Economic Development: Theory and Policy

Andreas Schäfer

Center of Economic Research at ETH
and
University of Leipzig
– Institute of Theoretical Economics –

SS 15
1. Introduction

2. Nutrition

3. Health

4. Unified Growth Theory and Comparative Development

5. The Role of Institutions for Economic Development

6. Why doesn’t Capital Flow to the Poor and the Effectiveness of Foreign Aid?

7. Charter Cities
5.1 Introduction

5.2 Institutions versus Geography

5.3 Democratization

5.4 Are Good Institutions Cause or Consequence of Economic Development?
5.4 Contents - Are Good Institutions Cause or Consequence of Economic Development?

5.4.1 Introduction
5.4.2 A Three-Class Model
5.4.3 Emergence of Partial Democracy
5.4.4 From Partial to Full Democracy
5.4.5 Repression and the Middle Class
5.4.6 Consolidation and the Middle Class
5.4.1 Introduction

• Percieved development strategies in the world
  1. how to promote growth
  2. how to establish democracy
→ Apparently, it is assumed that growth and democracy interact positively.

• Economic research identified two approaches to confronting this challenges
  1. democracy → constraints on governments and secure property rights
     → investments in human and physical capital
  2. democratization is not necessary since pro-market dictators can secure property rights as a matter of choice and not constraints
⇒ human and physical capital → institutional improvements and growth
5.4.1 Introduction - Institutions → Growth vs. Growth → Institutions

- Importance of constraining governments was stressed by Montesquieu (1748) and Smith (1776) and recently by North (1990), Easterly and Levine (2003), Acemoglu, Johnson, and Robinson (among many others).

- Importance of growth, income and human capital for institutional improvements is associated to Lipset (1960).
  - An educated society is able to resolve their conflicts without violence.
  - Education is needed to operate courts and to engage with government institutions and to control the government.

- Countries differ with respect to their endowments in social and human capital.
  - Differences depend on policies and not on the political system (Korea, Taiwan, China).
  - Institutions depend on these endowments.

- Lipset’s hypothesis that growth leads to institutional improvements received empirical support by Przeworsky et al. (2000).
Important similarities between the two views: need of secure property rights where secure property rights are a public policy choice.

Difference: institutional view sees pro-investment policies as a consequence on political constraints, where development view sees these policies as a choice of initially unconstrained leaders (see North and South Korea).

Glaeser et al. (2004) argue in line with Lipset’s hypothesis:
- Prior to the Korean war, the two countries were poor.
- Between the end of the war and 1980, both countries were dictatorships.
- South Korea started to democratize in the 1980s.
- Growth took off earlier.
- Pro market policies vs communism were a choice of dictators.
5.4.1 Introduction - Institutions → Growth vs. Growth → Institutions

Source: Acemoglu 2009

Source: Glaeser et al. (2004)
In Lipset’s view, the level of economic development and variables related to it (education, urbanization, etc.) drive institutional change, especially creation and consolidation of democracy (*modernization hypothesis*)

Moore (1966) suggested the *critical junctures hypothesis* explaining Britain’s gradual movement to democracy, Germany’s movement to fascism and Russia’s movement to communism

⇒ these different development paths are originated from differences at critical junctures, in this case the end of the medieval world

- in Britain, feudalism collapsed most comprehensively → path of capitalist development
- in Russia, feudal legacy endured → weak middle class and backward agriculture, eventually communist revolution

⇒ Testing the critical junctures hypotheses requires to control for common variables affecting both income and democracy (controlling for fixed effects) → takes out the effect of constant, potentially historical, factors.
5.4.1 Introduction - Critical Junctures Hypothesis

- In Lipset’s view, the level of economic development and variables related to it (education, urbanization, etc.) drive institutional change, especially creation and consolidation of democracy (*modernization hypothesis*).

- Moore (1966) suggested the *critical junctures hypothesis* explaining Britain’s gradual movement to democracy, Germany’s movement to fascism and Russia’s movement to communism ⇒ these different development paths are originated from differences at critical junctures, in this case the end of the medieval world.
  - in Britain, feudalism collapsed most comprehensively → path of capitalist development
  - in Russia, feudal legacy endured → weak middle class and backward agriculture, eventually communist revolution

⇒ Testing the critical junctures hypotheses requires to control for common variables affecting both income and democracy (controlling for fixed effects) → takes out the effect of constant, potentially historical, factors.
5.4.2 Measurement of Institutions

- Existing literature focuses essentially on three sets of variables
  1. International Country Risk Guide → survey indicators of institutional quality
  3. Polity IV data set → measures the limits of executive power

- Limitations
  1. measures rise with income
  2. measures are highly volatile

⇒ inconsistent with permanent or durable feature of the political environment

- in the first two sets, dictators choosing good policies receive high scores