LECTURE 10

THE HISTORICAL, GEOGRAPHICAL AND POLITICAL ECONOMY OF DEVELOPMENT

A. The Role of Government in Development

B. Normative vs. Positive Approaches to the Analysis of Government Failure

C. Geography, History, Ethnic Fragmentation, and Growth: Theory and Evidence

D. Democracy, Institutions, Corruption and Growth: Theory and Evidence

E. Lessons learnt?

For literature referred to, see last slide:

[10.2] Minimum (or Maximum) Role of Government in Development

Even the most hard-noosed free marketers would agree to:

- Provide the **collective goods** that private markets fail to do
- Correct for **externalities** in private markets
- Provide the **legal framework** and the institutions that are needed for markets to function
- Provide **defence, human rights, and law and order**

Most would also endorse:

- Achieve **macroeconomic** long-term balance and **stability**

  (few voices today arguing that governments should stay out of the current financial crisis)

- **Redistribute incomes** according to social welfare norms

Most economists could probably agree that at least the first four "policies" are **necessary**, although perhaps not **sufficient**, for accomplishing reasonably high **economic growth**. Still most **governments do not** pursue such policies. The main question in the literature to be covered in this final lecture, is **WHY**?

[10.3] NORMATIVE VS POSITIVE ANALYSIS OF GOVERNMENT FAILURE

1. **Normative Theory** deals with the question **what governments should and should not do** and **how** they should pursue policy. Governments are claimed to be:

A) **Constrained**: geographical, historical, demographic initial situation.

B) **Incompetent**:

i) governments often fail both by **commission** and **omission;**

ii) governments typically use the **wrong methods** when intervening;

iii) corrections, when they are implemented, come much **too late.**

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2. Positive Theory. In this strand of theory, the basic presumption is that **governments** are not generally uneducated or constrained and therefore **do the "wrong" things**. They simply have different objective functions which they optimise: ***Staying in power, enriching themselves and their supporters, become famous (build monuments or new capital cities).***

To find out whether the "normative" "or positive" explanations for bad government policies carry the most weight is of course fundamental for forming a policy approach in the international "development" community (UN, World Bank, IMF, etc).

[10.4] Exogenous Geographical, Historical and Institutional Factors as Constraints on Growth and Development:

A. Geographical location:

1-5) Altitude, near the equator, land-looked, tropical climate, disease vectors. **[10.5]**

B. Historical

1) Late Status as National States and Colonial Heritage **[10.6]**

2) Ethnic, Religious and Cultural Fragmentation **[10.7]**

C. "Inherited" political system

1) Degree of Democracy **[10.8-12]**

2) Corruption and Property Rights Enforcement **[10.13-14]**

3) Exogenous? Institutions [**10.15-17**]

4) Endogenous? Institutions **[10.18-24]**

Many of these characteristics have been shown to be significant and robust explanations for low growth in regressions-(cf Sala-i-Martin 1997). But as we shall see, there are unresolved problems with multi-colinearity and simultaneity!

[10.5] Geography (definitely exogenous) and Growth

Countries geographical location in the "tropics" has been hypothesised to affect growth adversely in two main ways:

1) Long distance to main markets with consequent lower interaction (technology spread) and higher **transport costs** for trade.

2) **Tropical climate** has adverse effects on people's health with detrimental effect on labour productivity and **human capital formation**.

The main proponents of this line of analysis are Sachs and Werner (1997) and Bloom & Sachs (1998). Collier (2000) takes a critical view of the relative importance of "geographical" explanations for slow growth.

Climate and disease are also the core explanations to differences in **growth across countries** according to a recent celebrated article by Acemoglu et al (2001), which we shall return to in some detail later on.

(Table with results of econometric test to be shown in class; from Sala-i-Martin 1997 and Sachs and Werner (1997) in reading assignment)

[10.6] National States and "Good" Institutions

Recently, economists, economic historians and political scientists (e.g. North (1990), Olsen (1996), and Acemoglu et al. 2001) have increasingly emphasised **the role of institutions as the basic fundament for growth** and development (via investments in physical and human capital):

*** Law and order**

*** Property right enforcement**

*** Democracy, etc.**

Most recent growth regressions include proxy variables that intend to capture these characteristics (**Sachs and Werner (1997),** Sala-i-Martin 1997, Barro 1996, 1999, Rodrik 1999). Usually, found to be significant and robust, but again, as we shall see, causality is difficult to establish.

The question ***why*** some countries have "bad" and other countries have "good" institutions has not until recently been seriously addressed (Acemoglu et al. 2001, Glaesner et al, 2004). We will come back to this question a little later. It is notable, though, that "good" institutions have taken considerable time to build up—several decades in the now rich countries. Most poor countries have **no pre-colonial history as national states**. More than 100 such countries today! Most of these countries are at the same time very fractionalised (ethnically, religions, etc.).

[10.7] Ethnic Fractionalisation and Growth: Direct vs Indirect Effects

	Theory	Mechanisms	Evidence?
Direct a)	Political instability	Assassinations, civil war	Significant when many controls are used
Indirect b)	Consensus decisions difficult to reach Un-coordinated[a] corruption and bribe taking, rent seeking (many political economy models)	Trade regulations as rent-generating activities * overvalued exchange rates * taxes and tariffs * quantitative import /export regulations Under-investment in infrastructure and schooling & health systems	 Yes ? ? Yes Yes ?

Measure: ETHNIC: Index that increases when (1) the number of groups increases and (2) the more equal in size the different groups are.

Main results:

a) Large direct negative effect on growth (Alesina and Ferrara 2005; Montalvo and Reynal-Quenol 2005).

b) Negative indirect effects on growth through many of the growth-enhancing variables (investments, etc). Going from complete homogeneity to complete heterogeneity means a fall in growth of 2.3 percentage points (mainly SSA, but not only)

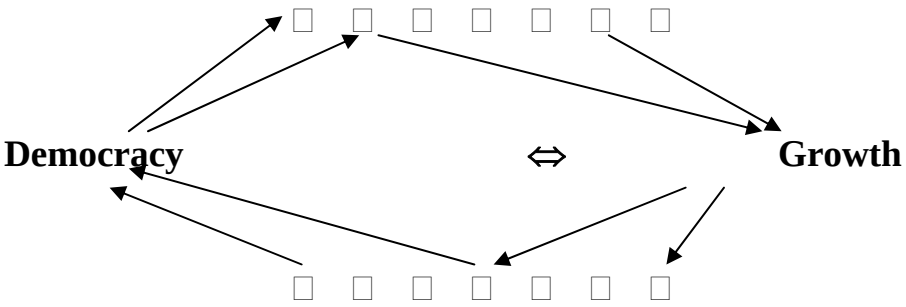
(Table from Easterly & Levine to be shown in class).

[10.8] Democracy and Growth

Up to rather recently, it was almost taken as an axiom that a democratic political system is a necessary pre-requirement for economic growth and poverty alleviation. Much of the reasoning has been muddled by blurring a **normative preference** for democracy that most people at least in the Western, rich countries, subscribe to, and the economic effects. But as we shall see, there is no clear evidence that democracy is favourable for growth in poor countries.

Figure 10.1. **Growth and Democracy: the two-way inter-relationship**

Examples: rule of law, less corruption, checks and balances in decision making, property rights ensured and enforced



Economic growth affects the progress towards democracy. Example: Schooling and increased demand for democracy and property rights when more people acquire wealth.

[10.9] Expected relationship between political, economic "freedom" and growth according to Barro (2000)

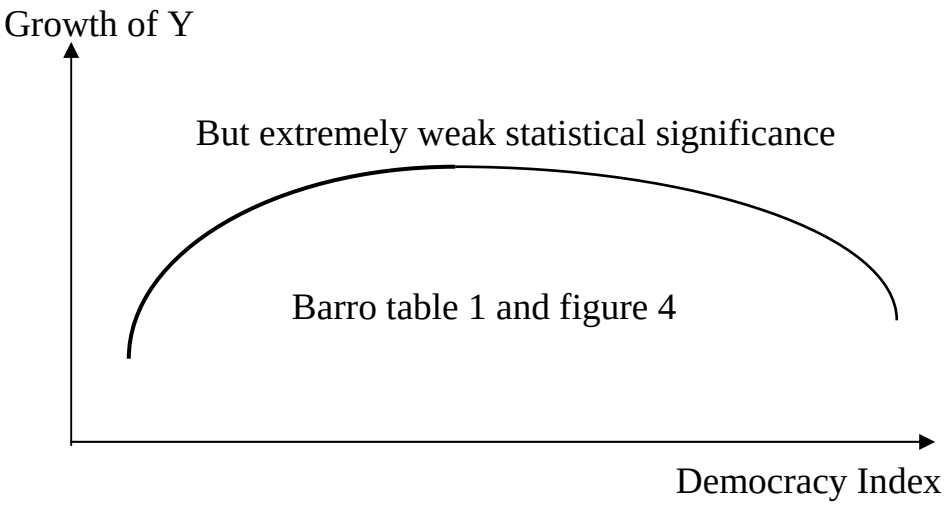
		Economic freedom	
		Low	High
Level of Democracy, or Political freedom	Low	Often predatory governments, endemic corruption, no property rights, low investments in infrastructure & private enterprises. Trade low **Examples**: most countries in SSA, Haiti, Central America before 1990. **Growth very low**	**Examples**: China since the late 1980s fits this description; Chile 1973-90 Vietnam post 1990 Liberal trade **Growth high**
	Middle	Private investment low, capital flight, inadequate property rights, discrimination of trade **Examples**: most of LA up to late 1980s, India until recently **Moderate growth**	High savings and investments in capital, human capital, infrastructure etc. Low taxation and government consumption and income transfers, liberal trade regime **Examples**: Korea, Taiwan, Hong Kong and Singapore 1960-1990. Japan 1870 - 1950 **Very high growth**
	High	Not very common	High government consumption and income transfers (majority voting). High taxes **Examples**: most OECD countries **Moderate growth**

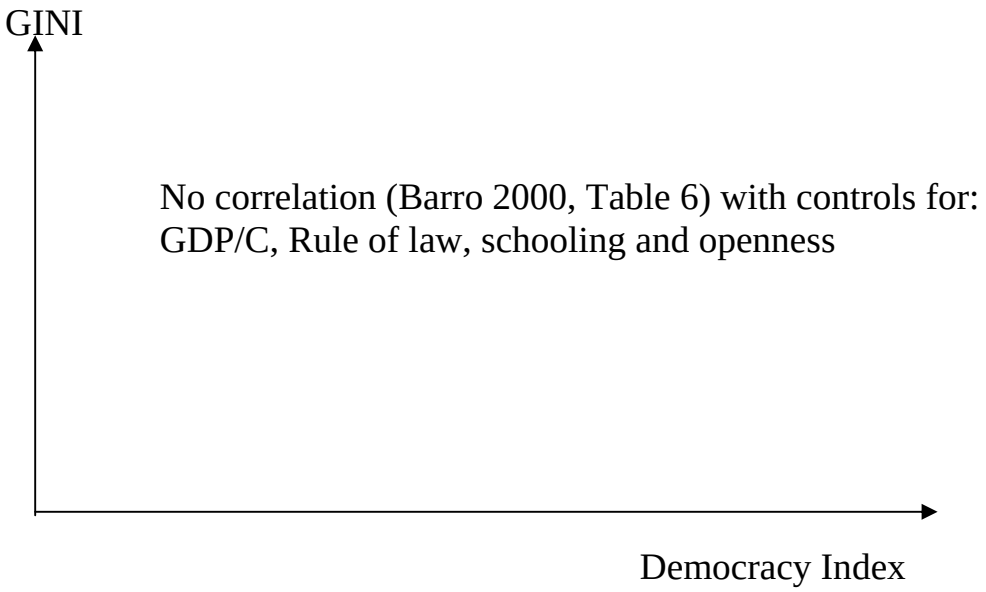
[10.10] Weak support for the hypothesis that democracy fosters growth

The reduced form relationship: no clear empirical correlation!

(Figure from Barro 1996, Figure 4, to be shown in class)

Figure 10.2. Growth and Income Distribution as Functions of Democracy





[10.11] The other way around: Estimated Determinants of Democracy (Barro 1996, Table 2)

Main finding: that with **higher incomes** (growth), countries tend to become **more democratic**.

Other variables of significance:
(1) **Female primary schooling**, but here the problem with reverse causality is obvious; that in democracies, female education is encouraged.

2) **Infant mortality rate**, but here again, the problem with reverse causality is obvious; that in democracies, basic health care is probably prioritised, and more public resources are devoted to this end.

3) Being an OPEC member (that is, to be a major oil producer and exporter) is "bad" for democracy. This result is in line with many other findings which suggest that in poor countries with **abundant "natural resources**", the power elites tend to fight for the spoils, rather than using the resources for general development. (Also see Sachs and Werner 1997.)

(Table 2 from Barro to be shown in class)

[10.13] Corruption and Growth (Bardhan 1997, Mauro 1995)

In recent years, economists have studied the (mainly adverse) effects of corruption on growth and, hence, poverty alleviation. The following negative effects have been identified:

1) Leads to **unproductive** activities (so called rent seeking)
2) Corruption that impairs property rights **discourage investment**
3) Increases uncertainty and risk, which also **discourage investment**
3) Leads to **misallocation** of investment and reduced efficiency
4) **Adds costs** to investment ($150 Billion estimate for SSA)
5) Loss of **tax revenue** for **public investment**
6) Public expenditure (investment) **diverted** into private consumption

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Decentralised corruption in countries with weak governments worse than centralised (which take external and long-term consequences into account?)

Difficult to draw an **unambiguous line** between corruption and illegal activities (bank robbery) and also “immoral” activities (“favours”).

Effects of growth on corruption: Several studies find that with higher incomes less corruption follows (see [10.14]).

Vicious circle: High corruption leads to no growth and increases the incentives for further corruption.

[10.14] Estimates of level of corruption

The index constructed by Transparency International (TI) is the most frequently cited. TI was established by some disillusioned former World Bank officials. It is a perception index, based on "polls of polls" (at least 3 for each country). The scale is from **0** (completely corrupt) to **10** (practically no corruption). Two-thirds of the 91 countries included (in 2005) have a score less than 5, which means widespread and deep corruption.

Very strong **correlation** with GDP per capita.

Table 10.1: Corruption in Selected Countries in 2005

Index range	Selected countries
8-10	Northern Europe, topped by Finland and Denmark (Sweden 6th), and Singapore. No developing country
6-8	Other Europe, USA, Japan and Hong Kong. One developing country: Botswana
4-6	A few East European, Taiwan, S. Korea, and a few in Latin America. Only Namibia, Mauritius and S. Africa in SSA
2-4	Most East European, Latin American, some African, Russia and former Soviet Republics
0-2	Bolivia, Cameroon, Kenya, Indonesia, Uganda, and at the bottom, Nigeria and Bangladesh

Problem: **perception index**, based on interviews with "experts" who may have perceived impression that "corruption" in countries is what last years index of corruption said.

[10.15] Exogenous? Institutions and Growth. New Evidence of what explains "bad" institutions (Acemoglu et al., 2001)

Some basic stylised facts:

1) Most of all the independent countries of the world today (ca 200) have **no history as national states** (before colonisation). This apply to almost all countries in Sub-Saharan Africa (ca 50), Latin America (ca 30), the Middle East (ca 20), North Africa (ca 7) and Central Asia (ca 15).

They were with few exceptions colonised up to rather recently, i.e. till the end of the second WW or the 1960s (Sub-Saharan Africa).

2) The GNI per capita around 1900 was the highest in the European countries and still is today, **only a few of the former colonies** have caught up, and some surpassed (US, Canada, Australia, NZ).

The majority of the former colonies have, however, slid further behind and many are still doing so (see lectures 1 and 4).

Acemoglu's *hypothesis*: The colonial powers left some colonies with "bad" institutions and others with "good" institutions and this is what explains today's differences in real income per capita (and hence the rate of growth differences over the past century).

Whether "bad" or "good" depends ultimately on the **climate** and the consequent prevalence of **disease**s in the former colonies, affecting mainly the settlers.

[10.16] New Evidence on what explains "bad" institutions (cont'd)

(Acemoglu et al., 2001)

* In places (colonies) where the **climate caused diseases** and high **mortality rates for European settlers, these were few**. Here the main interest was in extracting and exporting natural resources. No build up of institutions, or only "bad" ones.

In places with a **temperate climate** and few fatal diseases, the **settlers became much more numerous** and "good European institutions" were established, which have survived.

Line of reasoning:

(1) Settler mortality ⇒ (2) settlements ⇒ (3) early institutions ⇒ (4) current institution ⇒ (5) current economic performance.

Equations tested:

(1) $\log y_i = \mu + \alpha R_i + X_i'\gamma + \varepsilon$

(2) $R_i = \lambda_R + \beta_R C_i + X_i'\gamma + \nu_{Ri}$

(3) $C_i = \lambda_C + \beta_C S_i + X_i'\gamma + \nu_{Ci}$

(4) $S_i = \lambda_S + \beta_S \log M_i + X_i'\gamma + \nu_{Si}$

Variable definitions:
y = GDP per capita 1995
R = Property rights 1985-95
C = Early institutions 1900
S = Settler density 1900
M = Mortality rate for Settlers (ca 1900)
X = Vector of covariates
ε, ν = Error terms

[10.17] New Evidence of what explains "bad" institutions: Main Results (Acemoglu et al., 2001, Tables 2 and 3)

Reduced form equation:

(1) $\log y_i = \alpha + \beta_S \log M_i + X_i'\gamma + \varepsilon$

(.....) R^2-adj= 0.25

(.....) N = 75

Structural equations:

(1) $\log y_i = \mu + \alpha R_i + X_i'\gamma + \varepsilon$

0.52 R^2-adj= 0.54

(0.06)* N = 64

(2) $R_i = \lambda_R + \beta_R C_i + X_i'\gamma + \nu_{Ri}$

0.22 R^2-adj= 0.24

(0.08)* N = 63

(3) $C_i = \lambda_C + \beta_C S_i + X_i'\gamma + \nu_{Ci}$

5.40 R^2-adj= 0.46

(0.93)* N = 70

(4) $S_i = \lambda_S + \beta_S \log M_i + X_i'\gamma + \nu_{Si}$

-0.07 R^2-adj= 0.47

(0.02)* N = 73

Notes: a) * denotes significance at or above the 0.95 level

b) "Latitude" insignificant in (2) and (3), but significant in (4)

c) Large number of robustness tests were carried out

[10.18] Endogenous Institutions? Rebuking the Acemoglu findings

The article by Acemoglu et al has become one of the most **widely cited** in the entire growth literature since its publication in 2001.

It is certainly remarkable that the 4 "structural" regressions all turn out significant results, i.e. that **each step** in the analysis holds up empirically.

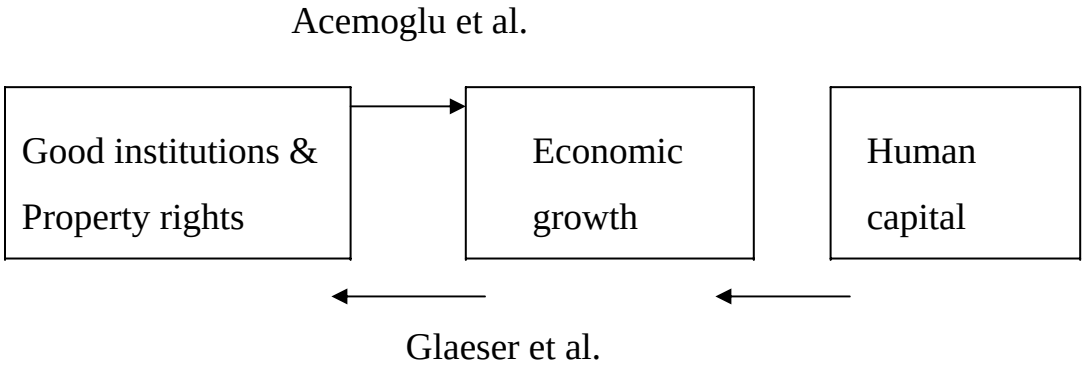
Still reasons not to accept the results without ado.

1) Notable that some countries **without any colonial "implantation" of Western institutions** have high per-capita incomes (Japan, S. Korea and Taiwan).

2) More **recent experiences** of remarkable growth in countries with **no Western institutions and no formal property rights**. **China** is the most prominent example, but also Vietnam may qualify.

3) The most pertinent critique of the Acemoglu et al results, however, focus on **what the "settlers" actually brought with them** to the colonies where they settled in large numbers. Acemoglu argues and finds evidence in the empirical data that it was "**good institutions**" and property rights. Glaeser et al. (2004) argue that (1) it was mainly the education and skills (**human capital**) that the settler brought and (2) that it is never or seldom that growth is initiated by the built up of good institutions. They argue that the **line of causation starts with investment in human capital** (next slide).

[10.19] Alternative line of Causation (Glaeser et al., 2004)



Glaeser et al. start by citing S. Korea, Taiwan and China as the most clear cases that corroborate their line of causal reasoning. **Neither of these countries were Western colonies with European settlers.**

Korea and Taiwan, without any Western institutions, had **stronger growth** in the 1960-1997 period than any other country had ever experienced before. Both were **dictatorships** up to very recently, but had well educated populations already in the early 1960s when high growth commenced.

China also emphasised education (literacy) already during the 1950s and 1960s, which may help explain why growth rocketed when market-reforms were initiated in 1978. As previously discussed, China has still **no formal property rights** of the European type (although informal ones). China is also still a **dictatorship** in most dimensions. It is difficult **not to ascribe** China's phenomenal growth 1978-2006 mainly to very high investments in physical capital and "unlimited supply" of literate labour (human capital).

[10.20] How to measure Institutions? (Glaeser et al., 2004)

Glaeser et al., argue that many of the proxy variables used in the literature (not only by Acemoglu et al, but also many others) are not **long-term constitutional, stable, institutions** of the kind North, Olsen and other pioneers of "institutional economics had in mind. Most of the measures of institutions used by Acemoglu are in fact **outcomes** of **short term policies pursued** by dictators as well as more democratic governments.

They go through the various measures of institutions, used in the literature (example: the International Credit Rating Guide index), which they claim reflects **short term** policies by governments and which rise with income and are highly volatile (examples are given). As good measures of institutions they cite **constitutions** and **electoral rules**.

It is therefore **spurious** to ascribe links from these "phony" institution variables as evidence of the role of institutions proper. Instead, Glaeser et al argue, it is the **growth-beneficial policies** that should be acknowledged, and these beneficial policies are related to **human capital** in their analysis.

When Glaeser et al. insert what they consider **proper variables** for institutions in the same regressions as carried out by Acemoglu et al, they obtain several **insignificant results** (their Table 3).

[10.21] Glaeser et al. New Tests (cont'd)

In order to test their **own hypothesis** that the **link of causation** goes from investment in human capital to growth and, as the final step, from growth to more democratic regimes and better institutions (property rights), they conduct three types of analyses.

1) Politics and growth in poor countries after 1960

Almost all poor countries were **dictatorships** in year 1960, although at varying degrees of harshness. The countries **differed**, however, considerably in the **amount of human capital** they possessed, as measured by the average years of schooling in the population (from less than 1 year to more than 7). Glaeser et al. (Tables 7-9) find that the initial amount of schooling had a strong link to subsequent rate of growth (1960-2000). The degree of authoritarianism (on a scale from 1 to 10) in the countries mattered less. In fact, the **highest growth** was accomplished in the then very **dictatorial** S. Korea, Taiwan, and Singapore (and later, China). Since the mid 1990s, the two first countries have become what seems to be rather stable democracies.

2) Substitution of "Institutions" for "human capital" in regressions

As a second test of their hypothesis, Glaeser et al. re-run some of the structural regressions carried out by Acemoglu et al, but with variables for **human capital** instead of (inappropriate) variables for "**institutions**".
The fits of the regressions then **improved substantially**.

[10.22] Glaeser et al. (cont'd)

3) Time-lagged estimates (Table 12)

As a third test, Glaesner et al., run the following regressions:

a) $\Delta\ SCHOOL_{t+5,t} = SCHOOL_t + lnGDP/C_t + INSTITUTION_t$

(-)sign (+)sign insign

The **significant minus** sign for initial schooling (mean reversal) indicate that countries lagging in education tend to **catch up**.

The **significant positive** sign for GDP/C tell us that **education is improved faster in rich countries**.

The **insignificant** sign for INSTITUTION suggest that "good" institutions do **not have a bearing on improvements in education**.
(problem with multi-colinearity between SCHOOL and GDP/C ignored!)

[10.23] Glaeser et al. (cont'd)

The second time-lagged regression they carry out is for 4 different measures of institutions:

b) $\Delta\ \text{INSTITUTION}_{t+5,t} = \text{SCHOOL}_t + \ln\text{GDP/C}_t + \text{INSTITUTION}_t$

(+)sign insign (-)sign

The **positive and significant** sign for SCHOOL_t (in 2 out of 4) regressions the authors interpret as strong evidence that **the link goes from human capital to "good institutions**".

The **insignificant** sign for $\ln\text{GDP/C}_t$, they gloss over (it does not corroborate their hypothesis that growth proceeds good institutions).

The **negative and significant** sign for INSTITUTION_t they simply say is yet another case of "mean reversal" (it means that countries with initially poor institutions had faster improvements in these).

[10.24] Is world-wide income growth and general welfare improvements an import from Europe??

*** Notable growth in per capita income indisputably started in Europe in the early 1800s.**

*** Growth spread quickly to the "Western off-shoots" in North America and South Pacific (Australia and NZ).**

*** Also to a lesser extent to the ex-colonies in South America**

*** In the rest of the world, no significant growth before 1960s**

*** In the 1960s, rapid growth was initiated in a few small south-east Asian countries (i.e. Taiwan, Korea, Singapore).**

*** It was not until the 1980s that a great number of people in poor countries experienced high growth in India and China**

*** In some parts of the world, notable income growth is still not taking place (most notably in Sub-Saharan Africa).**

Is it really, as claimed by both Acemoglu et al and Glaeser et al., that growth world-wide has been initiated by "spill-overs" from Europe or the imitation of European practices, be it institutions or education??

[10.25] What have we learnt from Acemoglu and Glaeser?

1) That it is indeed difficult to derive **adequate proxy variables** for both "Institutions" and for "Human capital", although the problem with the later is by and large ignored by Glaeser et al. (Cf. lecture 4).

2) That problems with **multi-colinearity** have to be dealt with in a serious way, which is not always done. For instance, in Glaeser et al's time-lag regressions, the obvious correlation between **schooling and GDP/C** is not mentioned, less so controlled for.

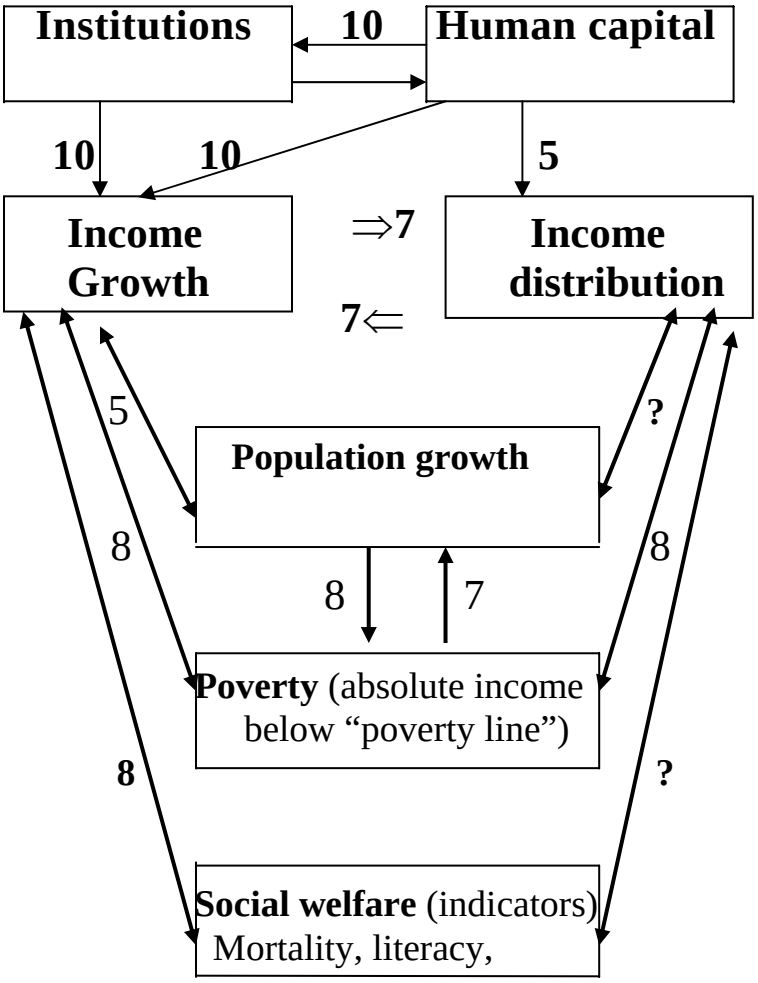
3) That **causality** is difficult to establish on the basis of **cross-country regressions** when there is reason to expect causal links in both directions, and there are sequencing problem to check for.

4) To strongly emphasise one factor, institutions by Acemoglu and human capital by Glaeser, when it is likely that both matters, is somewhat misleading. Settlers brought with them **institutions as well as their skills** and neither attempt to "prove" the superiority of one factor is totally convincing.

5) The fact that **China** and earlier Korea and Taiwan have experienced exceptionally rapid growth for prolonged periods **without Western settlements and institutions** suggest that there are some important variables **missing** in both analyses (as well as in the rest of the empirical growth literature).

[10.26] The Full Circle

All is causally inter-related



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