Ch. 6: Institutions as a Fundamental Cause of Long-Run Growth

shows that countries with more secure property rights, i.e., better economic institutions, have higher average incomes.

It is tempting to interpret Figure 1 as depicting a causal relationship (i.e., as establishing that secure property rights cause prosperity). Nevertheless, there are well-known problems with making such an inference. First, there could be reverse causation – perhaps only countries that are sufficiently wealthy can afford to enforce property rights. More importantly, there might be a problem of omitted variable bias. It could be something else, e.g., geography, that explains both why countries are poor and why they have insecure property rights. Thus if omitted factors determine institutions and incomes, we would spuriously infer the existence of a causal relationship between economic institutions and incomes when in fact no such relationship exists. Trying to estimate the relationship between institutions and prosperity using Ordinary Least Squares, as was done by Knack and Keefer (1995) and Barro (1997) could therefore result in biased regression coefficients.

To further illustrate these potential identification problems, suppose that climate, or geography more generally, matters for economic performance. In fact, a simple scatterplot shows a positive association between latitude (the absolute value of distance from the equator) and income per capita. Montesquieu, however, not only claimed that warm climate makes people lazy and thus unproductive, but also unfit to be governed by democracy. He argued that despotism would be the political system in warm climates. Therefore, a potential explanation for the patterns we see in Figure 1 is that there is an omitted factor, geography, which explains both economic institutions and economic performance. Ignoring this potential third factor would lead to mistaken conclusions.
choices, the distribution of political power in society is the key determinant of their evolution. This creates a tendency for 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. However, de facto political power occasionally creates changes in political institutions. While these changes are sometimes discontinuous, for example when an imbalance of power leads to a revolution or the threat of revolution leads to major reforms in political institutions, often they simply influence the way existing political institutions function, for example, whether the rules laid down in a particular constitution are respected as in most functioning democracies, or ignored as in current-day Zimbabwe. Summarizing this discussion, we have:

$$\text{political power}_t \implies \text{political institutions}_{t+1}.$$  

Putting all these pieces together, a schematic (and simplistic) representation of our framework is as follows:

$$\begin{align*}
\text{political institutions}_t &\implies \begin{cases}
\text{de jure political power}_t \\
&\& \text{distribution of resources}_t
\end{cases}
\implies \begin{cases}
\text{economic institutions}_t \\
&\& \text{distribution of resources}_{t+1}
\end{cases}
\implies \begin{cases}
\text{economic performance}_t \\
&\& \text{distribution of resources}_{t+1}
\end{cases}
\end{align*}$$

The two state variables are political institutions and the distribution of resources, and the knowledge of these two variables at time $t$ is sufficient to determine all the other variables in the system. While political institutions determine the distribution of de jure political power in society, the distribution of resources influences the distribution of de facto political power at time $t$. These two sources of political power, in turn, affect the choice of economic institutions and influence the future evolution of political institutions. Economic institutions determine economic outcomes, including the aggregate growth rate of the economy and the distribution of resources at time $t + 1$. Although economic institutions are the essential factor shaping economic outcomes, they are themselves endogenous and determined by political institutions and distribution of resources in society.

There are two sources of persistence in the behavior of the system: first, political institutions are durable, and typically, a sufficiently large change in the distribution of political power is necessary to cause a change in political institutions, such as a transition from dictatorship to democracy. Second, 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. This will tend to reproduce the initial relative wealth disparity in the future. Despite these tendencies for persistence, the framework also emphasizes the potential for change. In particular, “shocks”, including changes in technologies and the international environment, that modify the balance of
institutions on prosperity. Korea was split into two, with the two halves organized in radically different ways, and with geography, culture and many other potential determinants of economic prosperity held fixed. Thus any differences in economic performance can plausibly be attributed to differences in institutions.

Consistent with the hypothesis that it is institutional differences that drive comparative development, since separation, the two Koreas have experienced dramatically diverging paths of economic development (Figure 3).

By the late 1960’s South Korea was transformed into one of the Asian “miracle” economies, experiencing one of the most rapid surges of economic prosperity in history while North Korea stagnated. By 2000 the level of income in South Korea was $16,100 while in North Korea it was only $1,000. By 2000 the South had become a member of the Organization of Economic Cooperation and Development, the rich nations club, while the North had a level of per-capita income about the same as a typical sub-Saharan African country. There is only one plausible explanation for the radically different economic experiences on the two Koreas after 1950: their very different institutions led to divergent economic outcomes. In this context, it is noteworthy that the two Koreas not only shared the same geography, but also the same culture.

It is possible that Kim Il Sung and Communist Party members in the North believed that communist policies would be better for the country and the economy in the late 1940s. However, by the 1980s it was clear that the communist economic policies in the North were not working. The continued efforts of the leadership to cling to these policies and to power can only be explained by those leaders wishing to look after their own interests at the expense of the population at large. Bad institutions are therefore