Institutional Economics and Development II

A new institutionalist view on global inequality and an institutionalist critique

Development Economics, Lecture 6

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Institute for Comprehensive Analysis of the Economy

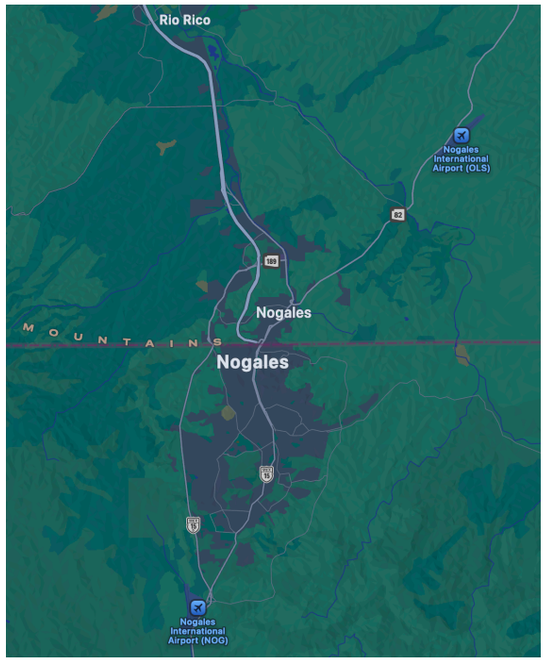
The Development Puzzle











Same geography, similar resources, identical culture and same colonial heritage…

…but vastly different living conditions. Why?

Institutional economics pretends to have the answer….

Overview

- New Institutional Economics and Development
- A Critical Appraisal
- Measuring Institutions
- Summary and Outlook

Recap: What are institutions?
Influential definitions

„Institutions are the **rules of the game** in a society...[and] the purpose of the rules is to define the way the game is played"

Douglass North (1990)

„There is only rational behavior, conditioned on expectations about the behavior and reactions of others…
'Institution' is just a name we give to certain parts of certain kinds of equilibria."

Randall Calvert (1995)

„Institutions are **systems of established and prevalent social rules** that structure social interactions."

Geoffrey Hodgson (2006)

Recap: The four traditional foci of NIE

Transaction costs

- Search costs, negotiation costs, enforcement costs
- Institutions reduce these costs

Property rights

- Secure, enforceable ownership → investment, exchange, development
- Institutions provide this security

New Institutional Economics and its rational choice framework

Incomplete contracts

- Contingencies always there
- Institutions for gap-filling and conflict resolution

Principal-Agent Problems

- Asymmetric information & hierarchies → conflicts of interest
- Institutions align incentives

NIE and Development

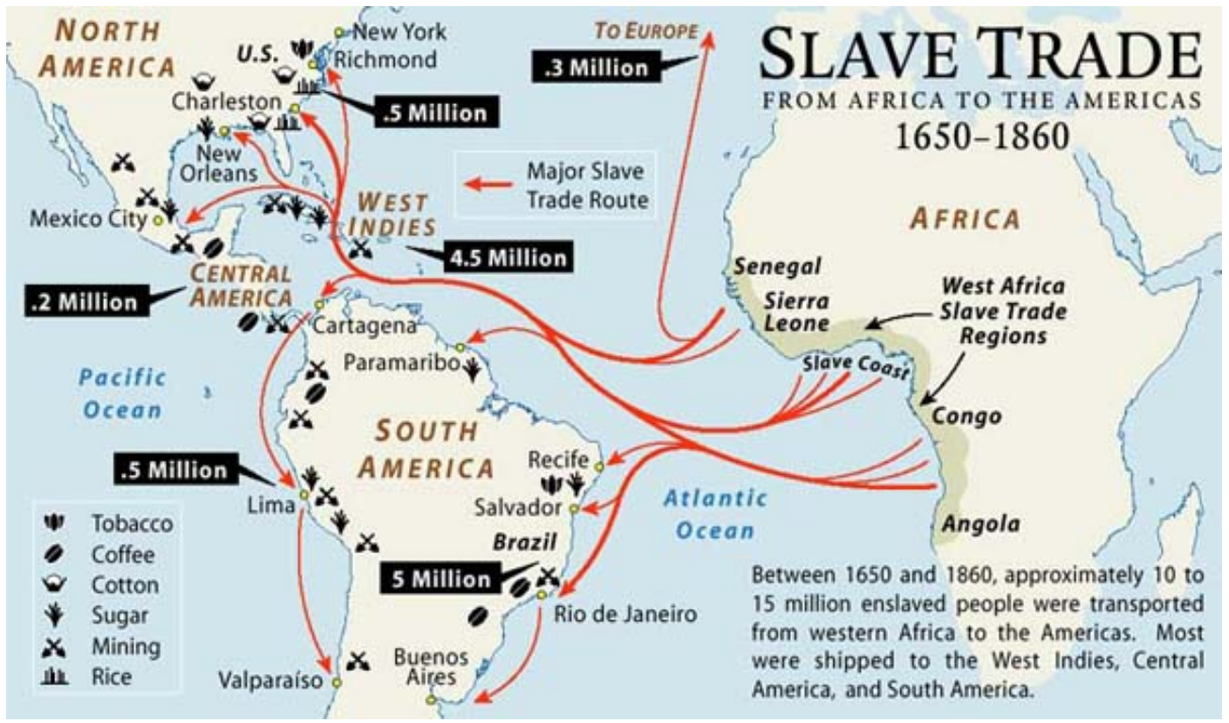
A selective chronology of colonialism

- 1482: First European base in Africa established by Portugal
- 1498 Discovery of the sea route to the east coast of Africa by Vasco da Gama
- 1492: Columbus' arrival in the Bahamas (the “discovery” of America)
- 1494: Treaty of Tordesillas
- 1519: Hernan Cortés' arrival in Mexico
- 1532: Francisco Pizarro begins his war against the Incas
- 1652: First European settlement at the Cape by the Dutch East India Company
- 1763: End of the Seven Years’ War, end of Spanish dominance
- From 1880: “The Race for Africa”
- 1954-1962: Algerian War

Immediate effects: The Latin American example

- **Complete genocide** of the Aztecs (Mexico) and Incas (Peru)
- Numerous other indigenous peoples largely murdered
- Through war, later through enslavement
- 8,000,000 deaths in the mines around Cerro Rico (Bolivia) alone

- Indigenous population **before** colonisation: 60,000,000
- Indigenous population **after** colonisation: 3,500,000
- '**Resettlement**': 7,500,000 slaves from Africa, 1,500,000 settlers



Excursus: Slavery

- Abolition of slavery alarmingly late
- Extensive photographic documentation available
- Last legal basis abolished in Mauritania only in 1981
- Global Slavery Index 2016: over 40,000,000 slaves worldwide







https://www.npr.org/sections/parallels/2013/11/12/244563532/photos-reveal-harsh-detail-of-brazils-history-with-slavery?t=1554720661490&t=1589799940700
https://upload.wikimedia.org/wikipedia/commons/thumb/6/69/Slavetreatment.jpg/170px-Slavetreatment.jpg

Long-Term Effects of Colonialism
The New Institutionalist Perspective

The Colonial Origins of Comparative Development:
An Empirical Investigation

By DARON ACEMOGLU, SIMON JOHNSON, AND JAMES A. ROBINSON*



- Explanation of today's global inequality through persistence of institutions implemented during the colonial era
- Argue that institutions *are the* determinant for long-term economic development
- Today: *the* mainstream explanation of long-term consequences of colonialism
- Also: the most influential explanation of long-term growth

Key arguments

The Colonial Origins of Comparative Development: An Empirical Investigation

By Daron Acemoglu, Simon Johnson, and James A. Robinson*

- **Colonisation has long-term effects** on the colonies and the colonial states
- Effects are extremely **heterogeneous**
- In the colonial states:
  - **Spain**: Stabilisation of the monarchy
  - No positive effects on the general Spanish population

> “The discovery of America, the rounding of the Cape, opened up fresh ground for the rising bourgeoisie.”
>
> Marx and Engels in the Communist Manifesto

Key arguments

The Colonial Origins of Comparative Development: An Empirical Investigation

By Daron Acemoglu, Simon Johnson, and James A. Robinson*

- **Colonisation has long-term effects** on the colonies and the colonial states
- Effects are extremely **heterogeneous**
- In the colonial states:
  - **UK**: catalyst for commercial revolt against monarchy
    - Positive effect on industraialization and economic development
- In the colonies
  - **USA and Canada** among richest countries in the world
  - **Congo and Simabwe** plagued by conflicts and poverty
- But: intentions of colonizers always the same

Key arguments
The role of path dependency

> “To claim that [...] the institutions created by colonial powers all over the world, influence development today is to make a claim about how colonialism influenced the political economy of these societies in a way which led these institution to **either directly persist, or to leave a path dependent legacy**.”

Acemoglu & Robinson (2017)

Two kinds of institutions (?)

Inclusive institutions

- Replication of European institutions ("Neo-Europes")
- Emphasis on private property, rule of law, business freedom
- Examples:
  - US Patent Sytem
  - US Homestead Act
  - Free incorporation without guilds
- Country examples: Australia, Canada, USA

Extractive institutions

- Rapid and effective expropriation
- Rights only for elites, arbitrary state power, elite capture of rents
- Examples:
  - Encomienda and Mita systems
  - Royal monopolies (e.g. East India Compania control of trade)
  - Plantation oligarchies
  - King Leopold's Congo Free State
- Country examples: Congo, Mexico, Peru

AJR's institutional explanation of development

- Two **colonization strategies**: set up extractive or inclusive institutions

> "The colonization strategy was **influenced by the feasibility of settlements**.
>
> In places where the disease environment was not favorable to European settlement, the **cards were stacked against the creation of Neo-Europes**, and the formation of the **extractive state was more likely.**"

Acemoglu et al. (2001, p. 1370)



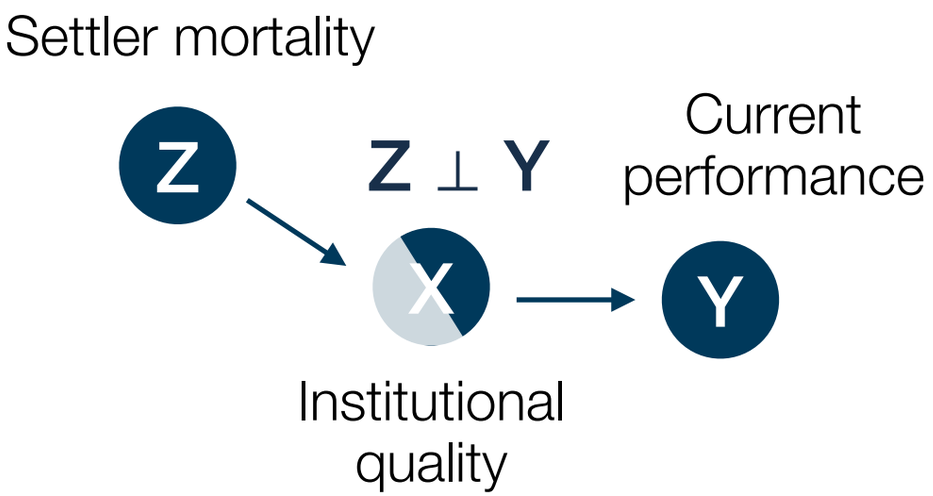
Important for methodological reasons → endogeneity problem

AJR's institutional explanation of development
The technical innovation

- Metholdolgical challenge: **endogeneity problem**



- Countermeasure: **instrumental variable estimation**



- Current institutions ~ current performance
- Settler mortality ~ colonial institutions
- Control for institutions → **no effect remains** for (i) geography, (ii) culture, (iii) trade
- **Conclusion**: institutions as THE fundamental cause for long-run development
  - Difference in colonial institutions explains ~**30% of contemporary inequality**

Summary of key contributions

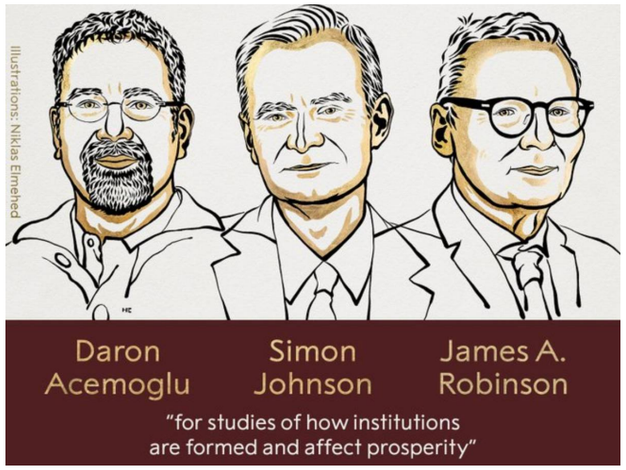
- Several key contributions of Acemoglu et al.:
  - Inclusive vs. Extractive institutions
  - Inclusive ~ rule of law, private property, entrepreneurial freedom
  - Use settler mortality as an instrument
  - Claim that institutions are *the* fundamantal determinant of development
    - Geography does not matter
    - Culture does not matter
    - Trade/integration etc. does not matter
  - Policy implication: fix institutions → solve poverty

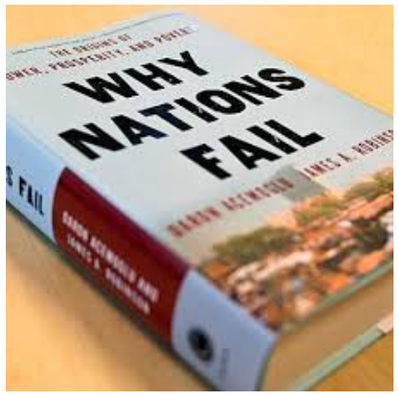
What is your take on these claims?

Critical debate

AJR: Successful, influential, controversial

- The mainstream explanation of growth and development
- Among the most highly cited papers in development economics
- Popular book version also highly successful
- Shapes policies of World Bank, IMF, etc.
- But their claims are also controversial:





Methodological (see readings)	Definition of institutions	Context specificity of good institutions	Failure to consider power	Obscuring historical complexity

Critical appraisal of AJR
A narrow view on institutions

- AJR focus on:
  - Property rights protection
  - Contract enforcement
  - Entrepreneurial freedom
  - Political checks & balances

→ **Typical for New Institutional Economics**

- What might be missing?
  - Labor (unions, worker protection,…)
  - Welfare (insurance, redistribution,…)
  - Education (schooling, higher education,…)

→ **Liberal Anglo-centric view**

Critical appraisal of AJR
Good institutions and Western Universalization Attempts

- Narrow view on (good) institutions → **Global Standard Institutions**
- Substantive critique from institutionalist scholars
- Methodological critique from **post-colonial** scholars
  - Example for Western desire to **universalize idea of development** → Session 1
- See Chang (2010) for a good summary

Critical appraisal of AJR
Good institutions and historical complexity

> “With Parliament supreme, absolutism was checked, and the economy boomed. So goes the economists’ history.
>
> However, as economists have been celebrating the superiority of English institutions, historians have been investigating how absolutist monarchy and Oriental despotism actually worked.
>
> The usual finding is that they promoted peace, order, and good government. [...] The greatest threat to prosperity was invasion by barbarians attracted to the civilization’s wealth – not expropriation or intervention by the emperor.”
>
> Allen (2011), p. 14

Critical appraisal of AJR
Good institutions and historical complexity

- **Anti-democratic institutions**: not always led to negative economic results
- **Democratic institutions**: not always led to positive economic results
- Example: British Constitution before Industrial Revolution
  - Parliament neither protected property nor reduced taxation
  - Taxes twice as high as in (absolutist) France
  - High expenditures on navy and army
    - Army: supressed protests against industrialisation and more democracy
    - Navy: conquered colonies and expanded British Empire
  - Landowners just forced to adapt productivity-enhancing irrigation projects
- Compare France: excessive property rights prevented progress

Critical appraisal of AJR
The relevance of socio-historical specificity

- NIE explanations with **universalist bias**: the same institution assumed to have the same effect everywhere and everytime

Same institutions, different ‘intensity’	Same institutions, same ‘intensity’, different place	Same institutions, ‘intensity’, place, different time
↓	↓	↓
Different implications	Different implications	Different implications

Intellectual property rights (IPR)

- **Moderate** protection of property requirement for investments
- **Too strong** protection harmful:
  - Articifial monopolies
  - Aggravated technology diffusion

IPR in rich and poor countries

- **Rich countries:** Stricter IPR tend to foster innovation
- **Poor countries:** Stricter IPR tend to block technology transfer and raise costs (medicines, seeds, …)

Land tenure in Japan

- Pre-WWI: concentrated ownership → investment & productivity growth
- Post-WWI: same institution hinders development
- Post-WWI land reform: redistribution → productivity growth

Critical appraisal of AJR
Monocausality problematic: the example of Haiti

- Haiti colonized in 1492, brutal (‘extractive’) rule of French colonizers
- 1804: Successful slave rebellion → Independent Republic (inclusive institution)
- France requires utopian 150 million Francs of ‘compensation’
  - Embargo by many nations until debt is paid
- 1825-1947: Haiti repays debt after borrowing from French and US banks
  - Extreme interest rates → temporarily **80% of GDP used for repayment**, artificially deflated export prices
- Perpetual poverty despite independence and ‘inclusive’ institutions
- Strong claim regarding institutions → potential blindness to other factors

Graeber (2011) for more details on this example; see Chang (2010) for many examples.

Critical appraisal of AJR
Technical sophistication instead of historical accuracy?

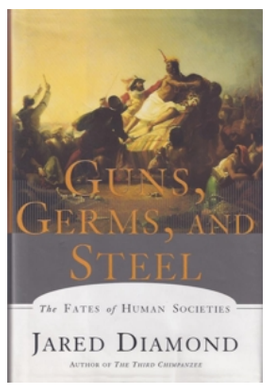
- Technical sophistication might obscure substantive ambiguities
  - Oversimplified historical narratives (see Britain's Constitution)
  - Cherry-picked examples and ignorance of confounding factors
  - Contemporary neocolonial practices and actions?
- Charmingly summarized by Elster (2015) as *Hard Obscuratism*

> "In academic debates, a more common term for obscurantism is 'bullshit', first identified as an intellectual pathology by Frankfurt (1988); later discussions include Cohen (2002) and Gjelsvik (2006). I shall not enter into the conceptual debate concerning the fine grain of bullshit. [...] **The term "hard" is vague, but points in the direction of quantitative, mathematical, computer-based, or formal analyses."**

Critical appraisal of AJR
A glimpse on the broader debate

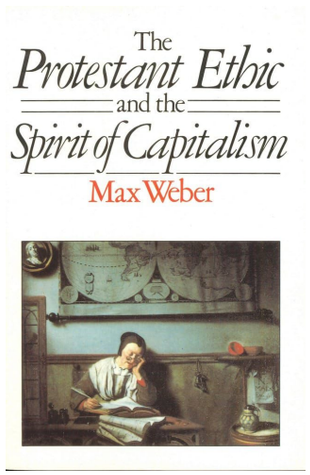
Geography & environment

- Climate, disease, and agricultural potential
- Distance from equator ~ development
- Tropical diseases burden poor countries



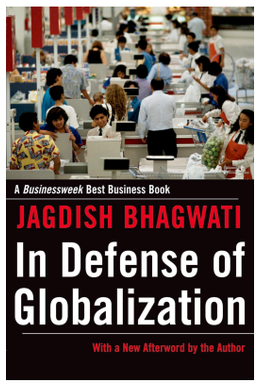
Culture

- Work ethic, trust, and social norms
- Religious values shape savings and entrepreneurship
- 'Developmental culture'



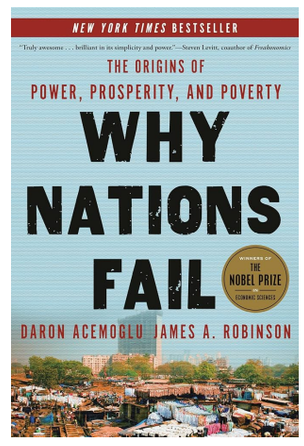
Trade and integration

- Trade openness and market access
- Foreign investment and technology transfer
- "Export-led growth" strategies



Institutions

- Property rights, rule of law, political accountability
- Inclusive vs. extractive institutions
- Colonial institutional legacies persist



- A&R claim: Institutions **trump everything else**
  - Alternative view: All of them interact in context-specific ways

Critical appraisal of AJR
Summary

- **Too narrow view on institutions:** focus only on property rights & political institutions, ignores labor, welfare, industrial policy institutions
- **Ahistorical and selective:** Oversimplifies complex colonial history, often mischaracterizes institutions (e.g., English vs. French)
- **Context-blind:** Assumes same institutions work everywhere, ignores path dependence and socio-historical specificity
- **Monocausal:** Claims institutions explain everything, dismisses geography, culture, power relations, and rests very much on methodological nationalism
- **Ideological and Eurocentric:** Promotes "Global Standard Institutions" (Anglo-American model as universal solution)
- Yet: Institutions clearly DO matter for development
  - Question is: Which institutions, in what contexts, and how?

Measuring and data

Measuring institutions?

- Measuring institutions is notoriously **difficult**
  - Always involves theory about what institutions are → **theory-ladenness of observation**
- **Example:** World Bank Worldwide Governance Indicators (WGI)
  - Based on surveys, expert assessments, and other indicators
  - Scale: -2.5 (weak governance) to +2.5 (strong governance)

Voice & Accountability
Political participation, free expression, free media

Political Stability and Absence of Violence
Likelihood of violent conflict, terrorism

Government Effectiveness
Quality of public services, bureaucracy, policy implementation

Regulatory Quality
Ability to formulate sound policies for private sector

Rule of Law
Contract enforcement, property rights, police, courts

Control of Corruption
Extent to which public power is exercised for private gain

See tutorial on course webpage

Synthesis and outlook

Summary

- **Institutions clearly matter** for development
  - But: ‘institutions’ as a broad and contested concept
- **Two traditions** with different insights:
  - OIE: Institutional change, power, path dependence, inefficiency
  - NIE: Transaction costs, property rights, efficiency (eventually)
- **Example:** Acemoglu et al on colonial history shaping current development
  - Shows potential and blind spots of new institutionalist approach
- **Measurement matters** but cannot be neutral
  - Indicators reflect theoretical assumptions

Relation to other session
The past

- Session 1: Grand theories of development
  - Global Standard Institutions as prime example for modernization hypothesis
- Session 2: How to measure development
  - Institutions are important but difficult to measure
- Session 3: Capabilities approach emphasized freedoms
  - Institutions enable or constrain capabilities
  - NIE misses much of capability approach
- Session 4: Simple growth models assumed institutions away
  - Today: Institutions are endogenous and path-dependent

Relation to other session
The past

- Session 6: Marxist & Dependency Theories
  - Alternative or complementary explanation?
  - Focus on power relations, not transaction costs
  - Global capitalism, not domestic institutions at centre stage
- Session 7: Technology, Innovation, and Trade-Led Development
  - Focus on Neo-Schumpeterian Evolutionary Economics
  - Institutions in National Systems of Innovation
- Session 8: Sustainable development, degrowth
  - What institutions are consistent with planetary boundaries?
  - Which institutions prevent necessary changes?