

ECO 330: Economics of Development

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Institutions and Development

Reasons for Thinking **Institutions** may be Important for Wealth of Nations

- Strong correlation between various measures of institution quality and development
- Economic theory predicts institutions are important for development and growth (e.g. encouraging innovation)
- Natural Experiments: When North Korea/South Korea split and East Germany/West Germany split, they quickly diverged in terms of development as new institutions were introduced.

How Do Institutions Form?

Understanding how institutions form is important for determining causality. Don't fully know.

Two Extremes for Institution Formation

- **Efficiency:** Society chooses institutions to maximize total economic/social surplus, “size of pie”. Winners and losers from institutions, but everybody’s welfare is taken into account. Leads to **inclusive institutions**.
- **Elites:** Elites chooses institutions to maximize their economic surplus. Partially by increasing the “size of pie”, partially by ensuring they get a bigger share than they otherwise would. Leads to **extractive institutions**.

Inclusive Institutions

Inclusive Institutions foster innovation and allow for social and economic mobility

- Innovation involves **creative destruction**, meaning there will be losers for innovation. For economic growth, it is important to allow this process to take place.
- The American Dream: If you're smart and work hard, can achieve success. Upward social mobility is possible.
- (Flip side) American Nightmare: People who are at the top should not be protected from downward social and economic mobility.

What Inclusive Institutions Support

- Property rights and contract enforcement. Markets and Competition. Access to education (equality of opportunity). Political inclusiveness.

Extractive Institutions

Extractive Institutions are designed to keep the elites in power and benefit only the elites

- Historically, most societies ruled by extractive institutions.
- Growth is still possible under extractive institutions, but typically not due to creative destruction. Limits to growth if don't allow for creative destruction.

Examples of Extractive Institutions

- Colonialism, Slavery, Corruption in Government, Regulation designed to serve as barriers to competition. Unequal access to opportunity and education, unequal justice, and unequal representation.