



Alfonso Palacio-Vera

Associate Professor of Economics
School of Economics & Business
Complutense University of Madrid
Madrid, Spain

e-mail: apv@ccee.ucm.es

ORCID no.: 0000-0002-2459-0901



Chapter 2: Conceptual Foundations of Economic Policy (II)

- Introduction
- The ‘logic’ of collective action and the role of pressure groups
- Ultimate causes of long-run economic growth: institutions, geography, and culture
- A taxonomy of economic institutions
- Barriers to institutional change: The ‘commitment’ problem
- Measuring social welfare: the ‘capabilities’ approach



Introduction (I)

- We argued in chapter 1 that market failures provide a *rationale* for government intervention.
- However, we also argued that the existence of market failures does not imply that public intervention is always desirable.
- The reason is that, even if public intervention is justified from a *technical* viewpoint, policy-makers' behavior may be misguided due to:
 - The activities of powerful pressure groups or lobbies
 - The fact that they may try to maximize their *own* welfare instead of social welfare.



Introduction (II)

- The interests of pressure groups do not usually coincide with the broader interests of society and policy-makers may pursue their own interests rather than *general* interests.
- This problem is compounded by the fact that, as I argue below, relatively small and homogeneous pressure groups may have a *disproportionate* power to influence government decisions due to their ability to overcome ‘collective action problems’.



Introduction (III)

- A fundamental premise of this chapter is that markets do not operate in a *vacuum*. They are always underpinned by a broad range of political and economic institutions which:
 - Help prevent the occurrence of *extremely unstable* outcomes or high degrees of *volatility* (e.g., central banks, macroeconomic policy)
 - Help reconcile efficiency with *economic security* and a *minimum* level of protection for vulnerable social groups (e.g., publicly-provided health care, unemployment insurance).
 - Mitigate the *unequal* distribution of income and wealth generated by markets *via* progressive taxation and the provision of a range of public goods (e.g., education, health care, public pension schemes).



Introduction (IV)

- The institutional framework that prevails in a society may be viewed as an *equilibrium* in the sense that there are no forces which can dislodge it since it captures the political *status quo*.
- Although *institutional change* may, in some circumstances, be socially desirable, powerful social groups may seek to block it off if they think that it will make them worse-off.
- Thus, the initial *distribution* of political power in a society is a crucial determinant of its institutional evolution and economic performance.



The logic of collective action (I)

- It is often assumed that groups of individuals with common interests will attempt to further them, namely, that they will pursue their common interests in the same way as individual actors pursue their own interests.
- This assumption stems from the premise of intentional self-interested behaviour that prevails in mainstream economics.
- However, the idea that social groups act in their self-interest does *not* follow logically from the premise of intentional and self-interested individual behaviour.



The logic of collective action (II)

- In *very small* social groups, there may be voluntary individual action to pursue the common goals of group members.
- That is, in *very small* groups each of the members or, at least one of them, may find that the personal gain from having the collective good *exceeds* the personal cost of providing some amount of it. Olson (1965) denotes these groups as ‘privileged’ groups.
- The reason is that, in a *very small* social group, each member gets a *large* proportion of the total gain because there are few others in the group (e.g., large oligopolistic firms).



The logic of collective action (III)

- Yet even in the smallest group the collective good may *not* be provided on an optimal scale. In most cases, collective action will cease *before* it reaches its optimal level.
- This tendency towards *sub-optimality* is due, first, to the fact that a collective good is like a pure public good (i.e., non-rival and non-excludable): other people in the group *cannot be kept from consuming it* once someone has provided it for herself.
- Since any member gets *only* part (and often a tiny part) of the benefit of any spending she makes to obtain the good, she will discontinue her provision of it *before* the optimal amount for the group has been provided.



The logic of collective action (IV)

- A second reason of the tendency towards suboptimality is that the amounts of the collective good that a member of a group receives ‘for free’ from other group members also reduce their incentive to provide more of that good at their own expense. In other words, they will have an incentive to ‘free-ride’.
- These problems aggravate themselves as the size of the group grows larger.
- In short, *the larger the social group is, the farther it will fall short of providing an optimal amount of a collective good and, hence, the less likely it is that the social group produces even a minimal amount of it.*



The logic of collective action (V)

- A third reason for the failure of large social groups to provide a collective good is that the smallest type of social group we have denoted as ‘privileged’ groups — groups in which one or more group members get such a large proportion of the total collective good that they find it worthwhile to provide it even if they pay for the entire cost — may get along *without* any group agreement or organization.
- However, in any group larger than this no collective good can be obtained *without* some group agreement, coordination, or organization. This problem is compounded by the fact that the larger a group is, the more agreement and organization it will need.



The logic of collective action (VI)

- To make matters even worse, costs of organization tend to be an increasing and, perhaps, even an *exponential* function of the size of the social group.
- These are communication costs among group members, costs of bargaining, and costs of creating, staffing, and maintaining a formal group organization.
- To conclude, the larger a social group is the farther it will fall short of providing an optimal supply of a collective good, and large groups will *not*, in the absence of coercion or selective incentives, provide themselves with minimal amounts of it.



The logic of collective action (VII)

- Can selective incentives *mobilize* members of a social group? *Pecuniary* incentives (e.g., income payments) are not the only ones available; some people may also be motivated by a desire to win prestige, friendship, self-esteem, and other psychological motives.
- Social sanctions and rewards ('stick' *versus* 'carrot') may help mobilize a *latent* social group or group that systematically fails to provide a common good (e.g., ethnic or national minorities in some countries).
- However, *non-pecuniary* incentives work *only* in social groups so small that their members can have 'face-to-face' contact with one another.



The logic of collective action (VIII)

- *Non-pecuniary* selective incentives have little applicability in large groups; the reason is that their efficacy is limited by the high degree of *heterogeneity* of the members of the group.
- In fact, most interactive social groups are *homogenous*. This helps reduce substantially bargaining costs among members since their tastes, preferences, and ideology tend to be similar (e.g., religious organizations).
- The ‘collective action’ problem has been overcome in some large social groups because their managers have successfully used *indoctrination* and *selective recruitment* to increase the degree of homogeneity of the group.



The logic of collective action (IX)

- There is the further problem that *information* and *calculation* about a collective good is *itself* a collective good. Members of a social group may have no incentives to collect information about the best strategy to further the group's interests.
- This type of 'coordination failure' is most evident in the case of the *typical voter* in an election:
 - The gain to a voter from studying issues and candidates is given by the difference in the value (or expected utility) to her of the 'right' (from her perspective) election outcome minus the 'wrong' one *multiplied by the probability that a change in her vote alters the election outcome.*
 - Since the probability that a voter changes the outcome of an election is *negligible* citizens of democratic societies tend to be ignorant about public affairs.



The logic of collective action (X)

- With well-informed and well-educated citizens policy-makers would find it much more difficult to adopt policies that are incompatible with the pursuit of *general* interests.
- It is for this reason that freedom of speech and the existence of independent and diverse media is of crucial importance for the *transparency* of public policy in *democratic* societies.
- In *non-democratic* societies or in societies where social media are highly concentrated, policy-makers can mask the activities of pressure groups as well as their own by manipulating information.



The logic of collective action (XI)

- A *first* implication of the ‘logic’ set out above is that it is in the interest of organized social groups to increase their gains by choosing public policies that, though *inefficient* for society, are advantageous for them because their costs fall disproportionately on the unorganized.
- Except for encompassing social groups, the only way most pressure groups can serve their members’ interests is by securing a *larger share* of society’s output for them. This is shown in Figure 1 below.

Contraction of the 'social pie' due to the actions of a special-interest group

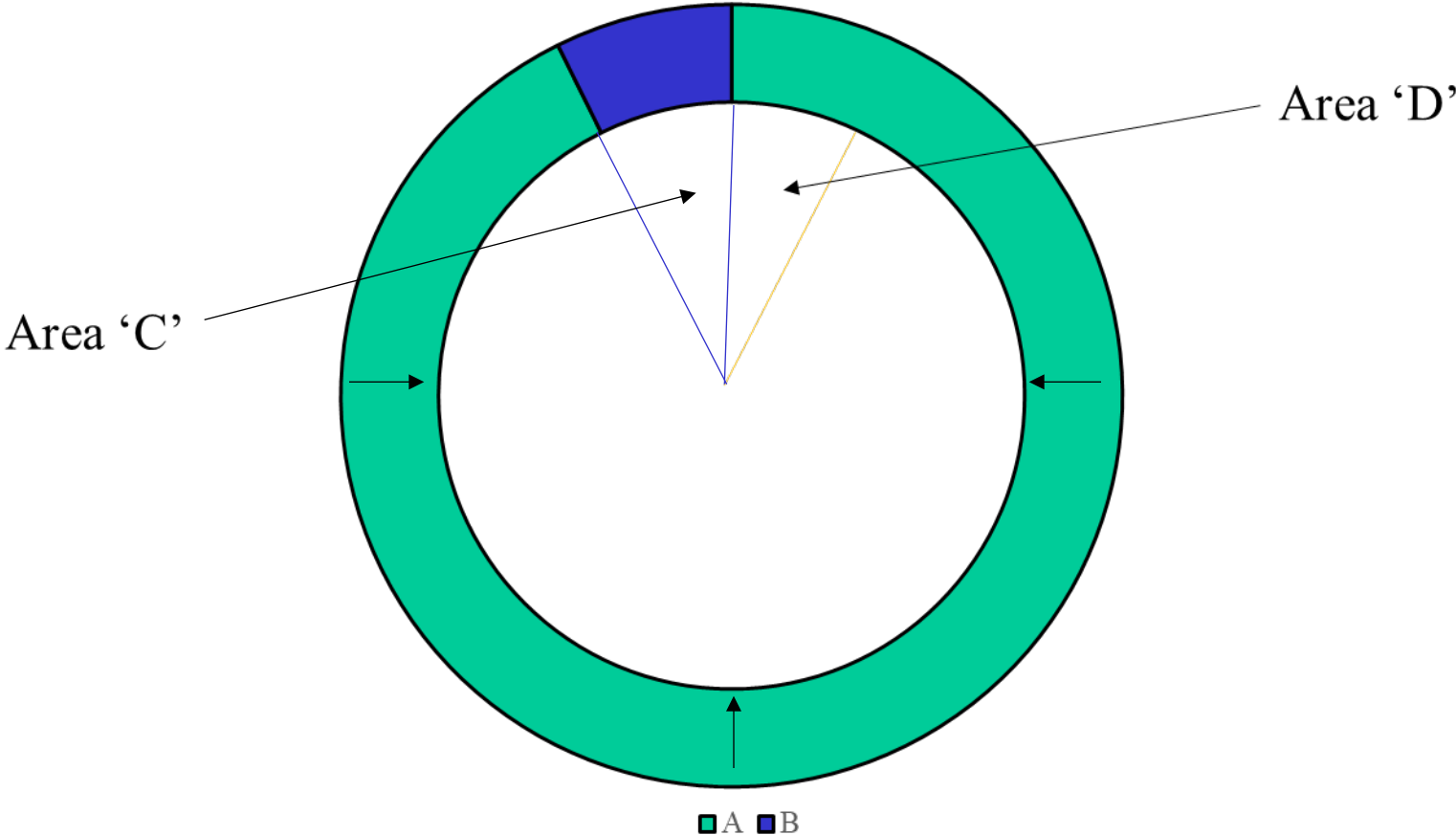


Figure 1

- **Scenario 1:** Contraction of the ‘social pie’ due to the actions of an imaginary special-interest pressure group:
 - $A + B$ + the ‘inner white circle’ denote the size of the ‘social pie’ *before* the lobbying activities of the pressure group.
 - The ‘inner *white* circle’ captures the size of the ‘social pie’ *after* the lobbying activities of the pressure group.
 - $C + B$ represent the *initial* share of the ‘social pie’ that goes to the pressure group.
 - A and B denote the size of the *contraction* of the ‘social pie’ that results from the lobbying activities of the pressure group.
 - B denotes the loss of income to the pressure group in the wake of the *contraction* of the ‘social pie’ brought about by its own lobbying activities.
 - D denotes the increase in the share of the (smaller) ‘social pie’ obtained by the pressure group due to its lobbying activities.



The logic of collective action (XII)

- In Figure 1 above, it pays a small pressure group to lobby the government if, as a result of the adoption of the public policies preferred by the group, *the size of D exceeds significantly the size of B* regardless of the contraction of the size of the ‘social pie’.
- The total cost to society of the actions of the pressure group is equal to the sum of A and B, i.e., the contraction of the ‘social pie’. The former is a consequence of the *negative* impact that the policy package has on society’s productivity.



The logic of collective action (XIII)

- Thus, a social group can serve its members either by making the ‘social pie’ larger so that its members (and all other social groups) get larger *slices* even if they get the same *share* as before or, alternatively, by getting a *larger* share of the ‘social pie’ for itself at the expense of other social groups.
- However, the first method will *rarely* be chosen because:
 - It will normally cost an organization something to make the society of which it is part more efficient. A campaign to attain such goal would have significant costs that the organization would have to bear.
 - But, crucially, the members of the organization would get *only* a small part of the benefits that would result if they made their society more ‘efficient’.



The logic of collective action (XIV)

- Hence, there is a *parallel* between the position of an individual *vis-à-vis* the social group it belongs to, and the position of a small social group *vis-à-vis* the society it is a part of:
 - The group that benefits society provides a collective good and, hence, is in the same position as an individual who contributes to the provision of a collective good for a group of which she is a part.
 - In each case the actor (individual or collective) gets *only* a tiny part of the benefits of their action, yet they bear the whole cost of it.
- Finally, if a social group seeks to obtain a *larger share* of the ‘social pie’, the resources devoted to it will not produce the same output they produced in their previous employment, and the ‘social pie’ will tend to contract.



The logic of collective action (XV)

- To conclude, the typical organization for collective action will, at least if it represents a narrow section of society, have little or no incentive at all to make any significant sacrifices in the interest of society; it will best serve its members' interests by seizing a *larger share* of society's output for them as shown in Figure 1 above.



The logic of collective action (XVI)

- A *second* implication is that there may be some organizations which *encompass* a large proportion of the society of which they are a part (e.g., a large workers' union) which may have an interest in making society more efficient.
- The incentives facing an *encompassing* organization or social group are dramatically different from those facing any social group that represents only a narrow segment of society.
- The former may well have an incentive to make society more prosperous, to redistribute income to their own members with as little burden as possible to the rest of society, and to cease it unless the amount redistributed is substantial in relation to its social cost.

Expansion of the 'social pie' due to the activities of an encompassing social group

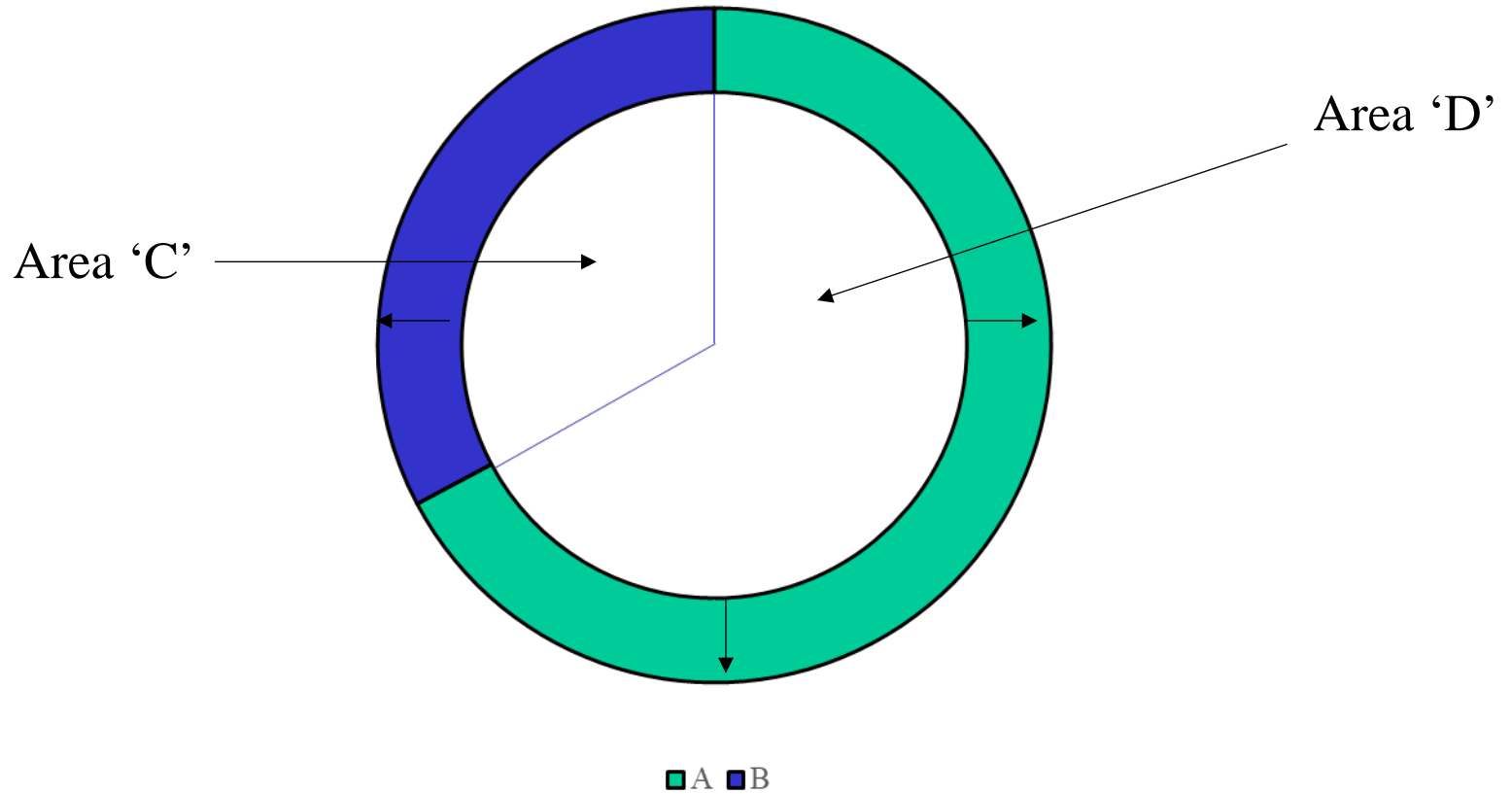


Figure 2

- **Figure 2:** Expansion of the ‘social pie’ due to the actions of an encompassing social group
 - $C + D$ (i.e., the inner white circle) denote the size of the ‘social pie’ *before* the lobbying activities of the group.
 - C denotes the initial size of the ‘social pie’ obtained by the group.
 - $A + B$ denote the *expansion* of the ‘social pie’ brought about by the lobbying activities of the group.
 - B denotes the increase in the size of the (larger) ‘social pie’ obtained by the group as a result of its lobbying activities.



The logic of collective action (XVII)

- This idea is shown in Figure 2 above. Olson (1965) explains the good growth performance of Sweden and Norway *vis-à-vis* the UK and the USA in the decades following WWII by the fact that many organizations in the former two countries were *encompassing* compared to those in the USA and UK.
- Olson's 'logic of collective action' leads to the prediction that those societies where *encompassing* social groups predominate exhibit better economic performance in the long run than those societies where dominant social organizations only represent a narrow segment of society.



The logic of collective action (XVIII)

- To conclude, Olson's theory of collective action suggests that the structure of typical pressure groups in a society affects the *distribution* of income and the structure of incentives and this, in turn, determines long-run economic performance.
- Hereafter, when we refer to social groups, we mean only those groups which have overcome the 'collective action problem' we have discussed above.

Olson, M. (1965) *The Logic of Collective Action: Public Goods and the Theory of Groups*, New York: Schocken Books.

Olson, M. (1985) *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, London: Yale University Press.

- **Questions for self-evaluation:**

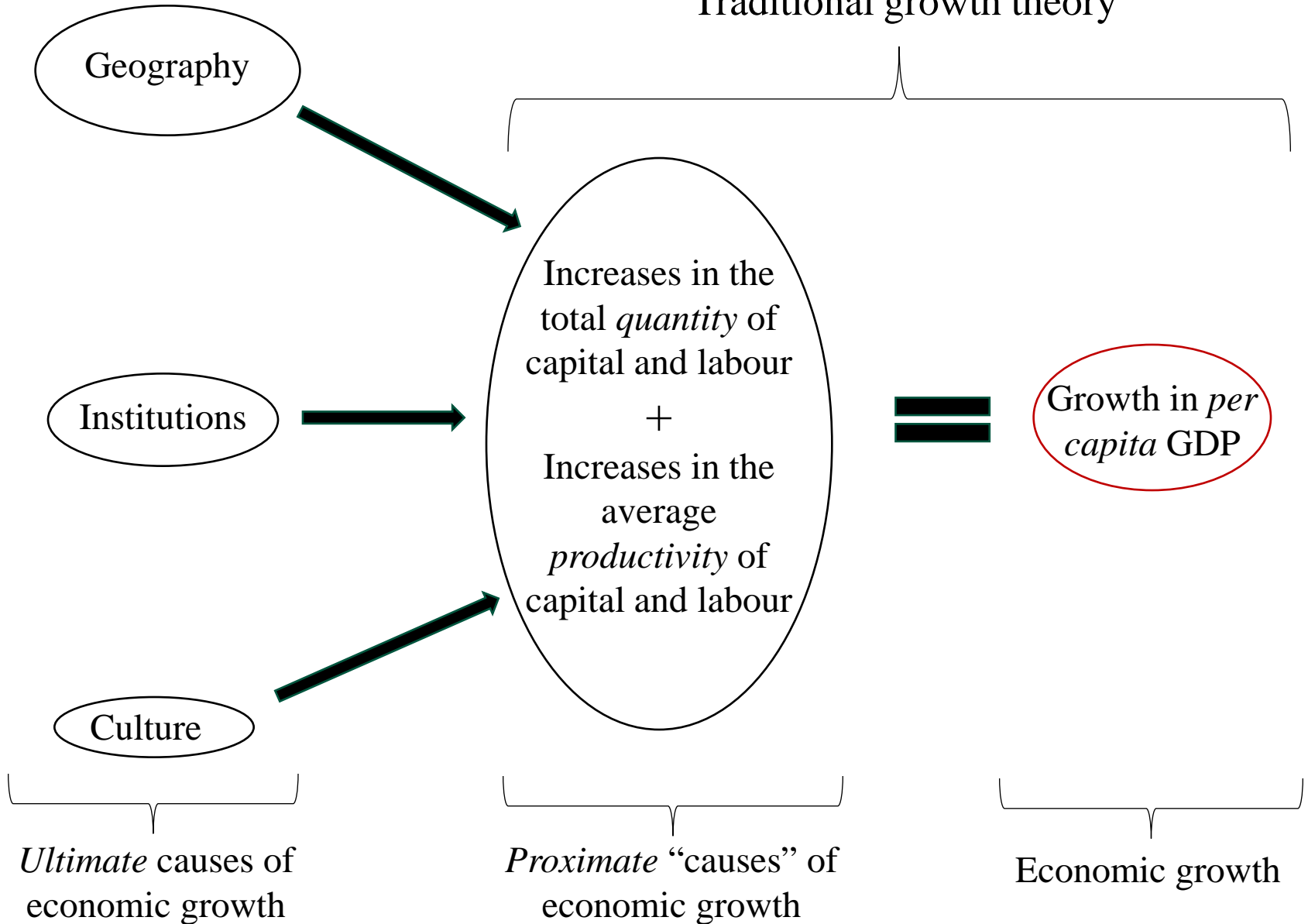
- 1) Why does the likelihood that even a minimum amount of a collective good is provided *decreases* as the size of a social group grows larger?
- 2) Can selective incentives help to mobilize the members of a *latent* social group? Why?
- 3) Why is *information* and *calculation* about a collective good *itself* a type of collective good? Can you provide an example?
- 4) What is the likely impact of the activities of small pressure groups on long-term economic growth? Why?
- 5) How are the lobbying activities of an *encompassing* social group likely to affect long-term economic growth?



Ultimate causes of economic growth (I)

- Standard economic growth models explain economic growth as the result of (i) the accumulation of factors of production like capital and labour, and (ii) increases in their productivity.
- However, production factor accumulation and increases in their productivity are only *proximate* causes of economic growth. In a sense, to say that economic growth is caused by these factors is *tautological* because these factors *are* economic growth.
- What types of explanations are *ultimate* or *fundamental* ones? *Ultimate* or *fundamental* causes of economic growth are those which can explain why production factor accumulation or the rate of increase of their productivity has been *higher* in some economies than in others over long periods of time.

Traditional growth theory





Ultimate causes of economic growth (II)

- What types of explanations would constitute *fundamental* ones? As we explain below, there are *three* broad families of ultimate explanations of comparative economic growth:
 - 1) Institutions:
 - The notion that differences in economic institutions are the fundamental cause of different patterns of economic growth is based on the idea that *it is the way people organize their societies that determines whether or not they prosper*.
 - Some ways of organizing societies encourage people to innovate, to take risks, to invest, to find better ways of doing things, to learn, to educate themselves, to solve problems of collective action, etc. Others do not.
 - The idea that the prosperity of a society depends on its institutions goes back to *Adam Smith* and, more recently, it has received a lot of attention.



Ultimate causes of economic growth (III)

- 2) Geography: There are at least *four* versions of the geography hypothesis each emphasizing a different factor for how geography may affect prosperity:
 - Diamond (2006) shows the crucial importance of the existence of local varieties of seeds and mammals that could be domesticated about 13,000 years ago and of *geographical* barriers. He answers the question: Why did Europeans colonize the rest of the World instead of people in other continents (i.e. Native Americans, Africans, Asians, Australasians, etc.) colonize Europe?
 - Climate may also be a determinant of work effort, incentives, and productivity. This idea dates back to French philosopher, Montesquieu (1748).
 - Lack of rivers and access to the sea may deter commerce and may also preclude the acquisition of skills and technology over time (e.g., Bolivia and Paraguay haven't access to the sea and are the poorest countries in South America).
 - Another version links poverty in some parts of the world to their *disease burden*. For example, Bloom and Sachs (1998) claim that the prevalence of malaria in sub-Saharan Africa reduces its annual growth rate by more than 1.3% a year.



Ultimate causes of economic growth (IV)

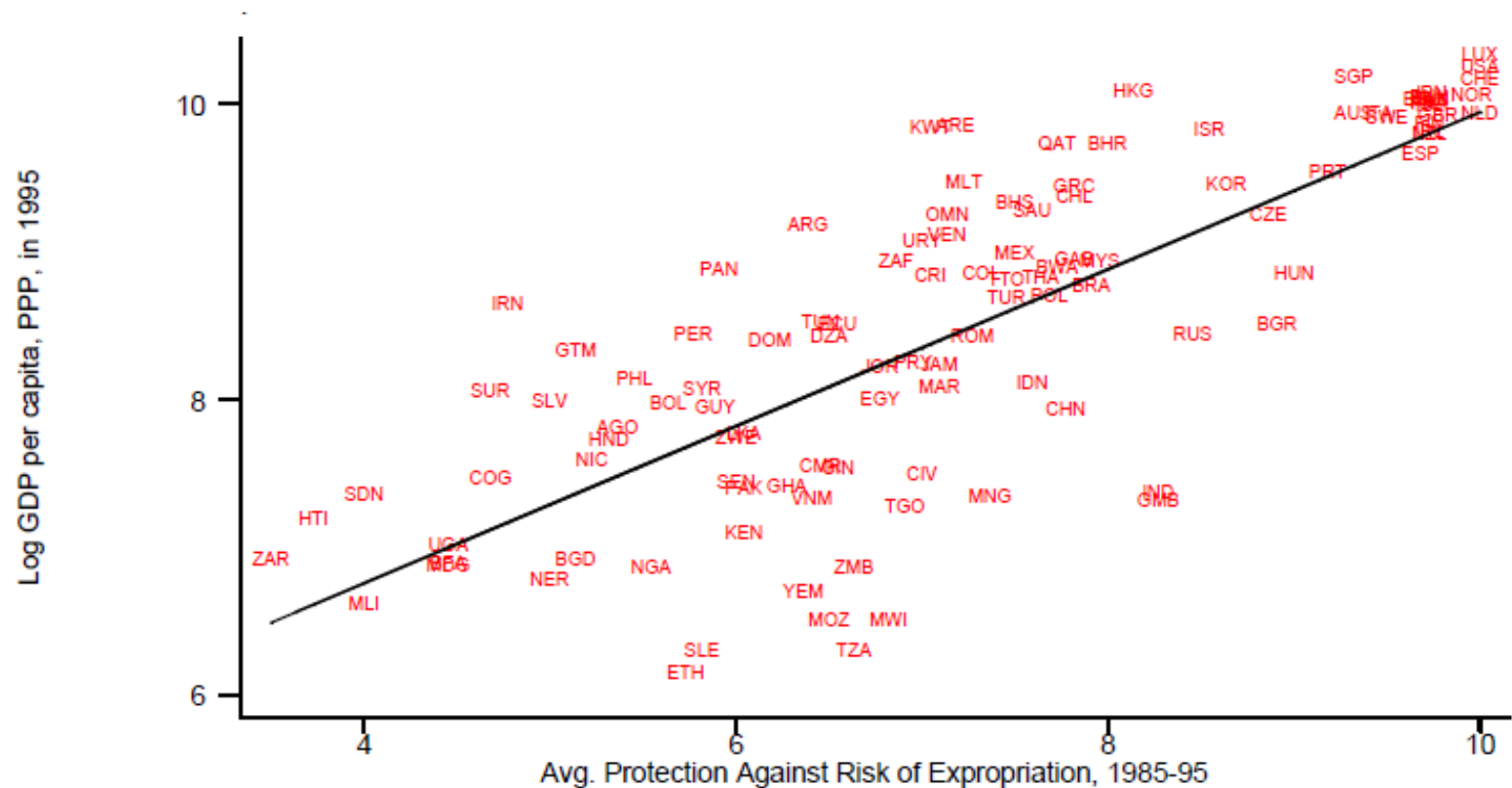
- 3) Culture: Cultural differences are viewed as a key determinant of the values, preferences, and beliefs that prevail in different societies which may substantially affect economic performance:
 - Landes (1998, 2006) argues that the origins of Western economic dominance are due to a particular set of *beliefs* about the world and how it can be transformed by human endeavour which is linked, in turn, to *religious* differences. He links the technological backwardness of China *vis-à-vis* Western powers since the 16th century to the influence of ‘Confucianism’ and its disdain for scientific research. Kuran (2004) stresses the negative impact of ‘Quranic Law’ on the economic institutions adopted in Islamic countries since the late Middle Ages.
 - Some economists show that cultural differences associated to factors like trust, moral, and social norms regarding social cooperation, work ethics, and work effort may also affect long-run economic growth through their impact on *transaction costs*, individual *sacrifice*, and *risk-taking* (Guiso, Sapienza, and Zingales, 2006).



Ultimate causes of economic growth (V)

- According to Acemoglu *et al.* (2004), there is empirical support for the hypothesis that differences in economic institutions and not differences in geography or culture cause differences in per-capita income over time.
- Figure 1 shows the cross-country bivariate relationship between the log of GDP per capita in 1995 and a measure of the degree of protection property rights, ‘protection against expropriation risk’, averaged over the period 1985 to 1995.
- The data on economic institutions assesses the risk that investments will be expropriated in different countries.

Figure 1
 Average Protection Against Risk of Expropriation 1985-95
 and log GDP per capita 1995





Ultimate causes of economic growth (VI)

- The scatter plot shows that countries with more secure property rights (i.e., better economic institutions) have higher income per capita on average.
- We could be tempted to interpret Figure 1 as depicting a *causal* relationship, namely, as implying that secure property rights do *cause* prosperity. However, there are well-known problems with making such an inference:
 - There could be *reverse causality*; perhaps only those countries that were sufficiently wealthy have enforced property rights better over time.
 - There may be another factor (e.g. geography, culture) that *simultaneously* affects prosperity and property rights (or institutional quality) and which may explain (i) why some countries are poor, and (ii) why the former also tend to have insecure property rights.

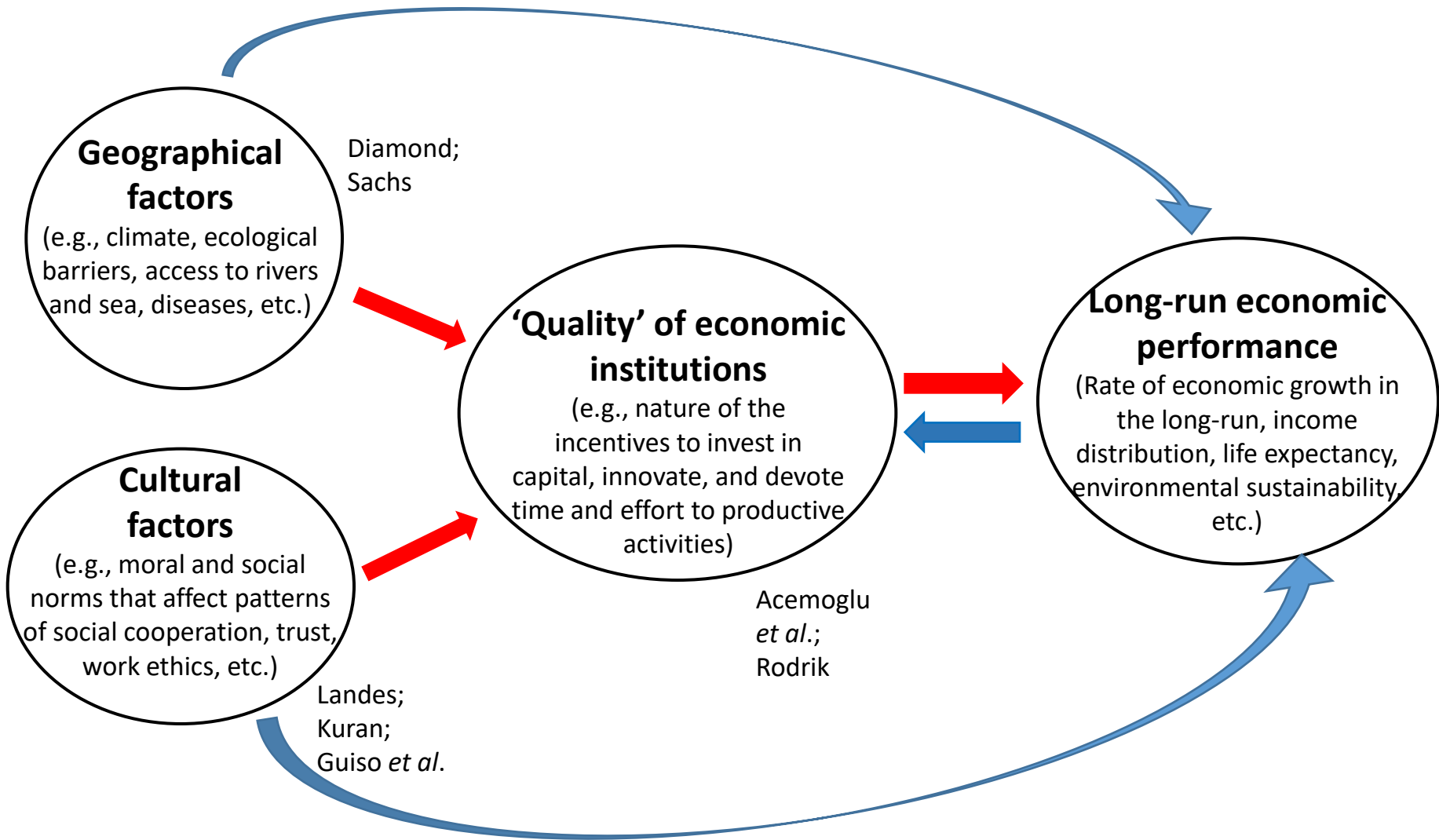


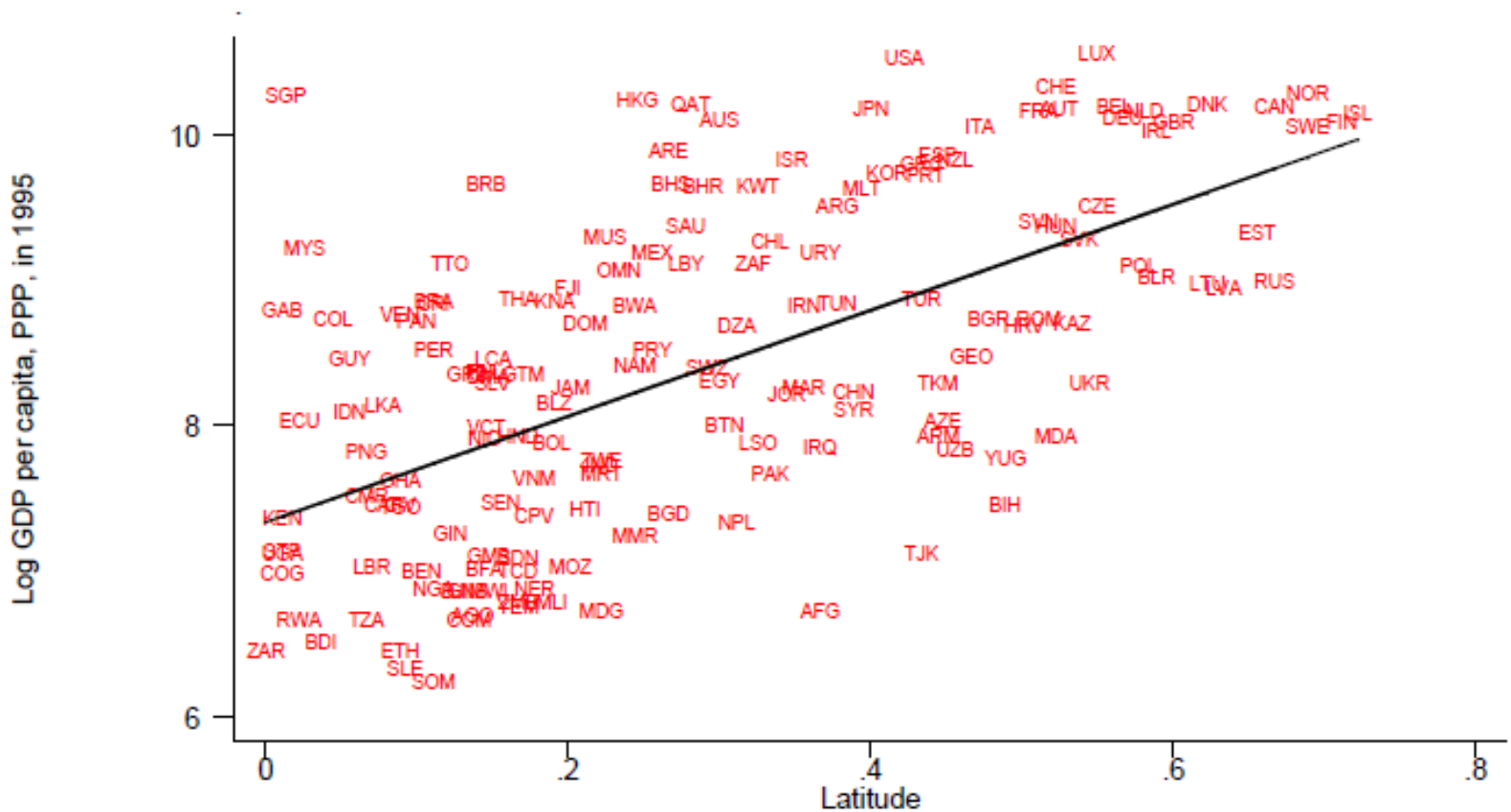
Figure 3



Ultimate causes of economic growth (VII)

- Let's assume that climate, or geography more generally, matters for economic performance. In fact, a simple scatter plot (Figure 2) shows a strong and positive correlation between *latitude* (the absolute value of distance from the equator) and per capita GDP.
- Thus, a potential explanation for the patterns we see in Figure 1 is that there is an *omitted* factor (i.e., geography) which explains *both* economic institutions and economic performance.
- The key point is that the relationships in Figures 1 and 2 are not necessarily *causal*; they may be *spurious*. In the social sciences correlation doesn't necessarily imply causality. The existence of a *causal* relationship or mechanism needs to be explained.

Figure 2
Latitude and log GDP per capita 1995





Ultimate causes of economic growth (VIII)

- The Korean experiment: After WWII the Korean peninsula was divided into two different countries. The Republic of Korea was proclaimed to the south of the 38th parallel whereas the North became the Democratic People's Republic of Korea.
- These two independent countries organized themselves in very different ways and adopted completely different sets of institutions:
 - The North followed both the model of Soviet socialism and the Chinese Revolution in abolishing private property of land and capital. Economic decisions were not mediated by markets, but by the communist state.
 - The South maintained a system of private property and the government, especially after 1961, attempted to use markets and private incentives to develop the economy.

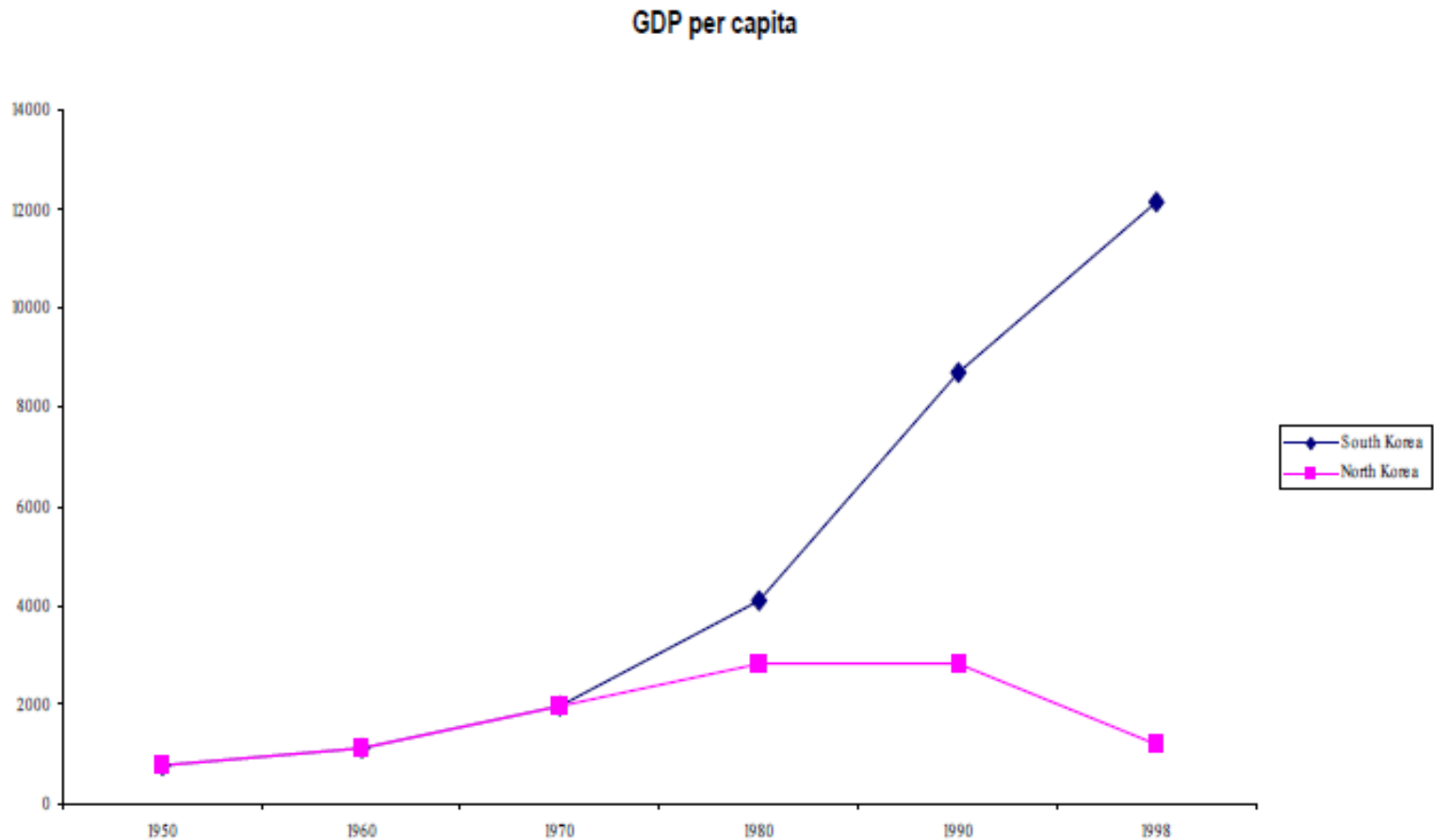


Ultimate causes of economic growth (IX)

- Before this ‘natural experiment’ North and South Korea shared the same history and cultural roots. In fact, Korea exhibited an unparalleled degree of ethnic, linguistic, cultural, geographic and economic homogeneity.
- Thus, we can think of the splitting of the Koreas about 75 years ago as a ‘natural experiment’ we can use to identify the *causal* influence of institutions on prosperity.
- Korea was thus split into two, with the two halves organized in radically different ways, with geography, culture and other potential determinants of economic prosperity held fixed.

Figure 3

GDP per capita in North and South Korea, 1950-98





Ultimate causes of economic growth (X)

- Consistent with the hypothesis that it is *institutional* differences that drive comparative development Figure 3 shows that, since separation, the two Koreas have experienced radically different patterns of economic development.
- 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 whereas North Korea stagnated. By 2000 the level of *per capita* GDP in South Korea was \$16,100 while in North Korea it was only \$1,000.
- Hence, there is *only* one plausible explanation for the radically different experiences of the two countries after 1950: their very different institutions led to *divergent* economic outcomes.



Ultimate causes of economic growth (XI)

- The ‘Colonial Experiment’: The colonization of much of the world by Europeans provides a large scale ‘natural’ experiment. Beginning in the early 15th century and massively intensifying after 1492, Europeans conquered many other nations.
- European colonization transformed the institutions in many diverse lands insofar as Europeans imposed different institutions in different parts of their empire.
- While geography was held constant, Europeans initiated large changes in economic institutions, and in the social organization of different societies. Acemoglu *et al.* (2004) claim that this experience provides evidence that conclusively establishes the key role of economic institutions in development.



Ultimate causes of economic growth (XII)

- The impact of European colonialism on economic institutions is perhaps most dramatically conveyed by a single fact – historical evidence shows that there was a remarkable *Reversal of Fortune* in economic prosperity within former European colonies.
- Societies like the Mughals in India or the Aztecs and the Incas in America were among the richest civilizations in 1500, yet the nation states that now coincide broadly with the boundaries of these empires are among the poorer societies of today.
- In contrast, countries occupying the territories of the less-developed civilizations in North America, New Zealand and Australia are now much richer than those in the lands of the Mughals, Aztecs and Incas.



Ultimate causes of economic growth (XIII)

- Acemoglu *et al.*, show that densely settled and highly urbanized colonies paradoxically ended up with worse ('extractive') institutions, while sparsely settled and non-urbanized areas received an influx of European migrants and developed institutions that protected the property rights of a broad cross-section of society.
- Colonialism led to an *institutional reversal* in the sense that the previously richer and more-densely settled places ended up paradoxically with worse institutions.



Ultimate causes of economic growth (XIV)

- Why did Europeans introduce better institutions in previously-poor and unsettled areas than in previously-rich and densely-settled areas?
- Europeans were more likely to introduce economic institutions facilitating the *extraction* of local resources in areas where they would benefit from the extraction of economic resources (e.g., precious metals, valuable agricultural commodities, and slave labour).
- In regions with a large indigenous population (e.g. Sub-Saharan Africa, South-East Asia), Europeans could exploit people *via* taxes, tributes, or forced labour in mines and plantations.



Ultimate causes of economic growth (XV)

- Crucially, this type of colonization was *incompatible* with institutions that provide economic or civil rights to the majority of the population. Thus, a more developed civilization and a denser population made it more profitable for Europeans to introduce *worse* economic institutions.
- In contrast, in places with scarce or no resources to extract and in sparsely-settled places where Europeans became the majority of the population, it was in their interest to introduce economic institutions *protecting their own property rights*.



Ultimate causes of economic growth (XVI)

- In addition, the *disease environments* differed markedly among the colonies, with obvious consequences upon the attractiveness of European settlement.
- When Europeans settled in other Continents, they tended to create institutions that they themselves had to live under. Thus, whether Europeans could settle or not had an *exogenous* effect on the subsequent path of institutional development.
- If the disease environment 200 or more years ago does affect outcomes today only through its effect on current institutions, we can use the historical disease environment as an exogenous source of variation in current institutions.



Ultimate causes of economic growth (XVII)

- Acemoglu et al. argue that one important reason why there is a strong correlation between geographical variables like latitude and per-capita GDP is that *Europeans did not have immunity to tropical diseases during the colonial period* and, thus, ‘settler colonies’ tended other things equal to be created in temperate latitudes.
- Without considering the role of economic institutions it is easy to find a *spurious* relationship between latitude and income per-capita. However, once economic institutions are controlled for, these relationships go away.



Ultimate causes of economic growth (XVIII)

- How about the impact of culture? Europeans not only brought with them new institutions; they also brought with them their cultures. There are *three* main ways to test this idea.
 - Culture may be related to the national identity of the colonizing power. For example, the British may have implanted a ‘good’ Anglo-Saxon culture into colonies such as Australia or the USA while the Spanish may have condemned Latin America by endowing it with a Hispanic or Iberian culture.
 - Europeans may have had a culture (e.g. a work ethics or a set of beliefs) that was uniquely propitious to prosperity (Landes, 1998).
 - Last, Europeans brought different religions with different implications for prosperity. Such a hypothesis could explain why Latin America is relatively poor since its citizens are primarily Roman Catholic, while North America is rich because its citizens are mostly Protestant.



Ultimate causes of economic growth (XIX)

- However, according to Acemoglu *et. al.* (2001) the evidence is *inconsistent* with these views. Once we control for the effects of institutions, neither the identity of the colonial power, nor the contemporary fraction of Europeans in the population, nor the proportions of the populations of various religions, are significant determinants of income per capita.
- These results are supported by historical examples:
 - In the 17th century the Dutch had perhaps the best domestic institutions in the world yet the colonies they created in South-East Asia ended up with institutions designed for the *extraction of resources* thus providing little economic or civil rights to the indigenous population.
 - The British in no way re-created British institutions in their colonies.



Ultimate causes of economic growth (XX)

- Acemoglu *et al.* conclude that differences in economic institutions have been the main determinant of differences in long-run economic performance.
- That said, Acemoglu *et al.*, only consider those differences in long-run economic growth that can be documented for the last five centuries. By contrast, other scholars (e.g., Diamond, 2006) argue that the main cause of differences in long-term economic growth are *geographical* and *ecological* differences across regions about 13,000 years ago.
- Likewise, cultural differences may have also been a significant factor in certain cases (e.g., China, Japan, Islamic World, etc.).

- **Questions for self-evaluation:**

- 1) What are the differences between the *proximate* and *ultimate* causes of economic growth? Can you provide examples?
- 2) Is the strong *positive* correlation we observe between latitude and per capita income based on a causal relationship?
- 3) Why was there a significant ‘Reversal of Fortune’ in prosperity among former European colonies starting in the late 15th century?
- 4) Can cultural differences explain the ‘Reversal of Fortune’ documented by Acemoglu et al. (2001)? Why?



A taxonomy of economic institutions (I)

- According to North (1994, 360), ‘institutions are the humanly devised constraints that structure human interaction’. They are made up of:
 - Formal constraints (e.g., rules, laws, constitutions), and
 - Informal constraints (e.g., social norms, conventions, codes of conduct), and their enforcement characteristics.
- When put together, both types of constraints define the *structure of incentives* of societies and economies.
- We think of *good* economic institutions as those which provide (i) security of property rights, and (ii) relatively equal access to economic resources for a broad cross-section of society.



A taxonomy of economic institutions (II)

- According to North (1994), it is the interaction between institutions and organizations that shapes the institutional *evolution* of economies. If social institutions are the ‘rules of the game’ then organizations and their members are the *players*.
- Organizations consist of groups of individuals who are bounded together by some common purpose to achieve certain goals.
- Organizations include: political bodies (e.g., political parties, Parliaments, City councils, regulatory bodies), economic bodies (e.g., corporations, unions) social bodies (e.g., churches, clubs, recreational associations), educational bodies (e.g., universities, schools), and pressure groups.



A taxonomy of economic institutions (III)

- Why have economies evolved a variety of economic institutions? Rodrik (2007) argues that markets cannot work without strong economic institutions because the former are not self-creating, nor self-regulating, nor self-stabilizing, and nor self-legitimizing.
- There are *five* types of institutions that respond to each of these failures: property rights, regulatory institutions, institutions that contribute to macroeconomic stabilization, institutions for social insurance and conflict management.
- Economic institutions are built on political institutions. There is a *hierarchy* of institutions. Political institutions come first.



A taxonomy of economic institutions (IV)

- First, the establishment of secure and stable property rights has been a central element in the rise of the West and the onset of modern economic growth since the later Middle Ages (Landes, 1998).
- Entrepreneurs will not have the incentive to either accumulate or innovate unless they have full control over the returns to the assets that are thereby produced or improved.
- Second, regulatory institutions are necessary because markets fail when market participants engage in either fraudulent or anti-competitive behavior, damage the environment, or abuse certain types of individuals.



A taxonomy of economic institutions (V)

- Markets may also fail if the presence of *asymmetric* information results in suboptimal social outcomes.
- *Asymmetric* information is pervasive in the health care industry, where (private) health providers can take advantage of patients' ignorance and engage in fraudulent behavior.
- *Asymmetric* information is also pervasive in financial markets. In the case of banks, the source of the problem is 'moral hazard' or the notion that, if banks know that they will be 'bailed out' in case they suffer large capital losses, they will have an incentive to adopt riskier investment strategies.



A taxonomy of economic institutions (VI)

- But if governments let large banks go bankrupt this may trigger off a banking crisis owing to *contagion* effects in the financial sector. It is for this reason that most economies as well as banks themselves regulate banking by establishing a range of capital quality requirements (e.g., Basel III).
- *Discrimination* against certain social groups may be aggravated in the marketplace:
 - Women's pay is typically *lower* than men's pay for similar jobs.
 - Sexual orientation can be a source of professional discrimination.
 - Some ethnic and religious minorities may be negatively discriminated in the labor market (e.g., Northern Ireland).



A taxonomy of economic institutions (VII)

- Third, since Keynes we have come to a better understanding of the reality that capitalist economies are not self-stabilizing. All advanced market economies have come to acquire monetary and fiscal institutions that perform *stabilizing* functions.
- Two critical economic institutions are the ‘lender-of-last-resort’ function of central banks and bank deposit insurance.
- Since the 1940s demand management *via* counter-cyclical fiscal and monetary policy, and automatic fiscal stabilizers contributed dramatically to:
 - A reduction in aggregate output and employment volatility, and
 - Preventing the occurrence of another Great Depression.



A taxonomy of economic institutions (VIII)

- Fourth, a modern economy is one where *change* is constant and ‘idiosyncratic risk’ (i.e., individual-specific) to employment and income is pervasive.
- In the US it was the Great Depression that paved the way for the ‘New Deal’ institutional package that brought about major institutional innovations: social security system (SS), unemployment insurance, public works and ownership, bank deposit insurance, and legislation favoring labor unions and minimum wages.
- Notably, SS may help *legitimize* a market economy by making it compatible with social cohesion (by reducing individual-specific risks) and helping to mitigate social and political conflicts.



A taxonomy of economic institutions (IX)

- Fifth, societies differ in their composition. Some are made up of an ethnically and linguistically homogeneous population marked by a relatively egalitarian distribution of resources (e.g. Sweden, Norway, or Finland). Others are characterized by deep cleavages along ethnic, linguistic, or religious lines.
- Social conflict is *harmful* to economic growth since:
 - It diverts resources away from productive activities
 - It discourages investment by generating non-measurable uncertainty
 - It may even lead to the loss of physical and human capital and destruction of public infrastructure due to social unrest (e.g., riots) and civil wars.



A taxonomy of economic institutions (X)

- Thus, healthy societies have evolved a wide range of institutions that make such conflicts less likely and less severe by setting up mechanisms that allow social and political actors to resolve conflicts in non-violent ways (e.g., majority-voting systems).
- The rule of law, democratic political institutions, an independent judiciary, free elections, unions, institutionalized representation of minority groups, and social insurance are some examples of such institutions.



A taxonomy of economic institutions (XI)

- These arrangements function as institutions of ‘conflict management’ because they entail a double ‘commitment technology’:
 - They warn potential ‘gainers’ of social conflict that their economic gains will be limited, and
 - They reassure potential ‘losers’ that they won’t be expropriated or abused (e.g., human and civil rights including the rights of minority groups are protected in Constitutions).
- Thus, they increase the incentives of social groups to *cooperate* by reducing the payoff to socially uncooperative strategies.

- **Questions for self-evaluation:**

- 1) Can markets deliver themselves good economic performance in the form of long-run economic growth, macroeconomic stability and a fair income distribution? Why?
- 2) How important is the protection of *property rights* in a market economy? Why?
- 3) Why are economic institutions such as central banks and counter-cyclical fiscal and monetary policy necessary in market economies?
- 4) Why is ‘idiosyncratic risk’ (i.e., individual-specific) to employment and income pervasive in market economies?
- 5) Why do social and political conflicts damage economic growth?



The commitment problem (I)

- Institutions are *endogenous*; they are chosen by society. Thus, the question why some societies are (much) poorer than others is, according to Acemoglu *et al.*, closely related to the question why some societies' economic institutions are worse than others.
- There is no guarantee that all individuals and social groups will prefer the same set of economic institutions because different institutions imply different patterns in the *distribution* of wealth and income.
- Thus, there is often a *conflict of interest* among social groups.



The commitment problem (II)

- How are *equilibrium* economic institutions determined? If there are, for instance, two groups with opposing preferences over the set of economic institutions to adopt, which group's preferences will prevail?
- According to Acemoglu *et al.*, the outcome will depend on their *political power*. While the relative efficiency of a set of economic institutions may play a role in this choice whichever group has *more* political power is likely to secure or impose the set of institutions that it prefers (e.g., large corporations *versus* unions in the US).



The commitment problem (III)

- Consequently, powerful groups will choose those institutions that *maximize their own rents*, so the resulting institutions are unlikely to be those that maximize the size of the ‘social pie’.
- Institutional change normally makes some groups worse-off. If institutional change increases the size of the ‘social pie’ would-be gainers could, in principle, duly compensate would-be losers. However, if compensation does not come about would-be losers will seek to block off institutional change.
- Thus, equilibrium institutions *will not tend to maximize the size of the ‘social pie’ but the share of it taken by powerful groups.*



The commitment problem (IV)

- Why don't societies replace bad institutions by good ones?
- Let's consider a situation where society can be governed either as a dictatorship or as a democracy. Suppose a dictator is not willing to relinquish his power but promises that he will obey the rules of democracy so that individuals can undertake the same investments as they would in democracy.
- This promise is unlikely to be *credible*. As long as the political system remains a dictatorship *there is no higher authority that can make the dictator stick to his promise*. He has the monopoly of military, judicial and political power and, thus, is the ultimate arbiter of conflicting interests.



The commitment problem (V)

- A similar problem will plague the *reverse* situation whereby the dictator agrees to a voluntary transition to democracy *in return for future transfers* of income or wealth to compensate him for the lost income and privileges.
- Those who would benefit from a transition to democracy may be willing to promise him a future compensation but, once the dictator has relinquished his power, there is no *guarantee* that citizens will be willing to tax themselves to make payments or transfers to him. In short, promises of compensation to former dictators *are simply not credible*.



The commitment problem (VI)

- Why don't the social groups with conflicting interests agree on a set of economic institutions that *maximizes* the size of the 'social pie' and then use their respective political power to compensate those social groups that will be worse-off?
- This rarely occurs because there are insurmountable *commitment* problems: would-be gainers cannot *credibly commit themselves* to compensate would-be losers in the future. This is shown in Figure 4 below.

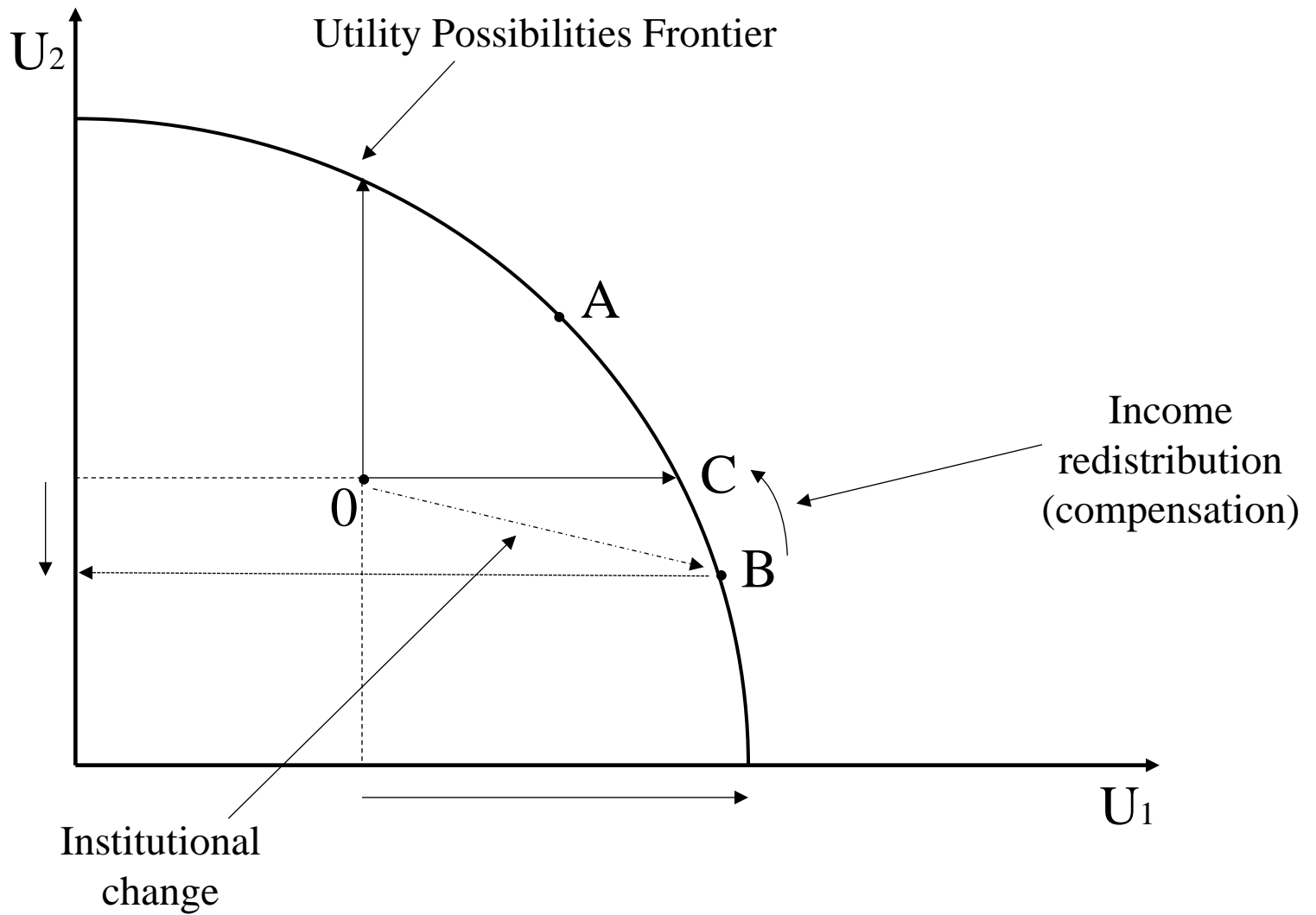


Figure 4



The commitment problem (VII)

- In Figure 4 we assume there are two groups whose respective welfare is measured along the axes. We also assume there is an *institutional innovation* that takes the economy from 0 to B on the ‘utility possibilities frontier’ (UPF) and leads to an increase in the size of the ‘social pie’.
- In the wake of institutional change group 1 is better-off whereas group 2 is worse-off. However, group 1 could hypothetically compensate group 2 by means of a *redistribution of income* so that point C (where group 2 is not worse-off) can be attained.
- Yet there is no guarantee that, once point B is reached, group 1 will be willing to compensate group 2.



The commitment problem (VIII)

- In the example above, the inability of group 1 to *commit* to how political power will be used after institutional change has taken place, coupled to its *irreversibility* means that the impact of a new set of institutions on efficiency, namely, on the size of the ‘social pie’ cannot be *separated* from their effects on income or wealth distribution.
- An ‘impartial enforcer’ could, in principle, help overcome the problem above. However, in most institutional choices there is no *impartial* third party who can be entrusted with the enforcement of social contracts by the parties involved. This is known as the *commitment problem*.



The commitment problem (IX)

- Hence, the essence of the problem is *commitment*. Neither party can commit to compensate the other nor can they commit to taking actions that would not be in their mutual interest *ex post*.
- This problem creates an *inseparability* between distribution and efficiency because credible compensating transfers of income or wealth *cannot* be made to offset the distributional implications of a particular set of economic institutions.
- If compensation to would-be losers were enforceable then the opposing groups could implant the institutions that *maximize* the size of the ‘social pie’ and then compensate the former.

- **Questions for self-evaluation:**

- 1) Why is there a *conflict of interest* among different social groups as to the type of economic institutions that should be adopted?
- 2) Are the economic institutions that prevail in a society normally the ones that maximize social welfare? Why?
- 3) Are institutional changes likely to be Pareto-improving? Why?
- 4) Why don't poor countries replace 'bad' economic institutions by 'good' ones?
- 5) Why does the 'commitment problem' create an *inseparability* between efficiency and distribution?



Measuring social welfare (I)

- The notion that per capita GDP is a poor measure of well-being is widely recognized. Many economic activities do not increase human well-being (e.g., gambling) and other activities which do increase it are not computed in GDP or related measures.
- In this section we explore an approach to measuring well-being originally proposed by Amartya Sen and Martha Nussbaum that inspired the UN's 'Human Development Index' (HDI).
- The 'capabilities approach' addresses a central problem of moral philosophy: to determine what things are *intrinsically good* for human beings: happiness, pleasure, etc.



Measuring social welfare (II)

- *Welfarism* is a central component of all versions of utility theory. It is defined as the requirement that the goodness of a ‘state of affairs’ be a function *only* of the utility associated to it.
- Given economists’ commitments to welfarism, it is natural that they look to levels of utility —preference satisfaction— as the fundamental measure of well-being for evaluative purposes and regard per capita GDP as a *proxy* for preference satisfaction.
- If one accepts economists’ identification of utility-maximization with individual welfare and rationality, it follows that ‘what one prefers must also coincide with what is *good* for us.’ However, this statement is controversial for various reasons.



Measuring social welfare (III)

- A first problem stems from *changes* in preferences. If a person's preference ranking changes frequently it is unclear whether she is made better-off by satisfying her original preferences. Should we be concerned about satisfying our current preferences once we recognize that they are likely to change?
- This problem is further compounded by the fact that our ranking of preferences may change in the wake of propaganda or even advertising. Preferences can be manipulated.
- A second problem is that one's ranking of preferences is often based on *false beliefs* in which case preference satisfaction may reduce one's welfare rather than increase it.



Measuring social welfare (IV)

- A third problem is that some people may have racist, sadistic, and other *antisocial preferences*. Given a preference satisfaction view of well-being, it seems that antisocial preferences ought to count. But does satisfaction of antisocial preferences contribute to increasing individual well-being?
- Likewise, a person may violate a moral norm in exchange for a reward (e.g., kidnapping someone for ransom). Should *immoral* or *antisocial* behaviour count when measuring well-being?
- Last, some people may have a particular ranking of preferences because of previous coercion or manipulation and may come to prefer things due to complex psychological mechanisms.



Measuring social welfare (V)

- For example, women who have been oppressed in the past may not have strong preferences for individual liberties, for the same wages that men earn, or for protection from domestic violence. But liberty, high wages, and protection from violence may make them better-off than giving them ‘what they prefer’.
- *Substantive* theories of well-being (as opposed to merely *formal* ones like preference satisfaction) purport to say which things are intrinsically good. These theories are *objective*; what is good for people may not be determined by whether they believe it is good for them. An example is the ‘classical utilitarian school’ founded by Bentham (1779) which identifies well-being with *hedonism* (i.e., difference between pleasure and pain).



Measuring social welfare (VI)

- Amartya Sen (1987) defends a *substantive* theory of well-being in terms of a person's capabilities and the functionings she does attain. The latter are those things that she does and experiences. Literacy is a capability while reading is a functioning. Likewise, being healthy is a capability; doing exercise is a functioning.
- Sen (ibid.) does not think that social policy should concern itself directly with the functionings that people achieve — with what people make of their capabilities — because they are determined largely by *individual choice*.
- He proposes instead that social policy focuses on capabilities or the *ability* to achieve a certain sort of functioning.



Measuring social welfare (VII)

- For instance, malnutrition may stem from a person's decision to embark on a religious fast rather than from any deprivation.
- According to him (ibid.), the focus of social policy should be on 'capabilities' and, hence, on *freedom*, broadly understood. This view inspired the United Nations' approach to measuring well-being known as the 'Human Development Index' (HDI).
- A country's HDI is calculated as a weighted average (adjusted for the standard deviation from the mean) of:
 - Per capita GDP
 - Life expectancy, and
 - Average years of schooling

HDI RANK	SDG 3		SDG 4.3		SDG 4.4		SDG 8.5	
	Human Development Index (HDI)	Life expectancy at birth	Expected years of schooling	Mean years of schooling	Gross national income (GNI) per capita	GNI per capita rank minus HDI rank	HDI rank	
	Value	(years)	(years)	(years)	(2021 PPP \$)			
	2023	2023	2023 ^a	2023 ^a	2023	2023 ^a	2022	
Very high human development								
1	Iceland	0.972	82.7	18.9 ^c	13.9 ^d	69,117	12	3
2	Norway	0.970	83.3	18.8 ^c	13.1 ^e	112,710 ^f	0	1
2	Switzerland	0.970	84.0	16.7	13.9 ^e	81,949 ^f	5	2
4	Denmark	0.962	81.9	18.7 ^c	13.0 ^e	76,008 ^f	4	4
5	Germany	0.959	81.4	17.3	14.3 ^e	64,053	13	6
5	Sweden	0.959	83.3	19.0 ^c	12.7 ^e	66,102	10	4
7	Australia	0.958	83.9	20.7 ^c	12.9	58,277	14	8
8	Hong Kong, China (SAR)	0.955	85.5 ^g	16.9	12.4	69,436	4	9
8	Netherlands	0.955	82.2	18.6 ^c	12.7 ^e	68,344	6	7
10	Belgium	0.951	82.1	19.0 ^c	12.7 ^e	63,582	9	13
11	Ireland	0.949	82.4	19.2 ^c	11.7 ^e	90,885 ^f	-6	10
12	Finland	0.948	81.9	19.5 ^c	13.0 ^e	57,068	10	11
13	Singapore	0.946	83.7	16.7	12.0	111,239 ^f	-10	14
13	United Kingdom	0.946	81.3	17.8	13.5	54,372	13	11
15	United Arab Emirates	0.940	82.9	15.6	13.0	71,142	-4	23
16	Canada	0.939	82.6	15.9	13.9	54,688	9	16
17	Liechtenstein	0.938	83.6	15.4	12.4 ^h	166,812 ^h	-16	15
17	New Zealand	0.938	82.1	19.3 ^c	12.9 ^e	47,260	17	17
17	United States	0.938	79.3	15.9	13.9	73,650	-7	18
20	Korea (Republic of)	0.937	84.3	16.6	12.7 ^e	49,726	11	19
21	Slovenia	0.931	81.6	17.5	13.0 ^e	46,361	15	21
22	Austria	0.930	82.0	16.3	12.4 ^e	63,479	-2	20
23	Japan	0.925	84.7	15.5	12.7 ^e	47,775	10	23
24	Malta	0.924	83.3	15.9	12.4 ^e	52,155	5	26
25	Luxembourg	0.922	82.2	14.4	12.6 ^d	85,461 ^f	-19	22
26	France	0.920	83.3	16.1	11.8 ^e	55,060	-2	27
27	Israel	0.919	82.4	14.9	13.5 ^e	48,050	5	23
28	Spain	0.918	83.7	17.8	10.8 ^e	46,008	9	28
29	Czechia	0.915	79.8	16.8	13.0 ^e	45,889	9	28
29	Italy	0.915	83.7	16.7	10.8 ^e	52,389	-1	32
29	San Marino	0.915	85.7 ^g	14.6 ^e	11.4	64,706	-13	30
32	Andorra	0.913	84.0	14.5	11.6	64,631	-15	37
32	Cyprus	0.913	81.6	16.2	12.6 ^e	45,394	7	31
34	Greece	0.908	81.9	20.8 ^c	11.6 ^e	35,761	17	36
35	Poland	0.906	78.6	16.7	13.2 ^e	42,218	5	33
36	Estonia	0.905	79.2	16.0	13.6 ^e	40,881	8	33
37	Saudi Arabia	0.900	78.7	16.9	11.6 ^e	50,299	-7	37
38	Bahrain	0.899	81.3	15.9	11.1	52,819	-11	33



Measuring social welfare (VIII)

- Nussbaum (2000) has developed a theory of well-being in terms of capabilities. She has elaborated a list of ten central human capabilities (ibid., pp. 416-418):

1. *Life*: Being able to live to the ends of a human life of normal length; not dying prematurely, or before one's life is so reduced as to be not worth living.

2. *Bodily health*: Being able to have good health, including reproductive health, to be adequately nourished; to have adequate shelter.

3. *Bodily Integrity*. Being able to move freely from place to place; to be secure against violent assault, including sexual assault and domestic violence; having opportunities for sexual satisfaction and for choice in matters of reproduction.

.....

7. *Affiliation*. Being able to live with and toward others, to recognize and show concern for other human beings, to engage in various forms of social interaction; Having the social bases of self-respect and non-humiliation; This entails provisions of nondiscrimination on the basis of race, sex, sexual orientation, ethnicity, caste, religion, national origin.

.....