

14.773 Political Economy of Institutions and Development. Lecture 1. Overview.

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February 5, 2008

Introduction

- What is this course about?
 - ▶ Political economy
 - ▶ Economic development
 - ▶ Their intersection and interaction

Why?

- Much of economics takes preferences, technology and *institutions* (market structure, laws, regulations, policies) as given.
- Thus institutions matter in the same way as preferences do.
- But in general, in the background
- Increasing body of evidence that for understanding economic development both over time and across countries, we need to understand *institutional differences*.
- For example, growth accounted by human capital, physical capital and “technology”. But where do these come from?

The Challenge of Institutions

- Suppose institutions matter (not a minor supposition, but see the evidence in the recitation).
 - ▶ Imagine for example that different laws and regulations, different political systems have a major effect on investment, education and allocation decisions and thus on economic development.
- But why do societies choose different institutions?
- And what are institutions anyway?

What Are Institutions

- Loosely defined in general.
 - ▶ Could be anything.
 - ▶ The challenge is to find a good workable and useful definition.
- Douglass North: role of institutions as “to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction.”
- But what does this mean?

Institutions: A First Definition

- Let us take another definition from Douglass North as a starting point:

“Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.”

- Key points: institutions are
 - ▶ are humanly devised
 - ▶ set constraints
 - ▶ shape incentives
- Economic institutions→ economic rules of the game (property rights, contracting institutions)
- Political institutions→ political rules of the game (democracy versus dictatorship, electoral laws, constraints)
- Not perfect, but will become clearer in the context of well-defined formal models.

How to Model Institutions?

- This is a key question for this course.
- Ideal approach:
 - ▶ good approximation to reality and the forces shaping institutional differences
 - ▶ amenable to formal theoretical and econometric analysis

Some Approaches

- 1 *Efficient institutions view*: Society or the economic agents will choose whichever set of institutions and regulations will maximize the size of the “pie”.
- 2 *The Social conflict view*: Institutions emerge as a result of economic agents’ *conflicting preferences*. They are not necessarily efficient. North: there is a: “persistent tension between the ownership structure which maximizes the rents to the ruler (and his group) and an efficient system that reduces transaction costs and encourages economic growth”.
Why are institutions not “efficient”? Notion of efficiency: Pareto efficiency? Growth maximizing?
Major barrier to efficiency: *commitment problems*.
- 3 *The ideology/beliefs view*: Different institutions chosen as a result of different beliefs. But where do beliefs come from?
- 4 *The incidental institutions view*: Institutions emerge as a byproduct of other interactions. *Historical accidents*.

1 and 2 (but not 3 and 4) are based on “consequentialist” reasoning.

Institutions and Political Economy

- Political economy intimately related to the *social conflict view*.
 - ▶ How are conflicting preferences of different agents aggregated?
 - ▶ How do political institutions affect aggregation?
 - ▶ How do conflicting preferences over outcomes imply *conflicting preferences over institutions*?
 - ▶ How are different preferences over institutions resolved?
- Much on this course will be about trying to develop models and language for investigating these issues.

Institutions: Formal Versus Informal

- Formal institutions, for example, whether the country in question has a Supreme Court, separation of power, parliamentary system etc.
- Informal institutions, which determine how a given set of formal rules and informal institutions function in practice. For example, many Latin American countries have a presidential system similar to the U.S., but in practice, they have very different “political institutions”.
- Example: Supreme Court under FDR and Juan Perón.
- But informal institutions should not be used as a “catchall”. We have to understand why a given set of formal rules imply different outcomes in different societies.

Politics and the State

- Much of political economy is about policies and enforcement.
- The state becomes a key part of the equation.
- How do we think of the state?
 - ① *The state as a non-actor*: standard public finance view.
 - ② *The state as a nexus of cooperation*: Hobbes/Rousseau.
 - ③ *The state as the agent of a social group*: Marxist views, Chicago school (interest groups and lobbies), voting models
 - ④ *The state as the grabbing hand*: Buchanan, Tullock, and the Virginia school
 - ⑤ *The state as the autonomous bureaucracy*: Max Weber, some modern Marxist approaches, much of political science (e.g., Charles Tilly, Peter Evans).

Developmental Versus Predatory Institutions

	Hobbesian Theories	Social Conflict Theories	Grabbing Hand View	Weberian Theories
Strong states?	Good	Ambiguous	Bad	Good
Institutional differences?	Accidental/ costs of inst. design	Due to econ. incentives of agents	Accidental/ strength of bureaucracy	Accidental
Developmental institutions?	Yes	Ambiguous	weak states	strong states
Agreement on institutions?	Yes	Generally no	Generally yes	Generally yes
Which view of institutions?	Efficient institutions view	Social Conflict institutions view	Incidental institutions view	Incidental institutions view

Political Power

- How are conflicting preferences reconciled?
- *Political power.*
- Distinguish between two different types of political power: *de jure* and *de facto* political power.
 - ▶ De jure political power is allocated by political institutions (such as constitutions or electoral systems)
 - ▶ De facto political power emerges from the ability to engage in collective action, use brute force, paramilitaries, armies, or other channels such as lobbying or bribery.
 - ▶ Equilibrium policies will be an outcome of total political power, which consists of the composition of these two sources of power.
- De facto political power useful for understanding why formal institutions function differently in different environments.

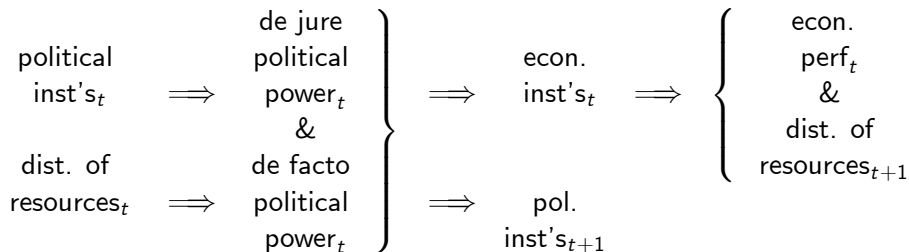
Sources of Inefficiencies

- Why will some economic agents support or opt for inefficient arrangements?

- ① *Hold-up*
- ② *Political Losers*
- ③ *Economic Losers*

Towards A Dynamic Framework

- Ideally a dynamical framework, with clear state variables, shocks and mechanisms



- Many models presented later in the course providing building blocks for a coherent framework of this sort.