DE GRUYTER OPEN

UDK: 330.362
DOI: 10.2478/jcbtp-2018-0001

Journal of Central Banking Theory and Practice, 2018, 1, pp. 5-16
Received: 5 March 2017; accepted: 9 August 2017

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Inclusive Institutions for Sustainable Economic Development

Abstract: In recent two decades, due to contributions of political macroeconomics, the focus of macroeconomics turned away from a narrow perspective based on market and privatisation (market fundamentalism) towards a broader perspective based on institutions and values (institutionalism). Within the institutional paradigm, the emphasis nowadays is put on inclusive institutions. The main thesis of one of leading proponents of political macroeconomics, D. Acemoglu, is: “growth is much more likely under inclusive (economic and political) institutions than extractive institutions.”

Good institutions are characterized by three attributes: 1) they establish and protect property rights; 2) they restrict social elites which strive to expropriate income and property of others members of society; 3) they provide equal chances for employment, social security and civil rights to all individuals. Good institutions contribute to political stability, successful macroeconomic policy, and enhance initiatives. The key role of institutions is to secure stability and continuity. Extractive institutions can negatively affect entrepreneurship and entire economic development in two ways: a) by increasing the opportunity cost, resulting in upward movement of the opportunity cost curve; and b) by affecting return to entrepreneurship resulting in leftward movement of the return to entrepreneurship curve.

Apart from independence and accountability of institutions what is needed is sufficient level of inclusion. Inclusion should encompass three dimensions: personal, financial, and political. The introduction of principles of independence, accountability, and inclusion is essential for emergence and performance of all institutions.

Key words: political macroeconomy, inclusive institutions, sustainability, good governance

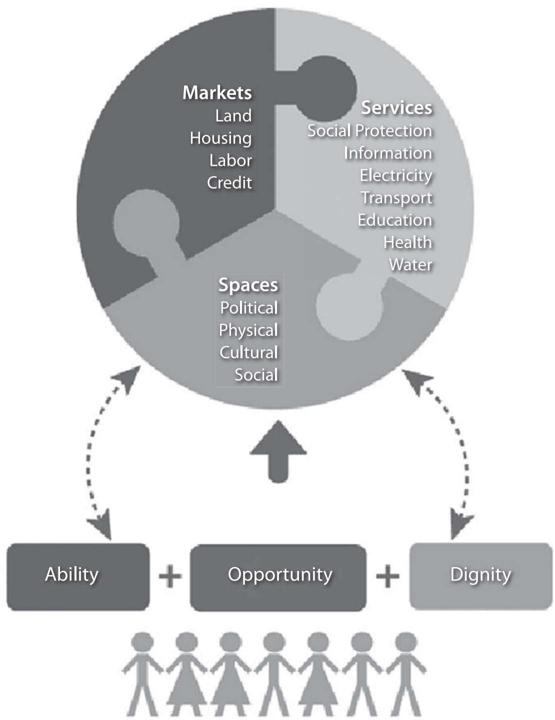
JEL Classification: B10, B15, O13

1. Why institutions are important

Economic and social growth nowadays has two important features: first is **sustainability**, measured as durability, and the second is **inclusiveness**, measured as pro-poor growth. Kakwani and Pernia (2000) define inclusive growth as pro-poor growth, which enable poor to share benefits of growth on the basis of inclusion and sharing positive impact of economic and social growth. Pro-poor "enables the poor to actively participate in and significantly benefit from economic activity" .

Gradually, the definition of inclusion was widened and included not only poor strata but all citizens which continuously communicate with various institutions which gradually become pillars of sustainable growth and development. Klasen (2010) defined it as: "Inclusive growth is arguably more general: it wants growth to benefit all stripes of society, including the poor, the near-poor, middle income groups, and even the rich."

Graph 1: Propelling Social Inclusion: A Framework



Source: World Bank (2013a), p. 9.

The World Bank report (2013) defines social inclusion in two ways. First, social inclusion is considered as "the process of improving the terms for individuals and groups to take part in society" and as "the process of improving the ability, opportunity, and dignity of people, disadvantaged on the basis of their identity, to take part in society." Building blocks are markets, services and spaces, and they rest upon abilities, opportunities and dignity of every single person.

2. Inclusive institutions are pillars of sustainable growth

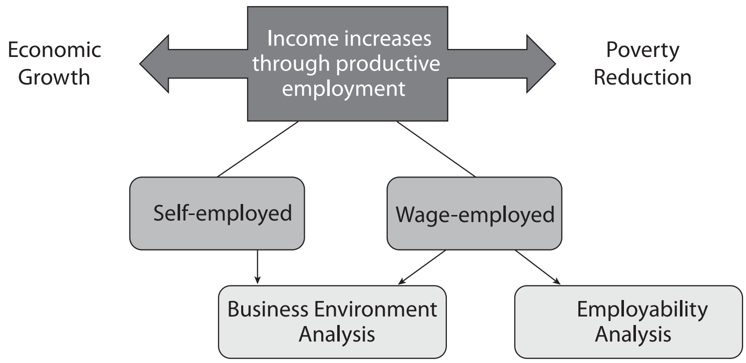
Ianchovichina & Lundstrom (2009, p. 4) explain inclusive growth (IG) with the following list of attributes:

- IG focuses on economic growth as crucial condition for poverty reduction.
- IG adopts a long term perspective and is concerned with sustained growth.
- IG focuses on both the pace and pattern of growth.
- IG focuses on productive employment rather than income redistribution.
- Hence the focus is not only on employment growth but also on productivity growth.
- IG has not only the firm, but also the individual as the subject of analysis.
- IG is in line with the absolute definition of pro-poor growth, not the relative one.
- IG is not defined in terms of specific targets such as employment generation or income distribution. These are potential outcomes, not specific goals.
- IG is typically fuelled by market-driven sources of growth with the government playing a facilitating role.

In line with such definition of inclusive growth is the definition of its basic components: $\overline{y}^* = \varpi \cdot \overline{y}$ Inclusive growth requires increasing $\overline{y}^*$, which could be achieved: (i) through increasing average income through growth $\overline{y}$; (ii) by increasing the equity index of income, through increasing equity ϖ; or (iii) a combination of (i) and (ii) (Anand, Mishra & Peiris, 2013, p. 7)

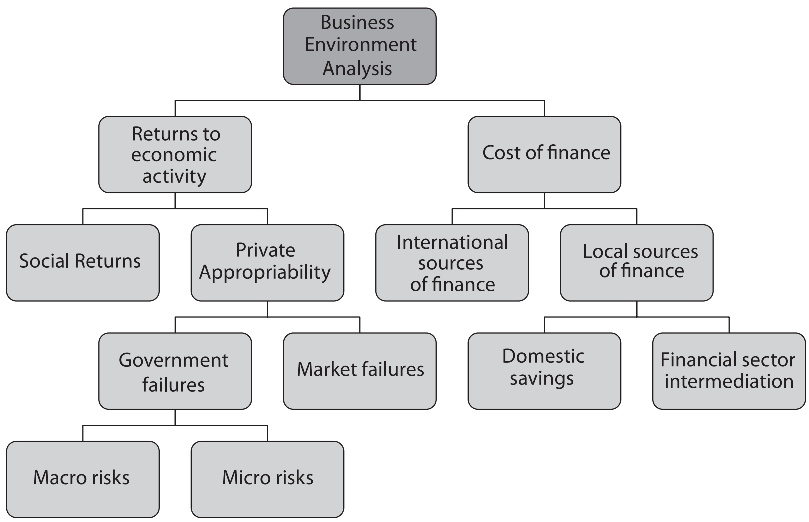
Basic algorithm of inclusive development is presented in the following diagrams:

Graph 2: Inclusive growth analytics



Source: Ianchovichina, E., Lundstrom S. (2009), p. 6.

Graph 3: Business environment analysis



Source: Ianchovichina, E., Lundstrom S. (2009), p. 6.

Two pillars are: 1. economic growth and 2. poverty reduction, as tools for productive employment, either self or wage employment. Results in domain of employment lead towards business environment analysis, where government and market failures are in the very centre of analysis. Such perspective led towards augmenting the ten principles of the Washington Consensus with institutional and regulatory principles.

Rising significance of institutions can be traced back to D. Rodrik "augmenting" the original Washington consensus.

Illustration 1: Rules of good behaviour for promoting economic growth

Original Washington Consensus:	"Augmented" Washington Consensus: ... the previous 10 items, plus:
1. Fiscal discipline	11. Corporate governance
2. Reorientation of public expenditures	12. Anti-corruption
3. Tax refom	13. Flexible labor markets
4. Interest rate liberalization	14. Adherence to WTO disciplines
5. Unified and competitive exchange rates	15. Adherence to international financial codes and standards
6. Trade liberalization	16. "Prudent" capital-account opening
7. Openness to DFI	17. Non-intermediate exchange rate regimes
8. Privatization	18. Independent central banks' inflation targeting
9. Deregulation	19. Social safety nets
10. Secure Property Rights	20. Targeted poverty reduction

Source: Rodrik, D. (2004), p. 44.

The World Bank (2013b, p. 33) report concludes: "An inclusive society must have the institutions, structures, and processes that empower local communities, so they can hold their governments accountable. It also requires the participation of all groups in society, including traditionally marginalized groups, such as ethnic minorities and indigenous populations, in decision-making processes."

3. Inclusive economic institutions

Institutions, now more precisely defined as inclusive institutions, affect whole social and economic development in following manner: "growth is much more likely under inclusive (economic and political) institutions than extractive institutions." (Acemoglu, 2012).

Inclusive economic institutions secure property rights, law and order, markets and state support (public services and regulation) for markets; they are open to a relatively free entry of new businesses; they uphold contracts; assure access to education and opportunity for the great majority of citizens, create incentives for investment and innovation and a level playing.

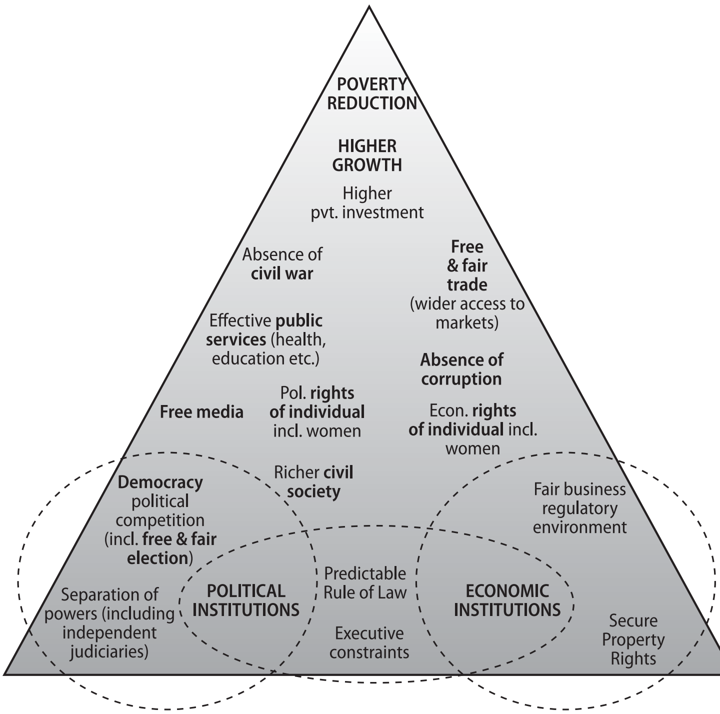
Extractive economic institutions are different from inclusive institutions in every aspect and they are, according to D. Acemoglu, designed by the politically powerful elites to extract resources from the rest of society.

Consolidated democracy and efficient markets depend on fundamental factor of growth, especially inclusive institutions which secure greater satisfaction of basic needs of population, primarily healthcare and education (Jakšić & Jakšić, 2014).

D. Acemoglu writes: "correlation is not causation of the type: higher GDP causes more democracy, and it leads toward deeper explanation, more fruitful one, how higher GDP causes democracy. Explanation lies in institutions, wider network of empowered institutions (good governance)." (Acemoglu & Robinson, 2006, pp. 55, 59).

The DFID report conclusions are similar: "1. there does not appear to be any automatic link between a country's democratic status and its ability to reduce poverty

Graph 4: (Snakes and) Leaders: the role of governance and institutions in growth and poverty reduction



Source: Evans, W., Ferguson, C. (2013). P. 12.

or improve human development. Non-democratic states are capable of growth, poverty reduction, and securing gains in human development. 2. The evidence suggests that a broader interpretation of democracy ('deep' democracy) requires consideration of democracy beyond elections. As such, the political institutions, processes and practices that really matter are more likely to be levels of political competition, as characterised by stronger, issues-based political parties, and more competitive recruitment to these parties." (Evans & Ferguson, 2013, p. 6).

Political and economic institutions are at the basis of pyramid ultimately leading to higher growth and reduction of poverty.

D. Acemoglu writes: "Much of economics takes preferences, technology and institutions (market structure, laws, regulations, policies) as given." He summarizes this schematically:

Graph 5: Dynamic Framework

$$
\begin{array}{ccccccc}
\begin{array}{c}\text{political}\\ \text{inst's}_t\\[2em] \text{dist. of}\\ \text{resources}_t\end{array} &
\begin{array}{c}\Longrightarrow\\[5em] \Longrightarrow\end{array} &
\left.\begin{array}{c}\text{de jure}\\ \text{political}\\ \text{power}_t\\ \&\\ \text{de facto}\\ \text{political}\\ \text{power}_t\end{array}\right\} &
\begin{array}{c}\Longrightarrow\\[5em] \Longrightarrow\end{array} &
\begin{array}{c}\text{econ.}\\ \text{inst's}_t\\[2em] \text{pol.}\\ \text{inst's}_{t+1}\end{array} &
\Longrightarrow &
\left\{\begin{array}{c}\text{econ.}\\ \text{perf}_t\\ \&\\ \text{dist. of}\\ \text{resources}_{t+1}\end{array}\right.
\end{array}
$$

Source: Acemoglu, D. (2014).

Institutions are said to be inclusive, "because they encourage the participation of a majority of the population in economic activities in a way that makes an efficient use of their talents and skills. On the other hand, extractive economic institutions fail to ensure protection of property rights, create barriers to entry in an industry, and restrict the free functioning of markets. Such institutions are often controlled by those who wield political power and extract resources from the rest of the society." (Acemoglu, Liabson & List, 2015)

World Economic Forum (WEF) *Inclusive Growth and Development Report 2015*, presents a framework and a corresponding set of indicators in seven policy domains (pillars) and 15 subdomains (subpillars) as the basis for sustainable and long lasting development based on the central role of institutions.

Illustration 2: Inclusive growth and development framework

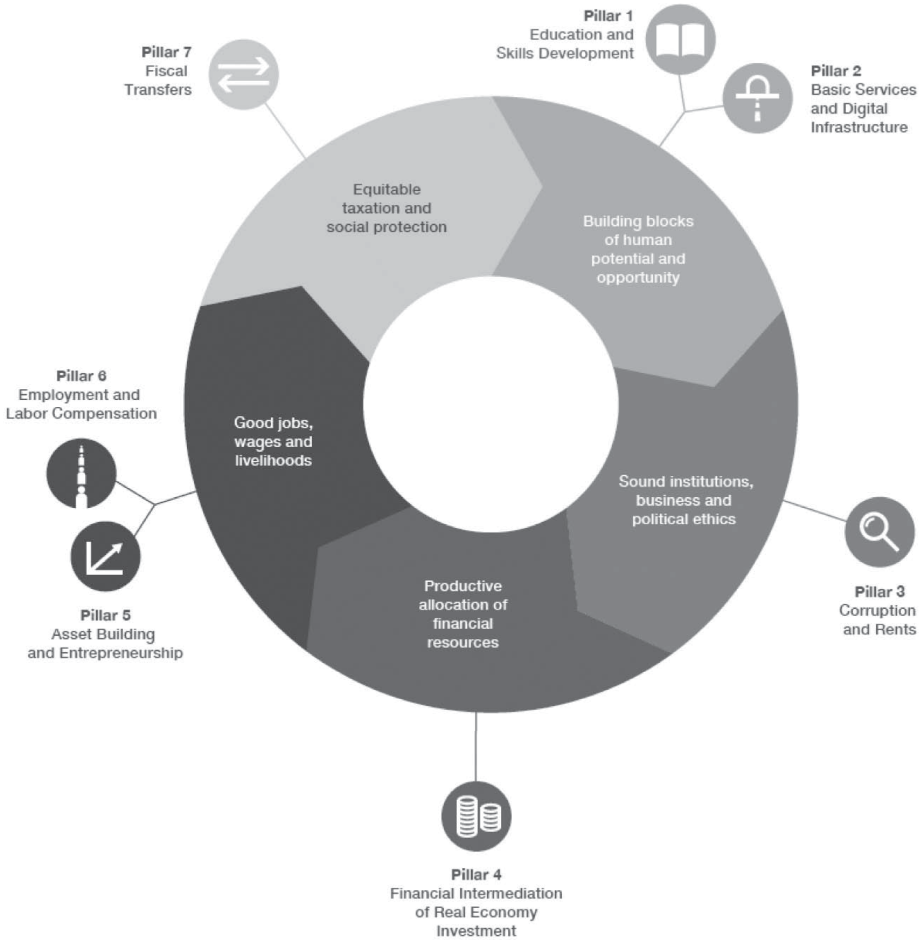
Pillar 1: Education and Skills Development	Pillar 2: Employment and Labor Compensation	Pillar 3: Asset Building and Entrepreneurship	Pillar 4: Financial Intermediation of Real Economy Investment	Pillar 5: Corruption and Rents	Pillar 6: Basic Services and Infrastructures	Pillar 7: Fiscal Transfers
Access	Productive Employment	Small Business Ownership	Financial System Inclusion	Business and Political Ethics	Basic and Digital Infrastructure	Tax Code
Quality	Wage and Non-wage Labor Compensation	Home and Financial Asset Ownership	Intermediation Of Business Investment	Concentration of Rents	Health-related Services and Infrastructure	Social Protection
Equity						

Source: World economic forum (2016).

Main six conclusions of the WEF report are:

- First, all countries have room for improvement.
- Second, it is possible to be pro-equity and pro-growth at the same time.
- Third, fiscal transfers can be helpful—but so can other policies.
- Fourth, lower-income status is no bar to success.
- Fifth, there are significant regional similarities.
- Finally, the current debate on inequality needs to be widened.

Graph 6: Virtuous Circle of Inclusive Growth and Development



Source: World economic forum (2017), p. 14.

Indices for measuring institutions and their outcomes are (Inclusive institutions, 2014, p.16):

- Worldwide Governance Indicators.
- Indices of Social Development database
- Human Development Index (HDI)
- Better Life Index
- Human Opportunity Index.

Table 1: Definitions of Inclusive Growth: Summary of Key Elements

	Poverty	Inequality	Growth	Productive Employment	Capabillities/Emprowement	Gender inequality	Access to infrastructure	Social protections	Participation	Targeted policies	Basic social services	Good governance	Opportunity	Barriers to investment	Benefits of growth
Ravallion and Chen (2003)	x														
Bhalla (2007)	x			x	x										
Ianchovichina and Lundstrom (2009)	x		x	x										x	
Habito (2009)	x														
Kakwani and Pernia (2000)		x			x					x					
White and Anderson (2001)		x													
Kakwani, Khandker and Son (2004)	x	x	x												
Son and Kakwani (2008)	x	x	x												
Kraay (2004)	x	x													
Ali and Son (2007)		x											x		
Grosse, Harttgen and Klasen (2008)	x	x			x										
Son and Kakwani (2008)		x	x												
Klasen (2010)		x													
Rauniyar and Kanbur (2010)		x	x		x			x	x				x		x
McKinley (2011)	x	x	x	x	x	x	x				x	x			

Source: Inclusive institutions (2014). p. 18.

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