

4.1 – Political Economy

ECON 317 • Economic Development • Fall 2021

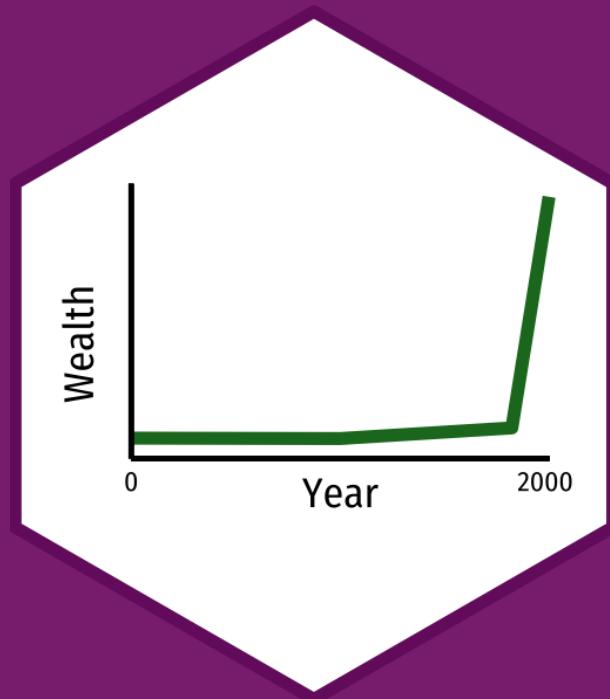
Ryan Safner

Assistant Professor of Economics

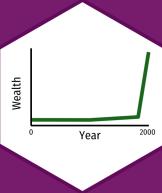
 safner@hood.edu

 [ryansafner/devF21](https://github.com/ryansafner/devF21)

 devF21.classes.ryansafner.com



Outline

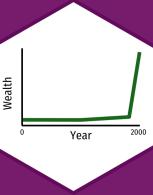


Institutions and Political Economy

Markets are Disruptive: Creative Destruction

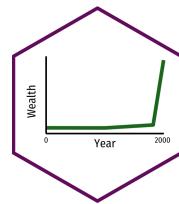
Profit-Seeking and Rent-Seeking

Back to Institutions: Rent-Seeking and Elites



Institutions and Political Economy

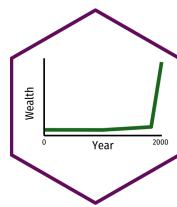
Economic Theory *Assumes* Good Institutions



- Markets & price theory: how consumers & producers specialize, produce, & exchange within **given, well-functioning markets (& politics)**
- **Assumes** existence of "good" economic & political institutions that facilitate market exchange
 - clear and enforced property rights
 - rule of law
 - contract enforcement
 - dispute resolution
 - complete contracts
 - low or no transaction costs
 - high level of social trust



Perhaps the Opposite Extreme is More Realistic



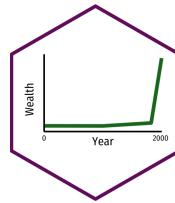
Raguram Rajan

1963-

"And there is hope, supported by a growing body of research, that more students of development are realizing that **a better starting point for analysis** than a world with only minor blemishes **may be a world where nothing is enforceable, property and individual rights are totally insecure, and the enforcement apparatus for every contract must be derived from first principles** - as in the world that Hobbes so vividly depicted. Not only will this kind of work **more closely approximate reality in the poorest, conflict-ridden countries, but it could also lead to more sensible policy**," (p.56).

Rajan, Raghuram, 2004, "Assume Anarchy?", *Finance and Development* September: 56-57

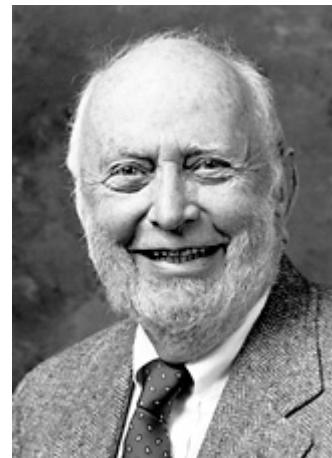
New Institutional Economics



“New Institutional Economics” (1970s-): focus on the importance of institutions, economic history, transactions costs, and economic organization



Ronald Coase



Douglass North



Elinor Ostrom



Oliver Williamson

1910-2013

1920-2015

1933-2012

1932-

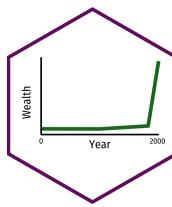
Economics Nobel 1991

Economics Nobel 1993

Economics Nobel 2009

Economics Nobel 2009

Recall: Two Problems of Political Economy

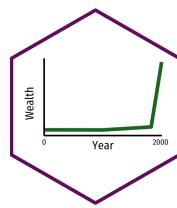


- All societies face two fundamental problems, which institutions emerge (or are created) to address:

The Knowledge Problem: How to coordinate the *tacit, fragmented* knowledge of opportunities and conditions *dispersed* across millions of individuals (and accessible to none in total) in order to maximize the ability of individuals to achieve their goals

The Incentives Problem: How to structure incentives that individuals face in a way that maximizes cooperative behavior (voluntary exchange and association) and minimizes non-cooperative behavior (cheating, opportunism, exploitation, violence, rent-seeking)

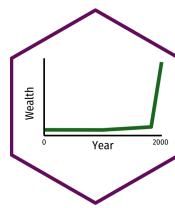
Recall: Making Fair Comparisons



- No system is perfect
- We need to find arrangements that are **robust** to knowledge & incentive problems
- **Easy case:** perfect information benevolence
- **Hard case:** uncertainty and selfish behavior
- Treat people as they are: sometimes good, bad, smart, stupid, opportunistic, altruistic
depending on the institutions



Hume: Assume the Worst (?)

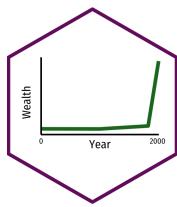


David Hume

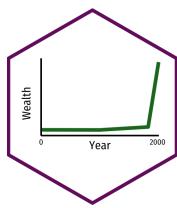
1711-1776

“Political writers have established it as a maxim, that, in contriving any system of government, and fixing the several checks and controuls of the constitution, **every man ought to be supposed a knave, and to have no other end, in all his actions, than private interest.** By this interest we must govern him, and, by means of it, make him, notwithstanding his insatiable avarice and ambition, co-operate to public good. **Without this, say they, we shall in vain boast of the advantages of any constitution, and shall find, in the end, that we have no security for our liberties or possessions, except the good-will of our rulers; that is, we shall have no security at all,**” (“Of the Independency of Parliament”)

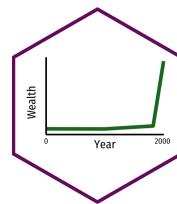
A Bad Argument for Markets



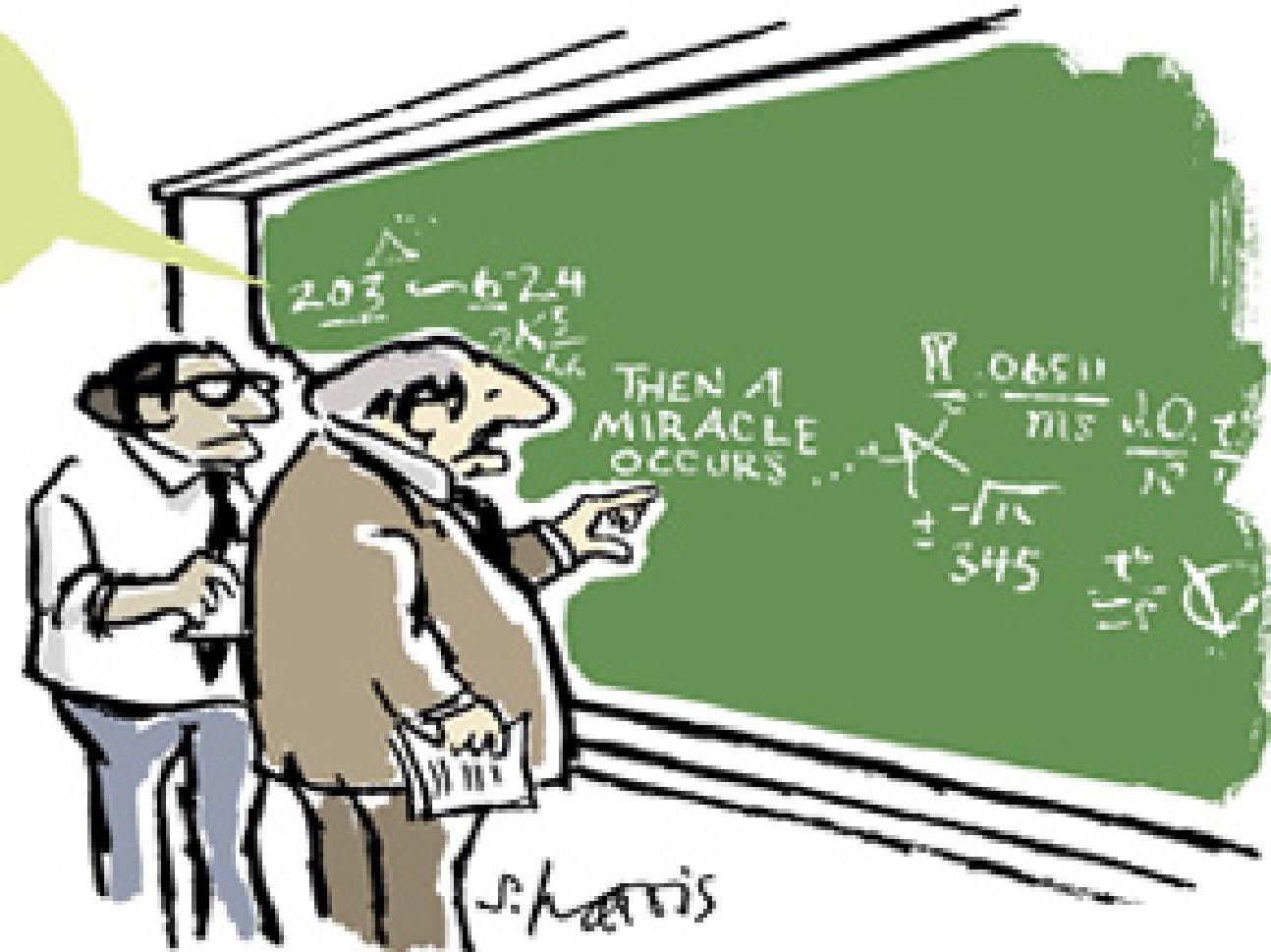
A Better, Comparative, Argument for Markets



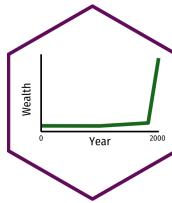
Recall: Making Fair Comparisons



I THINK YOU
SHOULD BE MORE
SPECIFIC HERE IN
STEP TWO



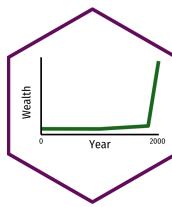
Recall: Making Fair Comparisons



- Economists (and others) often recommend optimal policies as if they could be installed by a **benevolent despot**
 - A dispassionate ruler with total control, perfect information, and right incentives to implement optimal policy
 - A “1st-best solution”
- In reality, 1st-best policies are distorted by the knowledge problem, the incentives problem, and politics
 - Real world: 2nd-to- n^{th} -best outcomes



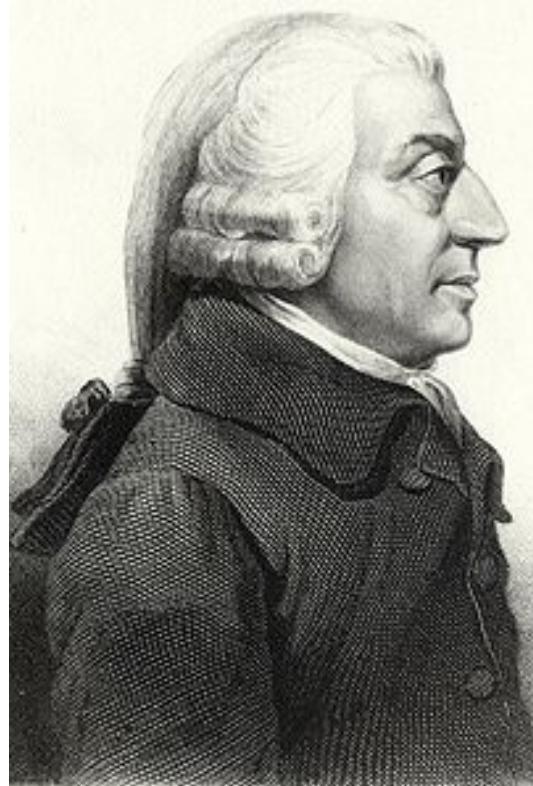
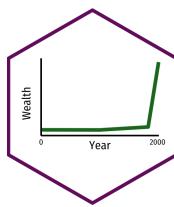
Recall: Comparative Analysis



- Compare imperfections of feasible and relevant alternative systems
 - **Nirvana fallacy**: comparing an imperfect, flawed system with some ideal, imaginably perfect system
- Economics: *think on the margin!*
 - One system's “failure” does not imply another's “success”!
 - the real world requires tradeoffs
 - “economics puts parameters on people's utopias”
 - “compared to what?”



Institutions: Operationalizing Adam Smith



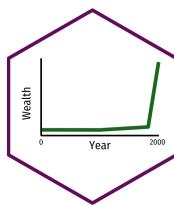
"[Though] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention...By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it," (Book IV, Chapter 2.9).

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*

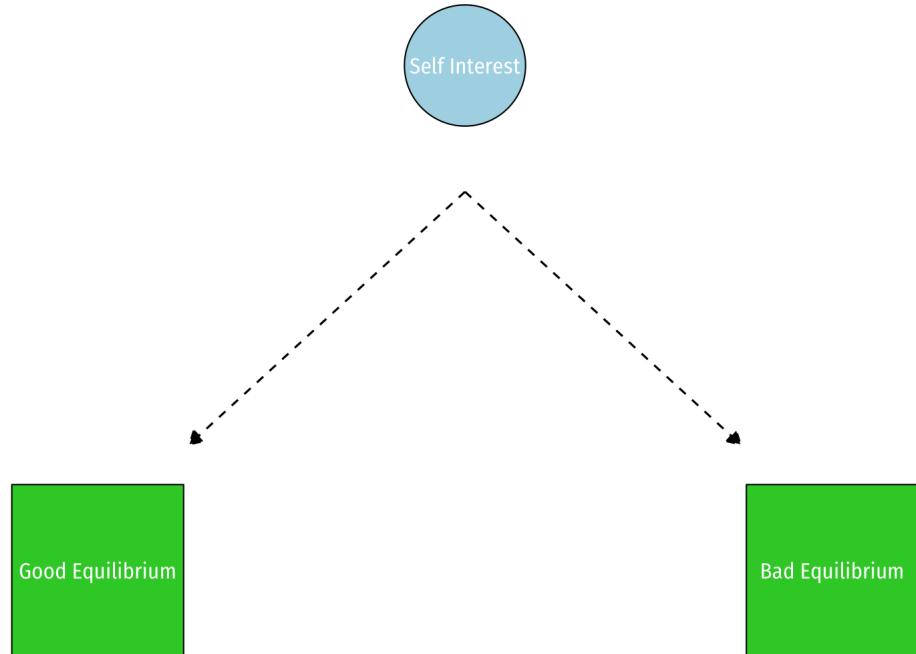
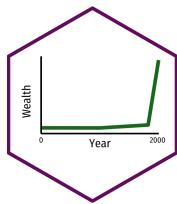
Adam Smith

1723-1790

Self-Interest Doesn't Always Benefit Society

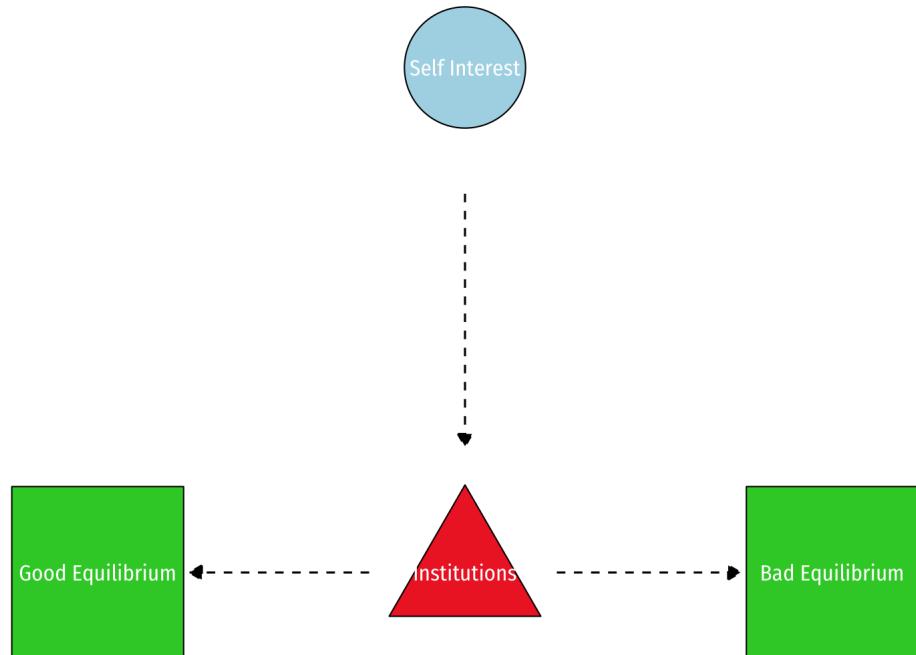
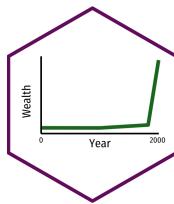


Institutions: Operationalizing Adam Smith



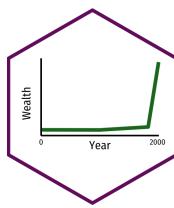
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Institutions: Operationalizing Adam Smith



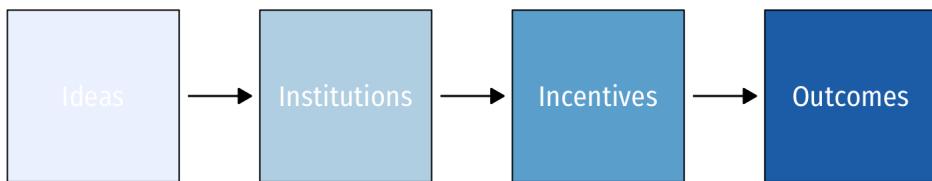
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A Logical Framework for Political Economy

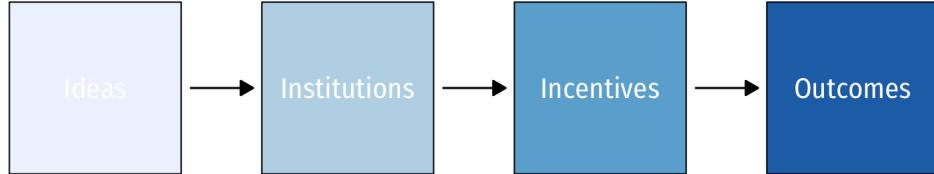
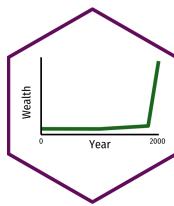


- **Outcomes:**

- relative level of wealth or poverty
- relative level of equality or inequality
- stability of politics, finance, macroeconomy

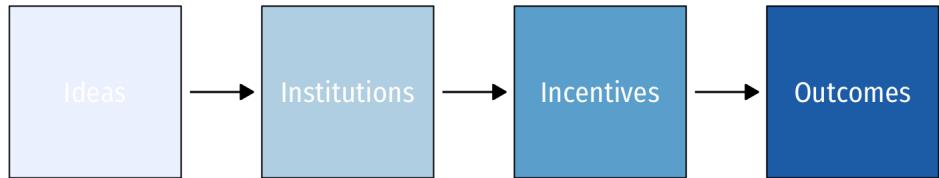
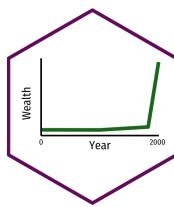


A Logical Framework for Political Economy



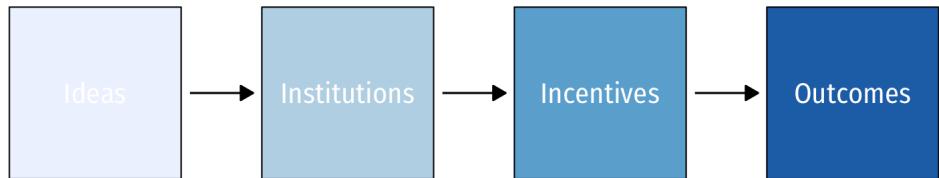
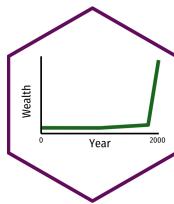
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- ...are determined by **Incentives:**
 - relative prices or costs of various choices
 - profits and losses
 - information

A Logical Framework for Political Economy



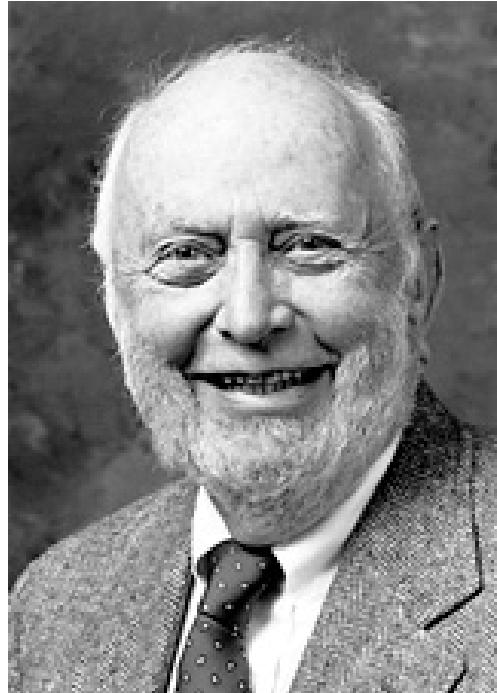
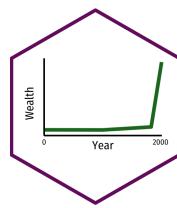
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 - (in)equality before the law or corruption
 - constraints on politics and economics

A Logical Framework for Political Economy



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 - constraints on politics and economics
- ...are determined by **Ideas:**
 - political and social worldview -"isms"
 - which groups (should) have status

What are Institutions?



Douglass C. North

1920-2015

Economics Nobel 1993

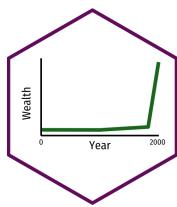
“Institutions are the humanly devised constraints that structure political economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)”,
(p.10)

“Institutions are the rules of the game in a society”,
(p.1).

North, Douglass C. (1991), "Institutions," *Journal of Economic Perspectives* 5(1): 97-112.

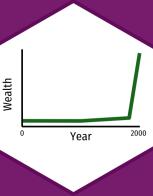
North, Douglass C. (1990), *Institutions, Institutional Change, and Economic Performance*

Incentives are Structured by Institutions



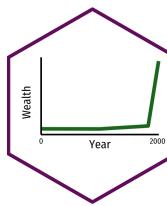
“Who needs this nail?”

“Don't worry about it! The main thing is that we immediately fulfilled the plan for nails!”



Markets are Disruptive: Creative Destruction

Markets as an Evolutionary Process



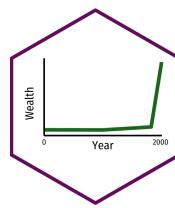
Joseph Schumpeter

1883-1950

"Capitalism...is by nature a form of economic change and not only never is but never can be stationary...The essential point to grasp is that in dealing with capitalism we are dealing with an **evolutionary process.**," (pp.82).

"[I]n capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization...**competition** which commands a decisive cost or quality advantage **which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives.**" (p.132).

Creative Destruction I



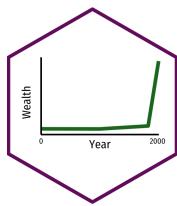
Joseph Schumpeter

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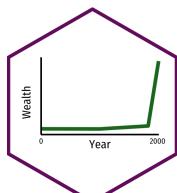
"Industrial mutation--if I may use that biological term --that **incessantly revolutionizes the economic structure from within**, incessantly destroying the old one, incessantly creating a new one. This **process of Creative Destruction is the essential fact about capitalism**. It is what capitalism consists in and what every capitalist concern has got to live in" (p.83).

Schumpeter, Joseph A. (1947), *Capitalism, Socialism, and Democracy*

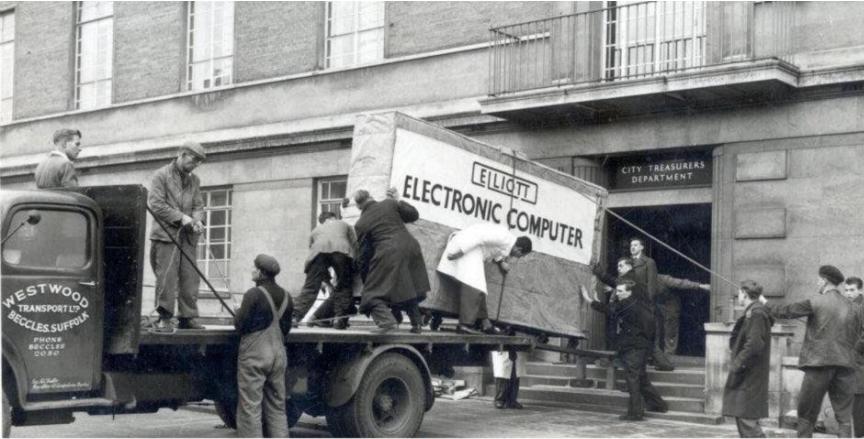
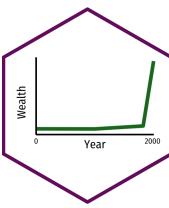
Creative Destruction: Examples



Creative Destruction: Example II

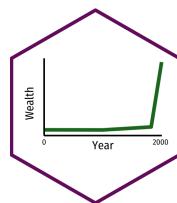


Creative Destruction: Example III



59 years of progress

No Corporate Monolith Lasts Forever (On Its Own)



Guardian

News | Opinion | Sport | Culture | Lifestyle

Will MySpace ever lose its monopoly?
Victor Keegan

Thu 8 Feb 2007 07.41 EST

HOW YAHOO! WON THE SEARCH WARS
BY RANDALL E. STROSS

Once upon a time, 'Yahoo!' was an internet search site with mediocre technology. Now it has a market cap of \$2.8 billion. Some people say it's the next America Online.

TECHNEWSWORLD

OPINION

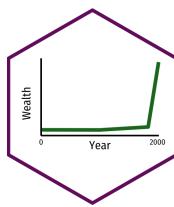
MySpace Is a Natural Monopoly

By John Barrett
Jan 17, 2007 4:00 AM PT

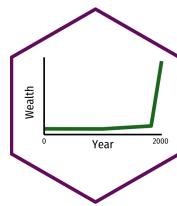
Economics teaches that the market for some goods and services are "natural" monopolies.

Take telephone service, for example. A telephone service is only really valuable if any person with a phone can be connected to any other person with a phone. For this reason, the market will "naturally" coalesce around a single, monopoly provider unless the government

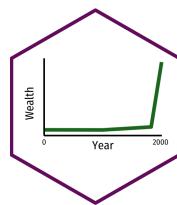
No Corporate Monolith Lasts Forever (On Its Own)



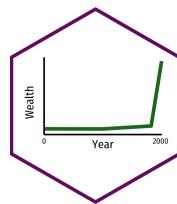
Creative Destruction: The Problem



Creative Destruction: The Problem



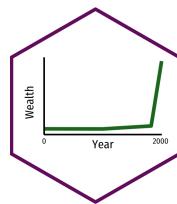
Successful *Economies* Create a *Political Problem* I



- Markets serve **consumers** (**consumer sovereignty**), *not* workers or producers!
- Successful market economies produce *wealth* and destroy *jobs*
- Economic growth \equiv more output with fewer inputs!
- A **political problem**: how do producers permit the *destructive* side of creative destruction?



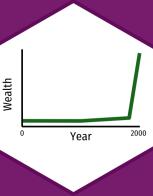
Successful *Economies* Create a *Political Problem* I



- **Moral dilemmas:**

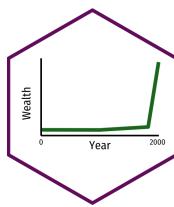
- Do we have a moral obligation to insulate workers from the pain of competition that is no fault of their own?
- How do we secure the gains from trade and innovation without punishing the workers who lose their jobs?





Profit-Seeking and Rent-Seeking

Profit-Seeking

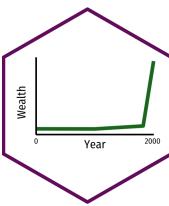


$$\pi = \underbrace{pq}_{revenues} - \underbrace{(wl + rk)}_{costs}$$

- The firm's costs are all of the factor-owner's incomes!
 - Landowners, laborers, creditors are all paid rent, wages, and interest, respectively
- Profits are the **residual value** leftover after paying all factors
- Profits are income for the **residual claimant(s)** of the production process (i.e. **owner(s)** of a firm):
 - Entrepreneurs
 - Shareholders



Who Gets the Profits?

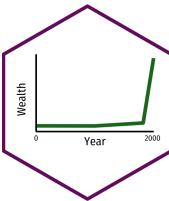


$$\pi = \underbrace{pq}_{revenues} - \underbrace{(wl + rk)}_{costs}$$

- Residual claimants have incentives to maximize firm's profits, as this *maximizes their own income*
- Entrepreneurs and shareholders are the only participants in production that are *not* guaranteed an income!
 - Starting and owning a firm is inherently **risky**!



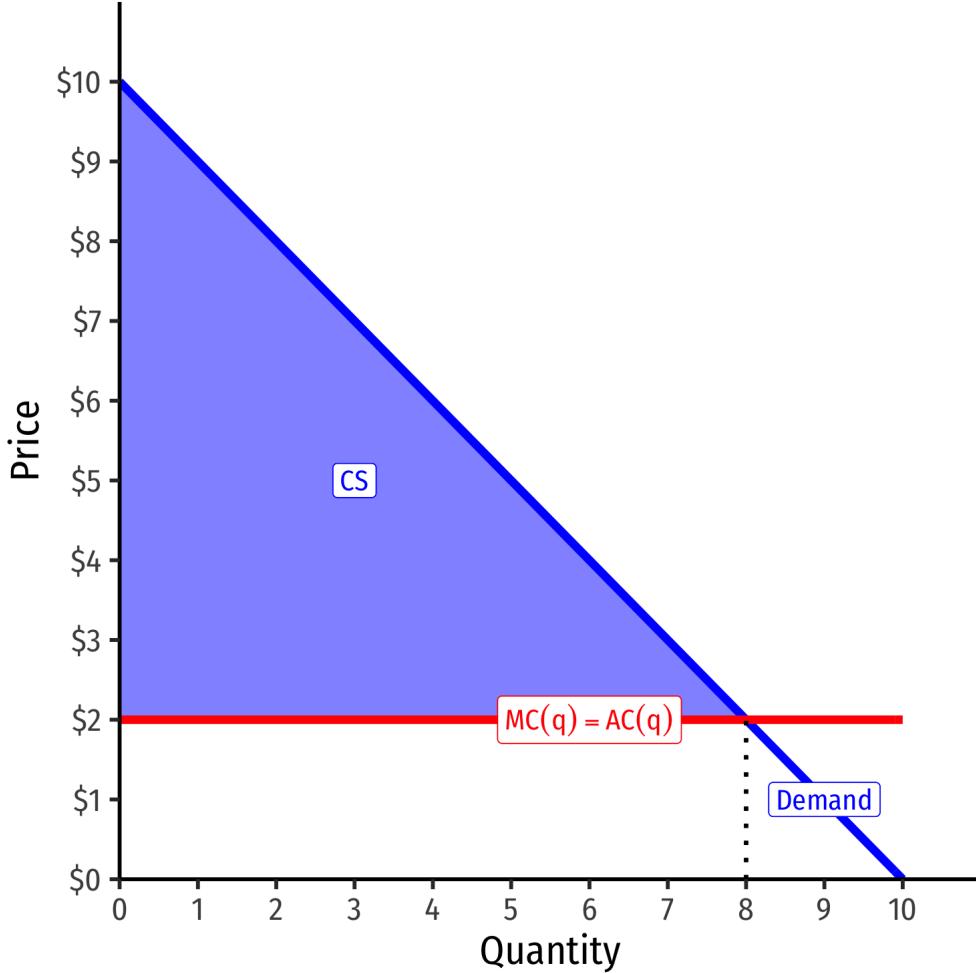
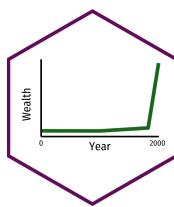
Profits and Entrepreneurship



- In markets, production must face the **profit test**:
 - Is consumer's willingness to pay > opportunity cost of inputs?
- Profits are an indication that **value is being created for society**
- Losses are an indication that **value is being destroyed for society**
- Survival for sellers in markets *requires* firms continually create value and earn profits or die

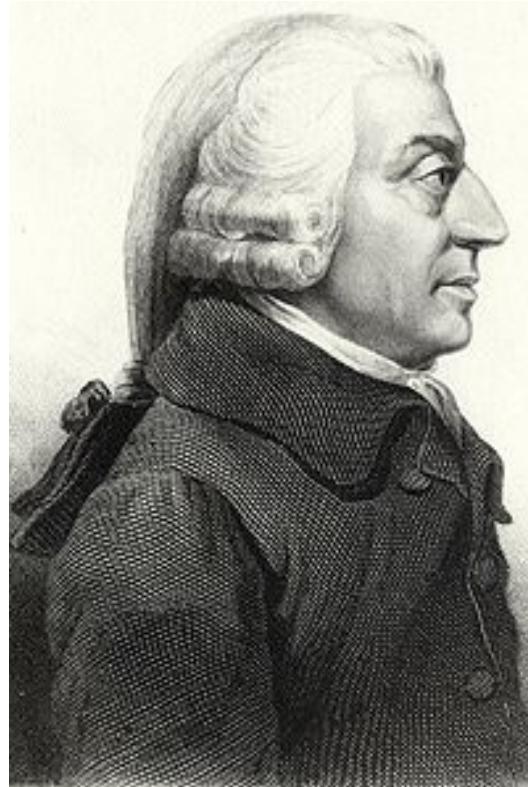
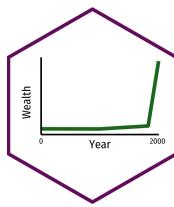


Profit Seeking: the Microeconomics I



- Production generates **economic surplus**
- In a *competitive* market in long run equilibrium, economic profit is driven to \$0.
 - $p = AC(q)_{min}$, otherwise firms would enter/exit
 - $p = MC(q)$, allocatively efficient (goods produced until $MB = MC$)
 - **Consumer surplus** and **producer surplus** is maximized

From Profits to Rents



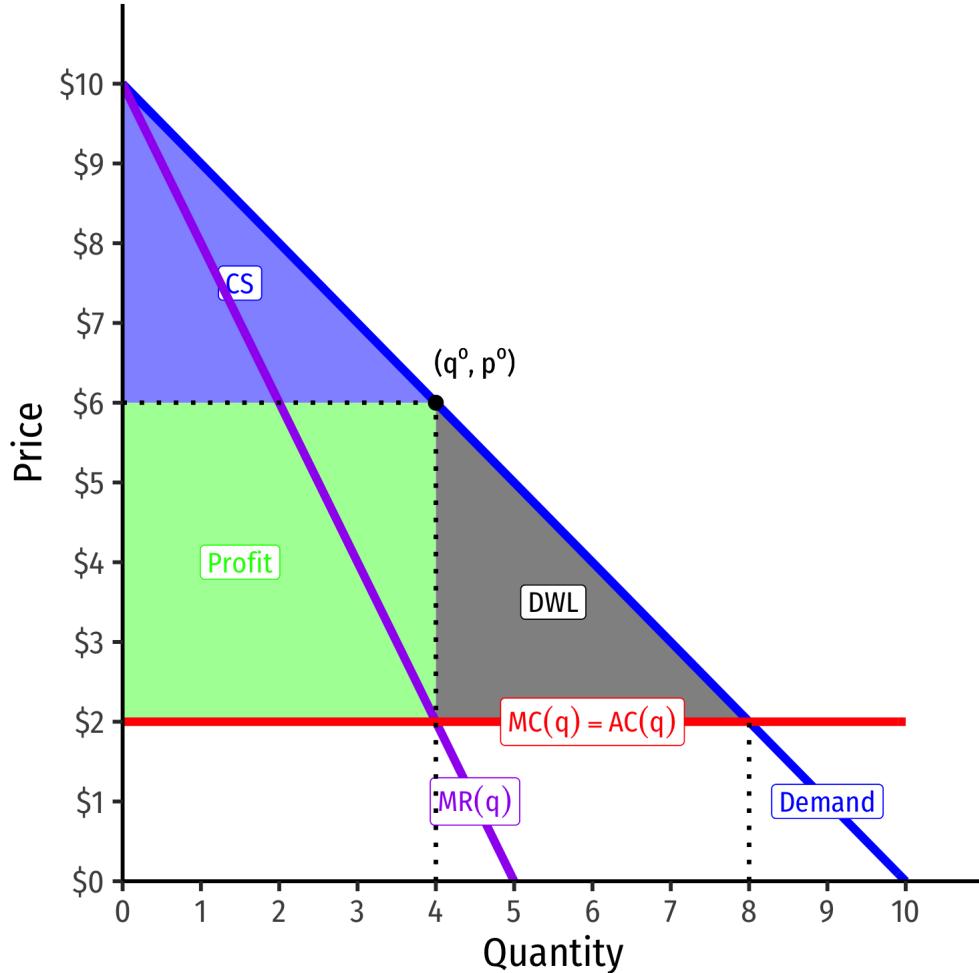
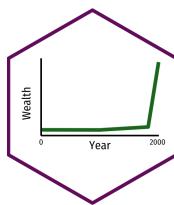
"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices," (Book I, Chapter 22).

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*

Adam Smith

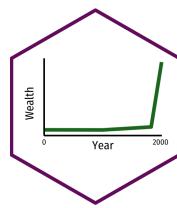
1723-1790

Profit Seeking: the Microeconomics II



- Firms with **market power** will want to set $q^* : MC(q) = MR(q)$ and raise price p^*
- Still creates **economic surplus**
 - Generates less **consumer surplus** than before
 - Some surplus is captured as **profit**
 - Some surplus is wasted as **deadweight loss**

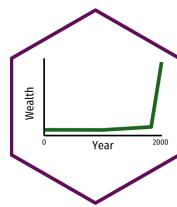
Economic Rent: Microeconomics I



- Firms may have different cost structures due to differences in:
 - Managerial talent
 - Worker talent
 - Location
 - First-mover advantage
 - Technological secrets/IP
 - License/permit access
 - Political connections
 - Lobbying

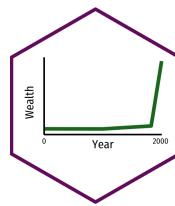


Economic Rent: Microeconomics III



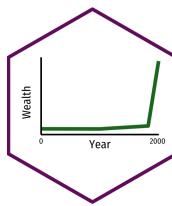
- Relatively scarce factors *in the economy* (talent, location, secrets, IP, licenses, being first, political favoritism, lobbying)
- Owners of these factors earn **economic rents**: returns higher than their opportunity cost (what is needed to bring them online, $p > AC(q)$)
- Economic rents arise from **scarcity** & **relative differences** between quality of these factors
- Inframarginal firms using the scarce factors gain a cost-advantage (in short run)
 - Rival firms willing to pay for rent-generating factor to gain advantage
 - In long run, competition over these factors **pushes up their prices** (i.e. costs to firms purchasing this factor; squeezes profits to zero)

Economic Rent: Microeconomics IV



- Rents \neq profits!
- **Rents are included in the opportunity cost (price) for inputs over long run**
 - Must pay a factor enough to *keep it out of other uses*
- Factor owners (workers, landowners, inventors, etc) earn the rents as higher payments for their services (wages, rents, interest, royalties, etc).

Recall: Ricardo on Rent in the Long Run

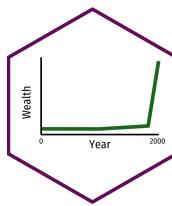


David Ricardo

1772-1823

- In Ricardo's view, *land* was the fixed factor
- Marginal product of land would fall to 0, requiring more and more labor and capital to scrape off marginal land
 - Profits to capital fall to 0
 - Wages to laborers fall to subsistence level
 - Rents to land skyrocket due to land being the fixed factor
- **Ricardian rents** describe these excess returns due to scarcity

Institutions Channel Entrepreneurship



William Baumol

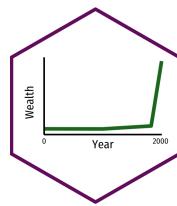
1922-2017

"If entrepreneurs are defined, simply, to be persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige, then it is to be expected that not all of them will be overly concerned with whether an activity that achieves these goals adds...to the social product," (pp.897-898).

"The rules of the game that determine the relative payoffs to different entrepreneurial activities do change dramatically from one time and place to another. Entrepreneurial behavior changes direction from one economy to another in a manner that corresponds to the variations in the rules of the game," (p.898).

Baumol, William J. (1990), "Entrepreneurship: Productive, Unproductive, and Destructive," *Journal of Political Economy* 98(5): 893-

Profit Seeking and Rent Seeking



Productive entrepreneurship

Profits from serving customers



**Unproductive
entrepreneurship**

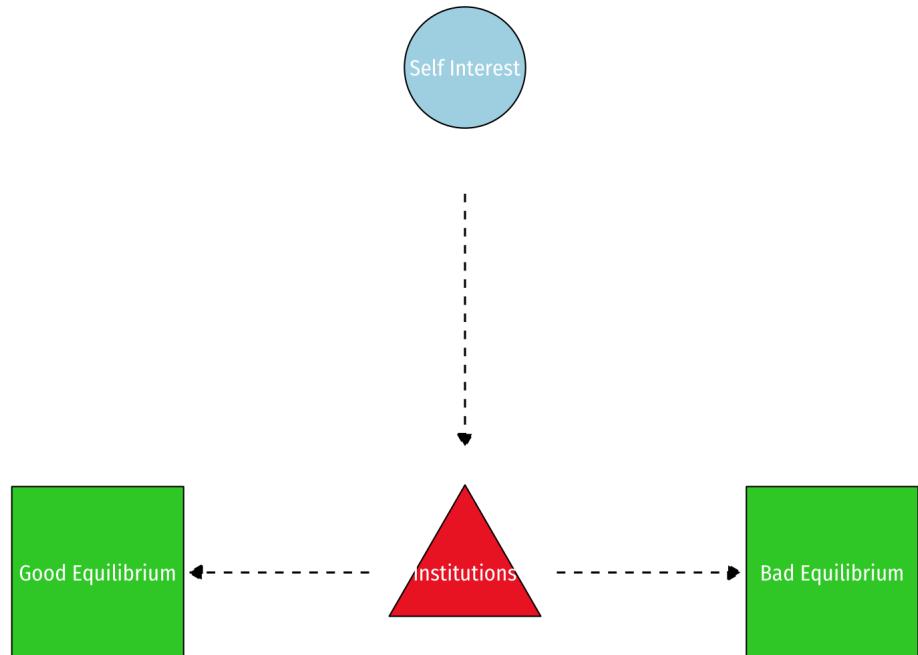
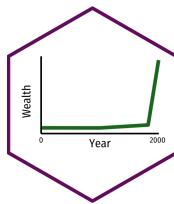
Rents from political
privileges



**Destructive
entrepreneurship**

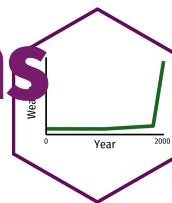
Loot from theft and
violence

Again: Institutions Channel Self-Interest



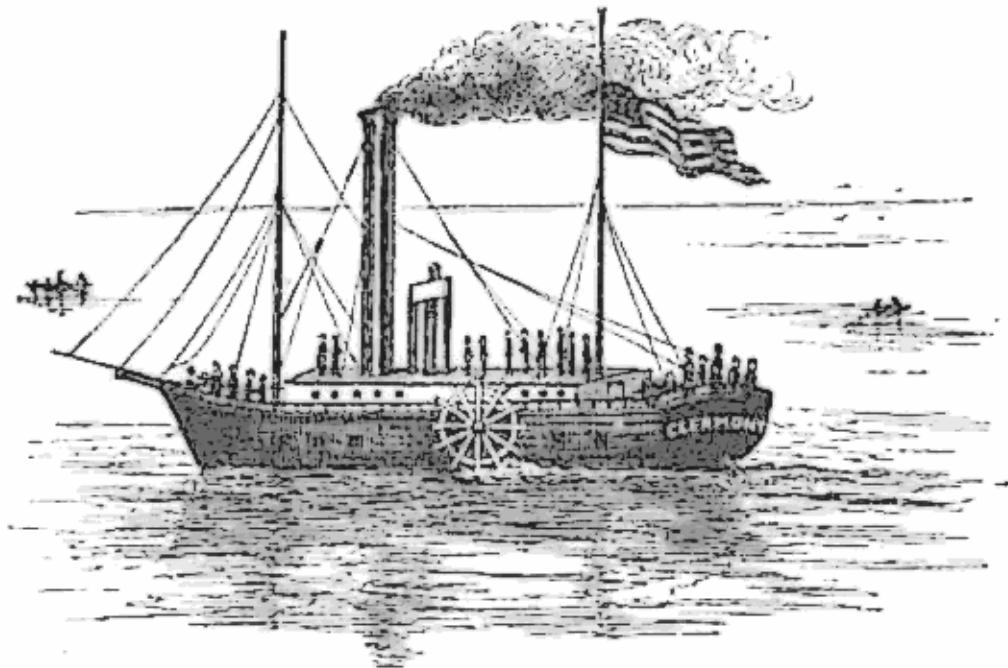
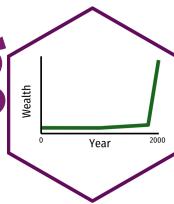
"[Though] **he intends only his own gain**, and he is in this, as in many other cases, **led by an invisible hand** to promote an end which was no part of his intention...By pursuing his own interest he frequently **promotes that of the society** more effectually than when he really intends to promote it," (Book IV, Chapter 2.9).

Profit Seeking vs. Rent Seeking: Some Generalizations



Profit-Seeking	Rent-Seeking
"market entrepreneurs"	"political entrepreneurs"
hire engineers	hire lawyers
use own/investor funds	use taxpayer funds
sell to consumers	sell to the State
face the profit test	<i>don't</i> face the profit test
earn profits or losses	earn rents
create surplus for consumers	creates artificial protection from competition
hopes to capture some of that surplus	captures rents from that artificial protection

An American Story of Rent-Seeking vs. Profit-Seeking

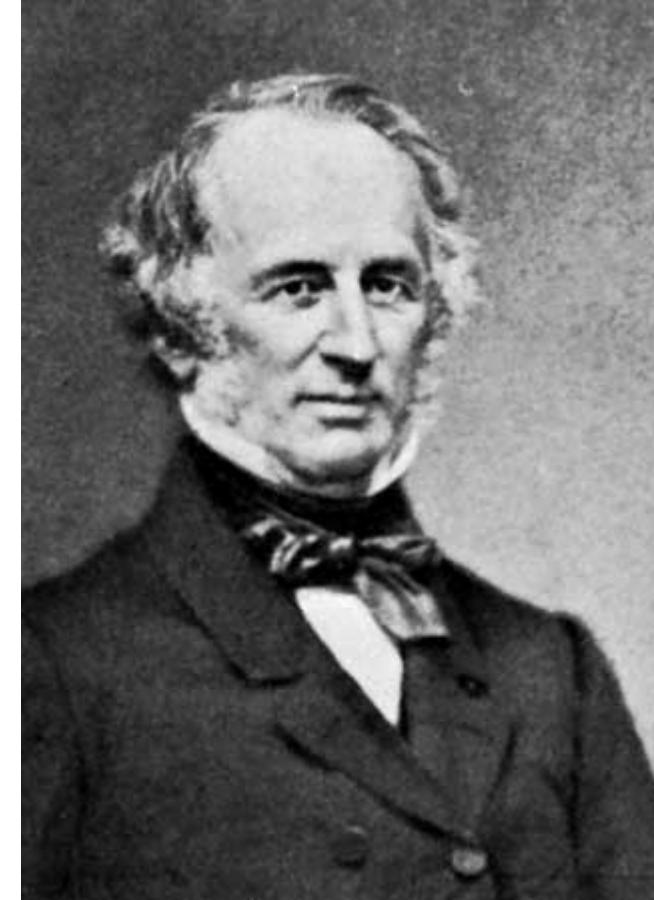
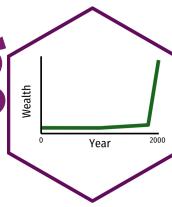


the "Clermont"



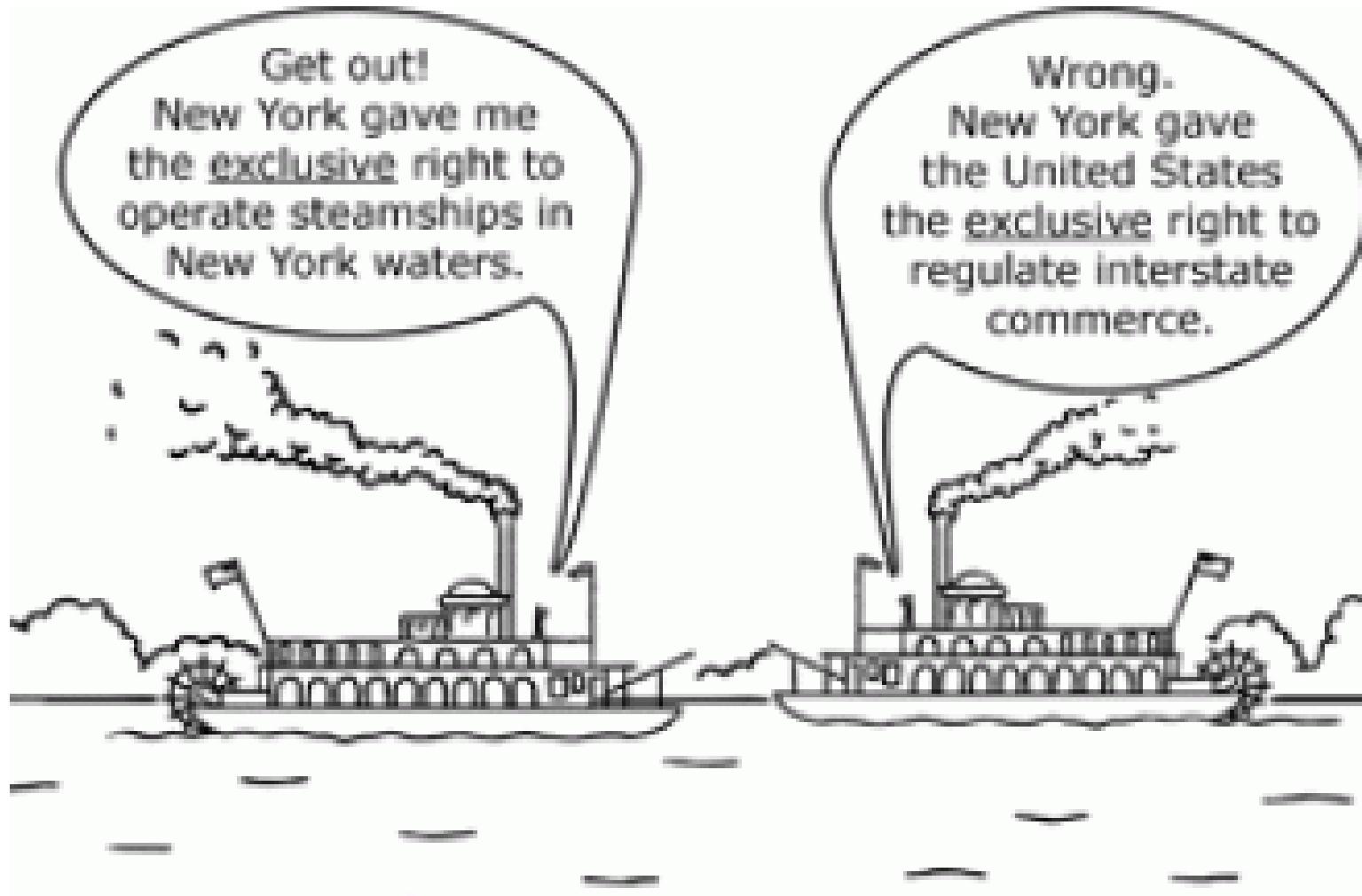
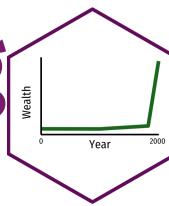
Robert Fulton

An American Story of Rent-Seeking vs. Profit-Seeking

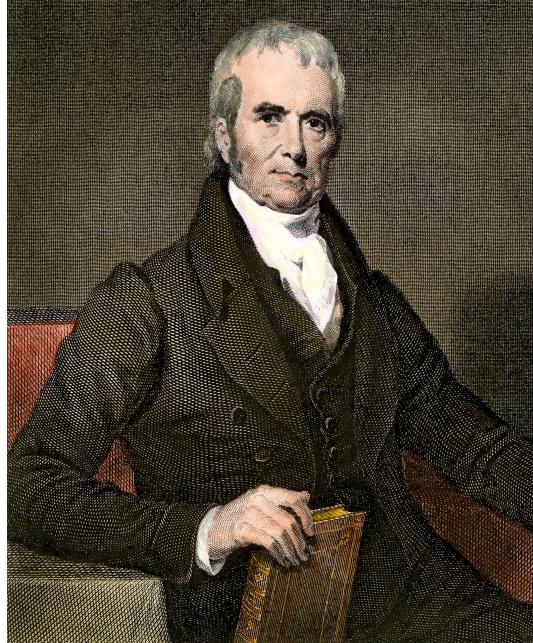
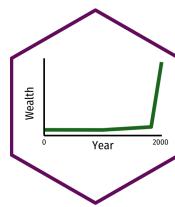


Cornelius Vanderbilt

An American Story of Rent-Seeking vs. Profit-Seeking



Gibbons v. Ogden (1824)



John Marshall

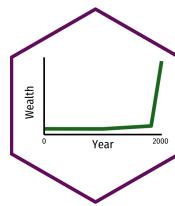
1755-1835

"A right over [licenses and patents] has never been pretended to in any instance except as incidental to the exercise of some other unquestionable power. The present is an instance of the assertion of that kind, as incidental to a municipal power; that of superintending the internal concerns of a State, and particularly of extending protection and patronage, in the shape of a monopoly, to genius and enterprise. The grant to Livingston and Fulton interferes with the freedom of intercourse, and on this principle, its constitutionality is contested.(p. 22 US 229)

"If there was any one object riding over every other in the adoption of the Constitution, it was to keep the commercial intercourse among the States free from all invidious and partial restraints," (p. 22 US 231)

Gibbons v. Ogden, 22 U.S. 1 (1824) [Justia Case Law](#)

The Allocation of Talent Matters I



"A country's most talented people typically organize production by others, so they can spread their ability advantage over a larger scale. When they start firms, they innovate and foster growth, but when they become rent seekers, they only redistribute wealth and reduce growth. Occupational choice depends on returns to ability and to scale in each sector, on market size, and on compensation contracts. In most countries, rent seeking rewards talent more than entrepreneurship does, leading to stagnation. Our evidence shows that countries with a higher proportion of engineering college majors grows faster; wheras countries with a higher proportion of law concentrators grow more slowly," (p. 503)

Murphy, Kevin M, Andrei Shleifer, and Robert M. Vishny, (1991). "The Allocation of Talent: Implications for Growth," *Quarterly Journal of Economics* 106(2): 503-530

The Allocation of Talent Matters II

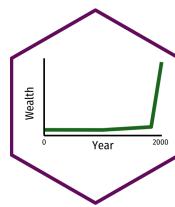
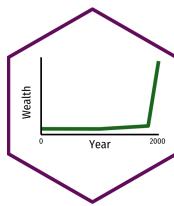


TABLE III
REGRESSIONS OF GROWTH OF REAL GDP PER CAPITA BETWEEN 1970 AND 1985 ON
PROPORTIONS OF MAJORS IN ENGINEERING AND LAW (IN 1970)

Model	All countries	> 10,000 students
	(1)	(2)
Constant	0.013 (0.005)	0.015 (0.004)
Engineering	0.054 (0.027)	0.125 (0.037)
Law	-0.031 (0.025)	-0.065 (0.049)
GDP 1960	0.000 (0.001)	-0.002 (0.001)
N	91	55
R ²	0.09	0.23

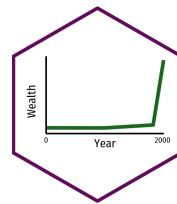
Murphy, Kevin M, Andrei Shleifer, and Robert M. Vishny, (1991). "The Allocation of Talent: Implications for Growth," *Quarterly Journal of Economics* 106(2): 503-530

Economic Rents Induce Rent-Seeking



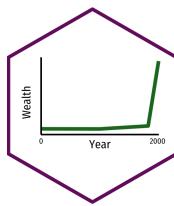
- Think of an **economic rent** as a “prize,” the payment a person receives for a good above its opportunity cost
- Creating rents creates competition for the rents, causing people to invest resources in **rent-seeking**
- The cost of the rent is not just the rent itself, but the resources invested in rent-seeking!

Government Intervention Creates Rents I



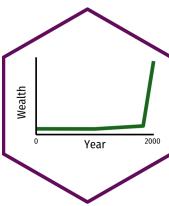
- Political authorities intervene in markets in various ways that benefit some groups at the expense of everyone else
 - subsidies to groups (often producers)
 - regulation of industries
 - tariffs, quotas, and special exemptions from these
 - tax breaks and loopholes
 - conferring monopoly and other privileges
- These interventions create **economic rents** for their beneficiaries by reducing competition
- This is a transfer of wealth from consumers/taxpayers to politically-favored

Government Intervention Creates Rent-Seeking



- The transfer is not the worst of it
- The real problem is **you cannot give away money for free even if you tried!**
- The promise of earning a rent breeds **competition over the rents (rent-seeking)**

Rent-Seeking I



Anne Kreuger

1934-

"In many market-oriented economies, government restrictions upon economic activity are pervasive facts of life. These restrictions give rise to rents of a variety of forms, and people often compete for the rents. Sometimes, such competition is perfectly legal. In other instances, rent seeking takes other forms, such as bribery, corruption, smuggling, and black markets."

"When quantitative restrictions are imposed upon and effectively constrain imports, an import license is a valuable commodity..."It has always been recognized that there are some costs associated with licensing: paperwork, the time spent by entrepreneurs in obtaining their licenses, the cost of the administrative apparatus necessary to issue licenses, and so on. Here, the argument is carried one step further: **"in many circumstances resources are devoted to competing for those licenses,"** (p.848).

Kreuger, Anne, (1974), "The Political Economy of the Rent-Seeking Society," *American Economic Review* 84(4): 833-850

Rent-Seeking II

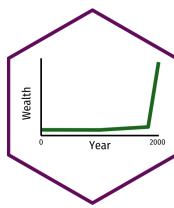
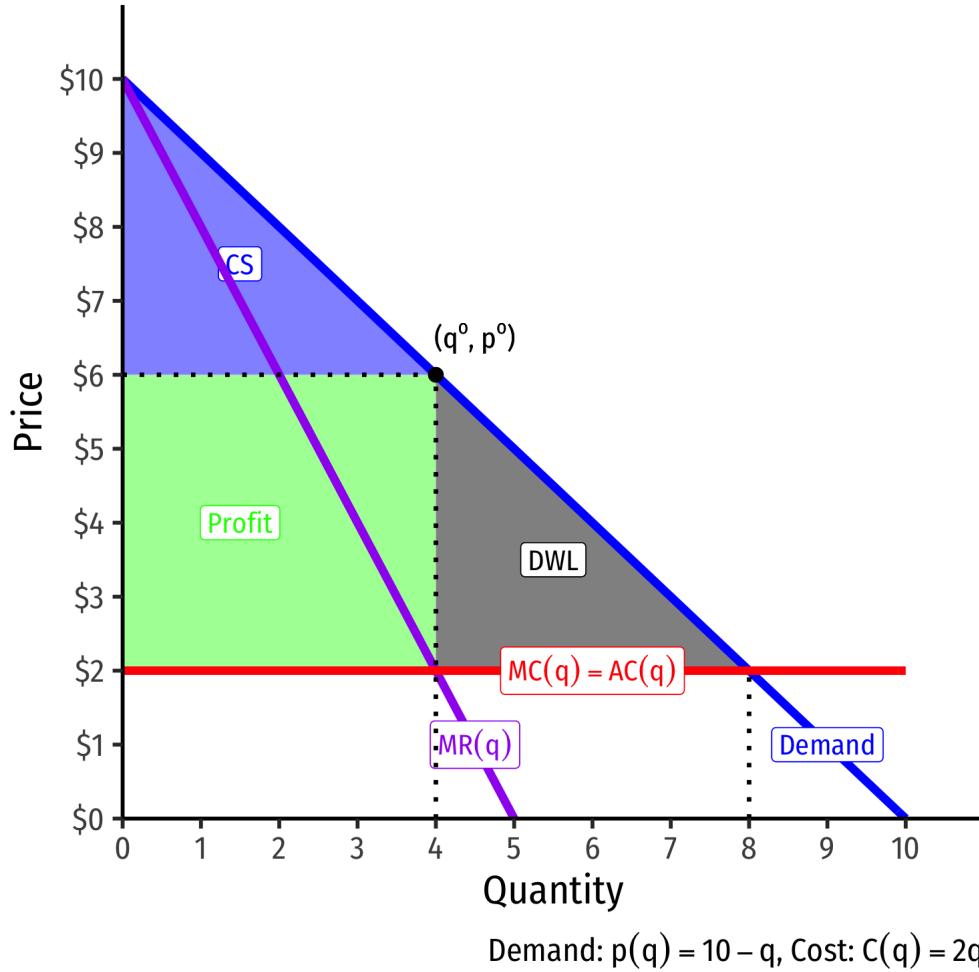
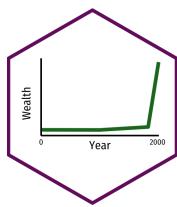


TABLE 1—ESTIMATES OF VALUE OF RENTS: INDIA, 1964

Source of Rent	Amount of Rent (Rs. million)
Public investment	365
Imports	10,271
Controlled commodities	3,000
Credit rationing	407
Railways	602
Total	14,645

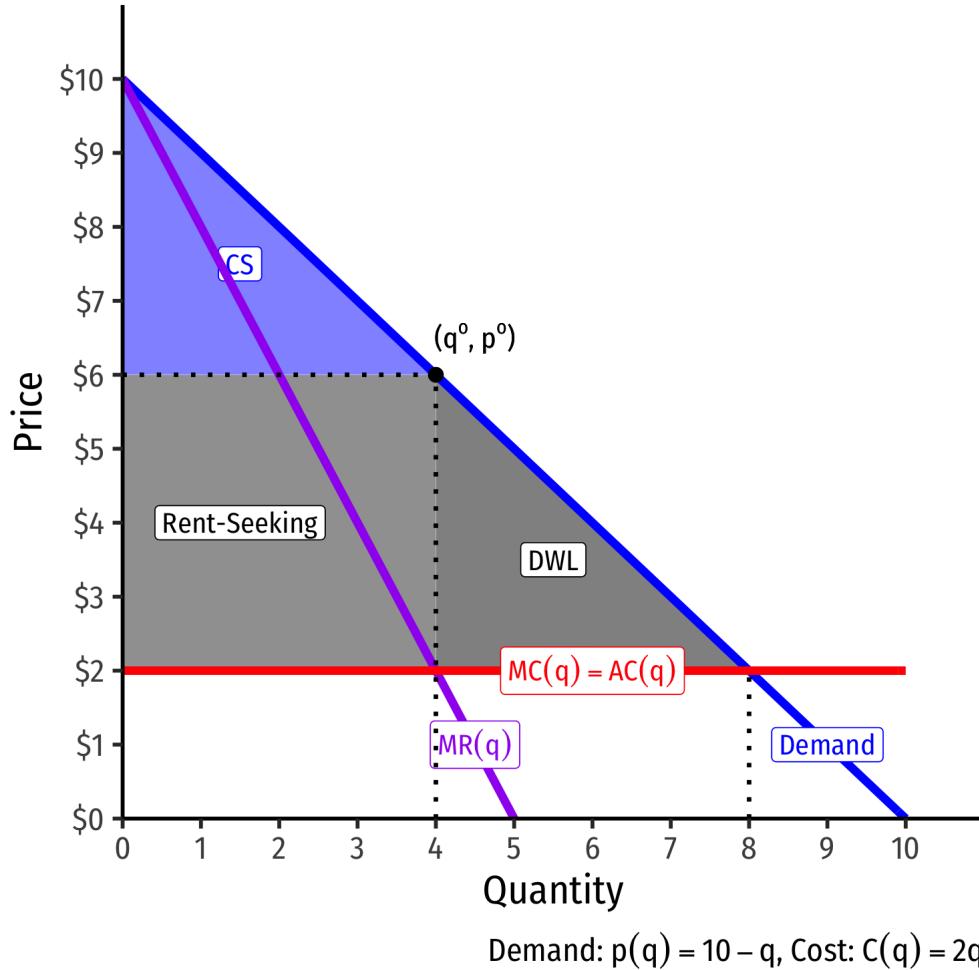
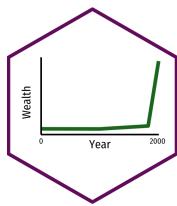
Kreuger, Anne, (1974), "The Political Economy of the Rent-Seeking Society," *American Economic Review* 84(4): 833-850

Rent-Seeking: The Ugly of Monopoly



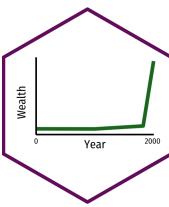
- The **monopoly profits** earned with market power are an **economic rent**
 - This is the "prize" of market power
- What if the market power is earned through political lobbying for an anti-competitive regulation?

Rent-Seeking: The Ugly of Monopoly



- The **monopoly profits** earned with market power are an **economic rent**
 - This is the "prize" of market power
- What if the market power is earned through political lobbying for an anti-competitive regulation?
- Firm(s) willing to invest resources into the "competitive market" of creating and maintaining economic rents
- **Total loss to society**
 $= DWL + \text{Rent-seeking} \text{ (of all competitors!)}$

Rent-Seeking III

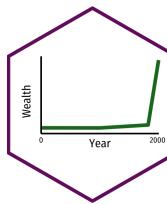


Gordon Tullock

1922-2014

"The rectangle to the left of the [Deadweight loss] triangle is the income transfer that a successful monopolist can extort from the customers. **Surely we should expect that with a prize of this size dangling before our eyes, potential monopolists would be willing to invest large resources in the activity of monopolizing. In fact the investment that could be profitably made in forming a monopoly would be larger than this rectangle, since it represents merely the income transfer,**" (p.231).

Rent-Seeking IV

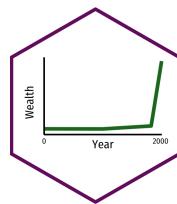


Gordon Tullock

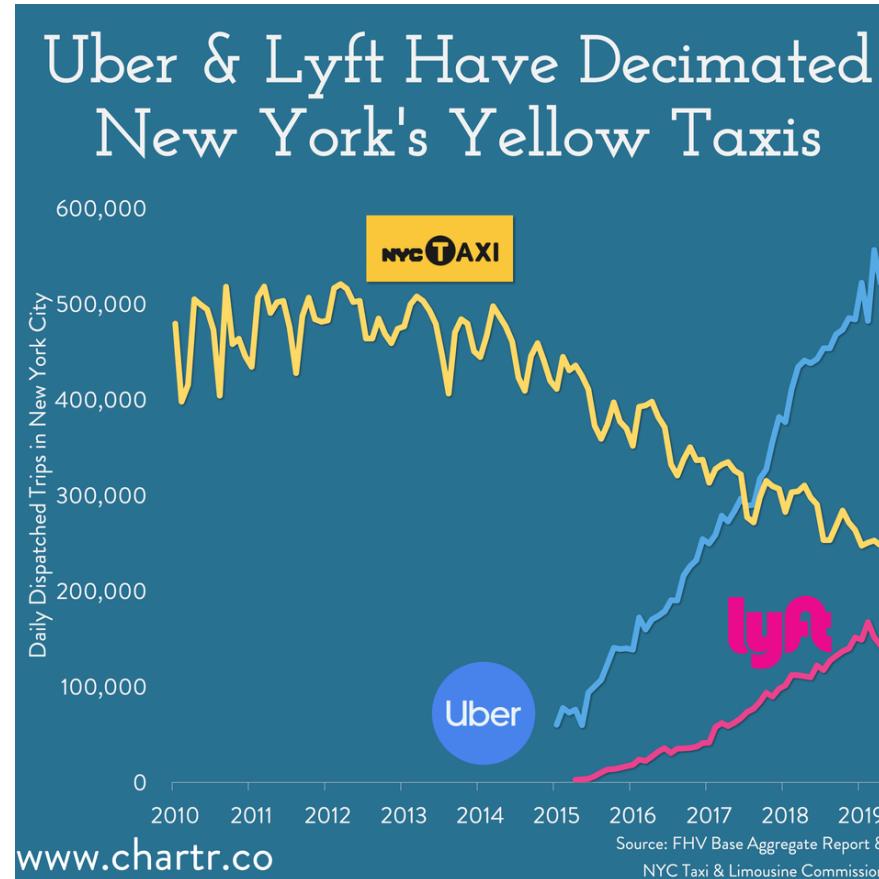
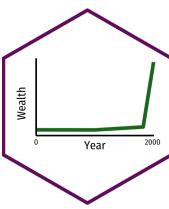
1922-2014

"Entrepreneurs should be willing to invest resources in attempts to form a monopoly until the marginal cost equals the properly discounted return. The potential customers would also be interested in preventing the transfer and should be willing to make large investments to that end. Once the monopoly is formed, continual efforts to either break the monopoly or muscle into it would be predictable. Here again considerable resources might be invested. The holders of the monopoly, on the other hand, would be willing to put quite sizable sums into the defense of their power to receive these transfers," (p.231).

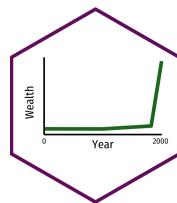
Rent-Seeking & Creative Destruction: Example



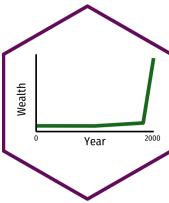
Rent-Seeking & Creative Destruction: Example



Rent-Seeking & Creative Destruction: Example



Another Mundane(?) Example



The New York Times

EAT

SUBSCRIBE NOW

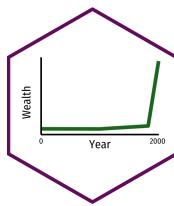
LOG IN

Got Almond Milk? Dairy Farms Protest Milk Label on Nondairy Drinks

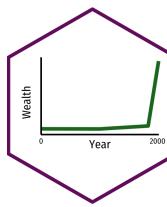
A photograph of a grocery store dairy aisle. The shelves are stocked with a variety of milk alternatives, including Lactaid, Silk, and a2 Milk. There are also traditional dairy products like Horizon Organic milk and Loma Linda almond milk. The shelves are well-lit, and the products are arranged in neat rows.

Source: [New York Times \(Feb 13, 2017\)](#)

If You Look at the World Long Enough...



Regulation has a Dark Side



George Stigler

1911-1991

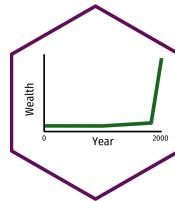
Economics Nobel 1982

"[A]s a rule, regulation is acquired by the industry and is designed and operated primarily for its benefits," (p.3).

"[E]very industry or occupation that has enough political power to utilize the state will seek to control entry. In addition, the regulatory policy will often be so fashioned as to retard the rate of growth of new firms," (p.5)." (p.5.)"

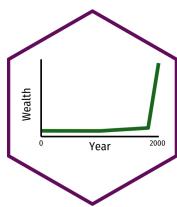
Stigler, George J, (1971), "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 3:3-21

Regulation has a Dark Side

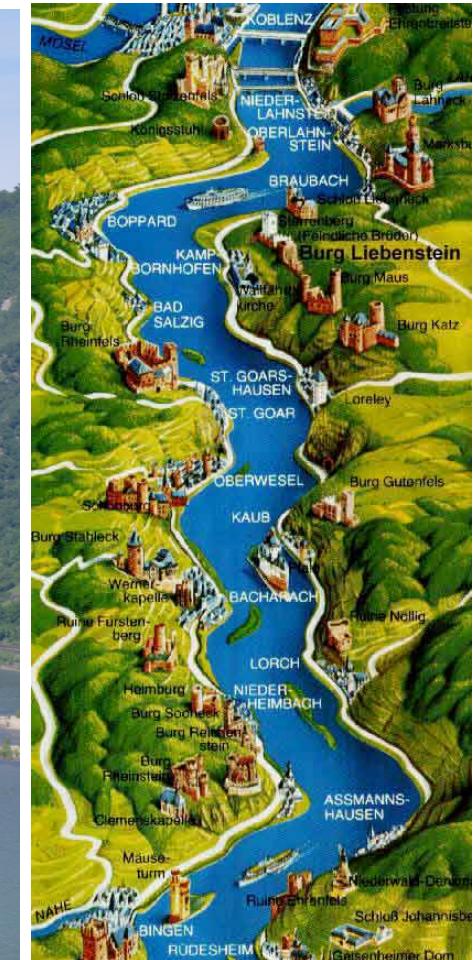
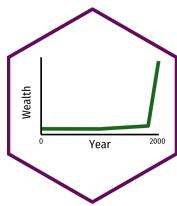


- **Regulatory capture:** a regulatory body is “captured” by the very industry it is tasked with regulating
- Industry members use agency to further their own interests
 - Incentives for firms to design regulations to harm competitors
 - Legislation & regulations written by lobbyists & industry-insiders

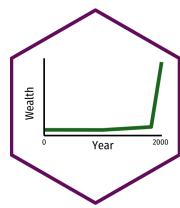
Private Rent-Seeking I

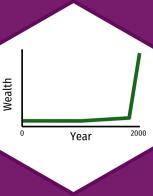


Private Rent-Seeking II



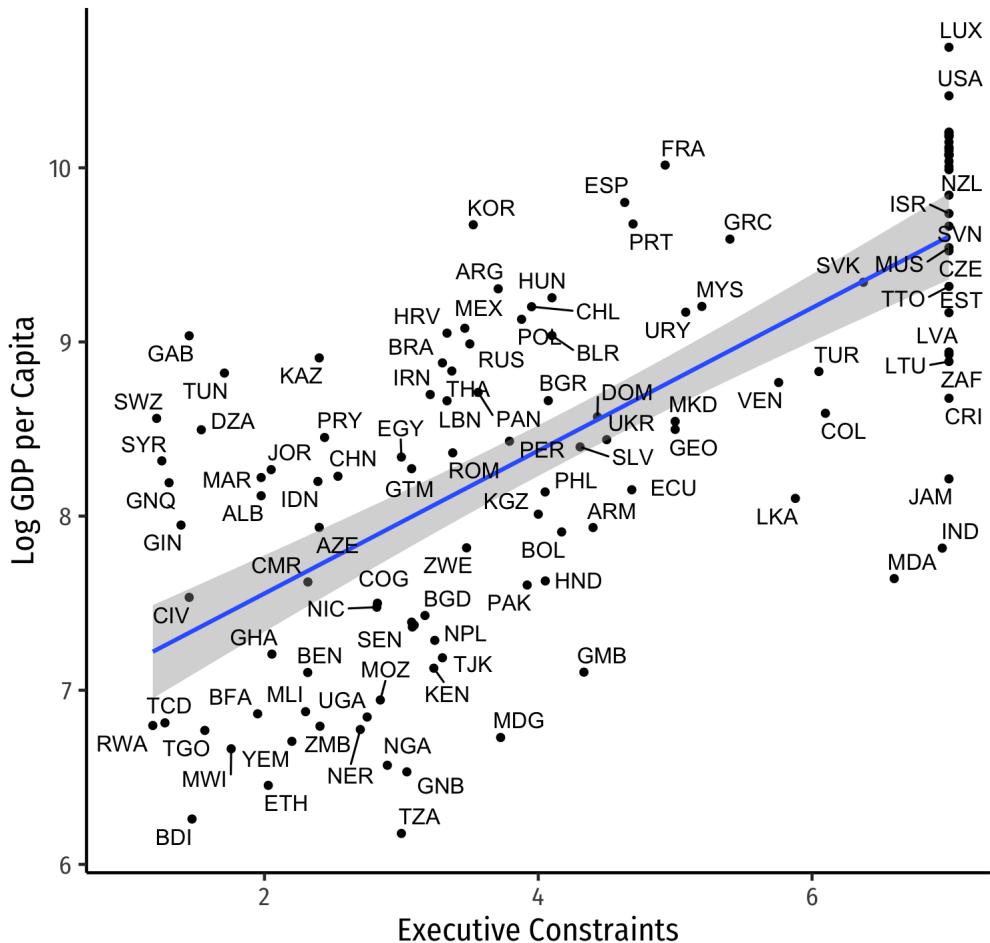
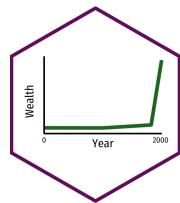
Private Rent-Seeking III





Back to Institutions: Rent-Seeking and Elites

Institutions Matter



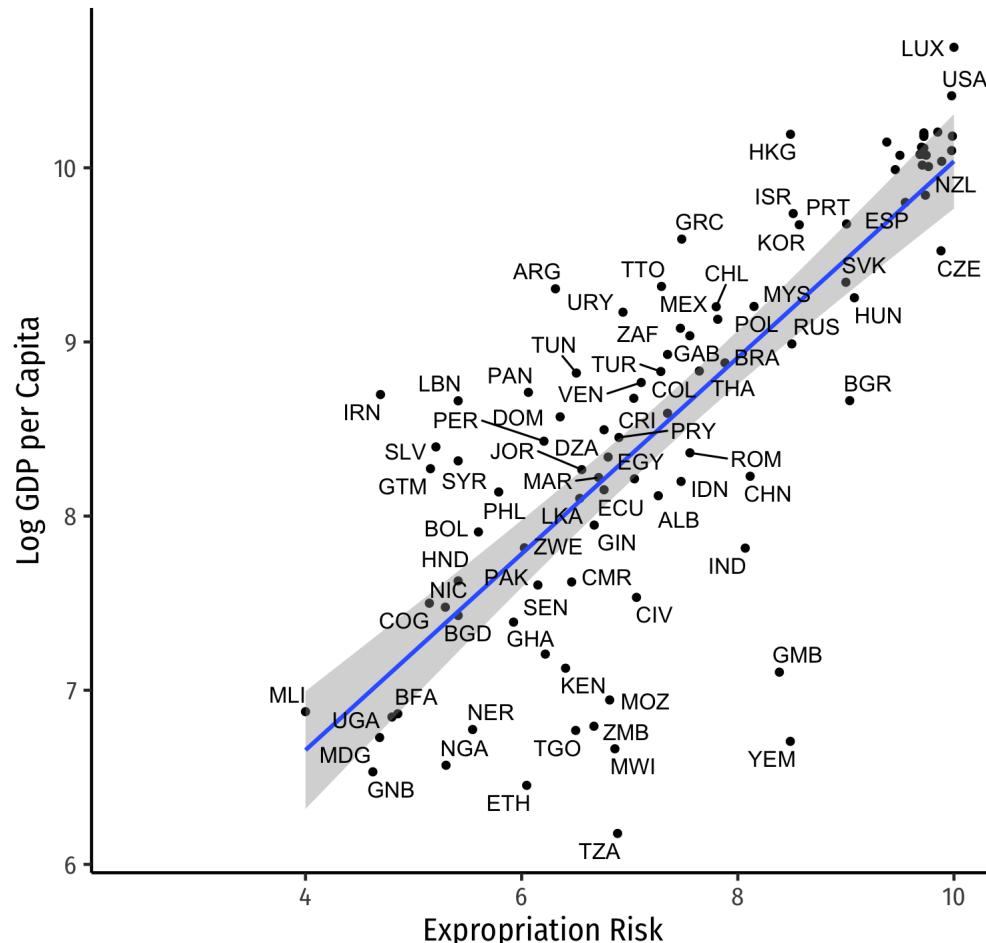
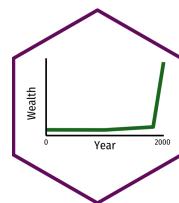
Executive Constraints: A measure of the extent of institutionalized constraints on the decision making powers of chief executives. The variable takes seven different values: (1) Unlimited authority (there are no regular limitations on the executive's actions, as distinct from irregular limitations such as the threat or actuality of coups and assassinations); (2) Intermediate category; (3) Slight to moderate limitation on executive authority (there are some real but limited restraints on the executive); (4) Intermediate category; (5) Substantial limitations on executive authority (the executive has more effective authority than any accountability group but is subject to substantial constraints by them); (6) Intermediate category; (7) Executive parity or subordination (accountability groups have effective authority equal to or greater than the executive in most areas of activity). This variable ranges from one to seven where higher values equal a greater extent of institutionalized constraints on the power of chief executives. This variable is calculated as the average from 1960 through 2000, or for specific years as needed in the tables.

Glaeser, Edward L, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2004,

"Do Institutions Cause Growth?" *Journal of Economic Growth* 9: 271-303

Data Source: Glaeser et. al (2004)

Institutions Matter II

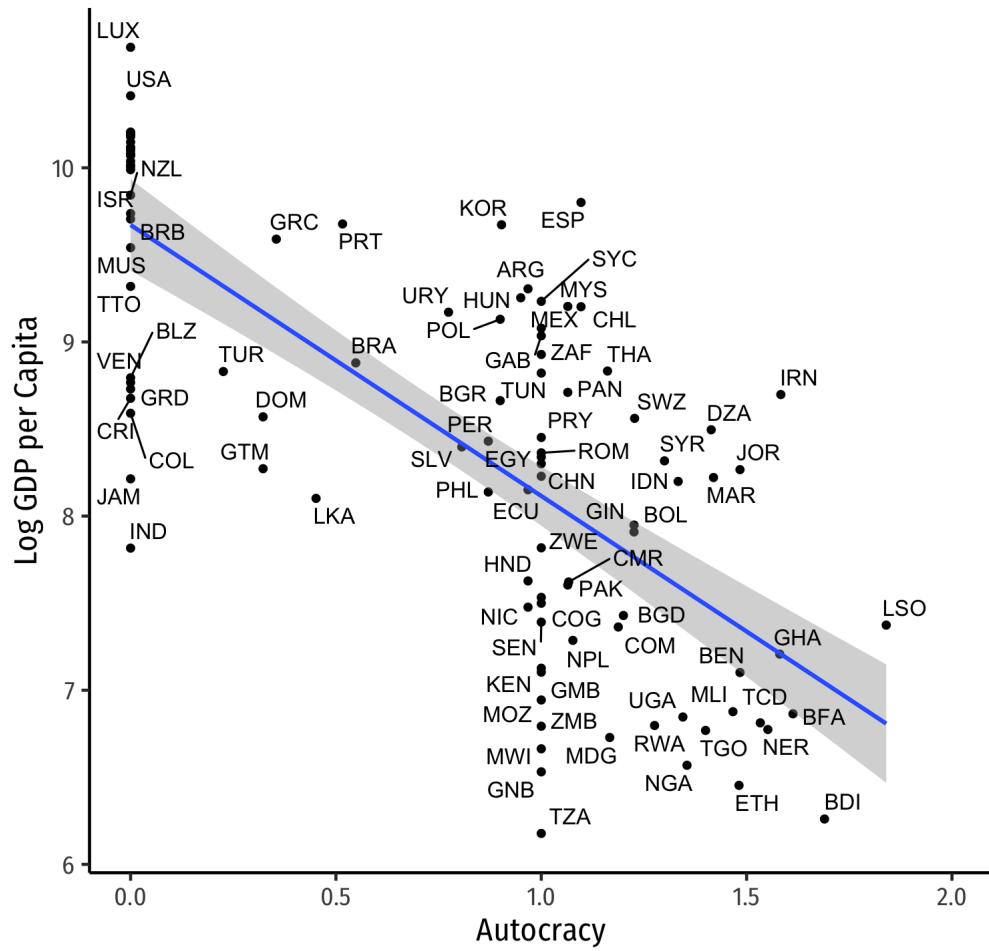
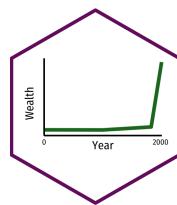


Expropriation Risk: Risk of "outright confiscation and forced nationalization" of property. This variable **ranges from zero to ten where higher values are equals a lower probability of expropriation.** This variable is **calculated as the average from 1982 through 1997**, or for specific years as needed in the tables. Source: International Country Risk Guide at <http://www.countrydata.com/datasets/>.

Glaeser, Edward L, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2004,

"Do Institutions Cause Growth?" *Journal of Economic Growth* 9: 271-303

Institutions Matter III

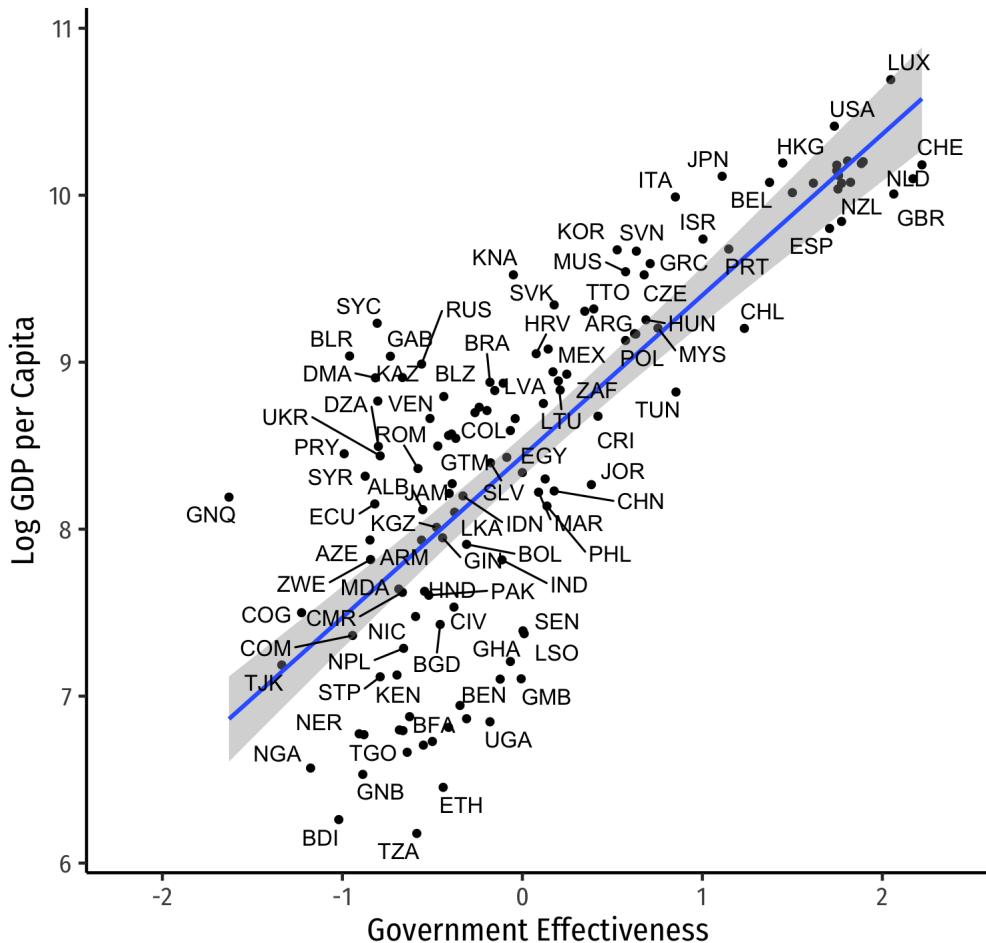
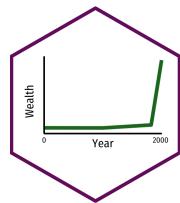


Autocracy: A measure of the **degree of autocracy in a given country** based on: (1) the competitiveness of political participation; (2) the regulation of political participation; (3) the openness and competitiveness of executive recruitment; and (4) constraints on the chief executive. This variable **ranges from zero to ten where higher values equal a higher degree of institutionalized autocracy**. This variable is **calculated as the average from 1960 through 2000**, or for specific years as needed in the tables. Source: Glaeser and Marshall (2000).

Glaeser, Edward L, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2004,

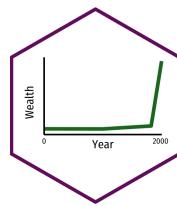
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Institutions Matter IV



Government effectiveness: This variable measures the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies. The main focus of this index is on "inputs" required for the government to be able to produce and implement good policies and deliver public goods. This variable **ranges from -2.5 to 2.5 where higher values equal higher government effectiveness.** This variable is **measured as the average from 1998 through 2000.** Source: Kaufman et al. (2003).

Political Institutions



- **Politics**: process by which society chooses rules that will govern it
- AJR¹:

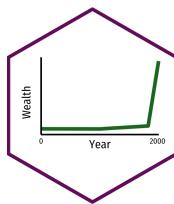
Economic performance ← economic institutions ← politics ← political institutions ← distribution of political power



- Key role of **state capacity** or "**political centralization**" in development

¹ The colloquial term for "Acemoglu, Johnson, and Robinson" who frequently collaborate together on these issues!

AJR: Inclusive vs. Extractive Institutions

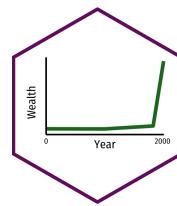


Extractive Institutions/Colonies



Inclusive Institutions/Colonies

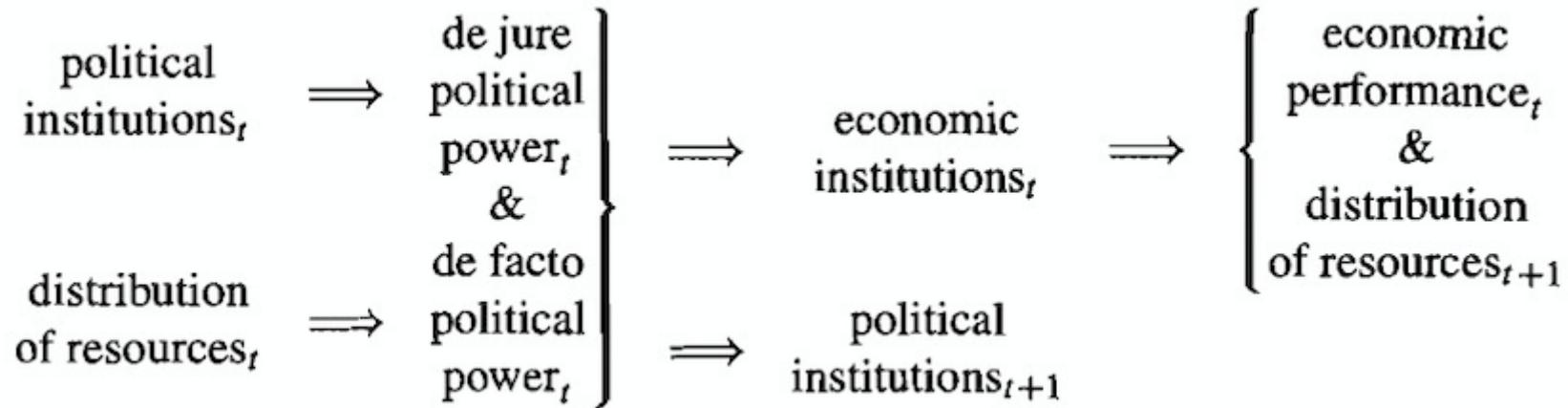
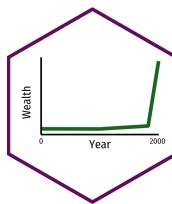
Political Institutions



- Strong feedback loops:
- Under **extractive institutions**, political & economic elite can structure institutions to maintain their wealth and power to extract rents at the expense of the population
- Under **inclusive institutions**, more equitable distribution of wealth and power, competition prevents any one group from creating and maintaining enough rents to exert control
- Institutions are maintained by elites who control power, choose economic institutions with few constraints or opposing forces to them!
- **Why would elites ever permit reform?**



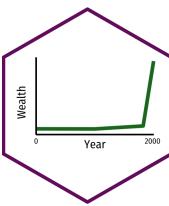
AJR's Ultimate Framework



Acemoglu, Daron, Simon Johnson, and James A. Robinson, 2006, "Institutions as a Fundamental Cause of Long-Run Growth," *Handbook of Economic Growth*, Philippe Aghion and Steven N.

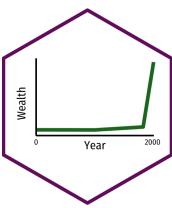
Durlauf, eds., pp.385-414

Luddites

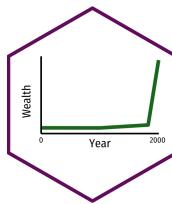


The "Luddites" destroying power looms in early 19th century Britain

Creative Destruction: Would You Want to Stop This?

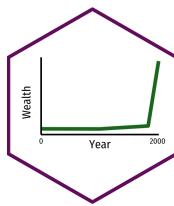


AJR: Political Losers Block Development



"**There are problems with this story**, however. First, despite the intuitive appeal of the idea, there are **relatively few instances where major economic change was blocked by economic losers**. Mokyr (1990) emphasizes the attempts of many skilled artisans to block the introduction of new machines. The most famous example is the Luddites, skilled weavers who were thrown out of work by mechanization. Interestingly, however, many of these groups, including the Luddites, were ultimately unable to block economic progress. Equally important, **the economic-losers hypothesis relies on the presumption that certain groups have the political power to block innovation**. But if so, **why not use this power to simply tax the gains generated by the introduction of the new technology?** This might be because there are limits on the nature of fiscal instruments, though it seems plausible that groups with sufficient political power to block innovation would be able subsequently to lobby effectively for redistribution. A more important reason, however, may be that **the introduction of new technology, and economic change more generally, may simultaneously affect the distribution of political power**," (126).

AJR: Political Losers Block Development



"We argue that the effect of economic change on political power is a key factor in determining whether technological advances and beneficial economic changes will be blocked. In other words, we propose a "political-loser hypothesis." We argue that it is groups whose political power (not economic rents) is eroded who will block technological advances. If agents are economic losers but have no political power, they cannot impede technological progress. If they have and maintain political power (i.e., are not political losers), then they have no incentive to block progress. It is therefore agents who have political power and fear losing it who will have incentives to block. Our analysis suggests that we should look more to the nature of political institutions and the determinants of the distribution of political power if we want to understand technological backwardness," (pp.126-127)

Acemoglu, Daron and James A. Robinson, 2000, "Political Losers as a Barrier to Economic Development," *American Economic*

Review 90(2): 126-130