

Institutional Quality and Human Capital: Key Levers for Indonesia's Economic Goals

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AIFED
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Let me tell you about an English family and what
Inclusive Institutions did for them ...

First Generation of the Coakers: From Bee Sands fisherman ..

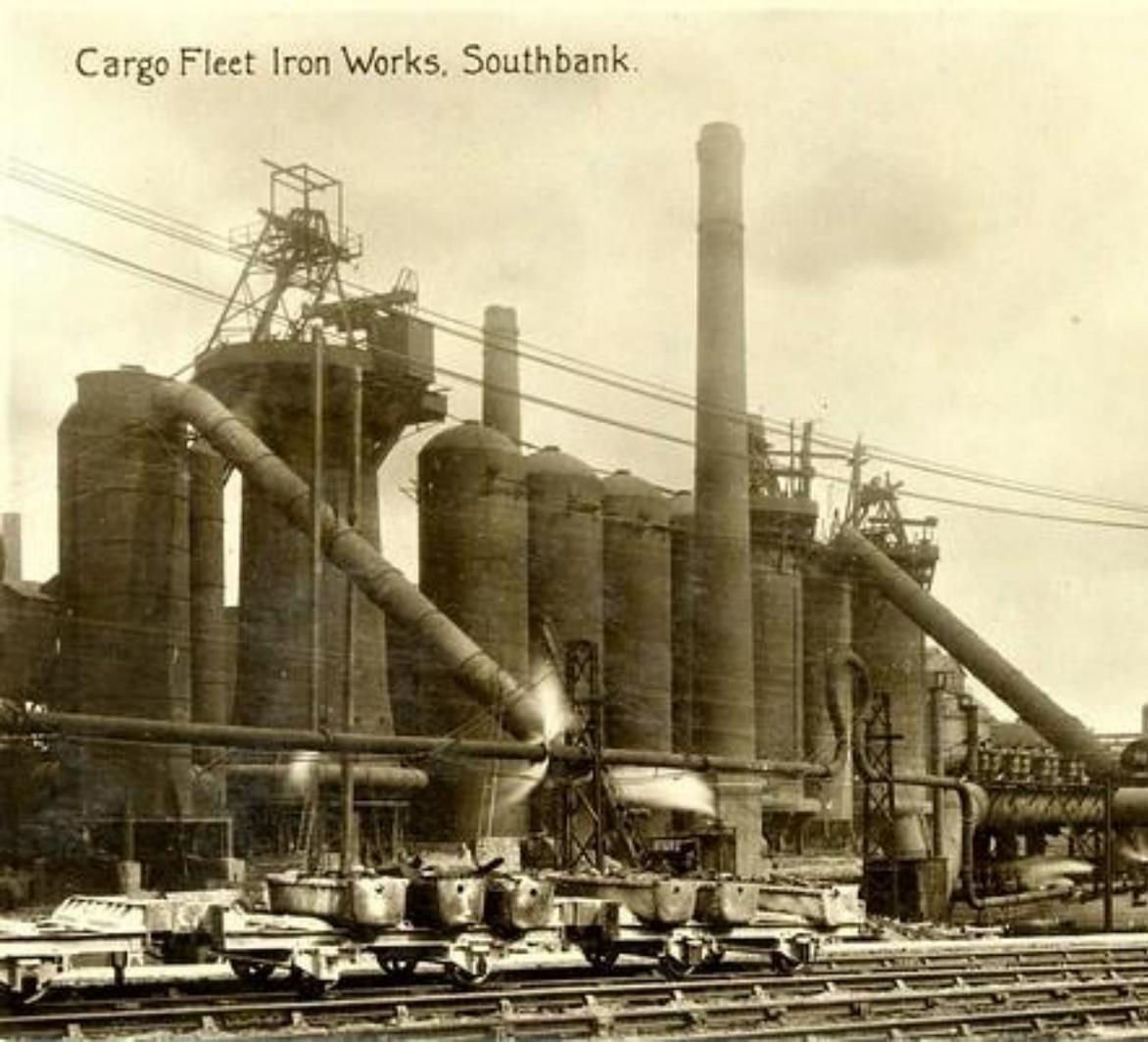
STREET COLLECTION

... to the Cargo Fleet Iron Works

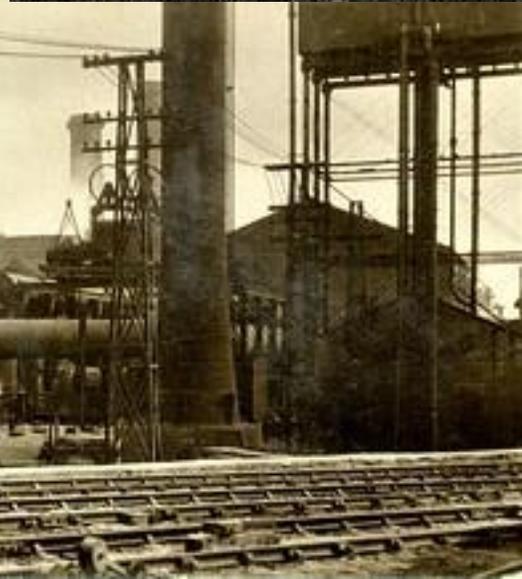
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Cargo Fleet Iron Works, Southbank.



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SCOTLAND

Southbank

WALES

Bee Sands

@www.itraveluk.co.uk

Second Generation of the Coakers: Shopworker

Born in Oxford Street, Southbank



Third Generation of the Coakers: First Coaker to ever graduate from (Saltburn) high school

and get a tertiary education
- at Darlington teacher training college





**Fourth Generation of the
Coakers. Nobel Laureate!**

The Proximate Secrets of their Success

- In four generations the Coakers went from poor fishing people to Nobel Laureate via middle class professional people (teacher).
- Let me point out some of the mechanisms that allowed this remarkable social mobility
 1. Formal private sector employment (in the Cargo Fleet Ironworks, Southbank; next generation Burtons, Corporation Road Middlesborough)
 2. Universal free high quality secondary education (Saltburn grammar school; next generation Kenilworth grammar school)
 3. Free tertiary education (Darlington Teacher training college; next generation London School of Economics)

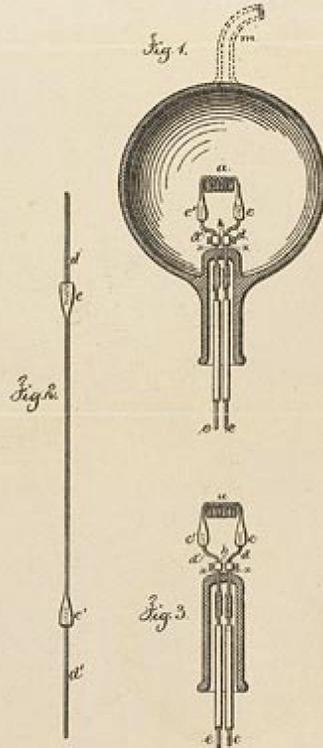
The Fundamental Causes

- Britain constructed **inclusive economic institutions** – a set of rules that created broad based economic incentives and opportunities.
- We know that economic growth is created by innovation (techniques for smelting iron), entrepreneurship (the Cargo Fleet company), and investment in physical (the Ironworks) and human capital (at Saltburn grammar school and the LSE) and the provision of key public goods (like grammar schools and universities).
- These processes happen if individuals in society and the state have incentives and opportunities.
- But which individuals?

T. A. EDISON.
Electric-Lamp.

No. 223,898.

Patented Jan. 27, 1880.

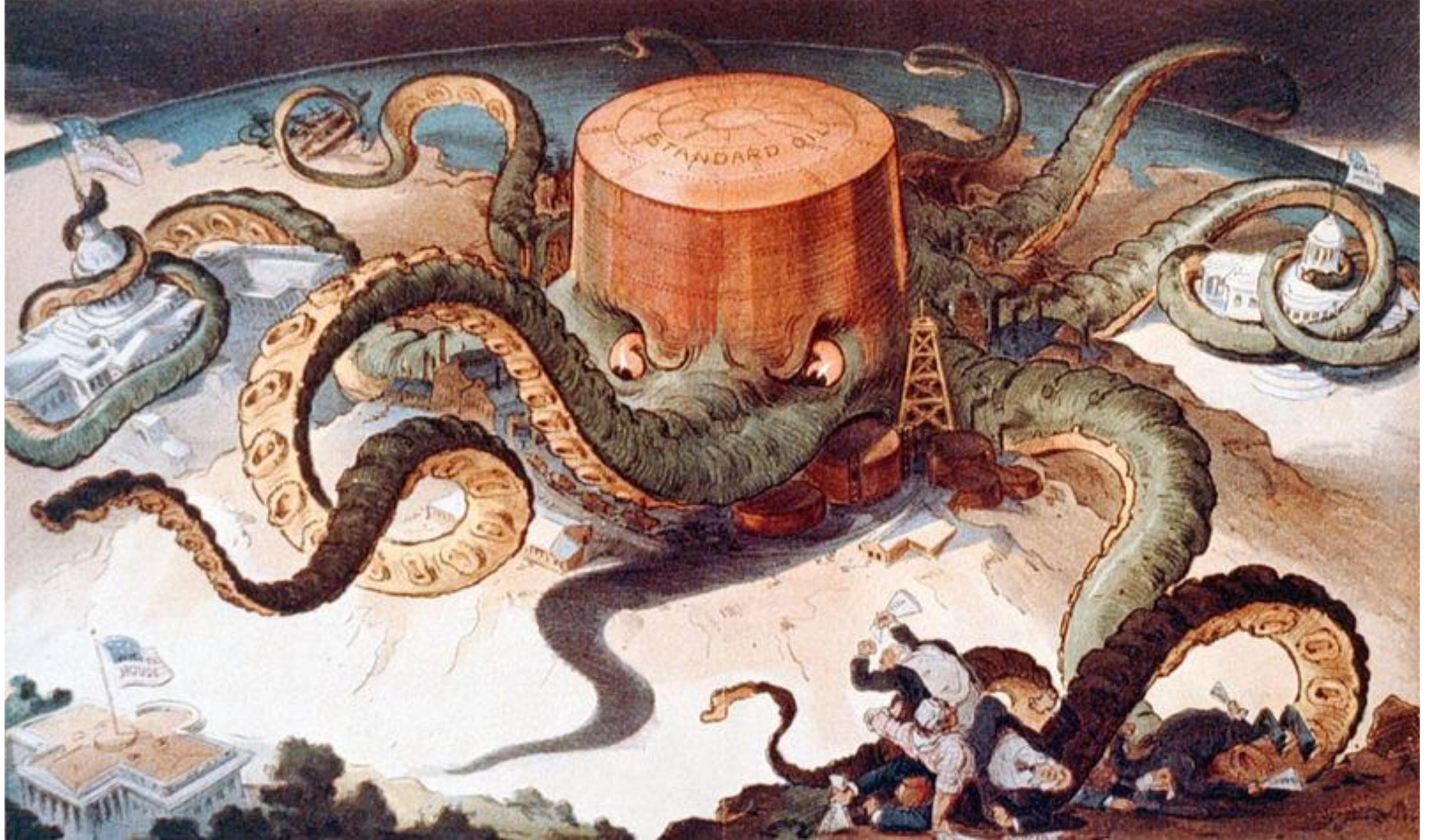


Witnesses
Chas. M. Smith
Geo. P. Mather

Inventor
Thomas A. Edison
for Lemuel W. Serrell
att'y

Innovation and
Inclusive Institutions:
a US example.





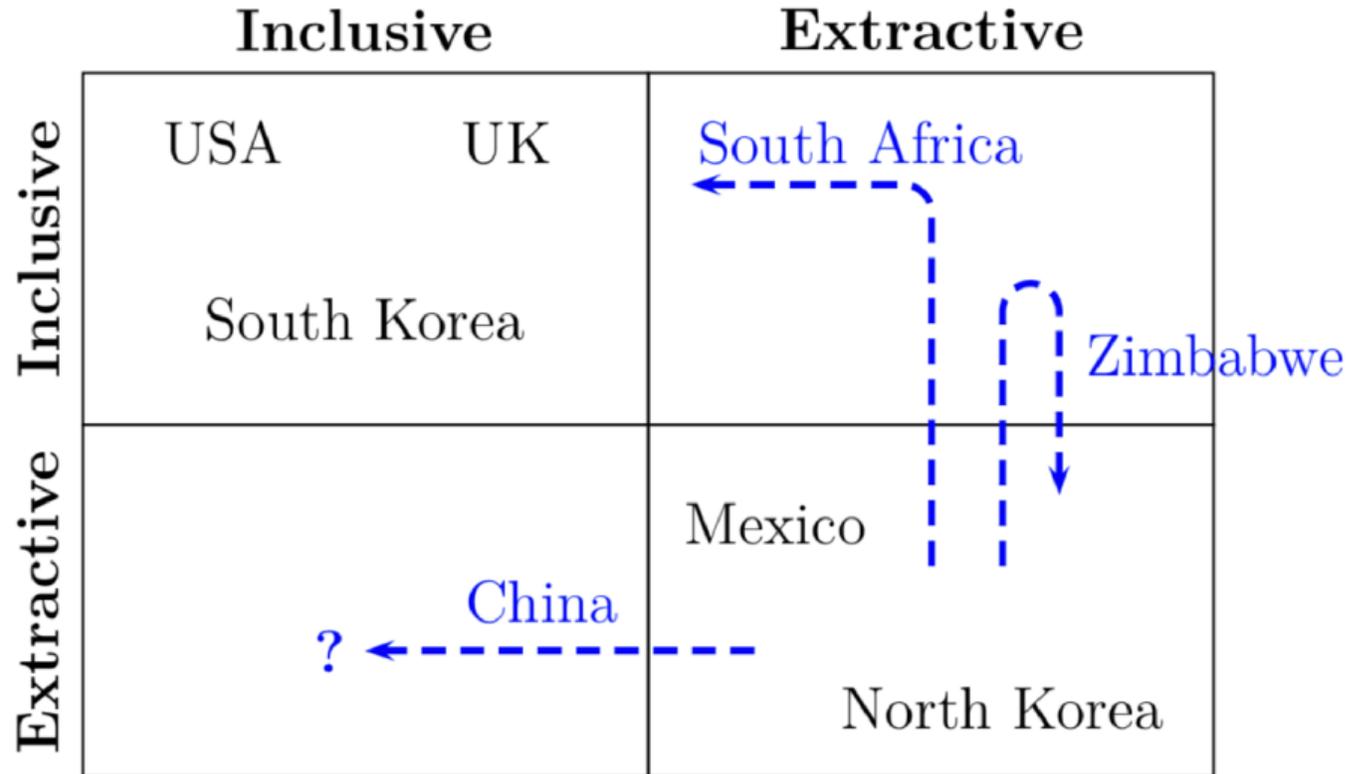
Inclusive and Extractive Political Institutions

- **Inclusive economic institutions** emerged in the United States because political power was sufficiently broadly distributed (the terms of the patent law, anti-trust law).
- But critical was the strength (you could say capacity) of the state to enforce the laws, for example the Sherman Anti-Trust Act on the (then) richest person in the world.
- These two elements – a broad distribution of political power and a strong state combine to make **inclusive political institutions**.
- This is what creates economic inclusion.

The Theory in a Nutshell

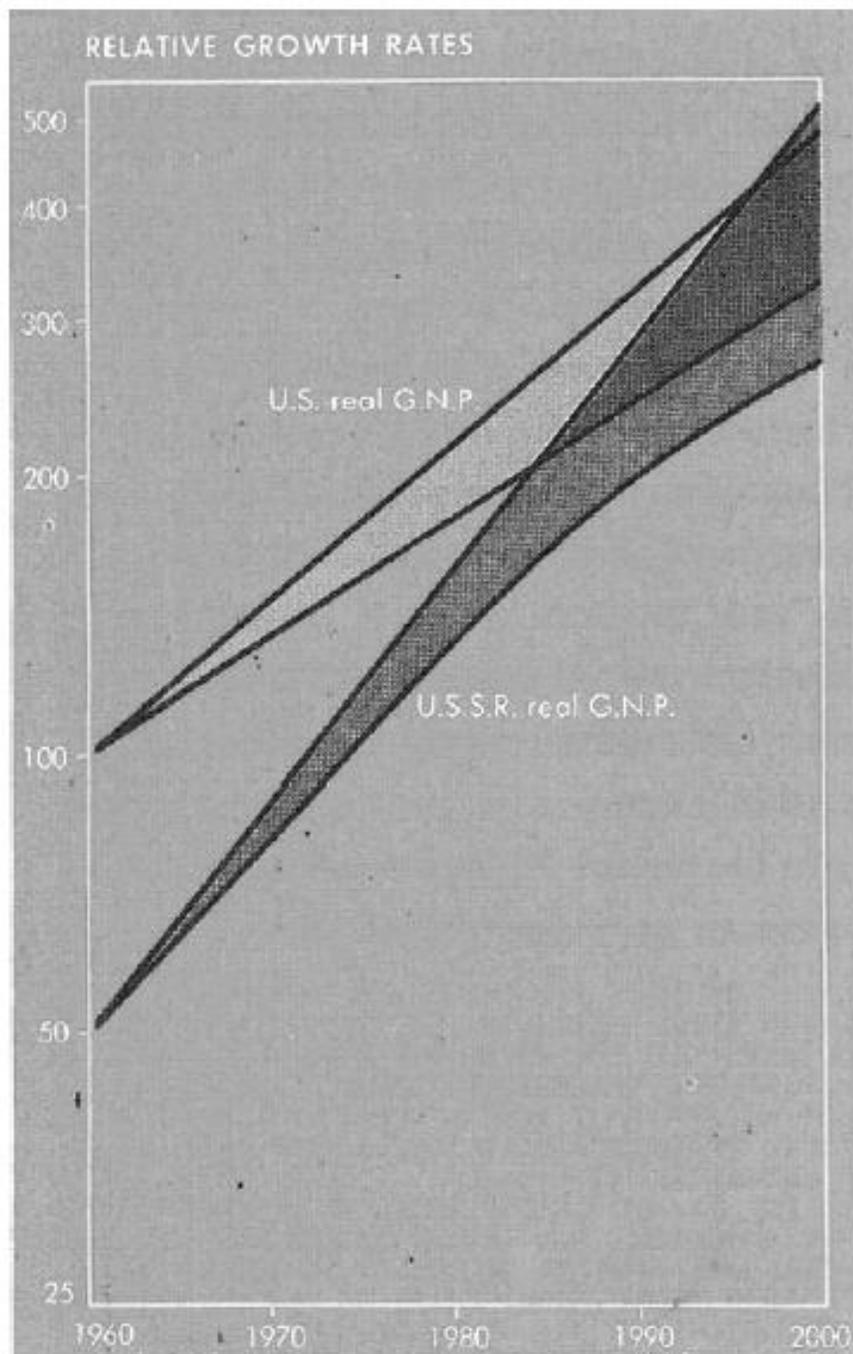
Economic Institutions

Political Institutions

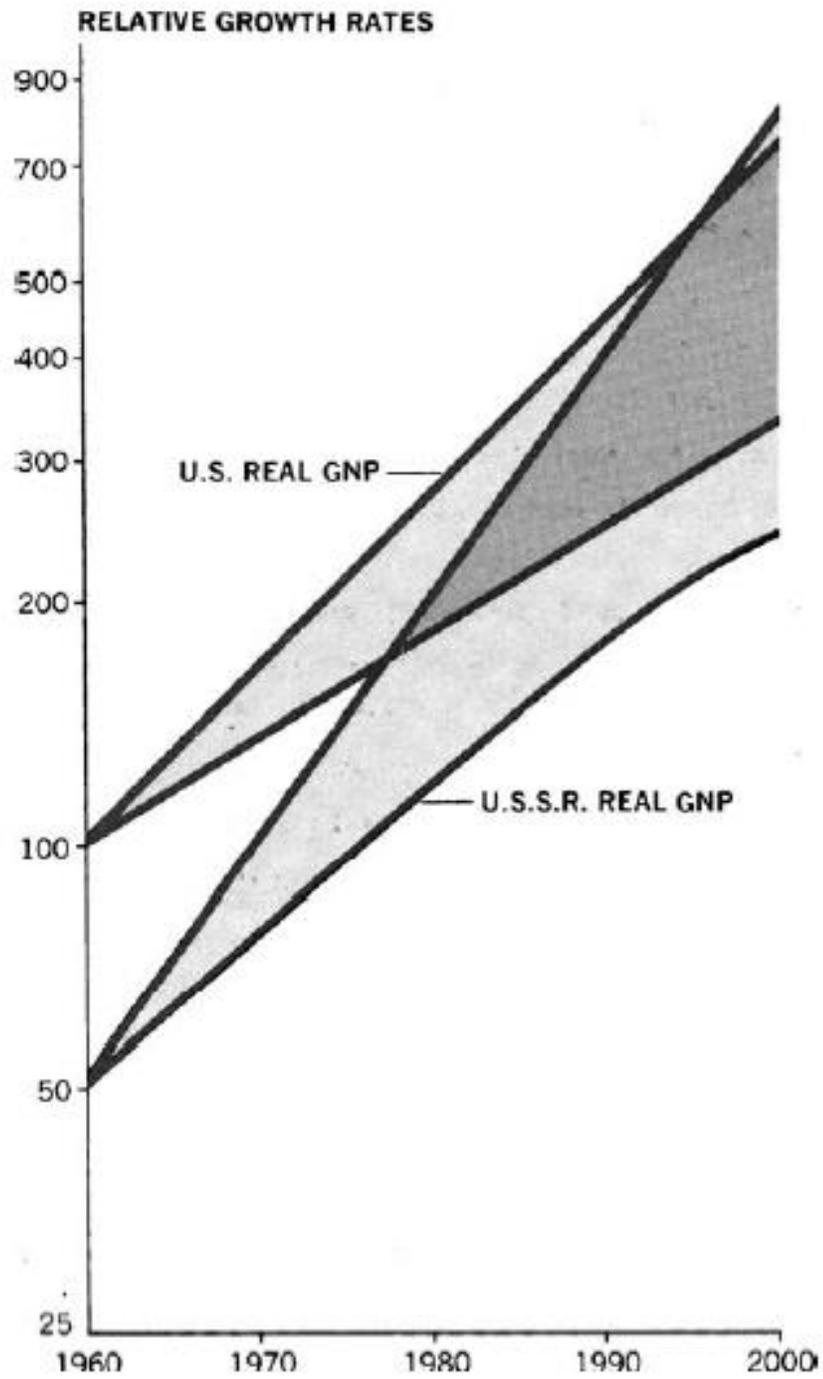


Extractive Growth

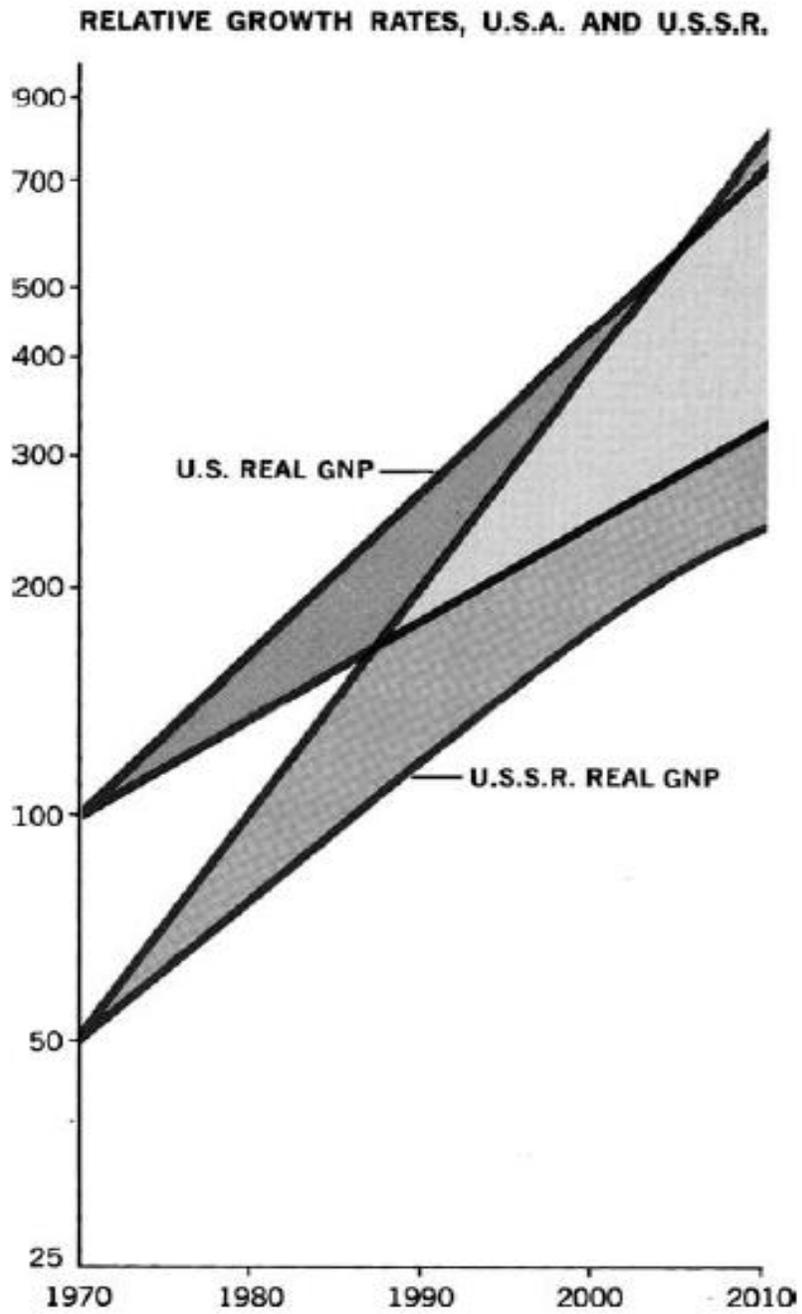
- Sustained economic growth and real prosperity requires inclusive political institutions.
- Nevertheless, **extractive economic growth** is possible when the state has strength even in the absence of a broad distribution of power.
- This growth however tends to be **transitory**.



Paul Samuelson's forecast
For US and USSR relative
economic growth
in the 1961 edition of his
textbook.



The 1967 Version



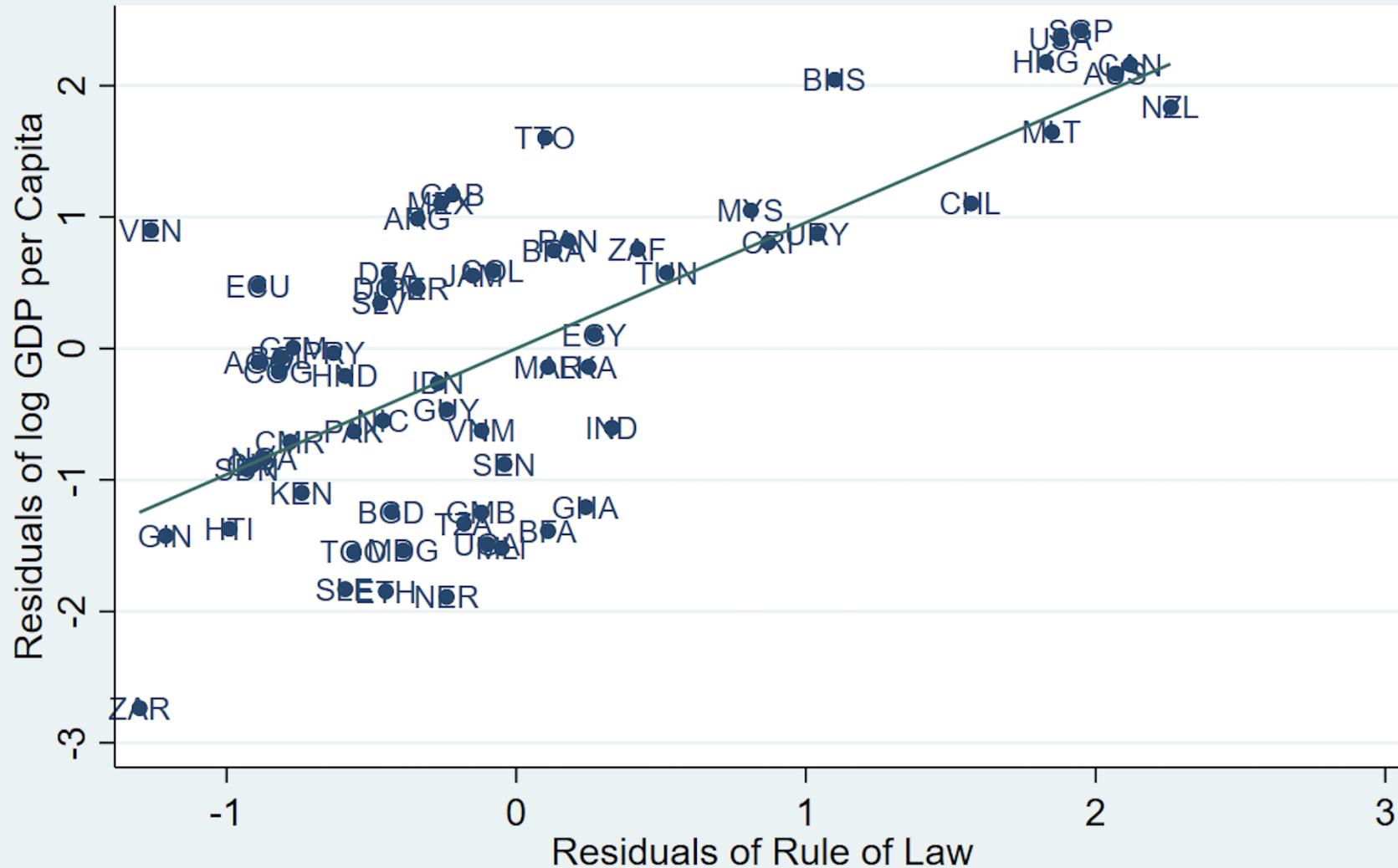
The 1970 Version
Overtaking delayed!

Why Transitory?

- Because history shows that you can't have inclusive economic institutions at the whim of narrow elites.
- As Lord Acton put it
“Power tends to corrupt, and absolute power corrupts absolutely”

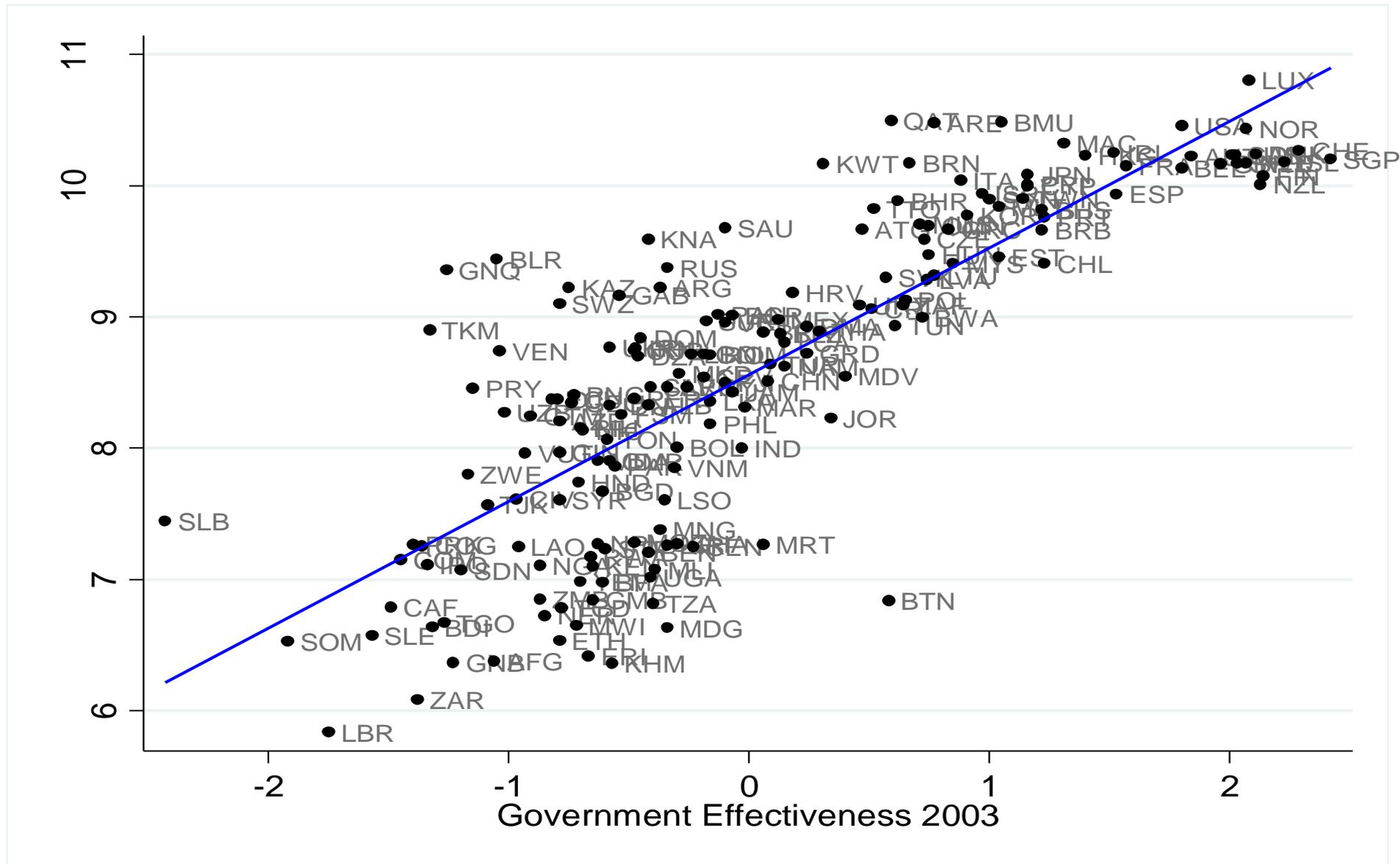
Economic institutions and prosperity

Scatter-plot: Rule of Law and Log of GDP per Capita



coef = .95841847, (robust) se = .09366368, t = 10.23

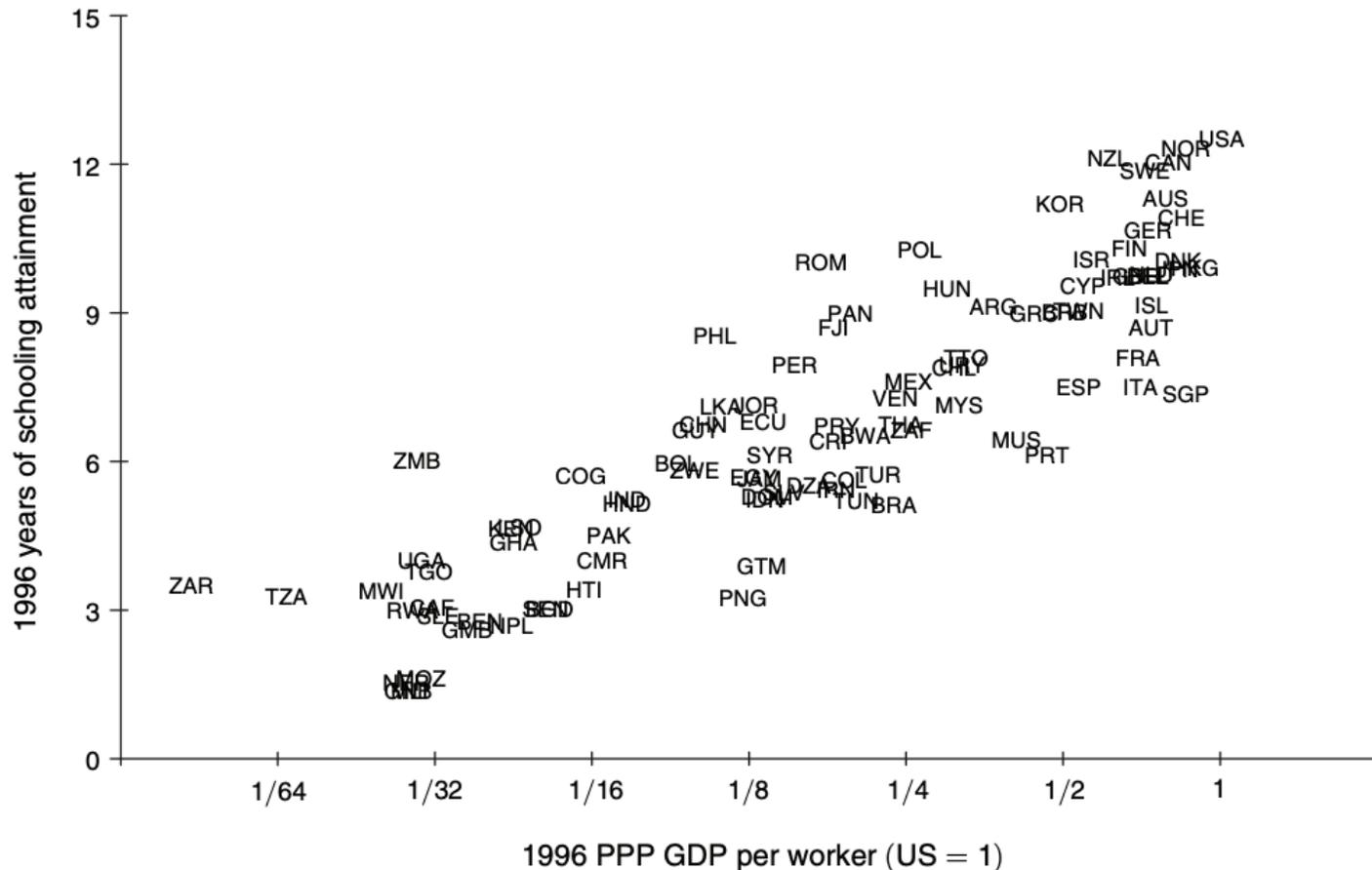
Political Institutions (Government Effectiveness) and Prosperity



From Fundamental to Proximate

- Innovation and investment in physical and human capital are key **consequences** of inclusive institutions.
- How important are these respective channels? Early work by Robert Solow very much emphasized innovation and new technologies.
- The best recent research by Chiang-Tai Hsieh and Peter Klenow decomposes differences in income per-capita across countries into these component parts.
- They find that human capital differences account for 10-30% of differences in income per-capita around the world, with 30% being a plausible number if education is as capital intensive as other activities.

The strong correlation between years of schooling and income per worker



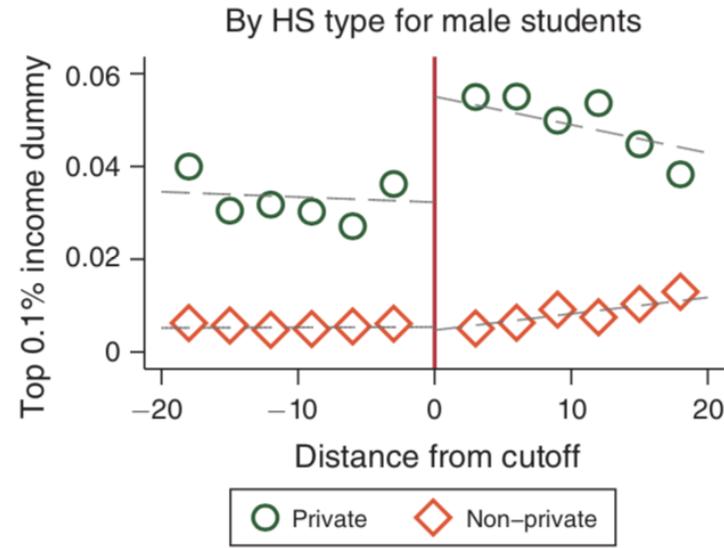
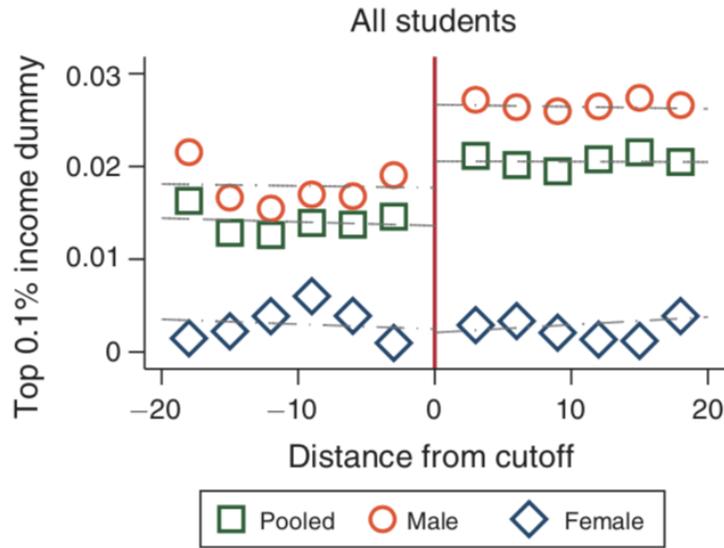
Source: Development Accounting
Chang-Tai Hsieh
Peter J. Klenow
American Economic Journal:
Macroeconomics
vol. 2, no. 1, January 2010
(pp. 207–23)

FIGURE 7. SCHOOLING ATTAINMENT VERSUS INCOME LEVELS

What explains different paths of human capital accumulation?

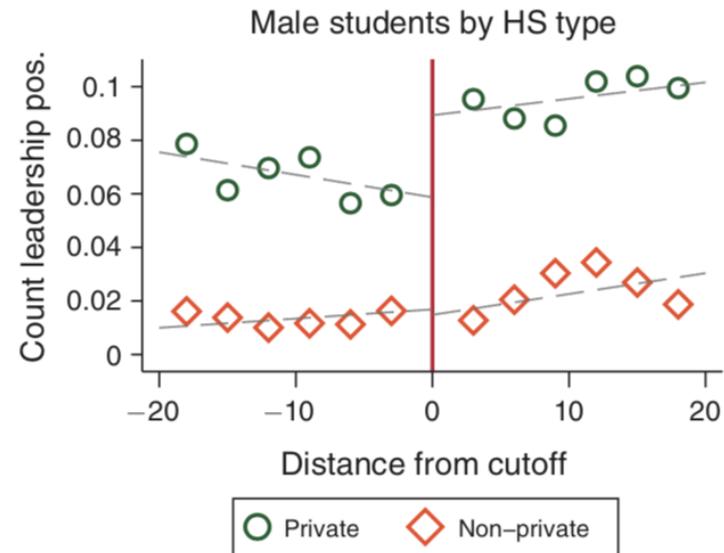
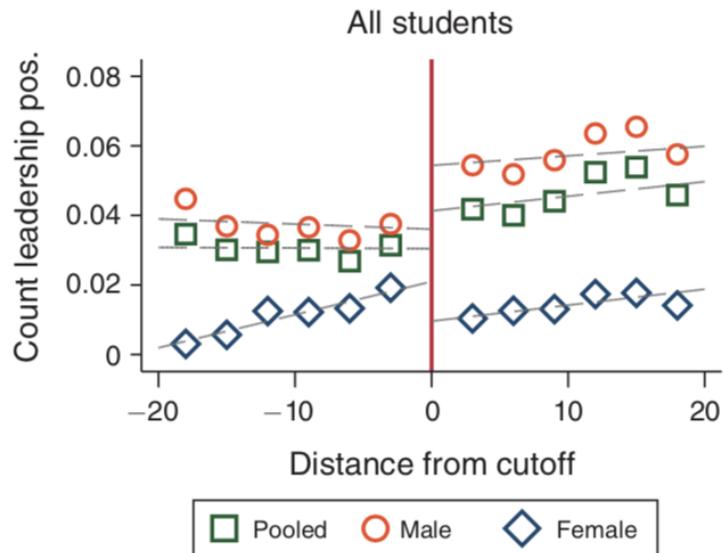
- I have emphasized broad economic institutions such as barriers to entry, monopoly and the rule of law in our work we also looked at the security of property rights.
- These influence the return to education and human capital and hence the demand for them.
- Consider the example of Chile where the payoff to getting into the prestigious Catholic University of the University of Chile depends critically on whether you went to a (private, male only) high school.

Panel A. Top 0.1% income



The (non) payoff to Education with extractive institutions - Chile

Panel B. Leadership positions



Source: Seth Zimmerman (2019) "Elite Colleges and Upward Mobility to Top Jobs and Top Incomes," American Economic Review.

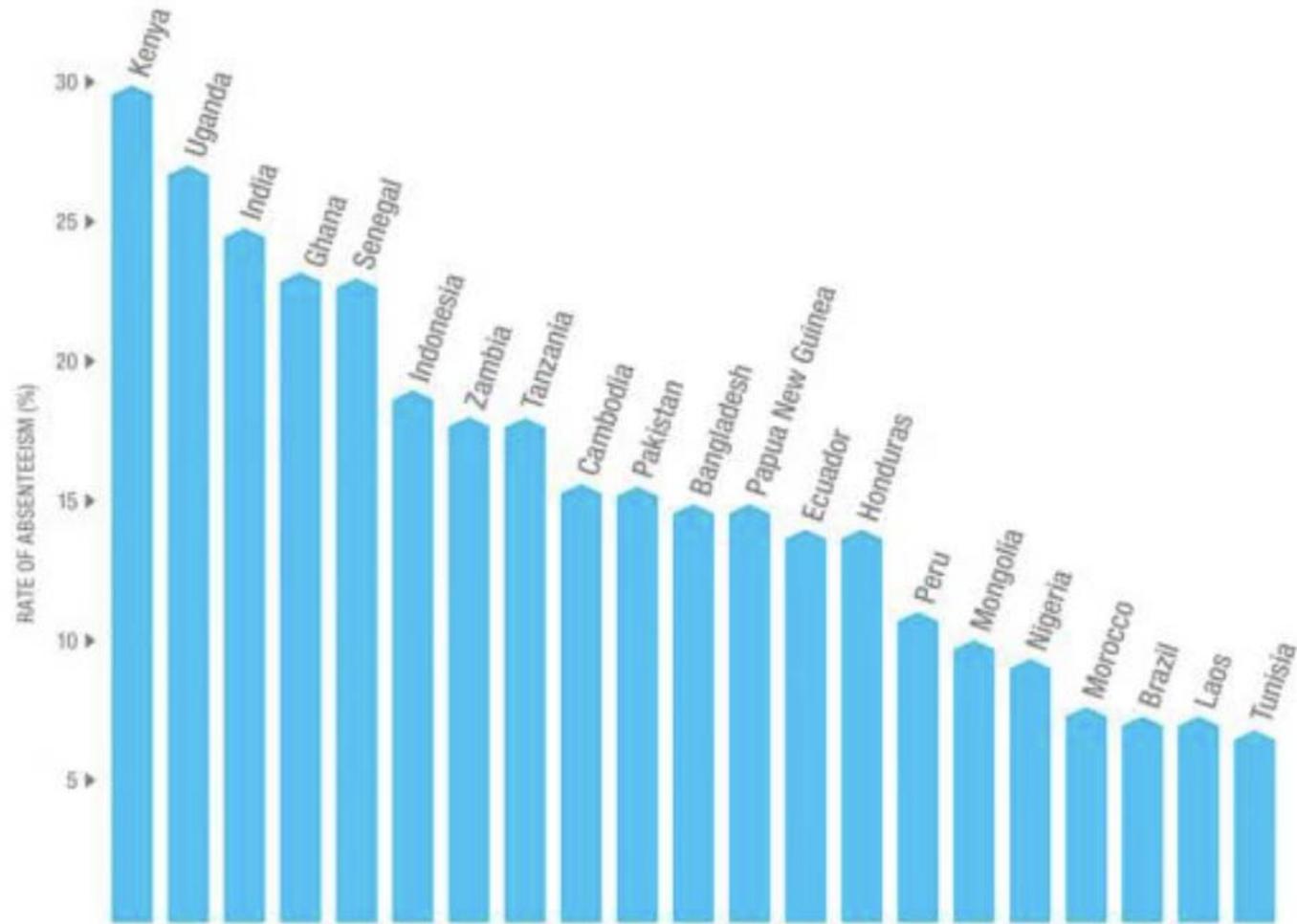
FIGURE 6. EFFECT OF ADMISSION ON LEADERSHIP AND TOP INCOME ATTAINMENT

What explains different paths of human capital accumulation?

- The school system and universities which critically influence the supply and quality of education are institutions themselves.
 - They can be under resourced (high pupil-teacher ratios)
 - They can create barriers to entry (when I was at school to attend Oxford or Cambridge you had to have Latin or Greek O-Level which most ordinary schools did not teach).
- Especially important: they can have poor governance
 - So that teachers are not incentivized to teach (the problem of absenteeism).
 - So that the best people are not hired or promoted (lack of meritocracy, the inheritance of teaching positions in Mexico)

HOW OFTEN DO TEACHERS MISS CLASS?

Survey findings of teachers absenteeism from 2004 to 2011

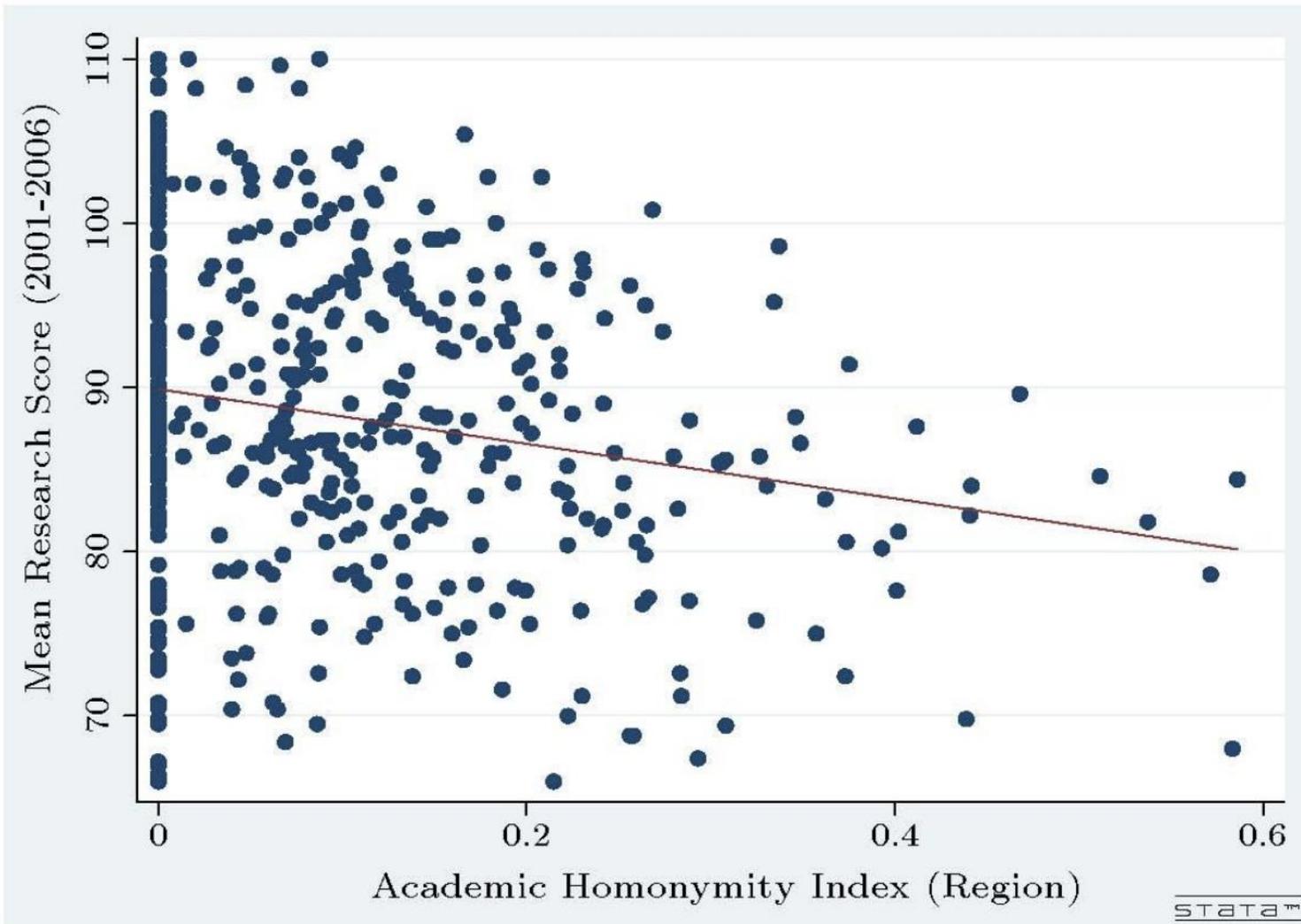


Source: World Bank

Teacher Absenteeism

Nepotism and research productivity in Italian Universities

Figure 1. Nepotism and Research

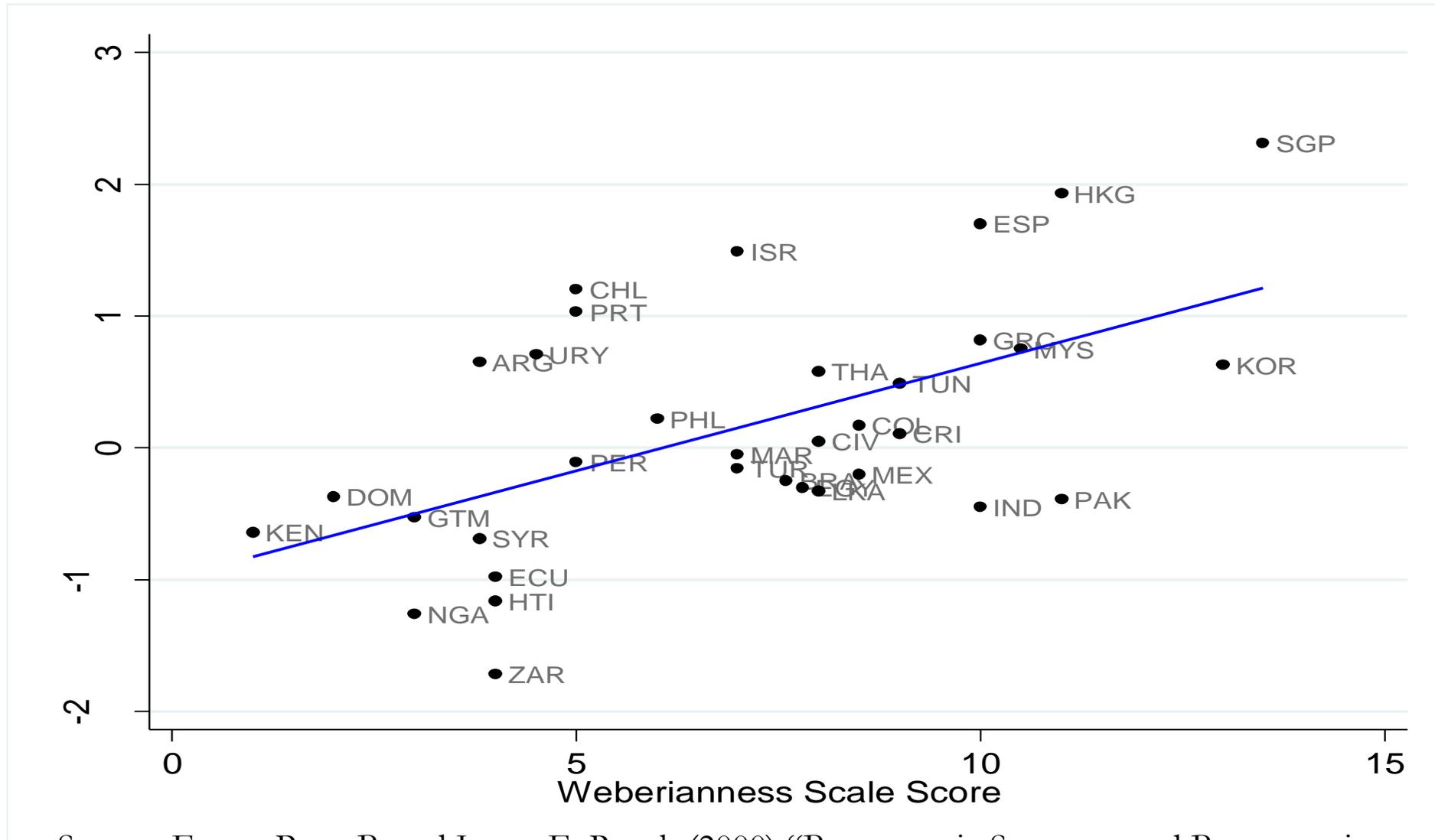


Source: “Academic dynasties,”
R Durante, G Labartino,
R Perotti, G Tabellini

The Importance of Weberianness

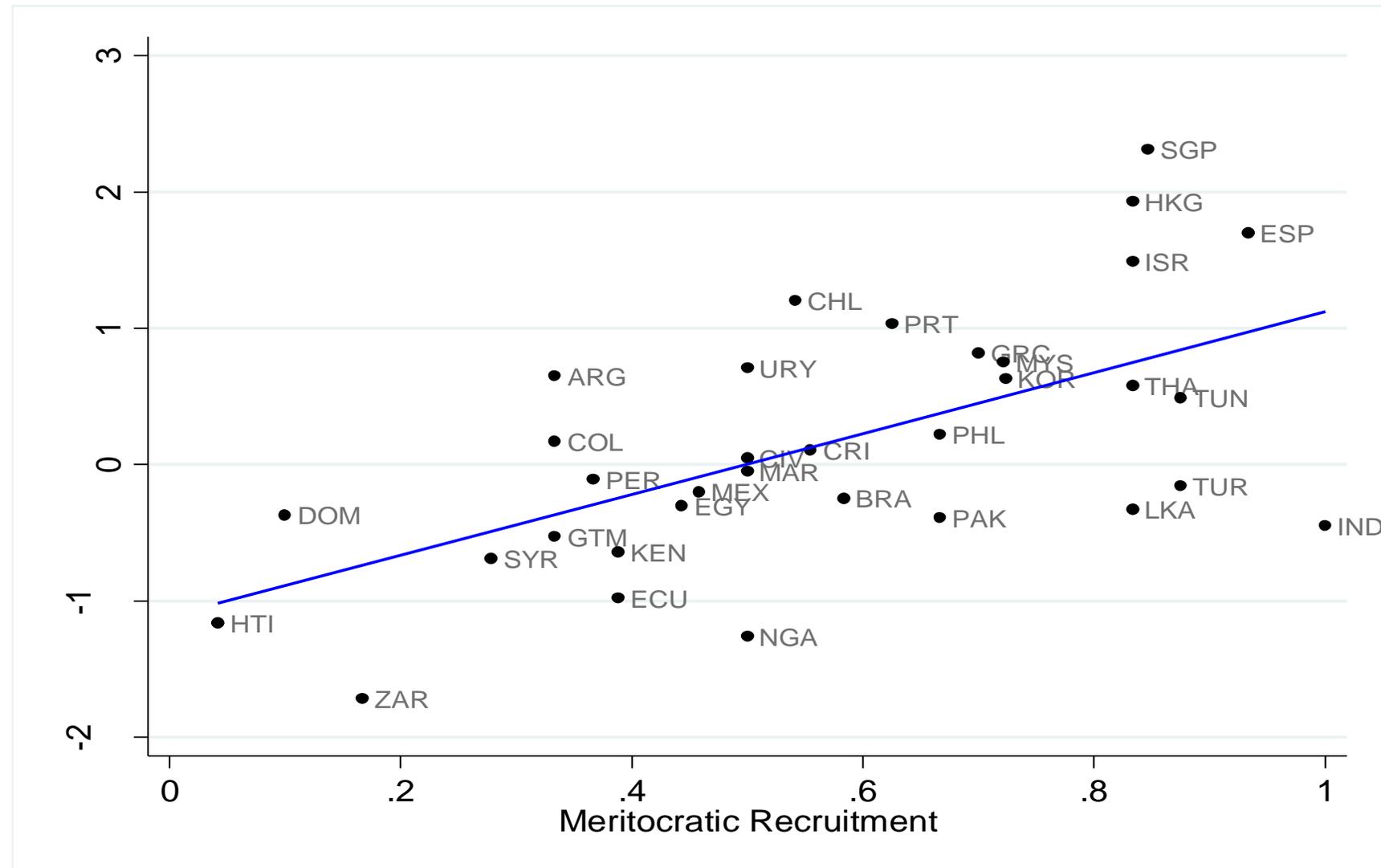
- These problems in the education sector are a class of far more general problems in public sector bureaucracies.
- Why does government effectiveness vary so much?
- Following the German sociologist Max Weber we point to some key features of bureaucracies that make them work effectively – if these features are present, we call the institution Weberian
- The absence of Weberianness, centrally bureaucratic practices and meritocracy, is the fundamental reason why government effectiveness varies – and hence a key source of variation in how inclusive political institutions are.

'Weberianness' and Government Effectiveness



Source: Evans, Peter B. and James E. Rauch (2000) "Bureaucratic Structure and Bureaucratic Performance in Less Developed Countries," *Journal of Public Economics*, 75, 49-71.

Meritocratic Recruitment and Government Effectiveness



Source: Evans, Peter B. and James E. Rauch (2000) "Bureaucratic Structure and Bureaucratic Performance in Less Developed Countries," *Journal of Public Economics*, 75, 49-71.

Weberianness is not a technical problem

- Why does Weberianness or meritocratic recruitment differ so much with such significant implications for political inclusion and government effectiveness?
- This is usually because the state is used as a political tool and a way of exercising political power, **not** an institution for implementing public policy.
- Let me give two Colombian examples.

Managing Power

La ruta de la mermelada y sus protagonistas según Musa Besaile

El ex senador habló del reparto de cuotas burocráticas en las instituciones por parte del gobierno.

En su colaboración, Besaile dice que todo se pactaba en el Palacio de Nariño, en reuniones con los parlamentarios.

Musa Besaile también le dijo a la Corte que el Gobierno “calificaba” a cada congresista de conformidad a su importancia electoral. Las entidades también tenían una categoría.

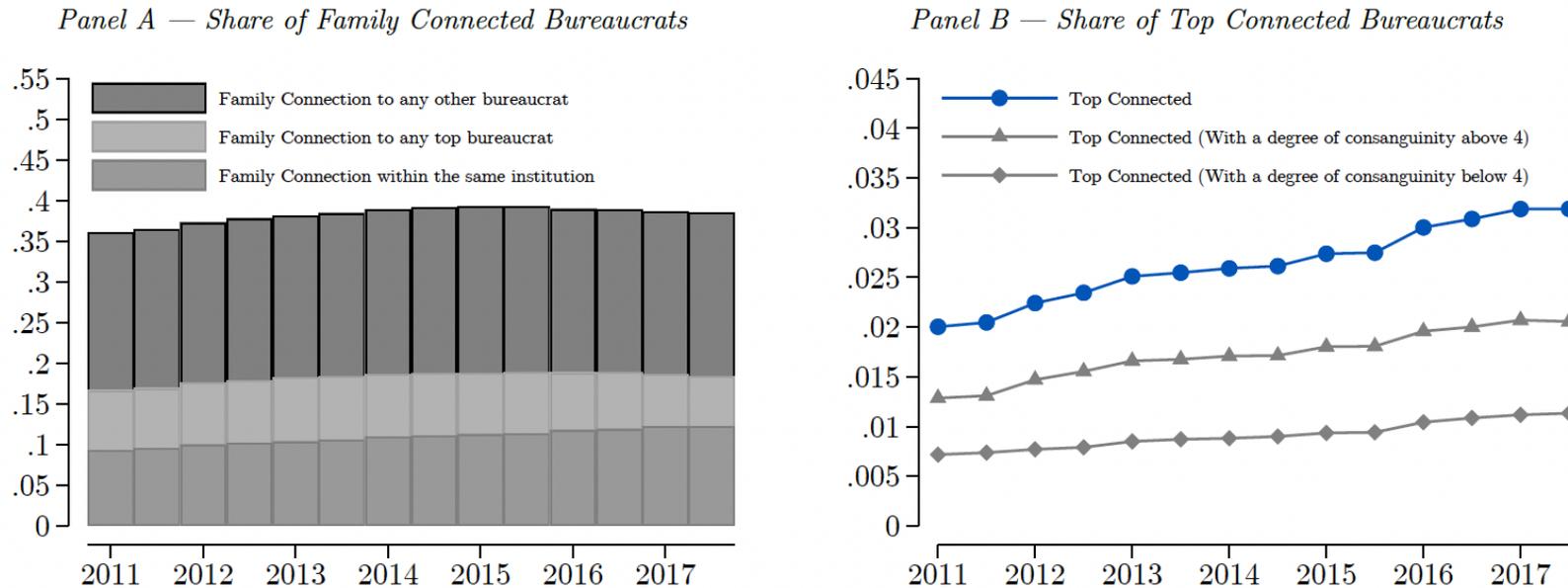
Según él, estas categorías funcionaban así:

- Entre los institutos clase A se encontraba el ICBF
- Entre los clase B se encontraban el Incoder, ICA (Instituto Colombiano Agropecuario), DPS (Departamento para la Prosperidad Social), Invías y Banco Agrario.
- Entre la clase C la Dian, la Aeronáutica Civil, el Ministerio de Transporte y 4-72.

Source:
W Radio

38% of people working for the Colombian public sector have relatives there

Figure 3: Shares of family connected bureaucrats within the public administration



Notes: Panel A presents the share of bureaucrats with family connections to any other bureaucrat, to a top bureaucrat (i.e., manager or advisor), and to any other bureaucrat within the same institution. Panel B presents the share of Top Connected bureaucrats, i.e., the share of bureaucrats with a family connection to a manager or advisor within the same agency they work in. It differentiates the share depending on whether the connections are above or below four degrees of consanguinity.

A connection to a top manager makes you 40% more likely to be promoted.

Implications

- To stimulate human capital accumulation and build a middle class in Indonesia it is not sufficient to allocate resources to school and universities.
- The actual amount of human capital accumulated for a given commitment of resources depends both on the broader institutional environment and how inclusive it is, and also the narrower institutional organization of schools and the educational system.

Conclusion

- Building inclusive institutions is critical for economic growth generally in Indonesia.
- Human capital accumulation will be one of the fruits of having better institutions, but human capital will only respond to broader institutional change if the institutions in the educational sector are also improved.
- We know a lot about how to do this in terms of providing incentives and structuring employment in Weberian ways.
- But actually implementing such institutions is a deeply political challenge.