

The Political Economy of Latin American Development: Lecture 3

James Robinson

Harvard

July 2011

Why do Institutions Differ?

- Finding that differences in economic institutions can account for the preponderance of differences in per-capita income between countries creates as many questions as it answers.
- For example, why do countries have different economic institutions?
- If poor countries are poor because they have bad economic institutions why do they not change them to better institutions?
- I now look at four approaches to institutions.

The Efficient Institutions View - The Political Coase Theorem

- Societies will choose the economic institutions that are socially efficient. How this surplus will be distributed among different groups or agents does not affect the choice of economic institutions.
- The concept of efficiency is stronger than simply Pareto Optimality; it is associated with surplus, wealth or output maximization.
- The underlying reasoning of this view comes from the Coase Theorem. Coase (1960) argued that when different economic parties could negotiate costlessly, they will be able to bargain to internalize potential externalities.

The Efficient Institutions View

- If the current economic institutions benefit a certain group while creating a disproportionate cost for another, these two groups can negotiate to change the institutions. By doing so they will increase the size of the total surplus that they can divide between themselves, and they can then bargain over the distribution of this additional surplus.
- The efficient institutions view regards the structure of political institutions or power as irrelevant. This may matter for the distribution of total surplus, but it will not matter for efficiency itself. The 'efficient' set of political institutions is therefore indeterminate.
- Many examples in economics, Demsetz (1967), Grossman and Hart (1986), Djankov et al. (2003).

- The PCT implies that if we improved institutions in Mali (made property rights more secure, created a more level playing field) then there would be little impact on output.
- In reality it is difficult to change institutions in Mali and conduct such an experiment.
- However, IF we had a source of variation of institutions in the world which was clearly something which did not determine output, then if this source of variation suggested large payoffs to better institutions, this would contradict the PCT.
- Hence the results we presented with settler mortality directly contradict the PCT.

The Ideology View #1

- Societies may choose different economic institutions, with very different implications, because they—or their leaders—disagree about what would be good for the society.
- According to this approach, there is sufficient uncertainty about the right economic institutions that well-meaning political actors differ about what's good for their own people.
- Possible that people have normative preferences about institutions which are independent of their effect on GDP (building socialism in Cuba?)
- Societies where the leaders or the electorate turn out to be right ex post are those that prosper.
- Just as with the efficient institutions view, there are strong forces preventing the implementation of policies that are known to be bad for the society at large.

The Ideology View #2

- Belief differences clearly do play a role in shaping policies and institutions.
- Several interesting examples of this come from the early experience of independence in former British colonies. For example, in India the Fabian socialist beliefs of Jawaharlal Nehru were important in governing the initial direction that Indian economic policies took.
- Nevertheless, the scope of a theory of institutional divergence and comparative development based on ideology seems highly limited.
- Can we interpret the differences in institutional development across the European colonies or the divergence in the economic institutions and policies between the North and South of Korea as resulting from differences in beliefs?

The Incidental Institutions View

- The efficient institutions view is explicitly based on economic reasoning: the social costs and benefits of different economic institutions are weighed against each other to determine which economic institutions should prevail.
- Efficiency arises because individuals ultimately calculate according to social costs and benefits. Institutions are therefore choices.
- A different approach is to downplay choices and to think of institutions as the by-product or unintended consequence of other social interactions or historical accidents. In other words, historical accidents at critical junctures determine institutions, and these institutions persist for a long time, with significant consequences.

Example: Legal Origins

- The legal origins theory of Andrei Shleifer and his co-authors is an example of this approach. They have argued that a central source of variation in many critical economic institutions is the origin of the legal system.
- For example, "Civil laws give investors weaker legal rights than common laws do, independent of the level of per-capita income. Common-law countries give both shareholders and creditors—relatively speaking—the strongest, and French-civil-law countries the weakest, protection. " (La Porta et al., 1998, p. 1116)

- These differences have important implications for resource allocation. For example, when shareholders have poor protection of their rights, ownership of shares tends to be more highly concentrated.
- Djankov et al. (2003) collected a cross-national dataset on how different countries legal systems dealt with the issue of evicting a tenant for nonpayment of rent and collecting on a bounced check.
- They used these data to construct an index of procedural formalism of dispute resolution for each country and showed that such formalism was systematically greater in civil than in common law countries, and is associated with higher expected duration of judicial proceedings, less consistency, less honesty, less fairness in judicial decisions, and more corruption.

- Countries legal systems are an accidental/incidental result who colonized them.
- Legal systems hard to change and so these institutions persisted over time with large effects.
- This view suggests that Colombia did not choose French legal origin, it got stuck with it.

The View I take

- Historical accidents and persistence are important, in reality the aspect of choice over institutions seems too important to be denied.
- Even if institutions have a tendency to persist, their persistence is still a choice, in the sense that if the agents decided to change institutions, change would be possible.
- Example: presidentialism in Latin America. Most see this from an incidental view, but in Africa after independence every British colony that started with a parliamentary systems switched to presidentialism. This seems to be a reflection of the way political power and authority is organized.

The Social Conflict View #1

- Economic (and political) institutions are not always chosen by the whole society (and not for the benefit of the whole society), but by the groups that control political power at the time..
- These groups will choose the economic institutions that maximize their own rents, and the economic institutions that result may not coincide with those that maximize total surplus, wealth or income.
- Institutions that enforce property rights by restricting state predation may not be in the interest of a ruler who wants to appropriate assets in the future. By establishing property rights, this ruler would be reducing his own future rents.
- Equilibrium economic institutions will not be those that maximize the size of the overall pie, but the slice of the pie taken by the powerful groups.

The Social Conflict View #2

- In contrast to the efficient institutions view, political institutions play a crucial role in the social conflict view.
- Which economic institutions arise depends on who has political power to create or block different economic institutions. Since political institutions play a central role in the allocation of such power they will be an intimate part of a social conflict theory of economic institutions.

- What distinguishes the social conflict view from the (non Cuban version of the) ideological view is that social conflict can lead to choices of economic institutions which cause underdevelopment even when all agents have common knowledge that this is so.
- What distinguishes it from the incidental view is that it emphasizes that institutional choices which cause underdevelopment are conscious choices, rather than the result of some historical accident.
- The aspect that distinguishes the social conflict view from the efficient institutions view is that it does not assume that institutions are always efficient. This is one possible outcome but it is not the only one or indeed the most likely.

Towards a Social Conflict Theory of Institutions

- Some clear elements have emerged from this discussion of ideas and data. I now present a simple framework which collects some of the ideas and will frame the discussion for the rest of the week.
- Economic institutions matter for economic growth because they shape incentives.
- Economic institutions not only determine the aggregate economic growth potential of the economy, but also the distribution of resources.
- I summarize these ideas schematically as (where the subscript t refers to current period and $t + 1$ to the future):

$$\text{economic institutions}_t \implies \left\{ \begin{array}{l} \text{economic performance}_t \\ \text{distribution of resources}_{t+1} \end{array} \right.$$

Economic Institutions are Collective Choices

- Economic institutions are determined as collective choices of the society, in large part for their economic consequences.
- However, there is typically be a *conflict of interest* among various groups and individuals over the choice of economic institutions.
- Whose's preferences will prevail? The answer depends on the distribution of *political power*. Although the efficiency of one set of economic institutions compared with another may play a role in this choice, political power will be the ultimate arbiter. Whoever has more political power is likely to secure the set of economic institutions that they prefer:

political power_t \implies economic institutions_t

- It is useful to distinguish between two components of political power, which we refer to as *de jure (institutional)* and *de facto political power*.
- Here de jure political power refers to power that originates from the *political institutions* in society. Political institutions, similarly to economic institutions, determine the constraints on and the incentives of the key actors, but this time in the political sphere.
- Examples of political institutions include the form of government, for example, democracy vs. dictatorship or autocracy, and the extent of constraints on politicians and political elites.
- This discussion therefore implies that:

political institutions_t \implies de jure political power_t

De Facto Power

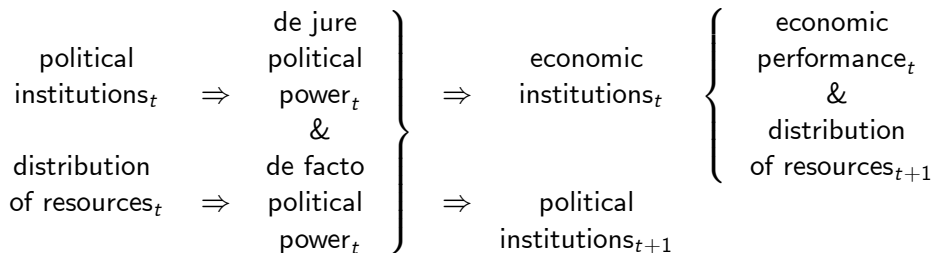
- There is more to political power than political institutions, however. A group of individuals, even if they are not allocated power by political institutions, for example as specified in the constitution, may nonetheless possess political power.
- First, it depends on the ability of the group in question to solve its collective action problem, i.e., to ensure that people act together, even when any individual may have an incentive to free ride.
- Second, the de facto power of a group depends on its economic resources.
- Since I do not yet have a satisfactory theory of when groups are able to solve their collective action problems, our focus will be on the second source of de facto political power, hence:

distribution of resources_t \implies de facto political power_t

- Societies transition from dictatorship to democracy, and change their constitutions to modify the constraints on power holders.
- Since, like economic institutions, political institutions are collective choices, the distribution of political power in society is the key determinant of their evolution.
- Summarizing this discussion, we have:

$$\text{political power}_t \implies \text{political institutions}_{t+1}$$

Putting it Together



Political and Economic Institutions

- So far we saw some empirical work suggesting there is a strong causal role for economic institutions in comparative development (“Colonial Origins”).
- Now I am arguing more explicitly for the political story behind differences in economic institutions.
- Let me return to the Glorious Revolution in England in 1688. This was a political revolution which severely diminished the power of the King and moved authority and policymaking power to parliament. This led to very different policy choices and according to some arguments was key to the subsequent development of the industrial revolution.
- For instance, parliament started passing legislation which facilitated the construction of infrastructure and began rationalizing property rights in land (via “enclosure” legislation).
- Here a change in political institutions (part of which was increases in constraints on the executive) led to changes in economic institutions.

Empirics of Political Institutions

- In the data what sorts of correlations between political institutions and development outcomes do we see?
- The above might suggest we ought to see some simple ones, and in a sense we do.
- Consider the relationship between measures of democracy and the level of income. These two things are very highly correlated in cross-section. However, when you look at the “within variation” the changes are much less correlated.
- In the post World War II period there is no tendency for democracies to grow faster than dictatorships.
- The story I told you about the Glorious Revolution was not really a story about democratization. After 1688 parliament had a very limited franchise based on tax payment and property ownership (less than 10% of adult males could vote). But parliament was nevertheless very open to influence from society (via petitions).

Figure 3

Democracy and Income 1990s

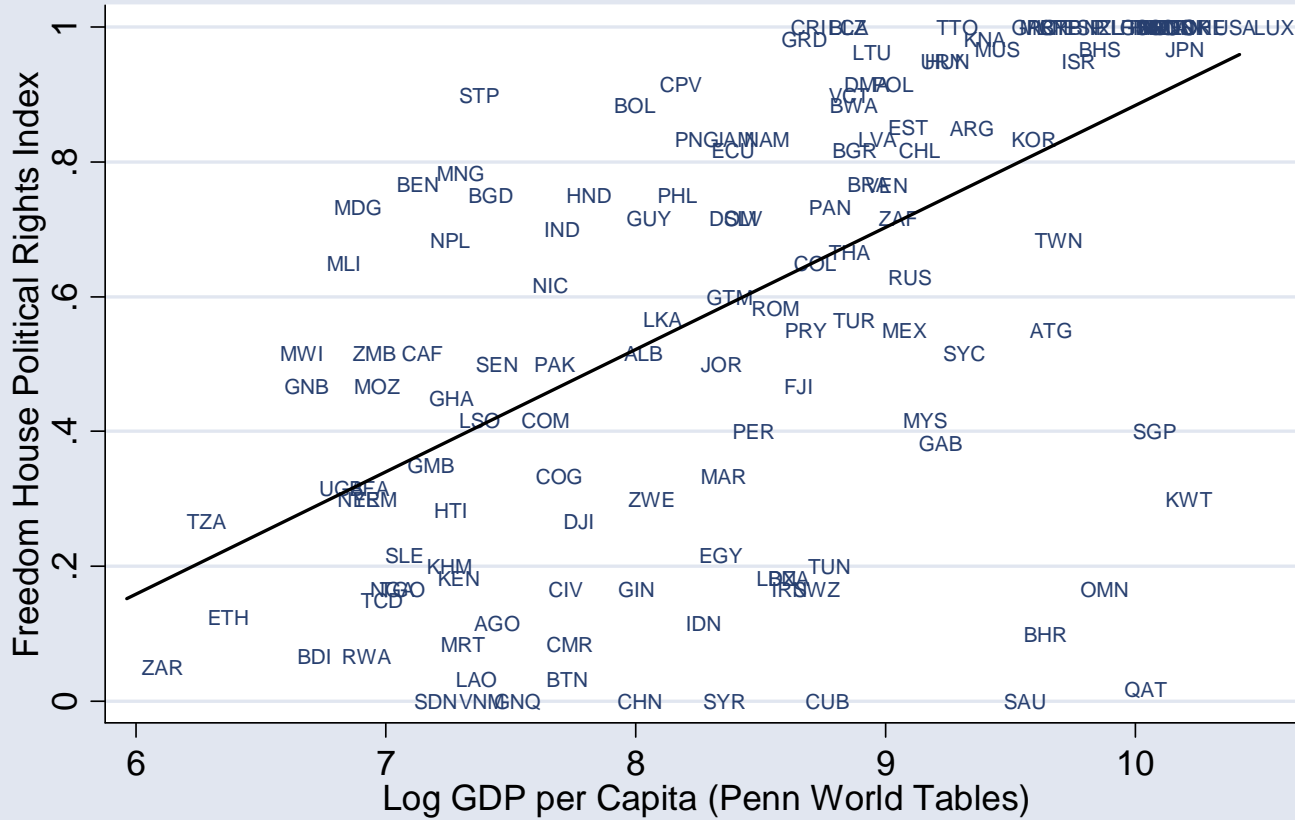


Figure 2
 Democracy Growth and Income Growth 1970-1995

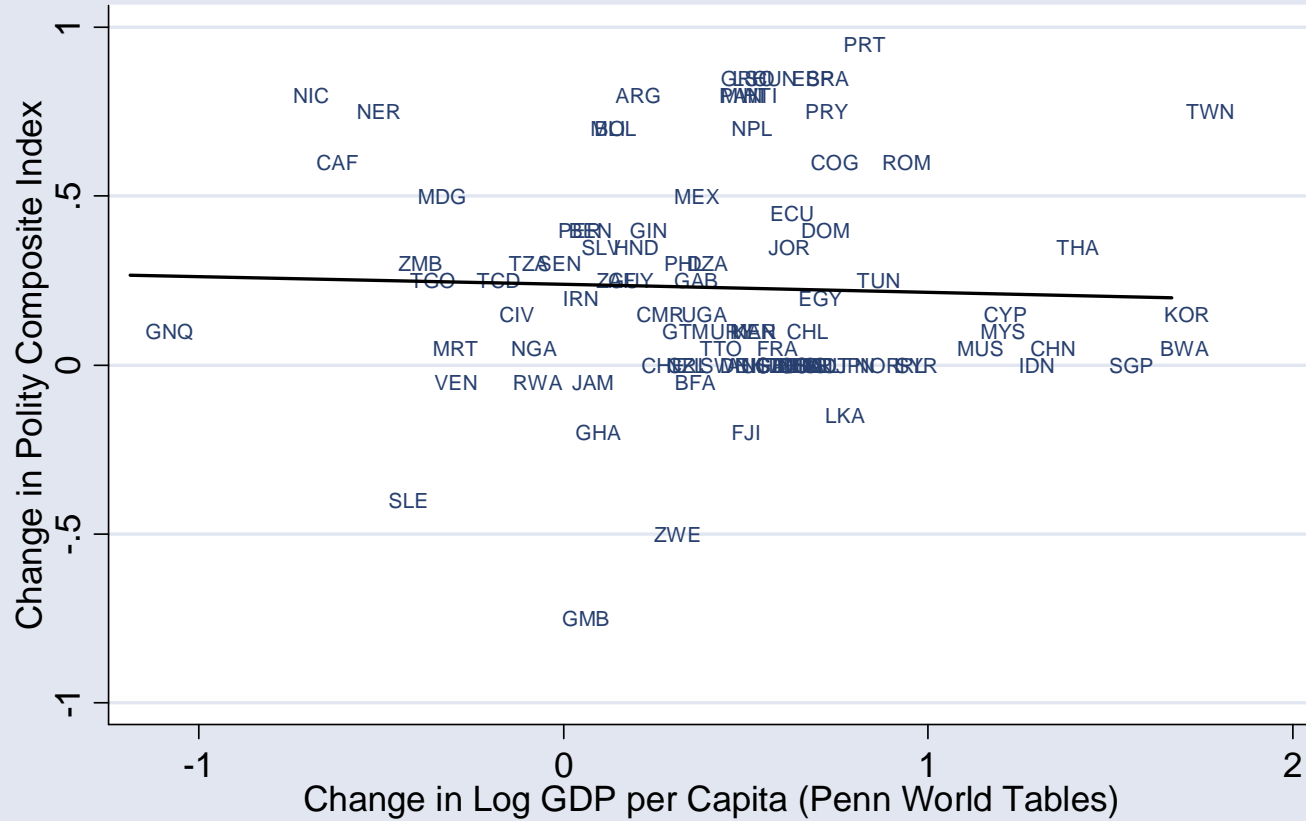
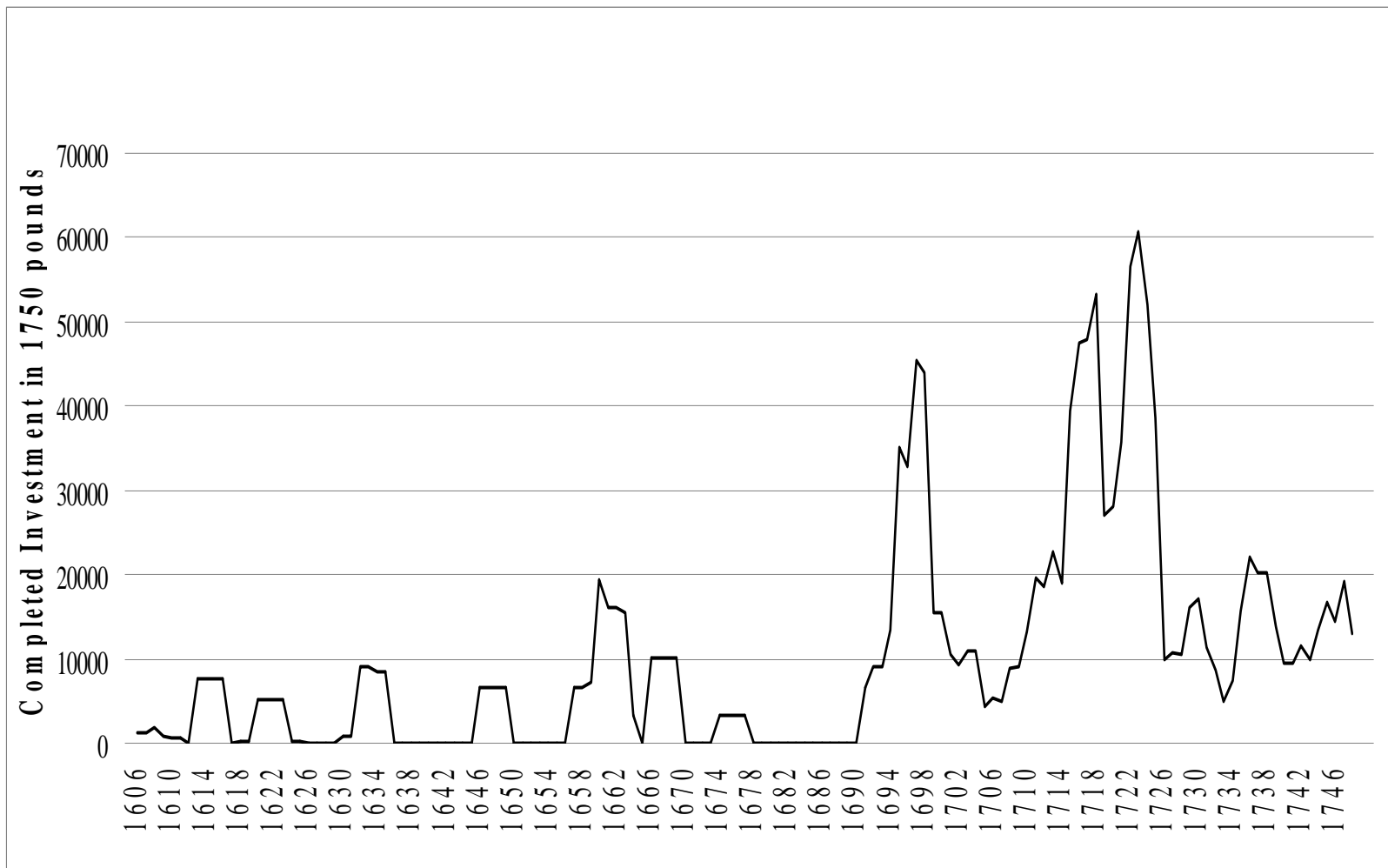
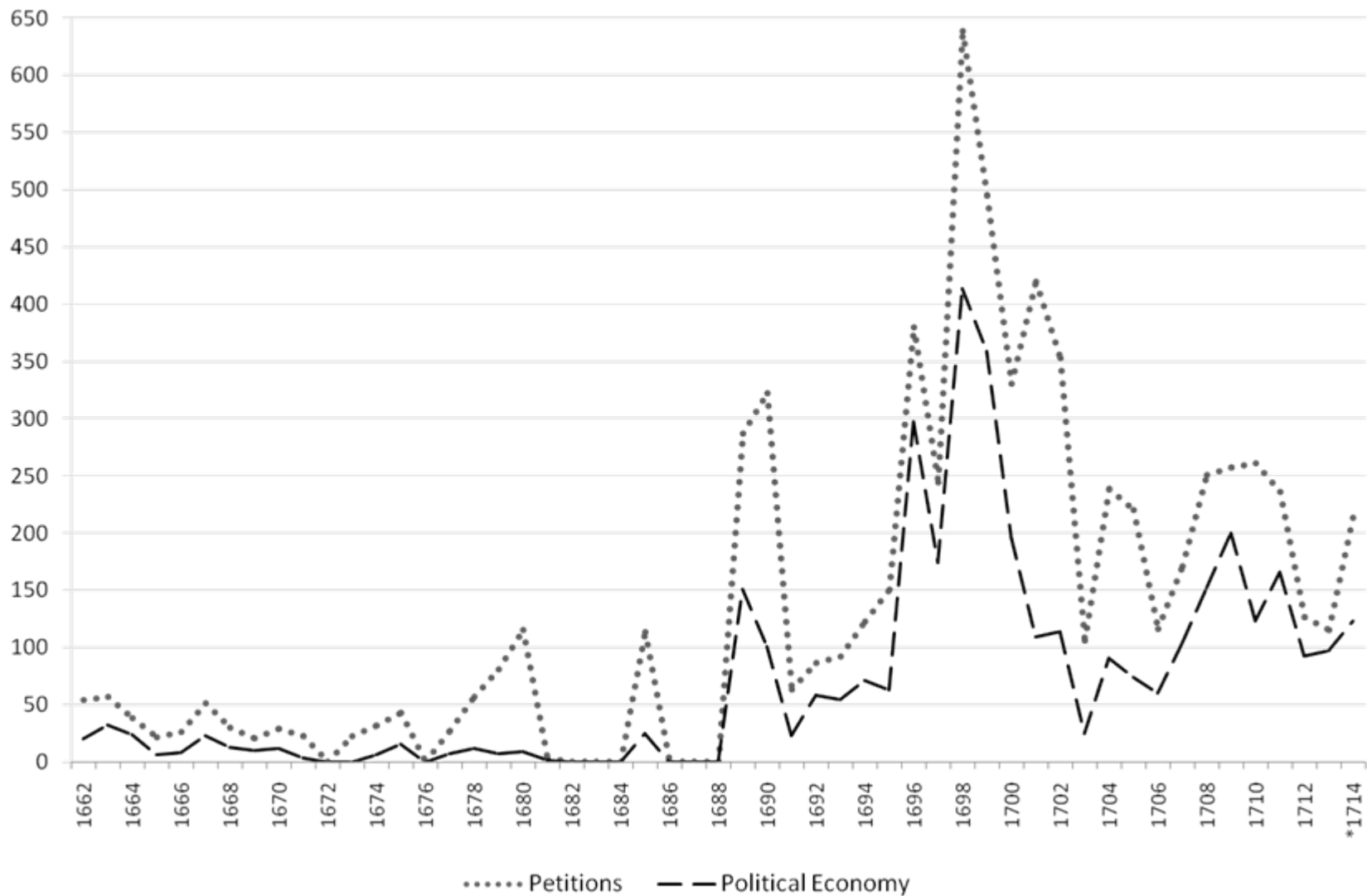


Figure 3: Four-Year Moving Average of Completed Investment in Road and River Improvements, 1607-1749



Source: Dan Bogart "Did the Glorious Revolution Contribute to the Transport Revolution? Evidence from Investment in Roads and Rivers," Forthcoming Economic History Review

Figure 4: Number of Petitions per-year received by the House of Commons, 1660-1715



Source: Authors calculations from the Journal of the House of Commons.

Variation in Political Institutions within Democracy

- Persson and Tabellini have shown that there are some correlations between different constitutional structures in democracy and public policy outcomes, such as the size of government.
- They focus on whether or not the constitution is presidential or parliamentary, and whether or not the electoral system is majoritarian or proportional.
- They find that presidential systems tend to have smaller governments as do those with majoritarian electoral systems.
- No real identification strategy.

TABLE 2—SIZE OF GOVERNMENT AND CONSTITUTIONS: OLS ESTIMATES

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dependent variable	<i>cgexp</i>	<i>cgexp</i>	<i>cgrev</i>	<i>dft</i>	<i>cgexp</i>	<i>cgexp</i>	<i>cgexp</i>
<i>pres</i>	-5.18 (1.93)***		-5.00 (2.47)**	0.16 (1.15)	-2.65 (2.70)	-7.75 (2.70)***	-6.46 (2.98)**
<i>maj</i>	-6.32 (2.11)***		-3.68 (2.15)*	-3.15 (0.87)***	-1.45 (2.32)	-7.94 (3.74)**	-6.33 (2.48)**
<i>propres</i>		-6.56 (3.01)**					
<i>majpar</i>		-6.96 (3.72)*					
<i>majpres</i>		-10.37 (3.03)***					
<i>pres_newdem</i>						3.50 (2.72)	
<i>maj_newdem</i>						3.58 (4.03)	
<i>newdem</i>						-4.08 (2.23)*	
<i>pres_baddem</i>							2.42 (4.16)
<i>maj_baddem</i>							2.06 (5.97)
<i>baddem</i>							-5.73 (3.46)
<i>F</i> -test (<i>pres</i>)		0.43				4.01**	1.40
<i>F</i> -test (<i>maj</i>)						3.18*	0.66
Sample	1990's	1990's	1990's	1990's	1960-1973	1990's	1990's
Observations	80	80	76	72	42	80	80
<i>R</i> ²	0.71	0.70	0.68	0.50	0.79	0.72	0.70

TABLE 3—SIZE OF GOVERNMENT AND CONSTITUTIONS: INSTRUMENTAL VARIABLES, HECKMAN, AND MATCHING ESTIMATES

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dependent variable	<i>cgexp</i>	<i>cgexp</i>	<i>cgexp</i>	<i>cgexp</i>	<i>cgexp</i>	<i>cgexp</i>	<i>cgexp</i>
<i>pres</i>	-5.29 (2.18)**	-11.52 (4.54)**	-6.51 (3.71)*	-4.22 (3.99)	-5.86 (4.53)	-2.54 (2.26)	-7.30 (2.36)***
<i>maj</i>	-6.21 (2.82)**	-6.77 (1.98)***	-4.83 (3.19)	-4.18 (3.17)	-4.86 (3.57)	-6.59 (3.40)*	-5.76 (2.59)**
Conts & Cols	Yes	Yes	<i>col_uka</i>	<i>col_uka, laam</i>			
Sample	1990's	1990's	1990's	1990's	1990's	1990's	1990's
Endogenous selection	<i>maj</i>	<i>pres</i>	<i>pres</i> <i>maj</i>	<i>pres</i> <i>maj</i>	<i>pres</i> <i>maj</i>	<i>pres</i> <i>maj</i>	<i>pres</i> <i>maj</i>
Estimation	Heckman ML	Heckman ML	2SLS	2SLS	Stratification	Nearest neighbor	Kernel
Rho	0.05 (0.29)	0.62 (0.33)					
Chi-2			3.29	2.23			
Adjusted R^2			0.59	0.59			
Observations	75	75	75	75	65(<i>pres</i>) 67(<i>maj</i>)	65(<i>pres</i>) 67(<i>maj</i>)	65(<i>pres</i>) 67(<i>maj</i>)

TABLE A2—FIRST-STAGE SPECIFICATION
OF 2SLS ESTIMATES

	(1)	(2)
Dependent variable	<i>pres</i>	<i>maj</i>
<i>con2150</i>	−0.04 (0.14)	−0.13 (0.12)
<i>con5180</i>	−0.13 (0.18)	0.28 (0.10)**
<i>con81</i>	0.29 (0.20)	0.12 (0.11)
<i>engfrac</i>	−0.68 (0.13)***	1.09 (0.13)***
<i>eurfrac</i>	0.39 (0.11)***	−0.21 (0.13)
<i>lpop</i>		0.07 (0.02)***
<i>lat01</i>	−1.43 (0.34)***	
<i>age</i>	0.56 (0.31)*	
<i>avelf</i>		0.74 (0.21)***
<i>F</i> -test	4.26***	3.26**
<i>R</i> ²	0.51	0.51
Observations	75	75

Public Policy Outcomes

- But even looking at variables like government spending as a % of GDP and other obvious policy outcomes there are not strong significant correlations with the extent of democracy.
- This is rather surprising. I think what is going on here is an open question. In this course we'll emphasize the idea that democratization is a redistribution of de jure power but this does not necessarily lead to large changes in the balance of power in society because de facto power can move in a direction which will offset this change.
- We will also discuss the idea of “dysfunctional democracy” in the sense that the redistribution of political power which comes with democracy may create perverse incentives for economic policy.

Table 1

Democracy and Spending Policy across Countries

<i>Independent variables</i>	<i>Dependent variable: (each is a percentage of GDP)</i>		<i>Government consumption, 1960–1990</i>	<i>Education spending, 1980–1990</i>	<i>Social spending</i>	
			<i>(1)</i>	<i>(2)</i>	<i>Pension (4)</i>	<i>Nonpension (5)</i>
Democracy index, 1960–1990	-1.27	1.57	0.42	-0.08	0.72	
	(2.14)	(1.99)	(0.52)	(0.44)	(0.63)	
Communist dummy	-0.87	-0.45	1.09	0.82	1.62	
	(1.75)	(1.66)	(0.45)	(0.40)	(0.60)	
British legal origin	2.80	2.91	0.53	-0.35	-0.86	
	(1.28)	(1.17)	(0.31)	(0.28)	(0.40)	
Percentage of population aged 65+, 1960–1990	0.01	0.25	0.07	0.58	0.49	
	(0.25)	(0.23)	(0.06)	(0.05)	(0.07)	
Log(population)/10, 1960–1990	-9.77	-8.16	-2.28	-0.24	0.02	
	(2.54)	(3.36)	(0.86)	(0.76)	(1.08)	
Real GDP per capita, 1960–1989 average, log	-2.96	-4.58	-0.06			
	(0.75)	(0.76)	(0.29)			
Share of value added from agriculture, 1960–1990			-3.38	-1.95	-2.01	
			(1.60)	(0.93)	(1.35)	
Military spending, percentage of GDP		0.60				
		(0.14)				
Adj-R-squared	.27	.38	.25	.78	.65	
Countries	131	125	110	110	102	

Source: “Do Democracies Have Different Public Policies than Nondemocracies?”

Casey B. Mulligan, Ricard Gil, Xavier Sala-i-Martin (2004) *Journal of Economic Perspectives*, 18:1, 51-74.