Saving Growth from Unequal Influence

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A striking finding in econometric studies is that countries that are more unequal – as measured by income differences or wealth differences – are typically poorer. Why is this? And what can be done about it?

The dominant view of how inequality and poverty are positively correlated relies not on the first causing the second, but on a common causal factor, poor political and economic institutions inherited from the past, that is responsible for both. I will argue that a simpler explanation is more compelling - that when endowments and opportunities are unequally distributed in a poor society, disagreements over the most appropriate reform path are harder to resolve (see Rajan (2006) for a more technical version of this paper). The desire of each subgroup to preserve its economic rents against all others – what I term competitive rent preservation – tends to ensure that it is very hard to move away from the status quo.

The policy implications are very different depending on which view of underdevelopment one espouses. This is why this debate is not simply an academic one. But before I talk about policy implications, let me start, first, by outlining the different views.

Coercive Political Institutions and Underdevelopment

The political institutions view of development (see Acemogulu, Johnson, and Robinson (2004) for one exposition and Hoff (2003) for an excellent survey), suggests that persistent coercive political institutions, set up to assert the power of a ruling elite in the distant past, serve to entrench the elite and their sub-optimal self-interested policies even today, when they have lost their initial sources of power. Thus many former colonies, where the initial colonizers set up coercive political structures to entrench their military power, are still mired in poverty because of the weight of the history.

There are, however, serious questions about a theory of underdevelopment that relies primarily on inherited coercive political institutions. For one, underdevelopment has persisted despite a dramatic increase in inclusiveness and decrease in coerciveness of the political institutions in poor countries – including independence, emancipation of slaves, democratization, and new constitutions. One explanation is that there are deep, hard-to-observe, “micro” political institutions that completely offset any effect of democratization or rewriting constitutions, and continue to entrench the coercive power of the elite. This is possible though implausible – that changes in the most important political institutions we know of have so little effect suggest other explanations may be in order.

Indeed, if persistent coercive political institutions were so easy to put in place, it is not clear that the elite would have to follow sub-optimal economic policies. Instead, it would make far more sense for the elite to follow the best economic policies they could that were consistent with their coercive political power, and use their political power to tax some of the resulting higher income. For instance, instead of allowing sub-optimal economic monopolies to limit national income, the elite should allow

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competition and maximize national income. Of course, the power of the elite to tax arbitrarily could reduce incentives to invest (and the elite themselves may be the only ones to invest in full confidence), but this is still no reason to limit competition.

A second problem with the argument that political institutions can be used to project power forward is there is little evidence that regimes that see their current power waning can create institutions to preserve that power. Consider, for example, Zimbabwe. As Acemogulu, Johnson, and Robinson (2004, p41) write,

“the white negotiators at the Lancaster House talks in 1979 that produced these agreements understood that any promises made by the black majority negotiators about what would happen after independence could not be believed. They sought therefore to find a set of rules [political institutions] that would get around this problem.”

But the political institutions that preserved white interests were quickly overridden. In 1990, the senate was abolished, and the Constitution amended to allow for redistribution of land, leading AJR to conclude that “these guarantees were not enough to protect the property rights (and rents) of the whites in anything other than the short run.”

Consider next another example from AJR (2004), Chile. Pinochet of Chile had a very strong incentive to put in place constitutional features that protected him from prosecution after he relinquished power. Indeed, he was willing to abide by the results on the 1989 plebiscite that he lost in part because as a senator, the constitution protected him from prosecution. Clearly, this faith in political institutions was misplaced because Pinochet only escaped impending prosecution by dying.

Indeed, it is hard to come up with examples of unpopular political institutions that endured without support from those rendered powerful by other means. Most examples of persistence are either inclusive institutions like the U.S. constitution that commanded popular support, or exclusionary institutions such as literacy requirements for voting in Latin America or Jim Crow laws in the U.S. South, which were supported by a powerful elite. If political institutions cannot project the power of an elite even just a few years into the future, it is hard to imagine them conferring power on an elite, centuries after the elite lose non-institutional sources of power. Coercive political institutions seem unlikely to be the primary source of persistence.

**Economic Power as the Source of Persistence**

Could it not simply be that the elite have economic power and use that power to implement preferred policies (see, for example, Engerman and Sokoloff (2003), Przeworski (2004))? For

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2 Good institutions, like the U.S. constitution, can for all practical purposes become exogenous. Yet one should not go to the other extreme and neglect the role of supporting constituencies – a constitution can also be simply a piece of paper, as suggested by the very different effects of much the same U.S. constitution, when transplanted to Liberia. Similarly, the very same institutional environment and leadership that gave rise to a Chiang Kai-shek, who was deemed too corrupt to be supported by the United States against the Communists, with a different set of constituencies, set the foundation for Taiwan’s prosperity.
instance, suppose the elite control economic monopolies, they would then have money power, enough to buy off legislatures to preserve their monopoly.

The problem with this view is that economic power based on rents, purchased from the public using that very same economic power, is likely to be very unstable. At the very least, we should see some dissipation of those rents when political institutions become more inclusive – unless we espouse the extreme view that political institutions are totally ineffective. Why is it then that democratization does not lead to a dissipation of those rents, a break-up of monopolies, and much stronger economic growth? Put another way, why even in an imperfect democracy does the larger public accept limited opportunities and high costs for itself, even while the elite enjoy a privileged existence?

In my view, the answer lies in doing away with the implicit assumption in the preceding question that the wider public is united in its interests, and in opposing the elite. Let a constituency be a group where each member has the same factor endowments, and therefore similar preferences over policies even without being organized.\(^3\) The status quo in an underdeveloped country constrains the opportunities of all constituencies except the elite. If we assume the constrained are one uniform constituency, they would be unified in their desire for reform. It is then puzzling why reforms do not take place, and the immediate diagnosis is the overwhelming power, de facto or de jure, of the elite. The solution to the problem of underdevelopment then seems to be destroy the power of the elite, often through reform of the oppressive political institutions. Yet as I observe above, political reform rarely seems to be key to economic growth.

In reality, the constrained in an underdeveloped country consist of multiple, unequal, constituencies. Matters are no longer as simple as in the two-constituency economy. Each reform typically expands the opportunities of a hitherto constrained constituency and reduces the rents of the elite but its effects on the other constituencies can be uncertain. Indeed, the disproportionate expansion of opportunities for one formerly constrained constituency can make other constrained constituencies worse off. As a result, the constrained may not act as a unified collective. Instead, they may act like crabs in a bucket, willing to pull down any crab that appears to be climbing out, with the active help of the elite, who prefer them all to stay in the bucket. The elite may even forego some reforms that could enhance their rents, for fear that the reforms would unify the crabs in the bucket and help them climb out and overwhelm the elite. Competitive rent preservation ensures the collective choice is indeed poverty.

**Competitive Rent Preservation**

A more concrete example may be useful to fix ideas. Consider a society with three “constituencies”: a monopolist who owns all the factories, the educated middle class who occupy jobs as factory managers (and professional jobs, such as architects and doctors), and the uneducated poor who work in the factories. Suppose any two groups who vote for a reform can push it through (like all democracies, this is imperfect, with the rich having power because of their money and the poor having power because of their numbers).

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\(^3\) I prefer the term constituency rather than interest group or class. Interest groups (e.g., textile workers) typically are much narrower than my notion of constituency (e.g., the uneducated), and imply organization (and thus, possibly, institutions), while the term “class” has prior associations (e.g., linked to the ownership of the means of production) that may confuse rather than enlighten.
Consider two reforms. First, promarket reforms allow anyone to open a factory in competition with the monopolist. Only the educated, however, can draw up the business plans and get the finance to take advantage of this opportunity. Second, education reforms allow everyone to get an education.

Clearly, the monopolist will oppose promarket reforms because he will face competition that will reduce his profits. And the educated will oppose education reforms because they will also experience competition (from the now educated masses) for the lucrative jobs they currently occupy. But will either one get support to vote down the reforms they dislike?

The answer could well be yes. The monopolist would prefer to educate the poor for it would give him a larger labor pool to pick managers from, thus reducing salaries he has to pay. However, the monopolist also knows that if he votes to expand education, he will have a workforce (the formerly uneducated and the formerly educated) that is united in interests. This enlarged constituency will then push for promarket reforms. To forestall the greater loss from promarket reforms, the monopolist will align himself with the educated against expanding education.

If education reforms are unlikely to be enacted, the uneducated may reject promarket reforms, preferring the status quo instead. While promarket reforms expand opportunities for the educated, they also have a dark side for the poor. Given that the educated have greater business opportunities, they can demand higher fees for services like health care. The uneducated, whose job opportunities go up only a little, if at all, may face a substantially higher cost of living because of the opportunities the educated now have. They may side with the monopolist in voting against promarket reforms.

In sum, even in a society where political institutions ensure that citizens’ preferences matter, initial inequalities (in education and wealth) may be self-perpetuating. Citizens, fearing that the advantage gained by one group may come at the expense of the meager rents of the other, become like crabs in a bucket, preventing each other from getting out. Uncertainty about who will get the benefits of reforms can further compound resistance. Underdevelopment can persist with the full connivance of the exploited, even with reasonably well-functioning political institutions. Finally, while stylized, the example is consistent with the evidence that far too many poor economies, like, India have underemphasized universal education while overemphasizing higher education and that the poor and uneducated in a number of countries in Latin America have turned against (partial) economic liberalization because they see few of the new opportunities while bearing additional costs.

**Competitive Rent Preservation in A Theory of Underdevelopment**

Thus inequality in endowments and opportunities within a society might itself cause adverse interactions between “exploited” constituencies, which might result in an underdevelopment trap. There is no need to appeal to the mediating role of coercive political institutions, or some other source of power for the elite. This is not to say that such coercion does not exist, but that if inequality itself is the root cause, simply changing political institutions may have little effect on economic outcomes.

In my view, therefore, the primary legacy of the early colonialists was the differential degrees of initial inequality in their colonies. In some settlements, they came upon existing, heavily populated, hierarchical societies following feudal modes of production, and simply displaced the rulers. In others that were amenable to plantation modes of agriculture, or mining, they enslaved the local population, or imported slaves (see Engerman and Sokoloff (2005)). In yet others where land was fertile and
plentiful, the disease environment not inhospitable, and the local population scarce, the colonists worked the land themselves in small holdings.

Initial inequality led to policies or economic institutions like schooling (see Engerman, Mariscal, and Sokoloff (2002)) that reproduced the inequality. Indeed, in my model, I get persistence without imposing coercive political institutions. That is a bonus, for it allows us to explain how political liberalizations may have had little effect on economic outcomes if they left untouched the underlying inequality of opportunity and endowments.

Once we accept that institutions, especially bad ones, may not be able to project power very far on their own, it becomes easier to understand why even though the years spent under communism affected peoples’ attitudes (see Alesina and Fuchs-Schudeln (2005)), socialist institutions were replaced by market institutions with remarkable speed. “Bad” socialist institutions were certainly not durable. Indeed, one of the virtues of communism is a very strong emphasis on education, and this created the broad constituencies that could press for market reforms once the power of the nomenklatura (based on control of the military and the secret services) was broken. Ironically, instead of capitalism containing the seeds of its own destruction, the seeds for flourishing capitalism may have been nurtured in the soil of communism. Capitalism may well be the final stage of communism!

**Discussion and Implications for Development**

When attempting to explain the slow economic growth in a country like Mexico, which has been through independence, revolution, one party rule, and democratization, far too many people continue to blame political institutions. When faced with a paralyzed economic and social reform process, those with presidential systems seek parliamentary systems and vice versa, those with proportional representation seek to change to a majoritarian system, and vice versa, some seek to decentralize, while others to centralize decision making. While economists have found some effect of these changes (see Persson and Tabellini (2002, 2005) for an excellent overview), they are subtle and far more limited than one might expect. Indeed, it is hard to rule out the possibility that the economic effects reflect the underlying change in circumstances that prompt the change in political structures, rather than the effect of changes in political structures themselves.

The point my paper makes is that economic paralysis may well reflect the broad aggregation of preferences of the electorate. Even though everyone can see a better place for the economy to be in, each constituency’s “better place” is not the same as every other constituency’s “better place” because they start with different endowments and opportunities, and therefore want to protect different rents. The status quo may be the only common ground since it happens to be the one everyone is standing on.

**Sequencing**

How does one jump start the economy in these circumstances? It may be tempting to do what is possible. For instance, some have argued that the strengthening of property rights and the expansion of competition and associated opportunities will help the very poor (see, for example, De Soto (1989,2002)). Such reforms could certainly create growth for a while but the lack of endowments, especially of education, may leave the poor unprepared for the market economy, and possibly worse off. Reforms could grind to a halt. To the extent that a large constituency -- the uneducated or, more generally, the poorly endowed -- benefit little from these pro-market reforms, it creates general skepticism about reform. Furthermore, it converts a constituency -- the educated or more generally
the well-endowed -- that is hungry for reforms into one that is unenthusiastic about further reforms. Perhaps then, in some situations of extreme inequality, it may be wiser to focus first on broadening the access to endowments. If market oriented reforms follow soon after, they may fall on more fertile ground.

Sequencing therefore matters. Broadening the ability to take advantage of opportunity first, and then broadening opportunity, will ensure widespread support for comprehensive and thorough reforms, while the reverse sequence, though politically more feasible, will likely leave reforms stalled and incomplete. Unfortunately, though, reforms expanding access to endowments are the hardest to effect, which is perhaps one reason why underdevelopment is so hard to cure. There are, however, situations when such reforms do take place.

**Motivated Government**

Let us leave aside the unrealistic possibility of a benevolent dictator which would solve many problems in political economy. What if a government sought reform but was in a situation where the polity was paralyzed by rent preservation? One common view is that the task of the government is persuasion, and that all it needs is to lay out its long term vision clearly for everyone to buy in to the reform process. Yet, if the conditions in the model hold, the polity may not want comprehensive reforms and too clear an articulation of the road may lead to a mobilization of the opposition.

Instead, the government may have to seize every opportunity it can, leaving unclear what its ultimate destination is. As we have seen, the right reforms can give political momentum to further reforms. If those initial reforms can be undertaken without much discussion of future steps – reform by stealth, so to speak – a government might have more success.

The right circumstances could also be a spur to reforms. Often, economic (especially fiscal) crises can break gridlock (see Binswanger and Deininger (1997)). In normal times, a constituency may be reluctant to place its rents on the negotiating table, for fear that only its rents will be reformed away. A grave economic crisis may make it credible that one constituency’s rents will be insufficient to remedy the situation, and could create a more conducive environment for negotiation, where everyone has to give a little.

At the opposite extreme, rapid growth, especially through trade, could also create a conducive environment for reform by creating enough opportunities to go around. In particular, the educated may be more willing to tolerate education for the uneducated when growth is rapid and more than enough new jobs are being created. Agglomeration economies would make them even more supportive. Similarly, an oligopolist, seeing the larger world market he could have access to if he became globally competitive through reform, may welcome an educated workforce, even if it eventually means more domestic competition. For example, Galor and Moav (2006) document that English industrialists supported universal education at the end of the 19th century as a way to increase their ability to compete with French and German companies.

**Non economic reasons to promote education mass-education**

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4 Policies such as pro-market reforms should lead to improved institutional outcomes such as rule of law. Johnson, Ostry, and Subramanian (2005) document an improvement in institutional outcomes as a result of growth spurts in poor countries with high initial education and a competitive external sector.
Forces outside economics have played an important part in helping some countries overcome the natural incentives of interest groups. Perhaps the strongest force has been religion. For example, Protestant leaders believed strongly in the value of personal knowledge of the Scriptures, unmediated by the Church, and hence emphasized education. As early as 1524, Martin Luther sent a letter to German municipalities insisting it was their duty to provide schools and the duty of parents to educate their children. In 1647, Massachusetts passed the Old Deluder Satan Law requiring local authorities to set up compulsory elementary schools. The law was so-called because the preamble said the old deluder Satan kept men from knowledge of the Scriptures (Wiener, 1991).

Nationalism seems to have been a second factor. After the Revolution the French government tried to break the hold of the Catholic church on education by creating state-run primary schools, forcing religious schools to follow an official curriculum, and employing teachers as civil servants. It redoubled its efforts as a way to strengthen the army after being defeated by Germany in 1870. In Japan, the Tokugawa elite believed education would make the masses more moral and more obedient (see Dore (1965)). In fact, a high level of literacy on the eve of the Meiji Restoration facilitated the introduction of compulsory education by the state in 1872 (Wiener (1991)). The Japanese concern for education also made its way into its colonies, Korea and Taiwan, though the Korean emphasis on mass education may have been spurred in part as a way of building national consciousness against Japanese influence (Wiener (1991)).

Communism has also been a strong force. Wiener (1991, p163) argues that while the rulers of imperial China regarded mass education as a political threat, the post-imperial regimes saw it as a way to bridge the differences between the elite and the masses, and of developing China as an industrial and military power (also see (Easterlin (1981))). The Communists may also have been more confident of their hold on power. The Chinese were not uninfluenced by Japan, whose success they saw as due to its emphasis on education. Thus again, national rivalry can help in breaking the hold of narrower domestic interest groups.

Finally, and briefly, successful land reforms also appear to have been undertaken under circumstances of political change. The rise of the gentry in Britain, the force behind the growing power of Parliament, accompanied the taming of the power of great lords and the Church by Henry VII and Henry VIII and the sale of their lands (see Tawney (1949), Rajan and Zingales (2003), Acemoglu et al (2004)). Similarly, the desire of the Allied occupiers to reduce the power of the Japanese landlords who backed the prior militaristic regime (see, for example, Nelson (1993)), or of Koreans to cut landlords who had been too cozy with Japanese occupiers down to size (see Jeon and Kim (2000)), led to successful land reforms in these countries.

External Pressure

Regional organizations like the European Union or organizations like the World Trade Organization (WTO) can promote reforms by offering the substantial benefits of membership only to those who reform enough to qualify. For instance, countries that desire membership in the European Union have to undertake a wide set of reforms to obtain the market access and transfers that accompany membership. Of course, to the extent that the underlying structure of society is still fundamentally unequal upon access and replete with rents, the pace of reform could slow considerably after membership. It might be beneficial then for the required reforms to not just mandate macroeconomic stability, but also more egalitarian access to factor endowments. In a similar vein, countries like
China have accepted tough conditions for accession to the WTO, as much because they value the impetus this gives to the domestic reform process, as for the benefits of WTO accession itself.

Finally, consider external advice. As international organizations have increasingly realized, the problem in many countries is not so much identifying necessary reforms but instead obtaining political support for them. One extreme reaction is to throw up one’s hands and blame the historic weight of institutions – that way lies paralysis. A second approach is to pressure a country into adopting reforms that do not have the underlying consensus, perhaps through the threat of withdrawing foreign assistance. As the international organizations have learnt, this approach will typically be met with subtle sabotage as domestic constituencies subvert the reforms. This is why the recent focus of international agencies on requiring country authorities to demonstrate ownership of reform programs is so important. This is not to say that the agencies are irrelevant. International agencies can have some impact at the margin, especially if they can strengthen the hand of an emerging reformist constituency in the government.

Evidence.

It is increasingly believed that the problem in many poor countries is not so much that they do not have any periods of high growth, but that ones that stay poor do not sustain growth. Berg, Ostry, and Zettelmeyer (2006) analyze the factors that lead to longer duration growth spells and find that one of the strongest explanatory variables is the degree of income inequality at the beginning of the spell. By contrast, they do not find that the quality of political institutions at the beginning of the spell has much explanatory power.

A study by Banerjee and Iyer (2005) is persuasive that inequality of endowments matters, because they examine its effects within a common political system – that of colonial and independent India. They find that districts in which proprietary rights were given to large landlords by the British had much greater inequality in land and incomes than districts where rights were given directly to the cultivator, and this inequality persisted till Indian independence. While inequality diminished after independence as a result of land reforms, it lingered on since the reforms were incomplete and, sometimes, ineffective. Bannerjee and Iyer find that landlord dominated areas could take much less advantage of the post-independence agricultural reforms, spending far less on development, even after correcting for differences in income. As a result, agricultural productivity was lower in landlord areas, despite some evidence that the non-landlord areas were poorer at the outset in colonial times. Particularly relevant to my model is the finding that in the period after independence, landlord areas had 21% fewer villages equipped with primary schools, while the gap in middle school and high school availability was 61% and 63% respectively, relative to the more equally endowed non-landlord areas. The persistence of inequality, the difficulty of taking advantage of reforms, including those funded by the central government, as well as the under-emphasis on education in unequal areas are all consistent with my model.

In a similar vein, Erikson and Ramcharan (2005) examine the effects of inequality in land holdings on public expenditure, such as on education, in the United States. Unlike Banerjee and Iyer (2005), where the pattern of land holdings is likely to be exogenously determined because the colonial system of land tenure was exogenously imposed, the system of land tenure in the states Erikson and Ramcharan examine is likely to be endogenous. Using the volatility of weather as an instrument (more volatile weather patterns means larger farm size in equilibrium), they find indeed that higher
inequality in land holdings around the beginning of the twentieth century meant lower public expenditure on public goods such as education.

Finally, Pal and Ghosh (2006) look at modern Indian data and find that in areas where there is a greater share of land held by the top 5 percent of the population, spending on education is lower. However, higher representation of backward minorities in the government seems to have little effect on education spending, which is consistent with the underlying point that the structure of interests matters more than formal political structures.

Thus there is prima facie evidence that initial inequality results in poor public policies and investment, and lower growth, even in systems that have broadly the same political institutions. Glaeser et al. (2004) goes further, and offers evidence questioning whether political institutions play even a contemporaneous role in economic growth. They argue that the best measure of institutions – a measure of constraints on the executive – does not predict economic growth, while other factors like human capital do. Also, the historical instruments in the literature (specifically settler mortality and population density in 1500 from AJR (2001, 2002)) are more highly correlated with contemporaneous measures of human capital than with contemporaneous measures of political institutions. Indeed, when they use instrumental variable estimation using the historical instruments, they find that measures of human capital trump measures of political institutions in explaining growth.

Conclusion

What lessons does all this suggest for development? Clearly, the answer, “fix the institutions,” is probably incomplete, if at all correct. “Fix the constituencies” is probably more on the mark, but how? A number of development successes like Korea undertook serious land and education reforms prior to their take-off, as have a number of the fast-growing Indian states. It seems that reforms reducing inequalities in factor endowments (like land) and those improving access to education and finance can strengthen the constituencies for broader economic liberalization. That is, the free-access economy may be a necessary stepping-stone to the free-enterprise economy. I should not, however, minimize the difficulty of enacting such endowment-spreading reforms in highly unequal societies. The bottom line is that development is likely to be a complex political process where the people themselves must do much of the heavy lifting. The outside world can help at the margin but only if the people have ownership. And ownership—even of something as beneficial as development reforms—can’t be taken for granted.

References


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