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Institutions Matter: How So?

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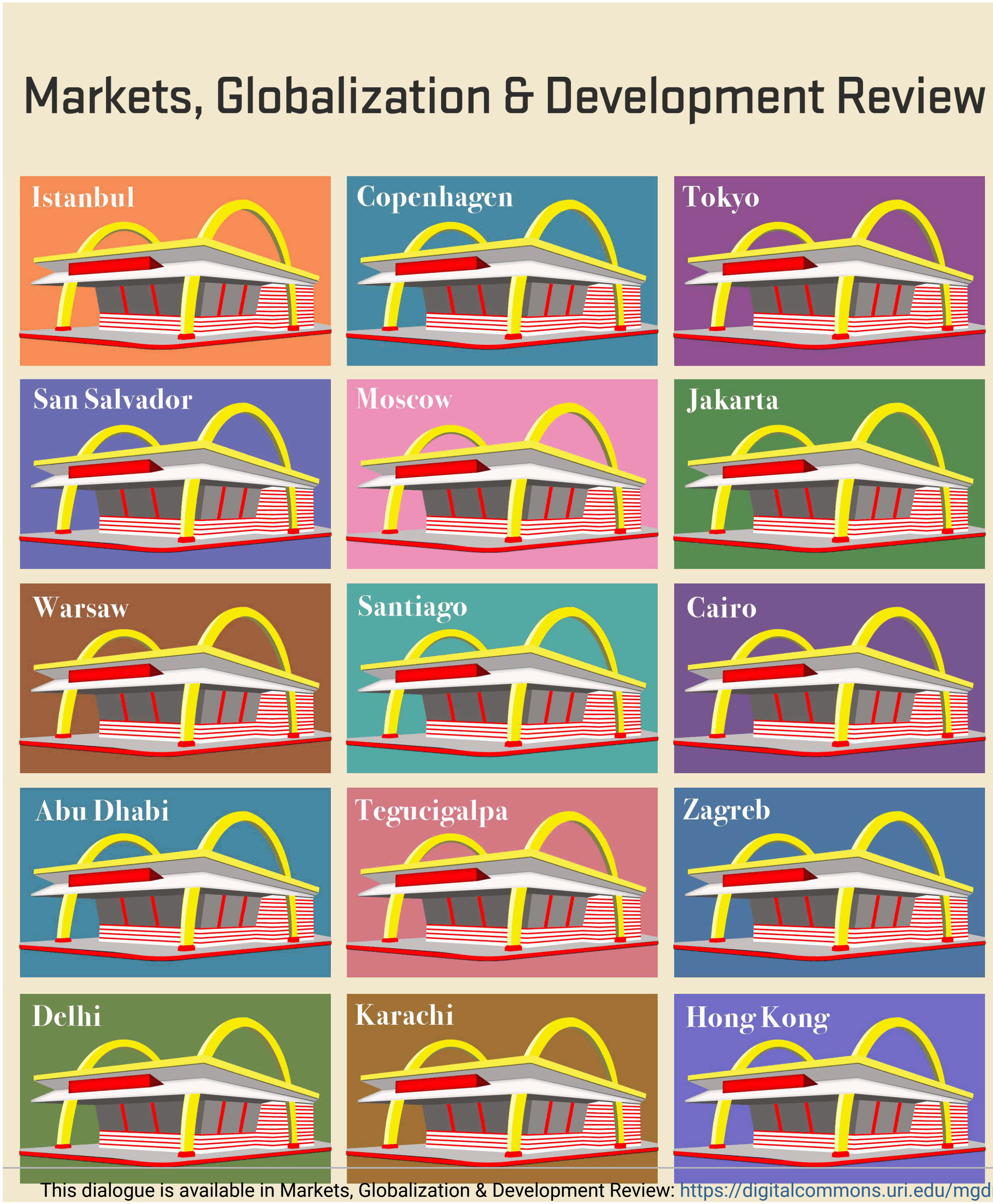
Cover Page Footnote

I would like to thank Oğuz Esen for his encouragement.



Institutions Matter: How So?

Introduction

Daron Acemoğlu, Simon Johnson, and James Robinson (AJR, hereafter) were awarded the 2024 Nobel Prize in Economics for their contributions to the research agenda of "how institutions are formed and affect prosperity" (Sveriges Riksbank 2024). It is rather ironic that most of the ensuing commentaries focused on the effects of institutions on prosperity. The main contribution of the AJR trio, however, is on how formal institutions really persist and change. As they persist and change, institutions affect the general structure of incentives and indirectly affect economic performance, by enhancing investment in physical and human capital and by increasing total factor productivity.

At the heart of AJR work lies the argument that institutions are the fundamental determinants of long-term economic success (Acemoglu et al. 2001, 2005; Acemoglu and Johnson 2005). AJR are the followers of Douglass North, credited with the “new institutionalist” label, although AJR characterizes their work as in the field of “political economy”. The AJR conceptualization of institutions is based on the humanly designed “rules of the game” notion. Institutions shape the interactions of people among themselves and of people vis-a-vis the state. The institutions can be formal or informal. Formal institutions are mostly macro level such as democracy, rule of law, constraints to executive power, and enforcement of contracts. Informal institutions are emphasized but scarcely studied. They define informal institutions as the unwritten rules, norms, and customs that shape political, economic, and social behavior. One example could be ostracism that was widespread in ancient Athens (Acemoglu and Robinson 2019): In ancient Athens, any citizen could be expelled from the city-state for ten years if a majority voted for it. It was used as a way of neutralizing someone thought to be a threat to the state or a potential tyrant, though in many cases, popular opinion often informed the expulsion. Older as well as modern institutions often arise organically within societies and can be as powerful as formal laws and regulations.

In their landmark book *Why Nations Fail* (2012), they explain that societies with inclusive institutions, those that create incentives for individuals to engage in productive economic activities, experience sustained economic growth. By contrast, extractive institutions, which consolidate wealth and power in the hands of a few, foster inequality and hinder development. Their analysis challenges earlier theories that attributed economic differences to factors like geography or culture, proposing instead that the quality of a country's political and economic institutions determines its economic trajectory (Acemoglu and Robinson 2012).

Their work is grounded in a wealth of historical and empirical evidence. They argue that the divergent economic outcomes of colonized nations can be traced back to the institutional frameworks established by European powers. Colonizers, especially in regions like Africa and Latin America, often established extractive institutions that concentrated power and wealth, a legacy that continues to shape the development prospects of these countries. By contrasting such societies with those that developed in settler-colonies rather than in occupied-colonies – e.g., inclusive institutions such as in the United States, Australia, and New Zeeland – AJR demonstrates that the key to prosperity lies in creating institutions that are politically inclusive, protect property rights, and provide economic opportunities for a wide swath of the population (Acemoglu et al. 2001).

In the next section, I will discuss the distinctive contributions of AJR in terms of power and conflict, inequality, and state-society relations. In the third section, I will introduce my critiques. One is that their results on the effects of particular institutions on economic performance are not robust. Second is that they underestimate the opportunity costs of forming and sustaining institutions. The last section offers discussion and concluding observations.

Distinctive Contributions of AJR

Power and Conflict

"Why did elites in Britain create a democracy? Our discussion makes it clear that democracy did not emerge from the voluntary acts of an enlightened elite. Democracy was, in many ways, forced on the elite, because of the threat of revolution" (Acemoglu et al. 2005, p. 441).

According to AJR, there is a hierarchy of institutions, with political institutions influencing economic institutions and economic institutions then affecting economic outcomes. Political institutions are primary. Political refers to power: who has power over whom. The appropriation of power into mainstream economics is a major step. Conventional economics avoided power by assuming that economics is mostly about constrained optimization. Given preferences and technology, how to allocate money (i.e., resources) on alternative consumption or production is taken to be the central research question. Abba Lerner declared that “Economics has gained the title Queen of the Social Sciences by choosing solved political problems as its domain" (Lerner 1972). Even the notion of power sneaking into economics should be appreciated. AJR could accomplish that by arguing for the primacy of political institutions. Political institutions are directly about who holds power in a society and about how they rule.

The conflict view of institutions embodies power. Formation and change of institutions are based on conflict of interest in different societal groups. It argues that the core determinant of whether a society develops inclusive or extractive institutions is the political conflict between these elites and the general population. When elites face little threat to their power, they have no incentive to reform institutions or share political and economic power. In contrast, when elites feel threatened – for instance, by the rising power of new political groups or by economic inequality that triggers unrest – they may face increasing pressure to either concede power or defend their interests through coercion (Acemoglu et al. 2005).

A key part of AJR theory is the concept of critical junctures: key historical moments or events that open a window of opportunity for institutional change. These critical junctures can be wars, revolutions, or other political crises that disrupt the existing balance of power.

Critical junctures allow for the possibility of a new distribution of de facto power, which can lead to a shift in the institutional framework. If the masses or disenfranchised groups are able to seize this opportunity, they can push for radical change in de jure political power so that inclusive institutions can be established. For example, after a revolution or a major societal upheaval, elites may be forced to share power or cede control, leading to the creation of institutions that provide more widespread opportunities for economic participation.

On the other hand, critical junctures can also lead to the reinforcement of extractive institutions if elites are able to manipulate the situation to consolidate their power. For instance, elites may co-opt the military or use coercive tactics to suppress popular movements and maintain control over the economy and political system. In this case, the critical juncture will result in an even more extractive system, where political and economic opportunities are even more tightly controlled by elites.

Thus, AJR's theory highlights that institutional change is not linear but occurs through contingent moments in history, shaped by conflict and competition over power and resources. Whether institutions evolve toward inclusivity or extractiveness depends on the outcome of these political struggles and the balance of power between elites and the broader population (Acemoglu et al. 2001).

The threat of revolution and the cost of repression are key factors that influence the decisions of elites about whether to maintain the status quo or make concessions that lead to the emergence of more inclusive institutions (Acemoglu et al. 2005).

The cost of repression refers to the resources and effort elites must invest to suppress potential uprisings, protests, or revolutionary movements. This cost includes the financial burden of maintaining a strong military or security apparatus, the political cost of being seen as a repressive regime, and the social cost of deepening resentment among the population. When the cost of repression becomes too high, elites may find that it is cheaper to negotiate and make concessions, thereby leading to a change in the institutional framework.

In the short run, elites may choose repression as a way to suppress unrest and maintain the status quo. The long-term sustainability of such a strategy, however, is questionable. As repression becomes more expensive (in terms of military spending, social legitimacy, and the threat of rebellion), the viability of extractive institutions weakens. High repression costs often signal an underlying institutional weakness, as the elite's inability to deal with popular discontent reflects a failure to address the root causes of that discontent, which is often institutionalized inequality or political exclusion.

The more repressive a regime becomes, the greater the risk of escalating violence. Repression may delay institutional change in the short run, but it can exacerbate social tensions and increase the likelihood of more radical forms of political instability (e.g., civil war or revolution). In this sense, elites may reach a point where repression becomes unsustainable.

The theory is based on political economic causes underlying the formation and the change of institutions. In this regard, it should be embraced as it avoids the pitfalls of mainstream economics in terms of assuming away most of these factors as exogenous.

Inequality

In the theory of institutional change proposed by Daron Acemoglu, Simon Johnson, and James Robinson (Acemoglu et al. 2005), the degree of inequality plays a critical role in determining the type of political and economic institutions that evolve within a society. Inequality is not just an economic outcome; it is also an important driver of institutional development. AJR argues that the distribution of political power and economic resources in society shapes the inclusivity or extractiveness of institutions, which in turn influences the path of economic development.

The degree of inequality in a society influences how elites and non-elites interact, which affects the stability of the political system and the likelihood of institutional reform or revolution. Their theory suggests that high inequality often correlates with extractive institutions that benefit a small elite at the expense of the broader population, while lower inequality tends to foster inclusive institutions that allow a larger portion of the population to participate in economic and political life, leading to more sustainable economic growth.

AJR argues that societies with high levels of inequality are more likely to have extractive institutions, systems of governance, and economic organizations that are structured to benefit a narrow elite while excluding the majority of the population from meaningful participation in economic or political life. In these societies, political and economic power is concentrated in the hands of a few individuals or groups who use institutions to perpetuate their privilege.

In societies characterized by high inequality, the elite has the incentive to maintain the status quo because they benefit from the existing distribution of wealth and power. To do so, they often create extractive political institutions that prevent the majority from gaining political representation, restricting access to education and controlling the economy in ways that allow them to maintain their privileged status.

This dynamic is particularly evident in countries where colonial legacies have left a deep imprint on the structure of society. For example, in many postcolonial countries, the local-national elites inherited extractive institutions designed to extract resources for the benefit of the colonizers. Once colonial powers left, these extractive institutions remained in place as the elites continued to extract wealth from the masses to sustain their privileged position.

High inequality is often associated with greater social unrest and a higher threat of revolution. When inequality becomes excessive, it creates deep societal divisions, which can fuel popular dissatisfaction and the demand for change. This creates pressure on elites to either repress the population or make reforms to address grievances. AJR's theory suggests that this pressure is one of the key mechanisms through which inclusive institutions emerge.

AJR emphasizes that excessive inequality increases the likelihood of revolution or political instability as the excluded population — often the majority — becomes increasingly disillusioned with the system. As inequality grows, the potential for conflict escalates, especially when the masses see little opportunity for social mobility or economic progress. The threat of revolution forces elites to reconsider the costs of maintaining extractive institutions. In many cases, elites may choose to adopt reforms or broaden political participation in an attempt to head off social unrest and prevent revolution.

The degree of inequality influences how likely it is that elites will opt for inclusive reforms. In highly unequal societies, the cost of repression increases because the mass of disenfranchised people — who feel excluded from the economic and political system — may eventually take collective action against the elites. As inequality reaches unsustainable levels, elites may recognize that inclusive institutions — those that provide broader access to political and economic power — offer a more viable path to stability than continued repression (Acemoglu and Robinson 2012).

State Capacity and the Shackled Leviathan

AJR argues that inclusive institutions, those that provide broad economic opportunities, secure property rights, and enforce the rule of law, are the key drivers of prosperity. The establishment and maintenance of these inclusive institutions, however, require a functioning and capable state. State capacity is essential for ensuring that institutions are not only designed but also effectively implemented and enforced (Acemoglu and Robinson 2019).

One of the key functions of the state, according to Acemoglu, Johnson, and Robinson, is to provide public goods that benefit society as a whole. Inclusive institutions are not just about protecting private property or enforcing contracts; they also include the provision of public goods such as education, healthcare, infrastructure, and public safety. These public goods are essential for human capital development, productivity growth, and overall economic development.

A state with high capacity can efficiently allocate resources for public goods, ensuring that these services are accessible to a wide range of people, especially the poor. Conversely, a state with weak capacity often fails to provide essential services equitably, leaving large portions of the population without access to basic services. This failure of the state to provide for the public welfare is a hallmark of extractive institutions, where public resources are often redirected to serve the interests of elites.

To constrain the state, however, a society should also be strong and mobilized. Leviathan should be shackled. Both the state's capacity and the strength of society in return depend on the preexisting institution in a very complicated way.

Critiques and Discussion

There are various critiques of their theory (Glaeser et. al. 2004, Luo and Wen 2015, Rodrik 2008). Glaeser et al. (2004) claim that geography rather than institutions is the primary driver of long term growth. Rodrik (2008) argues that although institutions matter, in most countries there are no optimal institutions: conditions allow only second-best institutions to be formed. Luo and Wen (2015) totally reject the primacy of institutions and emphasize the reverse causality running from development to institutional quality.

Their theory has also been challenged by evidence of countries that have succeeded despite extractive institutions. China, for example, has enjoyed remarkable economic growth over the past few decades despite an authoritarian regime that would be considered extractive by Acemoglu and Robinson's standards (Ang 2020; Wen 2015). Similarly, nations such as Singapore and South Korea have successfully leveraged state-led development models that do not necessarily conform to the Western liberal ideals of inclusive institutions (Amsden 2004). These examples suggest that the relationship between institutions and economic prosperity may be more complex than the theory proposes and that there might be other paths to development outside of the inclusive/extractive dichotomy.

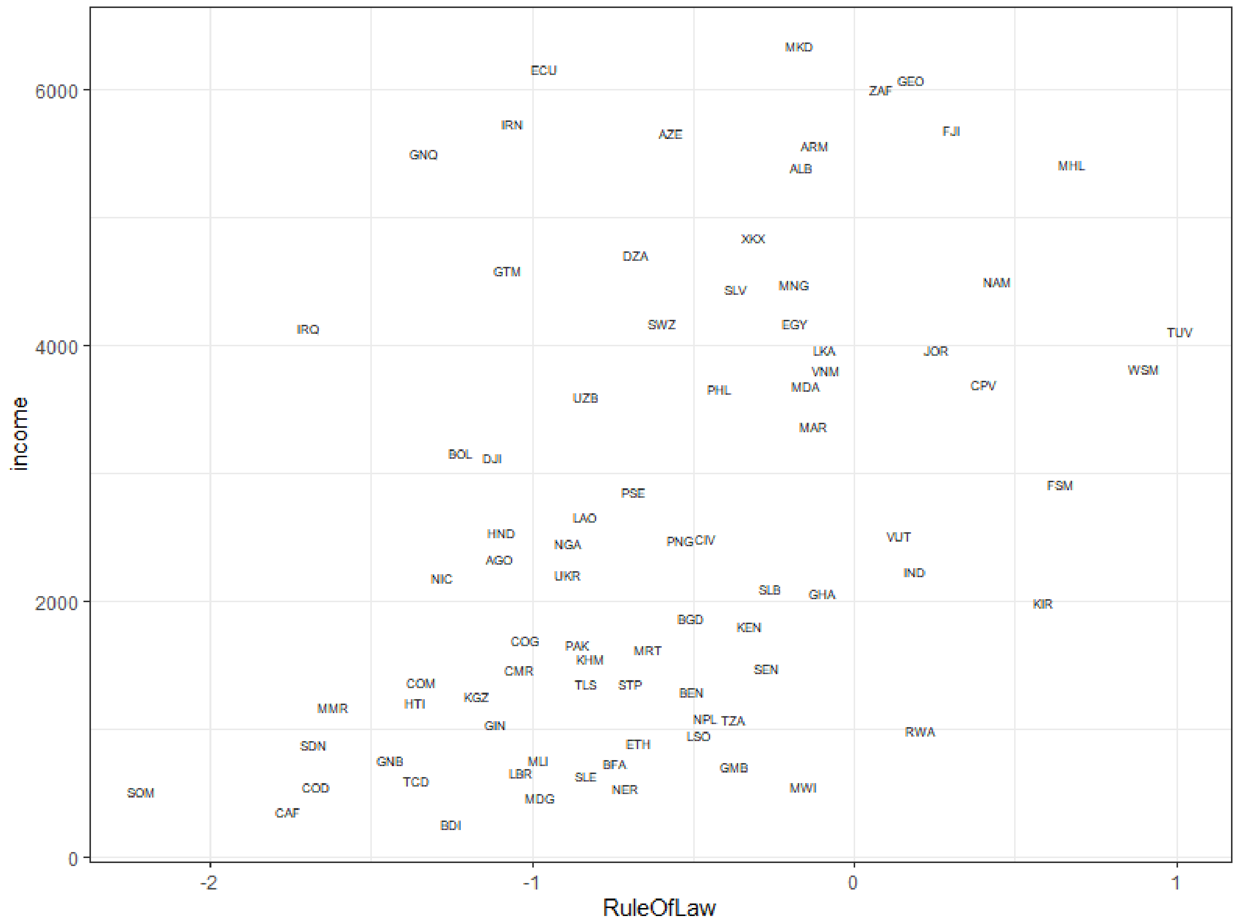
I will add two more critiques that I find more important. The first one concerns the robustness of their main argument that inclusive institutions will enhance economic performance in all countries. Second critique is devoted to the opportunity costs of forming and sustaining institutions.

Robustness

The theory states that inclusive institutions are good for economic performance. However, this prediction does not hold for the countries with an income below the median income as of 2023. Figure 1 illustrates this finding. There is no statistically positive correlation between the Rule of Law index and Gross Domestic Product per Capita in 2023 for the countries below median income.

The correlation holds for the richer countries. One reason could be that the institutions, such as the Rule of Law, are a public good with increasing returns to scale. They are financed only if there is a threshold of income in the first place. Another reason is related to the complementarity of institutions. As Rodrik (2008) argues, institutions come in packages. Thus, there has to be a certain level of development in order to attain the set of complementary institutions.

Figure 1: Rule of Law Index and Income



Source: Based on World Bank database on World Development Indicators

Institutions are Costly

One of the most profound but often overlooked aspects of Acemoglu, Johnson, and Robinson's theory is the *opportunity costs* associated with building and maintaining institutions. Their analysis emphasizes that inclusive institutions foster prosperity by aligning individual incentives with broader economic growth, but they offer relatively little discussion of the challenges and costs involved in creating these institutions, especially in countries with entrenched power structures, corruption, or legacies of extractive institutions. In their theoretical framework, institutions are portrayed as relatively stable structures that shape economic outcomes, but this overlooks the fact that institutions are not "free"; they are costly to establish, maintain, and reproduce.

Moreover, institutions are not static; they evolve over time and require ongoing effort to adapt to new economic challenges and changing political contexts. Reproducing inclusive institutions entails continuous investment in legal systems, education, infrastructure, and social services. In countries with limited resources or fragile governance systems, the challenge of maintaining inclusive institutions becomes even more daunting (Duman and Özgüzer 2017). This aspect of institutional development is critical to understanding the limitations of the AJR framework, as it downplays the political and economic challenges involved in building institutions from scratch or reforming entrenched systems.

Let us consider Turkey's situation in a parallel context. For example, let us try to deduce the time required to raise the institution of "relative state capacity" of Turkey to the level of Finland in 1960. According to the values in the Kugler and Tammen (2012) database, Turkey's state capacity was 0.739 in 1960 and 0.931 in 2011. Finland's value in 1960 was 1.139.

When the speed of improvement in state capacity in Turkey from 1960 to 2011 is taken into account, it will take Turkey approximately 50 years to reach Finland's level in 1960. Assuming that the material basis of the improvement in state capacity is also based on the ratio of tax revenues to GDP, if we make a linear inference, the ratio of tax revenues to GDP should reach 67% after 50 years. This is an almost impossible expectation in terms of both time and required resources.

Concluding Observations

The challenges involved in creating institutions that promote broad-based prosperity are immense, and the process is often politically contentious and resource-intensive. While AJR's work has provided invaluable insights into the role of institutions, it is important for future research to engage with the costs and complexities of institutional change, as well as to consider the broader factors, both domestic and international, that shape development. Ultimately, the recognition of Acemoglu, Johnson, and Robinson's work calls for a more nuanced understanding of the relationship between institutions and economic prosperity, one that takes into account the difficult realities of building and maintaining inclusive institutions in diverse contexts.

There are still open research questions regarding the AJR framework. One is the inclusion of informal institutions and the explanation of dynamic interactions between informal and formal institutions. The second question is related to the previous one. The complex dynamics of culture and institutions should also be incorporated into the core theory of institutions.

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