

The political economy of development

a practitioner's view

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November 2024

Outline

The Problem

- *Why are many countries so much poorer than the most advanced economies? Why is income inequality within countries so large, especially in poorer countries? Inequality of opportunity is a big part of the problem, which is ultimately a political-economy problem.*

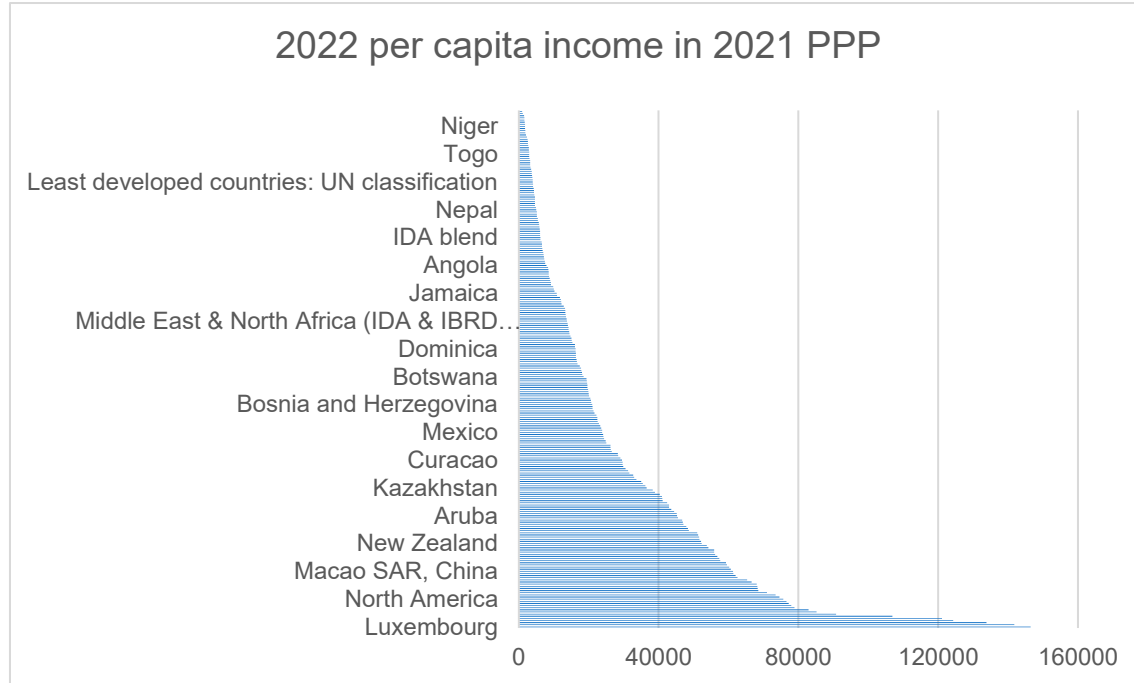
An analytical framework

- *A dual-economy model with segmented factor markets is the proper representation of inequality of opportunity, both within and across countries.*

Elements of a strategy

- *How to deal with elite capture, vested interests, or insider-outsider policies?*

The Problem: large income inequality across countries



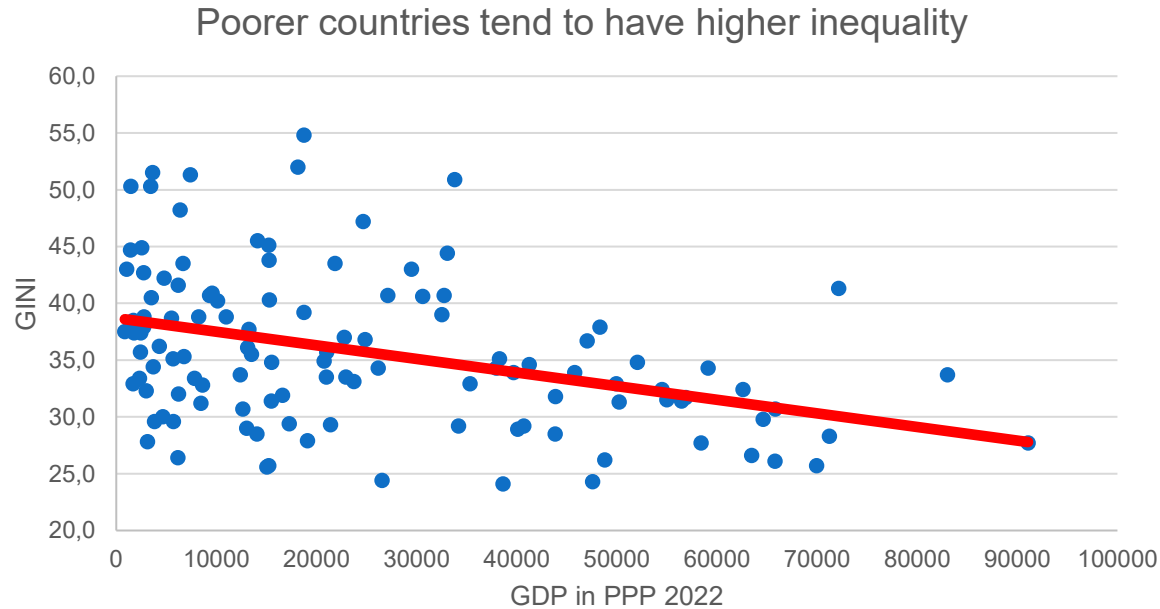
Nobel Prize 2024 for institutional analysis

Daron Acemoglu, Simon Johnson, and James Robinson have analyzed institutional root causes of inequality across nations.

This yielded powerful insights but is also incomplete or even flawed:

- Countries are often not useful units of analysis (India more diverse than Europe, China incomparable with Bhutan)
- Problems not merely concentrated within poor countries but often rooted in relationship between countries.
- Countries themselves are not uniform.

The Problem: large income inequality within countries



In 2020, the national income share held by the richest 1 percent Indians was more than 20 percent.

China has 406 billionaires, worth \$1.3 trillion



Key concepts measuring level playing field:

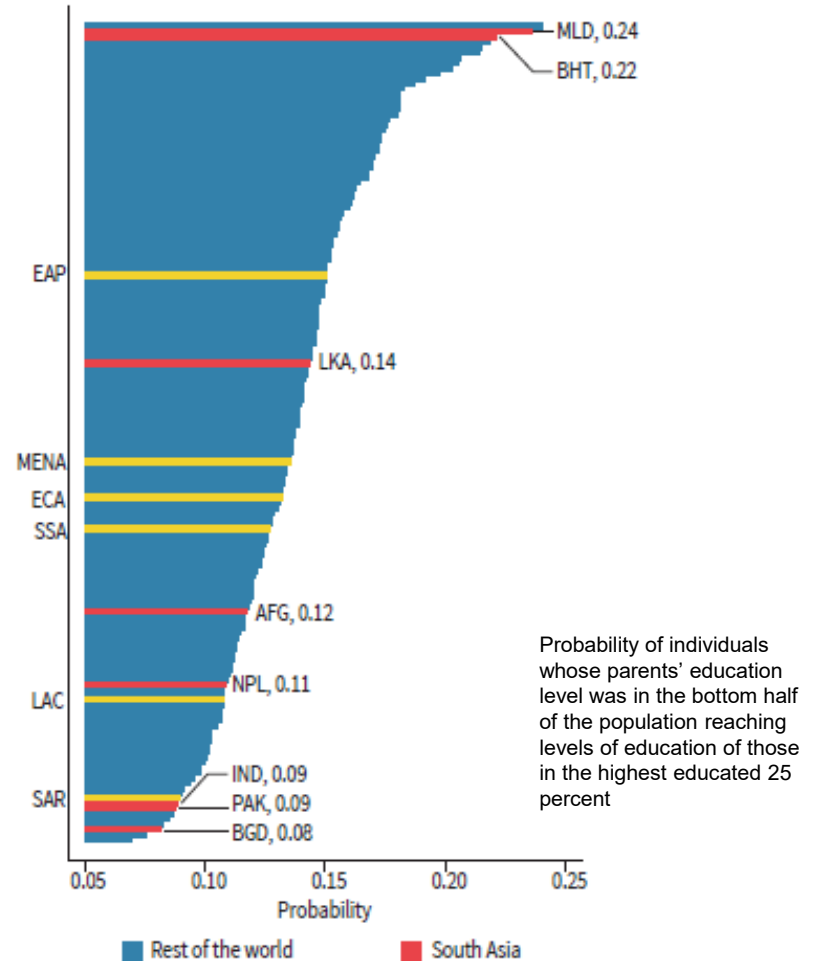
(Relative) Inequality of Opportunity (IOp):

The portion of inequality of outcomes (years of schooling, consumption etc.) due to circumstances beyond an individual's control (e.g. gender, ethnicity, caste, religion, place of birth etc.).

(Relative) Intergenerational mobility:

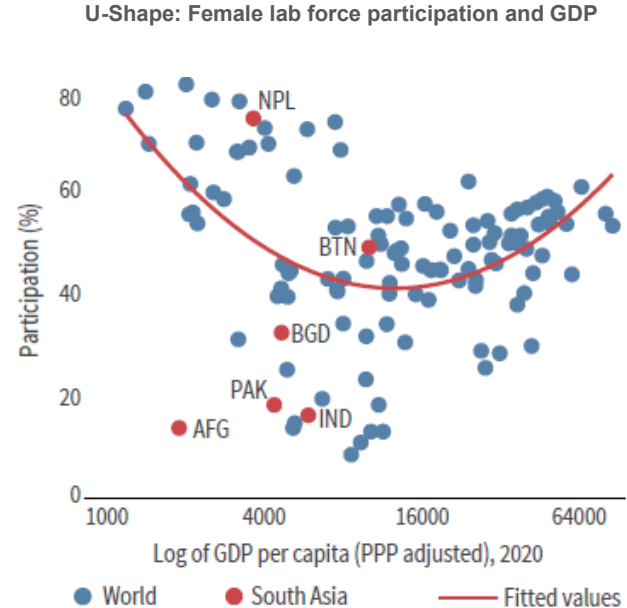
The measure of intergenerational mobility used in the current report is the bottom half mobility measure – the average education attainment rank of an individual born to a parent in the bottom half of the education attainment distribution within their generation.

Problem: Inequality of opportunity,
across countries and within countries.
For example: intergenerational mobility
in education is low



Deeply rooted social norms about gender can account for a large proportion inequality of opportunity

- Female labor-force participation follows a U-shaped path over the course of economic development.
- However, in South Asian countries rates of female labor-force participation are below what their level of economic development would predict.
- Deeply rooted social norms - especially those about household division of labor - account for a large share of these gaps in women's economic engagement.



Analytical framework:

A simple model of fragmented factor markets

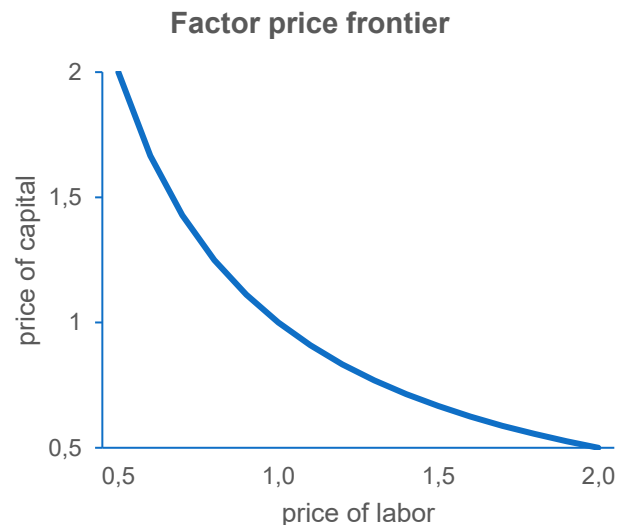
$$y_i = A(K_i)^\alpha (L_i)^{1-\alpha}$$

$$K_i = \alpha y_i / p_i^k$$

$$L_i = (1 - \alpha) y_i / p_i^l$$



$$(p_i^k)^\alpha (p_i^l)^{1-\alpha} = A\alpha^\alpha (1 - \alpha)^{1-\alpha}$$



Perfect capital mobility

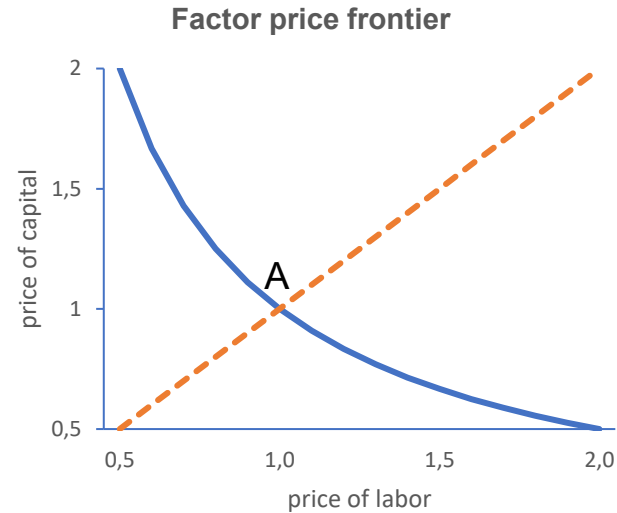
$$K_1 + K_2 = K$$

$$K_i = \alpha y_i / p^k$$

$$L_i = (1 - \alpha) y_i / p^l$$

$$\frac{K_i}{K} = \frac{L_i}{L} \text{ and } \frac{y_i}{y} = \frac{L_i}{L}$$

$$y = AK^\alpha L^{1-\alpha}$$



Perfect labor mobility

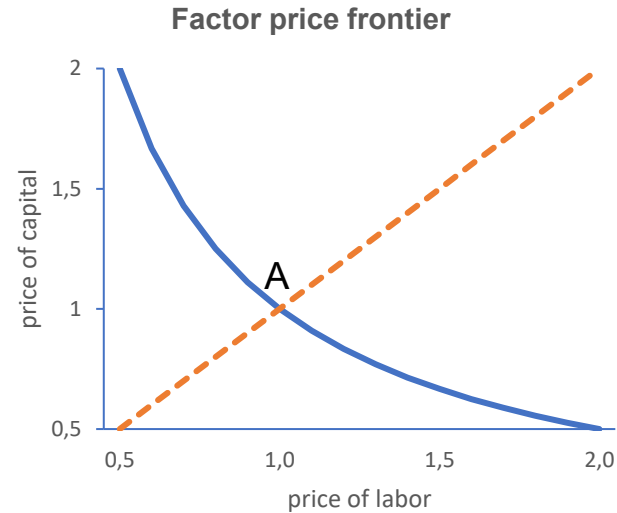
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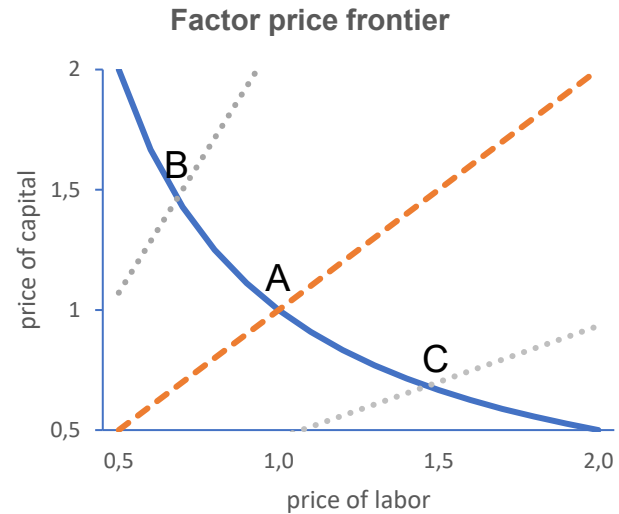
Segmented factor markets

Assume region 1 can benefit from lower interest rates, better access to credit, more favorable land deals, better schools or other privileges; Region 1 limits also immigration (insider-outsider policies in labor market):

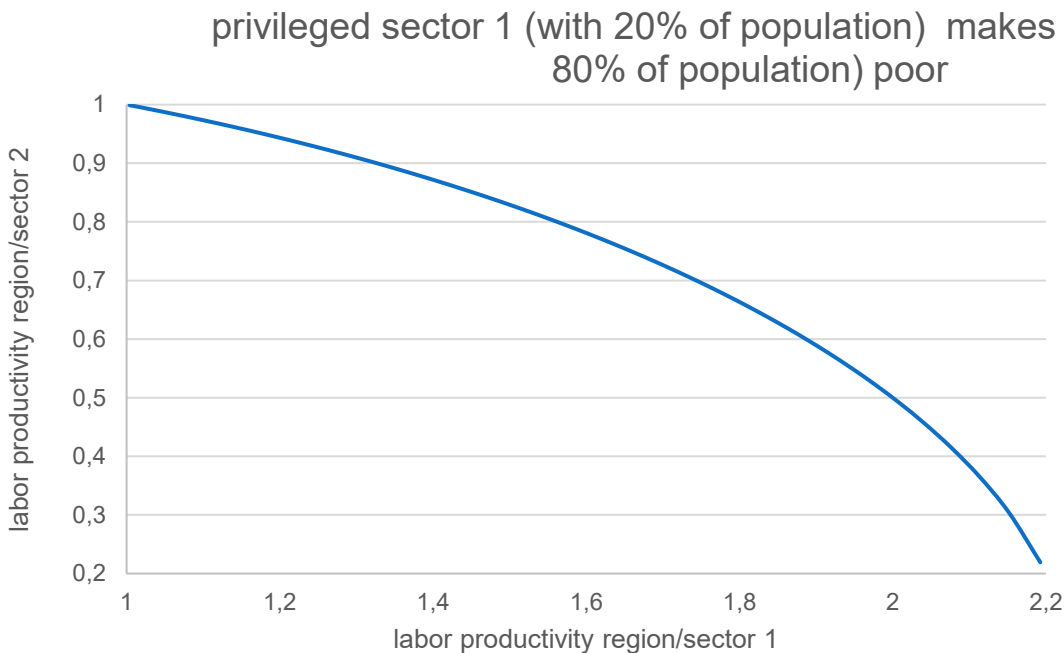


$$p_1^k < p^k$$

$$p_1^l > p^l; p_2^k > p^k; p_2^l < p^l; \frac{K_1}{L_1} > \frac{K_2}{L_2}$$



Segmented factor markets lead to trade-off and inefficiency



And macro
GDP
declines
because of
segmented
factor
markets, with
even worse
effects in the
long run

Applications

- Rich – Poor Countries
- Formal – Informal Economy
- Lagging regions
- Sectors of the economy
- Gender gaps; preferential treatment of privileged groups

Why has South Asia the largest rate of informality?

Choice

- Informal firms choose to remain small and avoid regulations and taxation.
- Informal firms illegally evade taxation



Exclusion

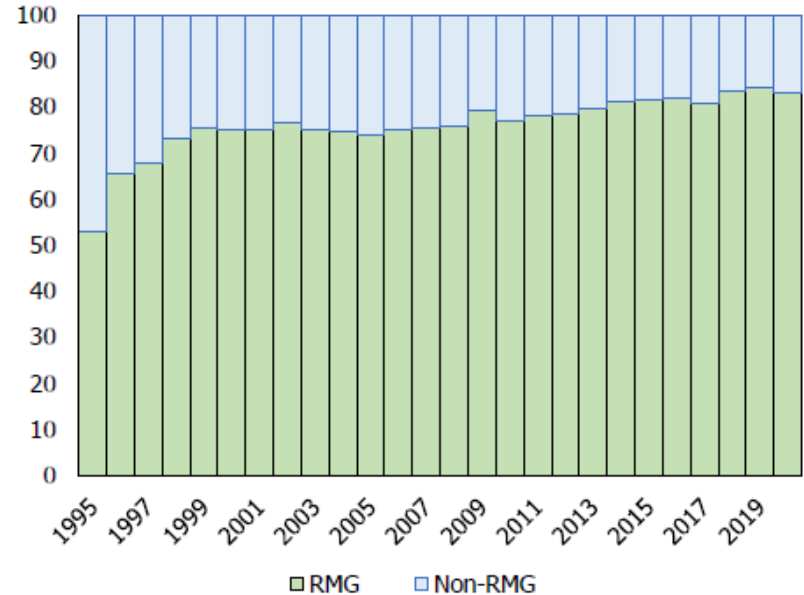
- Informal firms and workers are discriminated against in a dualistic economy and are small as a consequence.
- Entry barriers, rules and regulations benefit a few privileged insiders.

Informality in South Asia is dominated by firms that happen to be outside the purview of regulations because they are small, as opposed to those that remain small to escape regulations.

Preferential treatment of sectors: the case of RMG in Bangladesh

Does preferential treatment of one sector prevents diversification?

Bangladesh Composition of exports (%)



Source: Bangladesh Development Update April 2023, World Development Indicator 2022

Elements of a strategy 1

Don't challenge vested interests head on

- *Find conflicting vested interests (China)*
- *Engage with Champions in policy areas*
- *Ring-fence vested interests (zoo model)*
- *Focus on new opportunities, future rather than the past (informal sector)*



The way forward: Services-led Development

- Difficult to confront vested interests head on. Easier to develop new activities.
- Services are replacing manufacturing as pivotal part of middle-income economies: 1) services are increasingly tradable and can generate export revenues (services exports have been booming in recent years). 2) services produce the tools that increase productivity in the rest of the economy. 3) services create more jobs than manufacturing.
- Services can unlock potential of informal economy. India and Bangladesh provide the most gig-workers on the world's 5 largest platforms that match works with tasks. E-commerce and matching platforms increase productivity of small informal firms.
- The digital economy increase opportunities for women to work from home and to circumvent middlemen.

Elements of a strategy 2

Point out overall inefficiency of elite capture, insider-outsider policies

- *Global inefficiency (climate policies)*
- *Macro inefficiency (middle-income trap)*
- *Micro inefficiency (e.g., Karachi women)*

Elements of a strategy 3

Don't waste a good crisis (Uzbekistan, Sri Lanka)

After every global crisis, the world is never the same again. They bring new technologies, geopolitical shifts, changing international division of labor, and new economic paradigms.

Evolution of economic paradigms



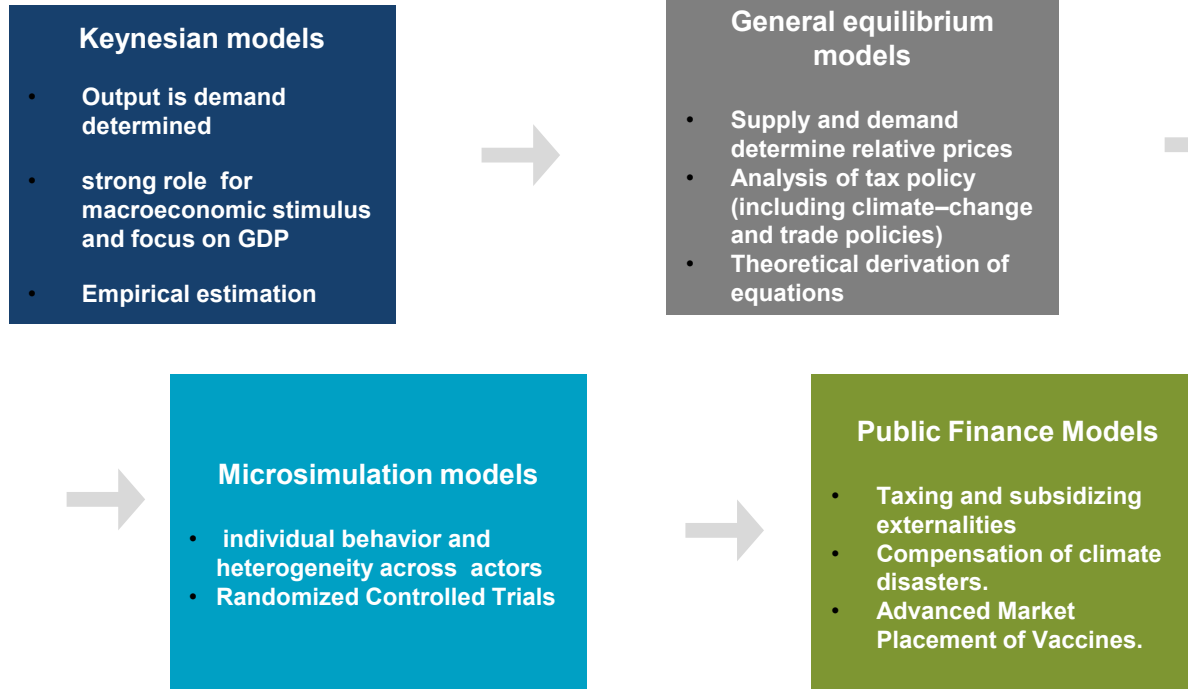
After Great Depression, governments assumed a dominant role in stabilizing economies and ensuring full employment. Keynesian Theory became the dominant paradigm.

After the oil crises in the 1970s, inward-looking economies could not deal with large shifts in relative prices. Keynesian model could not explain stagflation after the oil crises in the 1970s, because it missed the supply side effect. Neoclassical general equilibrium models brought in the supply side and were good in analyzing relative price changes in international trade.

After Global Financial Crisis in 2008, the dangers of unbridled globalization manifested themselves. Distributional impacts became more important. Micro simulation models were becoming more popular.

After COVID-19 and the impacts of climate change, there is increased demand for public goods and economists are rethinking again the role of governments and the provision of public goods.

Economic tools and paradigms change as the global economy changes





Elements of a strategy 4

Realize that technology is not neutral, institutions matter

- WDR 2016: “digital dividends
- Acemoglu and Johnson 2023 “Power and Progress”

New technologies emerged after Global Financial Crisis



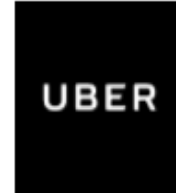
2007



2008



2009

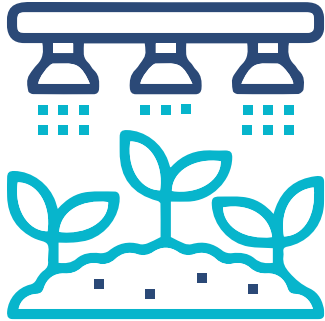




Digital Revolution reverses the economic relations established since the Industrial Revolution

Industrial Revolution	Economies of scale	Standardization	Full time labor contracts	Concentration Urbanization
Digital Revolution	Fragmentation of production	Customization	Gig economy	Dispersed Production?

Traditional development pattern



Low income

Agriculture largest share in economy. Land main factor of production.



Middle income

Manufacturing driving productivity growth. Physical capital main factor of production.

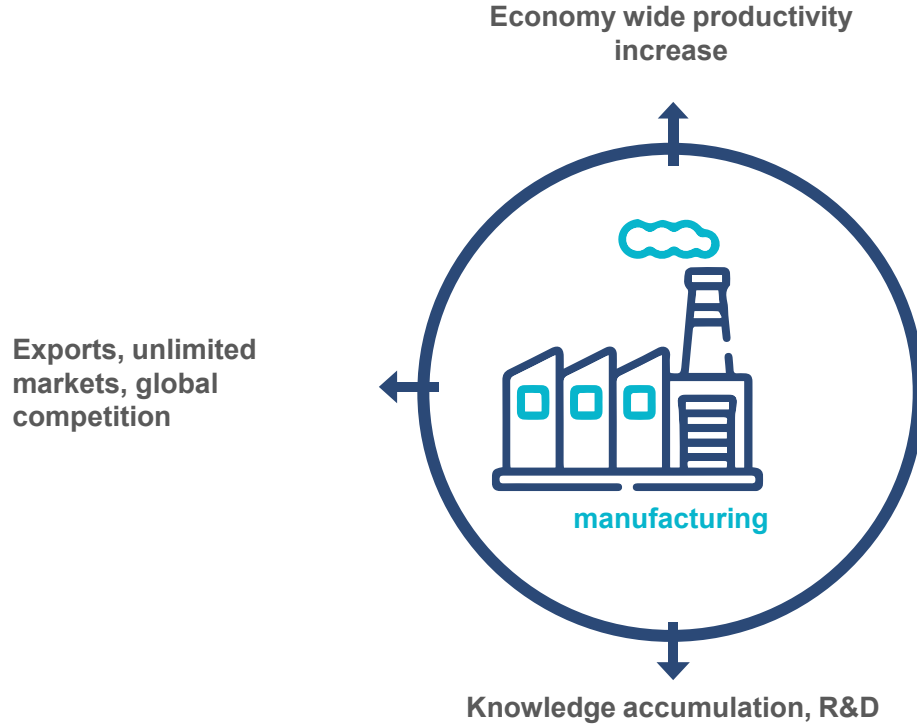


High income

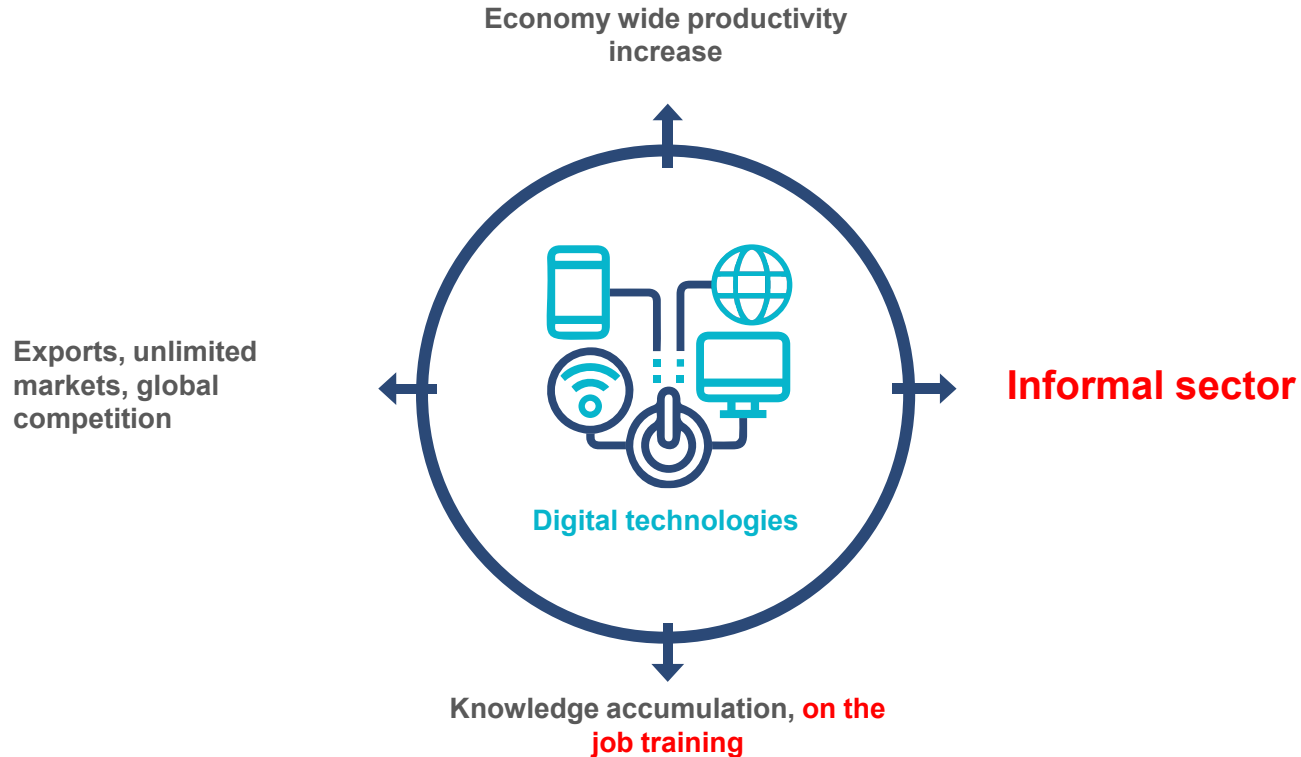
Shift towards High-skilled services. Human capital main factor of production.



Manufacturing was at the center of economic development



Digital technologies are at the center of economic development





Impact of digital technologies depends on government strategies

	governments	firms	people
good	accountability	competition	access to services
bad	control	natural monopoly	digital divide

Elements of a strategy 5

Find convincing examples of alternative development strategies

- *Saudi Arabia or Turkmenistan*

vs

- *Norway or California*

Elements of a strategy 6

Create space for debate

- *Avoid (self-)censorship*
- *Interact with stakeholders outside ruling class or parties*
- *Challenge own paradigms*

Elements of a strategy 7

Political economy at micro level

- *Direct cash transfers to women in households increases their agency*
- *Poor people react differently to environmental / climate incentives*
- *Behavioral experiments are useful*

Elements of a strategy 8

Understand how norms change, including our own

- *Actual vs perceived norms*
- *Norms adjust to circumstances*
- *Norms are being manipulated (current wave of populism and role of tech entrepreneurs)*

Conclusion

- We need to focus more on the economic consequences of elite capture and insider-outsider policies.
- Segmented factor markets can help us understand the consequences of inequality of opportunity.
- It is difficult to directly confront vested interests. But there are ample opportunities to unleash development potential.

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