The Role of Institutions in Growth and Development

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# Contents

Chapter 1. Framework 5  
1. Introduction 5  
2. What Are Institutions? 6  
3. The Impact of Institutions 8  
4. Modeling Institutional Differences 13  
5. A Simple Historical Example 15  

Chapter 2. Dysfunctional Institutional Syndromes 21  
1. Weak States 23  
2. Strong Unconstrained States 27  
3. Strong Constrained States 50  

Chapter 3. Pitfalls of Reform 61  
1. Persistence of Power and Incentives—The Seesaw Effect 62  
2. Persistence of De Facto Power 67  
3. Iron Law of Oligarchy 76  
4. Creating Oligarchies 78  
5. Ending Oligarchy 84  

Chapter 4. A Few Success Stories 87  
1. Botswana 87  
2. Mauritius 90  
3. Chile 94  
4. South Africa 97  

Chapter 5. Conclusions 99  

Chapter 6. References 101
CHAPTER 1

Framework

1. Introduction

Arguably the most important questions in social science concern the causes of cross-country differences in economic development and economic growth. Why are some countries much poorer than others? Why do some countries achieve economic growth while others stagnate? And to the extent that we can develop some answers to these questions, the next ones: what can be done in order to induce economic growth and improve the living standards in a society?

Economists have long recognized that output per capita in a society is intimately related to the amount of human capital, physical capital and technology that workers and firms in that country have access to. Similarly, economic growth is related to the ability of a society to increase its human capital, physical capital and improve its technology. In this context, technology is construed broadly; technological differences refer not only to differences in techniques available to the firms, but also to differences in the organization of production, implying that some countries will be able to use their resources more efficiently. Nevertheless, differences in human capital, physical capital and technology are only proximate causes in the sense that they pose the next question of why some countries have less human capital, physical capital and technology and make worse use of their factors and opportunities.
To develop more satisfactory answers to questions of why some countries are much richer than others and why some countries grow much faster than others, we need to look for potential fundamental causes, which may be underlying these proximate differences across countries. Only by understanding these fundamental causes we can develop a framework for making policy recommendations that go beyond platitudes (such as “improve your technology”) and also minimize the risk of unintended negative consequences.

In this essay, we will argue that institutions, also very broadly construed, are the fundamental cause of economic growth and development differences across countries and that it is possible to develop a coherent framework for understanding why and how institutions differ across countries, and how they change. We will also argue that our state of knowledge does not yet enable us to make specific statements about how institutions can be improved (in order to promote further economic growth). Nevertheless, a systematic analysis of institutions gives us a number of pointers about what types of institutional and social arrangements are likely to be barriers against growth or lead to unintended negative consequences. Therefore, on the policy side we can start by understanding dysfunctional institutional syndromes and the potential pitfalls of institutional reforms first, and modest steps towards avoiding those may be valuable enough to start with.

2. What Are Institutions?

Douglass North (1990, p. 3) offers the following definition: “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.” Three important features of institutions are apparent in this definition: (1) that they are “humanly devised,” which contrasts with other potential
fundamental causes, like geographic factors, which are outside human
control; (2) that they are “the rules of the game” setting “constraints”
on human behavior; (3) that their major effect will be through incen-
tives (see also North, 1981).

The notion that incentives matter is second nature to economists,
and institutions, if they are a key determinant of incentives, should have
a major effect on economic outcomes, including economic development,
growth, inequality and poverty. But do they? Are institutions key de-
terminants of economic outcomes or secondary arrangements that re-
spond to other, perhaps geographic or cultural, determinants of human
and economic interactions?

Much empirical research attempts to answer this question. Before
discussing some of this research, it is useful to emphasize an impor-
tant point: ultimately, the aim of the research on institutions is to
pinpoint specific institutional characteristics that are responsible for
economic outcomes in specific situations (e.g., the effect of legal in-
stitutions on the types of business contracts). However, the starting
point is often the impact of a broader notion of institutions on a vari-
ety of economic outcomes. This broader notion, in line with Douglass
North’s conception, incorporates many aspects of economics, political
and social organization of society. Institutions can differ between so-
cieties because of their formal methods of collective decision-making
(democracy versus dictatorship) or because of their economic institu-
tions (security of property rights, entry barriers, the set of contracts
available to businessmen). They may also differ because a given set
of formal institutions are expected to and do function differently; for
example, they may differ between two societies that are democratic
because the distribution of political power lies with different groups
or social classes, or because in one society, democracy is expected to
collapse while in the other it is consolidated. This broad definition of institutions is both an advantage and a curse. It is an advantage, since it enables us to get started with theoretical and empirical investigations of the role of institutions without getting bogged down by taxonomies. It is a curse, since, unless we can follow it up with a better understanding of the role of specific institutions, we have learned only little.

3. The Impact of Institutions

There are tremendous cross-country differences in the way that economic and political life is organized. A voluminous literature documents large cross-country differences in economic institutions, and a strong correlation between these institutions and economic performance. Knack and Keefer (1995), for instance, look at measures of property rights enforcement compiled by international business organizations, Mauro (1995) looks at measures of corruption, and Djankov, La Porta, Lopez-De-Silanes and Shleifer (2002) compile measures of entry barriers across countries, while many studies look at variation in educational institutions and the corresponding differences in human capital. All of these authors find substantial differences in these measures of economic institutions, and significant correlation between these measures and various indicators of economic performance. For example, Djankov et al. find that, while the total cost of opening a medium-size business in the United States is less than 0.02 percent of GDP per capita in 1999, the same cost is 2.7 percent of GDP per capita in Nigeria, 1.16 percent in Kenya 0.91 percent in Ecuador and 4.95 percent in the Dominican Republic. These entry barriers are highly correlated with various economic outcomes, including the rate of economic growth and the level of development.
Nevertheless, this type of correlation does not establish that the countries with worse institutions are poor *because* of their institutions. After all, the United States differs from Nigeria, Kenya and the Dominican Republic in its social, geographic, cultural and economic fundamentals, so these may be the source of their poor economic performance. In fact, these differences may be the source of institutional differences themselves. Consequently, evidence based on correlation does not establish whether institutions are important determinants of economic outcomes.

To make further progress, one needs to isolate a source of exogenous differences in institutions, so that we approximate a situation in which a number of otherwise-identical societies end up with different sets of institutions. European colonization of the rest of the world provides a potential laboratory to investigate these issues. From the late 15th century, Europeans dominated and colonized much of the rest of the Globe. Together with European dominance came the imposition of very different institutions and social power structures in different parts of the world.

Acemoglu, Johnson and Robinson, AJR, (2001) document that in a large number of colonies, especially those in Africa, Central America, the Caribbean and South Asia, European powers set up “extractive states”. These institutions (again broadly construed) did not introduce much protection for private property, nor did they provide checks and balances against the government. The explicit aim of the European in these colonies was extraction of resources, in one form or another. This colonization strategy and the associated institutions contrast with the institutions Europeans set up in other colonies, especially in colonies where they settled in large numbers, for example, the United States, Canada, Australia and New Zealand. In these colonies the emphasis
was on the enforcement of property rights for a *broad cross section* of the society, especially smallholders, merchants and entrepreneurs. The term “broad cross section” is emphasized here, since even in the societies with the worst institutions, the property rights of the elite are often secure, but the vast majority of the population enjoys no such rights and faces significant barriers preventing their participation in many economic activities. Although investments by the elite can generate economic growth for limited periods, for sustained growth property rights for a broad cross section seem to be crucial (AJR, 2002a, Acemoglu, 2003).

A crucial determinant of whether Europeans chose the path of extractive institutions was whether they settled in large numbers. In colonies where Europeans settled, the institutions were being developed for their own future benefits. In colonies where Europeans did not settle, their objective was to set up a highly centralized state apparatus, and other associated institutions, to oppress the native population and facilitate the extraction of resources in the short run. Based on this idea, AJR (2001) suggest that in places where the disease environments made it easy for Europeans to settle, the path of institutional development should have been different from areas where Europeans faced high mortality rates.

In practice, during the time of colonization, Europeans faced widely different mortality rates in colonies because of differences in the prevalence of malaria and yellow fever. They provide a possible candidate for a source of exogenous variation in institutions. These mortality rates should not influence output today directly, but by affecting the settlement patterns of Europeans, they may have had a first-order effect on
institutional development. Consequently, these potential settler mortality rates can be used as an instrument for broad institutional differences across countries in an instrumental-variables estimation strategy.

The key requirement for an instrument is that it should have no direct effect on the outcome of interest (other than its effect via the endogenous regressor). There are a number of channels through which potential settler mortality could influence current economic outcomes or may be correlated with other factors influencing these outcomes. Nevertheless, there are also good reasons for why, as a first approximation, these mortality rates should not have a direct effect. Malaria and yellow fever were fatal to Europeans who had no immunity, thus having a major effect on settlement patterns, but they had much more limited effects on natives who, over centuries, had developed various types of immunities. The exclusion restriction is also supported by the death rates of native populations, which appear to be similar between areas with very different mortality rates for Europeans (see, e.g., Curtin, 1964).

The data also show that there were major differences in the institutional development of the high-mortality and low-mortality colonies. Moreover, consistent with the key idea in AJR (2001), various measures of broad institutions, for example, measures of protection against expropriation, are highly correlated with the death rates Europeans faced more than 100 years ago and with early European settlement patterns. They also show that these institutional differences induced by mortality rates and European settlement patterns have a major (and robust) effect on income per capita. For example, the estimates imply that improving Nigeria’s institutions to the level of those in Chile could, in the long run, lead to as much as a 7-fold increase in Nigeria’s income. This evidence suggests that once we focus on potentially-exogenous sources
of variation, the data points to a large effect of broad institutional differences on economic development.

Naturally, mortality rates faced by Europeans were not the only determinant of Europeans’ colonization strategies. AJR (2002a) focus on another important aspect, how densely different regions were settled before colonization. They document that in more densely-settled areas, Europeans were more likely to introduce extractive institutions because it was more profitable for them to exploit the indigenous population, either by having them work in plantations and mines, or by maintaining the existing system and collecting taxes and tributes. This suggests another source of variation in institutions that may have persisted to the present, and AJR (2002a) show similar large effects from this source of variation.

Another example that illustrates the consequences of difference in institutions is the contrast between North and South Korea. The geopolitical balance between the Soviet Union and the United States following the WWII led to separation along the 38th parallel. The North, under the dictatorship of Kim Il Sung, adopted a very centralized command economy with little role for private property. In the meantime, South Korea, though far from a free-market economy, relied on a capitalist organization of the economy, with private ownership of the means of production, and legal protection for a range of producers, especially those under the umbrella of the chaebols, the large family conglomerates that dominated the South Korean economy. Although not democratic during its early phases, the South Korean state was generally supportive of rapid development and is often credited with facilitating, or even encouraging, investment and rapid growth in Korea.
4. Modeling Institutional Differences

Under these two highly contrasting regimes, the economies of North and South Korea diverged. While South Korea grew rapidly under capitalist institutions and policies, North Korea experienced minimal growth since 1950, under communist institutions and policies.

Overall, a variety of evidence paints a picture in which broad institutional differences across countries have had a major influence on their economic development. This evidence suggests that to understand why some countries are poor we should understand why their institutions are dysfunctional. But this is only part of a first step in the journey towards an answer. The next question is even harder: if institutions have such a large effect on economic riches, why do some societies choose, end up with and maintain these dysfunctional institutions?

4. Modeling Institutional Differences

As a first step in modeling institutions, let us consider the relationship between three institutional characteristics: (1) economic institutions; (2) political power; (3) political institutions.

As already mentioned above, economic institutions matter for economic growth because they shape the incentives of key economic actors in society, in particular, they influence investments in physical and human capital and technology, and the organization of production. Economic institutions not only determine the aggregate economic growth potential of the economy, but also the distribution of resources in the society, and herein lies part of the problem: different institutions will not only be associated with different degrees of efficiency and potential for economic growth, but also with different distribution of the gains across different individuals and social groups.

How are economic institutions determined? Although various factors play a role here, including history and chance, at the end of the
day, economic institutions are collective choices of the society. And because of their influence on the distribution of economic gains, not all individuals and groups typically prefer the same set of economic institutions. This leads to a conflict of interest among various groups and individuals over the choice of economic institutions, and the political power of the different groups will be the deciding factor.

The distribution of political power in society is also endogenous. To make more progress here, let us distinguish between two components of political power; de jure (formal) and de facto political power (see Acemoglu and Robinson, 2005). De jure political power refers to power that originates from the political institutions in society. Political institutions, similar to economic institutions, determine the constraints on and the incentives of the key actors, but this time in the political sphere. Examples of political institutions include the form of government, for example, democracy vs. dictatorship or autocracy, and the extent of constraints on politicians and political elites.

A group of individuals, even if they are not allocated power by political institutions, may possess political power; for example, they can revolt, use arms, hire mercenaries, co-opt the military, or undertake protests in order to impose their wishes on society. This type of de facto political power originates from both the ability of the group in question to solve its collective action problem and from the economic resources available to the group (which determines their capacity to use force against other groups).

This discussion highlights that we can think of political institutions and the distribution of economic resources in society as two state variables, affecting how political power will be distributed and how economic institutions will be chosen. An important notion is that of persistence; the distribution of resources and political institutions are
5. A SIMPLE HISTORICAL EXAMPLE

As a brief example, consider the development of property rights in Europe during the Middle Ages. Lack of property rights for landowners, merchants and proto-industrialists was detrimental to economic growth during this epoch. Since political institutions at the time placed
political power in the hands of kings and various types of hereditary monarchies, such rights were largely decided by these monarchs. The 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. These economic institutions also ensured that the monarchs controlled a large fraction of the economic resources in society, solidifying their political power and ensuring the continuation of the political regime.

The seventeenth century, however, witnessed major changes in the economic and political institutions that paved the way for the development of property rights and limits on monarchs’ power, especially in England after the Civil War of 1642 and the Glorious Revolution of 1688, and in the Netherlands after the Dutch Revolt against the Hapsburgs. How did these major institutional changes take place? In England until the sixteenth century the king also possessed a substantial amount of de facto political power, and leaving aside civil wars related to royal succession, no other social group could amass sufficient de facto political power to challenge the king. But changes in the English land market (Tawney, 1941) and the expansion of Atlantic trade in the sixteenth and seventeenth centuries (Acemoglu, Johnson and Robinson, 2002b) gradually increased the economic fortunes, and consequently the de facto power of landowners and merchants opposed to the absolutist tendencies of the Kings.

By the seventeenth century, the growing prosperity of the merchants and the gentry, based both on internal and overseas, especially
Atlantic, trade, enabled them to field military forces capable of defeating the king. This de facto power overcame the Stuart monarchs in the Civil War and Glorious Revolution, and led to a change in political institutions that stripped the king of much of his previous power over policy. These changes in the distribution of political power led to major changes in economic institutions, strengthening the property rights of both land and capital owners and spurring a process of financial and commercial expansion. The consequence was rapid economic growth, culminating in the Industrial Revolution, and a very different distribution of economic resources from that in the Middle Ages.

This discussion poses, and also gives clues about the answers to, two crucial questions. First, why do the groups with conflicting interests not agree on the set of economic institutions that maximize aggregate growth? Second, why do groups with political power want to change political institutions in their favor? In the context of the example above, why did the gentry and merchants use their de facto political power to change political institutions rather than simply implement the policies they wanted? The issue of commitment is at the root of the answers to both questions.

An agreement on the efficient set of institutions is often not forthcoming because of the complementarity between economic and political institutions and because groups with political power cannot commit to not using their power to change the distribution of resources in their favor. For example, economic institutions that increased the security of property rights for land and capital owners during the Middle Ages would not have been credible as long as the monarch monopolized political power. He could promise to respect property rights, but then at some point, renege on his promise, as exemplified by the numerous
financial defaults by medieval kings. Credible secure property rights ne-
cessitated a reduction in the political power of the monarch. Although
these more secure property rights would foster economic growth, they
were not appealing to the monarchs who would lose their rents from
predation and expropriation as well as various other privileges associ-
ated with their monopoly of political power. This is why the institu-
tional changes in England as a result of the Glorious Revolution were
not simply conceded by the Stuart kings. James II had to be deposed
for the changes to take place.

The reason why political power is often used to change political
institutions is related. In a dynamic world, individuals care not only
about economic outcomes today but also in the future. In the example
above, the gentry and merchants were interested in their profits and
therefore in the security of their property rights, not only in the present
but also in the future. Therefore, they would have liked to use their
(de facto) political power to secure benefits in the future as well as the
present. However, commitment to future allocations (or economic in-
stitutions) is in general not possible because decisions in the future are
made by those who hold political power at the time. If the gentry and
merchants would have been sure to maintain their de facto political
power, this would not have been a problem. However, de facto politi-
cal power is often transient, for example because the collective action
problems that are solved to amass this power are likely to resurface in
the future, or other groups, especially those controlling de jure power,
can become stronger in the future. Therefore, any change in policies
and economic institutions that relies purely on de facto political power
is likely to be reversed in the future. In addition, many revolutions
are followed by conflict within the revolutionaries. Recognizing this,
the English gentry and merchants strove not just to change economic
institutions in their favor following their victories against the Stuart monarchy, but also to alter political institutions and the future allocation of de jure power. Using political power to change political institutions then emerges as a useful strategy to make gains more durable. Consequently, political institutions and changes in political institutions are important as ways of manipulating future political power, and thus indirectly shaping future, as well as present, economic institutions and outcomes.
CHAPTER 2  

Dysfunctional Institutional Syndromes

We have so far argued that the broad cluster of institutions matters for economic outcomes, and in fact it matters a lot. Moreover, institutions are crucial because they shape economic and political incentives. What we would like to do both for better theoretical understanding and for developing a framework useful for policy analysis is to identify what good and bad institutions might be and how they may be reformed (or at least influenced by interventions). While existing research is not at a point where this can be achieved with a great degree of certainty, we can say quite a bit about what types of institutions are “dysfunctional” in the sense that they lead to bad economic outcomes. Since our purpose here is to stay away from speculation as much as possible, we focus on relatively extreme cases of dysfunctional institutions. While many real-world institutions are not at these extremes, the study of these extremes is useful in generating lessons that are more generally applicable.

The discussion so far has emphasized that to understand why bad economic institutions are in place, one needs to study the structure of political power and the nature of political institutions and incentives in society. To think about dysfunctional institutional syndromes therefore, we need to understand what sorts of political situations lead to bad economic institutions. This task is complex because one cannot simply point to specific political institutions to deduce the nature of the underlying political equilibrium. In terms of the last section one
has to consider both de facto and de jure power. Nevertheless, we can make a very preliminary attempt at some generalizations. Though the exact form of the constitution cannot in itself determine the nature of political incentives, there do seem to be three important factors that influence the nature of the political equilibrium in a society and consequently the type of economic institutions that will arise.

The first is the strength of the state. Good economic institutions are unlikely to arise in weak states, those not able to provide basic public goods to their citizens. However, state strength in itself is not sufficient to guarantee good outcomes. We therefore distinguish between two sorts of strong states, those that are constrained and those that are unconstrained. We shall consider not just constitutional constraints, such as the checks and balances built into the constitution of the United States, but also de facto constraints which can be just as important in practice. The third factor, in addition to the strength of the state and whether it is constrained, is whether or not the state is captured by an elite in society. We depict these potential situations in Figure 1. In the cells of this figure we put names on the different political equilibria that arise. In what follows we shall discuss all of these terms in more detail and discuss why these different juxtapositions of forces lead to good or bad economic institutions. To drive home where we are going in Figure 2 we reproduce Figure 1 but add the names of some of the countries that will figure in the discussion.

For the purposes of this paper we shall treat these different contexts as given. Though in the next section we discuss ideas about why some states are strong and others weak, to keep the discussion tractable we will take the extent of constraints on the exercise of power or whether or not the state is captured as exogenous. We shall focus on discussing
the different political equilibria that arise in different circumstances and sketching why these tend to create good or bad economic institutions.

Table 1: Classification of Political Systems

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<tr>
<th></th>
<th>Unconstrained</th>
<th>Constrained</th>
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<tbody>
<tr>
<td>Weak State</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Captured</td>
<td>lack of provision</td>
<td>oligarchy I</td>
</tr>
<tr>
<td></td>
<td>public goods</td>
<td></td>
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<tr>
<td>Uncaptured</td>
<td>lack of provision</td>
<td>kleptocracy or populism</td>
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<td></td>
<td>of public goods</td>
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</tr>
</tbody>
</table>

Table 2: Examples of Political Systems

<table>
<thead>
<tr>
<th></th>
<th>Unconstrained</th>
<th>Constrained</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weak State</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Captured</td>
<td>Kenya</td>
<td>Austria-Hungary</td>
</tr>
<tr>
<td></td>
<td>Russia</td>
<td>Russia</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mexico (Diaz)</td>
</tr>
<tr>
<td>Uncaptured</td>
<td>Tanzania</td>
<td>Congo (Mobutu)</td>
</tr>
<tr>
<td></td>
<td>Dominican Republic</td>
<td></td>
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<td></td>
<td>(Trujillo)</td>
<td>Venezuela (Chávez)</td>
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<td></td>
<td></td>
<td>Argentina (Perón)</td>
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</tbody>
</table>

1. Weak States

A central idea in the literature of sociologists and political scientists working on development is that the difference between poor and rich countries is state capacity. Poor countries have not developed states which are capable of providing public goods, such as enforced property rights, law and order and infrastructure, and in the absence of these basic inputs into development the private sector cannot flourish. Thus
if the state is weak it is unlikely that a prosperous capitalism can emerge.

The most recent sweeping version of this thesis is in the literature on state formation in Africa due to Herbst (2000) and Bates (2001) (see Robinson, 2002, for some caveats about the empirical applicability of this thesis and O’Donnell, 1993, Centeno, 2001, and Mazzuca, 2005, Soifer, 2006, for a related literature on Latin America). Herbst and Bates attempt to explain why African states have so little ‘capacity’ and why the continent is plagued by ‘state failure.’ A state is meant to provide certain public goods in society, such as law and order, defense, contract enforcement, and infrastructure. Yet in Africa most states provide very few of these. They are unable to exercise control over much of their territory, they do not provide order or public goods. What then is different about African states that leads them to diverge so radically from our ideal?

The Herbst-Bates thesis builds on a rich tradition of work on the origins of European Nation States initiated by Max Weber. This literature attempted to explain the origins of modern institutions such as nation states with well-defined territories. Nation states are characterized not just by borders and citizens with national identities, but also by bureaucracies, fiscal systems, and representative institutions such as parliaments. Especially influential has been the work of Tilly (1990). The central idea of this literature is that the high population density of Europe made land relatively scare and valuable to control, particularly from the late middle-ages onwards. This and technological change in the methods of warfare (e.g. more sophisticated battle tactics and firearms) drew states into continual conflict. But warfare is costly and early modern states required resources to attack and defend. Kings were therefore in a continual battle with Lords and Commoners over
1. WEAK STATES

taxes. To get money for wars, Kings had to build bureaucracies, they had to gather information and map their territory and people. They also had to make concessions - such as creating regular parliaments where citizens could have a voice. An alternative to concessions was to crush domestic opponents who resisted the demands of Kings. All these things were necessary to survive (Brewer, 1988, for a classic study of the creation of the ‘fiscal-military state’ in England). If a state did not become “stronger” then typically it became extinct, as was the case with Poland.

This process created the modern system of nation states with their familiar institutional infrastructures that consolidated in Europe in the nineteenth century. The Herbst-Bates thesis is that this process has not taken place in Africa. It did not take place historically in the pre-colonial era, it did not take place during the colonial epoch, and it is not taking place since or now. Why?

Africa is different because the structural conditions that led to the path of state formation and institution building in Europe were absent in Africa. Firstly, unlike in Europe, land was and is not scarce in Africa. Rather labor was scarce. Thus in the pre-colonial period states did not fight over land, but rather people. This explains why property rights in people (slavery) are well defined, but those in land were not (to this day most land in Africa is held communally). This meant that pre-colonial states had vague borders and were often very “weak”. Without the constant necessity of defending a well defined territory states did not need to invest in bureaucracies, censuses of their population, tax collectors, permanent militaries. Herbst also argues that this explains the absence of pre-colonial mapping in Africa.

This absence of external threats coupled with low population densities persisted. During the colonial period there was little fighting
over borders between the colonial powers. The conference of Berlin in 1885 largely determined which European power would have which bit of Africa. This meant that like the pre-colonial polities, European colonial powers had little incentive to develop state institutions. Instead they focused on commercial exploitation and outright plunder of the mineral and natural wealth. The exceptions to this are the settler-colonies of South Africa, Rhodesia, and to a lesser extent Kenya. Following independence, the situation could have changed but it did not because the International state system and United Nations decided to enforce the colonial boundaries that had largely determined the form that the new nations took. This trend was reinforced by Cold-War politics. Thus African states were still able to survive without having to engage in the type of institution building that occurred historically in Europe. When the borders were threatened, such as when Libya invaded Chad, they could reply on the United Nations or European powers sending troops to the rescue.

Herbst and Bates argue that the lack of development of African state institutions helps explain many aspects of modern Africa. Since states never had to fight to survive they never had to build effective fiscal institutions. Therefore they have no tax bases and instead have to engage in highly distortionary methods of raising taxes (such as taxing trade) or redistributing income (for example via employment in parastatals). Since states never had to fight to survive, rulers never had to consolidate their rule and crush domestic opposition. Hence the incidence of warlordism so evident in countries such as Angola, Liberia, and Sierra Leone. Since states never had to fight to survive, they never had to make political concessions to their citizens. Hence the lack of functioning domestic political institutions such as parliaments and the completely unconsolidated nature of democracy in Africa. Moreover,
the lack of these institutions can help explain the extent of venality and state corruption in Africa since these institutions provide key checks on abuses like this. Finally, this set of institutions has been further encouraged in the last fifty years by foreign aid and development assistance. These transfers give states valuable resources that allows them to stay in power without having to develop indigenous state institutions to raise taxes. Thus the incapacity of African states has been reinforced not just by Cold-War politics but also by less cynical attempts to help.

It is important to recognize that not all states in Africa are weak and there is a lot of variation. For example, though some would characterize the state in the Congo under Mobutu as weak, he was able to expropriate the assets of expatriates in the 1970s in his ‘Zaireanization’ program.

There has been very little research by economists on state strength. Acemoglu (2005) conceptualizes state strength as the ability of the state to tax its citizens and shows that the state can be either too weak or too strong. More recently, Acemoglu, Ticchi and Vindigni (2006) and Besley and Persson (2007) introduce politics into decisions to build state capacity focusing on the circumstances where even though it is socially desirable to build state capacity, it is not politically attractive to do so.

2. Strong Unconstrained States

Distinct from weak states are states that for historical reasons are strong. Even if the state is strong, this is not an automatic guarantee that economic institutions will create incentives for development. The impact on development depends on whether or not the state is constrained and the preferences of those who control the state. This is the language we use to talk about the incentives and constraints of
those who control political power. A strong state can be used to tax or
expropriate those who could create wealth or it can be used to further
the interests of some minority at the expense of society. Therefore it is
obvious that while state strength might be necessary for development,
it is certainly not sufficient. In general, constraints on the power of the
state tend to be good for development. But even a strong constrained
state may not lead to rapid improvements in prosperity because such
a state can be captured by some elite. In this case, even if the state
is not capable of expropriating assets or people to the benefit of this
minority, it may still create a lot of distortions which benefit this elite.
Ironically, it is possible that a constrained state may be even more
susceptible to capture than an unconstrained state.

Where do constraints on states come from? A strong intellectual
tradition following Montesquieu associates these with the nature of the
constitution. Constitutions which have separation of powers, or checks
and balances built into them, limit and constrain the use of political
power. We believe it is misleading however to focus simply on the na-
ture of the constitution. Britain, for example, has neither separation of
powers nor a written constitution, but it is clear that there are strong
constraints on the exercise of political power. In addition there are
countries, such as Zimbabwe, which have perfectly nice constitutions,
but where these institutions place little check on the actions of politi-
cians because their rulings are not enforced. Furthermore, there are
examples of countries, such as South Korea under President Park or
Taiwan under Chiang Kai-Shek where effectively the society was run
by a one party state. Though President Park did win a few elections,
the reality was that there were few constitutional constraints on these
leaders who had control of the military. Yet in a sense one can think of
both of these regimes as constrained because they were faced by severe
geo-political competition and the need to promote the internal legitimacy of their regime in highly mobilized societies. These international constraints heavily influenced the types of economic policies and institutions they promoted. A similar argument can be made about China after the cultural revolution. Unable to rely anymore on the legacy of communism for legitimacy, the Communist Party instead attempted to establish its legitimacy by promoting economic growth.

Now first examine the types of political equilibria that arise when states are strong but are also unconstrained either de jure or de facto.

2.1. Captured: Oligarchy I. We first consider states which are captured by some elite which leads to a type of political equilibrium we refer to as Oligarchy I. Unconstrained states are not typically democratic. The fact that a state is unconstrained means that the stakes from politics are high and democratic outcomes, such as those we discussed above, are often extreme. This implies that minorities or groups who cannot exercise power in democracy have an incentive to overthrow it (Acemoglu and Robinson, 2006). There may, of course, be many different sorts of oligarchies depending on which group captures power.

Case Study: Austria-Hungary in the 19th-century. In the nineteenth century, the Hapsburg Empire was known as “Europe’s China” or the “sick man on the Danube” (see Good 1984, 1991) and was generally regarded as having fallen far behind the other industrializing countries of Europe. Historians typically argue that this was what led to the weakness and disintegration of the empire during and after the First World War. The consensus view amongst historians now appears to be that the main explanation for the slow growth of Austria-Hungary in the nineteenth century is the opposition of the state. For instance Gross (1973) argues:
“In domestic as well as foreign policy the Vormärz regime, from 1815 to 1848, was determined to prevent another French Revolution anywhere in Europe. From this principle Francis I derived not only his opposition to the growth of industry (and with it the Proletariat) ... but his general reluctance to permit any change whatsoever.”

The analysis of Fruedenberger (1967) is similar. He notes (pp. 498-499):

“In the 1790’s fear of the French Revolution added a new dimension to government policy. High officials in the government, with the young Emperor Francis I in strong sympathy, felt that industrialization would create an industrial proletariat which to them was the carrier of revolutionary ideas and for that reason ... opposed not only large-scale enterprises but favored a policy that kept the population agrarian.”

The Hapsburg emperors opposed the building of railways and infrastructure and there was no attempt to develop an effective educational system. Blum (1943) pointed to the pre-modern institutional inheritance as the major blockage to industrialization arguing (p. 26) that

“these living forces of the traditional economic system were the greatest barrier to development. Their chief supporter was ... Emperor Francis. He knew that the advances in the techniques of production threatened the life of the old order of which he was so determined a protector. Because of his unique position as final arbiter of all proposals for change he could stem the flood for a time. Thus when plans for the construction of a steam
railroad were put before him, he refused to give consent to their execution ‘lest revolution might come into the country’.”

The creation of the first railway line had to wait until Francis’ death in 1835, yet even after that the government under Metternich kept to the same policies. It was the revolution of 1848 that perturbed this stasis. Eduard Marz places “the beginning of the industrial age in the 1850’s ... when the Ancien regime ceased to exist” (quoted in Good, 1984, pp. 40-41, see also Blum, 1948). The response of the domestic elites was peasant emancipation and agrarian reform followed by a switch in economic policy towards a rather vigorous promotion of industry.

Case Study: From Colonial Repression to the Apartheid Regime in South Africa. Another important example of an Oligarchy I regime is the coalition of mine owners and landed elites which ran South Africa until 1994. The origins of modern South Africa began in 1652 with the creation of Cape Colony by Dutch East India Company. The colony was annexed by Britain during the Napoleonic Wars and in the 1830s during the so-called ‘Great Trek’ the Boers/Afrikaners (Dutch) move inland and found two new republics, the Orange Free State and the Transvaal. The British gradually expanded into the interior, and Natal annexed by Britain in 1842. The turning point however was the discovery in 1867 of diamonds in Kimberly, followed in 1886 by the discovery of gold on the Rand.

Lured by diamonds and gold British expansion culminated in the Anglo-Boer war of 1899-1902. Though the British eventually won these conflicts they realized that social order necessitated concessions to the Boers. The outcome of this was the 1910 Union of South Africa brought together the Boer Republics with Natal and the Cape Colony.
most contentious issue was voting rights for Africans. The Transvaal and Orange Free State had explicitly racial franchises, which Natal and the Cape Colony did not. The major concessions of the British was to allow this status quo to persist. After 1910 the consequence of this was a move to completely disenfranchise everyone except whites. In 1910 both Natal and the Cape enfranchised rich blacks (disenfranchised 1936) and coloreds (disenfranchised 1956).

Early on South Africa began to develop repressive labor institutions. In 1841 the British passed a Masters and Servants Ordinance imposing penalties on workers who broke their contracts. It was a device aimed at impeding labor mobility. Harsh labor regimes also quickly developed in Kimberly and the Rand by the 1880s. A crucial innovation was the 1913 Native Land Act. This law stated that Africans could no longer own land outside the ‘native reserves’ which made up 8.3% of the land area. Africans working in the mines or on the land outside the reserves had to carry passes and were seen as migrants.

In 1897 George Albu, chairman of the Association of Mines, explained to a Commission of Inquiry how he proposed to cheapen labor “by simply telling the boys that their wages are reduced.” Here are his views (Feinstein (2005, p. 63)

Commission: Suppose the kaflirs retire back to their kraal? Would you be in favor of asking the Government to enforce labour?

Albu: Certainly ..I would make it compulsory .. Why should a nigger be allowed to do nothing? I think a kaflir should be compelled to work in order to earn his living.

Commission: If a man can live without work, how can you force him to work?

Albu: Tax him, then..
Commission: Then you would not allow the kaffir to hold land in the country, but he must work for the white man to enrich him?

Albu: He must do his part of the work of helping his neighbours.”

The 1913 legislation included provisions intended to stop black sharecroppers and squatters from farming on white-owned land in any capacity other than labor tenants. As the secretary for native affairs explained

“The effect of the act is to put a stop, for the future, to all transactions involving anything in the nature of partnership between Europeans and natives in respect of land or the fruits of land . . . All new contracts with natives must be contracts of service. Provided there is a bona fide contract of this nature there is nothing to prevent an employer from paying a native in kind, or by the privilege of cultivating a defined piece of ground ... But the native cannot pay the master anything for his right to occupy the land.” (quoted in Feinstein, 2005, p. 45)

Many other measures introduced at the same time to reduce the bargaining power of African workers and block them from competing with whites for jobs. In 1911 the Mines and Works Act extended a ‘colour bar’ which stopped Africans from taking specific occupations in the mining industry.

South Africa was an oligarchy of mine owners, landowners and a white labor aristocracy. It was based on economic institutions aimed at manipulating factor prices so as to redistribute income away from Africans towards whites.
One of the lessons from South Africa is that oligarchic societies can do quite well economically for some time if the oligarchy consists of those with some sort of vested interest in economic growth. This was not the case in Argentina under Perón or current Venezuela, but it was true in South Africa. Indeed South Africa grew quite rapidly from the 1890s onwards until the mid 1970s after which income per-capita fell for 15 years. In the meantime the economy generated OECD levels of living standards for the whites and overall performance does not look so great compared to Europe or even Latin America. But wasn’t Apartheid based on massive distortions of factor markets? How could such misallocation generate growth? The important observation here is that the economic costs of such institutions depend on the technology being used. In the 18th century the places with the highest per-capita income in the world were Barbados, Jamaica and Saint Domingue (Haiti) which used African slaves to grow sugarcane. These places had average income levels maybe 2 or 3 times that of Britain even though institutions were terrible for 95% of the population. It was only in the 19th century that these places fell behind.

These ideas can help explain why South Africa did relatively well when the economy was dominated by diamond and gold mining, where economic losses from labor repression were not too high. However, as the structure of the economy changed and manufacturing became more important then measures like the colour bar and ‘bantu education’ became more and more costly for society. Starting from around 1975 economic performance began to seriously deteriorate as a consequence of these inherited distortions, and it was only with the coming of democracy in 1994 that the growth rate picked up.

General Lessons. Oligarchy I states have the capacity to generate prosperity, but they make decisions not with an eye to social welfare
but rather with the interests of an elite in mind. In South Africa this elite was most of the white population (with the possible exception of white capitalists who might have liked cheaper white labor and more skilled African labor). In Austria-Hungary it was the monarchy and aristocracy. Such a situation tends to lead to poor economic institutions because the elite may create distortions to redistribute income to themselves and limit competition, as in South Africa, and they may also wish to block technical change and innovation if this undermines their power and dominance, a mechanism clearly evident in Austria-Hungary. This is in some sense in the logic of the oligarchic system; an oligarchy is an economic elite monopolizing political power for their economic again. In South Africa the most egregious example of this was the colour bar which blocked Africans from skilled occupations and the remorseless underinvestment in African education. They will be the losers from the process of economic modernization taking place with new technologies and in new sectors. This process was most evident in our first case study, that of the Hapsburg Empire in the first half of the 19th century. Rather than welcome the new productivity enhancing technologies of the industrial revolution, the Hapsburg state attempted to block them because it though that the social changes unleashed by these technologies would undermine the political status quo.

Nevertheless, what distinguishes oligarchies, at least at some point, is that they can generate economic growth. At least some people have secure property rights in these regimes (for instance, white people in South Africa). The Apartheid state that emerged in South Africa after the Union formed in 1910 focused on repressing black labor and developing the mining economy, which created sustained growth until the 1970s.
2.2. Uncaptured. We now focus on unconstrained states which are not captured by an elite. There are two main political equilibria which fall into this category. The first is that of kleptocracy or what political scientists studying Africa have called personal rule or neopatrimonialism (Jackman and Rosberg, 1982). The second is populism. Unlike oligarchy, these two distinct equilibria never seem to lead to good economic outcomes.

2.2.1. Kleptocracy (Personal Rule). Another obvious set of institutions that stifle economic growth are those dominated by a dictator or narrow clique, who are focused on self enrichment at the expense of the rest of the population. Of course, the deeper question is why some societies turn into kleptocracies or let kleptocrats remain in power despite their disastrous records. The institutional framework developed above is useful in answering these questions as well.

Case Study: Mobutu Sese Seko and Le Mal Zairois. Joseph Mobutu seized power in the Congo, which became independent from Belgium in 1960, in a military coup in 1965 and quickly established himself as a dictator at the head of a one-party state, the MPR (Mouvement Populaire de la Révolution). There is no doubt that the aim of Mobutu was to use the state for the enrichment of himself and his family. He was a true kleptocrat. In the 1970s, 15-20 percent of the operating budget of the state went directly to Mobutu. In 1977 Mobutu’s family took $71 million from the National Bank for personal use and by the early 1980s his personal fortune was estimated at $5 billion (Leslie, 1987, p. 72). Turner and Young (1985, pp. 178-183) devote six pages to listing Mobutu’s assets and wealth.

The social base of the Mobutu regime was very narrow. Mobutu himself came from a small ethnic group, the Ngbandi, in the Équateur province and there is some evidence of systematic favoritism towards
fellow Équateurians especially towards the end of his regime. For example, in 1990 46% of the officer corp, 34% of diplomats and 19% of the MPR Central Committee were from Équateur. Nevertheless, it was relatively few who constituted the base of support. These people, called by Zairians *les gros légumes* or *les barons du regime* constituted "an inner core of persons with especially close kinship, ethnoregional, or personal ties to the president; variously known as the ‘presidential brotherhood’ or the ‘untouchables,’ they were able to conduct their mercantile affairs in blatant disregard for normal legal regulations."

(Turner and Young, 1985, p. 398)

Mobutu used various strategies to maintain power, including the military and nationalist ideology, and most notably the philosophy of ‘Mobutuism’ after 1974. However, his most important strategy was "divide-and-rule,” creating an environment in which any person or group could be rewarded or punished selectively. For example, Leslie (1987, p. 70) describes this as: “Individuals in public office are totally dependent on him for selection and maintenance of power. By frequently rotating government posts, Mobutu manages to maintain uncertainty and vulnerability ... He plays the role of big chief ... bestowing favors on his subjects based on personal discretion.”

Turner and Young, in their seminal book on the Mobutu state, describe the same situation as follows: “Client office holders have been constantly reminded of the precariousness of tenure by the frequency of office rotation, which simultaneously fuels the hopes of those Zairians anxiously waiting just outside the portals of power. The MPR Political Bureau, for example, was revamped a dozen times in the first decade of party life. No one (except of course Mobutu) has been continuously a member, and only six persons have figured on as many as half of the membership lists ... Insecurity has been sustained among top state and
party personnel by the frequent application of sanctions. During the first decade of the Mobutu regime, 29 of the 212 leaders went directly from their posts to prison on either political or corruption charges. An additional 26 were removed on grounds of disloyalty or dishonesty, with penal sanctions... Frequently in presidential speeches reference is made to unnamed disloyal or corrupt persons in the leadership ranks... Cumulatively, these devices constitute a powerful mechanism of informal intimidation, and suggest why systematic opposition has never arisen within the top organs of the state.” (1985, pp. 165-166). Later they continue (pp. 397-398): “As a co-optative resource, a pool of vacant high offices was sustained ... the sanction for not cooperating ... was imprisonment on corruption, nepotism, or subversion charges, or exile. Access to high rank in all state agencies depended upon presidential favor.” They sum up the essence of Mobutu’s state as: “the shifting patterns of membership [of the Political Bureau] ... constituted the very essence of patrimonial politics.” (p. 193).

Gould’s analysis concurs when he notes that “the frequent cabinet shuffles and transfers of officials from region to region ... may be explained as largely reflections of the president’s skill at using people while they can provide assistance to him and at the same time keeping factions separated from each other, thus preventing autonomous power centers from developing.” (1980, p. 83)

The career of Nguza Karl-i-Bond, who started as an opponent of Mobutu in the 1960s, illustrates the workings of divide-and-rule and the nature of shifting personal alliances. In the 1970s he was brought into the Mobutu camp and at one point became the foreign minister. In 1977 he was accused of treason and sentenced to death. In 1979 he was released and made prime minister. By 1981 he was in exile and gained fame by his book on the Mobutu regime (Karl-i-Bond, 1982).
By 1985 he was back in favor, and became the ambassador to the United States (Leslie, 1987, pp. 70-71). There are many other cases like this, for example Kamitatu-Massamba and Mbujimayi Belshika (see Gould, 1980, p. 83). Turner and Young (1985, p. 166) note in this context “though sanctions could be severe, a fall from grace was not necessarily permanent. Those jailed seldom remained in prison for very long. Repentance and renewed cultivation of the favor of the sovereign could make possible a return to full grace.”

The impact of divide-and-rule was catastrophic for the efficiency of the bureaucracy and the state. Leslie (1987, p. 6) notes that in Mobutu’s regime: “what is considered to be simply bureaucratic disorganization and economic mismanagement by external actors such as the [World] Bank and the IMF, is to Zaire’s ruling elite a rational policy of ‘organized disorganization’ designed to maintain the status quo.”

Added to this, the personal wealth accumulation of Mobutu and his clique destroyed much of the economy. The nationalization of foreign owned firms, most of which ended up in the hands of Mobutu and the regime, under the Zairianization program initiated in November 1973 was particularly disastrous, destroying what was left of the economy. According to Maddison (1995) GDP per-capita in 1992 was less than half of what it had been at independence in 1960.

What factors facilitated Mobutu’s use of divide-and-rule? During the rule of Mobutu, the Congo was clearly very poor and characterized by low productivity, making it easy for him to buy off potential challengers. Moreover, the Congo is endowed with enormous natural resource wealth including 15% of the world’s copper deposits, vast amounts of diamonds, zinc, gold, silver, oil and many other resources (Leslie, 1993, p. 3). This vast natural wealth gave Mobutu a constant flow of income to help sustain his power.
The Congo is also a huge and geographically diverse country (see Herbst, 2000, for an analysis of the ‘difficult geography’ of the Congo) and many scholars have seen it as having a uniquely complex cultural heritage. The common estimate is that there are about 200 distinct ethnic groups in the Congo (Leslie, 1993, p. 68) and Young (1965, p. 271) argued that “The particular colonial experience has worked to make ethnic loyalties in the Congo stronger and supra-tribal identification probably weaker than in most other African states.” The fragmented nature of the country, combined with the impact of the Belgian colonial state, meant that there was no large group or socio-economic class that could offset the power of Mobutu and help obstruct his personal rule. As we note later this is in stark contrast to Botswana and Mauritius where the existence of such classes placed checks on state power and limited the potential for kleptocracy. Moreover, the regional and ethnic identification of different groups made it straightforward for Mobutu to engage in the types of targeted redistribution and punishment which are associated with clientelism.

Unconstrained kleptocracy of the type implemented by Mobutu impoverishes a nation.

Case Study: The Rule of the Goat. The Dominican Republic, the eastern half of the island of Hispaniola, became independent from Spain in 1821. However, in 1822 it was invaded by Haiti, and regained its freedom only in 1844 after a war of independence. The Haitian occupation destroyed the traditional ruling elite of large landowners who fled the country never to return. In the subsequent decades, the country was plagued by serious political instability and a series of dictatorships. In 1916 the United States took over the country (previously, they had controlled the customs since 1906 to recover deliquent loans), an occupation that lasted until 1924. During this period the country was run
by a military governor. To establish control of the country, the United States trained a domestic constabulary, which became the Nation Army after 1924. Rafael Trujillo (known as ‘the Goat’) became the head this constabulary in 1928 and in 1930 used it as a power base to help a coup against the government, after which he had himself elected President in a fraudulent election. Throughout his rule Trujillo carried out the facade of elections, regularly being re-elected by 100 percent of the vote and even on two instances, from 1938 to 1942 and from 1952 to 1961, stepping down from the Presidency and controlling power from behind the scenes.

As with Mobutu, there is no doubt about the kleptocratic tendencies of Trujillo. Indeed, relative to the size of the economy, Trujillo’s regime was probably the most successful case of kleptocratic accumulation in history. By the end of his regime, the fortune of the Trujillo family was equal to about 100 percent of GDP at current prices and the family, “controlled almost 80% of the country’s industrial production. About 60% of the country’s labor force depended on him directly or indirectly, with 45% employed in his firms and another 15% working for the state” (Moya Pons, 1995, p. 398).

Trujillo used many tools to maintain power. He used coercion and force against potential rivals, and murdered and tortured many opponents. But as in the Congo, divide-and-rule was a key strategy. As a result, Hartlyn explains that “Trujillo eventually became the single dominant force in the country by combining abuse of state power, threats and co-optation. Although certain of the country’s economic elite maintained some individual autonomy there was no possibility for independent organization” (1998, p. 99-100).\footnote{Those who benefitted from the regime were few outside Trujillo’s extended family. A 1953 New York Times article (quoted in Wiarda, 1968, p. 74) found that 153 relatives were employed by the government. Trujillo himself was minister of}
How the Dominican version of divide-and-rule worked is explained in Turits (2003, p. 7): “Trujillo continually shuffled cabinet members and other important officials in and out of government posts to prevent their developing an independent power base. He exerted still tighter control over the national legislature. Upon assumption of office, members of the National Congress were obliged to sign their own resignations, a document that on Trujillo’s order could be handed to them at any moment... In certain cases, these resignations were reportedly delivered to legislators in the middle of their speeches before the assembly. In the 1942 to 1947 period, for example, there were 32 resignations in a Senate of 19 members, and 139 resignations in a House composed of 42 deputies.”

Wiarda’s analysis is similar: “Trujillo’s was a highly personalistic dictatorship in which power was not shared, even among a small clique, but concentrated in the hands of one man” (1968, p. 26). He further demonstrates that “Trujillo’s principal method of controlling the governmental machinery was the constant shuffling and reshuffling of political officeholders. He had the constitutional authority ... to appoint and remove almost all government personnel and he used his power extensively. In addition, he kept a file of signed but updated resignations for all government employees, and officials frequently arrived at work only to learn that Trujillo had filled in the date and that they had ‘resigned.’ The technique of shuffling government personnel was employed for the same reason as Trujillo’s frequent changing of the armed forces and police commands ... Anyone who gained a powerful

foreign relations, minister of social security, ambassador at large, and special ambassador to the United States. Family members held the presidency (his brother), two senatorial posts, six major diplomatic assignments, the positions of commander in chief of the armed forces, undersecretary of defense, chief of staff of the air force, inspector general of the army, inspector of embassies, plus a great number of other posts.
position could expect to be replaced ... no potential opposition power centers were allowed to develop” (1968, p. 62). Wiarda continues:

“Trujillo’s technique was to fragment the power of the many and, correspondingly, to concentrate all authority in his own hands.” (p. 62)

As in Zaire, people who were demoted, jailed or exiled were often pardoned and returned to positions of power (Wiarda, 1968, p. 63 and Crassweller, 1966, for many examples). Hartlyn (1998, p. 100) adds: “Politically, Trujillo combined guile, cynicism, ruthlessness and co-optation. There was ... incredible manipulation of individuals, who found themselves moved and removed from public office in complex and disconcerting fashion even as personal rivalries were promoted and tested.”

Trujillo also employed the strategy of divide-and-rule to control the rural sector. Turits (2003, pp. 82-83, 95) describes this as follows: “in exchange for land access and state assistance, peasants were compelled to farm in a more sedentary, intensive and land efficient manner... The dual nature of the Trujillo state’s protección, or support, of the peasantry was evident in the severe methods it used to augment peasant production. The state distributed rewards to those it deemed ‘man of work’ by variously providing them with land, irrigation, tools, seeds, credit, and technical assistance, while it harshly punished with vagrant penalties (jail and forced labor) and withdrawal of usufruct rights those it considered to be idle... The distribution of lands under Trujillo was represented as a gift more than a right and thus served to dramatize the dictator’s personal power.” Most notably, Turits (2003, p. 113) explains: “the state’s mediation of peasants’ access to land fostered a high level of political control. All individuals who wished to obtain
land had to supply a certificate of ‘good conduct’ from the neighborhood authority ... Certainly anyone suspected of political disloyalty ... would be excluded.”

The divide-and-rule strategy was facilitated by the extraordinary control that Trujillo accumulated over the economy. According to Wiarda (1968, pp. 87, 90-91): “Trujillo could hire and fire whom he pleased when he pleased. Since the great majority of the population was absolutely dependent on him for day-to-day existence, his control over it was assured ... there was so little economic independence that even a bare minimum of political independence was impossible... Trujillo frequently employed his economic power to destroy his political opponents. Banks could and did ... refuse loans and foreclose mortgages; government agencies refused export or import permits ... electricity or phone services were interrupted; and streets and sidewalks in front of selected business establishments were torn up.”

As with divide-and-rule in the Congo, one effect was to destroy the efficiency of much of the state machinery. Turits (2003, p. 140) notes: “confusion within the state was an almost inevitable by-product of Trujillo’s system of continually circulating high-level functionaries into different positions almost every year for the purposes of maintaining his control.” Nevertheless, economic performance under Trujillo was not as bad as under Mobutu. Though there appears to be no reliable national account data for this period, the scholarly consensus appears to be that the Dominican Republic experienced some growth during Trujillo’s rule.

General Lessons. Despite a naïve intuition that one might have that an all-encompassing dictator might refrain from the most destructive policies, because he anticipates that this will reduce his potential revenues and loot in the future (McGuire and Olson, 1996), the evidence
very strongly suggests that kleptocrats interested in maximizing their and their families income and are able to stay in power for long times have been disastrous for economic institutions and development. The answer to the question of why this is is also intimately related to the question of how they remain in power. The key observation is that kleptocrats, even when they managed to stay in power for long periods, are not entirely secure in their positions. They manage to stay in power and steal a large fraction of the resources of the economy by forming alliances that are detrimental to the economy and preventing any type of economic or political developments that might endangered or a political grip. Both Mobutu and Trujillo illustrate this point of view.

2.2.2. Populism. The second type of capture we discuss is a relatively democratic one. The notion of populism amongst economists has come to mean popular but shortsighted and ultimately highly self-defeating economic policies (e.g., Dornbush and Edwards, 1991). Yet the essence of populism is politics, not economics. Despite the association between populism and discredited economic theories such as structuralism it is clear that what populism is in the hands of such figures as Juan Perón or Hugo Chávez, is a political strategy. Like General Pinochet, who we will discuss later, economic strategy is secondary to politics. We believe the best way to think about populism is an extreme form of inefficient income redistribution which occurs in highly unequal or polarized societies and can only succeed as a political strategy because the state is unconstrained.

Case Study: Argentina under Perón. The brief experiment with free democracy which had been initiated in Argentina in 1916 collapsed in 1930. After that a series of military or conservative restricted democracies ruled the country until the military coup of 1943 which brought
Perón to power, first as secretary of labor. Perón used this position to build his political base amongst organized labor and build his party and he was elected president in 1946 in an election which is viewed by nearly all scholars as free and fair. During this period economic policy in Argentina took three key turns. Firstly, it became heavily biased against agriculture. Second, it switched to promoting domestic industry and a policy of trade restrictions and import substitution. Finally, policy aimed to significantly redistribute income to urban workers. There is complete consensus amongst economists that this policy shift and its persistence even after the coup which deposed Perón in 1955 is the proximate cause of Argentina’s subsequent poor economic performance. Why was such a set of policies adopted given that until the 1930s Argentina had experienced 50 years of sustained economic growth based on export agriculture?

The conventional wisdom about Argentina in the economics literature is that Peronist policy was part of a misguided infant industry policy whose aim was to promote rapid industrialization. Having been adopted the policy persisted because it created vested interests. This policy was rationalized by economists in the ‘structuralist school’ who presented logical and empirical arguments against free trade (such as the Singer-Prebisch hypothesis about declining terms of trade) and appealed to the intellectual tradition of List, Hamilton, Prebisch and Rosenstein-Rodan. In their summary of “arguments in favor of ISI” Cardoso and Helwege (1992, pp. 85-89) present a list of such factors and Krueger (1993) similarly gives a similar analysis of the adoption of failed industrialization strategies (Haber, 2006, for a recent critique of the idea that industry policy in Latin America was designed to promote industrialization).
The story proposed by economists, that inward looking development was adopted because it was thought at the time to be the “best” policy for promoting industrialization, is implausible. Gerchunoff (1989) sums up Peronist economic policy in the following way,

“there was no specific and unified Peronist economic policy, much less a long-term development strategy. In spite of official rhetoric about a plan, the objective - and at times exclusive - priority was...an economic order capable of maintaining the new distributive model.”

The first real statement of Prebisch’s views was in his famous work of 1950 and he had no influence on policy in Argentina until 1955 when he was recalled from exile (where he had been sent by Perón after being dismissed from the central bank) following Perón’s fall from power. To speak of a “full-blown Peronist growth strategy” as Shleifer (1997) does, or to characterize Peronist policies as having “the goal of rapid industrialization” and “the intent of building a domestic industrial base behind tariff rates,” as Sachs (1990, p. 148) does, is to misunderstand their motivation. There was no such growth strategy. In line with the evaluation of Gerchunoff (1989), Diaz Alejandro (1970, p. 126) concludes,

“Peronist policies present a picture of a government interested not so much in industrialization as in a nationalistic and populist policy of increasing the real consumption, employment, and economic security of the masses - and of the new entrepreneurs. It chose these goals even at the expense of capital formation and of the economy’s capacity to transform.”

The adoption of Peronist policies was not simply, or even mainly concerned with promoting industrialization. One the one hand they
reflect changes in the economy and the rise of the political influence of labor and urban groups. But this was not simply a story about how interests captured the state, because it is clear that Perón himself constituted interests groups which he anticipated would support him in the future. He created a political base that would vote for him. The best way to think about the adoption of import substitution and a closed economy development strategy was as one element of a political economy strategy to consolidate power. Part of the attraction for this was that it strengthened urban groups who were Perón’s base, but also undermined the power of traditional agricultural interests who opposed him (on the structure of the Personist coalition see Mora and Llorente, 1980). Interestingly Diaz Alejandro saw this when he argued (1970, p. 65),

“The main problem arises in that policies which are best from the viewpoint of economic efficiency (e.g. free, or nearly free, trade) generate an income distribution favorable to the owners of the relatively most abundant factor of production (e.g. land) and therefore strengthen the position of the traditional elite ... long run efficiency and a popular income distribution could only be reconciled by a sophisticated fiscal system, not an easy thing to achieve.”

The ability of the Peronists to capture the state was facilitated by the absence of constraints. When the Supreme Court attempted to block Perón’s policies after his election in 1946 he simply expanded the court so he could pack it with his cronies. The highly polarized politics that emerged from the 1940s in Argentina and the distributional conflicts that they engendered with huge social losses are described in Mallon and Sourrouille (1975) and O’Donnell (1979).
Case Study: Venezuela under Chávez. Just as Perón was a genuinely popular figure who could win elections, so is Hugo Chávez. In some sense Chavismo is the reaction of Venezuelan society to the previous oligarchic regime created by the Punto Fijo pact in 1958. The exclusionary regime of the AD and COPEI began to unravel in the late 1970s after decades of resource misallocation and rent seeking initiated a sustained decline in economic performance (Monaldi and Penfold, 2006). Real GDP per-capita fell by about 1/3 between 1980 and 2000, while average real wages fell by about 2/3. The proportion of the population below the poverty line went from 25% to about 55% and there was also a large increase in the Gini coefficient. The sustained decline of oligarchic democracy in Venezuela began to lead to severe political instability and Chávez mounted his first coup attempt in 1992 and was elected President in 1998. After this Chávez organized a constitutional convention which greatly increased the powers of the Presidency and simultaneous moved from a bicameral to a unicameral legislature. Recently, the legislature voted to allow him to rule by decree in many different contexts.

In the Venezuela of Chávez we see popular rule, but unconstrained rule which very bad implications for the economy. Chávez uses his mandate to persecute those who oppose him (for example all of those who signed the petition which led to his recall election in August 2004 - government deputy Luis Tascón published on his web page the list and identity card numbers of those who had signed the petition to hold the referendum against Chávez) and engages in endemic clientelism to redistribute income and rents to his supporters. At the same time the private sector faces huge uncertainly over property rights and constant threats of a transition to socialism with nationalization of assets.
General Lessons. Populism occurs as a political strategy in societies riven with economic inequalities and often highly polarized along other dimensions. In such circumstances democracy may lead to a form of majority rule with highly dysfunctional economic effects which 19th century political thinkers would have referred to as the “tyranny of the majority.” Of course some redistribution may be desirable in a highly unequal society and there are theoretical mechanisms which suggest this may even improve growth. The reality of populist redistribution however is that it is unlikely to promote the efficient allocation of resources and the impact of such populist policies on investment and the potential for economic growth are typically disastrous.

3. Strong Constrained States

We now consider strong states which are constrained, de jure or de facto.

3.1. Captured States: Oligarchy II. We first study constrained strong states that are captured by an elite. In consequence these regimes are again oligarchic in nature. To distinguish such equilibria from the oligarchic ones discussed above we refer to them as Oligarchy II.

3.1.1. Case Study: The License Raj. Following independence in 1948 India developed a vibrant democracy where politicians have been accountable to the electorate. Perhaps the most notable example of this was the way the Congress Party and Mrs Ghandi were voted out of office after declaring a state of siege in the 1970s that many people considered to be unjustified. At the same time as there were real democratic constraints on power, a succession of independence leaders built on the meritocratic foundations of the Indian civil service. The state was therefore relatively strong, and also constrained.
Yet economic institutions have not favored strong growth in India until recently. Business interests were strongly represented in the Congress Party and after independence India created a regulatory state which closed the economy and blocked entry and competition (Bardhan, 1984, Chibber, 2003). The result was huge rents for conglomerates like the Tatas, but very slow economic growth and little industrial dynamism. Only after the liberalization of 1991 and the gradual deregulation induced by the decline of the Congress Party and increasing political competition has the Indian economy began to grow.

3.1.2. Case Study: Venezuela in the era of the Punto Fijo Pact. Modern democracy arrived in Venezuela in 1945 and was ended three years later by a military coup. The coup was precipitated by the victory of Rómulo Betancourt and his Acción Democrática party (AD) in the elections for a Constituent Assembly to draft a new constitution in 1946. The coup of 1948 initiated a ten year dictatorship under Marcos Pérez Jiménez, who was finally ousted by a popular uprising in 1958. The democracy which emerged after 1958 was however closely controlled and guided by the so-called Pacto de Punto Fijo. This was an agreement by AD and the other main political party, the Christian Democratic Comité de Organización Política Electoral Independiente (COPEI). This pact essentially limited electoral competition exclusively to these two parties. The consequence of this cessation of political competition was that the state in Venezuela became captured by the elite of these parties. Corruption was endemic and the misallocation of resources huge (Monaldi and Penfold, 2006).

Though Venezuela sustained some growth until the late 1970s on the basis of the expanding oil economy, after this point the economy went into steep decline.
3.1.3. **General Lessons.** When states have some capacity to provide public goods and raise taxes there is the potential to promote development and facilitate the creation of good economic institutions. Also, because the state is constrained one does not see the type of mass expropriation of incomes and assets that one sometimes sees when the state is unconstrained. Yet economic institutions may not be those which maximize social welfare if the state is captured by some social elite. In the case of India this was capitalists who structured policies to block entry, remove competition and secure their own rents. This led to a structure of incentives in the private sector which favored rent seeking over productive activity and little emphasis on the investment of public goods more generally other than those which favored the powerful groups. For example, there was little attempt to seriously invest in human capital. Venezuela under the Punto Fijo regime represents a related situation. Here the state was captured by the political elites of AD and COPEI who acted collusively to minimize political competition. As in India, huge entry barriers and distortions resulted as the parties redistributed rents to themselves and their supporters.

3.2. **Uncaptured States: Functioning Democracy and the Developmental State.** Constrained states which are uncaptured is probably the most favorable circumstance for development. Here we emphasize that there are different ways in which states may be constrained.

3.2.1. **Case Study: China since Deng Xiaoping.** The experience of economic development in China since 1978 gives an interesting example where one can argue that a political equilibrium has emerged where the state has been constrained and not captured by an elite. This idea is reflected in the academic literature on Chinese economic growth which
has emphasized that a balance of political power has been crucial in explaining why growth has occurred, but where this balance has evolved over time and has plausibly been permanently institutionalized. If the structure of political power in England in the early 17th century did not provide for the security of property rights necessary for investment and the development of good institutions, the situation with respect to the rule of the Chinese Communist Party (CCP) seems much worse. Not only is the power of the CCP apparently unchecked or constrained by political institutions, but it also had the legacy of a sometimes virulent anti-capitalist ideology. Since rapid growth has gone alongside the continued dominance of the CCP it appears difficult to argue that this is a situation where an equal distribution of power has been important in inducing good institutions. Moreover, one could doubt whether institutions have even been good in the sense described earlier. Yes, there has been relatively free entry into profitable economic opportunities, but whether or not private property rights exist and are stable is unclear and there is no independent judicial system to act as an independent arbiter.

Yet the experience in China is consistent with the thesis of this paper. Many scholars agree that after the trauma of the cultural revolution, the death of Mao in 1976, and the recognition by Deng Xiaoping and those who assumed power after 1978 that China had fallen disastrously behind economically, there was a strong desire amongst leaders of the CCP to promote growth (see Perry and Wong, 1985, Harding, 1987, Shirk, 1993). Particularly threatening to Chinese leaders was that by this time the extraordinary economic success of Taiwan had become apparent. The quandary was how to promote growth without loosening the control of the party. How could people be induced to invest? Deng understood that reform without some change in the
distribution of power was infeasible, but he realized that this could be achieved under the existing regime. In particular he realized that “he could use local officials as an effective counterweight to the centre without changing the political rules of the game” (Shirk, 1993, p. 12). In 1978 the Chinese state was much less centralized than the Soviet state had been and a great deal of the economy was already run by local governments. A crucial process of further political decentralization took place and Montinola, Qian and Weingast (1995, pp. 51-52) argue that

“China’s political decentralization shares much in common with Western federalisms. The modern Chinese system includes a division of authority between the central and local governments. The latter have primary control over economic matters within their jurisdictions. Critically, there is an important degree of political durability built into the system”.

In consequence “political reform in China has placed considerable limits on the discretion of the central government” (Montinola, Qian and Weingast, 1995, p. 50). Alongside political reform went economic reform: “For almost 20 years, reform in China has proceeded through the gradual reassignment of specific property rights from higher government agencies to lower government agencies, or from government agencies to enterprises, managers, families, or individuals” (Walder and Oi, 1999, p. 7). The strengthening of the powers of local governments and their direct economic interest in promoting local economic development was what got the Chinese economy moving. Central to this initial process were the rapid expansion of Township Village Enterprises whose investments were secure precisely because of the political

Has this process led to a permanent change in the distribution of power? The answer to this appears to be yes. Tellingly after the Tiananmen Square protests were suppressed in 1989 there was an attempt by some senior members of the CCP to recentralize power, but state governors refused and got their way (Montinola, Qian and Weingast, 1995, p. 68). Montinola, Qian and Weingast (1995, p. 71) conclude that “rival power centers have emerged in China. Local governments, particularly those in areas with the largest growth, now have substantial independent sources of revenue, authority, and political support.”

The growth process has reinforced the distribution of power, strengthening other forces outside the CCP. Lying behind these processes is another more subtle change in the balance of political power. The aftermath of the cultural revolution undermined much of the support for the CCP amongst the populace. In order to maintain social order the regime needed to deliver economic benefits since it could no longer rely on ideological support. The durability of the regime therefore came to rely on continued prosperity. This phenomenon is important because it can also help to explain why people anticipated property rights were secure: people understood that the regime could not risk undermining investment and growth by expropriating wealth. This type of constraint played important roles in the modern growth experiences of South Korea and Indonesia as well.

3.2.2. Case Study: The United States. The conventional wisdom about the United States is that the basis for good economic institutions are the formal political institutions of checks and balances and
the separation of powers which were enshrined in the Constitution written in 1787. These rules, along with the vibrant democratic competition which emerged, guaranteed that good economic institutions would emerge. The research by Haber (2001) shows specifically how important democracy and federalism were in the United States in the 19th century in allowing a string financial industry to develop. His work is particularly interesting since he makes an explicit comparison with Mexico where different political institutions led to very different outcomes for economic institutions.

Studies of the development of banking in the United States in the nineteenth century demonstrate a rapid expansion of financial intermediation which most scholars see as a crucial facilitator of the rapid growth and industrialization that the economy experienced. In his recent study Haber (2001, p. 9) found that in the United States, “In 1818 there were 338 banks in operation, with a total capital of $160 million—roughly three times as many banks and bank capital as in 1810. Circa 1860, the United States had 1,579 banks, with a total capital of $422.5 million. Circa 1914 there were 27,864 banks in the United States. Total bank assets totaled $27.3 billion.”

One might see this rapid expansion of banking and financial services as a natural feature. Yet Haber (2001) shows that the situation was very different in Mexico (p. 24). “Mexico had a series of segmented monopolies that were awarded to a group of insiders. The outcome, circa 1910 could not have been more different: the United States had roughly 25,000 banks and a highly competitive market structure; Mexico had 42 banks, two of which controlled 60 percent of total banking assets, and virtually none of which actually competed with another bank.”
The explanation for this huge difference is not obvious. The relevant technology was certainly readily available everywhere and it is difficult to see why the various types of moral hazards or adverse selection issues connected with financial intermediation should have limited the expansion of banks in Mexico but not the United States. Haber then shows that (p. 9), “at the time that the U.S. Constitution was put into effect in 1789, ... [U.S. banking] was characterized by a series of segmented monopolies that shared rents with state governments via taxes or state ownership of bank stock. In some cases, banks also shared rents directly with the legislators who regulated them.”

This structure, which looked remarkably like that which arose subsequently in Mexico, emerged because state governments had been stripped of revenues by the Constitution. In response, states started banks as a way to generate tax revenues. State governments restricted entry “in order to maximize the amount of rent earned by banks, rent which would then be shared with the state government in the form of dividends, stock distributions, or taxes of various types.”

Thus in the early nineteenth century, U.S. banks evolved as monopolies with regulations aimed at maximizing revenues for the state governments. Yet this system did not last because states began competing among themselves for investment and migrants.

“The pressure to hold population and business in the state was reinforced by a second, related, factor: the broadening of the suffrage. By the 1840s, most states had dropped all property and literacy requirements, and by 1850 virtually all states (with some minor exceptions) had done so. The broadening of the suffrage, however, served to undermine the political coalitions that supported restrictions on the number of bank charters. That
is, it created a second source of political competition—competition within states over who would hold office and the policies they would enact.”

The situation was very different in Mexico. After 50 years of endemic political instability the country unified under the highly centralized 40 year dictatorship of Porfirio Diaz until the Revolution in 1910.

In Haber’s argument political institutions in the United States allocated political power to people who wanted access to credit and loans. As a result they forced state governments to allow free competitive entry into banking. In Mexico political institutions were very different. There were no competing federal states and the suffrage was highly restrictive. As a result the central government granted monopoly rights to banks who restricted credit to maximize profits. The granting of monopolies turned out to be a rational way for the government to raise revenue and redistribute rents to political supporters (see North, 1981, Chapter 3).

A priori, it is possible that the sort of market regulation Haber found in Mexico might have been socially desirable. Markets never function in a vacuum, but rather within sets of rules and regulations which help them to function. Yet it is hard to believe that this argument applies to Mexico. Haber (2001) documents that market regulation was aimed not at solving market failures and it is precisely during this period that the huge economic gap between the United States and Mexico opened up. Indeed, Haber and Maurer (2004) examined in detail how the structure of banking influenced the Mexican textile industry between 1880 and 1913. They showed that only firms with personal contacts with banks were able to get loans. They conclude (p. 5):
“Our analysis demonstrates that textile mills that were related to banks were less profitable and less technically efficient than their competitors. Nevertheless, access to bank credit allowed them to grow faster, become larger, and survive longer than their more productive competitors. The implication for growth is clear: relatively productive firms lost market share to relatively unproductive (but bank-related) competitors.”

Despite the fact that economic efficiency was hurt by regulations, those with the political power were able to sustain these regulations.

3.2.3. General Lessons. The combination of a strong, constrained and uncaptured state seems to lead to political equilibria which are most advantageous for economic institutions. In some sense this idea is related to that of Evans’ (1995) notion of ‘embedded autonomy.’ In Evans’ argument, successful industrialization occurs when states have strong capacities and when they are both autonomous, or not captured, but also embedded in society so that they can understand the needs of businessmen and citizens.

The difficult problem from a policy point of view is that in practice there are many ways that states can be constrained. This is not just a matter of the constitution so that one cannot necessarily constrain states just by re-writing the constitution.
CHAPTER 3

Pitfalls of Reform

We have argued above that our framework for thinking about the effect of institutions on economic outcomes is useful in delineating a range of dysfunctional political equilibria and consequent economic institutions. We have also emphasize how it is important to understand the political forces and institutions that maintain these dysfunctional economic institutions in place and are often mutually self-reinforcing (complementary) with these economic institutions.

Our list was illustrative rather than exhaustive, and focused on the most extreme and clear cases of dysfunctional equilibria. These already give us an idea of the potential growth costs of inefficient and inappropriate economic institutions. The question that arises immediately is whether these economic institutions can be reformed.

One approach is to directly try to reform economic institutions. If security of property rights is the problem under kleptocracies, why not introduce (or force dictators to introduce) more secure property rights? The potential problems facing such an approach highlight the first set of pitfalls of institutional reform. Our framework emphasizes that one should not try to understand or manipulate economic institutions without thinking about the political forces that created or sustain them. While blatant disregard for property rights is a powerful distortionary force in kleptocratic societies, it is not the only instrument available to a dictator that wants to extract resources from the rest of the society.
The comparison of Ghana in the 1960s and 1970s and current Zimbabwe nicely illustrates these ideas. In Zimbabwe the mass expropriation and redistribution of agricultural land has led to a collapse in the economy (GDP per-capita has apparently fallen by around 50% since the introduction of the Fast-Track land reform policy in 2000). In Ghana agricultural policies were also motivated by the desire to redistribute incomes (Bates, 1981) but the property rights of rural producers were never challenged. Instead, a succession of governments used monopsony marketing boards to set very low prices for crops such as cocoa. The instruments were very different but the motivation and economic effects were similar.

This reasoning suggests that direct institutional reform in itself is unlikely to be effective and that instead it might be more useful to focus on understanding and reforming the forces that keep bad institutions in place. It is therefore important to focus on political institutions and the distribution of political power as well as the nature of economic institutions in thinking about potential institutional reform or institutions building. This raises the second potential pitfall of institutional reform; while we have recognized the importance of political institutions, we are still at the beginning of understanding the complex relationship between political institutions and the political equilibrium. Sometimes changing political institutions may be insufficient, or even counterproductive, in leading to better economic outcomes. Once again the use of a theoretical framework in thinking about these issues is useful both for academic research and in generating better policy advice.

1. Persistence of Power and Incentives—The Seesaw Effect

Many dysfunctional economic institutions, like the labor-repressive agricultural societies or the oligarchic barriers mentioned above, are
supported by a system of specific laws and regulations that relate to economic institutions. An obvious idea might be to change the laws and regulations. For example, if Latin American countries grew slowly after the Second World War because they levied high tariffs on imports, then irrespective to what forces led these tariffs to be put in place, removing them ought to stimulate growth.

The first pitfall of institutional reform is that directly reforming specific economic institutions (such as the trade regime) may not be sufficient, and may even backfire. The reason why reforms of specific economic institutions may be ineffective is that there are many different ways and a multitude of instruments to achieve a specific goal. Taking away one instrument without altering the balance of power in society or altering the incentive environment can simply lead to the replacement of one instrument by another. This phenomena was dubbed the *See-Saw Effect* by Acemoglu, Johnson, Robinson and Thaicharoen (2003).

1.1. **Case Study: Reform and the new clientelism in Latin America.** A prominent example of reforms were those imposed on Latin American countries following the debt crisis of the 1980s. As part of packages to repay debt, Latin American countries abandoned many aspects of the economic institutions which had been prevalent since the 1930s and 1940s. Policy reforms which took place in the late 1980s and 1990s included deregulation of the trade regime and severe cuts in tariffs, privatization and financial deregulation. Though this had been done earlier in Chile and attempted by the military regime in Argentina after 1976, this was now done wholesale in most Latin American countries. Even though there was an economic crisis, the acceptance of these policy reforms by such institution as the Peronist party in Argentina appears to be quite strange. Enduring crises and many rounds of policy reform have not induced many African countries
to reform. One difference, of course, is that Latin American countries are more democratic than African ones making it more difficult to maintain the status quo in the face of economic collapse. Another important difference is that Latin American politicians realized that the policies of neo-liberalism could be manipulated to fulfill clientelistic ends. As Roberts (1995, p. 114) convincingly argues in his analysis of the reforms of Fujimori “the Peruvian case demonstrates that it may be possible to craft populist formulas that complement neoliberalism.” For example, privatization could be organized to redistribute rents by reducing competition and giving privatized assets as favors to political supporters (see Gibson, 1997, Roberts and Arce, 1998, Weyland, 1998, 2000). There were of course differences, for example in Argentina the Peronist party distanced itself from its traditional supporters in the labor movement. But such a strategy was feasible because the political power of the labor movement had been severely damaged by repression under the military. The Peronist party was able to re-invent itself (Levitsky, 2003) and carry on with clientelism as usual.

The see-saw effect operates here in the following sense: to win power in Argentina, for example, the Peronist party traditionally engaged in redistribution of incomes and rents. The instruments it used to do this included rationing of foreign exchange, or the distribution of rents via industrial licenses. The policy reforms of the 1990s meant that these old instruments could not be used. For example, the currency board took away the ability of ration access to foreign exchange. But other instruments were available to use to achieve the same ends, for example the labor movements were compensated for some deregulation by being able to benefit from privatization.

1.2. Case Study: The Structural adjustment of Politics in Africa. Another important example of the see-saw effect comes from
the politics of structural adjustment in Africa. The attempt to induce African countries to implement institutional reforms such as reducing distortions was not a success (van der Walle, 1993, 2000), mostly for the reason that international financial institutions did not take into account the political rationale for the inefficient policies they were trying to reform. The most dramatic example of this is due to Herbst (1990) and Reno (1998). They argued that attempts by IFIs to induce downsizing of the public sector, for example by closing down unprofitable parastatals had played an important role in creating civil war in Sierra Leone and Liberia. Regimes in both countries had used public sector employment as a method of redistributing rents to opponents or potential opponents of the regime and buying political support. Once these options had been taken away by structural adjustment, more opposition to the regimes emerged and incumbents switched from using carrots to using sticks. In this story policy reform induced a switch from one inefficient instrument, patronage through public sector employment, to an even more inefficient one, repression. This is the see-saw effect in action.

1.3. General Lessons. Making or imposing specific institutional reforms may have little impact on the general structure of economic institutions or performance if they leave untouched the underlying political equilibrium. Of course, as the framework above emphasized, political power will to some extent reflect economic institutions so it is possible that a change in economic institutions may induce a change in de facto power and ultimately in the broader political equilibrium. Nevertheless, as the above examples make clear, this is far from certain. A piecemeal approach may be dangerous. Often we see the symptoms, but they are precisely the symptoms of deeper causes. Dealing with the symptoms other than causes may backfire.
Despite all of the Washington consensus reforms that took place in Argentina, for example, there was little change in the way politics worked. The political genius of Menem and the Peronist party after 1989 was to recognize that the policies of the Washington consensus could be bent to function as ‘politics as usual’. In consequence there was little change in the underlying political equilibrium though the instruments which the Peronists used after 1989 were different. This perspective is of course very different from that which claims that the Washington consensus reform failed (Rodrik, 2006). Our view is not that they failed but that for them to succeed it would be necessary for there to be a change in the political equilibrium in Argentina. Though it is possible that such reforms could change the political equilibrium, it did not happen.

The points are related to those made by Stigler (1971, 1982) and Coate and Morris (2005) in their discussion of the political economy of income redistribution. Stigler pointed out that it was political incentives that led income redistribution to take a socially inefficient form. For instance, while it might be better to redistribute to farmers by giving them lump-sum transfers, subsidizing farm output might be more attractive politically because it was not perceived as income redistribution by other voters (see Coate and Morris, 1995, for a formalization of this idea). This being the case, Coate and Morris (2005) noted that policy reform which aimed at banning the use of particular inefficient instruments might be counterproductive because rational politicians would already be using the least cost way of redistributing, given the political constraints and incentives they faced.
2. Persistence of De Facto Power

The last section illustrated that reforming specific economic institutions without perturbing the underlying political equilibrium may not lead to improved economic institutions or performance. Moreover, we shall now argue that even reforming de jure power (for instance enfranchising former slaves) or introducing democracy may not be sufficient to induce broader institutional change. The reason why changes in de jure power may not be sufficient to trigger a change in the political equilibrium is that the political and economic system is kept in place by a combination of de jure and de facto political power. An external or internal impetus to change de jure institutions may still leave the sources of de facto power intact, and groups that have lost their de jure power may use their de facto power in order to re-create a system similar to the one that has departed (Acemoglu and Robinson, 2006,b,c). The new system may be as inefficient as the old one.

This is not to argue that reform of de jure institutions is not possible or that it is irrelevant. For example, democratization in many European societies in the 19th century appears to have significantly changed economic institutions, for example leading to sustained expansions of educational systems (Acemoglu and Robinson, 2000, Lindert, 2004). Nevertheless, this section emphasizes that such reforms come with pitfalls.

2.1. Case Study: New South, Old South.

“De landlord is landlord, de politician is landlord, de judge is landlord, de shurf is landlord, ever’body is landlord, en we ain’ got nothin.” Testimony of a Mississippi sharecropper to an official of the Agricultural Adjustment Administration in 1936, Schulman (1994, p. 16).
An important example which illustrates our thesis in the continuation of the economic system based on labor repression, plantation and low-wage uneducated labor in the U.S. South before and after the significant changes in political institutions brought about by the Civil War.

Before the Civil War, the South was significantly poorer than the U.S. average income at about 70% of GDP per-capita. The South lacked industry (Bateman and Weiss, 1981, Wright, 1986, Table 2.4, p. 27) and in 1860 the total manufacturing output of the South was less than that of either Pennsylvania, New York or Massachusetts (Cobb, 1984, p. 6). The South had very low rates of urbanization (around 9% as opposed to 35% in the Northeast) and relatively little investment in infrastructure. For example, the density of railroads (miles of track divided by land area) was three times higher in the North than in Southern states. The situation with respect to canal mileage was similar (Wright, Table 2.1, p. 21). Perhaps more importantly, especially in the context of the potential for future economic growth and industrialization, the South was not even innovative for the sectors in which it specialized.

The relatively backwardness of the South was to the plantation economy and slavery. Wright (1986) argues that because slaves were a mobile asset, there was no incentive for planter interests to support investment in public goods such as infrastructure, and so manufacturing could not develop. Bateman and Weiss (1981) show that Southern planters did not invest in industry, even though the rate of return was superior to that in agriculture. A plausible explanation for the lack of innovation is that slavery limited the possibilities for productive investment. Slaves were forbidden to own property or to become educated in most Southern states, presumably because this made them easier to
control. But this pattern of labor repression also condemned plantations to low-skilled labor forces and possibly removed the incentives of planters to innovate.

In the aftermath of the Civil War, the income per-capita of the South fell to about 50% of the U.S. average. If the organization of the slave economy had been the reason why the South had been relatively backward in 1865, one might have imagined that the abolition of slavery in 1865 would have removed this blockage to Southern prosperity. The evidence and historical interpretations show that the abolition of slavery had a surprisingly small effect on the Southern economy. Though planters initially tried and failed to reintroduce the gang labor system with the freed slaves, out of the ashes of the Civil War emerged a low wage labor intensive economy based on labor repression. Cut off from the rest of the United States, income per-capita remained at about half the average until the 1940s when it finally began slowly to converge. Just as before the Civil War, there was systematic underinvestment in education (Margo, 1990). The main incentive for this seems to have been to impede migration (see Wright, 1986, p. 79). In 1900 all but two of the non-Southern states had enacted compulsory schooling laws, while none had such laws in the South except Kentucky (Woodward, 1951, p. 399). Though industrial development did begin more systematically after 1865, Cobb (1984, p. 17) notes:

“The industries that grew most rapidly in the post-Reconstruction decades were typical of an underdeveloped economy in that they utilized both cheap labor and abundant raw materials... such industries hardly promised to elevate the region to economic parity with the rest of the nation”.

So why did the economic system of the South change so little following the Civil War, especially given the significant changes in political
institutions? At first, this persistence of economic institutions appears at odds with the significant changes in the distribution of *de jure* power that took place after the Civil War, for example, with the enfranchisement of the freed slaves, and the repeal of the Missouri compromise, which had previously cemented the political power of the South in the federal government.

We believe the answer is related to the exercise of *de facto* political power by the Southern landed elites to compensate for the loss of their *de jure* political power. Consistent with our approach, there was considerable persistence in the identity and power of the political elites. For example, Wiener (1978) studied the persistence of the planter elite in 5 counties of the black belt of western Alabama. Tracking families from the U.S. census and considering those with at least $10,000 of real estate, he found that (p. 9) “of the 236 members of the planter elite in 1850, 101 remained in the elite in 1870.” Interestingly, this rate of persistence was very similar to that experienced in the antebellum period; “of the 236 wealthiest planters families of 1850, only 110 remained in the elite a decade later” (p. 9). Nevertheless, “of the 25 planters with the largest landholdings in 1870, 18 (72%) had been in the elite families in 1860; 16 had been in the 1850 elite group.”

After the end of the Civil War, more or less the same group of planter elites controlled the land and used various instruments to re-exert their control over the labor force. Though the specific economic institution of slavery did not persist, the evidence shows a clear line of persistence in the economic system of the South based on plantation-type agriculture with cheap labor. This economic system was maintained through a variety of channels, including both control of local
politics and exercise of potentially violent de facto power. As a consequence, in the words of W.E.B. Du Bois (1903, p. 88), the South became “simply an armed camp for intimidating black folk.”

The planter elite successfully staffed or co-opted the members of the Freedmen’s Bureau, whose remit was to supervise the freed slaves. In 1865 the state legislature of Alabama passed the Black Code, an important landmark towards the repression of black labor. Wiener (1978, p. 58) describes this as: “The Black Code of Alabama included two key laws intended to assure the planters a reliable supply of labor—a vagrancy law, and a law against the ‘enticement’ of laborers”. These laws were designed to impede labor mobility and reduce competition in the labor market.

In addition to moulding the legal system in their favor, “Planters used Klan terror to keep blacks from leaving the plantation regions, to get them to work, and keep them at work, in the cotton field” (Wiener, 1978, p. 62). In his seminal study of the politics of the South after World War II, Key (1949, p. 9) sums up the pattern of persistence of the institutions of the South both before and after the Civil War as the “extraordinary achievement of a relatively small minority—the whites of the areas of heavy Negro population.”

A key to the persistence of the antebellum system after the Civil War was the continued control over land. For example, in the debate over the redistribution of 40 acres of land to the freedmen (vetoed by President Andrew Johnson in 1865), Congressman George Washington Julian argued (quoted in Wiener, 1978, p. 6):

> “Of what avail would be an act of congress totally abolishing slavery ... if the old agricultural basis of aristocratic power shall remain?”
A third strategy, again consistent with the emphasis on the de facto political power of the elite in our theoretical analysis, was control of the local political system. Following the Civil War, the period called ‘Reconstruction’ lasted until 1877. In this period Republican politicians contested power in the South and, with the help of the Union Army, engineered some social changes. Nevertheless, this induced a systematic backlash in the guise of support for the Democratic Party and the so-called ‘Redeemers.’ In 1877, in the context of a log-roll between President Rutherford Hayes and Southern national politicians, Union soldiers were withdrawn from the South and the region left to its own devices. The period after 1877 then marked the real recrudescence of the antebellum elite. The ‘redemption’ of the South involved the systematic disenfranchisement of the black (and poor white) population through the use of poll taxes and literacy tests (Key, 1949, Kousser, 1974) and the creation of the one-party Democratic regime.

Key (1949, pp. 309-10), in his analysis of the primary elections of the Democratic party, noted the hegemony of southern society’s “upper brackets” and the political marginalization of its “lower brackets.” He discusses in detail the control of North Carolina’s economic oligarchy over politics, noting that (p. 211): “The effectiveness of the oligarchy’s control has been achieved through the elevation to office of persons fundamentally in harmony with its viewpoint.”

This picture is also confirmed by the analysis of Wright (1986, p. 78), who writes “Even in the 1930s, southern representatives in Washington did not use their powerful positions to push for new federal projects, hospitals, public works and so on. They didn’t, that is, as long as the foundations of the low-wage regional economy persisted.”

In addition to disenfranchisement a whole gamut of segregationist legislation—the so-called Jim Crow laws—was enacted (Woodward,
1955, for the classic analysis). These laws turned the postbellum South into an effective “apartheid” society where blacks and whites lived different lives. As in South Africa, these laws were aimed at controlling the black population and its labor supply.

Consequently, the South entered the 20th century as a primarily rural society. “It remained an agrarian society with a backward technology that still employed hand labor and mule power virtually unassisted by mechanical implements” Ransom and Sutch (2001 pp. 175-176). In 1900, the South’s urbanization rate was 13.5%, as compared to 60% in the Northeast (Cobb, 1984, p. 25).

Ransom and Sutch’s (2001, p. 186) assessment of the implications of this economic and political system in the South for economic progress is representative of the consensus view: “Southerners erected an economic system that failed to reward individual initiative on the part of blacks and was therefore ill-suited to their economic advancement. As a result, the inequities originally inherited from slavery persisted. But there was a by-product of this effort at racial repression, the system tended to cripple all economic growth”:

“When whites used threats of violence to keep blacks from gaining an education, practicing a trade, or purchasing land, they systematically prevented blacks from following the three routes most commonly travelled by other Americans in their quest for self-advancement. With over half the population held in ignorance and forced to work as agricultural laborers, it is no wonder that the South was poor, underdeveloped, and without signs of economic progress” Ransom and Sutch (2001, p. 177).

All in all, the Southern equilibrium, based on the exercise of de facto power by the landed elite, plantation agriculture and low-wage,
uneducated labor, persisted well into the 20th century, and only started to crumble after World War II. Interestingly, it was only after the demise of this Southern equilibrium, that the South started its process of rapid convergence to the North.

2.2. Case Study: The Reinvention of the Cambodian People’s Party. The Prime Minister of Cambodia, Hun Sen, is a former member of the Khmer Rouge who, along with others, fell out with Pol Pot and the leadership after the Khmer Rouge came to power. To avoid being purged they ran away to Vietnam who installed them in Phnom Penh in 1979. They have been running the country ever since. In the 1980s they tried to implement socialism but after the Berlin Wall came down Hun Sen became a democrat and negotiated an opening of the political system (Hughes, 2003). Though this involved the return of King Norodom Sihanouk from exile and necessitated that Hun Sen share power, his party, the Cambodian People’s Party (CPP) managed to reinvent itself as a democratic political machine. Primarily via its control of the bureaucracy and military, the CPP wins every election and those who oppose it too strenuously, such as Sam Rainsy, are exiled or arrested. Here despite the change in de jure institutions, the huge de facto power advantage of the CPP means that they can dominate democratic politics through superior organization, resources alongside threats and intimidation.

2.3. General Lessons. Just as reforming economic institutions without changing the political equilibrium may not improve the institutional equilibrium, so changing de jure power, while leaving the sources of de facto power intact, may have little impact on economic performance. In the US South, the same economic system based on the repression of cheap labor got reinstated after Reconstruction. Even though the enfranchisement of the freedmen meant that there had been
a change in de jure power, and after the Civil War blacks exercised this power and voted in large numbers, Southern elites were able to use their de facto power to re-assert control over labor and eventually by the 1890s disenfranchise the blacks. The persistence of de facto power stemmed from the fact that white elites had kept hold of the land after the Civil War, and because these elites had avoided being killed during the Civil war and still had a huge comparative advantage over blacks in the ability to engage in collective action. Control was exercised via coercion, lynching and the Ku Klux Klan and other extra-legal methods and eventually institutionalized via control of state legislatures.

In Cambodia, the transition away from socialism after 1989 and the opening of the political system and creation of de jure democracy after 1993 has not been sufficient to change the political equilibrium. The Cambodian People’s Party, led by former Khmer Rouge cadres like Hun Sen and Chea Sim, have been able to use their control of the bureaucracy and the army to win elections and have emasculated, co-opted and sometimes banned the opposition. Though there have been large changes in specific economic institutions, particularly with the move away from socialism to capitalism, and alternations in de jure political institutions, the society continues to be run to the benefit of a small elite who are free to enrich themselves at the expense of the wider society.

The general lesson seems to be that change in institutions which affects the distribution of de jure political power, needs to be complemented by changes in the sources of de facto political power of the elite and reductions in the benefits that political incumbents have in intensifying their use of de facto political power (for example, use of paramilitaries, bribery, corruption etc.).
3. Iron Law of Oligarchy

Another pitfall of institutional reform comes from the replacement of an existing dictator or elite by the first available alternative. Often-times, it is the institutional structure of a society that makes politicians and elites act in rapacious ways. If these institutional structures remain unchanged, new leaders are likely to behave in the same way as the old elites they replace. This pitfall is reminiscent of the classic idea in sociology of an Iron Law of Oligarchy going back to the work of Michels (1962), Mosca (1939) and Pareto (1968). This hypothesis states that it is never possible to have real change in society because when new groups mobilize or are created in the process of socio-economic change they simply replace pre-existing elites and groups and behave in qualitatively similar ways (see Acemoglu and Robinson, 2006d).

3.1. Case Study: The Bolivian revolution. Bolivia features centrally in accounts of comparative development in the Americas. It was at the heart of the Inca Empire with high density of indigenous peoples and during the colonial period economic institutions designed to extract rents – the encomienda, repartamiento, the Potosí mita (forced labor draft for the silver mines) - were all central. Although the mita was abolished at independence a highly inegalitarian and authoritarian society persisted. In 1950, for example, 6% of landowners owned 92% of all lands and the smallest 60% of landowners owned 0.2% and the tin mines which formed the basis of the export economy were owned by three families. A mere 31% of the adult population was literate and only 4% of labor force was employed in industry. Indians still subject to unpaid pongueaje (personal services) for the landowners whose lands they worked.

The remains of this system were swept away by the Bolivian revolution of 1952. Masterminded by the MNR (Movimiento Nacionalista
Revolucionario) this implemented land reform, expropriated large estates and redistributed them to the labor force and Indian communities. It also introduced universal suffrage by abolishing literacy requirement on voting and nationalized the mines of the tin barons.

These appear to be huge, radical institutional changes. Surely Bolivia was launched on a new path of institutional development? Unfortunately it was not. Following the Revolution the 1950s saw a failed attempt by MNR to create a one-party state and in the process they re-built the military which had been disarmed in 1952. They were also able to use clientelism to gain the support of the indigenous majority. Indeed, there are striking comparisons between the traditional clientelism which had existed before 1952 and that which emerged during the regime of the MNR afterwards (Heath, 1972). Kelley and Klein (1981) estimated that 10 years after the Revolution, inequality had returned to 1952 levels and in 1964 a military coup brought to and end the experiment with democracy until 1982.

3.2. General Lessons. One might conclude from our discussion of the US South that the real problem was the persistence of the elite and their resources. If only the North had implemented land reform and given the freed slaves their 50 acres and a mule, everything would have been different. The example of the Bolivian Revolution shows that the situation is more complex than this. In Bolivia the previous elite were expropriated and their power taken away, yet the new elite that emerged (the MNR) used strategies that were very similar to the old elite and which had the same impact on economic institutions. The general lesson here seems to be that it is wrong getting rid of “bad guys” will necessarily solve the problem.
4. Creating Oligarchies

In many societies, the quickest way to get growth started is to support groups that already have economic power. This can fuel economic growth in the short run, but turns these groups into strong oligarchies, with all of the costs oligarchies discussed above. Experience also shows such growth to be transitory.

4.1. Case Study: Houphouët-Boigny and the “economic miracle” of the Ivory Coast. One of the few economic success stories in the early independence period was the Côte d’Ivoire. While the cocoa sector of neighboring Ghana was being taxed practically into oblivion by successive governments, that of the Côte d’Ivoire expanded. Many of the economic policy and institutional problems of Ghana were avoided because political power was in the hands of a southern agrarian elite (Widner, 1993, 1994). This oligarchy had a direct interest in protecting their own property rights and developing the cocoa and coffee export sector. This elite also used theory political power to take over the rest of the society including not just the public sector but the entire private sector (e.g., Fauré and Médard eds. 1982). Yet the death of Houphouët-Boigny in 1993 precipitated a collapse in the oligarchy. He was succeeded by Henri Konan Bédié who began to emphasize authentic Ivorian nationality as a way as disenfranchising northerners and some of his opponents. The economy, already in decline under Boigny, deteriorated further and in 1999 Bédié was removed from power by a military coup, the first sign of increasing political instability. Since the contested election of Laurent Gbagbo in October 2000 the country has been more or less in civil war.

4.2. Case Study: Suharto and the Indonesian oligarchy. That some political equilibria which promote growth are transitory
should already be evident from our discussion. Though Bates (1981) demonstrated why economic policies had been better in Kenya than Ghana in the 1960s and 1970s, this advantage did not survive the coming to power of Daniel Arap Moi in Kenya (Bates, 1989). The change in the ethnic basis of the regime, from Kikuyu to Kalenjin, undermined the coalition which had supported good agricultural policies, since the export farmers were not only large, but also predominantly Kikuyu. As a result economic performance declined precipitously in the 1980s and 1990s. The constraints that had checked the power of the regime and that sustained good economic institutions in the 1970s was not sustained.

Another important example of successful oligarchic growth with underlying bad institutions in Indonesia after the rise to power of Suharto and his New Order regime in March 1966. The economic performance of Indonesia since independence in 1950 had been highly unstable (see Bevan, Collier and Gunning, 1999) particularly under Sukarno’s ‘Guided Democracy’ after 1957. In 1965 this regime collapsed in the context of economic crisis and an attempt by the Communist Party to mount a coup. The communists were ruthlessly suppressed by the army under Suharto and a new regime formed.

Central to this regime, called the New Order, was the promotion of rapid economic development, particularly in the rural sector where there was heavy investment in fertilizers, extension and credit programs, and infrastructure such as irrigation. The regime also invested heavily in education and launched ambitious school building programs which resulted after 1983 in universal primary education for boys and girls. Relatively oil rich, Indonesia managed to allocate the windfalls of the 1970s to investment and escaped the familiar patterns of the Dutch disease. Macroeconomic policy was also very sound and when things
began to go wrong and budget constraints soften, Suharto intervened to correct this. This was clear in the 1970s when he curtailed the activities of the government oil company Pertamina in 1975 (Bevan et al., 1999, pp. 251-253). The regime intervened again after oil prices fell in 1982 in order to force fiscal balance and during the 1980s undertook extensive reforms to reign in excessive corruption. The most famous instance of this is Suharto’s issue of a presidential decree to sell off the customs to Swiss business interests in 1985 after it became apparent how endemic corruption was (MacIntyre, 2001c, p. 12). This and many other similar interventions had the effect of “curtailing corruption that had become sufficiently costly or disruptive to pose a serious threat to continued investor confidence” (MacIntyre, 2001c, p. 13). The economic success of Indonesia after 1966 even elevated it into the class of an Asian ‘miracle economy’ (World Bank, 1993).

There seems little doubt that the New Order regime was authoritarian and Suharto had wide discretionary powers in all dimensions of policy. If his power was constrained it is not clear by what. Though there were elections, the president’s Golkar party was always assured of a solid majority and political opposition was closely controlled and restricted. The puzzle is why people invested in such an environment. At least two factors seem to have been important.

The first, on which all scholars concur, is that the social policies of the New Order were a direct response to the social disorders of 1965 and 1966 and the threat of rural communism. This was the driving factor behind the agrarian and educational policies which had such a huge positive impact not just on growth but on poverty alleviation and income distribution. McIntyre (2001b, p. 258) expresses the consensus view when he notes
“Suharto was determined to avoid a resurgence of rural radicalism and political instability of the sort that had gripped the country in the mid 1960s. In short, the success of these initiatives was a function of his keen political survival instincts.”

More generally, Suharto recognized that economic growth was necessary to keep the regime in power and that to achieve this good economic policies had to be in place. This constraint induced him to delegate macroeconomic policy to technocrats and to respond to the oil booms wisely. It also led him to intervene to attempt to control corruption and excesses that would put in jeopardy the underpinnings of the regime (McIntyre argues, 2001b, p. 259).

Yet this constraint, real thought it was, at least in the 1960s and 1970s, is only part of the story about Indonesian growth. It is also clear that Suharto managed to create a system which, while it did not introduce good institutions, was able to induce investments and growth from which the regime could benefit. One of the secrets behind this appears to have been the role of Sino-Indonesian businessmen, the so called cukong entrepreneurs. Many firms and businesses were controlled by Indonesians of Chinese origin who were very marginal politically. Suharto granted such businessmen monopoly rights and placed members of the military and his supporters on their boards of directors (Elson, 2001, pp. 194-201, 280-281, Rock, 2003, p. 14). Rock (2003, p. 10) argues “There is little doubt that the ... distortions in New Order microeconomic policies thwarted competition, rewarded cronies, and encouraged substantial investment in uneconomic projects.” Yet they also generated wealth, economic growth and rents for the regime. It was precisely the political marginality of the cukong entrepreneurs that made them an attractive business partner for the regime.
“The Indonesian government was indisputably the senior partner with an uncontested ability to both grant ... privileges (rents or rights) to cukong entrepreneurs and to protect the economic rights so granted. Because [they] were a scorned ethnic minority totally lacking in political power, they had few opportunities to either challenge the government’s economic priorities or to turn this exchange ... into simple growth retarding rent-seeking behavior. They also had to suspect that their continued access to privileges depended on them investing wisely to grow the economy” (Rock, 2003, pp. 36-37).

Thus Suharto entered into relationships with Chinese businessmen because their prosperity could not be a threat to his regime and also because their lack of political power meant he could discipline them if they failed to invest. Chinese businessmen did invest because, even though they must have been concerned about state predation, they were granted huge rents and they also understood that the regime needed them to generate wealth.

4.3. General Lessons. It may be important to recognize the trade-off between short-run and long-run economic success. Protecting businesses, so that they have the right incentives to undertake investments, may come together with giving them too much political power, which they will then used to solidify their position and turn into oligarchies.

In the Côte d’Ivoire, the early political power of the cocoa and coffee farmers led to a set of economic institutions which were consistent with the development of the country. Boigny even invested in the north of the country to promote political instability. But the elite which prospered also spread its economic control into all other areas of life with increasingly adverse effects on resource allocation. Indeed the fact that the elite were heavily invested in export agriculture may have
impeded the diversification of the economy. After 25 years of growth, the economy went into sustained decline.

The experience of Indonesia shows that oligarchic growth is possible when elites can credibly make a contingent commitment to make institutions better, and also when they manage to forge mechanisms for indirectly benefiting from encouraging the investment opportunities of others. The acceleration of growth after 1966, and particularly the pro-poor aspect of growth, was clearly driven by the threat of communism and rural social disorder. The spillover from the conflicts of 1965 and 1966, was a redistribution of power towards the rural sector, in the same way that the collapse of the cultural revolution in China redistributed power away from the Communist Party. In both cases sustained growth was necessary for the political survival of the regime. Yet the redistribution of power that occurred in Indonesia was not institutionalized and turned out not to be completely permanent. Moreover, it did not force the New Order regime to improve institutions outside of the rural and educational sectors though the connection between promoting economic development and social order may well have helped the government to sustain its relationship with the cukong entrepreneurs. When the constraints which had induced the economic policies of the new order regime relaxed in the 1990s it appears to have been more and more difficult to avoid a massive and debilitating upsurge in corruption and rent seeking. Moreover, the type of collusive agreement that the state managed to forge with the Sino-Indonesian entrepreneurs appears to have been very fragile. It rested on shared expectations about the future longevity of the relationship which clearly deteriorated with Suharto’s failing health (Fisman, 1991) and it could not survive the 1997 crisis (MacIntyre, 2001a, Stern, 2003). It is interesting to contrast the implications of Suharto’s health with that of
Vice President Dick Cheney. Fisman et al. (2006) conducted a similar study on the impact of Cheney’s heart attack on the share prices of firms linked with him. They found that it had no effect on the share prices of these firms which they interpret as a testimony to the strength of US institutions.

5. Ending Oligarchy

Oligarchy societies create gains for a small fraction of the society, while large segments of the population do not benefit from potential economic growth or the range of policies. This creates a platform for a backlash against the oligarchic society. The pitfall here is that years of repression and oligarchic rule may lead the population to opt for populist leaders or lead to political instability. In some sense we have seen part of this outcome already. The policies of Chávez are a reflection of decades of elite rule in Venezuela and we saw that the collapse of the cocoa elite in the Côte d’Ivoire has led to civil war and instability. We now point out that one problem with oligarchy is that it can create very adverse initial conditions for a new regime. In Latin America the long years of isolation and regulation allowed for the creation of very powerful industrial conglomerates or cartels. Though institutions may now have changed, these oligarchs remain a powerful impediment to a more dynamic economy.

5.1. Case Study: Democratization in Mexico. An interesting example of this is Mexico. As Haber et al. (2007) point out, during the formation of the coalition which underpinned the rule of the PRI, an implicit commitment was given not to tax capitalists. This was partially as a compensation for the fact that the PRI were committed to some pro-labor policies. A consequence of this and the highly regulated economy was the emergence of a class of super-rich monopolists. The
most famous of these, Carlos Slim, is currently the third wealthiest person in the world after Bill Gates and Warren Buffet. These people got incredibly rich on the basis of monopoly rents. Many of the regulations were simultaneously beneficial for both labor and capital. The most famous is that all imports of new textile machinery were banned from the 1920s to the 1970s. Workers were opposed to these machines because they would undermine their high wages, while incumbent firms did not want them either because they thought importing new technology would facilitate entry into the industry. When the transition to democracy took place in Mexico in the 1990s and policy reforms were implemented, these people were in an superb position to take advantage of reforms, for example by buying up privatized industries so as to sustain their monopoly positions.

5.2. General Lessons. Support for oligarchies is likely to reduce the chances that the regime that will succeed the oligarchy will be successful. This may be because oligarchies induce political instability or populism or it may be because the inherited structures of privilege from an oligarchy make it very difficult for a new regime to alter economic institutions.
A Few Success Stories

While we still do not know how the World Bank or the IMF or the United States can easily spearhead institutional reform to facilitate economic growth, there are a number of success stories that give clues about what types of institutional structures are likely to lead to rapid economic growth without running into political hurdles. It is also important to emphasize the success stories to dismiss the misperception that history is destiny. While institutions persist and have historical elements, institutions are different from culture and geographic factors in that they can be changed; they are under human control. The success stories show how in many unlikely places successful institutions can emerge and then lead to rapid economic growth. We briefly discuss a number of success stories as a conclusion to this essay showing how it was that a political equilibrium emerged in diverse places which created economic growth.

1. Botswana

Although Botswana is in many ways unique, it exemplifies how democratic political institutions, secure property rights and orthodox macroeconomic policies are possible even in the poorest societies and that they are likely to lead to economic growth if implemented appropriately.

Botswana a small, tropical, landlocked country in sub-Saharan Africa has had the fastest average rate of economic growth in the world in the
last 35 years. So what explains Botswana’s success? One can list several factors,

1. Botswana is very rich in diamonds.
2. It appears to have had a relatively unique set of indigenous sociopolitical institutions.
3. Colonization had a very limited impact on these indigenous institutions.
4. The post-independence political elite inherited the legitimacy of these institutions.
5. It was also rural-based and heavily invested in the main non-mining productive sector (cattle ranching).

The argument of Acemoglu, Johnson and Robinson (2003) is that it is not any of these key factors by itself, but a combination of them—i.e., the interaction between them—that has been important in Botswana. They argued that Botswana was able to adopt good policies and institutions because they were in the interests of the political elites, which included the cattle owners and powerful tribal actors. But it wasn’t simply that cattle owners were politically powerful. Instead, they inherited a set of institutional prerequisites that ensured that they would keep their political power by pursuing good policies and placed restrictions on infighting among themselves over political rents. In addition Botswana did not become an oligarchy because the traditional elites did not capture the state.

Crucial in this was the fact that, contrary to many other nations in Africa, South America or the Caribbean, Botswana avoided the adverse effects of colonial rule. This is particularly important in the Botswana case because, as noted above, its pre-colonial sociopolitical institutions were relatively good. These institutions lowered the stakes from politics and the vested interests in bad policies, and increased
the legitimacy and breadth of the coalition that sustained the post-
independence political elite. These institutional features also helped
to make good economics also good politics in Botswana, while restricting the range of distortionary economic policies that the leaders could pursue.

These structural factors created a political equilibrium in which the diamond wealth that came on stream in the 1970s could be efficiently exploited. The diamond reserves, in turn, created enough rents that the critical actors were relatively satisfied with the status quo, and did not want to fight to increase their share at the expense of destabilizing the whole system. Acemoglu, Johnson and Robinson (2003) conjectured that, although it was not simply the diamonds that made Botswana grow, the diamonds played a very important role, not only by providing a resource base that could be exploited effectively with the correct set of institutions, but also by creating sufficient rents in the system, so as to increase the opportunity cost of further-rent seeking by the key actors.

Although this explanation is in terms of structural features, it also appears that Botswana benefited from outstanding political leadership that made several critical decisions that clearly influenced the development path. These leaders operated in a relatively helpful environment, but they probably also made a big difference. Seretse Khama’s handling of the independence negotiations and constitutional convention, minerals policy, and generally political issues ensured that political stakes remained low, contributing to political stability and an environment with secure property rights. For example, it appears plausible that had Seretse Khama not transferred the property rights over subsoil diamonds away from his own tribe, the Bangwato, to the government, there could have been much greater conflict among tribes over
the control of the wealth from diamonds. Or had he not reduced the real political powers of tribal chiefs shortly after independence, tribal cleavages may have been more important.

One can therefore see Botswana’s exceptionality as a hopeful example of what can be done, even with relatively unfavorable initial conditions—though perhaps the juxtaposition of a number of favorable characteristics was also necessary in enabling relatively good leadership. Despite many apparent disadvantages, a good political equilibrium emerged in Botswana and from this many good things flowed - political stability, astonishingly prudent macroeconomic policy, hard budget constraints everywhere in the public sector, a socially rational minerals policy. Botswana has also been able to respond to droughts and threats of famine with very effective famine relief policies so that actual famines have never arisen. Finally, in the 1970s when the political hegemony of Khama’s Botswana Democratic Party first began to be challenged it responded to the rise in political competition by expanding education, not by engaging in clientelism.

Botswana then is a nice example of a state which has been constrained, for example by traditional political institutions, but also not captured.

2. Mauritius

Mauritius is another example of a relatively democratic political system defeating the burden of history and turning a society that then appeared destined to political strife and economic stagnation into one of the fastest-growing countries in the world.

In the 1960s as Mauritius moved towards independence it was a poor country dominated by sugarcane production and export. It was highly diverse ethnically with a majority Indian population, the descendents
of people who had come as indentured laborers in the 19th century, but also with significant minorities of people of African, European and Chinese descent. In the 1960s James Meade famously predicted Malthusian collapse. Yet since independence Mauritius has become one of the most dynamic and successful LDCs. It has successfully industrialized and maintained competitive democratic politics.

Mauritius was taken from the French during the Napoleonic wars (Bowman, 1991, for the best overview of Mauritian politics and history). In the 19th century it developed important sugarcane economies and after the abolition of slavery in the British Empire in 1834, imported large numbers of indentured laborers from India. After the Second World War, early elections for democratic legislative assemblies were dominated by a pro-independence political party led by See-woosagur Ramgoolam. Ramgoolam’s Mauritian Labour Party used extensive socialist rhetoric and proposed land reforms and relatively radical policies. As independence arrived political forces re-formed into a situation where parties led by Indo-Mauritians faced parties which represented a coalition of the non-Indian population, led by Gaetan Duval.

The Mauritian Labour Party won power initially and quickly abandoned its radical policies and by the early 1970s investment in the export processing zone had begun. The political hegemony of the Labour Party was quickly contested by the emergence of a strong socialist party, the MMM (Mouvement Militant Mauricien) led by Paul Berenger and Dev Virahsawmy, and in response the Labour Party entered into a coalition with Duval and his PMSD (Parti Mauricien Social Democrat) and the previous opposition groups. The Labour Party quickly drew back from repression of the new political forces, allowed
the MMM to contest the 1976 election, and instead adopted social policies, such as the provision of universal secondary education, to improve its popularity. The Labour Party also dropped populist macroeconomic policies and in the late 1970s implemented a serious stabilization program under the IMF. The final test of Mauritian institutions was the election of an MMM government for the first time in 1982. Once in power the MMM also abandoned its more radical policies and once the broad political consensus to good institutions became clear, the export processing zone boomed.

In Mauritius the British colonial state faced a powerful and homogeneous French planter class which did not leave the island after Mauritius was annexed to Britain in 1812. In the 1870s when Britain was reducing the autonomy of many colonial administrations, they were forced to create a legislative assembly in Mauritius. Though this was initially dominated by the planters, by the turn of the 20th century the first Indo-Mauritians were elected, a clear sign that the greater political autonomy of the island was allowing for a more open society with greater upward mobility of the former indentured laborers. In consequence, the power of the colonial state was checked, as was evident by the fact that during the 1960s Mauritian independence leaders were able to negotiate post-independence institutions closer to those that they wanted. This juxtaposition of different local interests and the weakening of the legacy of the colonial state gave rise to a relatively balanced distribution of political power in Mauritius. From this situation more fluid interests also emerged. Though ethnic identities were certainly important in politics, so were different cleavages, as is clear from the development of the MMM into a powerful political force and the coalition of Ramgoolam and Duval in the 1970s. In consequence politics became significantly less polarized than it might have been.
In Mauritius property rights have also been secure and the country has experienced open democratic politics. There has been intensive investment in education and free access into profitable investment opportunities. This is illustrated most clearly in the case of the export processing zone. The colonial history of Mauritius allowed the development of a stronger domestic political society. This was able to resist the colonial state more effectively and it ultimately generated a both a more egalitarian distribution of political power where the power of elites was checked, and a less polarized structure of political conflict.

Nevertheless, the development of good institutions in Mauritius was not just the outcome of historical circumstances. Individual decisions were also important in both these cases. Critical decisions were made in Mauritius by Seewoosagur Ramgoolam, the Prime Minster and head of the Labour Party in the 1970s and by Paul Berenger and the leaders of the MMM when they initially came to power in 1982. Both parties abandoned policies to implement land reforms which might have seriously undermined property rights, and the Labour Party pulled back from unconstitutional measures to control political opposition in the 1970s. Moreover, the modern choice of institutions, particularly the electoral system in the 1960s was clearly important in determining how political conflicts were resolved, with important implications for subsequent economic development.

Again we see in Mauritius the development of a political equilibrium with a strong constrained state which was not captured by the elite and was able to act decisively to promote good economic institutions.
Since the mid 1980s Chile has experienced the most rapid rate of sustained economic growth in the history of Latin America. Even Argentina in the Belle Epoch before 1920 and Mexico during the Porfiriato grew slower. Though Brazil grew very rapidly in the mid 1960s it did not manage to sustain this rate of growth for very long. How can we understand what appears to be a transition to sustained growth in Chile using our framework?

There are definitely aspects of 19th century history in Chile which are different from other Latin American nations. For example, the central state managed to exert its authority over the nation far earlier than elsewhere in the subcontinent and it developed a capacity which was unusually high. This was demonstrated in the stunning defeat of Peru and Bolivia during the War of the Pacific in 1890 (Soifer, 2006). Nevertheless, in the 1950s Chile did not very different from a normal Latin American country. During that decade it experienced some quite extreme populism under the Presidency of Carlos Ibañez, a former military dictator turned democrat (a typically Latin American phenomena). The political spectrum was very similar to other Latin American countries with traditional Liberal and Conservative parties along with more personalized populist parties. Also, despite many claims for the rich democratic political tradition of Chile, the Communist party was banned from standing in elections, illiterates could not vote, and as Baland and Robinson (2006) showed, rural elections were endemically corrupt until the introduction of the secret ballot in 1958. Moreover, Chilean agriculture was found to be the least efficient in Latin America (Steverhagen, 1965). The political reforms of 1958 led to a movement to the left in politics as peasants, whose votes had previously been supplied by their landlords to right wing parties, began to vote for the
Christian Democrats and subsequently the socialists led by Salvador Allende. Land reform and radical policies quickly came onto the policy agenda and this culminated in Allende’s election in 1970. Allende tried to move the society towards socialism via land reform and nationalization and also had a highly populist macroeconomic policy. All of this was ended by the Pinochet coup of 1974.

Pinochet did not come to power with an economic agenda other than to reverse land reform and nationalization. He did have a political agenda of destroying the Allende regime and its supporters so as to return the country to the political status quo. As he tried to consolidate his power he searched for an economic policy which would be complementary to his political agenda. He found it in the Chicago economics department. The policy of trade liberalization and deregulation was a perfect one because by destroying the import substitution sector, he undermined the economic basis of one of his main opponents, the trade union movement. Since the copper mines had been nationalized by Allende, the unions there could be relatively easily controlled. Pinochet did not privatize the mines. Indeed, he did not give back all of the land which had been redistributed. A portion was given back, but much was sold and much, which had been already distributed, was too difficult to give back to the former owners (Jarvis, 1980). A consequence of this is that the traditional landed elite in Chile, which had been destroyed by Allende’s reforms, did not reconstitute itself after 1974. Instead, much of the land which had been given to peasants or farm workers was re-sold and a new breed of agrarian capitalists moved into the countryside (Martínez and Díaz, 1996). Though economic performance was poor during the first decade of the dictatorship (growth was basically zero) due to banking and exchange rate crises, by the mid
1980s this new dynamic rural sector had begun to export and has been the driving force in Chile ever since.

Why did Chile not grow rapidly before 1985? Chile seems to be a classic case of a coalition of rural and urban oligarchs creating distortions in order to get rents. The picture is very similar to other Latin American countries and this was the economic model that emerged after the early stage of integration into world markets in the 19th century. What happened after 1974? The explanation for the transition to sustained growth in Chile, we believe, is the unique combination of socialist and military repression! The swing first to the left and then to the right had the effect of first destroying the traditional rural elites, and then destroying those who opposed opening the economy. This allowed a vibrant capitalist agriculture to develop which has been the basis of the Chilean boom. This would not have been possible without Allende, since even if Pinochet had deregulated the trade regime, he would have been unable to create capitalism in the countryside. But it might also not have been possible without some of the deregulation implemented (“at the point of a bayonet” as Andre Gunder Frank observed) by the dictatorship. There is a quite remarkable similarity here between the structural transformation of the rural sector in England after Henry VIII’s expropriation of Church lands described by Tawney (1941). In essence, the economic success of Chile has been a consequence of some rather unique events which fundamentally altered the political equilibrium in a way which reduced distortions to more efficient resource allocation. This persisted because the alteration in the structures of political power was permanent.
4. South Africa

Another interesting and ongoing example in South Africa. After a century of pernicious oligarchic rule in South Africa, democracy was created in 1994 with the election of the government of the ANC. Despite huge pressures for radicalism, the government has adopted very prudent economic policies which have created the conditions for sustained economic growth, even if the results so far have been disappointing. So far the end of an oligarchic system has not implied the emergence of a populist regime. Yet the government has to walk a tightrope. On the one side many Africans call for more radical measures which could undermine property rights completely. On the other side white elites attempt to co-opt members of the ANC by giving them shares and putting them on their board of directors. The ANC has to avoid being captured by the previous elite while at the same time taking important measures to unwind inherited inequities so as to defuse populism. No doubt this will take considerable political skill.
CHAPTER 5

Conclusions

There are several key conclusions that we believe can be drawn from this analysis.

- The main determinant of cross-country differences in income per-capita are differences in economic institutions.
- Though institutions often persist for long periods of time and have unintended consequences, differences in institutions across countries primarily reflect the outcome of different collective choices.
- Different collective choices reflect differences in political institutions and consequently different distributions of political power.
- As a result understanding underdevelopment implies understanding why different countries get stuck in political equilibria which result in bad economic institutions.
- Solving the problem of development means pushing poor countries into better political equilibria where those with an interest in good economic institutions can make their preferences felt and where the power of those who would undermine such institutions can be checked.
- At the current time we do not understand how to use conventional policy instruments to reliably achieve beneficial changes in the political equilibrium of a country and there is the potential for many pitfalls in conventional types of policy advice.
• Yet, in spite of these problems, there is no alternative but to try to understand the politics of development and institutions. For 50 years economists and policymakers have been trying to solve the problem of development on the basis that poor countries did not understand what to do, or that all that was required was to understand which lever needed to be pulled to solve the critical market failure. This approach has been based on a flawed understanding of underdevelopment and the policy advice that it has generated has failed to achieve its goals.
CHAPTER 6

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