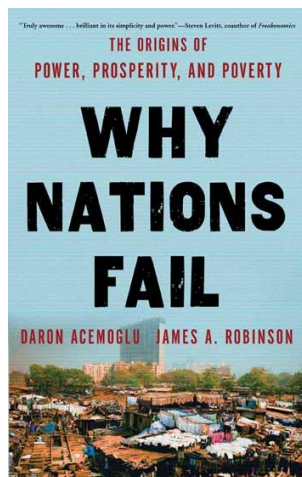


## Development Policy Lecture 4

# Inclusive Institutions



## Acemoglu and Robinson (2012)



- Successful countries create “inclusive institutions” that enable people to make the best use of their talents.
- Failed countries have “extractive institutions” that extract income from the mass of the population to give to powerful groups.

## Inclusive institutions

- Protection of property rights
- Rule of law and an impartial judiciary
- Free markets and the right to start up a business and compete with existing businesses
- Public services like roads and basic regulation to make it possible for everyone to compete
- The right to choose your own career and a level playing field so the most talented people thrive.
- Rewarding innovation so that the best ideas are implemented and bad ideas are discarded

## Technology and inclusive institutions

- Innovation is crucial for economic growth: technological change drives productivity growth
- Inclusive institutions reward innovation
- Universal access to education needed so that the workforce can make use of new technologies.
- Education also helps young people to realize their potential for innovation in science, technology and business

## Political and economic institutions

- Extractive economic institutions persist because distribution of political power is narrow.
- Political elites establish economic institutions to enrich themselves and increase their power.
- When power is widely distributed in society groups will press for inclusive economic institutions
- Economic and political institutions are mutually supportive

		Economic Institutions	
		Inclusive	Extractive
Political Institutions	Inclusive	⌚	←↓
	Extractive	↑→	⌚

## Centralized political authority

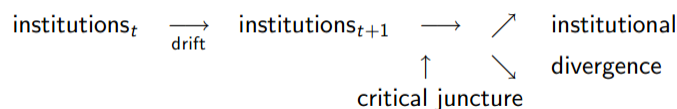
- A wide distribution of power but the absence of central authority does not result in inclusive institutions
- When power is held by many different clans of equal power markets will not thrive: Example of Somalia
  - Law and order not enforced: perpetual state of war
  - Public services not provided equally to all
- So inclusive institutions require that the state has a monopoly on the use of force (Max Weber)

## Creative destruction

- The economist Joseph Schumpeter characterized the process of technological change as “creative destruction”
- Change creates both winners and losers: automobiles made horse-drawn carriages obsolete; personal computers destroyed the typewriter industry.
- Creative destruction threatens political elites in extractive political systems so they do not want inclusive economic institutions

## Where do inclusive political institutions come from?

- Small changes: Magna Carta, English Civil War constitute “institutional drift” away from extractive institutions
- A critical juncture occurs that empowers social forces in favor of inclusive institutions: the Atlantic trade favored commercial interests in England, and the monarchy in Spain.



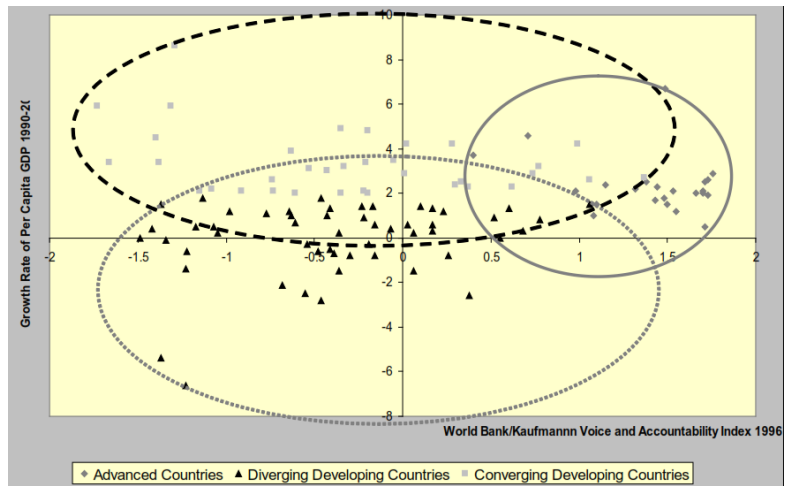
## Institutions are decisive

- Geography does not explain wealth: Latin America was richer than North America until the 18<sup>th</sup> century
- Culture is important but does not explain wealth: North and South Korea

## Do inclusive political institutions accelerate economic growth?

- Most statistical analyses do not find a relationship between inclusive institutions and economic growth
- Tavares and Wacziarg (2000): overall effect is of democracy on growth is slightly negative
  - Positive effect on human capital formation and equality
  - Negative effect on investment
- Fast growing extractive political systems and slow growing democracies
  - China, South Korea (until 1987)
  - India (before 1995); Philippines (since 1986)
  - Latin America since 1980s

## Khan (2007): “Voice and Accountability” and growth, 1990-2003



## Khan (2007): “Voice and Accountability” and growth, 1990-2003

	Advanced countries	Diverging Developing Countries	Converging Developing Countries
Number	24	53	35
Median voice and accountability index, 1996	1.5	-0.4	-0.3
Observed range of property rights index	0.4 to 1.8	-1.5 to -1.1	-1.7 to -1.4
Median per capita GDP growth rate 1980-2003	2.1	0.4	3.0

## Are inclusive political institutions necessary?

- Bockstette, Chanda, and Putterman (2002): Older states associated with political stability and productivity per capita
  - Consistent with the idea that centralized states are needed for growth in Acemoglu and Robinson
  - Also consistent with Diamond: older states also have longer history of productive agriculture
- It takes time to develop national identity, public administration, complex institutions
- Property rights, public services and a reasonably predictable legal system are found in many places without inclusive political systems.

## Direction of causality

- Do inclusive economic and political institutions create wealth or does wealth create inclusive institutions?
- Can poor countries afford expensive legal, educational and participatory political systems?
- Is it possible to build inclusive institutions in the absence of a large middle class with the resources and knowledge

## Khan (2007) Market enhancing vs. Growth enhancing institutions

Market Enhancing	Growth Enhancing
Enforcement of property rights	Intersectoral transfer of assets and resources from less to more productive sectors
Rule of law and contract enforcement	Managing incentives for technological learning and raising productivity
Minimizing risk of expropriation	Maintaining political stability even as social and economic change accelerates
Minimizing corruption	
Transparent and accountable provision of public goods	

## Implementing growth enhancing governance

- Capacity to discipline (withdraw support) from under-performing firms/agencies
- Fragmentation of political power undermines discipline (many powerful political factions)
- Growth strategy must match governance capabilities: Malaysia could not pursue Korea's chaebol strategy