"Institutions Matter"?

Adam Przeworski
Department of Politics
New York University

Abstract

New institutional economics is based on two propositions: (1) Institutions matter, (2) Institutions are endogenous. These propositions are meaningful and logically consistent only if (1) Outcomes depend on institutions, (2) Different institutions are feasible under the same conditions, and (3) There is an equilibrium path leading from one institution to another. I apply this analytical framework to examine the recent economic history and the recent statistical analyses of the impact of institutions.

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> "That institutions affect the performance of economies is hardly controversial. That the differential performance of economies over time is fundamentally influenced by the way institutions evolve is also not controversial." (North 1990: 3)

1 Background

During the past year or so, I have been mulling over several thoughts, some substantive and some methodological, with only a vague intuition that they are somehow related. And since the calendar of conferences does not always clear one's mind, I am compelled to reproduce these thoughts in a state of confusion.

One of my entry roads into this vaguely contoured terrain is a substantive question: "Why is it so hard to equalize market incomes?" The other is methodological: "What does it mean to say that 'institutions matter'?" These roads cross at several junctions. The main intersection is "Is it true that inequality is perpetuated because it is reproduced by institutions?" This question, in turn, generates a meta-theoretical echo: "Isn't the recent economic institutionalism just a reverberation of marxism, particularly, of the 'historical-structural' method?" (Engerman and Sokoloff vs Cardoso and Faletto). Digging deeper under this intersection, I discover statistical issues: "How does one go about identifying the effect of institutions?" (Banerjee and Duflo). Finally, buried even deeper are again substantive questions: "Which are the institutions that matter for development and income distribution? Are they political or social, say family?" (Jelin).

These meandering lines do not, hopefully only as yet, add up to a research question. I do not yet have a "project." Hence, I intend to tackle them one-by-one. As the title indicates, this note will focus on the issue of institutions. I need to warn that these are just first thoughts, about which I am often uncertain or unclear. I did not attempt to reference the paper in any systematic way: I just stuck in those references that immediately come to mind.

Since this paper is a shaggy dog story, here is a preview of the conclusions:

(1) Institutions can be said to matter only if they can be changed and this change leads to different outcomes.

(2) While such possibilities have been variously described in general terms (most recently by Holmes 2003), they are absent from historical accounts of international income disparities.

(3) If insecurity of property rights is an impediment to development, the path from economic *cum* political inequality (second best) to eco-

nomic *cum* political equality (first best) passes through crises and may not be followed.

(4) A gradual equalization of market incomes may be impossible. Perhaps only revolutionary changes are.

(5) To conclude that institutions matter, we must know which institutions matter for what. As of now, we still do not.

2 The new institutionalism

The new institutionalism is founded on two propositions: (1) Institutions[1] matter, (2) Institutions are endogenous.[2] The embarrassingly obvious observation is that if endogeneity means that only those institutions that generate a particular outcome can function under given conditions, then institutions cannot matter: the counterfactual "had the institutional framework been different" is in *modus irrealis*.

The central claim of "institutional economics" is that institutions affect political performance. The theoretical program has been laid out by North (1997: 224):

> To make sense out of historical and contemporary evidence, we must rethink the whole process of economic growth. Current theory stems from the development of national income and growth accounting literature and explores the superficial aspects of economic growth – technology or human or physical capital – rather than the structure of incentives and disincentives that make up the institutional framework of an economy and polity.... The primary source of economic growth is the institutional/organizational structure of a political economy.... economic growth is dependent on stable political/economic institutions that provide low costs of transacting in *impersonal* political and economic markets.

[1] While we share strong intuitions, strangely enough we do not a commonly agreed to definition of institutions. I do not want to get mired into definitional issues, so let me just declare that by "institutions" I mean rules (previously announced or learned inductively) which people expect to be followed (in a centralized or decentralized manner) by sanctions in case of deviations. I assume that this definition does not offend sociologists, since it is due to Parsons (1951), or to economists, since regularity and out-of-equilibrium threats are common features of their definitions (Greif 2002).

[2] There is nothing new about the claim that institutions are endogenous. Montesquieu as well as Rousseau, the latter in his folkloric description of Poland, claimed that particular institutions can function only if they correspond to cultures, mores, religions, or geographic conditions. J.S. Mill considered the issue of endogeneity in the first chapter of *Considerations*, entitled "To What Extent Forms of Government are a Matter of Choice." What is new is the combination of these two propositions.

Specifically, we learn that "Third World countries are poor because the institutional constraints define a set of payoffs to political/economic activity that do not encourage productive activity." (1990: 110).

The consequences are obvious. Install independent judiciary, establish clear property rights, create independent central banks, and manna will fall from heaven. In the language of Washington Consensus, this is the "third stage of reforms."

If institutions are exogenous, that is, if different institutions can exist under the same conditions, and if these institutions generate different outcomes, then they obviously matter. But "institutional economics" also claims that institutions are endogenous: "Why does a fundamental change in relative prices affect two societies differently?... In each society the change will result in adaptations at the margin ... and the solution will be determined by the relative bargaining power of the participants.... Thus, a common set of fundamental changes in relative prices or the common imposition of a set of rules will lead to widely divergent outcomes in societies with different institutional arrangements" (North 1990: 101).[3] But if this is true, it may be that the "institutional constraints define a set of payoffs to political/economic activity that do not encourage productive activity" precisely in those countries where returns to productive activity are relatively low. When returns to producing are low, those who populate political institutions prefer to engage in rent seeking (Murphy, Shleifer, and Vishny 1993). And if anything like this is true, then North's explanation of the poverty of the Third World is circular.

Moreover, the institutional reforms program of international financial institutions may be doomed to failure. For example, one of the main items on the agenda of institutional reforms is making the judiciary independent of political control. Yet if judges receive salaries as low as politicians, making them independent just lowers the cost of bribes: when the judiciary depends on political control, politicians have to share bribes with judges and perhaps with fellow politicians who provide the cover, while independent judges can be bribed one by one.

Unfortunately, clarifying these assertions calls for a fair amount of hair-splitting. I assume that by "institutions matter" we mean that given some exogenous conditions, an institutional framework i generates a different outcome than an institutional framework j. "Geography" –

[3] For future reference, compare this argument to Cardoso and Faletto (1969: 19; translation mine): "The configuration at a given moment of the political-institutional aspects can be understood only in function of the structures of domination [read: relative bargaining power]. In consequence, it is also through their analysis that one can capture the process of transformation of the political-institutional order."

a summary reference in recent economic history – constitutes such conditions: climate, quality of soil, natural endowments, topography, frequency of airborne diseases cannot be changed in a short to medium run and are thus exogenous. Institutions i and j may be democracy and dictatorship, parliamentarism and presidentialism, extended family and a nuclear one, public and private education, etc.

Note that institutions may be irrelevant in two different ways: (1) It may be that all institutions generate the same outcome under particular conditions. This was the point of the story about judicial reform. As Guillermo O'Donnell once remarked to me, "One cannot prevent a coup d'etat by an article in the constitution," any article in the constitution. When all institutions would generate the same outcome, the proposition "Institutions matter" is just false. (2) Only those institutions that generate a particular outcome are feasible under given conditions. In this case, the proposition "Institutions matter" is logically meaningless, because the counterfactuals are an empty set.

By "endogenous," I mean that institutions must be self-enforcing under the particular conditions (Greif 2002). Since it is relative, "endogeneity" is a more complicated notion. One distinction we may wish to make is between endogeneity with regard to conditions and with regard to outcomes. An institution is endogenous with regard to conditions if only some institutions are self-enforcing under these conditions. Colin Turnball argued in *The Forest People* that kinship structures arise from the conditions under which people produce: pygmies, who live in the forest and live from hunting, have a different kinship structure than people who live on the plane and cultivate land. The causal chain here is from conditions to institutions to outcomes. But one could use the same story as an illustration of endogeneity with regard to outcomes: in his story, men who can acquire wives without giving away sisters in exchange could not be effective hunters because hunting requires cooperation of men, women, and children. Hence, if hunting is a more profitable activity than cultivation, a kinship system in which women are bought is not feasible in the forest. The causal chain is from conditions to outcomes to institutions.

Whether this is a useful distinction depends whether one thinks that suboptimal institutions are feasible: if they are not, then functional explanations of institutions are logically valid, even if they are not intuitively illuminating.[4] Yet we know that in general there may exist paths that there are locally optimal while being globally suboptimal: a society

[4]Roemer (19xx) argued that theorems of social science are macro, while proofs are micro. If only optimal institutions are feasible, then from the observation that a particular institution is present one can infer, even without spelling out the micro

can "lock into" bad institutions. Hence, "incentive compatibility" does not imply global optimality. When this is true, the path of institutions depends on the initial conditions (or exogenous shocks). In this sense, institutions can be endogenous with regard to conditions while not being endogenous with regard to outcomes.

With these clarifications, we can investigate the conditions under which the two axioms of the new institutionalism are logically meaningful and consistent. My claim is that *institutions affect outcomes only if (1) alternative institutions are feasible under the same conditions, (2) these institutions generate different outcomes under the same conditions, and (3) it is possible to somehow get from one institution to another.*

The third requirement is the least obvious and may be controversial, so it needs a justification. Note, for example, that while Diermeier and Krehbiel (2001: 11; also Hurwicz 1994) postulate that theories of institutions must specify alternatives, they do not require equilibrium paths to connect these alternatives.[5] For them, institutions are endogenous when they have been chosen by actors operating under some, including institutional, constraints. But, given the extant institutions and other constraints, institutional change is possible only if the path to the alternative is an equilibrium under these conditions.

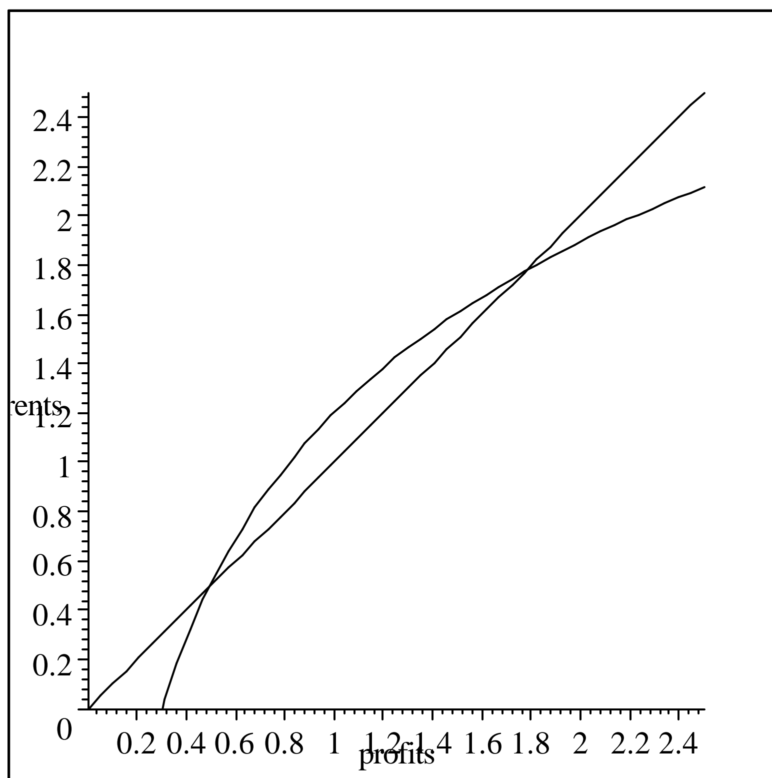
Suppose that in country W the economy starts at $t = 0$ in a state in which institutions are weak, by which I mean, in the spirit of North, that costs of anonymous transactions are high. In the equilibrium of this economy, the actual transactions costs are going to be low, because everyone will avoid costly anonymous transactions and productivity will be low because gains from anonymous transactions will not be exploited. In another country, S, institutions are strong – costs of anonymous transactions are low – and productivity is high. The World Bank will say that all we need to do is to install strong institutions in W to transform it into S. As Kindleberger (1952: 391-2) observed some fifty years ago, "These [World Bank country reports] are essays in comparative statics. The missions bring to the underdeveloped country a notion of what a developed country is like. They observe the underdeveloped country. They subtract the former from the latter. The difference is a program."

Yet there may be reasons institutions in W are weak and one of them may be that productivity is low. Consider the following story. When

story, that it is optimal, that is, that individuals have incentives to sustain it in their decentralized actions.

[5] The relevant passage is "in order to know why a certain institution exists, it is essential to know, with reasonable confidence, not only the consequences of the focal institution but also the consequences of alternative institutional arrangements that could have instead been crafted."

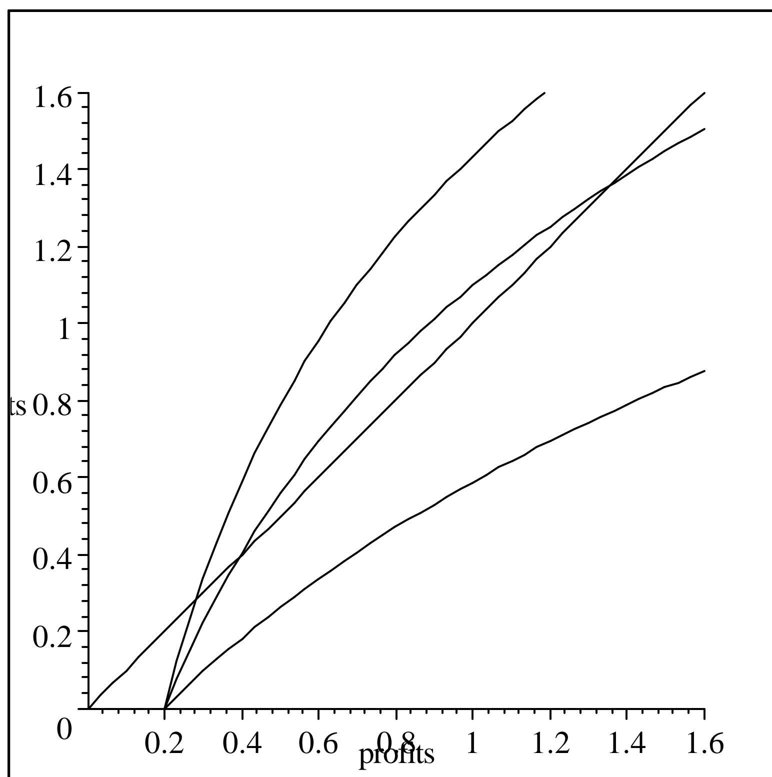
return to productive activities is low, some people can do better collecting rents from those who produce than rather than produce themselves (Murphy, Shleifer, and Vishny 1993). People can earn incomes either by producing at the rate of return π or by collecting rents $r(\pi)$ from producers. They allocate their labor to the sector in which rates of return are higher. In the low level equilibrium, W, return to production is low and so are the rents. The high level equilibrium is a path in which profits increase faster that rents. Now suppose that the country is in W and it lowers the rents to the point S. Since in the upper neighborhood of W rents are higher than profits, this economy will return to W and get stuck there. W is a low level trap.[6] Even though there are multiple equilibria, the equilibrium to which a country converges is determined by the initial conditions. If a country starts anywhere below the bifurcation equilibrium, call it $\bar{\pi}$, it converges to W. Institution S is not feasible in $0 \leq \pi < \bar{\pi}$; only institution W is.



Proponents of institutional engineering will counter this story by arguing that institutions do not just cause a shift along an equilibrium path

[6] For the mathematically oriented, $\dot{\pi} = \gamma(\pi - r), r = r(\pi)$, concave, $r(0) < 0$ will do it.

but alter this path, say by reducing the rents at each level of productivity: an independent auditing bureau reduces corruption and lowers rents while increasing the rate of return to production. Now institutions are characterized by the function $r_i(\pi), i \in Weak, Medium, Strong$, where for any π, $r_W(\pi) > r_M(\pi) > r_S(\pi)$. Initially, the country has weak institutions, with the low level equilibrium at W. If these institutions are moderately strengthened, with equilibrium is M, still a low level trap. But if a country builds strong institutions, the country is out of the trap region and continues growing along S.



But, *if institutions are endogenous,* how do we get from W to S? When the U.S. occupying forces left Haiti, they left as a their legacy a constitution patterned on the U.S. Constitution, which did not prevent the Duvaliers from doing whatever they wanted. Holmes (2003) tells a story in which the Russian oligarchs did not blink an eye when the Duma adopted a U.S. inspired anti-monopoly legislation: they knew that this legislation could not be and would not be implemented. Even communists could not reform their own institutions: the Polish Communist regime went from one institutional reform to another and nothing would budge. The cemetery of institutional reforms must be enormous.

This is why the existence of multiple institutional equilibria is not sufficient to render the proposition "Institutions matter" meaningful. A necessary condition for this proposition to be falsifiable is that there must exist an *equilibrium path* from one equilibrium to another. Stories about institutional reform must have microfoundations. Ferejohn (1999), for example, claims that the U.S. Congress made its activities more transparent to citizens because citizens were willing to grant the Congress more authority if it would become more accountable. The terms of the trade-off between secrecy and authority induced the Congress to reform itself. But such stories are hard to find. And it may be for a good reason: they may be rare.

It is not easy to understand why people who have power under some institutions would want to reform them.[7] If a particular set of institutions protects the privileges of some group, why would members of this group be willing to change it? And, unless we take the interests of those in power as the point of departure, all the talk about institutional reforms will remain hortatory. Unless institutional reforms are strictly Pareto superior, as in the Calvert (19xx) model, they must entail conflicts. Potential Pareto superiority – situations in which the winners could compensate the losers – is already problematic because, as Stiglitz (19xx) reports on his stint in the U.S. government, the promise of compensation is often not credible. What, then, are the conditions for an institutional change to be feasible?

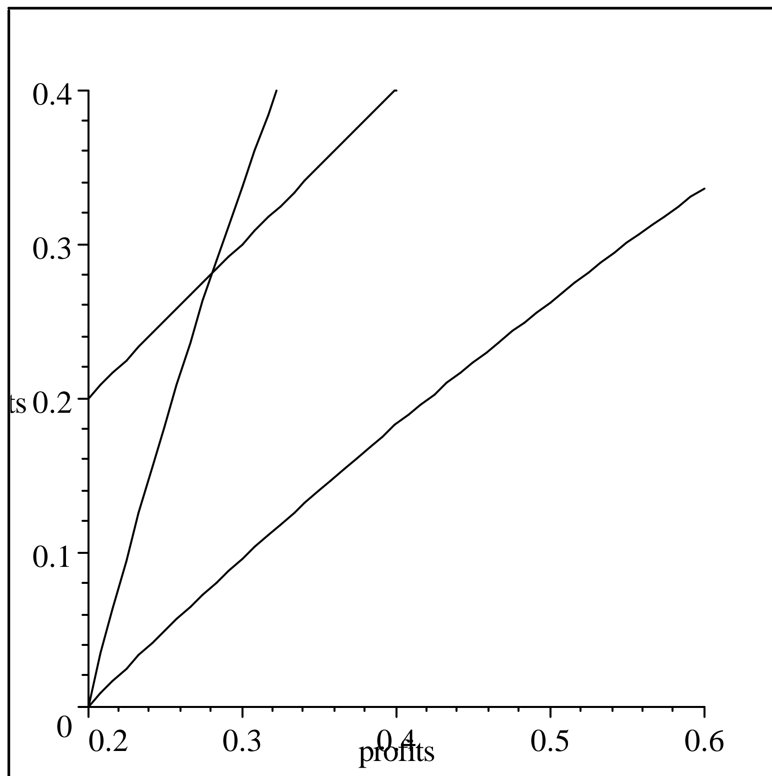
As already North and Thomas (1973: 6) observed, "new institutional arrangements will not be set up unless the private benefits of their creation promise to exceed the costs." In terms of our example, the issue is whether there is an equilibrium path from W to S. Note that getting from here to there may be costly to the rent collectors: rents must decline during some period below the level $r_W(\pi)$. The rent collectors will want to transit to S if the present value of this reform is higher than the present value of remaining in the low equilibrium:

$$\int e^{-\rho t} U(transition\ path) dt > \int e^{-\rho t} U(r_W) dt.$$

Whether this inequality holds depends on the initial conditions and on the speed with which producers respond to lower rents, γ. If a very small reduction of rents generates a big jump in productivity, then transition is instantaneous, but if the speed of adjustment is slow, transition

[7] The best answers to this question I know are offered by Holmes (2003), who specifies various conditions under which the powerful may want to share their power in their own self-interest.

is lengthy and may not be undertaken even if the S equilibrium is superior to W.



Without getting deeper into mathematics, let me summarize the general conclusions of Krugman (19xx). There are three kinds of situations. In some, there may be a unique equilibrium, with bad or good institutions. In the second class of situations, there are multiple equilibria but the time paths are history dependent, determined by the initial conditions. Finally, there may be some situations – where adjustment cost is low and the gains are high – in which the time paths are expectations driven and thus indeterminate. Only in the last situation does it makes sense to say that institutions matter. Multiple equilibria are not enough if they are determined by the initial conditions. Institutions matter only when institutional change is possible.

3 Institutionalism and economic history

These distinctions, even if they may appear scholastic, are necessary to analyze the structure of theories that focus on the role of institutions in explaining the patterns of development and of income distribution.

Sokoloff's (2000, also Engerman and Sokoloff 1997, 2001; henceforth E&S) interpretation of Latin American history goes as follows:

(1) When Europeans colonized the Americas, they found natural endowments differing in terms of climate, quality of soil, availability of mineral resources, and the size of native populations. Those areas which had humid climate and soil appropriate for the cultivation of sugar as well as small native labor force were best for and ended up with plantations operated by imported slaves. Those areas which had a large native population or mineral resources were best for and ended up with enterprises operated by enslaved indigenous population, *encomiendas*. Finally, those areas which had a moderate climate, small native population, and the soil appropriate for intensive agriculture became populated by family farms.

(2) Slavery and encomienda were forms of legal inequality. Moreover, plantations and latifundia generated inequality of income. Even after legal inequality was abolished, economic inequality was perpetuated by institutions that initially arose to protect property:

> initial conditions in these economies had long-lasting effects. Not only were certain fundamental characteristics of the New World economies and their factor endowments difficult to change, but government policies and other institutions tended to reproduce the conditions that gave rise to them. In the societies that began with extreme inequality, elites were better able to establish a basic legal framework that insured them disproportionate shares of political power and to use that greater influence to establish rules, laws, and other government policies that advantages members of the elite over others. These legal frameworks and policies contributed to persistent inequality over time (Sokoloff 2000:).

(3) Inequality was adverse to growth. The reason was that the poor did not have the access to productive resources: "the greater inequality in wealth contributed to the evolution of institutions that commonly protected the privileges and restricted opportunities for the mass of the population to participate fully in the commercial economy even after the abolition of slavery."

The role of institutions is most explicitly spelled out in the following passage:

> various endowments of three categories of New World economies, including soils, climates, and the size or density

> of the native population, predisposed them towards paths of development associated with varying degrees of inequality in wealth, human capital, and political power. Although these conditions might be reasonably treated as exogenous at the beginning of European civilization, such an assumption becomes increasingly tenuous later. Factor endowment and degree of inequality may influence the directions in which institutions evolve, but institutions in turn affect the evolution of factors and the distributions of wealth, human capital, and political power (Sokoloff 2000:).

As I read this passage, it says the following. Exogenous conditions determined the initial patterns of development and the initial institutions. But these institutions shaped the evolution of the conditions under which subsequent development would occur, so that conditions became endogenous with regard to institutions. Institutions were reproducing the conditions which originally gave rise to them and, in turn, were reproducing themselves under these conditions. When some conditions changed exogenously, specifically the possibility of industrialization appeared on the historical horizon, rendering the initial economic activities relatively less productive, the effect of institutions was to block a transition to industrialization. Acemoglou, Johnson, and Robinson, (henceforth AJR, 2002) argue exactly the same. The role of institutions was to *block* a potential path to industrial activities.[8]

What, then, were the counterfactual alternatives? Natural endowments were given and could not be altered. The choice of production and the legal institutions that protected the plantations and the encomiendas were certainly locally optimal: one of the surprising discoveries of E&S is that sugar plantation islands were the wealthiest countries in the world around 1700. As hard as it is to believe, Cuba had per capita income much higher than the United States. Hence, the choice of production and the initial institutions were determined by the conditions European encountered. Alternatives emerged only later, when these forms of production became relatively less profitable. Here, then, is where institutions come in. The reason for Latin American underdevelopment is that the institutions that were created to protect legal inequality prevented a transformation toward political and economic equality even after slavery was abolished.

[8]It is not entirely apparent why the landowning elites would not embrace the new economic activities when they became more profitable. After all, this is an influential explanation of the English success. Note that this issue is a important and controversial in the Chilean historiography (The classical study is Edwards 19xx, a recent one is Contreras 2002).

In fact, Engerman and Sokoloff never specify any alternatives.[9] All they can muster as a counterfactual is that "New World economies might have been able to realize growth in much the same way as the United States if not for their initial factor endowments and the governmental policies that upheld their influence" (1997: 291). When and how were the political institutions of Cuba transformable? Given their emphasis on suffrage and public education, the question is "Why would the Cuban elite extend suffrage and public education to former slaves?." I am not saying that there are no conceivable answers to this question: Acemoglou and Robinson (2000) offered a story in which there are conditions when elites extend suffrage to thwart the threat of revolution, Galor (200x) has a model in which capitalists support public education to increase the rate of return to physical capital. But without a clearly specified counterfactual path, institutions remain "epiphenomenal": they are a phenomenon that, in a dictionary definition (Webster, Collegiate Edition 1958: 489) "occurs with and seems to result from another."

Since I already slipped into the marxist language, I wonder what is new about the new institutional economics. Consider an equally schematic summary of Cardoso and Faletto (1969): (1) Countries are distinguished by their "modes of insertion" into the world economy, where these modes are determined by natural endowments as plantations, latifundia, enclaves, etc.; (2) Economic structure shapes interests that become political organized as classes or fractions thereof; (3) Classes make political alliances; (4) Institutions – the state – are but a "pact of domination" of the victorious alliance; (5) The state reproduces the economic structure in the interest of the dominant classes; (6) The results is "associated dependent development."

Cardoso and Faletto are equally silent about counterfactuals but the issue was raised by Weffort (1972) and led to an acrimonious debate. One counterfactual is socialism: public ownership of the means of production with state management of the economy. The other counterfactual is national economic independence: expropriation of foreign monopolies and economic autarky. But whichever it is, how does one get to it?

Marxism offers a magnifying glass for detecting the difficulty facing the new institutional economics. The causal relations between "forces of production" and the "relations of production" that together constitute

[9] I cannot find any in North (1990) either. Once "institutions" become populated by "organizations," their response to any exogenous change is uniquely determined: "Path dependence means that history matters." (p. 100) "Because the bargaining power of groups in one society will clearly differ from that in another, the marginal adjustments in each society will typically be different as well." (p.101) Hence, time paths are contingent on the initial conditions.

the "base," and between the "base" and the "superstructure" are the cornerstone of marxist theory. Indeed, Balibar (1971) and Poulantzas (1969) both developed an arcane conceptual apparatus for analyzing the "relative autonomy of instances ": economic, political, ideological, etc. The general idea was that power can be organized only by the state, yet the state can organize only that power which exists elsewhere, specifically, in the economic realm. In Poulantzas's rendering of "relative autonomy of the state," the state is needed to coerce the competing bourgeois to act on their common interest against their class enemy: the state organizes the bourgeoisie as a class. But under capitalism the state can organize only the bourgeoisie because this is the class that holds economic power. In the analysis of Sánchez-Cuenca (2003), the state transforms "brute" into "institutional" power: The economically powerful cannot pass laws; only a parliament can do this. Hence, the economically powerful must become organized within the parliament. This organization has consequences in that, to be effective as a group, the economically powerful must discipline their individual interests. But, organized within the political institutions, the economically powerful hold political power. And once this power is organized, institutions necessarily reproduce power relations that gave rise to them.

This apparatus, however, hurls itself against the impossibility of conceiving change in terms other than a *breakdown* of the extant system. The difficulty goes back to Parsonian functionalism and haunts Althusserian marxism. If "every act of production is an act of reproduction of the social relations under which it takes place" (Marx), how can social relations be changed? Note, by the way, that Sokoloff's reference to "institutions [that] tended to reproduce the conditions that gave rise to them" is almost identical. A social system can either reproduce itself or break down, *tercerum non datum*.[10] And the "breakdown" is not even a unique path: we can understand the emergence of a new system only retrospectively, by studying the "genealogy" of its elements (Balibar 1971).

There are good reasons to think that institutions reproduce social relations that gave rise to them: institutions protect interests of the powerful. But if institutions reproduce a particular organization of society, how can they evolve to reproduce a different one? Even if formal institutions are transformed or abolished, as was slavery, informal mech-

[10] Attempts to cope with this difficulty within marxism consisted of introducing a concept of "expanded reproduction" but no such processes were ever specified. The same concept reappears in Greif (2002: 1-20) under the name of "self-reinforcing institutions": institutions that evolve gradually in response to the outcomes they generate.

anisms arise to reproduce social relations. In a beautiful paper, Banerjee and Iyer (2002) show that tenancy institutions introduced by the British in India in the first half of the nineteenth century and abolished at independence continued to economically differentiate the different regions still at the end of the twentieth century.

Let me emphasize that I am not disputing the validity of Engerman's and Sokoloff's, AJR's, or Cardoso's and Faletto's accounts of underdevelopment. Natural endowments made it rational for Europeans to produce different things differently in different areas; these forms of production gave rise to institutions that protected dominant interests; and these institutions blocked the possibility of change even when conditions had changed and alternative institutions would have generated development. All this makes sense. But without a way to reach these alternative institutions, I just do not see how "institutions mattered."

4 Inequality, political institutions, and development

Inequality is the culprit in Engerman's and Sokoloff's explanation of underdevelopment. But why is inequality bad for development? Engerman and Sokoloff refer rather vaguely to the importance of the size of the market, "broad, deep markets" on the demand as well as the supply side (1997: 286-7). The recent economic literature invokes, in turn, two distinct, even if not mutually exclusive, mechanisms.

One focuses on access to productive resources (Banerjee and Newman 1991, 1994). When credit markets are imperfect, as they must be because the poor have no collateral assets and lending entails moral hazard, the poor cannot educate their talented children, employ their entrepreneurial skills, or implement their inventions. They may even not eat enough to be able to work. A larger mean preserving spread implies therefore that more people are precluded from using the productive assets they have, even if it is just unskilled labor. As long as the production function is concave in a particular asset, output is lower in societies where this asset is more unequally distributed.

The second mechanism, cherished by North and his followers (North and Weingast 19xx), is the "security of property rights." One argument here is that inequality increases the threat to property and the uncertainty leads its owners to invest less.[11] Another argument is that inequality breeds conflicts, which are economically costly because they divert energies and resources away from production.

[11] The argument goes back to Machiavelli: "For everybody is eager to acquire such things and to obtain property, provided that he be convinced that he will enjoy it when it has been acquired." (Discourses on Livy. II.2, cited after Holmes 2003)

Now, if the only mechanism is the access to productive resources, then increasing political equality accelerates development. As more people acquire political rights, the group of rights holders becomes differentiated. Those with lower assets pressure for redistribution, at least at the margin, in the sense that their assets would grow faster than those of people with larger assets (Pasha). Asset inequality is reduced and output increases. There is now a class of models, focusing on education, that analyze such paths. They show that these paths depend on (1) the initial per capita income, specifically, the relation between the cost of education and average income and (2) the initial income distribution, which needs to be parametrized by two moments (lognormal distribution is not enough), namely, the ratio of the incomes of the rich to the middle incomes and the ratio of middle to low incomes. The first condition determines whether a path of sustained growth is feasible: if a country is so poor that the costs of education (or, generally, of financing productive assets) is higher than average income, then either redistribution finances consumption and no one can afford to invest, or no redistribution occurs, only the rich can afford to invest, inequality increases, incentives to tax increases, and development is aborted. The second condition determines whether redistribution of assets includes the poor or is limited to the middle class: in general, if incomes of the middle class are close to the average income and far from the incomes of the poor, the middle class has lower incentives to tax and the costs of making the poor productive is higher, so that redistribution stops at the middle (For a summary of these models, see Manzano 2003).

Whatever the details, the point is that if the only mechanism through which inequality affects development is the access to productive resources, institutional change may reduce economic inequality and induce development. Equalizing political rights activates the assets of those who are newly incorporated into the political institutions, and their marginal product is higher than that of the previously narrow elite.

If the mechanism, however, is the security of property rights, then increasing political equality, in the Engerman-Sokoloff story by extending suffrage, should generate an economic disaster, of the sort we are currently witnessing in Zimbabwe. North and his followers, AJR included, just does not see that combining political equality with economic inequality generates a threat to property rights:

> democracies have ever been spectacles of turbulence and contention,; have ever been found incompatible with personal security or the rights of property (Maddison, Federalist 10)[12]

[12] This quote raises complex issues into which I cannot get, namely, whether

or

> The classes whose social slavery the constitution is to perpetuate, proletariat, peasantry, petty bourgeoisie, it puts in possession of political power through universal suffrage. And from the class whose old social power it sanctions, the bourgeoisie, it withdraws the political guarantees of this power. It forces the political rule of the bourgeoisie into democratic conditions, which at every moment help the hostile classes to victory and jeopardize the very foundations of bourgeois society. From the ones it demands that they should not go forward from political to social emancipation; from the others that they should not go back from social to political restoration (Marx 1952 [1851]: 62).

Modern intuitions point the same way. In the median voter model, a combination of political equality (one-person-one-vote) with economic inequality generates tax rates that stop short of fully equalizing incomes only because of the deadweight costs of taxation. Benabou (1997, simplifying the seminal model of Benhabib and Rustichini 199x) modelled a repeated game over distribution between two groups that enjoy different market shares of the output and different degrees of political power. The maximum sustainable growth rate is a decreasing function of the difference between the two: growth is faster when political power reflects market shares.

A combination of economic with political equality may be the first-best for development: many people can invest and they are willing to invest since they have political rights with which to defend their return to investment. But solving the problem by a definition – "We take a good organization of society to correspond to a cluster of (political, economic, and social) institutions ensuring that a *broad section of society* has effective property rights" (AJR 2000: 1262, italics supplied) – obfuscates the dynamic issues. For even if economic plus political equality is the first best, economic inequality accompanied by political equality is not the second-best: economic inequality protected by unequal political power is. The road from second to first best passes through a valley.

If the security of property rights matters, neither the Engerman-Sokoloff[13] nor the Acemoglou-Johnson-Robinson stories can be right.

whether the extent of suffrage is a good measure of political equality. Suffrage may be universal but political access may still be highly unequally distributed.

[13]To be fair, Engerman and Sokoloff refer only marginally to the property right mechanism (in the context of discussing patent laws, 1997: 287). Hence, their story

Economies should have been developing luxuriantly when political inequality protected economic inequality and should have stagnated when and where institutional reforms equalized political rights. To put it in statistical terms, given economic inequality, growth should have been slower where these was more political equality. The path in which development originates from political institutions is locally costly. Equalizing political rights undermines the security of unequal property and enhances conflicts over distribution, thus lowering investment of the property owners or diverting resources from production to distributional struggles. Hence, transition costs are high and the path may be unsustainable.

5 Reform über Revolution?

Let me posit a stylized fact about which I am far from certain: I have not done enough digging into history. The strongest evidence, albeit for a relatively short period, comes from Li, Squire, and Zou (1997), who report that about 90 percent of total variance in the Gini coefficients is explained by the variation across countries, while few countries show any time trends.[14] It appears that there are no countries which over the long run equalized market incomes without some kind of cataclysm. The cataclysms come in two kinds: (1) destruction of large property as a result of foreign occupation (Japanese in Korea, Soviet in Eastern Europe), revolution (Soviet Union), or war (France according to Piketty 2000), or (2) massive emigration of the poor (Norway, Sweden). If this is true, then institutional reforms are not a feasible path for equalizing incomes. Even where institutional reforms did occur – for example, suffrage was extended in Western Europe – these reforms did not radically alter the distribution of market incomes.

Again, I am not certain whether this is true. But the possibility is sufficiently plausible to be puzzling. Note first that I am referring to market (gross), not post-fisc (net), incomes, so that this assertion need not contradict Meltzer and Richards (19xx). But even with regard to redistribution through the fisc, it is not at all apparent that countries with more unequal distribution of market incomes redistribute more through the fisc. The empirical results for the OECD, more precisely LIS, countries depend on the sample and the treatment of old-age pensions (Milanovic 1999 vs Rodriguez 199x). The data for less

is logically consistent. I am just saying that if the property rights mechanism is operative, then their story could not be valid.

[14]Note that while the Kuznets curve shows up in cross-sectional analyses using the Deininger and Squire data sets, it appears only in a few countries for which sufficiently long time series are available (***cite).

development countries are almost non-existent, but it appears that very unequal poor countries redistribute next to nothing. Several categories of transfers utilized in the OECD countries do not even appear in the Mexican national accounts.

Here is what I find puzzling. Suppose that the post-fisc, net, income of individual $i \in N$ at time t is y_{it}, given by

$$y_{it} = (1 - \tau_t)f(k_{it}) + \tau_t y_t(1 - \lambda\tau_t), \tag{1}$$

where $f(k_{it})$ stands for market income, y is the average market income, λ is the shadow price of public funds, and $\lambda\tau^2 y$ is the per person deadweight loss of redistribution. Assume that individuals maximize the present value of the utility of their consumption stream $U_i^* = \int e^{-\rho t}U(c_{it})$ subject to

$$\dot{k}_{it} = (1 - \tau_t)f(k_{it}) + \tau_t y_t(1 - \lambda\tau_t) - c_{it}. \tag{2}$$

The decisive voter chooses the time path of the tax rate and then everyone adjusts their consumption. The result is some time path $\{\tau_t^*, c_{it}^*\}$, with realized utility U_i^*.

Alternatively, suppose that, instead of redistributing incomes, tax revenue is used to invest in productive assets, that is, the per capita tax revenue, $\tau_t y_t(1 - \lambda\tau_t)$, is used to publicly provide all individuals with productive assets that cannot be sold or consumed. Education is an obvious example. Having received these assets, individuals, whose post-fisc income is now $(1-\tau_t)f(k_{it})$ decide whether to investment more privately. Hence, the time path of capital stock is still given by (2) but with an additional constraint, namely, $\dot{k}_{it} \geq \tau_t y_t(1 - \lambda\tau_t)$.

In the first model, incomes are redistributed according to some tax rate and then everyone decides how much to invest. In the second model, public investment is decided first and then everyone decides how much to invest privately. These models should generate the same time paths as long as the production function is globally concave. But suppose that $f(k)$ is convex at low k and concave at high k. In the extreme, suppose that

$$f(k) = \begin{cases} s, & if\ k < \bar{k} \\ s + (k - \bar{k})^{\alpha}, \alpha < 1, & if\ k \geq \bar{k} \end{cases}$$

People with endowments lower than $\bar{k}$ produce subsistence income and $f'(k|k < \bar{k}) = 0$: unless their assets reach the threshold $\bar{k}$ the poor cannot produce more. The extreme example would be food. If your calorie intake is well below the level enabling one to perform physical labor and you will receive a small income transfer, you will eat more and

still be unable to work.[15] Or consider education. Perhaps completing the fourth year of schooling does not increase productivity: you will be selling combs on the street whether you completed three or four years.

I am not enough mathematician to solve these models, but I have the following intuition. In the redistribution of income model, tax rates will be high but the people whose assets would remain below the threshold even if they were to invest the entire transfer will consume it: their rate of return to investment will remain at zero. In the public investment model, however, the poor will be accumulating productive assets even if their current rate of return is zero. Suppose that the decisive voter has income lower than the mean. Then the tax rate will be positive in the redistribution model, consumption of the poor will be subsidized, but income distribution will change little if at all, since the poor will produce subsistence in each period. Hence, this society will be accumulating deadweight losses period after a period. In the investment model, in turn, the poor will be starving until they accumulate enough assets to produce above subsistence, but then income inequality will decline, tax rates will decline, and the economy will grow. Hence, prima facie it would appear that investing in the productivity of the poor is a superior strategy for the rich. I suspect that if such strategies are not implemented, it may be because they are not supported by the poor, who are not willing to sacrifice their immediate consumption. Something like this is among the equilibria in the Fernandez and Rogerson (19xx) model of education, where education is publicly financed but the poor cannot afford to avail themselves of it.

This is pure speculation: unfortunately solving these model is beyond my skills. But let me return to the stylized fact which motivated this discussion. Perhaps gradual equalization of market incomes is just politically not feasible, whatever the institutional framework. Think of Brazil: during the past two centuries, this country was a royal colony, an independent monarchy, an oligarchical republic, a populist military dictatorship, democracy with a weak presidency, a right-wing military dictatorship, and democracy with a strong presidency. Yet, to the best of our knowledge, income distribution did not budge. Moreover, it seems that asset distribution, including education, accounts for only one half of the observed inequality: the rest is left unexplained. For productive assets to be equalized, perhaps something does need to break down.

[15] When I was working in India many years ago, the boy who served tea did not appear for work during a couple of weeks. It turned out that his brother got a better paying job and the two brothers shared one pair of pants. Unless the assets of both included pants, one of them could not work.

6 Detecting the effect of institutions

Ultimately, detecting the effect of institutions boils down to econometrics. What is the evidence that institutions matter?

It is beyond the scope of this paper to even begin summarizing the econometric literature on the impact of institutions on economic performance. My general impression is that thus far the results of confronting the institutional program with the data have been disappointing. Whether we consider political regimes dichotomized as democracy and dictatorship, the distinction between presidential and parliamentary democracies, the independence of central banks, electoral systems, federalism or decentralization measured in other ways, the results are either negative or highly sensitive to samples, model specification, and the choice of estimators. Indeed, I cannot think of a single example in which an observable institution has a robust effect of some outcome.

I say "observable"[16] because subjective measures – innumerable indices of various aspects of the "quality of institutions," typically generated by some experts within the Beltway – always work. But, as Aron (2000) points out, this is a paradoxical situation: our subjective judgements of institutional quality predict economic performance but we cannot pinpoint any observable institutions that account for this quality. Moreover, these findings are useless for policy: one cannot institute "good institutions," be they accountability, transparency, security of property rights, absence of corruption, or rule of law, only specific institutional arrangements, such as oversight agencies, independent central banks, electoral systems, or independent judiciary.

AJR (2002) rely on two measures of institutional quality: protection against the risk of expropriation, as measured by a Washington consulting firm, and constraints on the chief executive, from Polity III.[17] Even if we assume that these are valid measures of what they intend to measure, the obvious question is whether they indicate that quality of institutions which is theoretically relevant for AJR After all, it is not apparent that the main threat to the security of property rights would arise from the chief executive, rather than the parliament (the Chilean Congress unanimously voted in 1970 to nationalize copper mines), the courts, the bureaucracy, the military, or the police. Even more importantly, I do not see how either of these measures relates to "ensuring that

[16] By "observable," I mean measures such that if anyone is given the information available to the researcher and is told the rules the researcher applies to classify this information, this person can unambiguously reproduce the classification. Hence, "reproducible" would be a better term.

[17] Note that while other components of the Democracy-Autocracy scales in Polity are observable, constraint on the executive is a judgement by Gurr and his associates.

a *broad section of society* has effective property rights." The Washington political risk analysts are not concerned about the property rights of street sellers who are repeatedly harassed by the police nor of tenant farmers arbitrarily exploited by their landlords. And what do constraints on the chief executive have to do with equality of property rights just beats me: for most people the relevant institution is the local police. At least Engerman and Sokoloff pinpoint the institutions that in their view affect development, namely, suffrage, public education, and the banking system.

Let me first spell out why I am not persuaded by AJR and then focus on generic issues. My first doubt stems from what I just said. The relevant variable for work in this vein is the overall quality of political institutions, "broad institutions," while the specific operationalization is a particular institutional feature, such as "constraints on the chief executive." AJR (2002: 1270) are aware of this difference: they observe that their measure of institutions may "correspond poorly to the real concept that is relevant to development (which is likely to be a broad range of institutions, whereas we only have an index for a particular type of institutions)." Now, it may be that mortality of European settlers at the time of colonization is a valid instrument for the narrow index (they use $XCONST$ from Polity III), that the narrow concept is correlated with the broad one, and yet that mortality is not a good instrument for the broad concept. This is not a trivial possibility: we know that bad instruments are worse than no instruments (***cite).

The second doubt concerns the assumption that institutions, as measured by constraints on the chief executive established during European colonization had lasted until today. This is an important assumption since it serves to instrument the current institutions by instrumenting the initial ones. Here is a crosstab of the exit year institutions (when countries ceased to exist or information is last available) by entry year institutions (the year of independence or soon after) for all countries that appear in the Polity IV data set (including those that were never colonies).

Entry/Exit	1	2	3	4	5	6	7	*All*
1	10	5	14	3	5	6	15	58
2	1	3	2	1	0	1	0	8
3	6	5	11	3	8	11	7	51
4	1	0	0	1	1	0	0	3
5	0	2	6	0	6	1	3	18
6	0	0	0	0	0	0	2	2
7	3	3	5	1	4	1	29	46
All	21	18	38	9	24	20	56	186

The crosstab shows a lot of volatility. Of the fifty-eight countries that entered the world with worst possible institutions, twenty-six ended up with good institutions (5 or more), while eleven out of forty-six countries went from best possible to bad institutions (3 or less). The correlation between entry and exist institutions is only 0.26. This correlation is higher, 0.55, when we consider only those countries that were not independent as of 1945, but this is still only 28 percent of variance.

I do not want these observations to be interpreted as implying that institutions do not persist. Przeworski et al. (2000) found that among 135 countries they studied between 1950 and 1990, 100 had the same regime, either dictatorship or democracy throughout the period. Moreover, the systems of democratic separation of powers – presidentialism, semi-presidentialism, and parliamentarism – are almost perfectly stable as long as democracy lasts. Hence, big institutional changes are rare. But this does not seem to be true of the particular measure of institutions which AJR employ. And if institutions did change, then anything that instruments the initial institutions is not a valid instrument for the current ones. If good institutions are more likely to survive in more affluent countries, then institutional quality today is still endogenous with regard to income.

The third, and final, problem is even more bothersome. AJR estimate a model in which *per capita* income at the most recent date depends on institutions, finding that good institutions are associated with higher incomes independently of conditions. This model implies that good institutions should generate higher growth rates during any period subperiod. Consider during the period 1950-1999 countries that were colonies as of 1945. It turns out, as Przeworski et al. (2000) would expect, that institutions affect demographic rather than economic performance: the rate of population growth ($POPG$) falls as the quality of institutions increases, the rate of growth of total output (YG) does not depend on institutions, so if the rate of growth of per capita income (G) does increase slightly with the quality of institutions it is only because

of lower population growth. The table below shows means of these variables conditional on $XCONST$ as well as the OLS and 2SLS coefficients of $XCONST$.[18]

$XCONST$	YG	$POPG$	G	N
1	4.12	2.88	1.25	763
2	5.24	2.66	2.58	316
3	4.13	2.95	1.27	557
4	6.45	2.55	3.89	33
5	4.03	2.33	1.70	192
6	5.37	1.45	3.62	55
7	3.95	2.07	1.87	415
OLS	−0.0431	−0.1446	0.1020	2331
	(0.0809)	(0.0191)	(0.0816)	
$2SLS$	0.1083	−0.1814	0.1728	2331
	(0.1824)	(0.0539)	(0.1838)	

Hence, it looks like countries with better institutions had higher per capita incomes in the recent period because they had experienced lower population growth, not because their total output grew faster.

Here, then, are some conclusions. Instrumenting the current institutions is difficult because it is hard to find right-hand side variables that are exogenous with regard to institutions. Hence, AJR adopted a reasonable strategy of going far back to find instruments that are exogenous and they have conducted an unprecedented amount of research to measure the initial conditions. But the validity of this strategy hinges on the assumption that institutions remained the same throughout the entire period. And while this assumption may hold for some broad notion of the quality of institutions, it does not hold for the one measure of institutions for which we have a long historical series, the Polity data. As a result, we are back to the endogeneity problem.

The issue of the dependent variable is not specific to AJR. As Przeworski et al. (2000) observed, economists are notoriously cavalier about taking the growth of per capita income as the dependent variable. The rate of growth of per capita income is a result of two, partly independent, processes: the growth of total output and the growth of population. Yet the dynamic of population is ignored altogether in the "kitchen-sink"

[18] The first-stage equation for 2SLS includes per capita income, number of past transitions to democracy, the proportion of other countries in the world that are democracies during a given year, and a dummy for British colonies. Controlling the estimates for per capita income makes no difference except for POPG in 2SLS, which is reported with this control and AR1. Standard errors in parentheses.

regressions, such as Barro's, while population is assumed to grow at a constant exogenous rate in the theoretically motivated studies following Mankiw, Roemer, and Weil (1992). But, very much to their surprise, Przeworski et al. (2000) found that political regimes systematically affect the rate of growth of population and the same finding holds for the Polity measure of institutions. It appears that political institutions affect demographic, rather than economic, performance.

The central lesson I draw from these observations is that a "broad notion of institutions" is not good enough. If we want to hold that "institutions matter" we must identify institutions that matter. As Diermeier and Krehbiel (2001: 3-4) put it,

> Because a central and immediate application of the perspective of institutionalism as a method is that there is no such thing as "the theory of rational choice"..., designing and conducting test that discriminate between group of theories that share methodological but not substantive assumptions is crucial to the viability of the research program.

The Holy Grail of the institutional program is to find which matter for what. As of now, we still do not know.

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