Origin, Persistence and Institutional Change

Lecture 10 – based on Acemoglu’s Lionel Robins Lecture at LSE
Four Views on Origins of Institutions

1. Efficiency: institutions that are efficient for society (e.g., for aggregate growth or welfare) will be adopted.

2. Ideology: differences in beliefs determine institutions (societies choose radically different institutions because citizens or elites have different beliefs about what’s good for economic growth).
   - Perhaps North Korea chose planned economy because its leaders believed it was “better”.

3. History: institutions determined by historical accidents or unusual events, and are unchanging except for random events and further accidents.
   - Legal system today determined by past historical accidents.

4. Social conflict: institutions chosen for their distributional consequences by groups with political power.
The Efficiency of Institutions View

Efficient institutions view:

– Every set of institutions creates different losers and beneficiaries. Efficient institutions require either the losers to be compensated or the beneficiaries to impose their choice.

– But in practice, losers generally not compensated ex post, and often can be powerful enough to block institutional change that is beneficial in the aggregate.

– Although, *everything else equal*, there would be a tendency to adopt efficient institutions, everything else far from equal in practice.

– Empirically, efficient institutions view cannot help us understand why some societies adopt institutions that were disastrous for economic growth.

-> not a useful framework
Ideology View

Ideology view:
– Beliefs across societies differ: institutional reforms are shaped by beliefs
  • Propaganda and media extremely important for regime survival

– Some empirical patterns cannot be explained by ideology.
  • Koreas: the original divergence in institutions ideological, but the persistence of communist system – not: those with political power want the continuation of the system.

– Explaining the institutional reforms at the onset of transition but does not explain the institutional divergence after

→ partly useful framework
Historical Accidents View

Examples:
– While the communist system persisted in North Korea, it collapsed in Eastern Europe and Russia.
– Persistence in China until 1978 and change thereafter.
– Very different institutions in North and South America during the early colonial era and after independence.

These are *choices*, not simply dictated by history.

Need to understand why institutions persist, and why, and how, they change.

⇒ Partly useful framework
Social Conflict View: Motivation

Institutions and social conflict:

(Economic) Institutions shape incentives and determine the allocation of resources

– Each set of institutions creates beneficiaries and losers; certain groups obtain high incomes, rents and privileges.
– Thus “distributional” implications from institutional choices.
– Preferences over institutions determined by their distributional implications.
  – Example: monopolist would be opposed to a reduction in entry barriers even if these increase aggregate income.

– Social Conflict View empirically more promising:
  - We can explain inefficient choices
  - Also we can investigate when institutions will be more or less efficient by performing “comparative statics” exercises
  - Policy implications relevant
Social Conflict View: Details

– Economic institutions chosen for their economic consequences: determine distribution of resources
– Makes sense taking into account of their “distributional implications”
– How does society make decisions in conflicting situations? (when no agreement on what should be done): round tables for compromise or…?

Importance of *Political power*: the power to impose or secure social choices against the wishes of other groups.
  – Political power $\rightarrow$ social choices;
  – Political power $\rightarrow$ economic institutions

Questions to consider:
• Where does political power come from?
• How are political institutions shaped?
Social Conflict View: Examples

• Financial institutions in Mexico and the U.S. in the 19th c. during the critical period of income divergence: highly competitive banking system in the US, highly monopolized in Mexico → efficient allocation of capital in US; lending to friends and insider firms in Mexico

• 21st c. Bulgaria: “one trader-one pavilion” rule changes in favor of larger traders who can now use many pavilions at the same time

• Explanation: the (lack of) political power of the affected groups
Summary of views

Institutions not dictated purely by history, but chosen by society.

They are chosen neither for efficiency nor because of differences in beliefs, but for their distributional consequences.

– Social conflict and political power important.
– In all cases economic institutions chosen for their consequences, and particularly the rents created for the politically powerful groups.
– In almost all cases, the resulting economic institutions harmful for certain groups, and in many cases harmful for society at large.

Key lesson:

political power $\rightarrow$ economic institutions $\rightarrow$ political power $\rightarrow$
Implications of social conflict view

When do we expect a society to adopt good institutions?

1. When those holding political power also will benefit from well-enforced property rights (and financial development, free entry, functioning markets etc.)

2. When there are relatively few resources to be extracted or exploited using political power (poorer natural resources, lower population density)

3. When constraints on political power preclude expropriation or the imposition of institutions detrimental to excluded groups:

   → societies with relatively democratic institutions were the ones allowing free-entry by new entrepreneurs

Discussion: formulate empirically testable predictions from the theory implications above
Is BG Democracy an Oligarchic Regime?

Oligarchic structures, where the rich dominate politics, may generate investment, because the rich will have incentives to protect their own property rights.
– However, oligarchy also costly: Costly because it creates a non-level playing field and a potential hold-up problem because power is monopolized by the rich.
– What is there to stop oligarchs from expropriating others, or erecting entry barriers to protect their monopoly positions?

Consequences:
• More efficient producers do not enter and invest enough → lower aggregate welfare
• Persistence of inefficient institutions favoring the elite

Problem: how to transition from oligarchy to a democracy?
Emergence of Democracy

In the early 19th century Western Europe: political power in the hands of rich elite.

– In Britain extremely limited franchise with less than 2 percent of the population with the vote → Policies and economic institutions looking after the interests of the rich elite.

Challenge from excluded groups, threat of revolution, making concessions necessary.

– Industrialization increased power of workers and the poor.
– Unusual circumstances and solution to collective action problem further increased de facto political power for excluded masses.
– Social unrest, possible revolution; some response necessary
Emergence of Democracy

Response:

Promises of pro-poor policies and changes in economic institutions within the non-democratic system: credible or not credible?

– Standard problem of commitment with political power
– Credible commitment to future pro-poor policies $\rightarrow$ change political institutions to increase the political power of the poor, democratization

Democracy $\rightarrow$ the poor have more political power than in non-democracy.

Democratic political institutions also harder to reverse than policies. Thus:

– temporary de facto political power (threat of revolutions) $\rightarrow$ change in political institutions $\rightarrow$ change in future political power $\rightarrow$ change in policies, economic institutions and outcomes.
Decline of Monarchies: the context

Average population in Atlantic ports, Mediterranean ports, and West European cities not ports (balanced panel)
Decline of Monarchies: the consequences of trade

• Changing environment: opening of trade routes to New World and Asia via the Atlantic.

• Different effects of this new economic opportunity depending on economic and political institutions
  – In countries with some degree of entry into foreign trade (i.e., Britain and the Netherlands): new groups of merchants enriched.
  – In countries with tight crown monopoly of trade (i.e., Spain, Portugal, France), the monarchy and its allies became the main beneficiaries
  – For countries without access to the Atlantic; no direct benefits and indirect costs through diversion of trade
Decline of Monarchies: the social conflict underway

Social conflict:
In Britain and the Netherlands: merchants and segments of landowners demand greater security of property rights, lower taxes and free entry into foreign trade.

- New merchants’ greater economic fortunes increased their *de facto* political power.
  - De facto power not granted: Atlantic shock + solution to the collective action problem
- Forces against the monarchy led and largely financed by mercantile interests, especially those benefiting from overseas trade.
- In fact, merchants and their allies demanded not only changes in economic institutions but changes in political institutions.

In Spain and Portugal, the monarchy remained strong. Why? economic institutions implied a different distribution of gains, and therefore the distribution of *de facto* political power was very different

→ no regime change, institutional persistence
Institutional persistence: some things we know

• Institutions are by their nature durable:
  → democracy more likely tomorrow if today there is democracy than if dictatorship today.

• Bad institutions create bad incentives and self-sustain:
  → an extractive state apparatus will give incentives to political elites to use it for extraction.

• Bad institutions create instability and self-replicate:
  → if controlling the state is a major source of rents, there will be incentives to control the state

• Bad institutions affect the composition of assets and distribution of income, contributing the persistence:
  → bad institutions → greater inequality → political power of the rich to sustain bad institutions.
Institutional persistence: an illustration of the problem

• The interplay between economic institutions and political power adds to institutional persistence.
  – De jure 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

How was it during socialism in the eastern bloc?
How about during ‘democracy’ in BG?
Institutional persistence: policy implications for reforms

- In the presence of social conflict:
  - good institutions emerge when they benefit those with political power.
- Constraints on elites often conducive to better institutions

- Discussion: How to make the de facto politically powerful groups less powerful?
Understanding institutional change

Recall:

– Political institutions $\rightarrow$ economic institutions. Thus important to understand change in political institutions
– Political institutions a way of regulating the allocation of future political power

Two sources of change:

1. Elite-driven versus conflict-driven:
   • Elite-driven: when the politically powerful elite wish to change institutions in order to increase its rents/utility
   • Conflict-driven: when institutional change forced from the non-elites: Rise of democracy because of the threat of revolution; Rise of constitutional monarchy resulting from the fight between the crown and groups of merchants

2. Internal versus external
   • Internal shocks: the rise of trade in Britain, increase in the middle class in China
   • External shocks: EU membership; Crimean peninsular.

Is ignoring internal dynamics helpful to reform?
Readings

• Acemoglu, Johnson, Robinson (2005). Institutions as the Fundamental cause of Long-Run Growth. Handbook of Economic Growth, Volume IA. Edited by Philippe Aghion and Steven N. Durlauf (pp. 421-428; 448-463)

• A better copy at: http://www.nber.org/papers/w10481 (the NBER WP version of the chapter)

• Acemoglu: Understanding institutions, Lionel Robbins Lectures at LSE