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 Geography Factor
The Institutions Factor

log GDP per capita in 1995 vs. Average Protection Against Expropriation Risk, 1985-1995

[Graph showing a scatter plot with various countries labeled and plotted on a linear scale from 6 to 10 on the y-axis and 3 to 10 on the x-axis.]
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 delay
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
Figure 3
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”.