

Law, Politics and the Wealth of Nations: Lessons From History

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(based on joint work with Simon Johnson and James Robinson)

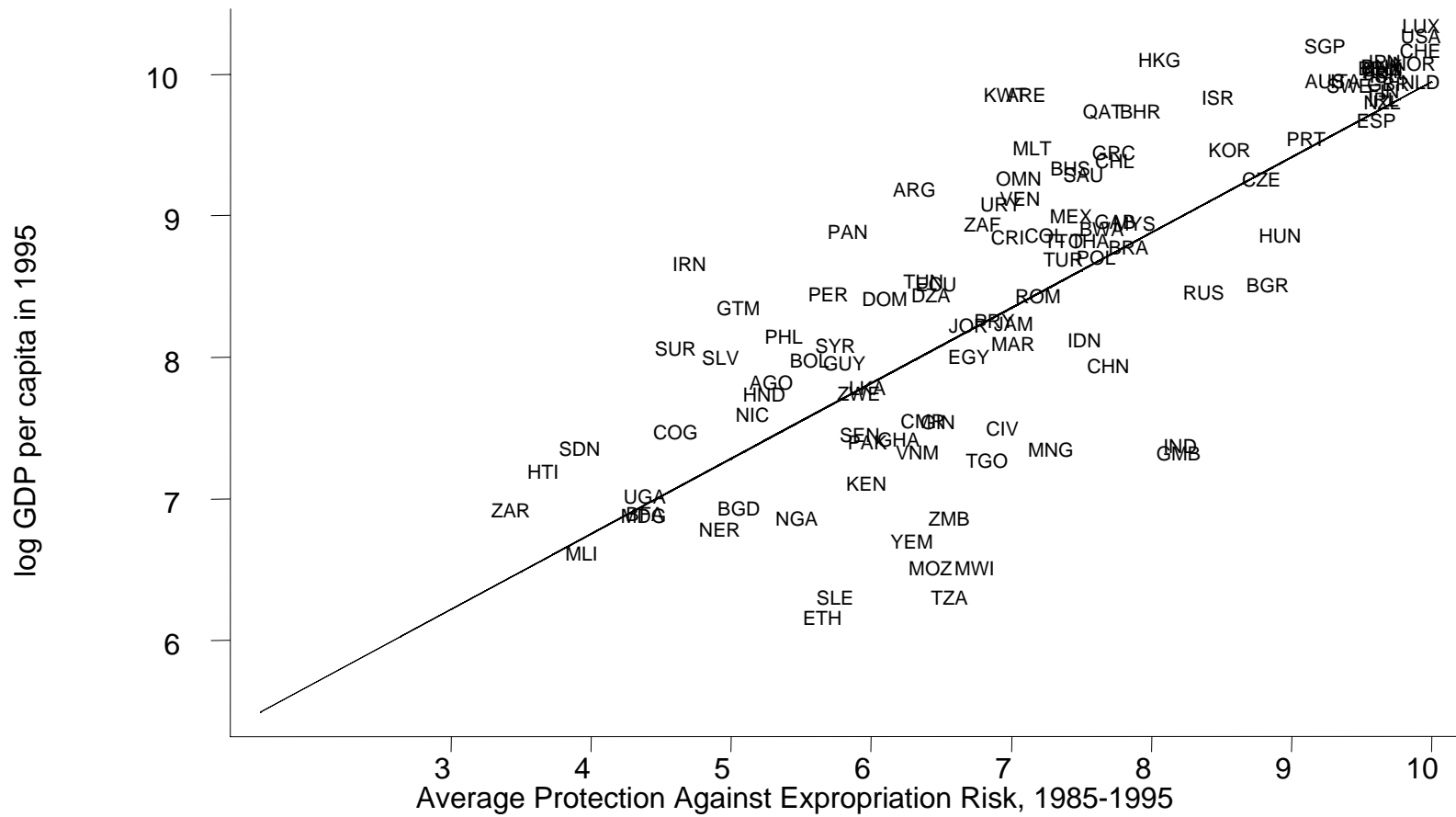
Wealth of Nations

- Enormous variation in the wealth of nations and living standards across the globe.
- What are the causes?
- What can we do about it?
- How do we expect the world distribution of income will change in the future?

Competing Views

- **Geography view**: importance of ecology, climate, disease environment, geography, in short, factors outside human control.
- **Institutions view**: importance of man-made factors; especially organization of society that provide incentives to individuals and firms.

The Institutions Factor



Lessons from History

- Try to distinguish these two broad hypotheses by looking at history
- Roots of big differences in history
- At the end of 15th century, small differences in prosperity all around the world
- Big changes since then, both in organization of society and in prosperity

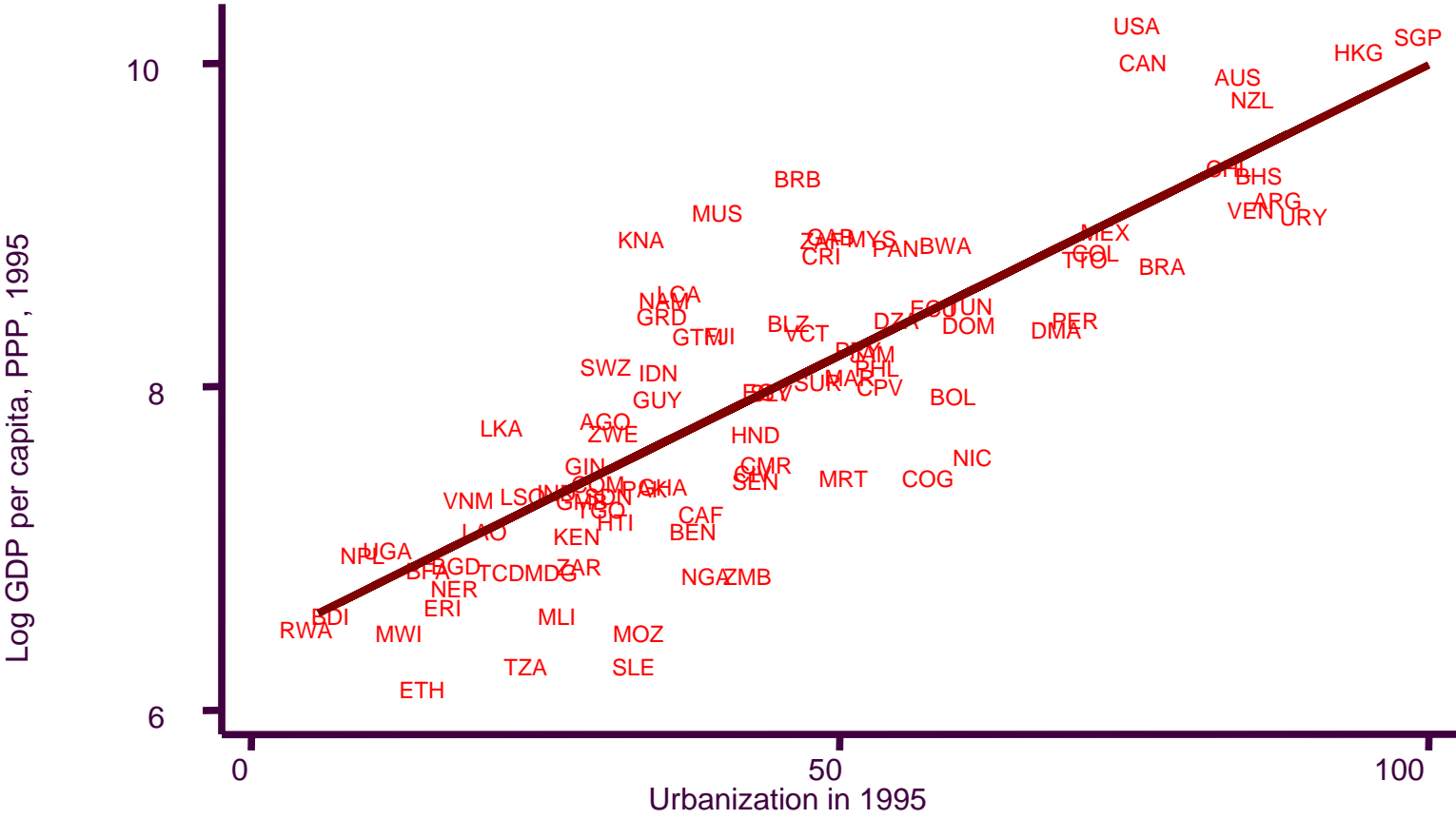
European colonization as a “natural” experiment

- After the discovery of the New World and the rounding of the Cape of Good Hope, Europeans dominated many previously diverse societies, and fundamentally affected their social organizations.
- How did this “intervention” affect the development of these societies?
- How did it affect Europe? Unfortunately, no time to talk about this today.

Measuring prosperity

- To answer these questions, we need a measure of prosperity before the modern era.
- Urbanization is a good proxy for GDP per capita.
- Only societies with agricultural surplus and good transportation network can be urbanized.
- Urbanization is highly correlated with income per capita today and in the past.
- In addition, use population density as a check.

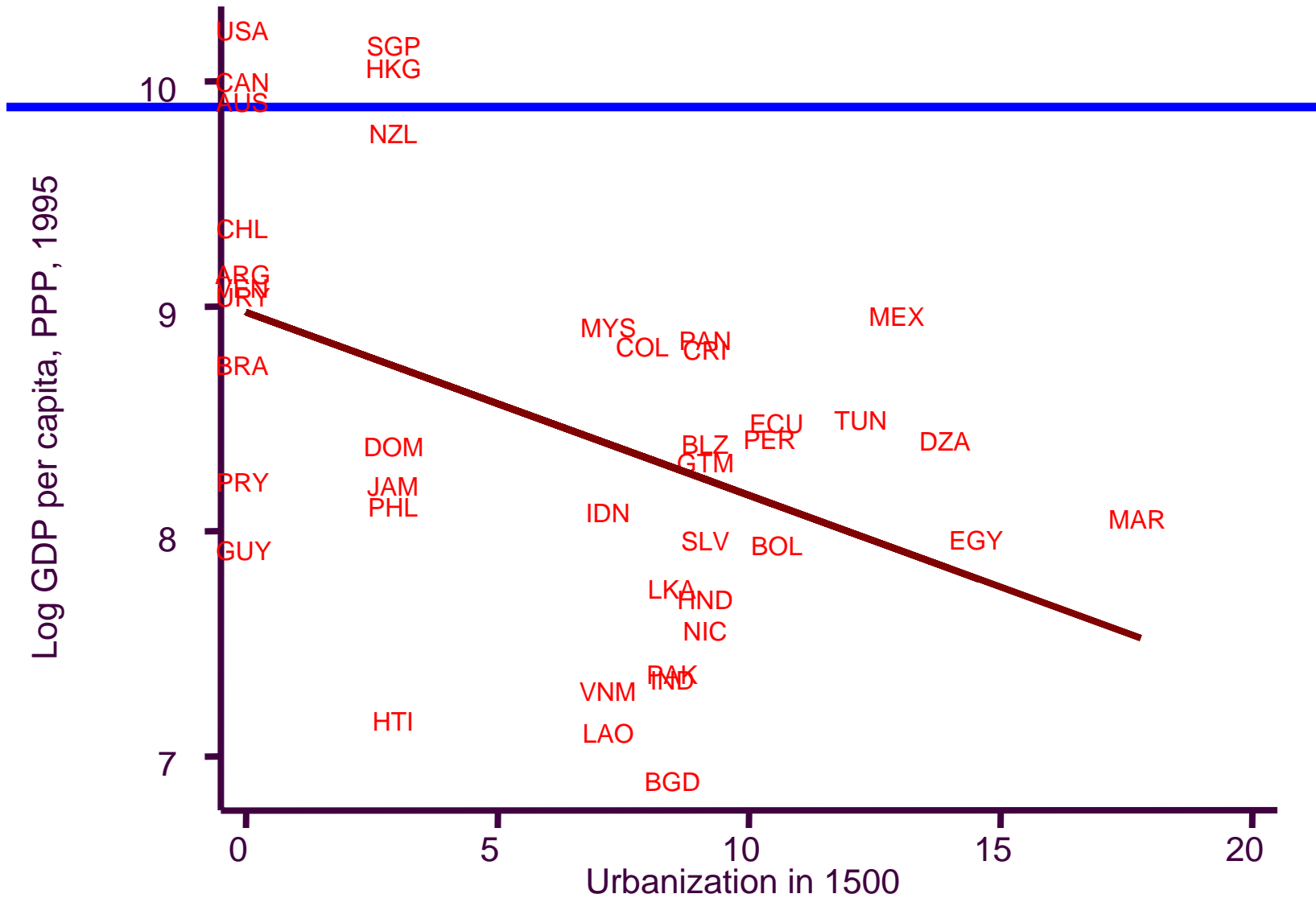
Urbanization is a good proxy for income today



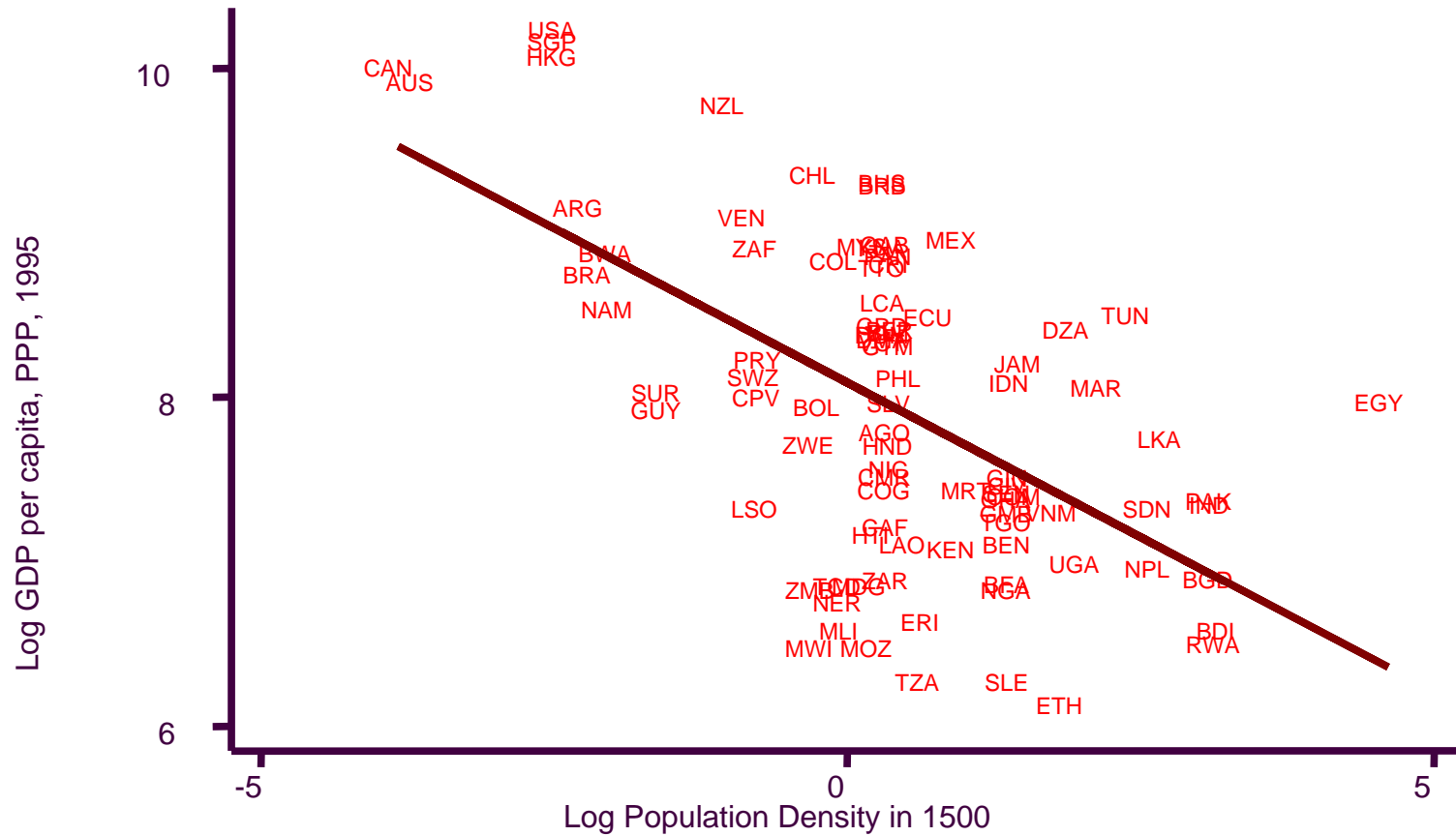
Results: until 1500

- After the initial spread of agriculture, there was remarkable persistence in urbanization and population density
 - see 1000 BC to 1500 AD and subperiods
 - true also for countries that were later colonized

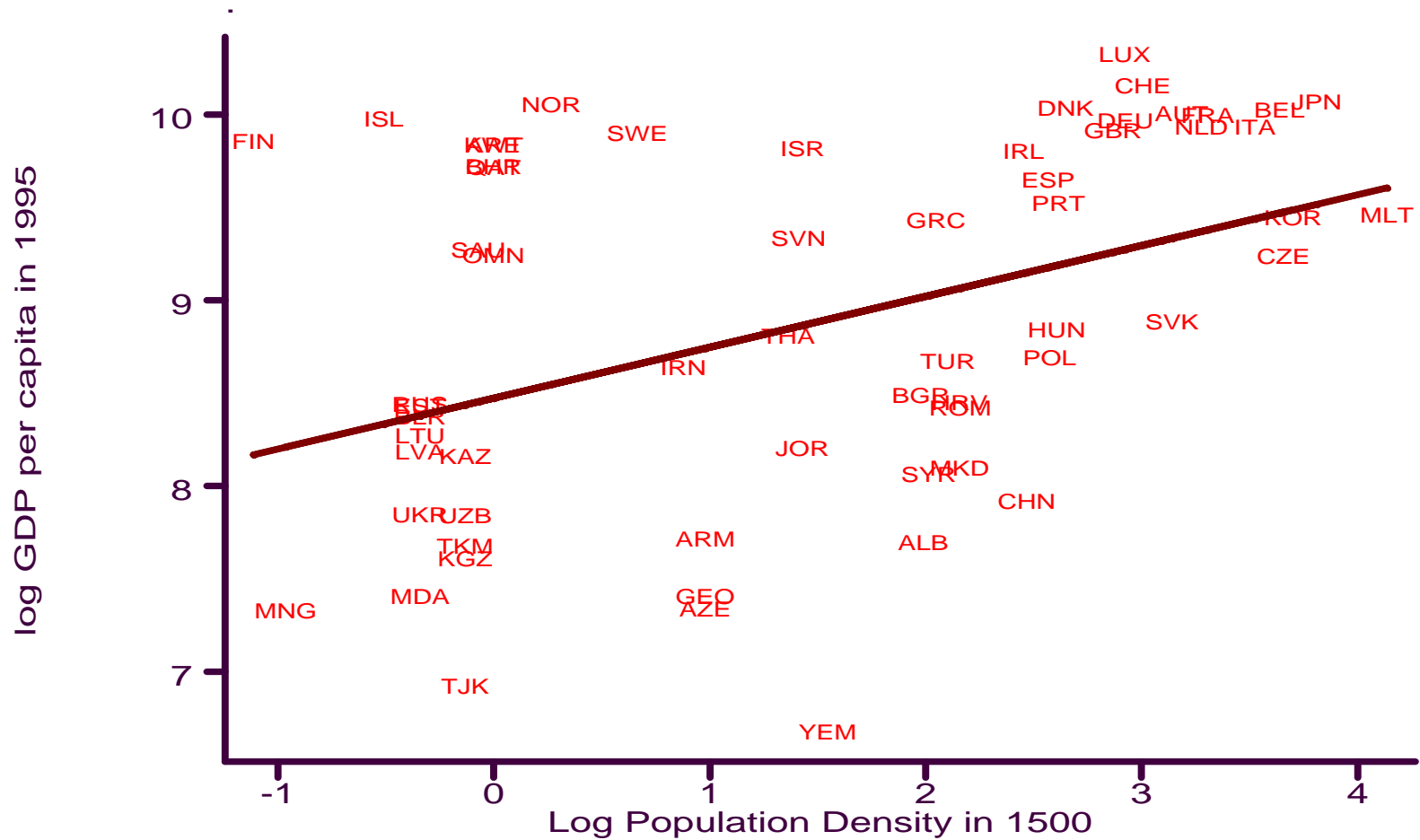
Reversal since 1500 (1)



Reversal since 1500 (2)



No Reversal Among the Non-Colonized



What's happening?

- It cannot be geographical differences
 - no change in geography
- Perhaps certain geographic characteristics that were good in 1500 are now harmful?
 - no evidence to support this view
- Reversal resulting from changes in social organization

Results: from 1500 to 2000

- Europeans established relatively better institutions/social organizations in places that were previously poor and sparsely settled.
 - E.g., compared United States vs. the Caribbean or Peru.
- Institutions have persisted and affected the evolution of income, especially during the era of industrialization
- Former colonies with high urbanization and high population density in 1500 have relatively low GDP per capita today.

“Institutions” Matter

- But what are these institutions?
- The institutions that Europeans set up or maintained in place, both good and bad, had many dimensions.
- Can we make more progress?

Law Versus Politics

- Two hypotheses:
 1. **Property rights institutions** (“politics” or “political institutions”): distribution of political power, determined by political institutions
 - When political power of elites unconstrained:
 - weak property rights for investors because of holdup
 - potential for blocking of new technologies
 - non-level playing field
 2. **Contracting institutions** (“law” or “legal institutions”):
 - Affect enforcement of contracts
 - E.g.: Greater legal formalism.

Key Empirical Question

- Relative roles of law and politics for
 - Economic growth
 - Investment
 - Overall financial intermediation
 - Form of financial intermediation
- Theory:
 - Perhaps law relatively less important than politics, because possible to “contract” around “law”?

Measurement

- Measures of political institutions:
 - Risk of expropriation by government (measures how unconstrained governments and elites are in expropriating others' income and assets); from political risk services
 - Constraints on the executive (more generally on politicians and elites:
 - Typically low in countries with extractive institutions; e.g., Caribbean planters, corrupt tyrants, many colonial regimes
- Measures of legal costs of private contract enforcement:
 - Legal formalism data from DLLS.

Data on Legal Formalism

- Legal scholars: concept of legal formalism
 - Contrasts to “neighbors” model with third party judgments based on fairness
 - Formal rules about evidence and other procedures
 - Generally more costly (more formal), possibly more arbitrary and less fair
- Legal formalism can be measured
 - Extent of formal inflexible rules when
 - tenant eviction for nonpayment of rent
 - collection of check returned for nonpayment
 - Previous research: more formalism correlated with
 - longer duration of dispute resolution
 - less consistency and less fair

Data on Legal Formalism (2)

- Cases specified so defendant has no justification & avoids voluntary payment
 - Comparable across countries
 - Simple disputes resolved in lower level courts, most relevant to ordinary citizens
- Dimensions legal formalism
 - Use professional vs. lay judge/lawyer
 - Need make written vs. oral arguments
 - Legal justification of claims and judges' decisions
 - Regulation of evidence
 - Superior review of first-instance judgment
 - Engagement formalities
 - Number of required independent procedural actions
- Raises cost of adjudication and creates delay²¹

Determinants of Legal Formalism

- Legal formalism comes from legal origin in Europe (Berman, Merryman, etc)
- Plus “exogenous” transplantation to colonies
 - (French) civil law systems in French and Spanish colonies and common law and British colonies.
- Legal origin explains a large fraction of variation in formalism.

Political Institutions: Colonization as a Natural Experiment

- Within each empire, not all countries received the same institutions
 - e.g., U.S. got much better institutions, including courts, than did Jamaica or Nigeria (all British colonies)
- Europeans took “better” institutions where
 - they wanted to settle
 - where there was no large population to exploit.
- Institutions: a tendency to persist
 - Not remaining the same, but places with worse institutions 200 years ago more likely to have bad institutions today.

Disease Environments and Political Institutions

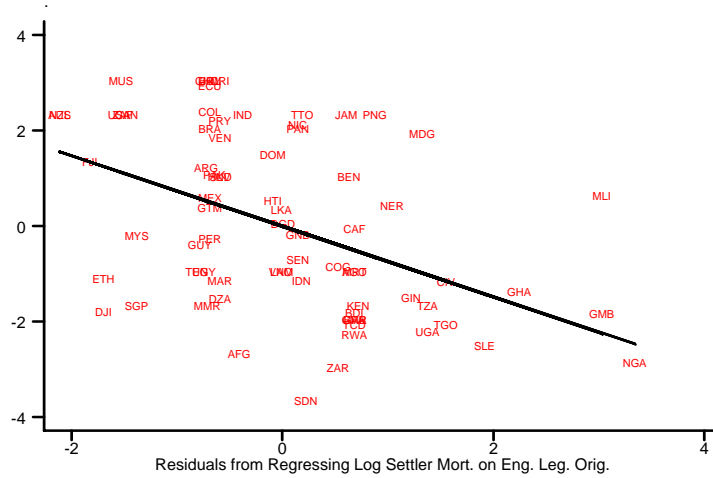
- Big variation in the ability of Europeans to settle because of local disease environments
- “Potential Settler mortality” data (from military & clergy records, particularly Philip Curtin)
 - Australia, New Zealand, the U.S.: healthy for Europeans
 - Africa, India, Indonesia, Caribbean: much less healthy
- Most European deaths from **malaria and yellow fever**
 - Local populations had much greater immunity.
- Europeans more likely to set up better institutions in places they settled.
 - Better institutions in areas with disease environment favorable to Europeans.
- Mortality rates of potential settlers as an instrument.

Population Density and Political Institutions

- Colonial powers typically introduced extractive institutions, forced labor systems, high tax/tribute systems in areas with high population density.
 - Example: Peru vs. United States.
- Population density of indigenous people before colonization as a potential instrument.
- Data on population density in 1500 from McEvedy and Jones.

Figure 2

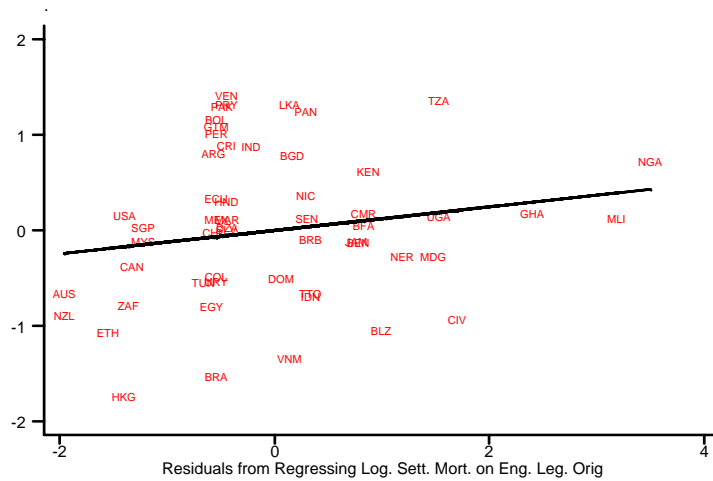
Residuals from Regressing Constraint on Exec on Eng. Leg. Orig.



Resid. from Regress Cons. on Exec on Log Settler Mort.



Residuals from Check Measure Formalism on Eng. Legal Orig.



Residuals from Check Measure Formalism on Log Sett. Mort.

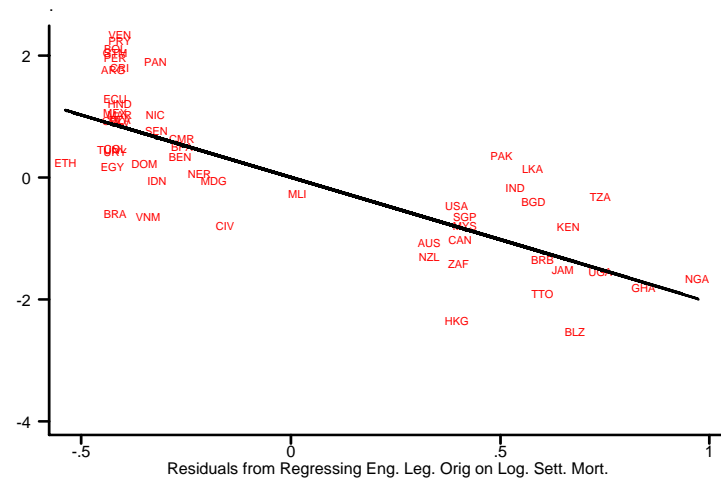
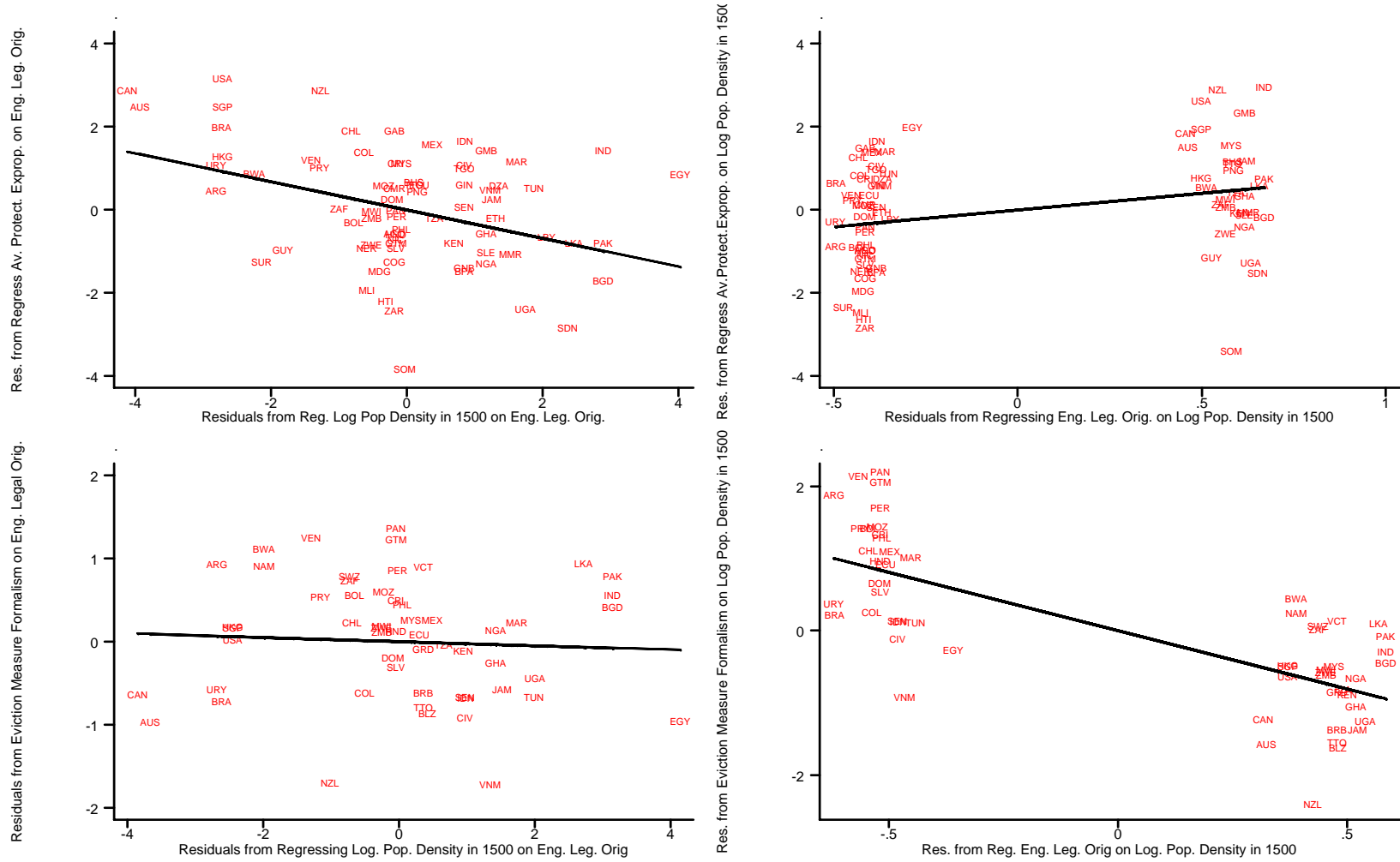


Figure 4



Empirical Strategy

- Exploit differences in colonization strategy and identity of colonizer as sources of variation in legal and political institutions among former colonies today.
- Formally: multiple instrumental-variables approach.

Legal vs. Political Institutions: Results (1)

- GDP per capita today
 - no effect of legal formalism (contracting institutions)
 - often wrong sign
 - strong robust effect for property rights institutions.
- Similar result for economic growth between 1970-95.

Legal vs. Political Institutions: Results (2)

- Investment-GDP ratio.
 - legal institutions insignificant
 - strong robust effect for political institutions.
- Overall financial development
 - same results
- Stock market development
 - now both legal and political institutions significant (though political institutions quantitatively more important).

Legal vs. Political Institutions: Results (3)

- Form of business regulation
 - legal institutions matter a lot.
- Real costs of business regulation
 - political institutions make the difference.

Summary Findings

- **Property rights institutions** (expropriation risk, constraint on executive), and **not contracting institutions**, matter for
 - GDP per capita
 - Investment-GDP ratio
 - Credit to the private sector
 - Real costs of regulation
- **Both set of institutions matter for**
 - Stock market development
 - Form of financial intermediation.

Interpretation

- Political institutions most important for understanding wealth of nations.
- Businesses and individuals can often “contract” around legal imperfections.
 - E.g.:
 - write different types of contracts (debt versus equity)
 - enter into long-term or trust-based relationships.

What Can Be Done?

- Important to encourage political reform.
- But how?
- We are far from an answer, but:
 - Success stories: Neo-Europes, South Korea, Taiwan, Botswana, Mauritius, Eastern Europe.
- Pitfall to be avoided:
 - Dealing simply with the symptoms not the fundamental causes.
 - Ignoring internal dynamics.

The Future

- Hard to predict.
- A general, but slow, tendency towards institutional reform in many countries.
- End of Cold War may encourage faster institutional reform
 - but the threat of “war against terrorism”.