



## CHAPTER 5

# The Role of Institutions in Growth and Development

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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? To the extent that we can develop some answers to these questions we can address the next ones: what can be done to induce economic growth and improve living standards in a society?

Economists long have recognized that output per capita in a society is intimately related to the amount of human capital, physical capital, and technology to which workers and firms in that country have access. Similarly, economic growth is related to the ability of a society to increase its human capital and physical capital and improve its technology. In this context, technology is construed broadly; technological differences refer not only to differences in techniques available to firms, but also to differences

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in the organization of production, which implies 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 of production and opportunities. To develop more satisfactory answers to questions about 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 that may be underlying these proximate differences across countries. Only by understanding these fundamental causes can we develop a framework for making policy recommendations that go beyond platitudes (such as “improve your technology”) and minimize the risk of unintended negative consequences.

In this chapter 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, as well as 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 (to promote further economic growth). Nevertheless, we can use this framework in several ways. One is to illustrate the potential *pitfalls of institutional reforms*. Although this in itself is not a solution to the problem of development, avoiding such pitfalls may be valuable enough to start with. We can also use the framework to structure our understanding of cases of economic success. Although such an *ex post* understanding is not a substitute for policy, it is the first step toward the goal of knowing how to reform institutions.

## What Are Institutions?

Douglass North (1990: 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, such as geographic factors, that are outside human control; (2) that they are “the rules of the game” setting “constraints” on human behavior; and (3) that their major effect will be through incentives (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 determinants of economic outcomes, or are they secondary arrangements that respond 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 important point: ultimately, the aim of the research on institutions is to pinpoint *specific* institutional characteristics that are responsible for economic outcomes in specific situations (for example, the effect of legal institutions on the types of business contracts). However, the starting point is often the impact of a broader notion of institutions on a variety of economic outcomes. This broader notion, in line with North's conception, incorporates many aspects of economics and the political and social organization of society. Institutions can differ between societies because of their formal methods of collective decision making (democracy versus dictatorship) or because of their economic institutions (security of property rights, entry barriers, or 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 whereas in the other it is consolidated. This broad definition of institutions is both an advantage and a curse. It is an advantage because 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 because unless we can follow it up with a better understanding of the role of specific institutions, we have learned only little.

## **The Impact of Institutions**

Tremendous cross-country differences exist in the way that economic and political life is organized. A voluminous literature documents large cross-country differences in economic institutions, as well as a strong correlation between these institutions and economic performance. Knack and Keefer (1995), for instance, looked at measures of property rights enforcement compiled by international business organizations, Mauro (1995) looked at measures of corruption, and Djankov and others (2002) compiled measures of entry barriers across countries. Many other 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, as well as significant correlation between these measures and various indicators of economic performance. For example, Djankov and others found that, although the total cost of opening a medium-sized business in the United States was less than 0.02 percent of GDP per capita in 1999, the same cost was 4.95 percent in the Dominican Republic, 0.91 percent in Ecuador, 1.16 percent in Kenya, and 2.7 percent of GDP per capita in Nigeria. 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 the Dominican Republic, Ecuador, Kenya, and Nigeria 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 through which to investigate these issues. Beginning in the late fifteenth 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 (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 institutions.” 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 Europeans 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, Australia, Canada, New Zealand, and the United States. 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, because 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 faced significant barriers preventing their participation in many economic activities. Although investments by the elite can generate economic growth for limited periods, property rights for a broad cross section seem to be crucial for sustained growth (Acemoglu 2008).

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, Acemoglu, Johnson, and Robinson (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. These therefore 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). A number of channels can be identified 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 indigenous peoples 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, for example, Curtin 1964).

The data also show major differences in the institutional development of the high- and low-mortality colonies. Moreover, consistent with the key idea in Acemoglu, Johnson, and Robinson (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 sevenfold increase in Nigeria's income per capita, which accounts for the preponderance of the difference between the countries. This evidence suggests that once we focus on potentially exogenous sources of variation, the data point 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. Acemoglu, Johnson, and Robinson (2002) focus on another important aspect: how densely different regions were populated 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 Acemoglu, Johnson, and Robinson (2002) show similar large effects from this source of variation.

Another example that illustrates the consequences of difference in institutions is the contrast between the Democratic People's Republic of Korea and the Republic of Korea. The geopolitical balance between the Soviet Union and the United States following World War II led to separation along the 38th parallel. The Democratic People's Republic of Korea, under the dictatorship of Kim Il Sung, adopted a very centralized command economy with little role for private property. In the meantime, the Republic of Korea 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 Republic of Korea's economy. Although not democratic during its early phases, the Republic of Korea's state was generally supportive of rapid development and is often credited with facilitating, or even encouraging, investment and rapid growth.

Under these two highly contrasting regimes, the economies of the Democratic People's Republic of Korea and the Republic of Korea diverged. Although the Republic of Korea has grown rapidly under capitalist institutions and policies, the Democratic People's Republic of Korea has 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. This, however, is only part of a first step in the journey toward 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?

## **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, and (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 determine not only 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 be associated not only with different degrees of efficiency and potential for economic growth, but

also with different distribution of the gains across different individuals and social groups.

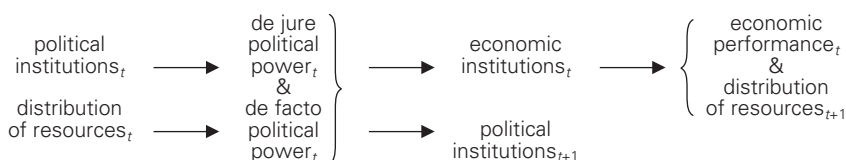
How are economic institutions determined? Although various factors play a role here, including history and chance, at the end of the day, economic institutions are collective choices of the society. Because of their influence on the distribution of economic gains, not all individuals and groups typically 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* and *de facto* political power (see Acemoglu and Robinson 2006a). *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 versus 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 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 the economic resources available to the group (which determines its 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 is relatively slow changing and persistent. Because, like economic institutions, political institutions are collective choices, the distribution of political power in society is the key determinant of their evolution. This creates a central mechanism of persistence: political institutions allocate *de jure* political power, and those who hold political power influence the evolution of political institutions, and they will generally opt to maintain the political institutions that give them political power. A second mechanism of persistence comes from the distribution of resources: when a particular group is rich relative to others, this will increase its *de facto* political power and enable it to push for economic and political institutions favorable to its interests, reproducing the initial disparity. We shall see later that these ideas are powerful in developing ideas about why reform is so difficult. Reform comes with pitfalls because either *de facto* or *de jure* power may persist even if other things change.

**Figure 5.1. The Determinants of Institutions**



Source: Acemoglu, Johnson, and Robinson (2005b).

Despite these tendencies for persistence, the framework also emphasizes the potential for change. In particular, “shocks” to the balance of de facto political power, including changes in technologies and the international environment, have the potential to generate major changes in political institutions, and consequently in economic institutions and economic growth.

Acemoglu, Johnson, and Robinson (2005b) summarized this framework with the schematic representation shown in figure 5.1.

## A Simple Historical Example

As a brief example, consider the development of property rights in Europe during the late Middle Ages and Early Modern period. Lack of property rights for landowners, merchants, and proto-industrialists was detrimental to economic growth during this epoch. Political institutions at the time placed political power in the hands of kings and various types of hereditary monarchies, so 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 the 1640s and the Glorious Revolution of 1688, and in the Netherlands after the Dutch Revolt against the Hapsburgs between 1568 and 1648. 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 2005a) 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 on both 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 late 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 necessitated 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 associated with their monopoly of political power. This is why the institutional changes in England as a result of the Glorious Revolution were not easily conceded by the Stuart kings. James II had to be deposed for the changes to take place.

The reason that political power is often used to change political institutions is related. In a dynamic world, individuals care about economic outcomes not only 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 institutions) 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 had been confident of their future de facto political power, this would not have been a problem. However, de facto political 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 among 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.

## Pitfalls of Reform

The framework we have sketched above is useful in delineating a range of dysfunctional political equilibria and consequent economic institutions. We have also emphasized how important it is to understand the political forces and institutions that keep these dysfunctional economic institutions in place and are often mutually self-reinforcing (complementary) with these economic institutions. Nevertheless, at present we do not have a satisfactory understanding of the circumstances under which dysfunctional political equilibria arise and sustain themselves. A natural idea would be to focus on specific political institutions such as democracy. Yet we know that democracy per se is not necessarily associated with better development outcomes, and we all know the famous examples of “developmental dictatorships” such as in the Republic of Korea or Taiwan, China. However, as yet, we do not understand why some dictatorships are developmental and others are not, or why, for instance, there has never been a developmental dictatorship in sub-Saharan Africa or Latin America.

Although we cannot yet say under what circumstances political equilibria that lead to economic growth will arise, we can illustrate the power of the ideas we have developed by examining the issue of institutional reform. If economic institutions do not create the right incentives in society, then a natural approach is to directly try to reform economic institutions. If

security of property rights is the problem under kleptocracies, then 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. Although blatant disregard for property rights is a powerful distortionary force in kleptocratic societies, it is not the only instrument available to a dictator who wants to extract resources from the rest of the society.

The comparison of Ghana in the 1960s and 1970s to Zimbabwe today 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 percent 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 institution building. This raises the second potential pitfall of institutional reform; although 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.

The pitfalls of institutional reform are related to the fact that patterns of relative economic performance are very persistent. Indeed, our framework emphasized persistence. This is not to say that change does not occur: it does, and some countries manage to dramatically change their position in the world income distribution. However, it is a striking fact in the Americas, to take one example, that the rank order of countries in terms of income per capita has been basically unchanged at least since the middle of the nineteenth century. This suggests that it is difficult to change institutions and that there are powerful forces at work reinforcing the status quo. Examining the pitfalls of reform is one way of approaching this issue. We then move to examining successful change.

We begin our discussion by focusing at more length on whether reforming specific economic institutions is likely to be effective. We argue that such

reforms may not work if they do not change the political equilibrium. We then examine if these pitfalls of reform can be solved by reforming political institutions (thus altering the distribution of de jure power in society). We argue that this may not work either, because de facto power may persist and may override the effects of reforms on political institutions. From this it might seem to follow that a successful reform necessitates changes in both de jure and de facto power. We show that simultaneously changing both may not achieve real reform either because the political equilibrium may be path dependent.

## **Persistence of Power and Incentives—The Seesaw Effect**

Many dysfunctional economic institutions are supported by a system of specific laws and regulations that relate to these institutions. This is true of the labor-repressive agricultural societies of nineteenth-century Russia and Eastern Europe (Acemoglu and Robinson 2006b) or twentieth-century El Salvador and Guatemala, where the legal system kept workers in semi-servile status and blocked their mobility. It is also true of highly oligarchic societies with very concentrated industrial structures, such as modern-day Mexico, where specific barriers to entry block competition. 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 of what forces led these tariffs to be put in place, removing them ought to stimulate growth. This was the sort of reasoning that led to the famous Washington consensus.

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 that reforms of specific economic institutions may be ineffective is that many different ways and a multitude of instruments may be used to achieve a specific goal. Taking away one instrument without altering the balance of power in society or the basic political equilibrium can simply lead to the replacement of one instrument by another. This phenomenon was dubbed the *see-saw effect* by Acemoglu and others (2003).

### **Case Study: Reform and the New Clientelism in Latin America**

Prominent examples 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 that had been prevalent since the 1930s and 1940s. Policy reforms that took place in the late 1980s and 1990s included deregulation of the trade regime and severe cuts in tariffs, privatization, and financial deregulation. Although 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 institutions 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 toward 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 neoliberalism could be manipulated to fulfill clientelistic ends. As Roberts (1995: 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, 2002). 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 reinvent 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. Other instruments were still available for use to achieve the same ends: for example, the labor movements were compensated for some deregulation by being able to benefit from privatization. Despite the crises in the 1980s, changes in the distribution of political power in Argentine society (the unions were weaker), and changes in the feasible instruments through which to pursue clientelism, the political incentive environment was remarkably stable over time, and as a consequence little improvement was seen in the economic incentive environment in Argentina.

### **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 de Walle 1993, 2000), mostly for the reason that international financial institutions did not take into account the political rationale for the inefficient policies that they were trying to reform. The most dramatic example of this is discussed by Herbst (1990) and Reno (1998). They argued that attempts by international financial institutions (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 Liberia and Sierra Leone. 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.

### **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, little change occurred 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, although the instruments that the Peronists used after 1989 were different. This perspective is, of course, very different from that which claims that the Washington consensus reforms failed (Rodrik 2006). Our view is not that they failed, but that for them to have succeeded a change in the political equilibrium in Argentina would have been necessary. Although 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, although 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 that 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.

## Persistence of De Facto Power

The last section illustrated that reforming specific economic institutions without disturbing 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 that 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 to re-create a system similar to the one that has departed (Acemoglu and Robinson 2006c, 2008). 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 nineteenth 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.

### Case Study: The Persistence of the Southern Equilibrium

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: 16)

An important example that illustrates our thesis is 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. Most obviously these changes in de jure power included the enfranchisement of the freed slaves.

Before the Civil War, the South was significantly poorer than the U.S. average income at about 70 percent of GDP per capita. The South lacked industry (Bateman and Weiss 1981; Wright 1986: 27, table 2.4), and in 1860 the total manufacturing output of the South was less than that of either Pennsylvania, New York, or Massachusetts (Cobb 1984: 6). The South had very low rates of urbanization (around 9 percent as opposed to 35 percent 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 1986: 21, table 2.1). Perhaps more important, 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 relative backwardness of the South was because of 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. This pattern of labor repression, however, 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 percent of the U.S. average. If the organization of the slave economy had been the reason that 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. Although 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 national 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: 79). In 1900 all but two of the non-Southern states had enacted compulsory schooling laws, whereas no states in the South had such laws except Kentucky (Woodward 1951: 399). Although industrial development did begin more systematically after 1865, Cobb (1984: 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. . . . [S]uch industries hardly promised to elevate the region to economic parity with the rest of the nation."

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 that 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, considerable persistence was seen in the identity and power of the political elites. For

example, Wiener (1978) studied the persistence of the planter elite in five 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 “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.” Nevertheless, “of the 25 planters with the largest landholdings in 1870, 18 (72 percent) had been in the elite families in 1860; 16 had been in the 1850 elite group” (Wiener 1978: 9).

After the end of the Civil War, more or less the same group of planter elites controlled the land and used various instruments to reexert their control over the labor force. Although 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: 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 toward the repression of black labor. Wiener (1978: 58) describes this as follows: “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 molding 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: 62). In his seminal study of the politics of the South after World War II, Key (1949: 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: 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: 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, “The effectiveness of the oligarchy’s control has been achieved through the elevation to office of persons fundamentally in harmony with its viewpoint” (Key 1949: 211).

This picture is also confirmed by Wright’s analysis (1986: 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 (see 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 twentieth 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: 175–76). In 1900 the South’s urbanization rate was 13.5 percent, as compared to 60 percent in the Northeast (Cobb 1984: 25).

Ransom and Sutch’s (2001: 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.” The South remained relatively poor because

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: 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 twentieth century, and started to crumble only 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.

### **Case Study: The Reinvention of the Cambodian People's Party**

In 1978 senior Khmer Rouge cadres, including Heng Samrin, Chea Sim, and Hun Sen, escaped to Vietnam after falling out with Pol Pot. In 1979 they were placed in power in Phnom Penh by the Vietnamese Army and formed the Communist Party of Kampuchea. In the 1980s they tried to implement socialism, but after the Berlin Wall came down, Hun Sen and his colleagues renamed their party the Cambodian People's Party (CPP), became democrats, and negotiated an opening of the political system (Hughes 2003). Although this involved the return of King Norodom Sihanouk from exile and necessitated that Hun Sen share power, his party, the CPP, managed to reinvent itself as a democratic political machine. For instance, in 2002 elections were introduced for commune chiefs, who had previously been appointed. The CPP won 1,591 of 1,621 positions. 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 of the CPP means that it can dominate democratic politics through superior organization and resources, heavily aided by threats and intimidation.

### **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 U.S. South, the same economic system based on the repression of cheap labor was reinstated after Reconstruction. Even though the enfranchisement of the freed slaves 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 reassert 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 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, 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 have not been sufficient to change the political equilibrium. The Cambodian People's Party, led by former Khmer Rouge cadres such as 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. Although large changes have taken place in specific economic institutions, particularly with the move away from socialism to capitalism, as well as alterations 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, and corruption).

## The Iron Law of Oligarchy

The conclusion one might make from the last section is that to change the political equilibrium there needs to be changes in both de jure and de facto power. For instance, if an elite is structuring institutions to its benefit with adverse aggregate effects, then to engineer a transition to a better equilibrium both their de jure and de facto power must be simultaneously reformed. To take a contemporary example, this would imply that to reform Iraq, it would not be sufficient to simply remove Saddam Hussein and introduce democracy, because the Ba'ath Party would still have considerable de facto power and would be able to capture the new political institutions. To really achieve reform it would be necessary to undermine the de facto power of the Ba'ath Party, something the U.S. government clearly succeeded in doing.

Unfortunately, things are not quite so simple as this, because even if de jure and de facto power changes, those who acquire the power in the new political equilibrium may not have the correct incentives either. More important, their incentives to use their power and the institutions they find it optimal to create may be fundamentally shaped by the status quo they replace—they may be path dependent. If an elite with power is initially structuring economic institutions to extract rents from society, then the fact that it is doing this may induce a new elite to do likewise. The replacement of one elite by another may therefore do little to improve economic performance. This pitfall is reminiscent of the classic idea in sociology of an *iron law of oligarchy* going back to the work of Mosca (1939), Michels (1962), 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 socioeconomic change, they simply replace preexisting elites and groups and behave in qualitatively similar ways (see Acemoglu and Robinson 2007). Many circumstances may exist in which “iron law” types of behavior may occur, and quite possibly many mechanisms may generate behavior like this. We focus on two that appear to be first order. The first is motivated by the experience of Bolivia following the Revolution of 1952. The second is motivated by the experience of Africa, where many countries have experienced a series of one bad leader after another.

### **The Bolivian Revolution and the Iron Law**

Bolivia features centrally in accounts of comparative development in the Americas. It lay at the heart of the Inca Empire with a high density of indigenous peoples, and during the colonial period economic institutions designed to extract rents—the *encomienda*, *repartamiento*, and 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 percent of landowners owned 92 percent of all lands, and the smallest 60 percent of landowners owned 0.2 percent. The tin mines, which formed the basis of the export economy, were owned by three families. A mere 31 percent of the adult population was literate, and only 4 percent of the labor force was employed in industry. Indians still were 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, which was masterminded by the Movimiento Nacionalista Revolucionario (MNR), a political party that had formed in urban areas in the 1940s to contest the power of the traditional elite. Following the revolution, the MNR formed a government that implemented land reform, expropriated large estates, and redistributed them to the labor force and Indian communities. It also introduced universal suffrage by abolishing the literacy requirement on voting and nationalized the mines of the tin barons.

These appear to be huge, radical institutional changes. In particular there was a shift in the distribution of both *de jure* and *de facto* power. Surely Bolivia was launched on a new path of institutional and economic development. At the least one would have anticipated a sustained fall in inequality. Unfortunately none of these good outcomes occurred. Following the revolution, the 1950s saw a failed attempt by the MNR to create a one-party state, and in the process it rebuilt the military that had been disarmed in 1952. The party was also able to use clientelism to gain the support of the indigenous majority. Indeed, striking comparisons can be identified between the traditional clientelism that had existed before 1952 and that which emerged during the regime of the MNR afterwards. In a seminal study, Heath (1972) showed that although the identity of the patrons was different and the instruments of clientelism had changed following the institutional changes brought by 1952, very strong similarities were present

in the basic structure of the political equilibrium. Kelley and Klein (1981) estimated that 15 years after the revolution, inequality had returned to 1952 levels.

How can we understand an outcome such as this? We believe that mechanisms exist that can generate persistence in the political equilibrium even when de jure and de facto power changes and that can produce an iron law of oligarchy. The idea is quite simple. Initially, in Bolivia, institutions were structured to the benefit of traditional elites. A new elite emerged, spearheaded by the MNR. The MNR needed to win support of the *campesinos* and other urban groups. To do this, MNR had to develop a political strategy, but the form that strategy took was highly influenced by the strategies being used by the traditional elite. The traditional elite were clientelistic, so it was optimal to use clientelism to compete with them. Similarly, the traditional elite ran a political system with few checks and balances. Would the MNR find it optimal to create a political system with checks and balances? Not necessarily. After all, although this might have appealed to citizens and garnered more support, it would also have been disadvantageous to them once they were in power. Hence there is a well-defined trade-off. Indeed, the MNR was able to attain power and create highly imperfect political institutions that it was then able to undermine.

### **General Lessons**

One might conclude from our discussion of the U.S. 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 40 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 those of the old elite and that had the same impact on economic institutions. Thus a huge path dependence can exist in political equilibria, even when de jure and de facto power changes hands from one group to another. This implies that, for reformers, a policy of changing political institutions and trying simultaneously to undermine the de facto power of incumbents may not work. To reform Iraq it is not sufficient to introduce democracy and undermine the Ba'ath Party. Instead, reformers must change the incentives for the new elites and decouple their choices from those of the previous elites.

### **Fighting Fire with Fire**

A related phenomena to what happened in Bolivia, but that seems to involve different mechanisms, arises mostly in sub-Saharan Africa. Many African countries have experienced changes in the identity of elites and groups in power, but the new leaders seem to be as bad as the old. Most strikingly this happened with the transition from colonial authority. After suffering under King Leopold and then the Belgian colonial state, the Congolese were faced

with Patrice Lumumba, Joseph Mobutu, and Laurent Kabila. Is this just a coincidence? Similar transitions occurred in many African countries. After the cocoa farmers in Ghana had protested against the policies of the British authorities, they were exploited even more vigorously by the government of Kwame Nkrumah. Other salient examples in British colonies are Siaka Stevens in Sierra Leone and perhaps the transition from Ian Smith to Robert Mugabe in Zimbabwe. Elsewhere on the continent the transition in Ethiopia from Haile Selassie to Mengistu Haile Mariam in the 1970s is yet another example (see Meredith 2005 on the extraordinary extent to which Mengistu ended up behaving like Haile Selassie). Transitions from one bad leader to another occurred not just at the time of decolonization, but also subsequently. In Zambia, for instance, the long struggle to remove Kenneth Kaunda and his United National Independence Party from power was headed by Frederick Chiluba and the Movement for Multiparty Democracy (MMD). Chiluba was elected president in 1991 after 27 years of United National Independence Party rule. Although Chiluba introduced economic reforms, he also engaged in massive corruption.

The succession of bad leaders seems to be another example of the iron law of oligarchy. On the surface change appears to take place, and often IFIs and foreign governments rush in to give aid and support to the new regime, only to become disillusioned with the lack of real change. Very good reasons for this phenomenon may exist, however (Acemoglu and Robinson 2007). Consider a situation in which a society has a very predatory ruler or ruling clique that is willing to use repression and violence and bend all the rules to stay in power. How can citizens remove such a ruler? To get rid of the regime, it may be necessary to “fight fire with fire” and support a challenger who can be as unscrupulous as the incumbent regime. Think perhaps of the difference between supporting Mahatma Gandhi or Nelson Mandela. Gandhi was obviously a highly principled leader who, had he attained office, would have had the public interest at heart. It turned out that this was also true of Nelson Mandela, but this must have been much less clear in the period before he attained office. In the 1960s Mandela was prepared to be tough, and he played an important role in the formation of Umkhonto we Sizwe, the armed wing of the African National Congress. Who would citizens back, Gandhi or Mandela? A Mandela is attractive because he has a much bigger chance of removing the apartheid state from power, yet when he wins will he be as bad? Gandhi was clearly better than British colonialism, yet he had a much smaller chance of winning. So there is a well-defined trade-off here. In African countries, where there are few checks and balances, it may be relatively attractive for citizens to fight fire with fire. Yet doing this runs the risk of replacing one bad leader with another and not experiencing any improvement in the economic environment.

### **General Lessons**

When citizens decide to fight fire with fire, what can reformers do? The mechanism at work here is different from the one we hypothesized for

Bolivia, where the initial strategy of the incumbent elite influenced the strategy of a new elite. Here, however, it is the citizens who make the most important decisions, and this generates different implications. Again, direct reform of economic institutions is unlikely to be very useful, and this mechanism applies in environments in which political institutions probably place few constraints on the behavior of politicians. Nevertheless, this may be a case in which external intervention to remove bad rulers would imply that citizens no longer need to support unscrupulous opponents to generate change. Potential lessons could therefore be drawn from the recent experience of Sierra Leone, where the strong intervention of British soldiers in 2000 seems to have played an important role in destroying the power of various rebel movements and precipitating the movement of the country back to democracy and some stability. Now it may no longer be necessary for the citizens of Sierra Leone to fight fire with fire, as perhaps they did in 1967 when they put Siaka Stevens in power. The case of Sierra Leone, however, suggests how incomplete our understanding of dysfunctional political equilibria is. In the presidential election in September 2007, the people voted back into power the All People's Congress Party, the political machine built by Stevens that he and the ruling clique used as a basis to rule and loot the country for two decades before the onset of the civil war.

## Successful Reform

In the last section we used our framework to explain why reform is so difficult and why patterns of relative economic performance are so persistent over time. Nevertheless, countries do reform their institutions and move onto different development paths. Obvious examples that come to mind from the post-World War II development experience include Taiwan, China, in the late 1950s; Botswana, the Republic of Korea, and Singapore in the 1960s; and Chile, China, and Mauritius in the 1970s. Important historical episodes of reform have occurred as well. As we noted earlier, Britain underwent an important process of institutional change in the seventeenth century, and again in the nineteenth century when it expanded democratic rights and began to invest more systematically in education. Obviously some of these instances of institutional transition took place under democracy, as in Botswana and Mauritius, and some took place under authoritarian regimes. Some countries, such as Spain, experienced institutional reforms under authoritarianism in the 1960s and democracy in the 1980s.

Earlier in the chapter we described what drove this process of change in Britain. In particular we argued that changes in economic opportunities altered both interests and the balance of de facto power in society, which in turn destabilized the initial absolutist equilibrium. This led to a process of cumulative change in political and economic institutions. This did not end with the Glorious Revolution but extended to the nineteenth-century

Reform Acts and many other subsequent changes in economic institutions. All of these other examples of successful reform can be described within our framework. Let us consider just one example, Botswana.

As is well known, Botswana, a small, partially tropical, landlocked country in sub-Saharan Africa, has had the fastest average rate of economic growth in the world in the last 35 years. What explains Botswana's success? At a proximate level Botswana has been aided by large quantities of diamonds, yet in general natural resources are not associated with successful economic outcomes in Africa. It has also had very good macroeconomic and microeconomic policies and ranks at the same level as Western European countries in terms of indexes of governance and corruption (Parsons and Robinson 2006). The argument of Acemoglu, Johnson, and Robinson (2003) and Parsons and Robinson (2006) is that Botswana's success is precisely because of its economic and political institutions. Botswana benefited immensely from having indigenous political institutions that put constraints on Tswana chiefs and political elites, and in the nineteenth century the Tswana tribes engaged in a quite successful process of defensive modernization that strengthened these institutions. Significantly, these institutions were not undone by the impact of colonialism, which was very marginal in the country. Thus at independence Botswana emerged with political institutions that placed checks and balances on political elites. This was important for the security of property rights and governance, and it is an almost unique phenomenon in Africa. In consequence economic institutions were good. Economic institutions were also good because the Tswana chiefs and elite were heavily invested in the main economic sector, ranching, at independence. Hence, as in Britain after the Glorious Revolution, political elites had a vested interest in economic institutions that were socially desirable. In addition, other historical factors were certainly important, such as the fact that the modern nation of Botswana had a certain coherence that other African nations lacked, though much of the apparent homogeneity of Botswana is actually an outcome of the process of state formation, rather than a prerequisite for it (see Leith 2005).

Botswana did well because its political equilibrium facilitated good economic institutions in a way similar to the situation in late-seventeenth-century Britain. Indeed, we can even understand this in the same way in terms of the interaction of *de jure* political constraints and economic interests. The agenda ahead is to understand better how such an equilibrium can be created elsewhere in Africa.

## Conclusions

We believe that several key conclusions can be drawn from this analysis. The main determinants of cross-country differences in income per capita are differences in economic institutions. Although 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 different distributions of political power. As a result, understanding underdevelopment implies understanding why different countries get stuck in political equilibria that result in bad economic institutions. Solving the problem of development entails understanding what instruments can be used to push a society from a bad to a good political equilibrium.

Unfortunately, this is far beyond what we understand at the moment, and, as yet, we do not have a deep enough comprehension of the forces that lead to good or bad political equilibria. One can note robust patterns in the cross-national data and say a few obvious things. For instance, in the case of Africa, promoting democracy and accountability and checks and balances will almost certainly lead to better economic policies and institutions. Although it is true that developmental authoritarian regimes have held power in East Asia, one has never taken hold in sub-Saharan Africa, so creating one seems a good option from the point of view of neither political freedom nor economic growth. Nevertheless, clear pitfalls lie before those who promote both good economic and political institutions, and we cannot say that improvements in accountability, for instance, will push African countries onto much better growth paths. In this chapter we have focused on these pitfalls and showed that they demonstrate how cautious one must be in promoting reforms. For instance, one cannot necessarily change the political equilibrium by introducing democracy. These pitfalls also illustrate why, for example, so many people in Latin America have been disappointed by the results of the apparent application of the Washington consensus. It is not that these reforms would not be good, other things being equal; it is just that other things are not equal. Reform in one area leads other areas to become unreformed. Our analysis poses challenging problems for those who would wish to solve the problem of development and poverty. Nevertheless, experience strongly suggests that it is difficult to solve these problems, and we believe that the main reasons for this are the forces that we have outlined in this chapter. Better development policy will come only when we recognize this and understand these forces better.

Nevertheless, countries do reform their institutions and move from situations of stagnation to rapid growth. We have argued that this is because of changes in the political equilibrium. It can hardly be denied, for example, that the rapid take-off of growth in China after 1978 was a result of policy and institutional reforms. These were a direct result of the defeat of the “Gang of Four” and a dramatic shift in those who controlled the Communist Party. Growth did not occur because the culture of the Chinese changed, or because some geographical constraint was lifted. Growth also did not occur because previously the Chinese were mistaken about the correct form of policy. They did not suddenly discover

what to do. Rather, growth occurred because the political equilibrium changed in a way that gave more power to those who wanted to push through reforms. Said in this way our analysis is an optimistic one. The institutional approach opens the promise that if we can understand the determinants of political equilibria, then we can design interventions that will make poor societies prosperous.

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