad organisation of the administration? Moreover, why is it that reforms that seem adequate to correct major institutional inefficiencies have not been undertaken or why important reforms voted in the parliament have not been effectively implemented? Who would be the gainers and the losers of particular reforms, and, consequently, who is likely to promote or oppose them?

Based on these detailed analyses of key thematic areas, the third step of the case studies, and the most challenging task, is to synthesise what has been learned into an articulated view of the main institutional problems hindering progress in various areas, their negative consequences for development and, most importantly, their causes, proximate or more distant, as well as their susceptibility to reforms. This is the essence of the 'diagnostic' that each case study is expected to deliver.

It bears emphasis that the above exercise is a diagnostic, not a reform agenda. Because there are gainers and losers from most reforms, political and economic circumstances will determine whether they can be undertaken or not. This needs to be thoroughly discussed, but it must be clear that no firm conclusion about the political feasibility can be reached without a precise evaluation of the distribution of political power in the society, something that goes beyond the contemplated diagnostic. From the strict standpoint of the diagnosis, however, its critical contribution is to expose the nature of the institutional dysfunction, and highlight possible reforms and the stakes involved. In other words, the diagnostic must eventually make all key actors aware of the implications of the needed reforms, and of the expected collective gains and the possible losses, which they would entail for some groups of the population or some categories of key economic and political actors.

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