

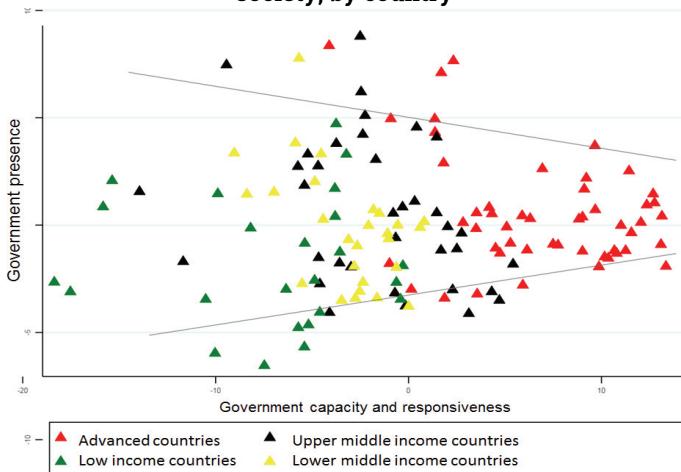
Trésor-economics

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Institutions and development: Insights from the Institutional Profiles Database (IPD)

- The Institutional Profiles Database (IPD) was created in 2001 and now covers 144 countries that account for 99.6% of the world economy. Developed by the Directorate General of the Treasury, the IPD's goal is to shed light on the role played by institutions (political, economic, social, etc.) in development policies. It attempts to provide a quantitative measure of countries' institutional characteristics, based on a survey completed by the overseas economic missions of the French Ministry for the Economy and Finance.
- The data in the 2016 edition emphasise the existence of several key institutional features that are both strongly connected to a country's economic development level, and strongly correlated between themselves. These key features include i) the functioning of public administrations; ii) the coordination of stakeholders, strategic vision and innovation; iii) social cohesion and social mobility; iv) security of transactions and contracts; and v) market regulation and social dialogue. Other features, such as political institutions and their democratic nature, or markets' room to manoeuvre, correlate less with the development level.
- The database also shows a wide range of institutional profiles amongst developing countries, whereas advanced economies have more similar profiles (see chart). This fact tends to support the theory that institutional characteristics converge as countries develop.
- This convergence is stronger when it comes to (i) the government's capacity to provide basic services (security, justice, other public services, economic stewardship) and (ii) the presence of government in political, economic and social life.
- The IPD is available (in French and English) at: https://www.tresor.economie.gouv.fr/Ressources/8087_une-mesure-originale-des-caracteristiques-institutionnelles-des-pays and <http://www.cepii.fr/ipd.asp>

Government's capacity and presence in the economy and society, by country



Source: DG Trésor, 2016 IPD data.

1. Certain institutional features are strongly correlated with development: business security, government efficiency, social cohesion, etc.

1.1 The IPD survey seeks to quantify institutions for the purpose of informing economic analysis and public policy

Despite the established connection between institutions and long-term development and growth, institutions remain

difficult to measure, and there are few objective criteria to analyse their impact on growth. The IPD was designed to address this lacuna by attempting to quantify countries' institutional features.

Box 1 : The connection between institutions and growth

There is a well-documented link between institutions and long-term growth in economic literature, despite debate about the exact nature of interactions and the impact of development assistance.

Work on the subject has expanded since the 1990s, notably with contributions from Daniel Kaufman, Dani Rodrik and Daron Acemoglu.^a More recently, focusing on the concept of resilience, Wallis (2016) estimated that long-term growth is fostered less by episodes of rapid growth than by governments' capacity to withstand external shocks (conflicts or economic crises).^b

There is less consensus about the connection between institutions and official development assistance.

A body of literature dating back to the work of Burnside and Dollar (1997, 2000)^c posits that the impact of aid on the recipients' prosperity is positive only in countries with "good governance". Their study – much discussed – was included in the World Bank's "Assessing Aid" report (1998). It concluded that (i) aid would only have a positive impact in countries with "good" economic policies (fiscal, monetary, trade) and that (ii) as a result, allocating aid to countries with high-quality institutions and policies would maximise the impact on development. Donors were then encouraged to allocate their aid on the basis of the quality of national policies and institutions – in what the World Bank calls "ex post conditionality". Some programmes have been created specifically with this objective, such as the Millennium Challenge Corporation, which was set up by the United States in 2004.

However, the impact of aid on countries with less robust institutions should not be downplayed. Critics of aid effectiveness – notably Easterly (2006) and Deaton (2013)^d – believe that aid can exacerbate these countries' difficulties. Others (Goldsmit, 2001; Dunning, 2004; Wright, 2009; Dietrich *et al.*, 2013^e) conclude that aid can help establish healthier policies and develop more efficient and democratic political institutions. Some stress the need for aid to specifically target these fragile countries, which are caught in a "development trap" from which they are struggling to emerge, due to conflicts, poor governance, difficulties in managing natural resources, geographical situation, etc.^f Overall, the impact of aid is strongly dependent on how it interacts with the national context and which stakeholders it tends to strengthen. Thus, to promote more transparent governance and direct it towards broad-based improvements in national well-being, donors are increasingly including the goal of bolstering civil society and counter-powers in their development policies.

- a. Acemoglu, Johnson and Robinson (2005), "Institutions as the Fundamental Cause of Long-Run Growth". Kaufmann, Kraay and Zoido-Lobaton (1999), "Governance Matters", *World Bank Working Paper*.
- b. Wallis John (2016), "Governance and Violence", *Background paper World Bank*.
- c. Burnside A. C. & Dollar D. (1997), "Aid, policies, and growth", World Bank policy research working paper.
- d. Easterly, William Russell (2006), "The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good", Deaton A. (2013), "The Great Escape: Health, Wealth, and the Origins of Inequality", *Princeton University Press*.
- e. Goldsmith (2001), "African Governance and Civil Society Equity, Efficiency and Participation"; Dunning (2004), "Conditioning the Effects of Aid: Cold War Politics, Donor Credibility, and Democracy in Africa"; Wright (2009), "How Foreign Aid Can Foster Democratization in Authoritarian Regimes"; Dietrich S. and Wright J. (2013), "Foreign Aid and Democratic Development in Africa".
- f. Collier P. (2007), "The Bottom Billion: Why the Poorest Countries Are Failing and What Can Be Done about It".

Created in 2001, the IPD has benefited from numerous partnerships, including with the French Development Agency, Maastricht University and the French Research Institute for Development (IRD). The 2016 edition covers 320 variables, each of which is given a score from 0 to 4.

These variables, each corresponding to one of the survey questions, are grouped under 127 summary indicators distributed across 9 main institutional functions as shown in the table below. This is survey data gathered between September and December 2016 from the overseas

economic affairs departments of the French Ministry for the Economy and Finance.

The database covers the institutions that oversee political, economic, financial and social life. The assessment focuses on practices currently observed and the rules that are actually applied, rather than on the existence of legislation or regulations.

The approach is intended to be the least prescriptive possible. It does not presuppose the existence of a single

"best" institutional model that is favourable to growth, regardless of a country's level of development and institutional legacy.

The results of the survey are now used by various research centres¹ and universities, certain donors to direct their aid, and the World Bank to add to its World Governance Indicators.

Table 1: Institutional functions covering data from the Institutional Profiles Database

Institutional functions	Description
1 - Political institutions	Functioning of political institutions, civil liberties and freedoms, legality and legitimacy of the public authorities
2 - Security, law and order, control of violence	Security of persons and goods, existence of internal conflicts
3 - Functioning of public administrations	Transparency and effectiveness of public action, corruption, effectiveness of the justice system, civil society autonomy
4 - Free operation of markets	Size of the public sector, privatisations and nationalisations, freedom to set prices and interest rates, labour market flexibility
5 - Coordination of stakeholders, strategic vision, innovation	Ability of the government to coordinate interests and expectations, authorities' strategic vision, ability to absorb new technologies
6 - Security of transactions and contracts	Security of property rights and contracts, handling of commercial disputes
7 - Market regulations, social dialogue	Competition in the goods, services and capital markets, financial system regulation and supervision, social dialogue
8 - Openness	Freedom of movement of goods, services, capital, persons and information
9 - Social cohesion and social mobility	Social and regional balances, equal treatment of individuals (according to gender, ethnic group, etc.), solidarity (traditional, institutional), social mobility, etc.

Source: DG Trésor, IPD 2016 data.

1.2 Five of the nine major functions appear to be strongly inter-related and form the core of countries' institutional structure

A statistical analysis known as the Principal Component Analysis (PCA) was carried out on the 127 IPD indicators, in order to represent each country's institutional profile according to the two features that best differentiate between countries.

If we project the nine major institutional functions onto these two axes (see chart 1), we observe groupings which make it possible to characterise each axis. Thus, the first axis can be interpreted as reflecting the government's capacity and responsiveness, since it includes four

government roles, namely: (i) providing security and protecting citizens, (ii) legislating, ensuring justice and resolving conflicts, (iii) mobilising and effectively increasing revenue and delivering essential services thanks to it, and (iv) fostering economic development and employment. The second axis, for its part, can be interpreted as reflecting the government's presence in the economy and society.

The projection onto these two axes also indicates that five of the nine institutional functions identified above are strongly inter-correlated in that, in each country, they evolve in parallel. These include: the functioning of public administrations; coordination of stakeholders, strategic vision and innovation; security of transactions and

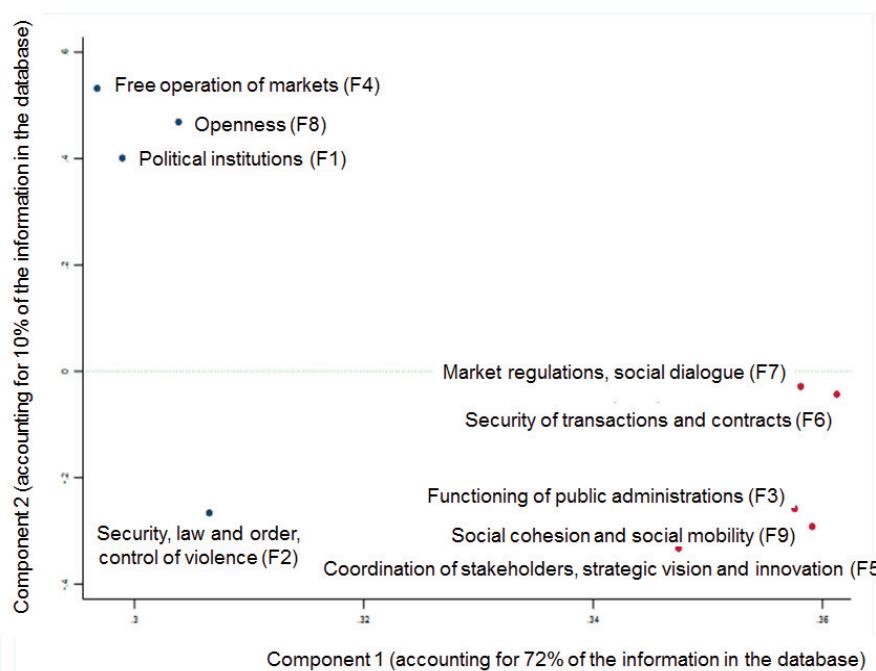
(1) Berthelier, Desdoigts and Ould Aoudia (2004), "Profils institutionnels: une base de données sur les caractéristiques institutionnelles de pays en développement, en transition et développés", *Revue Française d'Économie*, Association Française d'Économie, 19, pp.121-196; Meisel N. and Ould Aoudia J. (2007), "Une nouvelle base de données institutionnelles : Profils Institutionnels 2006", AFD, *Working Paper* no. 46 and (2008), "La bonne gouvernance est-elle une bonne stratégie de développement?", AFD, *Working Paper* no. 58; De Crombrugge and Cingolani (2012), "Exploring the panel components of the institutional profiles database (IPD)" UNU-MERIT *Working Paper Series*; No. 037) Maastricht Economic and Social Research and Training Centre on Innovation and Technology.

contracts; market regulations and social dialogue; and social cohesion and social mobility.

These five functions appear to form the core of the countries' institutional identity (accounting for 72% of the

total variance across countries, i.e. the information contained in the database). They are grouped at the bottom right of the X-axis in chart 1.

**Chart 1: Projection of the nine major institutional functions onto the PCA factor model
(accounting for 82% of the information in the database)**



Source: IPD 2016 data.

How to read this chart: functions 3, 5, 6, 7 and 9 play the largest role in the formation of axis 1 and are negatively correlated with functions 1, 4 and 8, which play the largest role in the formation of axis 2. We base our findings on the Kaiser criterion, which leads us to retain only 2 axes, accounting for 82% of the total information contained in the database. Function 2 is uncorrelated with the two point clouds formed by the functions.

1.3 This institutional core is highly correlated to each country's development

These five institutional functions are also amongst those most correlated with the level of economic development, as measured by gross national income (GNI) per capita. Chart 2 shows this correlation for each of the nine functions.

The correlation is positive for all of the IPD's nine major fields: an improvement in the quality of institutions goes hand in hand with economic development – this is a statistical link that does not by itself imply a causal relationship.

However, several institutional aspects show a stronger correlation: this is particularly true for social cohesion and social mobility, which refer to the concept of "social capital" that certain growth theories include as part of economic development factors. This is also the case, however, for the other core institutional functions: the coordination of stakeholders, the government's strategic vision and

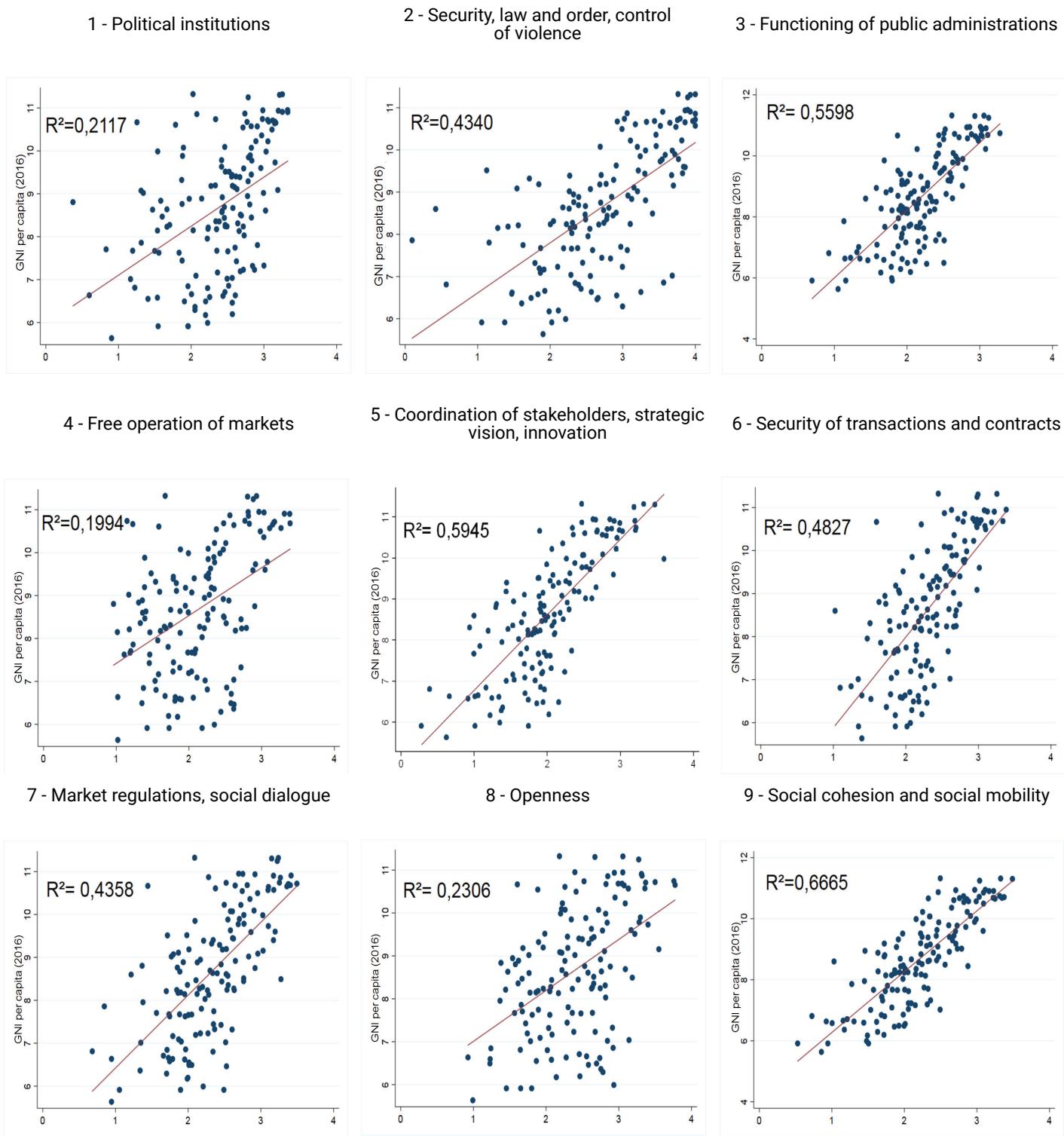
innovation, security of transactions and the functioning of public administrations. The connection is also significant, albeit to a lesser extent, in terms of market regulations and social dialogue.

Conversely, the link appears weaker with respect to political institutions, the free operation of markets and openness, which are also the functions furthest from the "core" institutions identified above. This suggests that development would be compatible with different, more or less democratic, political systems, with several degrees of market freedom or, on the contrary, government interventionism, and with varying levels of openness to foreign trade.

As regards the political system and the link between democracy and development, the results are consistent with the contrasting conclusions of empirical literature,² which are not able to identify a systematic, direct causal link.

(2) In particular Barro (1996); Acemoglu and Robinson (2006); and Acemoglu, Naidu, Restrepo and Robinson (2015).

Chart 2: Correlation between institutional functions and per capita GNI



Source: IPD 2016 data.

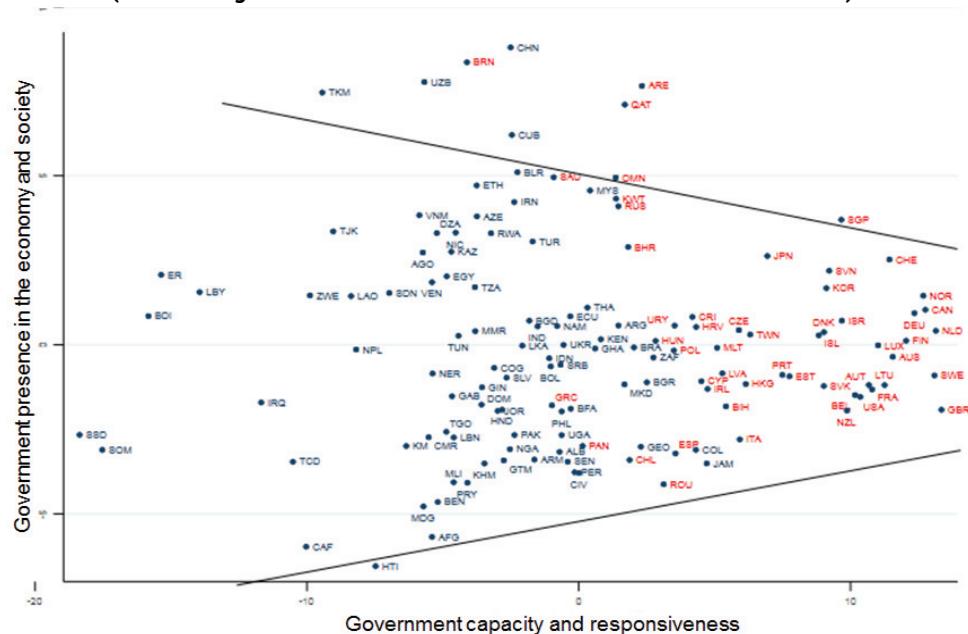
2. Institutional profiles converge as economies develop

Institutional profiles converge as income levels increase. Less-developed economies have a greater diversity of institutional systems.

This can be seen in chart 3, which shows the position of each country in relation to the two PCA axes. The distribution of countries is funnel-shaped, with the wide end to the left, where countries with low levels of development are located, and narrow to the right, where advanced

economies are positioned. This reflects, on one hand, the fact that the government's capacity and responsiveness (first axis) are highly correlated with the development level and, on the other, the fact that the government's presence in the economy and society (second axis) varies much more widely between developing countries than between the more developed countries.

**Chart 3: Position of countries on the first two PCA axes by level of development
(accounting for 45% of the information contained in the database)**



Source: 2016 IPD data - Each point represents a country (3-letter ISO codes).

Note: Advanced economies are identified in red on the chart (per capita income above \$12,240 in 2016).

The "Government capacity and responsiveness" axis accounts for 38% of the information in the database, whilst the "government presence" axis accounts for 7%.

More specifically, several profiles become apparent:

- In some countries, economic and social systems remain vulnerable, and the government is unable to fulfil its core functions: corruption and unequal treatment are significant and government efficiency and transparency are weak. This is the case, for example, in South Sudan, Somalia, Burundi and Eritrea (left side of the chart). Other countries are characterised by a shrinking government with weaknesses in terms of its ability to regulate political, economic and social activities. This is the case in Haiti, the Central African Republic and Afghanistan (at the bottom of the chart).
- Other countries where the government is quite present, even interventionist, but whose level of development may

be higher, are characterised by more limited political, economic and social freedoms as well as a strong government intervention in the economic sphere. These include China, Brunei, Uzbekistan, Turkmenistan, the Gulf States and Cuba (at the top of the chart).

- In more advanced economies (in red), there is moderate government intervention in the economy and citizens are afforded greater space for freedom. In the countries on the right side of the chart, the government has the resources to perform its core functions (security, justice, provision of services, economic stewardship). They are characterised by a formal set of rules, security of contracts and property rights and an efficient functioning of the court system. High-quality public services cover the entire territory and the government invests as part of

long-term strategies and support for innovation and research. This is the case in European countries as well as in the United States, Japan and Australia.³

Overall, these results show a strong correlation between government effectiveness and the level of development. On the other hand, the country profiles are more diverse concerning the government's presence in political, economic and social spheres.

Box 2 : Mobilising domestic resources in developing economies

For the period 2009-2016, the IPD suggests that developing countries' "domestic resource mobilisation" for growth has not improved, with varying trends between countries. Domestic resource mobilisation, which refers to countries' ability to acquire resources from within their borders to finance development and the economy, consists of two components: public resources (taxation, income from natural resources) and private resources (existence of markets to mobilise savings and direct them towards financing the economy).

On average, both components have deteriorated, with an overall decline in the effectiveness of tax authorities. Administrations suffered from insufficient geographic coverage, with no improvement in the fight against tax evasion. It appears that banking and financial supervision has also deteriorated.

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(3) On the graph, France and the United States are surprisingly close. This is due to the statistical method used: several variables are used to define the PCA's two axes and an equivalent average score may conceal certain disparities (here, for example, greater innovative capacity for the United States but less provision of public services). In addition, the PCA can detect the general properties contained in the data but some information does not come across. The main differences between France and the United States are not contained in the variables that define the graph's two axes.

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