

Origin and Effects of Economic Institutions

Lecture 8

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- 1 Origin of Institutions
- 2 A Political Economy of Institutions
- 3 Ronald Coase and History
- 4 Contemporary Issues

Two Ways to Do History of Institutions

- 1 listing when an institution appeared in which country: a shopping list of facts, without understanding the reasons why the historical fact has finally occurred at its time and its place
- 2 using data to understand what shaped institutions in the way they were shaped across a number of countries

Institutions

Rules of behavior: formal or informal

The Colonial Origins of Comparative Development

An Empirical Investigation by Acemoglu, Johnson and Robinson (2001)

Deal with:

- ① how institutions affect economic performance
- ② where do institutions come from

A traditional empirical design: $GDP = \alpha + \beta INST + \gamma X + \varepsilon$

However, ε affects both \rightarrow spurious results.

The gap: “We lack reliable estimates of the effect of institutions... It is likely that rich economies choose better institutions + economies that are different for a variety of reasons will differ both in their institutions and in their income per capita.” \rightarrow a need of source of exogenous variation in institutions.

The contribution: “In this paper, we propose a ... possible source of exogenous variation:” the settler mortality

Settler mortality

The main point

European settlers' mortality → settlements → early institutions → current institutions → current economic performance

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THE AMERICAN ECONOMIC REVIEW

DECEMBER 2001

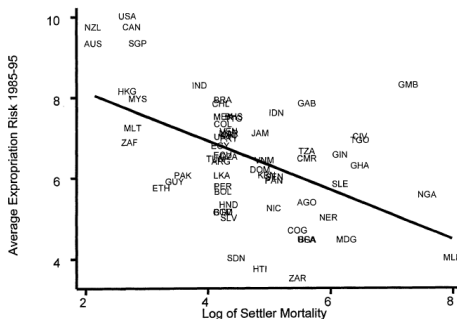


FIGURE 3. FIRST-STAGE RELATIONSHIP BETWEEN SETTLER MORTALITY AND EXPROPRIATION RISK

A proxy for institutions: expropriation risk

Settlers' mortality

So what?

European settlers' mortality → settlements → early institutions → current institutions → current economic performance

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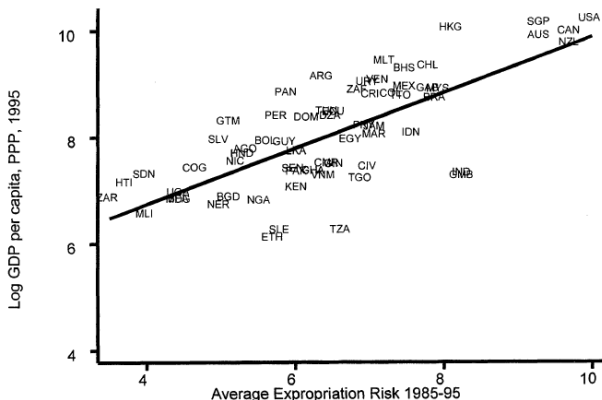


FIGURE 2. OLS RELATIONSHIP BETWEEN EXPROPRIATION RISK AND INCOME

Settlers' mortality

So what?

So what:

- “Countries with better “institutions,” more secure property rights, and less distortionary policies will invest more in physical and human capital, and will use these factors more efficiently to achieve a greater level of income.”;
- “Colonies where Europeans faced higher mortality rates are today substantially poorer than colonies that were healthy for Europeans.”

AJR theory in further detail

Different types of colonization

Two extreme types of early European colonization:

- 1 **Extractive states:** the main purpose of the extractive state was to transfer as much of the resources of the colony to the colonizer
- 2 **Neo-Europes** (Alfred Crosby, 1986): The settlers tried to replicate European institutions, with strong emphasis on private property and checks against government power: AUS, NZL, CAN, USA.

AJR theory in further detail

Origin and Persistence over time

How did extractive states V Neo-Europes come to exist?

→ The feasibility of settlements: In places where the disease environment was not favorable to European settlement → extraction more likely

Once established, institutions change slowly and persist even after gaining independence from Europeans

The Gap: "We are not aware of others who have pointed out the link between settler mortality and institutions"

Data: We use data on the mortality rates of soldiers, bishops, and sailors stationed in the colonies between the seventeenth and nineteenth centuries

Comments: Once the effect of institutions on economic performance is controlled for, neither distance from the equator nor the dummy for Africa is significant → Africa is poorer than the rest of the world not because of pure geographic or cultural factors, but because of worse institutions.

A Political Economy of Institutions

Persson and Tabellini's *The Economic Effects of Constitutions*

A review by Acemoglu:

A good understanding of how different organizations of markets lead to different economic outcomes. But:

- why are markets organized differently in different societies?
- why do policies differ over time, across countries and more broadly across polities?
- why, do some governments impose price controls while others do not intervene?

Political economy: a framework for thinking about why policies and institutions differ across countries or within a country over time

How to aggregate collective preferences? The central working hypothesis has been that agents - as voters, lobbyists, revolutionaries, politicians - have induced preferences over policies: their preferences over policies are shaped by their preferences over the outcomes that will be induced by the policies.

A Political Economy of Institutions

Main results of Persson-Tabellini

Main results:

- 1 Presidential and majoritarian systems have smaller governments than parliamentary and proportional representation systems.
- 2 Majoritarian systems also have smaller welfare state spendings and budget deficits.
- 3 Parliamentary systems have more "*persistent fiscal outcomes*" than presidential system: increases in government spending during downturns not reversed in booms.
- 4 Proportional representation leads to a greater expansion of welfare spending close to elections.

Conclusion:

- Institutions matter for shaping economic performance;
- Certain traits of institutions matter more than others

The institutional structure of production (1937)

Ronald Coase's contribution to understanding history

Coase's contribution:

- 1 The Nature of the Firm (1937): (1931 observation): The view of the pricing system as a coordinating mechanism was clearly right, but there were aspects of the argument which troubled me... we had a factor of production – management – whose function was to coordinate. Why was it needed if the pricing system provided all the coordination necessary? I found the answer by the summer of 1932. It was to realize that *there were costs of using the pricing mechanism*.

Prices have to be discovered. There are negotiations to be undertaken, contracts have to be drawn up... arrangements have to be made to settle disputes... These costs have come to be known as *transaction costs*.

The contribution of this article: the explicit introduction of transaction costs into economic analysis. The existence of transaction costs leads to the *emergence of the firm*.

The problem of social cost (1962)

Ronald Coase's second contribution to understanding history

Coase's contribution:

- Coase theorem: In a regime of zero transaction costs – an assumption of standard economic theory – negotiations between the parties would lead to those arrangements being made which would maximize wealth and this irrespective of the initial assignment of rights.

The significance of the Coase theorem:

- there is no economy with zero TC
- inefficient allocation of resources is normal
- reducing TC may bring the economy closer to efficient allocation of resources

“Until quite recently, most economists seem to have been unaware of this relationship between the economic and legal systems except in the most general way.”

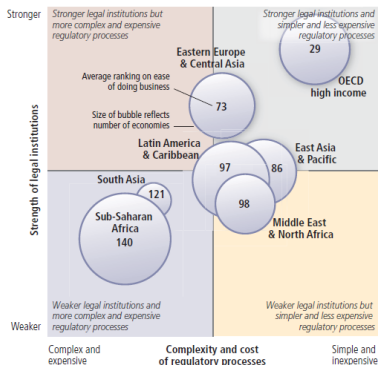
“The time has surely gone in which economists could analyze in great detail two individuals exchanging nuts for berries on the edge of the forest and

How legal provisions affect the economy?

Correlation b/w regulatory processes and the legal institutions

FIGURE 1.1 OECD high-income economies combine efficient regulatory processes with strong legal institutions

Average ranking on sets of *Doing Business* indicators



Note: Strength of legal institutions refers to the average ranking on getting credit, protecting investors, enforcing contracts and resolving insolvency. Complexity and cost of regulatory processes refers to the average ranking on starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders.

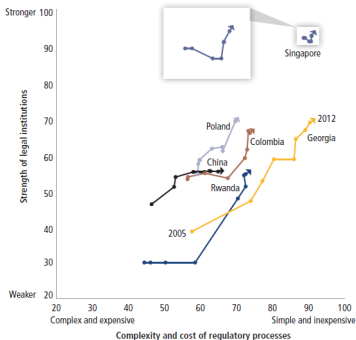
Source: *Doing Business* database.

Correlation across countries

How legal provisions affect the economy?

Correlation b/w regulatory processes and the legal institutions

FIGURE 1.7 Different economies have followed a variety of regulatory reform paths
Average distance to frontier in sets of *Doing Business* indicators (percentage points)



Note: Strength of legal institutions refers to the average distance to frontier in getting credit, protecting investors, enforcing contracts and resolving insolvency. Complexity and cost of regulatory processes refers to the average distance to frontier in starting a business, dealing with construction permits, registering property, paying taxes and trading across borders. Each dot refers to a different year, starting in 2005 and ending in 2012. The reform progress of Singapore, the economy with the most business-friendly regulation for the seventh year in a row, is shown for purposes of comparison. For visual clarity the series for Singapore starts in 2007. The distance to frontier measure shows how far on average an economy is from the best performance achieved by any economy on each *Doing Business* indicator since 2005. The measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier).

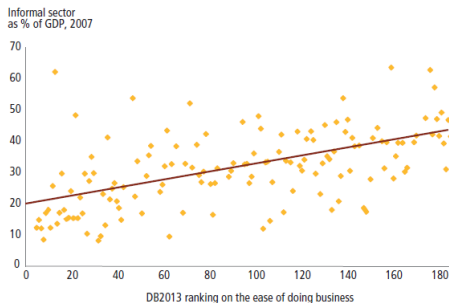
Source: *Doing Business* database.

Correlation within a country over time

How legal provisions affect the economy?

The role of cheaper doing business for informality

FIGURE 2.2 Higher levels of informality are associated with lower *Doing Business* rankings



Note: The correlation between the 2 variables is 0.57. Relationships are significant at the 5% level after controlling for income per capita. The data sample includes 143 economies.

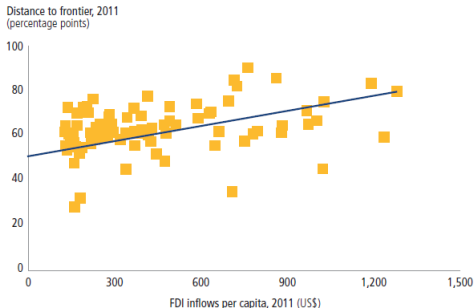
Source: *Doing Business* database; Schneider, Buehn and Montenegro 2010.

Expensive to do business in the legal economy: you start up in the shadow economy.

How legal provisions affect the economy?

Doing business and FDI

FIGURE 7.1 Better overall regulation is correlated with more FDI inflows per capita



Note: The distance to frontier measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier). Sample includes 157 economies with positive 2011 FDI inflows per capita of \$1,500 or less. This includes all economies covered by *Doing Business 2012* for which data are available, excluding outliers with negative inflows or inflows greater than \$1,500 per capita. Dropping these outliers does not significantly affect the trend line.

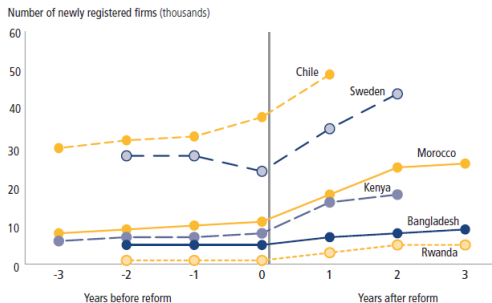
Source: *Doing Business* database; United Nations Conference on Trade and Development, UNCTADstat database.

Countries closer to the reform leaders attract more FDI.

How legal provisions affect the economy?

Starting a business made easier

FIGURE 1.9 More new firms are registered after reforms making it simpler to start a business



Note: All 6 economies implemented a reform making it easier to start a business as measured by *Doing Business*. The reform year varies by economy and is represented by the vertical line in the figure. For Bangladesh and Rwanda it is 2009; for Chile, 2011; for Kenya, 2007; for Morocco, 2006; and for Sweden, 2010.

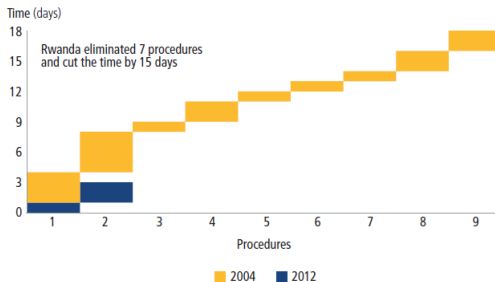
Source: World Bank Group Entrepreneurship Snapshots, 2012 edition.

Cheaper start-up reduces TCs → makes more people start a business.

How legal provisions affect the economy?

Starting a business made easier: the case of Rwanda

FIGURE 5.1 Rwanda streamlined the procedures for starting a business



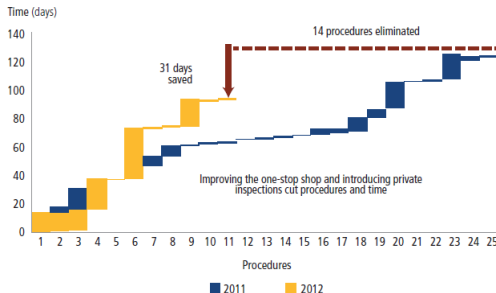
Source: Doing Business database.

Cheaper start-up reduces TCs → makes more people start a business.

How legal provisions affect the economy?

Dealing with construction permits

FIGURE 10.1 Taiwan, China, made dealing with construction permits faster and easier



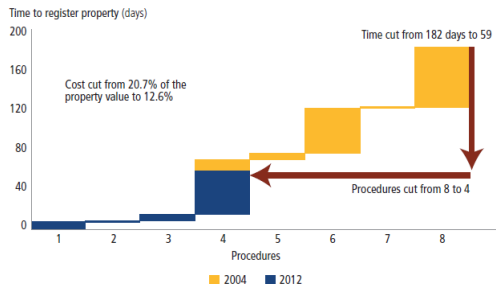
Source: Doing Business database.

Supply-side policies in the REstate sector – WHY?

How legal provisions affect the economy?

Transferring property

FIGURE 12.3 Burkina Faso made transferring property faster and easier



Source: Doing Business database.

Cheaper to transfer property – more deals.

Things to pay attn to

- 1 What are institutions?
- 2 Why do we need to look into history to say how institutions affect growth today?
- 3 How does settler mortality matter?
- 4 Are countries w better institutions better off (and Why?)?
- 5 What is political economy and how it helps explain history?
- 6 Do different traits of a political system affect government spending?
What is a persistent fiscal outcome?
- 7 Why does the firm emerge?
- 8 What is the significance of the Coase theorem?
- 9 Where can I find more contemporary data on the parameters of the doing business environment? (+ *BEEPS*)

- ① *** Acemoglu, D., Johnson, S., & Robinson, J. (2001): The Colonial Origins of Comparative Development: An Empirical Investigation, AER, Dec. 2001
(Intro, lit. review, main argumentation, and conclusion)
- ② D. Acemoglu (2005). Constitutions, Politics, and Economics: A Review Essay on Persson and Tabellini's the Economic Effects of Constitutions, JEL, 43(4), Dec.
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- ④ *** Coase, R. (2005): Institutional structure of production. In: C. Menard & M.M. Shirley (eds.) Handbook of New Institutional Economics, Springer, pp. 31-39.