Political institutions and economic development

Chapter 3 on
Democracy, Institutions and Economic Policy

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3. Political institutions and economic development

The goal of this chapter is to examine the main academic debates that have arisen at various times in relation to the effects of political institutions on economic progress. The impact of institutions on a nation's economic evolution is an academic question that has held a central position in the research agenda for the political economy of development. Institutional growth theories generally strive to ascertain which institutions and institutional frameworks influence economic growth and development, and through which causal mechanisms. Although these theories identify specific explanatory mechanisms that vary depending on the type of institution under examination, the explanations do however share the idea that the influence of institutions on economic results is due, to a large extent, to their impact on political decisions. Institutions bring about certain policies which, in turn, generate particular results.

The most abstract analytical framework that is commonly used in studies of political economy for the analysis of public decisions assumes that they are the product of the interaction between, on the one hand, the preferences of the agents and, on the other, the institutional environment that structures the process through which these demands or preferences are translated into policies. Institutions play a particularly important role as a factor that explains state policies when not all the agents respond to the same interests or share the same preferences for policies. In such contexts of conflict of interest between politically significant groups, institutions —which distribute power between these conflicting groups— can potentially exercise considerable influence on government decisions.

By way of example, let's suppose that we want to explain why certain governments have the capacity to respond to economic crises with efficient market restructuring programmes, while others do not. The key agents in the analysis are the incumbent government and the coalitions of stakeholders that are affected by the reforms in question. If all the agents involved in the reforms were in favour of similar courses of action, such as introducing effective structural changes for the economy to run smoothly, then institutions would have an insignificant part to play in the matter. The fact that, for instance, some countries have institutional arrangements that enable certain groups to mobilise and effectively influence governments would make no additional contribution to answering the question in which we are interested. Both in cases in which politicians make decisions that do not reflect the demands of social coalitions —as we would expect, perhaps, in authoritarian regimes— and in cases in which governments have to cater to the preferences of these groups —as may occur in democratic systems— it is no surprise that the policies eventually adopted would be the same in both institutional scenarios, because the policy preferences of the agents are identical.

In contrast, when the agents want different courses of action, a certain divergence should be expected between the policies depending on the type of institutional arrangement that organises the political process. Let's imagine that the government prefers a sound economy that functions efficiently and the interest of the social groups is to minimise the costs that they have to bear as a consequence of the reforms. With this new structure of preferences, it may be assumed that it is less likely that adjustment measures that are harmful to stakeholders would be implemented in democratic contexts —which are more sensitive to pressure from such groups— than in authoritarian institutional structures.

This chapter is organised in the following way. Section 1.1 compares the economic implications of political systems in which power is highly concentrated, such as absolute monarchies for instance, with systems in which there is an institutional framework that limits the power of the executive government, primarily thanks to the presence of a parliament —which is not necessarily elected through a popular vote— with extensive decision-making capacity. In this discussion, the link between institutions and growth manifests itself through the protection of the property rights of the economy's producers and investors. Section 1.2 presents the latest academic contributions on the importance of institutions and geography in the explanation of economic development. This section compares, on the one hand, institutional systems which are oligarchies (in which the economic elite monopolize the control of the State) and, on the other, more democratic scenarios in which the principle of political equality is guaranteed. In the literature, the impact of institutions on the economy depends on the degree of equality of rights and economic opportunities among the population. Lastly, Section 2 focuses on the alternative causal mechanisms proposed in the literature with respect to the effect of the political regime (dictatorship versus democracy) on economic growth.

1. The 'ultimate' causes of economic progress: political institutions and geographical conditions

According to the growth theories covered in the previous chapter, the differences between countries with respect to levels of economic progress are due both to the different national rates of accumulation of physical and human capital and to countries' unequal capacity to generate (or adopt) technological innovation. Despite the indisputable achievements of these models in the study of the mechanics of growth, innovation and capital accumulation are only the most immediate causes of growth. Why do some countries invest more in physical and human capital than others? Why is it that certain countries are more productive and allocate more resources to technological innovation than others? The answer to these questions requires us to identify the 'ultimate' or fundamental determining factors of economic development.

The intense academic debate that has recently surrounded these issues can be divided into two acclaimed theories[1] that rival each other. Firstly, there is the "geography" theory, which focuses on the direct effects on productivity and technology diffusion generated by variables related to countries' geographical conditions, such as climate, type of territory, the availability of natural resources,

1 The most interesting and influential contributions in the literature in relation to the socio-political determining factors of growth focus on countries' institutional and geographical conditions. However, other explanatory factors have been proposed, such as religion, cultural traditions and international trade.

sea access and the environmental propensity to certain diseases. Secondly, there is the institutional theory, according to which the fundamental explanation for development is found in the institutional framework that organises the society and structures the incentives and opportunities available for investment. According to this latter perspective, countries with institutions that promote economic exchange between private agents and, at the same time, limit the arbitrary actions of the government against individual property rights have greater growth potential.

In the following parts of this section, we will firstly review of the contributions that set the research agenda for new institutional economics, before looking at the latest literature on the economic impact of institutions and the influence of geographical features.

1.1. Limitations to government action and the protection of property rights

According to the most acclaimed pioneer of the new institutionalism approach to economics, Douglass North (1981, 1990), the essential institutions are those that protect property rights and guarantee contract compliance. The protection of property rights is crucial for a society's economic progress as it has a decisive impact on the incentives to participate in transactions that involve growing specialisation and division of labour in an advanced economy, as well as the incentives for investment in physical and human capital, and in technology.

The incentives for investment, capital accumulation or economic exchange depend on the expectations of individuals with respect to whether they can acquire the earnings derived from their economic activities. As the degree of uncertainty intensifies in relation to the control that individuals can exercise on the ownership of the revenue generated by their activities, it becomes less likely that, in effect, economic agents will take part in economic exchange. Therefore, establishing a legal system for protecting property rights is a necessary condition for significant progress in societies, according to the institutionalist approach. The performance of the kind of transactions on which a modern economy is based, with a high degree of specialisation[2], requires a greater number of contractual and

2 For instance, impersonal transactions in which the agents do not have prior knowledge of each other and, as a result, are uncertain whether the other party will abide by the initial conditions of the contract.

judicial institutions that impartially guarantee contract compliance under the agreed terms, as well as limiting the opportunistic actions of private agents. However, the existence of these institutions implies the development of a strong State capable of controlling property rights and ensuring that contracts are respected (North, 1990: 59).

Threats to property rights do not exclusively come from private agents. An issue that is a huge concern for the new institutional economy is that governors may use the coercive power of the state for their own benefit, to the detriment of the rest of society. Certain historical experiences, such as the frequent abuses of power of the European Monarchies in the Middle Ages and at the start of the Modern Age, are partly responsible for fuelling this concern (North and Thomas 1973). During this period, "monarchs often used their powers to expropriate producers, impose arbitrary taxation, renege on their debts, and allocate the productive resources of society to their allies in return for economic benefits or political support. Consequently, economic institutions during the Middle Ages provided little incentive to invest in land, physical or human capital, or technology, and failed to foster economic growth" (Acemoglu, Johnson and Robinson, 2005: 393).

Although the State's position as an impartial mediator in contractual relations between citizens is essential for growth, the risk of expropriation by the government is seen as the most concerning threat against the certainty of property rights. The greater the likelihood that the governing power may execute arbitrary actions against these rights, the lower the expected returns on investment will be and, therefore, the less attractive the option of investing will appear (North and Weingast, 1989).

Are there factors that could limit the potential violation of (property and/or contractual) rights by the State? In view of the economic challenges posed by the possibility of a government conducting autocratic manoeuvres against these rights, the institutionalist literature has focused a great deal of its research on ascertaining the political reasons for which state leaders do not use coercive power to confiscate all of the economy's productive assets or to renege on their commitments, such as repaying public debt, for instance. In short, the aim is to identify under which conditions the government has incentives not to manipulate property rights for its own benefit and, therefore, to set the political foundations for economic development. We shall now take a look at what these conditions are.

Let's suppose that the people who control the State are rational individuals who want to stay in power and maximise their revenues, which depend on the amount of resources directly appropriated from society, the generation of public debt and other types of regulations, such as the concession of monopolies in the market. The governor faces the following dilemma in the pursuit of their objectives: on the one hand, they would prefer to extract the largest possible amount of resources from society but, on the other hand, taxation and political confiscation of assets reduces the material wellbeing of the country because it deters producers from continuing to invest, accumulate capital and produce. If the sovereign raises the tax pressure on income or company profits, they may get a higher percentage, but of a lower overall production.

It is obvious that, faced with such a dilemma, the governor will not always choose an arbitrary policy of wealth expropriation. By committing to limiting taxation to a certain level, producers can obtain a predictable proportion of their companies' yields and, as a consequence, they will still be keen to continue their economic activities. The economy will grow, and the State can therefore increase its revenues. In addition, as Olson (2000) pointed out, it should be expected that the government, in its own self-interest, will dedicate a certain amount of tax revenue to public investment measures that promote productivity, such as building new schools and investment in education, the construction of roads and infrastructures to facilitate transportation and communication, or maintaining a police force to prevent crime and ensure contract compliance. The government may provide these public services because it is then likely to obtain a portion of the increased wealth that they generate.

Although, as we have just argued, the sovereign has an *ex-ante* interest in promising a policy that upholds property rights to boost investment and growth, the problem is that this promise is not credible, as the sovereign's interests after the investments have been made are inconsistent with this commitment. Once the economic agents have concluded their commercial operations, the most attractive option for the governor is an opportunistic tax hike and even, in an extreme case, expropriating all the economy's yields.

Known in the literature as the "time inconsistency of preferences", this problem occurs when one of the parties to the agreement has different preferences or interests at the time of entering into the contract and after the other part has fulfilled their obligations. To illustrate this more clearly, consider the case of the government being granted a loan by private agents. Beforehand, when they are negotiating the terms of the contract, the government promises to repay the capital and the loan interest on the stipulated date.

However, once it has received the loan, because the lender cannot appeal to an impartial third party to force the governor to fulfil their obligations, as they ultimately have a monopoly over political power, they have an incentive to renege on their promises and breach the contract. The private agents, meanwhile, anticipating these *ex-post* motivations of the government, will refuse to lend funds to the State so there will be no capital market available to finance the public debt generated by the State.

The fact that this fiscal policy suffers from a problem of time inconsistency of preferences leads producers rationally to anticipate arbitrary *ex-post* violations of property rights by governors and, as a consequence, reduce their investment plans. Therefore, in the words of North and Weingast (1989: 803), "For economic growth to occur, the sovereign or government must not merely establish the relevant sets of rights [for the proper functioning of the economy], but make a credible commitment to them".

One reason often put forward in the literature that may lead a governor to fulfil their political commitments is to preserve their own reputation: by implementing the previously announced policies, such as paying off public debt and not violating property rights, they demonstrate that they are an honest politician and generate confidence among lenders and investors, so that they will have the opportunity to obtain income in the future. For reputation to serve as an effective mechanism for restricting the arbitrary actions of politicians, they must be able to evaluate to a certain extent the economic yields that they could extract in the future. Even an autocrat with a complete monopoly on political power would be interested in upholding their political promises for reputation reasons as long as they do not neglect their future possibilities too much. In other words, as long as they operate with a long-term time vision to satisfy their interests. For an absolute monarch secure in their position and who wants to maximise their present and future incomes, it is not rational for them to ransack their subjects' properties because, if they did so, investment and production would drop and, by extension, their long-term tax revenues would also fall (Olson 1997).

There are situations in which reputation is not a sufficient reason for limiting the arbitrary actions of monarchs against property. One typical context is when the survival of the regime is at stake, such as in a war or in the face of strong domestic opposition. With a decreasing likelihood of remaining in power, the sovereign places less importance on the future so that, despite the resulting lost opportunities, they may be attracted to the short-sighted option

Box 3.1 The reputation mechanism and international trade in the Middle Ages

The advantages attributed to reputation as a cooperation mechanism have been widely studied within the context of commercial relations between private agents. The main conclusion of the literature is that, when it is expected that these interactions will be repeated over time, reputation can be a driving force for compliance with agreements, even when the market or legal system lacks instruments to guarantee that contracts are upheld. Let's look at an example.

Avner Greif (1989), in his study on Jewish traders settled in Northern Africa in the Middle Ages, showed how reputation and trust between members of the community drove trade around the Mediterranean. For the expansion of international trade in this period, it was essential that the traders could entrust their commercial operations abroad to agents who would act on their behalf. In this way, they could save the costs of having to travel with their wares and, moreover, they could diversify their business between various commercial cities. The problem that this posed was how to resolve the conflict of interests between the trader and their representative or agent.

The main source of this conflict was that the agent was able to manipulate the information about various aspects of the transaction —aspects unknown to the trader— such as how the goods arrived and in what condition, the price of products set for the destination market, the storage costs, etc. *A priori*, the agent has an interest in falsifying this information, for instance, by saying that they sold the merchandise at a lower price than was actually the case, to gain additional income. For their part,

of confiscation or property or non-payment of debts. As North and Weingast (1989) suggest, the several occasions on which the English and French monarchies evaded their commitments in the beginnings of modern Europe were due to fiscal pressures resulting from the wars that they were fighting.

A second way of preventing irresponsible decisions by the State against property rights is the establishment of political institutions that restrict the *ex-post* actions of the government. This is the causal mechanism on which the institutionalist theory was initially based in order to justify the essential role of institutions in economic development. According to this theory, the institutions of limited government (a parliament that, representing the interests of lenders and capital owners, has the

the traders, anticipating that the agents would take advantage of this situation, would not contract anybody, thereby impeding the potential development of trade and, subsequently, growth.

Despite the lack of a legal system to organise the relations between the trader and their agents, the Maghrebi Jewish traders managed to establish relationships of trust with their representatives through a system of regulations sanctioned by the "coalition". This was a closed organisation in which the trader-agent pacts were established solely between the members of the coalition and in accordance with the following rules: firstly, each trader had to contract agent members of the organisation exclusively (Maghrebi Jews who had emigrated to the commercial hubs of the Mediterranean such as Sicily, Palestine and Spain) and pay them a service bonus higher than their reserve salaries (in other words, more than the salaries they would be able to earn in other jobs).

Secondly and most importantly, the traders were under the obligation never to hire an agent who had cheated another member. Therefore, any agents tempted to stray from the path of cooperative behaviour put their future business prospects at risk with all the traders who were members of the coalition. Another crucial function of this organisation was that members who lived in different trading towns had to supply the rest of the members with information free of charge in relation to the local trading conditions, which facilitated the detection of fraud.

Thanks to these regulations, therefore, the long-term earnings generated by being honest were higher than the immediate gains to be made through short-term opportunism, so that there were incentives for the agents to cooperate and uphold their reputation as honest representatives.

power to control the executive government and exclusive authority over taxes, as well as an independent judiciary system) impose restrictions on the sovereign's capacity to arbitrarily alter the rights and agreements reached by the economic agents. As a result, the implementation of a system of separation of powers, in which the legislative branch could overrule the decisions of the executive government (for instance, tax rises), gives greater credibility to government commitments with respect to the protection of property rights.

According to the first studies of new institutional economics, the political institutions that are important for growth are therefore the institutions that prevent the concentration of political power. The empirical hypothesis for this argument compares the economic consequences of an absolutist state and an organisational structure in which the parliament —not necessarily elected by popular vote but representative of commercial interests— exercises effective authority over public decision-making. Countries governed by absolute monarchs or dictators, due to great economic uncertainty, will have lower growth potential than constitutional monarchies or regimes characterised by a balance of power between the assembly and the government.

The historical evidence in this respect seems to support this hypothesis. Using data on the urbanisation of European regions between 1050 and 1800, De Long and Shleifer (1993) show that the towns that prospered most during this period formed part of non-absolutist states such as Holland after the uprising against Spain or England after the "Glorious Revolution" of 1688.

Other more qualitative studies that compare the economic trajectories of certain European nations also point in this direction (North and Thomas, 1973; Acemoglu *et al*., 2005). They have often compared, for instance, the economic progress brought about by the institutional changes introduced after 1688 in England with the economic backwardness of the absolute French and Spanish monarchies. In line with the main argument of institutionalist theory, North and Weingast (1989) suggest that the institutional evolution that took place in England during the 17th century was an intentional process designed to reduce the discretional powers of the crown, which resulted in an increased degree of reliability of government decisions.

During the reign of the House of Stuart in England (17th century), the English crown systematically carried out abusive wealth extraction practices to cover the growing costs of the Stuart reign without the consent of the parliament[3]. Some of these practices consisted of unexpected rises in customs taxes, the sale of market monopolies, compulsory loans to the State —which earned the name of "forced lending", and the repayment of which was never made in accordance with the agreed terms— and even the direct confiscation of the citizens' assets. The parliament hardly had any power over political decisions to prevent such abuse of rights. Moreover, there were alternative institutional measures in place through which the crown could completely forego parliamentary approval or annul judicial rulings against offences committed by the monarch himself.

According to North and Weingast, three fundamental elements of the political system underpinned the sovereign's absolute power.

3 The summary presented below of the institutional changes that took place in England in the 17th century is based on North and Weingast (1989).

Firstly, there was the royal prerogative, which granted the crown the capacity to enact new laws without referring to parliament, so it enjoyed certain legislative powers. Secondly, there was the Star Chamber, which constituted a kind of state council with legislative, executive and judicial powers, and which, on matters of prerogatives, was the supreme authority. On occasions, the king made use of this body to annul resolutions that were contrary to his decrees. Lastly, it was commonplace for the crown to bribe judges to influence their rulings in favour of the monarch's interests. The most immediate effect of this institutional framework was to concentrate political power in the hands of the monarchy and deprive the parliament and legal system of their traditional functions of controlling the government's actions. In turn, as we have seen, this generated considerable legal uncertainty with negative consequences for investment and commercial exchange.

With the revolution of 1688, the groups opposing the monarchy, primarily the gentry and traders, managed to replace the previous institutions with new institutional formulas that proved to be more favourable to the economy. The political independence of the judicial bodies from the crown was guaranteed. For instance, the king's power to suspend judges from their posts was abolished (they could now only be suspended by a joint decision of both chambers of parliament). The parliament assumed a permanent role in politics, and the king could no longer convene or dissolve the assembly at whim. On certain matters, such as government finance, the Parliament's position was central. It had the exclusive authority to raise taxes, it could overrule the State's budget and spending, and it exercised control over the government's actions. This was the dawn of what is now known as the Age of Parliament Supremacy.

This new constitutional order introduced a system for the division of powers in which producers and the owners of wealth, through their representatives in parliament, had the power to paralyse changes to policies that were against their interests. The certainty of property rights rose as a result, as did the credibility of government pledges. One demonstration of this is the expansion undergone by the capital market available for funding State activities and, by extension, investment by private agents. By renewing confidence that the government would respect the conditions of the loans granted, lenders were far more willing to take their savings out of their houses and use them to give loans to the State in order to make a profit on them.

The solution to the problem of time inconsistency hugely improved the State's capacity to obtain resources. As can be seen in Table 3.1, the trend in public expenditure, although growing, was particularly low before the revolution, amounting to 1.8 million pounds in 1688. In the same year, debt barely represented 3% of the gross national product (1 million pounds). This was the result of "forced lending" policies, changes in the conditions and delays in debt repayment by the monarch. Just nine years later (1697), and under new limited government institutions, public spending rose four-fold and public debt reached 17 million pounds, in other words more than 40% of the gross national product. Such spectacular growth in public debt in such a short space of time was accompanied by a marked drop in interest rates (from 14% to 6% and 8%), all of which suggests that the risks associated with government decisions had fallen drastically[4].

Table 3.1. Growth in the debt of the English Government 1618-1750 (in £ million)

Year	Government spending	Debt
England under the Stuarts		
1618	0.5	0.8
Mid-1630s	1.0	1.0
1680	1.4	
1688	1.8	1.0
After the Glorious Revolution		
1695	6.2	8.4
1697	7.9	16.7
1700	3.2	14.2
1710	9.8	21 .4
1714	6.2	36.2
1720	6.0	54.0
1730	5.6	51.4
1740	6.2	47.4
1750	7.2	78.0

Source: North and Weingast (1989)

4 Clark (2007) offers a set of historical data to counter the hypothesis that the institutional change that occurred in England as a result of the Glorious Revolution was the origin of the subsequent economic progress. In broader terms, Clark generally questions the institutionalist perspective that the Industrial Revolution and consequent rise in income per capita, thanks to the increased efficiency of production processes, were due to the transformation of the political and economic institutions that governed the certainty of private property.

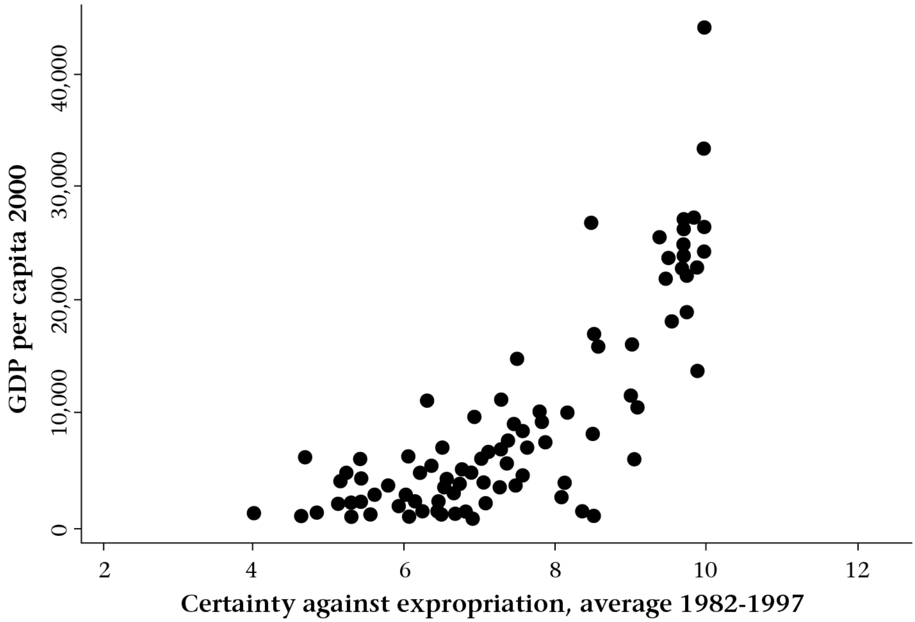
Focusing on the latest quantitative evidence, the patterns observed also seem to confirm the institutional hypothesis. According to Graph 3.1, the risk of expropriation by the State appears to have a significant negative impact on economic development. This scatter graph shows the relationship between GDP per capita in 2000 (shown on the vertical axis) and the degree of certainty with respect to possible state expropriations of wealth from 1982-1997 (horizontal axis)[5]. The data seem to indicate that countries with a lower likelihood of public interventions affecting property (values further to the right on the horizontal axis) tend to have higher levels of income per capita (higher values on the vertical axis). In accordance with these results, various empirical studies on countries—using more sophisticated statistical models—suggest that, in effect, the protection of property rights is crucial for investment and economic progress (Knack and Keefer, 1995; Clague *et al.*, 1997; Hall and Jones, 1999).

Moreover, the presence of limited government institutions[6] makes the risk of expropriation lower. According to Graph 3.2, the indicators used to measure these variables show a positive relationship between them, although the relationship is not as strong in this case. As the scope of the constraints on the executive expands (values further to the right on the horizontal axis), the legal certainty against possible expropriation threats from the government appears to increase. As such, taking into account the information presented on the two graphs, we can conclude that institutions that

5 The expropriation risk data is taken from the International Country Risk Guide (ICRG) and refers to the risk of "unlimited confiscation and compulsory nationalisation of property". This data is compiled by a private company that provides information to international investors on different key aspects for investment, such as the legal system, political stability, corruption and state expropriation risk in several countries. The variables range from nought to ten, with a higher value indicating a lower probability of expropriation . Specifically, the data in Graph 3.1 represents the average value of this variable from 1982 to 1997 for each of the countries on which information is given. The sample includes a large number of countries from different regions around the world, in Africa, Latin America, Europe and Asia.

6 The "constraints on the executive" variable comes from the Polity IV database, constructed by Jaggers and Marshall (2000). This variable measures the degree of concentration of power in the executive government, ranging from 1, which indicates unlimited authority of the executive, to 7, which indicates the presence of other bodies with authority equal to or greater than the executive over political decision-making. Graph 3.2 shows the national averages calculated over the period 1960-2000.

Graph 3.1 The impact of state expropriation risk on economic development

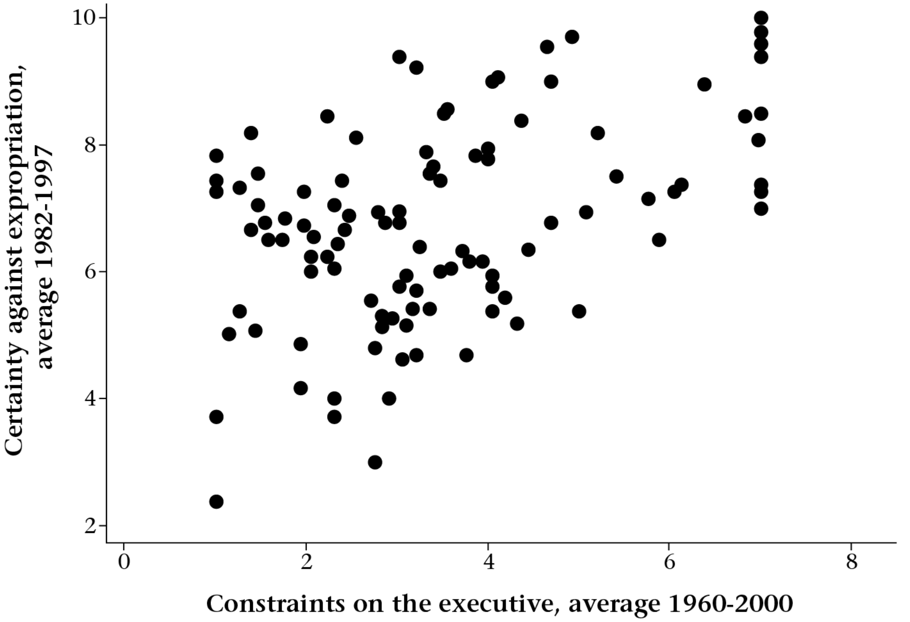


SOURCE: International Risk Guide for the variable of the risk of expropriation. Penn World Tables, version 6.1, for the GDP per capita variable.

limit government power have a positive effect on property rights, which, in turn, facilitates a legal and political environment that is favourable to investment and economic progress.

While institutions such as a legal system protecting individual property rights of the kind established in most advanced Western societies, an independent judiciary system or a political structure in which the different units of power provide effective checks and balances may be beneficial in terms of the proper functioning of the economy, there are, however, other institutional formulas that can generate the same result in terms of the certainty of property rights and material prosperity. Rodrik (2007) has recently developed this idea to explain why societies with institutional frameworks that differ from those conventionally considered as being the most suitable for growth have still had considerable rates of economic growth for several years, such as the case of India and, most importantly, China. The extremely positive evolution of the Chinese economy since the 1980s onwards is particularly surprising from the perspective of

Graph 3.2 Limited government institutions and state expropriation risk



SOURCE: International Risk Guide for the variable of the risk of expropriation. The 'constraints on the government' variable is taken from the Polity IV database constructed by Jaggers and Marshall (2000).

institutionalist theory. Despite being a country governed using forms of authoritarian power and, even more so, a centrally planned society controlled by the autocratic communist party, China has managed to increase its levels of material wellbeing systematically to the point where it has become one of the world's most powerful economies.

Rodrik (2007) explains this apparent paradox by emphasising that there are various institutional alternatives that are favourable to growth. The set of "good" institutions includes all those capable of guaranteeing the economic principles central to neoclassical analysis, such as protection of property rights, the existence of guarantees that enforce contract compliance and the incorporation of market-based competition incentives. The idea is that the different institutional forms can generate these principles effectively. One of these is the structure generally implemented in Western capitalist societies, with legal protection of individual property rights, an independent judiciary system and the division of political powers. This institutional block was mentioned in the famous "broader" Washington Consensus of the 1990s (Rodrik 2007: 17; Clark 2007: 146) to guide the recommendations of international cooperation bodies to countries "in need" of political and economic reforms. According to Rodrik (2007), there are other institutional models, such as the East Asian model, that have equally demonstrated their strength in terms of generating constant increases in a country's wealth.

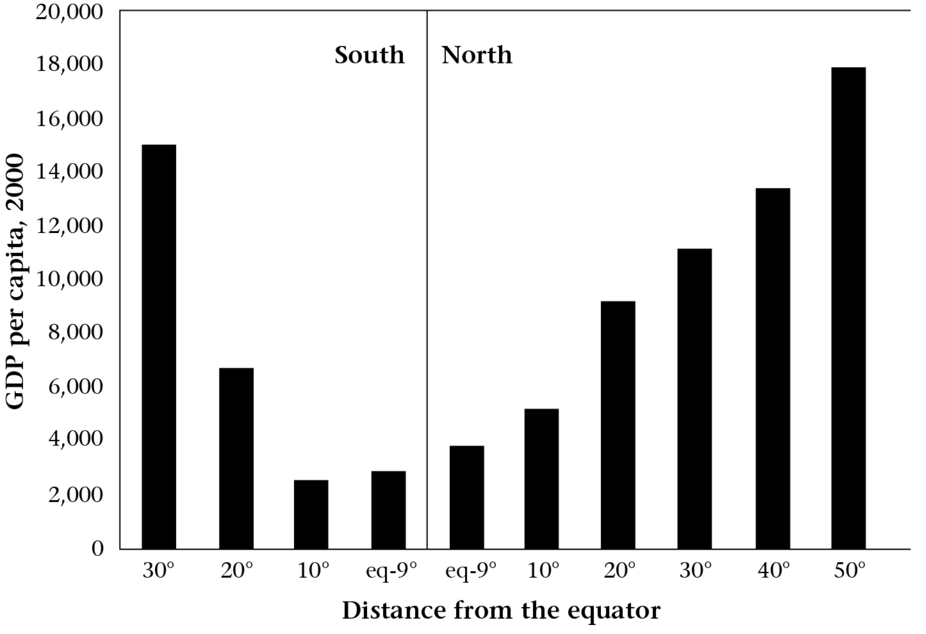
Specifically, China adopted a fairly innovative perspective on reform through which —although it did not follow the orthodox institutional guidelines— it managed to satisfy the neoclassical goals of property rights, macroeconomic stability and the presence of market incentives. With respect to property rights, the Chinese government managed its land and industrial resource distribution policy through a system based on family responsibility and local businesses at the town level, rather than introducing a generalised shift towards the privatisation of land and economic resources. The formal property rights of these businesses were not assigned to private agents or the central government, but rather they were placed under the direct control of local governments, which, having strong incentives to enhance the prosperity of their businesses, ensured that property rights remained fully guaranteed despite the absence of a system of private property (Rodrik, 2007: 24). To summarise, Rodrik's approach suggests that different institutional forms are able to guarantee the principles of macroeconomic stability and safeguarding of property rights, etc., required for economic development.

1.2. Institutions and geography: the economic trajectories of the former European colonies

The main theory put forward as an alternative to institutional explanations of growth considers that the ultimate source of a country's development is its geographical features. This theory focuses on the differences in climate, geography and environment between societies to explain their different levels of development. Identifying a geographical pattern in the disparities of wealth between nations dates back to Montesquieu (1748), who suggested the idea that climate conditions influence the effort exerted in work and productivity. However, the geographical theory has recently been revived thanks to new research (for example, Diamond, 1997 and Sachs, 2001) partly motivated by the spatial concentration of underdeveloped countries in the planet's tropical regions.

Graph 3.3 shows evidence consistent with the geographical thesis[7]. The horizontal axis represents the latitude intervals, i.e. the distance of countries from the equator[8]. The vertical axis plots the average GDP per capita (2000) of countries in the same latitude interval. According to the graph, the average income of countries tends to grow as we move further from the equator. Territories in the tropical zone (between the latitudes of 23.5 degrees north and 23.5 degrees south) have a much lower GDP per capita than in the temperate zones at more northerly or southerly latitudes (such as Western Europe, North America, the Southern Cone of Latin America and Oceania).

Graph 3.3 Average income and distance from the equator



7 This graph is based on Figure 2 by Sachs (2001). The statistics on GDP per capita come from the Penn World Tables, version 6.1, and the data on the latitude of countries are taken from the Global Development Network Growth database, built by the Development Research Institute of New York University.

8 Specifically, latitude is the distance between a terrestrial location and the equator. It is measured in degrees and ranges from 0 to 90 degrees to the north and south. The vertical line that divides Graph 3.3 represents the equator (ec) and separates the northern and southern latitude intervals.

Apart from climate conditions, other causal mechanisms can explain this correlation between the progress of different countries and their geographical location. One such explanation, formulated by Sachs (2001), emphasises the geographical determinants of the technology available in an economy. The technologies used primarily in the production of food, energy or healthcare are specific to the territory's environmental features and such technologies are not easily disseminated around different ecological zones. Along with the fact that, for a number of reasons, the state of technology in temperate zones is more productive than in tropical zones, the result is the association that we can see in Graph 3.3. In short, the idea is that tropical countries have an ecological propensity towards technological underdevelopment, particularly in relation to agriculture and energy, which cannot be overcome by assimilating the more productive methods used by nations further from the equator. This is due to the fact that these types of technology work in certain ecological settings and not in others.

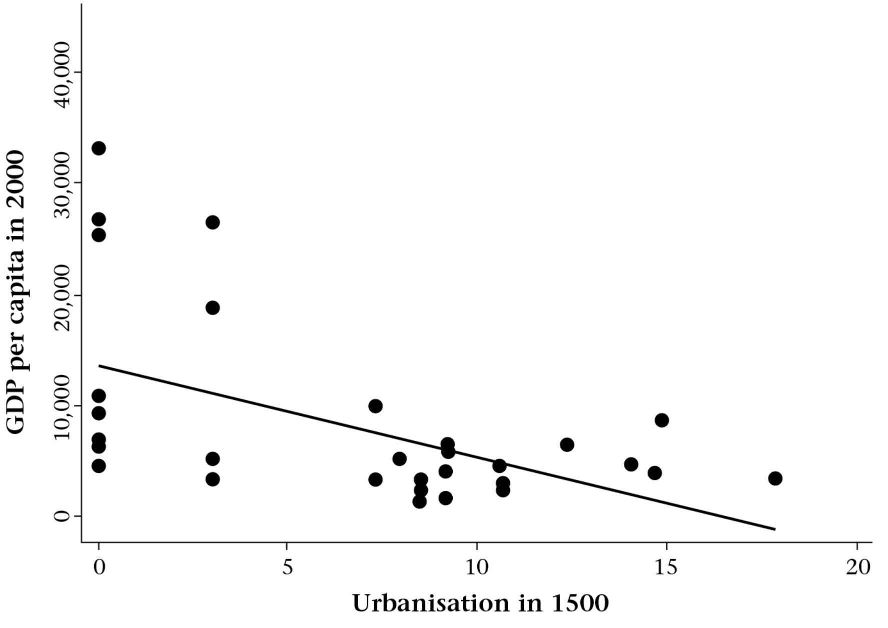
An additional explanatory factor focuses on the ecological conditions that promote the development of infectious diseases. The greater incidence in tropical climates of diseases that are difficult to control, such as malaria or yellow fever, reduces the possibilities for growth in these areas. In comparative terms, the economic inequality that exists between tropical countries and nations further from the equator is, to a certain extent, due to the fact that the "burden of disease" borne by territories in tropical climates is significantly larger than in temperate areas (Sachs 2001). One statistic that Sachs offers to support this claim is that life expectancy and infant mortality rates are better in temperate zones, even when adjustments for the average income level in the economy are taken into account.

However, several recent studies from the institutional perspective present empirical evidence that contradicts the argument that geography has a direct impact on economic progress. The fact most commonly used against the geographical hypothesis is the drastic turnaround that has taken place with respect to the economic positions of countries that are former European colonies. The colonies that were the wealthiest in 1500 are now the countries that are currently least developed, and vice versa (Acemoglu *et al.*, 2002). The temperate zones in 1500 were usually less prosperous than the tropical regions. Specifically, in the case of the Americas, Engerman and Sokoloff (2002) report that, until the end of the 18th century, the differences in the levels of income in economies in the Americas were very small and, in the case of certain colonies in the Caribbean (such as Cuba and Barbados) and South America, they even had a higher income per capita than colonies that would later go on to comprise the United States and Canada.

It is hard to fit this data in with the geography theory. As geographical variables such as climate and latitude hardly vary at all over time, if we apply the resulting logic of this theory, we should observe a certain continuity in the income rankings. The countries that were relatively wealthier in 1500 should still be so in the present. The discovery of the existence of a change in the economic trajectories of the former European colonies, to a large extent, has driven the research agenda of institutional theory.

Using the degree of urbanisation and population density in 1500 as prosperity indicators for that time[9], Acemoglu *et al*. (2002) detect a negative relationship between these indicators and current economic development for a sample of European colonies[10]. As

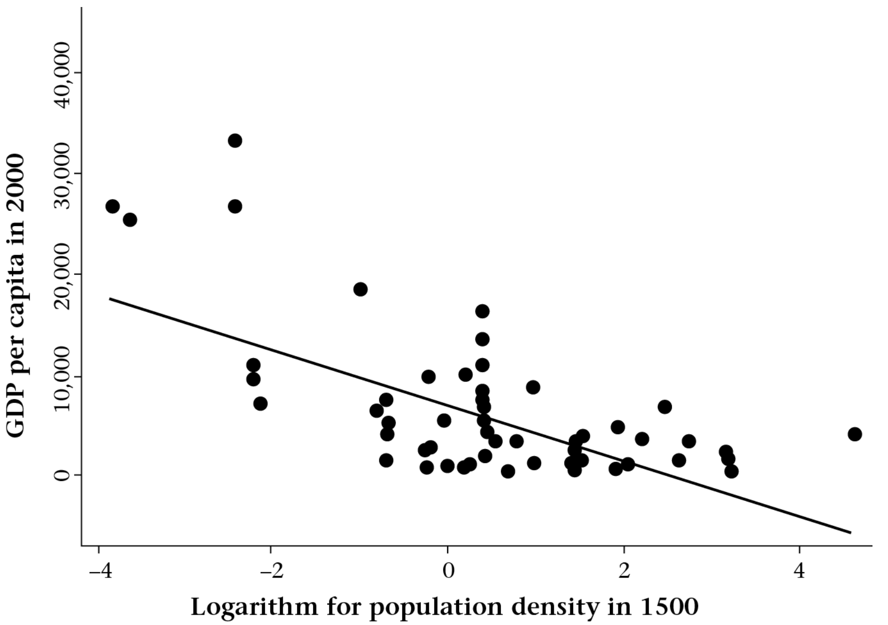
Graph 3.4 Urbanisation (1500) and GDP per capita (2000)



9 There are theoretical reasons for thinking that urbanisation and population density are positively associated with the level of wealth of societies. For instance, one reason is that the existence of a large urban population (or high density) requires a certain agricultural surplus and advanced transport infrastructures. Acemoglu *et al*. (2002) present empirical evidence that supports this argument.

10 The sample includes all the countries that were colonised by European nations between the 15th and 19th centuries.

Graph 3.5 Logarithm for population density (1500) and GDP per capita (2000)



shown in Graphs 3.4 and 3.5, which plot these correlations, the most urbanised or densely populated territories in 1500 tend to hold lower economic positions today, and vice versa.

Another factor that, as we will see, is central to the explanation is that the turnaround in the relative wealth of colonies did not take place shortly after colonisation. This phenomenon occurred at in the late-18th and early-19th centuries, together with the industrialisation process. This is demonstrated by the work of Acemoglu *et al.* (2002) and other research, such as that of Maddison (2001), which reveals that India, Indonesia, Brazil and Mexico were wealthier nations than the United States until 1700. However, by 1820, they were lagging behind this country in terms of the international distribution of wealth.

As far as the advocates of the institutional approach are concerned, this historical shift in the development paths of these countries is due to the different institutions that were established in the colonies as a consequence of the colonisation strategies of European nations. Specifically, the explanation for this economic turnaround can be found in the fact that the wealthier colonised economies ended up with institutions that were not very conducive to industrial progress, while the poorer colonies benefited from an institutional framework that fostered economic modernisation.

Acemoglu *et al.* (2002) distinguish between two types of institutional arrangements —with different implications for modern growth— that the Europeans established in the conquered territories and which continued after independence. Firstly, there were "extractive institutions" or oligarchic political systems in which political power is concentrated in the hands of the economic elite (landowners, producers and investors) and the majority of the population does not have effective legal certainty.

This type of organisational structure obviously guarantees the property rights of producers and members of the elite, but also allows them to use their privileged positions within the system to violate the rights of the rest of society. They can introduce economic regulations designed to create and maintain monopolies that hinder the entry of potential entrepreneurs onto the market[11], or policies that exclude the majority of the population from new economic opportunities. They may even carry out expropriation practices or directly exploit the work of the most disadvantaged groups.

Secondly, there are the democratic political systems, which promote the political and legal equality of all citizens. By distributing political power more fairly, this system protects the property rights of a large part of society and helps different social groups to access production opportunities[12].

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11 One interesting case, cited in Acemoglu (2008), is "Mexico at the end of the 19th century, when the rich elite controlled the banking system during the regime of Porfirio Díaz (1876–1911). The protection by entry barriers, and the resulting lack of loans for new entrants enabled the elite to maintain a monopoly position in other sectors" (p. 2).

12 Note the difference in the type of institutions compared here and those analysed in the research mentioned in the previous section. In accordance with a fairly comprehensive categorisation of the political regimes, it is necessary to distinguish between absolute dictatorships, in which the power is concentrated in the hands of a single person; oligarchies, in which the economic elite determine the public decisions to a large extent; and democracies. The previous section gave an analysis of the importance of establishing controls on governors to guarantee the rights of capital owners. The conclusion was that a regime with a strong parliament that represented their interests or, in other words, an oligarchic parliament, was better for growth than an absolutist monarchy. This section, meanwhile, compares the economic effects of oligarchies with those of democracies. The question is, based on a system of the separation of powers, to what extent does the political equality of citizens effect development?

The choice of European colonists with respect to the type of political structure to be implemented in the conquered territories was based on their interest in maximising their income, which, in turn, depended on certain conditions that they faced in the colonies. As will be justified below, the result was that, in the more prosperous territories, oligarchic institutions for extracting resources were established while, in the poorer societies, the colonists were more interested in setting up democratic institutions to protect the property rights of most of the population.

The consequences of the institutional choice on the long-term development of the colonies was primarily demonstrated by the industrialisation process that began in the late-18th and early-19th centuries. As this process required the widespread participation of the population (middle class, small landowners, workers, etc.) in economic exchange and new investment opportunities, the societies with more egalitarian institutions started off from a far more beneficial position for taking advantage of the modern technological challenges of industry and trade.

Why did the colonists choose different institutional arrangements in different territories? A range of factors influenced the institutional decisions of the European colonists. In the work of Acemoglu *et al.* (2002, 2005), population density and the availability of mineral and farming resources play a crucial role. On the one hand, in areas that had a large indigenous population and were rich in resources, such as Mexico and Peru, it was more profitable for the colonists to establish extractive institutions to exploit the abundant workforce for mineral or agricultural production. This type of institution was generally established in the most prosperous territories with larger populations, simply because there was greater wealth to extract.

Moreover, low population density directly facilitated the settlement of the Europeans themselves. In addition, poor regions with a smaller, dispersed indigenous population, such as the United States, Canada, New Zealand and Australia, offered better environmental conditions for preventing the spread of diseases that were a particular threat to Europeans, such as malaria and yellow fever. All of this lead the colonists to develop large-scale immigration and settlement policies, so that the majority of the inhabitants of these colonies were immigrants from European nations. The colonists in these societies clearly preferred a more democratic institutional framework that guaranteed their own rights, demanding "similar or fuller protection to what they enjoyed in their countries of origin" (Acemoglu *et al.*, 2002: 1266).

The institutions created by the Europeans lasted beyond the colonial era. With the arrival of independence, while the European settlements generally became countries with more democratic governments, in the case of oligarchic colonies, the post-colonial elites took advantage of the existing institutions to block political and economic changes that threatened their privileges, even to the detriment of long-term development. The success of the industrialisation process of the 19th century, which was a fundamental factor in the economic modernisation of countries, depended on a series of social, economic and educational transformations that gave different social groups access to the new investment opportunities (such as in human capital). It is not surprising, therefore, that the more egalitarian societies had a larger growth trend than the former oligarchic colonies with a greater starting wealth.

Engerman and Sokoloff (2002) also emphasise the causal role of the institutions established in the age of colonisation with respect to the different economic trajectories of the colonies in the Americas. According to the theory of these authors, in order to maximise their profits, the European nations chose different modes of production and ways of organising society based on the particular conditions in the colonies associated with climate, land quality, population density and the abundance of mineral resources. We can distinguish between three types of colonies in the New World.

The first category encompasses the territories with land and climate features that are particularly suitable for growing sugar and cotton, such as Barbados, Cuba, the Dominican Republic and Brazil. In view of the economies of scale of such crops, and in relation to efficiency criteria, production was organised in the form of large plantations that used slaves who had been brought from Africa on the international market. The distribution of wealth that resulted from this economic structure was extremely imbalanced. On the one hand, a small elite of plantation owners monopolised practically all the resources while, on the other, there was a very significant proportion of the population living in slavery. This inequality also spread to the public sphere, with the power concentrated in the hands of the elite. This situation continued even after the abolition of slavery, thanks to the evolution of institutions designed to uphold the elite's privileges to the detriment of the societies' more disadvantaged groups.

The second category of colonies includes those conquered by Spain —such as Mexico and Peru— which were characterised by a great amount of mineral resources and very large indigenous populations. In these regions, the colonial authorities approved the distribution of the land, resources and native workforce in a way that resulted in large-

Table 3.2 Electoral legislation and extension of suffrage in the Americas, 1840-1940

Period/ Country	Year	Secret ballot	Wealth requirements	Education requirements	Voters as percentage of population
1840-1880					
Chile	1869	Yes	Yes	Yes	1.6
	1878	Yes	No	No	—
Ecuador	1848	No	Yes	Yes	0.0
	1856	No	Yes	Yes	0.1
Mexico	1840	No	Yes	Yes	—
Peru	1875	No	Yes	Yes	—
Uruguay	1840	No	Yes	Yes	—
	1880	No	Yes	Yes	—
Venezuela	1840	No	Yes	Yes	—
	1880	No	Yes	Yes	—
Canada	1867	No	Yes	No	7.7
	1878	Yes	Yes	No	12.9
United States	1850	Yes	No	No	12.9
	1880	Yes	No	No	18.3
1881-1920					
Argentina	1896	No	Yes	Yes	1.8
	1916	Yes	No	No	9.0
Brazil	1894	No	Yes	Yes	2.2
	1914	No	Yes	Yes	2.4
Chile	1881	Yes	No	No	3.1
	1920	Yes	No	Yes	4.4
Colombia	1918	Yes	No	No	6.9
Costa Rica	1912	No	Yes	Yes	—
	1919	No	No	No	10.6
Ecuador	1888	Yes	Yes	Yes	2.8
	1894	Yes	No	Yes	3.3
Mexico	1920	Yes	No	No	8.6
Peru	1920	No	Yes	Yes	—
Uruguay	1920	No	Yes	Yes	—
	1920	Yes	No	No	13.8
Venezuela	1920	No	Yes	Yes	—

Table 3.2 *(continued)*

Period/ Country	Year	Secret ballot	Wealth requirements	Education requirements	Voters as percentage of population
Canada	1911	Yes	No	No	18.1
	1917	Yes	No	No	20.5
United States	1900	Yes	No	Yes	18.4
	1920	Yes	No	Yes	25.1
1921-1951					
Argentina	1928	Yes	No	No	12.8
	1937	Yes	No	No	15.0
Bolivia	1951	—	Yes	Yes	4.1
Brazil	1930	No	Yes	Yes	5.7
Columbia	1930	Yes	No	No	11.1
	1936	Yes	No	No	5.9
Chile	1920	Yes	No	Yes	4.4
	1931	Yes	No	Yes	6.5
	1938	Yes	No	Yes	9.4
Costa Rica	1940	Yes	No	No	17.6
Ecuador	1940	Yes	No	Yes	3.3
Mexico	1940	Yes	No	No	11.8
Peru	1940	Yes	No	Yes	—
Uruguay	1940	Yes	No	No	19.7
Venezuela	1940	Yes	Yes	Yes	—
Canada	1940	Yes	No	No	41.1
United States	1940	Yes	No	Yes	37.8

SOURCE: Engerman and Sokoloff (2002).

scale estates and land assignments. The main exports were the gold and silver obtained from the mines in Mexico, Peru and Bolivia with the forced labour of native people. As in the case of the first category, this organisational structure of society generated great economic and political inequality between the landowners and the rest of the population.

Lastly, the third type of colonies included the North American territories: the United States and Canada. These regions lacked an abundant native population and their climate was more suitable for growing cereals and raising livestock on smaller-scale family farms. The inhabitants of these colonies were mostly small landowners of European origin, so the population was more homogeneous and the distribution the wealth was fairer.

The initial conditions of inequality that emerged in the colonies determined the direction of their institutional evolution. In the first two categories, the extreme inequality contributed towards the creation of political and institutional framework run by the elites, with power assigned asymmetrically among citizens in favour of the wealthiest groups. These, in turn, used the disproportionate control that they exercised over public decisions to serve their own interests, thereby reproducing the unequal conditions that maintained their privileges. In contrast, the development of the institutions and the economy was fairer in the colonies that started with a lower degree of inequality. The institutional evolution in such societies was more democratic and the political approaches did not distribute economic opportunities so asymmetrically.

To demonstrate the distribution of political power in the various colonies, Engerman and Sokoloff analyse the percentage of voters with respect to the population and the regulations defining the extension of the vote for a large number of countries in the Americas. The assumption is that the higher the proportion of citizens who vote and the less restrictive the conditions for suffrage from a legal perspective, the fairer the distribution of power will be between the different social groups. Table 3.2 presents information about the legislative changes with respect to the secret ballot and the existence of educational or wealth requirements to obtain the right to vote from the mid-19th to the mid-20th centuries. The last column also shows the proportion of the population who had the right to vote.

The United States and Canada were the first countries in the Americas to eliminate the suffrage barriers associated with issues of wealth and illiteracy[13] and which guaranteed the right to vote in secrecy. According to the historical analysis of Engerman and Sokoloff, at the end of the 1850s, almost all the states of the American Union gave the vote to all adult white men, with Canada following suit shortly after. However, in Latin America, the incorporation of poor and illiterate groups onto the electoral register did not take place until well into the 20th century. This partly explains why, from the beginning of the period under study, the percentage of the population participating the electoral system in the United States and Canada was systematically far higher than in the rest of the countries, as can be observed in the last column of Table 3.2.

The degree of democratisation of the political institutions affected the capacity of the elites to drive forward economic

13 However, in the United States, certain educational requirements were reintroduced at the end of the 19th century, primarily aimed at the black and immigrant population.

policies and regulations that benefitted them to the detriment of other social groups. While in Latin America they capitalised on their political influence with the aim of preserving their privileges and systematically excluding the poorest citizens from economic opportunities, in North America, this happened to a far lesser degree. The policies associated with land distribution and the expansion of public education, as well as the regulatory standards of the banking and patent systems, are some of the factors that Engerman and Sokoloff highlight in support of this hypothesis.

For instance, there are huge differences between the countries in the Americas in terms of the policies they applied in relation to land ownership. The measures adopted in the United States and Canada during the 19th century resulted in a fairer distribution. Family-sized plots of land were given to anyone who was willing to settle and work the land for a certain period of time. In contrast, the privatisation of public land in Latin American countries such as Argentina, Brazil and Mexico almost exclusively benefitted the large landowners. Looking at the available data, it is worth noting that in 1910 only 2.4% of rural Mexican families were landowners, while in the United States this percentage had reached 75% by 1900.

Another example of the effect of colonial institutions on the distribution of production resources among citizens can be found in education policies. The expansion of public schooling, as well as having a direct impact on growth through the accumulation of human capital, plays a crucial role in determining who benefits from economic progress. Significant differences can also be observed between the countries in the Americas in terms of universal access to education (see Table 3.3)[14].

The undisputed leaders in the expansion of public schooling were the United States and Canada. "The United States probably had the most literate population in the world by the beginning of the 19th century, but the common school movement, which got under way in the 1820s, put the country on an accelerated path of investment in educational institutions, [...] encouraging or requiring localities to establish free schools open to all children and supported by general taxes" (Engerman and Sokoloff, 2002: 76). The educational results obtained were highly significant, bearing in mind the standards of the time. In the mid-19th century, around 40% of school-age children were enrolled in schools, and almost 90% of the white adult population could read and write, as shown

14 The numbers in the last column refer to the percentage of the adult population at the age specified in the 'Age' column with the ability to read and write.

Table 3.3 Literacy rates in the Americas, 1850-1950

Country	Year	Age	Literacy rate (%)
Argentina	1869	> 6	23.8
	1895	> 6	45.6
	1900	> 10	52
	1925	> 10	73
Bolivia	1900	> 10	17
Brazil	1872	> 7	15.8
	1890	> 7	14.8
	1900	> 7	25.6
	1920	> 10	30
	1939	> 10	57
Chile	1865	> 7	18
	1875	> 7	25.7
	1885	> 7	30.3
	1900	> 10	43
	1925	> 10	66
	1945	> 10	76
Colombia	1918	> 15	32
	1938	> 15	56
	1951	> 15	62
Costa Rica	1892	> 7	23.6
	1900	> 10	33
	1925	> 10	64
Cuba	1861	> 7	23.8
	1899	> 10	40.5
	1925	> 10	67
	1946	> 10	77.9
Guatemala	1893	> 7	11.3
	1925	> 10	15
	1945	> 10	20
Mexico	1900	> 10	22.2
	1925	> 10	36
	1946	> 10	48.4
Paraguay	1886	> 7	19.3
	1900	> 10	30
Peru	1925	> 10	38
Uruguay	1900	> 10	54
	1925	> 10	70
Venezuela	1925	> 10	34

Table 3.3 ***(continued)***

Country	Year	Age	Literacy rate (%)
Canada	1861	All	82.5
United States			
White Northern people	1860	> 10	96.9
White Southern people	1860	> 10	91.5
Whole population	1870	> 10	80 (88.5/21.1)*
	1890	> 10	86.7 (92.3/43.2)
	1910	> 10	92.3 (95/69.5)

*The percentages in brackets refer to the literacy rates for white people and non-white people, respectively.

source: Engerman and Sokoloff (2002).

in Table 3.3. Canada followed the path taken by the United States by expanding the public provision of education, albeit slightly later.

As Table 3.3 shows, the Latin American countries did not achieve comparable rates of literacy until well into the 20th century, even if we only focus on the most educationally advanced societies (such as Argentina and Uruguay). However, "fairly generous support was made available for universities and other institutions of higher learning that were more geared toward children of the elite" (Engerman and Sokoloff, 2002: 79).

Inequality in terms of access to investment or the accumulation of means of production affected the prospects of the countries in question. A high degree of inequality, with a large proportion of the population being prevented from taking part in economic exchanges and the new technological and investment opportunities offered by the industrialisation process, had a negative impact on economic development[15]. The societies with less egalitarian institutions,

15 This idea is based on a conceptualisation of economic growth in which equality is good for growth because it expands trade and markets. This expansion would lead to "a more effective and intensive use of resources, the attainment of economies of scale, higher investments in human capital and greater specialisation of the factors of production" (Engerman and Sokoloff, 2002: 84). In response to this viewpoint, there is a theoretical tradition that emphasises the role of accumulation of physical capital and capital-intensive sectors in a society's growth potential. As the wealthiest groups in an economy tend to have higher rates of saving and investment, according to this approach, equality should not be so favourable for growth.

located in Latin America, found themselves lagging behind in the race towards modernisation, despite having enjoyed greater wealth throughout the pre-industrial period.

Various empirical studies have statistically demonstrated the role of institutions, in comparison to the impact of geographical factors, for explaining the variation in levels of income per capita between countries (Easterly and Levine, 2003; Rodrik, Subramanian and Trebbi, 2004). Using statistical methods to resolve problems of causality (instrumental variable models) that may have distorted the relationship between institutions and development[16], these studies conclude that national differences in income can be explained to the greatest extent by institutional variables. Another significant finding of these authors is that geographical conditions do not qualify as statistically significant causes once the effect of institutions on long-term economic growth is excluded.

However, other research has called into question the causal role of institutions as the ultimate source of growth by including other explanatory variables of an economic nature in the analysis, such as accumulation of human capital (Glaeser *et al.*, 2004). These authors examine the extent to which countries' political institutions or their aggregate levels of education act as the fundamental cause behind their economic trajectories over time. In the context of the former European colonies, and in response to the theory of Acemoglu *et al.* (2002), Glaeser *et al.* (2004) argue that, in the territories in which the Europeans decided to settle, rather than establishing institutions to exploit the local population, they not only brought their political institutions of limited government but also themselves and, as a consequence, "their know-how and human capital". Right from the outset, the colonising strategies involved different institutional frameworks as well as different rates of human capital in their respective populations. In the regions of large European settlements (for instance, in North America), which later benefitted from the constantly positive evolution of their economies, there were both political institutions that were favourable to growth and a population with a higher level

16 There are basically two of these causality problems; the first deals with the causal link between institutions and development, with the correlation that we observe between these two variables possibly also being the result of the positive effect of wealth on the development of democratic systems. The second issue involves the omission of variables that simultaneously effect institutions and development. In this case, the correlation may be spurious, so it is not possible to conclude that either of the variables (institutions or development) is the cause of the other.

of education. This argument therefore suggests the possibility that the relationship between institutions and growth is a spurious association determined by the effects of a third factor —human capital— on economic and political progress. The empirical evidence presented by Glaeser *et al*. (2004) seems to support the hypothesis that human capital accumulation, and not the institutional framework, is the true exogenous cause of development.

2. Democracies and dictatorships

The conclusion of the most recent institutionalist research is, firstly, that institutions are the fundamental cause of progress and, secondly, that democratic systems foster growth most effectively. The mechanism of the latter relationship is based on the political equality or the protection of property rights across a broad sector of the population. In the context of the former European colonies, political equality enabled economic opportunities to come within the reach of most of society and, to a large extent, frustrated the aspirations of the elite to block the entry of new producers and investors onto the market.

In response to these positions, in the debate held throughout the 1980s and 1990s with respect to the impact of political regimes on growth, certain authors questioned the goodwill of democratic institutions in relation to protecting property rights. The introduction of universal suffrage and the use of majority rule when making most decisions—elements that constitute a democracy—may lead to political equilibriums that involve the redistribution of the wealth of the richest groups to more economically disadvantaged sectors of society. In fact, as advocates of this idea argue, the confrontations between the working classes and the industrial elites in the 19th century with respect to the extension of the vote were precisely due to the redistributive consequences of democracy (Przeworski *et al*., 2000: 209). In Chapter 6 of this book, there is a detailed analysis of the reasons for which democratic politicians may introduce wealth redistribution measures and the implications they may have for economic growth.

Apart from the protection of property rights, in the debate mentioned above, other alternative mechanisms and hypotheses have been proposed regarding the effect of the political regime on growth. The classification on which the majority of these studies are based divides the political systems into democracies and dictatorships. The former includes all the countries in which politicians gain power through contested elections (with more than one party competing electorally) with universal suffrage (all citizens have the right to vote regardless of their income or gender). By default, all other countries are classified as dictatorships[17]. Based on these definitions, the prevalent research question in the academic debate concerns the extent to which democratic systems provide a better political foundation for economic development than authoritarianism.

2.1. Authoritarianism and economic reforms

A theory that is commonly cited in the literature on the economic consequences of the political regime refers to the State's capacity to implement development policies or structural adjustment measures for the economy in times of crisis. During the 1980s, many developing countries faced an intense recession characterised by excessive public debt, balance of payments disequilibrium, high inflation, a decrease in real salaries and the stagnation or even reduction in GDP per capita. In Latin America, the recession of the 1980s was partly due to the protectionist and price control policies that had set the course of the industrialisation strategies of several governments in the 1960s and 1970s. The new emerging democracies in Easter Europe also underwent a significant deterioration of their economies with the change of regime (Bresser *et al.*, 1993). The greatest challenge they faced was the shift from a planned, centralist model to a market economy.

In response to these economic imbalances, there was a general consensus among specialists, political leaders and advisors to international organisations regarding a series of proposed adjustments required for recovery. In short, this programme of reforms consisted of reinforcing the role of the market in the economy through structural adjustments such as greater liberalisation of trade, the introduction of restrictive monetary and fiscal policies and real exchange rates set by the market to control inflation and restore the balance of payments, and a shift towards the deregulation and privatisation of public companies.

17 Although, theoretically, the arguments have commonly been structured as a dichotomy —in the sense that they compare the economic effects of democracies with those of autocracies— quantitative empirical studies have often used continuous indicators of the degree of organised democracy that exists in regimes based on scales that range, for example, from 0 (least democratic) to 10 (most democratic). See Przeworski *et al.* (2000) for a defence of the dichotomous empirical classification of political regimes.

The short-term distributive consequences and social costs of these reforms, which we will analyse below, also triggered a parallel debate about the institutional preconditions required to adopt these structural measures. The discussion focused on the extent to which the political dynamics of democracies worked against market restructuring, while, at the same time, certain academics acknowledged that autocracies may have greater powers in this respect. In addition, the idea was supported empirically by a diverse range of reformist experiences in Latin America and Eastern Asia. While the Latin American democracies of the 1980s (Brazil, Argentina, Bolivia, Peru, etc.) came up against different obstacles in the implementation of "orthodox" policies, which many believed was the cause of costly delays to the reforms, the countries of Eastern Asia (South Korea, Taiwan, Singapore, etc.) managed to redirect their economies towards more efficient market forms during their autocratic periods in the 1960s and 1970s, thanks to which their growth rates remained positive even through the global economic crisis of the 1980s (Haggard and Kaufman 1992).

In order to understand the theoretical reasons that justify the supposed benefits of authoritarian regimes, we need to understand the main political dilemmas posed by stabilisation and economic restructuring policies[18]. Firstly, a collective action issue may arise that is similar to the problem faced in the provision of public goods. To illustrate this, let's consider a public expenditure containment policy that requires the cooperation of various stakeholders in accepting cuts to the subsidies they receive. All the groups benefit when the public deficit is not very high because this helps to ensure the State's solvency to perform its most essential functions of ensuring public safety, providing education and building infrastructures. The problem is that the cost of accepting lower subsidies is extremely high when the other groups do not face similar cuts at the same time, as the deficit will remain excessive. Unless the cooperation of all the stakeholders is guaranteed, no group will have an incentive to cooperate by reducing their subsidy demands.

A second dilemma in relation to certain economic reforms is the distributive conflict that arises between the winners and the losers of the reform. In this case, the long-term results of the measure in question are not rated positively by all the parties involved. Some sectors of society directly benefit from the reform, while the wellbeing of other groups is reduced. One example of this is controlling salary

18 The following presentation of these dilemmas is based on Haggard (1997).

growth as a measure to slow down inflation. This policy involves unilateral sacrifices from workers, while businesspeople "win", as their products will be more competitive on international markets due to the reduction of their labour costs.

If the policy generates net benefits for society as a whole, the potential winners could —in theory— compensate the losers by transferring some of their earnings in the future, thereby getting the losers to agree to the reform. However, these pledges are not very credible because of the future winners' incentives to break their promises once the other party has paid the costs of the reforms. In the absence of mechanisms to guarantee compliance with agreements, the introduction of structural adjustments to the economy which involve an asymmetrical distribution of costs and benefits will depend on the relative strengths of the conflicting groups. The success of the salary containment policy described in the previous example will be greater if the political influence of trade unions or other workers' organisations is lower.

Lastly, the reforms involve time swaps that cause dilemmas for political decision-makers. Most market restructuring programmes consist of implementing a serious of austerity measures in the short term in exchange for better economic prospects in the future. The positive consequences on the agents' wellbeing only take effect after they have spent a period of time making sacrifices. This time sequence in the reforms requires governors to take future benefits into account in their utility calculations so that they are willing to put "unpopular" policies into action in the present. In other words, it is important that governments are not short-sighted and do not make decisions taking only the short-term consequences of the policies into consideration, but rather with a more long-term perspective.

According to the literature examined in this section, political institutions play a role in the scope of these problems by buffering or, on the contrary, worsening their effects. For advocates of the economic utility of authoritarianism, "institutions can overcome these collective action dilemmas by restraining the self-interested behaviour of groups. Collective action problems can be resolved by command" (Haggard, 1990: 262). Olson (1982) suggest that the application of efficient policies requires institutions capable of controlling and neutralising the individual pressures of social coalitions, so that governments have more room for manoeuvre in the political decision-making process.

According to this line of argument, the benefits of autocratic regimes come from the fact that the leaders of such systems can more easily impose the burden generated by market reforms —such as decisions on public spending cuts and trade subsidies— on the various groups. As their power does not depend on their degree of popular support, dictators enjoy greater autonomy with respect to social demands. As Haggard states, “since authoritarian political arrangements give political elites autonomy from distributionist pressures, they increase the government’s ability to extract resources, provide public goods and impose the short-term costs associated with efficient economic adjustment” (1990: 262).

Meanwhile, political liberalisation, which implies a democratic institutional setting, promotes activism by stakeholders. One case often cited in the literature is the rise in power achieved by trade unions with the democratisation of institutions. The increase in the influence of the working class was not only due to its greater capacity to organise itself, but also the fact that democratic decision-making processes became more sensitive to the interests of social groups. It is assumed that in autocracies, in contrast, workers often lack the legal instruments or resources to organise themselves effectively, to the detriment of their ability to defend their interests. As a result, dictatorial countries face fewer obstacles when applying measures that disproportionately harm the working class—such as the privatisation of public companies, imposing monetary or fiscal restrictions or reducing pay rises—but which promote saving and investment. Some authors consider this a key factor in the success of East Asian economies.

Apart from the supposed inferiority of democratic governments in terms of executing efficient economic plans as they have less autonomy if groups are unwilling to assume the resulting losses in the short term, it has also been argued that democracy incentivises short-sighted behaviour from governors. Due to the periodicity of elections, the yields from structural adjustments and economic recovery may not occur before the end of the term of office. If voters do not anticipate or sufficiently value the future increases in their wellbeing and only base their voting decision on the costs of the policies, it is less likely that the government will be re-elected. For its part, the government will therefore have fewer incentives to implement these reforms at the start of its term of office. Regular elections, therefore, shorten the time horizon on which politicians evaluate the effect of their decisions. In contrast, dictators who are secure in their position, in theory, adopt a less short-sighted approach to politics.

The arguments that advocate the economic superiority of dictatorships have generated a series of criticisms. Firstly, even if we accept that such regimes are equipped with institutional mechanisms that facilitate the implementation of economic adjustment measures, this does not guarantee that dictators are going to take such measures. Just because autocrats have the power to do something does not mean that they are going to do it. What happens if, rather than implementing development strategies, the dictators want to maximise their own income? From this perspective, the absence of electoral control mechanisms may simultaneously have a negative effect as it eliminates the possibility of citizens punishing the leaders' potentially opportunistic and corrupt behaviour.[19]

The latest contributions regarding the impact of democratisation on the reduction of corrupt government practices, however, suggest that the association between democratisation and corruption is not linear. With the aim of understanding the reasons for Africa's economic backwardness, Robert Bates (2008b) attributes the material deterioration of societies on this continent to the greater incidence of cases of civil war and state collapse. When the political order collapses, firstly, the state becomes a predatory tool in the hands of the political leaders, who use their power abusively to promote their own interests —even though this triggers greater political and economic uncertainty in the country. Secondly, the collapse of the state leads to a loss of the monopoly held over the means of coercion. Political groups become armed militias that threaten state power, and private agents, rather than dedicating themselves fully to producing wealth and their everyday tasks, affiliate themselves with one of these armed groups in an attempt to obtain the safety that the state can no longer guarantee them (Bates, 2008b: 2). This process of political disintegration obviously generates significant economic costs for the country.

With respect to the causes that promote state collapse, Robert Bates (2008a, 2008b) highlights the role of democratisation in view of the coincidence between the periods of democratisation and the periods of collapse of political order in certain African societies. The central argument is that, during the initial phases of democratisation, in which the political system could be classified as a "partial" democracy or intermediate regime (i.e. systems halfway between stable dictatorships and consolidated democracies), there

19 Moreover, as we analysed in the first section of this chapter, when there are no limitations on government action, the risk of expropriation and violation of rights by the state increase and, as a consequence, investors have fewer incentives to develop their economic projects.

is a high risk of political instability because the new opposition groups can challenge the dictator's monopoly over power which, until then, had been reasonably secure in their hands. This increase in the dictator's political uncertainty drives them to adapt a more short-sighted approach to their governance. This creates a greater likelihood that governments will become more corrupt and more aggressive in their attempts to eliminate the sources of opposition to the regime. In turn, in response to these state actions, political groups may organise themselves militarily to provide the sectors of society that support them with political and economic protection from the abusive interference of the state.

With respect to the association between the degree of democratisation and political corruption, the argument follows the hypothesis that corruption and abuses of power committed by dictators to maximise their private incomes tend to be more common in contexts of democratic transition than in either stable dictatorial regimes or during the consolidation of democracy.

A second criticism of theories that see dictatorships as the most favourable institutional structure for growth is that there is little evidence that autocratic governments are, by nature, free from the pressures of stakeholders. Dictators sometimes have to appeal to certain sectors of the population to build support or to respond to the individual interests of groups that they cannot repress, which may on occasions have terrible consequences for growth. For instance, the agricultural price regulation policy implemented by some African dictatorships encumbered the productivity and expansion of farming. Moreover, although the comparative advantage of these poorer countries in international trade was precisely in this sector, these policies actually resulted in negative growth rates.

According to Bates (1981), the regulation of agricultural processes was the result of these governments' strategies to satisfy urban demand. In many African regimes, "the governments faced a dilemma: urban discontent, which could not be eradicated through coercion or repression, posed a real threat to its interests [...]. Its response was to try to appease urban interests without offering high salaries, but defending policies designed to reduce the cost of living and, in particular, the cost of food. The agricultural policy, therefore, became a sub-product of the political relations between the government and the urban coalitions" (1981: 33).

Another criticism that calls the arguments for authoritarianism into question is the existence of democratic institutional formulas that help to resolve the distributive conflicts generated by reforms.

It is worth highlighting the role of corporate collective bargaining institutions, which have been established in some European democracies to instigate credible pledges with trade unions with respect to the introduction of adjustment and stabilisation plans. Thanks to these institutions, business, trade union and government representatives regularly negotiate crucial matters of economic policy, such as salaries and investment. For a number of reasons, the institutionalisation of the relations between trade unions, businesspeople and the government can reinforce the credibility of distributive commitments between the parties, thereby reducing the collective action problems generated by economic reforms.

Empirically, although the economic success stories of the Asian "tigers" (Taiwan, South Korea, Hong Kong and Singapore) are the typical cases used to support the hypothesis of the positive effects of authoritarianism on growth, the fact is that not all autocratic regimes have achieved such spectacular economic results. In fact, there are several cases of dictatorships that have caused authentic economic disasters. There have even been dictatorships in which, after a period of expansion, growth rates have stagnated or become negative, such as in the cases of Iraq, Nigeria, the Ivory Coast and Yugoslavia during the 1980s (Przeworski *et al.*, 2000). As stated by Przeworski *et al.* (2000), "any list of [economic] miracles and disasters is populated almost exclusively by dictatorships. As such, observing the most successful cases leads to error: the tigers may be dictatorships, but dictatorships are no tigers" (p. 178).

2.2. Democracy and economic efficiency

One of the main theses used to defend democratic institutions in the debate on growth and the political regime suggests that democracies use their available resources more efficiently. Although it has not been developed in depth, the argument focuses on the free access to information that exists thanks to the political and civil liberties that accompany democratisation. In societies in which the freedom of the press and the right of association are guaranteed, citizens are better informed with respect to the actions of the authorities and they can exercise more effective pressure for the improvement of public services. As a result, democracies tend to be more efficient in providing public goods. It is also assumed that economic decisions are more effective when the agents and authorities have access to various sources of information and information is more widely circulated.

One well-known study that follows this theory is the work of Amartya Sen on the relationship between democracy and the prevention of famine. By concluding that a famine has never occurred under a democratic government, Sen (1992) suggests that the causal link is based on the roles of free press and opposition in distributing relevant information for the prevention of famine. According to Sen, "a free press and active political opposition constitute the best early-warning system a country threatened by famines can have" (Sen 1992: 3).

To support his argument empirically, Sen compares the responses of the governments of India and China to the first indications of a potential famine. In India, "the warning is usually raised by the local press, which is followed by regional urban newspapers, which are then immediately covered by the national press. In a matter of days, the questions are raised in the Indian Parliament or State Assembly" (p. 6). The government has greater knowledge of the conditions in which vulnerable groups live and, in some way, they feel under greater pressure to react in time, thanks to the truthful reports in the press and the mobilisation of the opposition. As a result, since gaining independence in 1947, India has not suffered any famines, despite having had severe droughts on many occasions.

According to this interpretation, the Chinese famines of 1958-1961, in which many thousands of people died, were not the consequence of worse objective economic conditions in China, but rather the lack of truthful information issued by the central government, which contributed towards the lack of a fast response from the State. Sen explains this in the following way: "The lack of a free system of news distribution even misled the government itself. It believed its own propaganda and the rosy reports of local party officials competing for credit in Beijing. By adding up these numbers, the Chinese authorities mistakenly believed that they had 100 million more metric tons of grain than they actually did, just when the famine was moving towards its peak" (p. 7).

The quantitative empirical evidence on the impact of the political regime on growth is fairly abundant. However, despite the massive output of statistical analyses in this respect, the results are contradictory. With samples from countries observed during the period after the Second World War, a number of studies concluded that dictatorships had more growth while others reported greater growth in democracies[20]. One of the reasons for this ambiguity in the

20 For a detailed review of the empirical literature, see Przeworski & Limongi (1993) and Sirowy & Inkeles (1990).

statistical findings is the existence of different causal mechanisms at play in the relationship, which may be pulling in opposite directions[21]. It may be the case that democracies and dictatorships have distinct advantages in different aspects of the development process, as demonstrated in the previous paragraphs. In line with this idea, Przeworski *et al*. (2000) proposed that, although there are no significant differences between the two types of institutions with respect to growth rates, there is a divergence in terms of the *sources* that underpin the growth. Democracies fundamentally grow due to increases in work productivity and the technological progress, while dictatorships offset their inferior results in terms of productivity by increasing the total workforce and achieving higher rates of investment in physical capital.

In conclusion, the role of institutions has been a key factor in economic development according to new institutional economics. Thanks to the separation of powers and the existence of an independent judiciary system, Western countries managed to achieve greater protection of property rights in comparison to the abuses of power that had occurred in the earlier absolute monarchies. The extension of the vote and the fairer distribution of political power in the North American colonies partly explain the economic success in these regions in comparison to the former colonies in Latin America, where a small wealthy elite controlled political power. There appears to be a certain theoretical consensus, therefore, in terms of the beneficial consequences of an institutional framework that prevents the concentration of power, as it ensures better protection of property rights and enables a broader sector of society to take advantage of the investment opportunities offered by technological advances, as was seen during industrialisation. However, there are also theoretical contributions that emphasise certain advantages of authoritarianism, such as the greater capacity to implement economic reforms in times of crisis. With this in mind, the final conclusion is that the various political institutions can have different effects depending on the economic dimension being analysed: the protection of property rights, the degree to which society is involved in economic activities and the government's commitment to implementing "unpopular" economic policies that are efficient in the long term.

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21 Another reason is the incorrect statistical methodology used in the majority of these studies (Przeworski *et al*., 2000).

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4. Questions

3.1 Why are the protection of property rights and guarantees with respect to contract compliance key factors in the proper functioning of the economy, according to the institutional theory of development?

3.2 Explain why reputation is an imperfect mechanism for resolving the problem of the time inconsistency of promises made by governors with respect to taxation policy.

3.3 Why do the political institutions that comprise a limited government increase the protection of property rights in comparison to an absolute monarchy?

3.4 What role do political institutions play in explaining the change that has occurred in the relative wealth of former European colonies? Describe this change and explain why the explanatory capacity of geographical variables is limited.

3.5 In the debate on the impact of the political regime (democracy vs. dictatorship) on economic growth, what arguments have been put forward in favour of the economic advantages of both types of system?