Introduction

If the misery of the poor be caused not by the laws of nature, but by our institutions, great is our sin. (Charles Darwin)

Economic and financial developments of the past few decades offer a very rich environment for development economists. As the existing theories of economic development proved to be inadequate in explaining many developmental experiences, an institutional viewpoint started to dominate the search for a better understanding of the diverse experiences and complex processes of development in the world.

An overview of the evolution of earlier development theories highlights the need for a new approach to understanding the process of economic development. After providing an overview of these theories, this book reviews the main pillars of institutional economics: transaction cost and collective action theories. This review also leads to an original attempt to formally model institutional evolution by combining these two theories within a dialectical framework.

In view of the theory of institutional evolution, the book presents discussions on the main fiscal and monetary policy institutions, along with related evidence from countries’ diverse experiences. Hence, this book contributes to the literature by reconciling the new development economics framework with empirical findings on the relationship between macroeconomic institutions and outcomes. It thus constitutes source material for new development economics courses offered as a part of an economics syllabus.

Adopting the institutional perspective, this book highlights the role of the government as the agent assuming the
role of a mechanism designer or social planner that delivers sustainable development as a public good. As a pure public good, sustainable development requires the visualization and accommodation of encompassing interests that may not be advocated by politically strong special-interest groups, which often represent the core constituencies of governments in democratic societies. Hence, the need to design efficient mechanisms of policy implementation and enforcement that serve the long-term developmental needs of a society may not be sufficiently addressed by the shorter-term interests that each government tends primarily to accommodate during its incumbency. Striking a balance between the more politically powerful and less politically powerful, or between the vocal and not so vocal, however, is essential in order to achieve sustainable development. If it is highly probable that policy switches by subsequent governments will lead to significant welfare costs, designing enduring mechanisms for policy implementation and enforcement with a long-term perspective is a necessity. For purposes of social planning, it may therefore be optimal for a government to delegate specific administrative powers to independent agencies, shielding them from the demands of special-interest groups and assigning them specific responsibilities geared to achieve broader or long-term developmental objectives.

Utilizing the framework of institutional economics, this book examines various fiscal and monetary institutions that often complement each other. In the framework of fiscal policies, fiscal decentralization, budgetary mechanisms and fiscal rules are critically investigated; and in the framework of monetary policy making, central bank independence (CBI), inflation targeting (IT), monetary union (MU) and currency board (CB) mechanisms are examined. These institutions are evaluated from the perspective of their ability to deliver public goods such as efficiency, equality and stability while withstanding short-term and narrow-interest group pressures. As the coordination of fiscal and monetary
policies is also a requirement of sustainable development, several interwoven issues regarding fiscal and monetary-policy institutions are also addressed in this book.

The book contains four main chapters: Chapter 1 reviews earlier development theories as well as the two main approaches to the theory of institutions: transaction cost theory and collective action theory. Chapter 2 proposes a formal model that incorporates the essential elements of institutional theory and lays out the issues pertaining to the measurement of institutional characteristics and the empirical analyses involving such measurement. Chapter 3 provides the theoretical framework of and empirical evidence on fiscal institutions, covering budgetary rules and procedures as well as fiscal decentralization. Chapter 4 reviews the theoretical framework for monetary institutions such as central bank independence, currency boards, monetary unions and inflation targeting as well as some empirical evidence on their effectiveness; it also gives an overview on the roles of international financial institutions and investigates the measurement of and empirical evidence on bank regulation and supervision.