Institutions, Growth and the Washington Consensus: Where Do We Stand?

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There has been intense debates on the so-called "Washington consensus", in particular around its following implications:

1. Growth-enhancing institutions (liberalized markets and open trade, privatized firms, stable macroeconomy, stable legal environment with adequate property right protection,..) are the same in to all countries at all stages of development.

2. Liberalization is unambiguously good for economic performance and government intervention should always be minimized.

Joe has undoubtedly become a leading figure among those, including myself and all of us at this table, who question these two principles. A main difficulty for us is that while departing from the overly simplistic view of growth and development put forward by the strongest advocates of the Consensus, we still believe: (i) in the universal role of some institutions or policies (property right protection, stable macroeconomy, good education and health systems,..) and in the importance of a good "investment climate"; (ii) in the virtues of competition and entry as growth-enhancing devices. So, a main challenge for us is to formulate our criticisms in a way that does not create scope for "amalgam" between us and radical anti-globalization forces.

Let me illustrate our razor-edge position by showing you some pictures and tables about: (a) the effects of the 1991 liberalization in India on subsequent TFP growth across states and industries; (b) the interplay between productivity growth, entry or openness, and a country’s level of development.

1 The Indian liberalization

Advocates of full liberalization reforms argue that, by increasing the size of markets and by fostering product market competition, liberalization enhances growth (see, for example, Dollar and Kray (2001, 2002), Frankel and Romer (1999), Sachs and Warner (1995) and World Bank (2001)). Critics instead

The evidence gathered so far on this issue is mainly at the country level and does not arrive at any clear consensus. In recent work with Burgess, Redding, and Zilibotti (ABRZ)\footnote{I have done parallel research on entry and growth in the UK, with Blundell, Griffith, Howitt and Prantl (ABGHP (2003)), and obtained very similar results as those on India.} we look at the extent to which the effect of the 1991 liberalization on performance measures such as productivity, investment and output, varies according to the technological capabilities of industries/firms and the institutional environments which they face across Indian states.

Our main finding is that reducing barriers to entry to foreign products and firms, has a more positive effect on economic performance for firms and industries that are initially closer to the technological frontier. In contrast, performance in firms and industries that are initially far from frontier may actually be damaged by liberalization. As a result, liberalization magnifies the initial differences in productivity. The reason is that incumbent firms that are sufficiently close to the technological frontier can survive and deter entry by innovating. An increased entry threat, thus, results in higher innovation intensity aimed at escaping that threat. In contrast, firms and sectors that are far below the frontier are in a weaker position to fight external entry. For these firms, an increase in the entry threat reduces the expected payoff from innovating, since their expected life horizon has become shorter.

Another key finding is that the institutional environment in which firms function, has a central bearing on whether or not they benefit from liberalization. Here, our focus is on labor market institutions which affect the distribution of rents between firms and workers. More precisely, our theory predicts that the response of innovative investments to liberalization is dampened in regions with more pro-worker labor regulations. Thus, in relative terms, trade reforms hurt growth in regions with pro-labor regulations, while enhancing growth in regions with pro-employer regulations.

These findings allow us to draw several important policy insights. The first is that the stage of technological development of a firm or industry matters. Policies which allow firms to upgrade their technological capabilities or which enable workers to relocate from low to high productivity sectors, will help to increase the extent to which a country or region benefits from liberalization. A second is that the impact of liberalization on firm performance, depends upon institutions such as labor regulations which differ across regions and affect the incentives for firms to invest and innovate. This, in turn points to a complementarity between liberalizing product and labor markets. Domestic policy reforms can thus play a central role in determining the extent to which firms and industries benefit from macroeconomic reforms which lower barriers to entry.
2 Appropriate institutions

While the strongest advocates of the Washington consensus advocate a minimal degree of government intervention, Joe, Dani, and others after them, call for greater government intervention in less developed countries where market failures tend to be more severe and where imitation and learning by doing externalities may sometimes justify "infant-industry" type of policy. On the other hand, several economists and political scientists emphasize the greater danger of government failures in less developed nations, where checks on governments are weaker (e.g., Shleifer and Vishny, 1999).

I believe that some non-competitive policies may have limited costs, or even benefits, when countries are far from the world technology frontier, but become much more costly near the frontier. While a detailed empirical analysis is beyond the scope of the current paper, a brief look at the data reveals some notable patterns consistent with this implication.

Figures 1a and 1b look at the relationship between growth and initial distance to frontier (GDP per capita relative to the U.S.) in the sample of non-OECD, non-socialist countries separately for those with high and low degree of “non-competitive” policies/barriers to entry (here we do this using the measure of number of procedures necessary for opening a new business, from Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2002). The figures show growth in per capita income between 1965 and 1995 plotted against distance to frontier in 1965, where we also control for a dummy for sub-Saharan African countries, which have much lower growth rates. While there is a strong negative relationship between growth and distance to frontier for countries with high barriers, the relationship is much weaker for countries with low barriers. In other words, high-barrier countries do relatively well when they are far from the frontier, but much worse near the frontier, while low-barrier countries grow almost equally successfully near or far from the frontier. This is consistent with the notion that barriers to entry are more harmful to growth closer to the frontier, though this cross-country relationship may be driven by other omitted cross-country differences.

Figures 1d and 1e show the same pattern when we look at growth in 5-year intervals and control for country fixed effects and time effects. These figures show that near the frontier a country with high barriers grows less than its “usual” growth rate. Therefore, as implied by our model, countries with high barriers slow down more significantly as they approach the frontier.

Figures 2a-2d show that the same results hold when we look at the differential growth experiences of countries that are more and less open to international trade. Here we split the sample according to the predicted openness measure constructed by Frankel and Romer (1999), which exploits “exogenous” differences in openness from a standard “gravity equation” due to differences in population, land area, proximity and common borders to other countries, and whether a country is landlocked.

Thus liberalizing entry or opening up to trade is particularly growth-enhancing for countries already close to the world technological frontier, but less so for
countries far below the frontier. A main issue is that of the transition from "catching-up" institutions that are more adapted to the latter case to "frontier" institutions adapted to the former case.

3 Conclusions

The above examples suggest a middle line between the unconditional advocates of the Washington consensus on the one hand, and the radical opponents of liberalization and globalization. This line is more one of "completing" the Washington consensus than throwing it away altogether. While following Joe as my spiritual father on these issues, I might have well converged to a view which is somewhat different from Joe’s view, but this is an unavoidable feature of all relationships between fathers and sons.