

Political Economy of Growth

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The Wealth of Nations

- Vast differences in prosperity across countries today.
 - Income per capita in sub-Saharan Africa on average 1/20th of U.S. income per capita
 - In Mali, Democratic Republic of the Congo (Zaire), and Ethiopia, 1/35th of U.S. income per capita.
- Adam Smith's legacy: we have to understand the functioning of markets and organizations to understand the wealth of nations.
 - The invisible hand and markets
 - The division of labor
 - Skills
 - Policies

Rethinking the Wealth of Nations

- Standard economic answers (à la Smith):
 - Physical capital differences (poor countries don't save enough)
 - Human capital differences (poor countries don't invest enough in education and skills)
 - “Technology” differences (poor countries don't invest enough in R&D and technology adoption, and don't organize their production efficiently)
 - Markets (markets don't function in poor countries).are **proximate** causes.
- We need to understand why poor countries don't save enough, don't invest enough, don't develop and use technologies and don't have functioning markets.
- Potential answer: differences in **incentives**

Towards Political Economy of Growth

- Where do incentives come from?
- Adam Smith:
 - “little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.”.
- Potential answer: **institutional differences**
- Institutions: organization of society, “rules of the game”.
- To understand the wealth of nations, we need to understand institutional differences.
- Institutional differences related to **social conflict**.
- To understand social conflict, we need to understand **the political economy of growth**.

Sources of prosperity

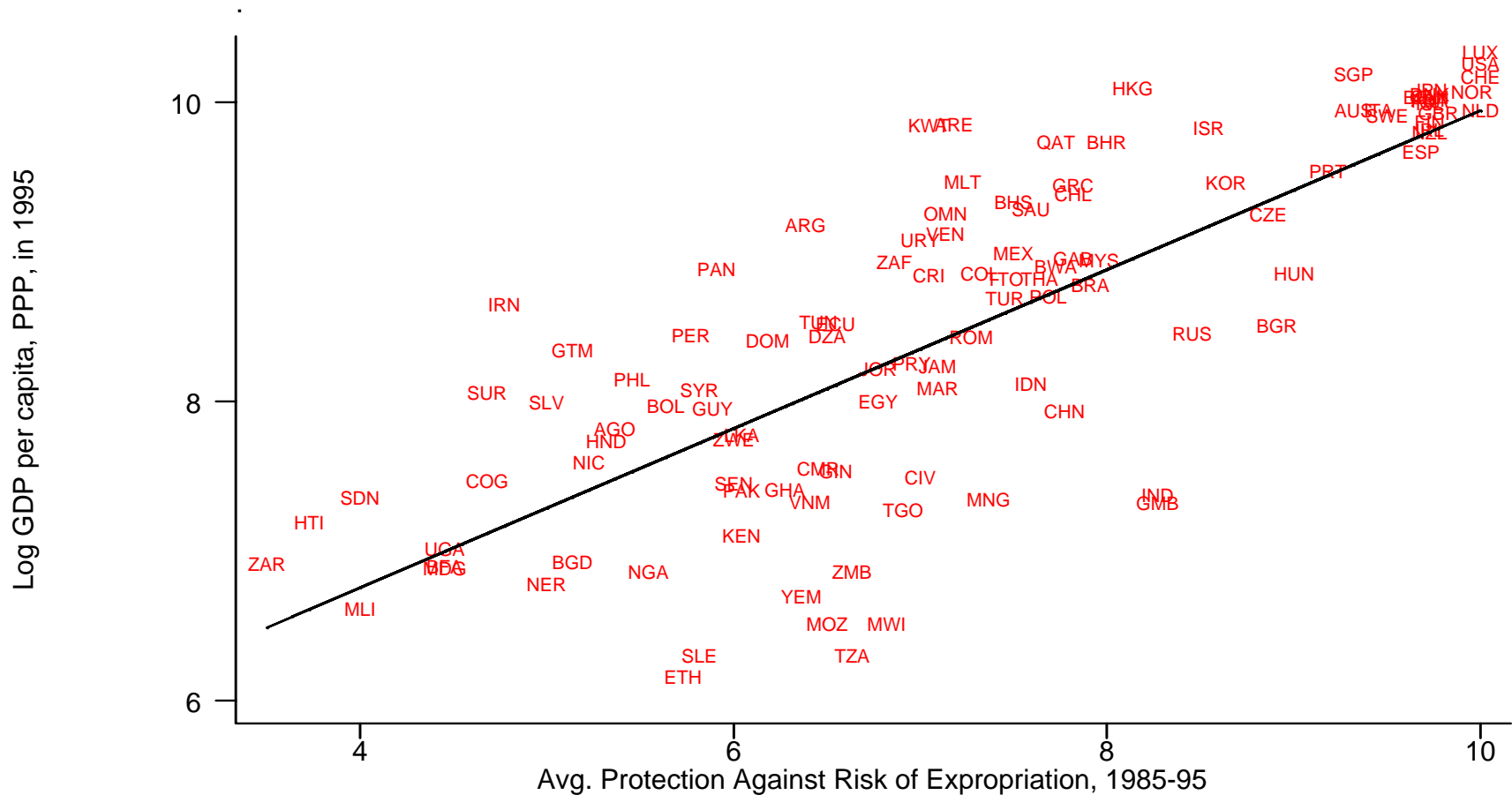
- What lies beneath the proximate causes?
- Potential **fundamental** causes of differences in prosperity:
 - **Institutions** (humanly-devised rules shaping incentives)
 - **Geography** (exogenous differences of environment)
 - **Culture** (differences in beliefs, attitudes and preferences)

What are institutions?

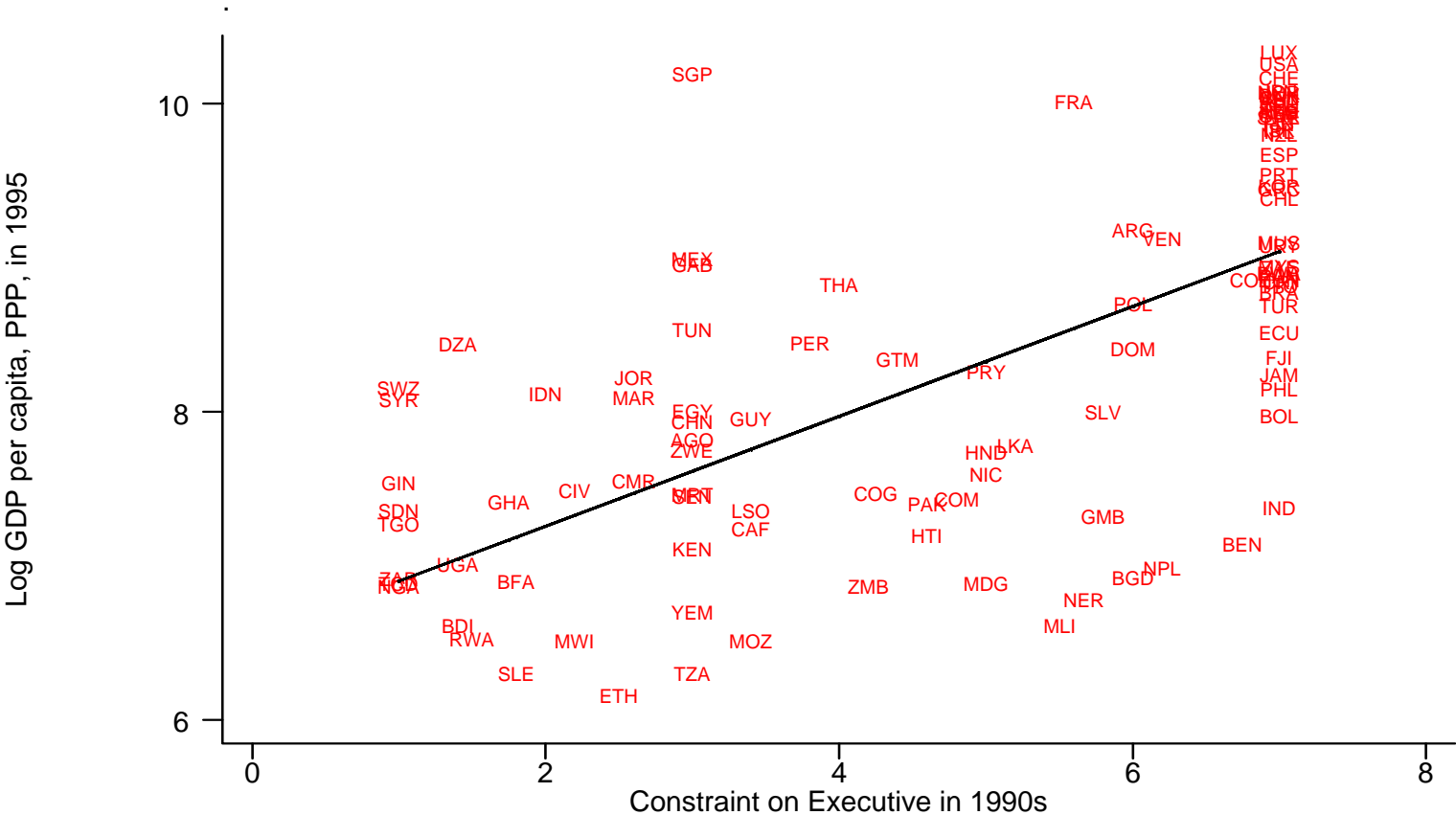
- Institutions: the rules of the game in economic, political and social interactions.
 - Institutions determine “social organization”
- North:

"Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."
- Key point: institutions
 - are humanly devised
 - set constraints
 - shape incentives

Economic institutions and economic performance



Political institutions and economic performance



But institutions are endogenous

- Institutions could vary because underlying factors differ across countries.
 - Geography, ecology, climate
 - Culture
 - Perhaps other factors?
- Montesquieu's story:
 - Geography determines “human attitudes”
 - Human attitudes determine both economic performance and political system.
 - Institutions potentially influenced by the determinants of income.
- **Identification problem:**
 - We can learn only a limited amount from correlations.

Geography hypothesis: Montesquieu

- Montesquieu:
 - “The heat of the climate can be so excessive that the body there will be absolutely without strength. So, prostration will pass even to the spirit; no curiosity, no noble enterprise, no generous sentiment; inclinations will all be passive there; laziness there will be happiness,”
 - “People are ... more vigorous in cold climates. The inhabitants of warm countries are, like old men, timorous; the people in cold countries are, like young men, brave”.
- Moreover, Montesquieu argues that lazy people tend to be governed by despots, while vigorous people could be governed in democracies; thus hot climates are conducive to authoritarianism and despotism.

Geography hypothesis: modern versions

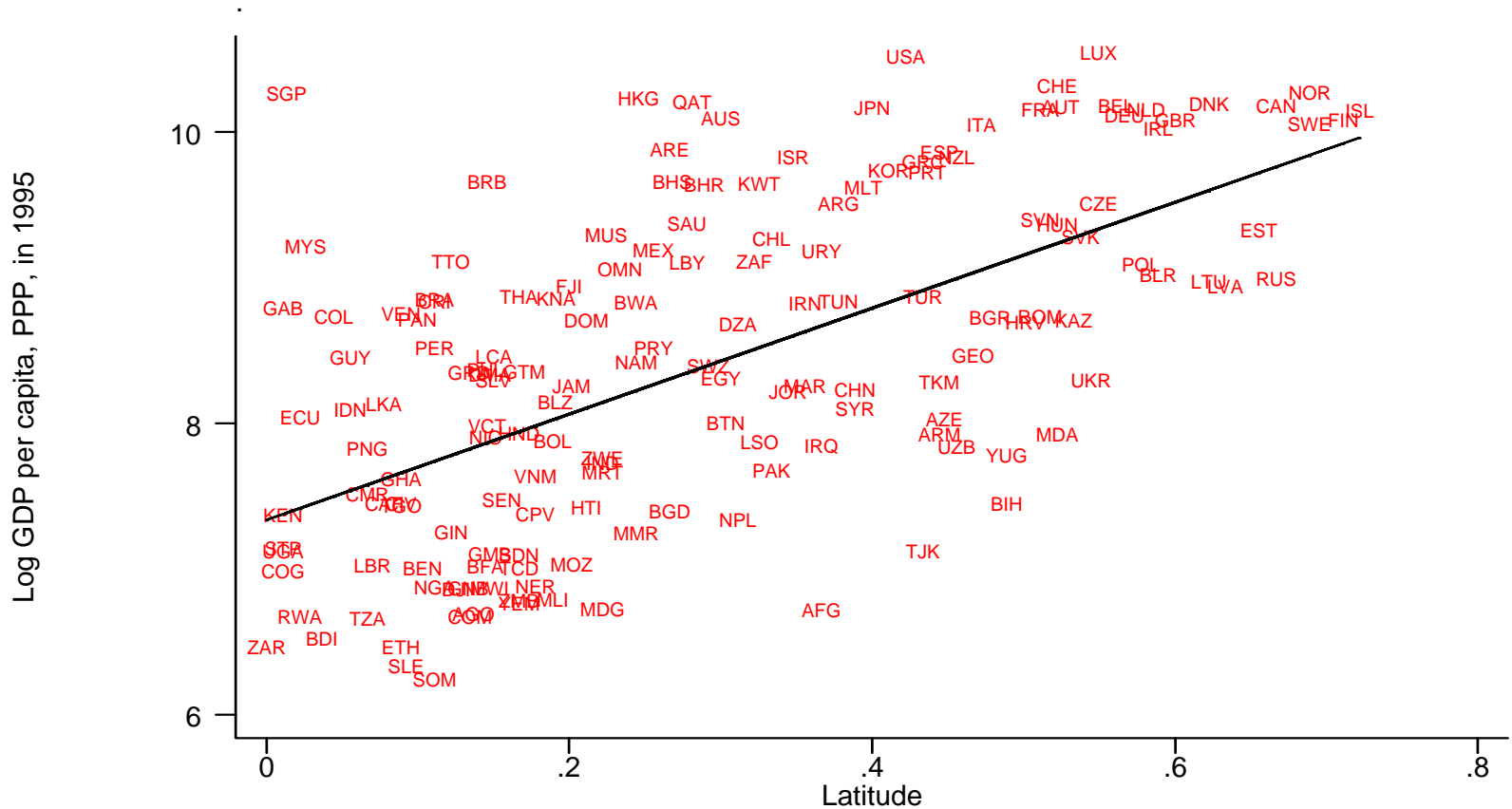
- Jared Diamond:
 - Importance of geographic and ecological differences in agricultural technology and availability of crops and animals.
- Jeff Sachs:
 - "Economies in tropical ecozones are nearly everywhere poor, while those in temperate ecozones are generally rich" because "Certain parts of the world are geographically favored...Tropical agriculture faces several problems that lead to reduced productivity of perennial crops in general and of staple food crops in particular" ...
 - "The burden of infectious disease is similarly higher in the tropics than in the temperate zones"

Culture hypothesis

- Institutions and prosperity may be jointly determined by culture (beliefs, preferences, social norms).
- Max Weber:

"Montesquieu says of the English that they "had progressed the farthest of all peoples of the world in three important things: in piety, in commerce, and in freedom". Is it not possible that their commercial superiority and their adaptation to free political institutions are connected in some way with that record of piety which Montesquieu ascribes to them?"
- Culture closely related to institutions, but different.
 - Not directly chosen by the society for its consequences
 - Not clear how it changes.

Montesquieu's story?



Empirical pitfalls of correlations

- Montesquieu's story example of omitted variables bias and identification problem.
 - Other omitted factors---human nature, culture, geography--- vary across countries and affect economic performance.
 - They also are correlated with or have a causal effect on institutions.
 - Similar problem affects inferences about geography on income; potentially correlated with omitted variables.
- Reverse causality:
 - Income affects institutions.

Need for exogenous variation

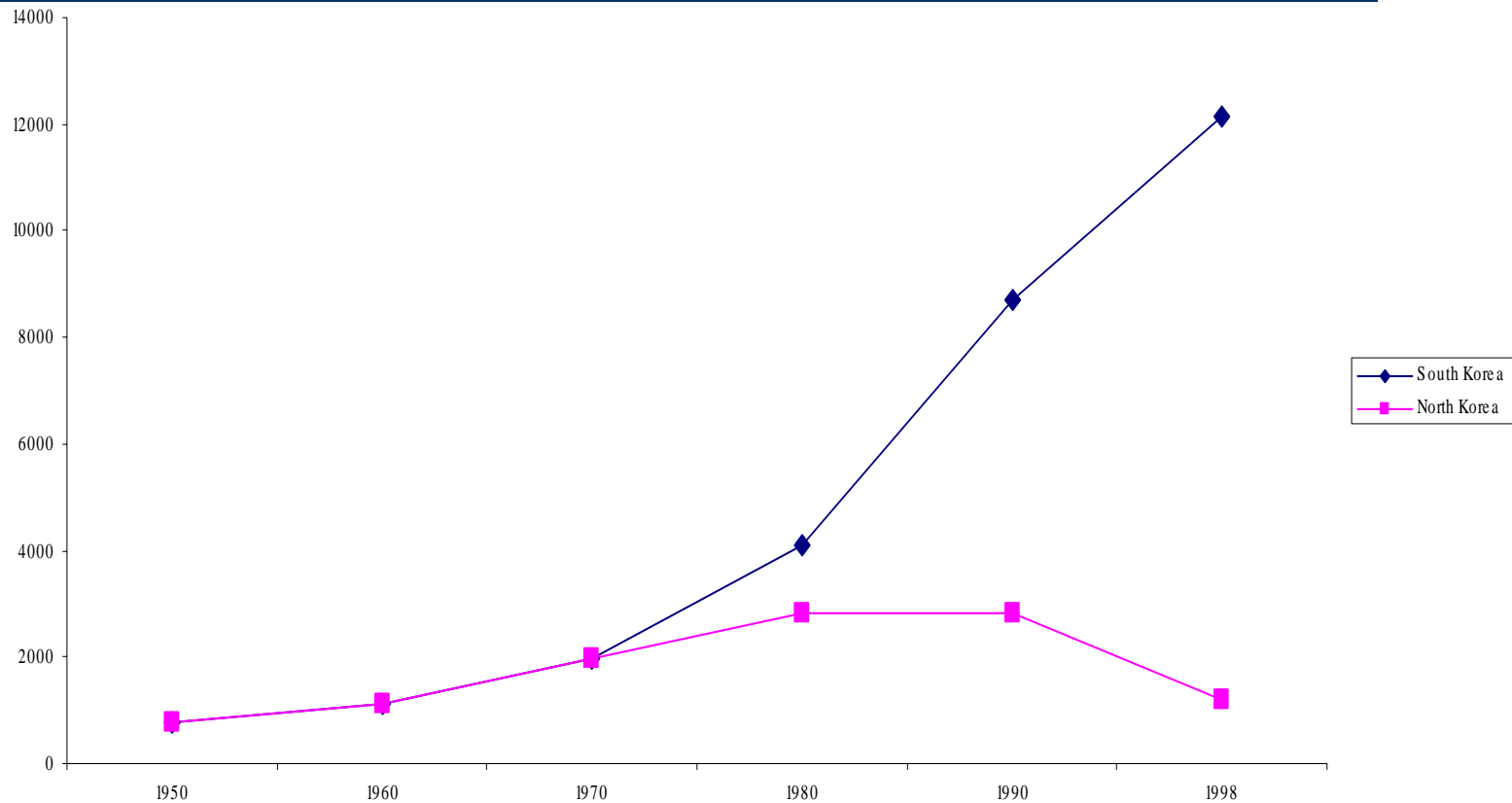
- Exploit “**natural experiments**” of history, where some societies that are otherwise similar were affected by historical processes leading to institutional divergence.
 - Building towards an “instrument” for institutions;
 - a source of variation that affects institutions, but has no other effect, independent or working through omitted variables, on income.
- Examples of potential natural experiments of history:
 1. South versus North Korea
 2. European colonization

The Korean experiment

- Korea: economically, **culturally** and **ethnically homogeneous** at the end of WWII.
- If anything, the North more industrialized.
- “Exogenous” separation of North and South, with radically different political and economic institutions.
 - Exogenous in the sense that institutional outcomes not related to the economic, cultural or geographic conditions in North and South.
 - Approximating an experiment where similar subjects are “treated” differently.
- Big differences in economic and political institutions.
 - Communism (planned economy) in the North.
 - Capitalism, albeit with government intervention and early on without democracy, in the South.
- Huge differences.

North and South Korea

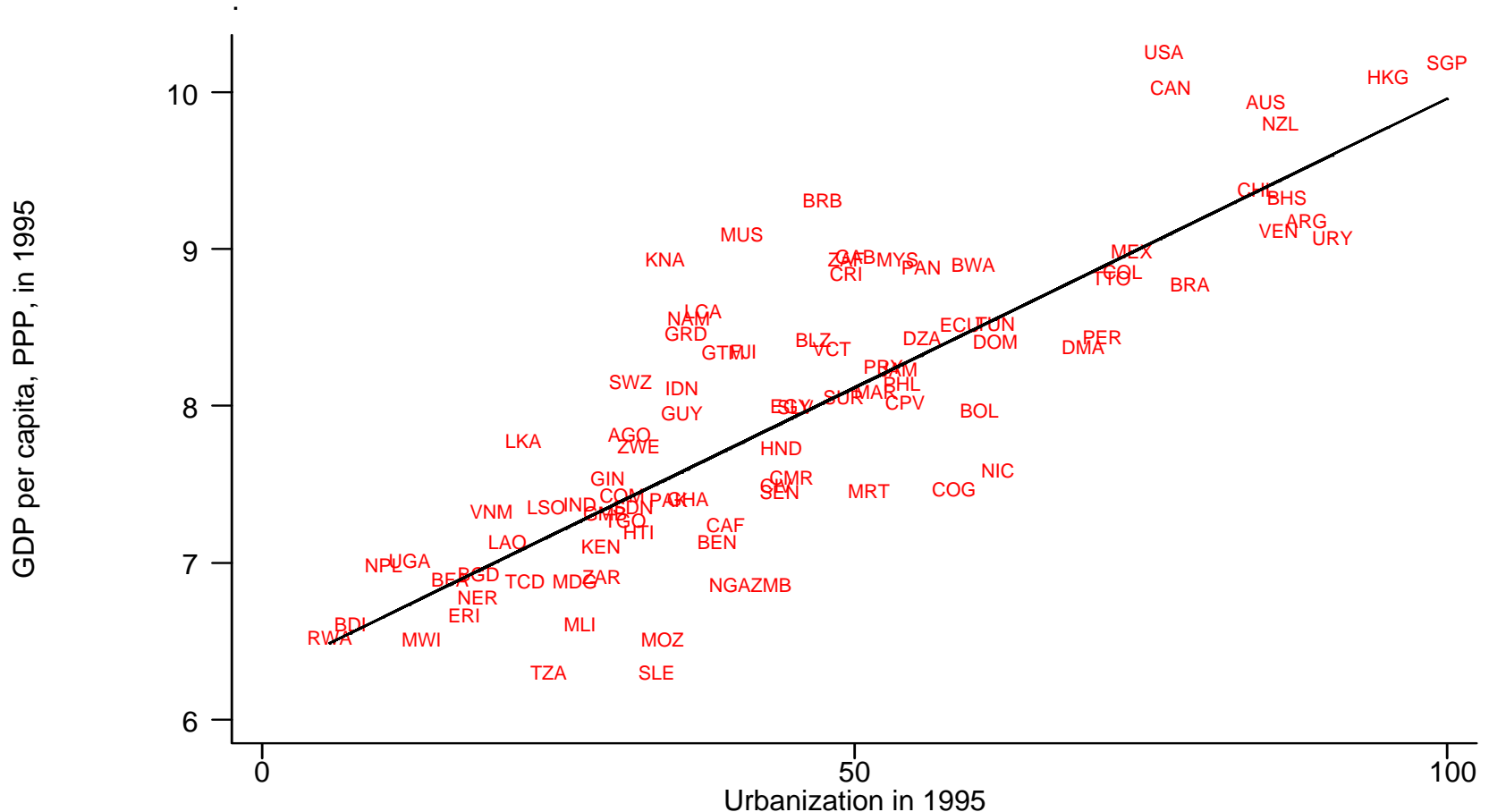
GDP per capita



European colonization as a “natural experiment”

- After the discovery of the New World and the rounding of the Cape of Good Hope, Europeans dominated many previously diverse societies, and fundamentally affected their social organizations (institutions).
- Approximating a “**natural experiment**” because
 - Many factors, including geographic, ecological and climatic ones, constant, while big changes in institutions.
 - Changes in institutions not a direct function of these factors.
 - Analogy to a real experiment where similar subjects have different “treatments”.
- Consequences?
- Look at changes in prosperity from before colonization (circa 1500) to today in the **former colonies sample**.
- Measure of prosperity before the modern era: urbanization rates
 - Supported with information on population density.

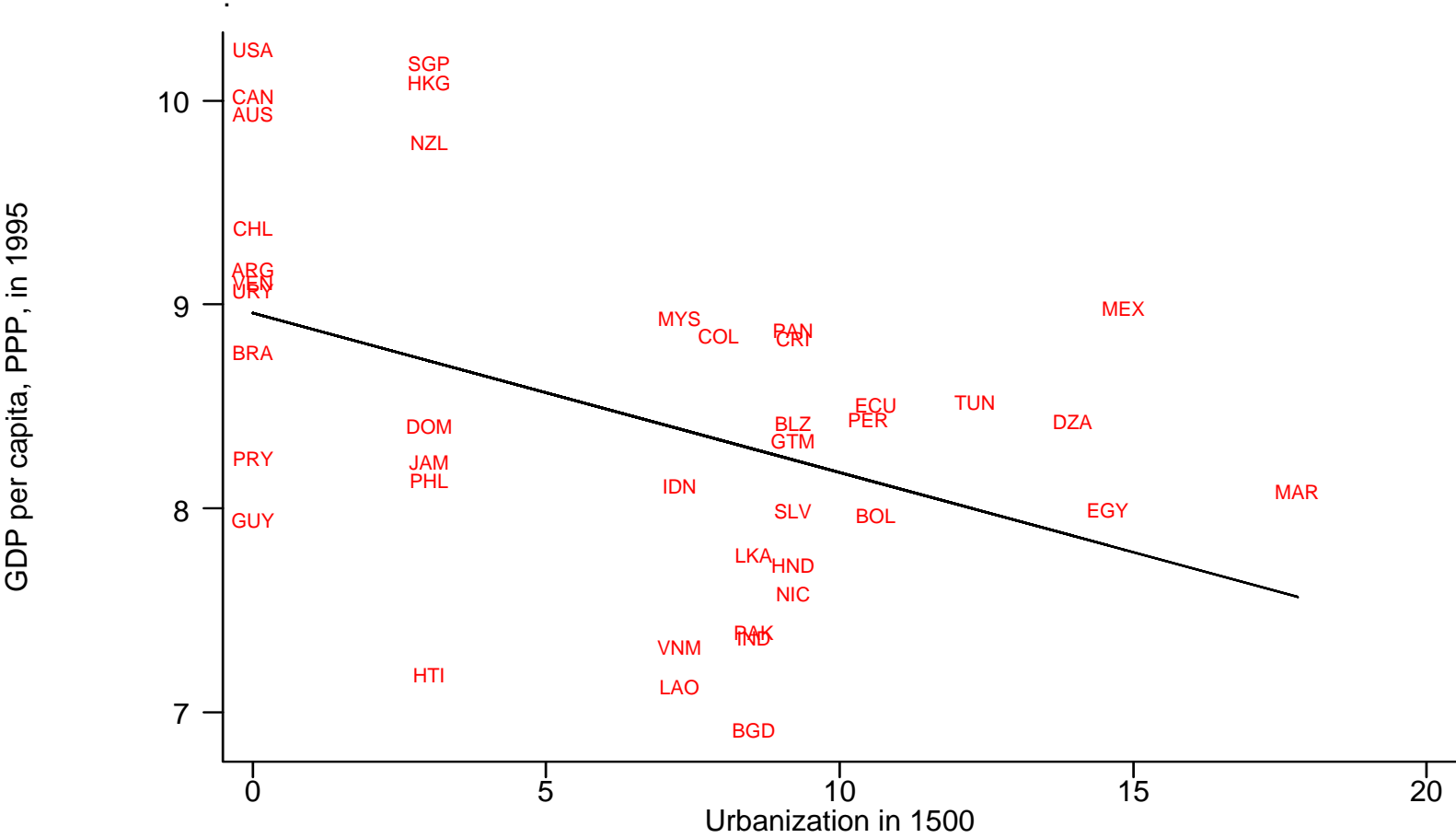
Urbanization and income today



Results: until 1500

- **Persistence** is the usual state of the world.
 - There is “mean reversion” and rise and decline of nations, and certainly of cities.
 - But countries that are relatively rich at a point in time tend to remain relatively rich.
- The data confirm this persistence.
 - After the initial spread of agriculture, there was remarkable persistence in urbanization and population density.
 - Largely true from 1000 BC to 1500 AD, and also for subperiods.
 - More important, true also in the former colonies sample.

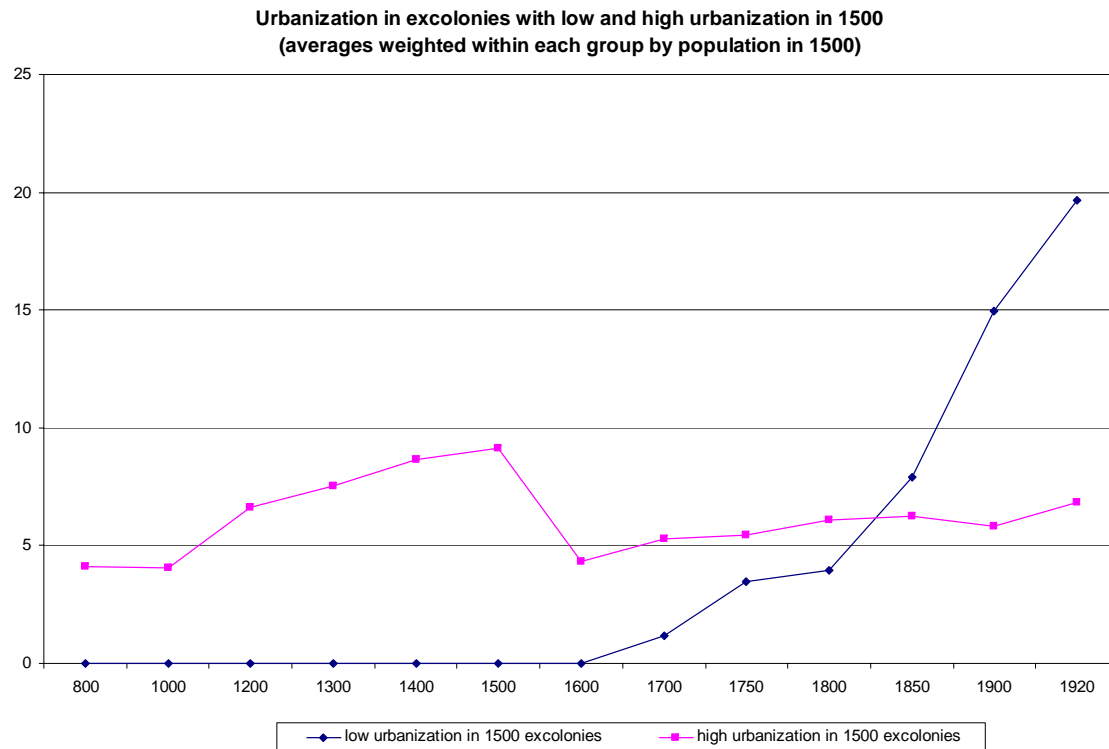
Reversal since 1500 (1)



Reversal since 1500 (2)

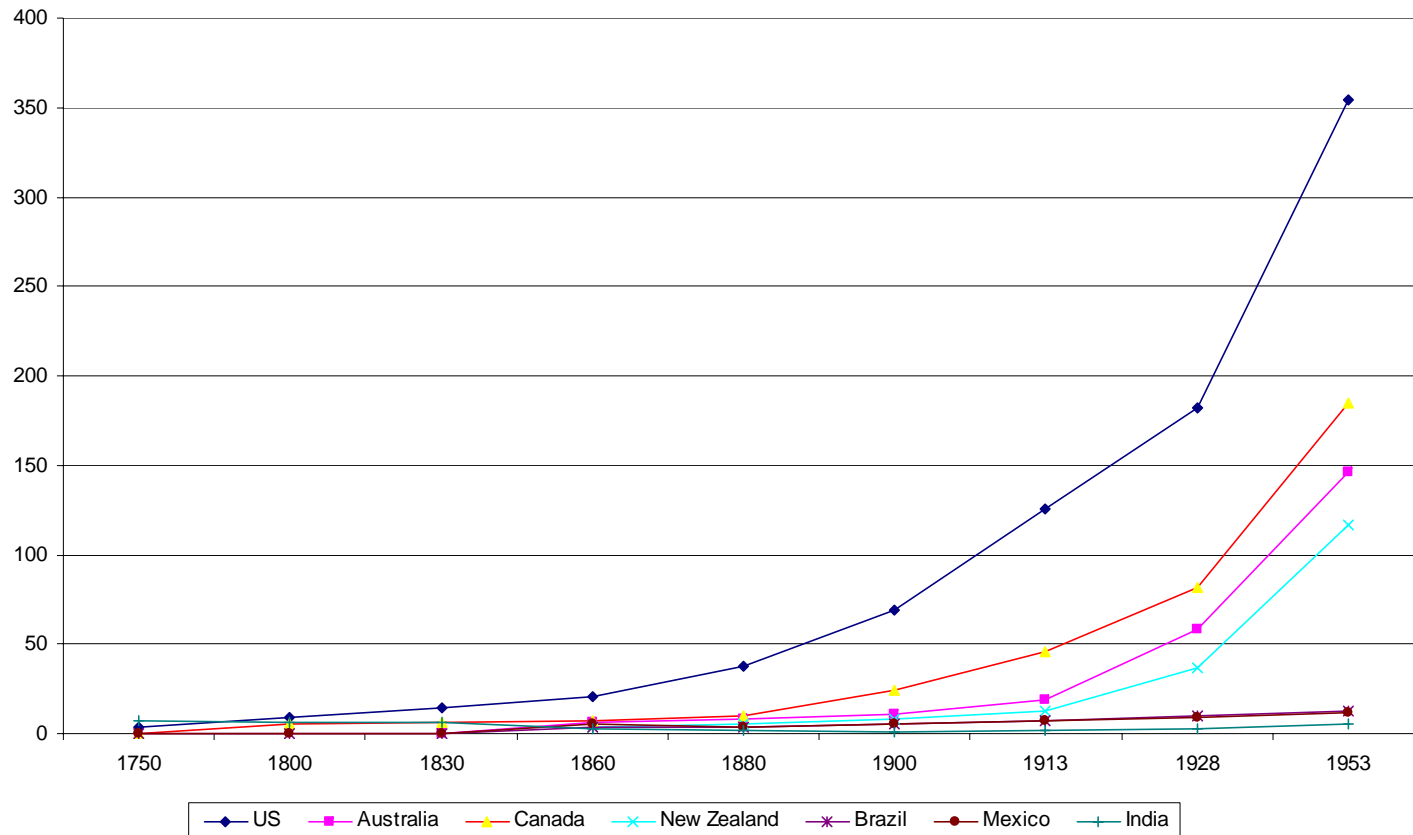


When did the reversal happen?



The nature of the reversal: industrialization

Industrial Production Per Capita, UK in 1900 = 100
(from Bairoch)



What's happening?

- Former colonies with high urbanization and population density in 1500 have relatively low GDP per capita today, while those with low initial urbanization and population density have generally prospered.
 - But gains in the growing societies not always equally shared. Native Indians and aborigines in the New World have all but disappeared.
- (Simple) Geography hypothesis?
 - It cannot be geographical differences; no change in geography.
- Sophisticated geography hypothesis? Certain geographic characteristics that were good in 1500 are now harmful?
 - no evidence to support this view; reversal related to industrialization, and no empirical link between geography and industrialization.

Understanding the patterns from 1500 to 2000

- Reversal related to changes in institutions/social organizations.
- Relatively better institutions “emerged” in places that were previously poor and sparsely settled.
 - E.g., compare the United States vs. the Caribbean or Peru.
- Thus an **institutional reversal**
 - Richer societies ended up with worse institutions.
 - Europeans introduced relatively good institutions in sparsely-settled and poor places, and introduced or maintained previously-existing bad institutions in densely-settled and rich places.
 - E.g.; slavery in the Caribbean, forced labor in South America, tribute systems in Asia, Africa and South America.
- Institutions have persisted and affected the evolution of income, especially during the era of industrialization
 - why to be discussed more below.

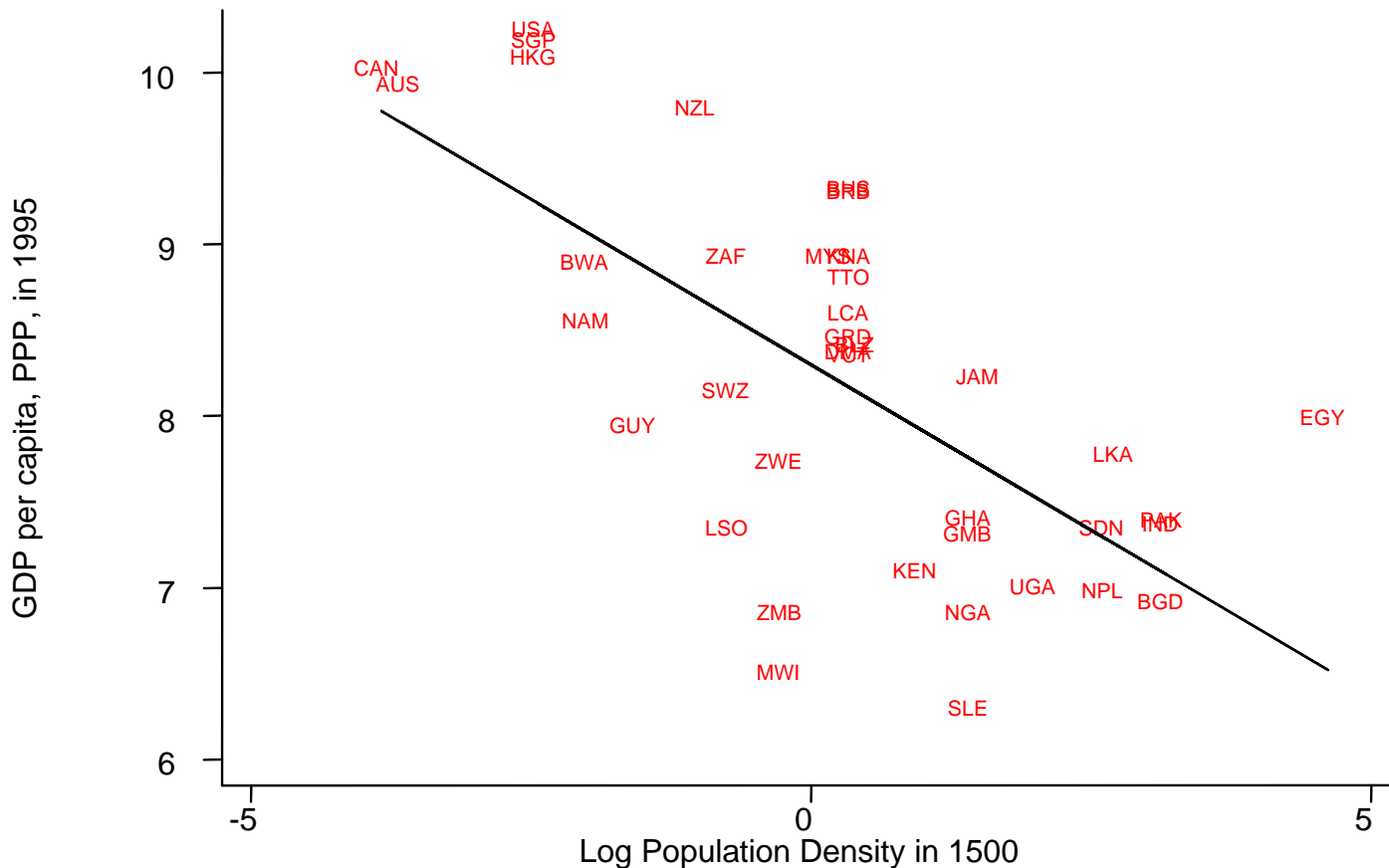
Institutions matter

- Reversal in prosperity resulting from the institutional reversal, combined with persistence in institutions.
 - Countries with “better” institutions prosper, while those with “bad” institutions stagnate or decline.
 - The reversal also emphasizes that the differences are not only between capitalist and communist systems.
 - What matters more is the “type” of capitalism.
- But then why different institutions?
 - And what are “good” and “bad” institutions?
- For now, take good institutions to be those that encourage investment in physical, human capital, and in technology, and bad institutions in the opposite
 - Are the same institutions always good and bad?

Are British colonies special?

- Popular view going back to Adam Smith and Winston Churchill that British cultural and political influence was beneficial, certainly better than that of Spanish and French influence.
- Closely related to the culture view.
- Does the evidence support this view?
- The answer is no.
 - The patterns shown above are robust to controlling for the identity of colonial power.
 - Similar patterns when we look at only British colonies.

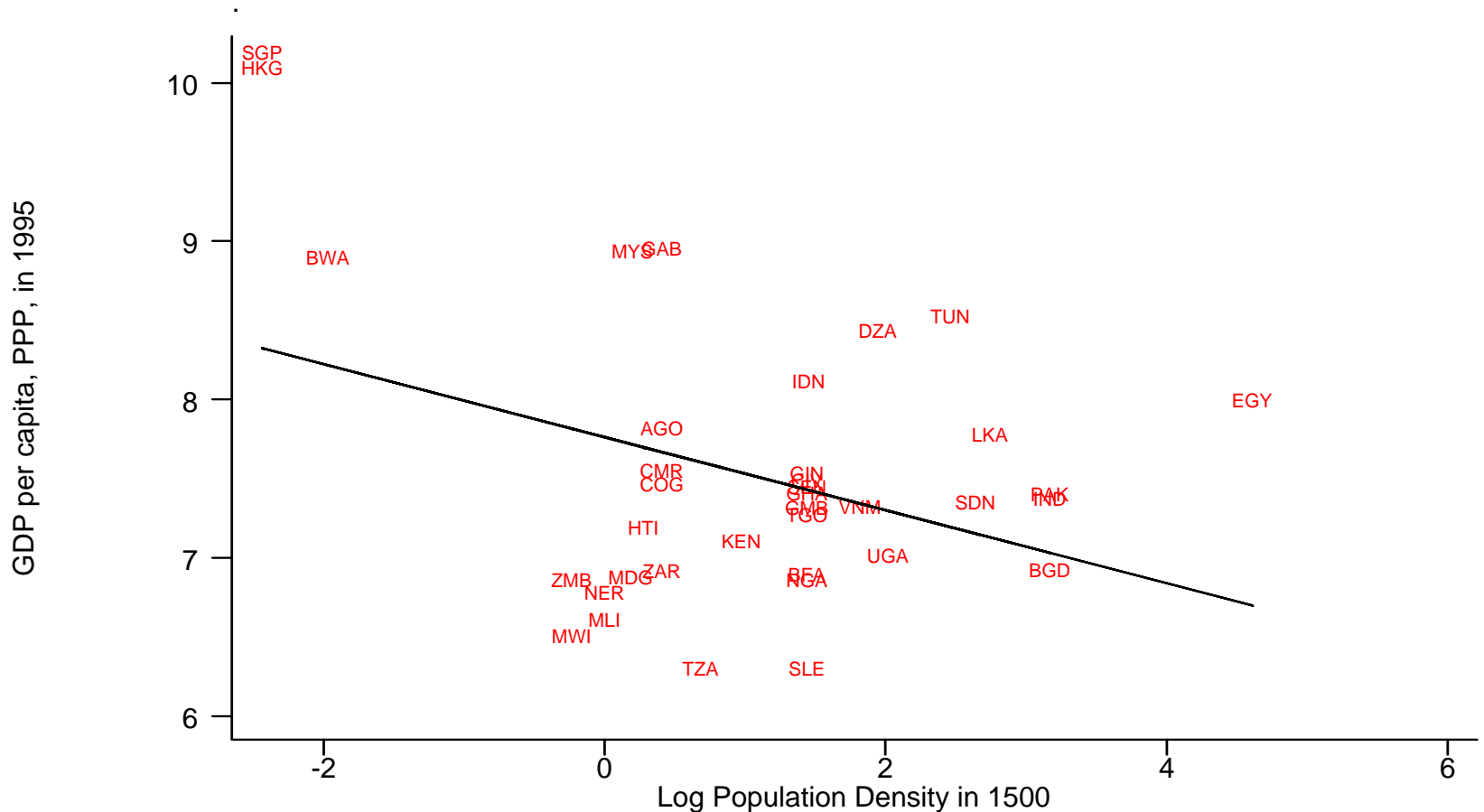
The Reversal among former British colonies



More on the role of culture

- Culture not useful in understanding the Korean divergence
 - North and South were culturally homogeneous.
- Possible that the reversal related to culture.
 - But the growth trajectories of British colonies similarly to Spanish, Portuguese and French colonies once we control for differences in local conditions.
 - Moreover, no econometric evidence that religion matters for understanding the reversal or for long-run growth.
- Reversal also not related to the presence of Europeans.
 - Examples of prosperity in Singapore and Hong Kong, where population is now almost entirely non-European, but institutions protect investment.
- No evidence that European values or culture played a special role.

The Reversal for colonies with less than 1% of European descent in 1975



But why do institutions differ? Towards political economy

- If institutions so important for growth, why do they differ across societies?
 - Answer: **social conflict**.
 - Economic growth, like everything else, creates winners and losers.
 - E.g.: a monopolist would be opposed to a reduction in entry barriers even if these increase aggregate income.
 - Whether growth-promoting institutions will be adopted or not depends on who has **political power** and on checks and balances.
- **Political economy of growth**

Institutions and social conflict

- **Institutions chosen for their economic consequences.**
 - In particular, economic institutions which shape incentives and determine distribution of resources.
- But also taking account of their “distributional implications”
- How does society make decisions in conflictual situations (i.e., when there is no agreement on what should be done?)
- Importance of **political power**
 - Political power: the power to impose or secure social choices against the wishes of other groups.
- Political power → social choices;
- Political power → economic institutions
- Key questions to be addressed later;
 - Where does political power come from?
 - What about political institutions?

Towards the political economy of growth

- When do we expect a society to adopt good institutions?
 1. When those holding political power benefit from property rights (and financial development, free entry, etc.)
 - Importance of creative destruction
 2. When there are relatively few resources to be extracted
 - Importance of factor endowments and resources
 3. When constraints on political power create real checks
 - Importance of political institutions
- **Social conflict and political power** are key.
 - Europeans monopolized political power and set up institutions for their own benefit, even if not beneficial for the society at large.

Understanding the timing of the reversal

- Why did the reversal take place in the 19th century?
- Coercive institutions imposed by Europeans not extremely costly when they dominated the major productive opportunities.
 - E.g., the plantation complex generated investment in sugar production; Barbados, Cuba, Haiti, Jamaica among the richest places in the world at some point between 16th and 19th centuries.
- The major cost of these institutions arises when new opportunities, in this instance in industry and commerce, require investment by new groups, broad-based participation and creative destruction.
 - 19th century was a period of industrialization, and societies with relatively democratic institutions were the ones allowing free-entry by new entrepreneurs.
 - Highlights that the same set of institutions can have very different effects under different circumstances.

Sources of political power

- Two types of political power:
 - **De jure (formal) political power**
 - Allocated by political institutions
 - E.g., political power allocated to a party or Prime Minister by an election.
 - **De facto political power**
 - Determined by economic and military power, or access to extra-legal means
 - E.g., the political power of rebel groups in a Civil War, or of masses who can create social unrest or a revolution.
 - De facto political power typically relies on military superiority or on solving the “collective action problem”.
- Distribution of political power in society determined by the distribution of de jure and de facto political power.

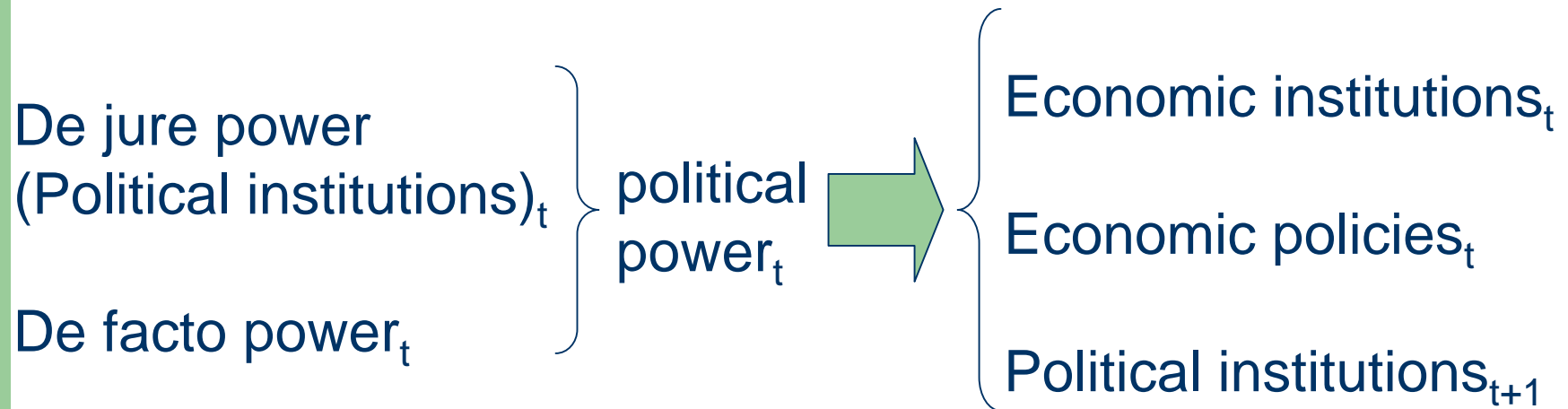
Economics and political power

- The interplay between economic institutions and political power adds to institutional persistence.
 - Political power → economic institutions
 - Economic institutions → distribution of resources
 - Distribution of resources → de facto political power
- A non-level playing field in the economy favors those with political power, which in turn increases their political power further
 - Example: colonialism in the Caribbean;
 - planters monopolized political power, which enabled them to capture the majority of the gains from sugar and other products.
 - The planters' incomes enabled them to dominate military power and control the state → persistence of the system

A “theory” of institutions

- Economic institutions essential for the prosperity of nations
 - But also benefit different groups and individuals → social conflict
- In the presence of social conflict;
 - **political power → economic and political institutions**
 - good institutions emerge when they benefit those with political power.
 - **political institutions → de jure political power**
 - Constraints on elites often conducive to better institutions.
 - **de facto political power → political institutions → de jure political power, both today and in the future**
 - Toward a theory of institutional change
 - **political power → institutions → political power**
 - Source of persistence.

Schematic representation



Conclusions

- Growth intimately linked to institutions.
 - Central to understand the **political economy of growth**.
- Progress towards a useful framework for thinking about institutions and political economy of growth.
- Emerging framework:
 - **formal theory** + careful **econometric** research
- Much research left to be done
- Future areas:
 1. Unbundling institutions
 2. Institutional persistence
 3. Institutional change
 4. Policy to influence institutions? (further further in the future!)