

ECON 4921: Lecture 8

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Roadmap

1. Introduction
2. Institutions and Economic Performance
3. The Firm
4. Organized Interest and Ownership
5. Complementarity of Institutions
- 6. Institutions and Commitment**
7. Agency problems: Voters- Politicians-Bureaucrats
8. Fiscal Federalism
9. System Competition

Summary of model from last week

- Research question:
 - Why did the West extend the franchise?
- Model:
 - Suppose that a country is initially run by a wealthy elite.
 - The elite faces demand from the poor majority for policies that benefit the latter.
 - How will the elite respond?
 - Redistribution
 - Franchise extension

Summary of model from last week

- The elite always prefer redistribution to franchise extension.
- Why do they not always choose redistribution to the poor?
 - The policies favored by the poor may be overturned at a later date, when pressures for social changes have eased.
 - Only by transferring de jure political power, which is much harder to reverse, can the elite credibly commit to a regime that delivers policies favored by the masses.

Summary of model from last week

- Threat of revolution varies with circumstances.
 - The elite cannot make credible promises to redistribute when the threat is transitory
 - democracy
 - EXAMPLE 1: ENGLAND
 - When the threat is permanent, the rich are able to commit.
 - redistribution
 - EXAMPLE 2: GERMANY

Democratization in W. Europe

- In the early days of democracy the franchise was restricted to a subset of the population.
 - Minimum income /tax
 - Property holding requirements
 - Gender
 - Ethnic or religious affiliation
 - Age
- Universal franchise was completed in two stages.
 - The economic franchise
 - Property and income qualifications for male voters were lifted (completed in most countries by 1920).
 - The female franchise
 - Women got the right to vote (typically after WW1 or after WW2).

Britain as an example

- Beginning in 1832, the british political elites made a series of strategic concessions aimed at incorporating the previously disenfranchised into politics.
 - Reform Act 1832 - extended voting rights to adult males who rented land of a certain value: **1 in 7 males**
 - Reform Act 1867 - enfranchised the urban working class: **2 in 7 males**
 - Reform Act 1884 – enfranchised country side.
- Alternatives was seen to be social unrest, chaos and possibly revolution.

Britain as an example

There is no-one more decided against annual parliaments, universal suffrage and the ballot, than am I The principal of my reform is to prevent the necessity of revolution ... I am reforming to preserve, not to overthrow.

Earl Grey in the British parliament 1832, cited in A&R

Britain as an example

The 1832 reform act ... introduced by the whigs ... as a measure to stave off any further threat of revolution by extending the franchise to the middle class.

Darwall (1934), cited in A&R

Britain as an example

- Democratization changed the economic institutions/policies away from those preferred by the elite
 - Allowing trade unions.
 - Labor market legislation
 - Welfare state arrangements (1906 - 1914)
 - Health and unemployment insurance.
 - Pensions.
 - Minimum wages
 - Redistributive taxation
 - Educational reforms (1870 →)

*a major commitment to mass education is frequently symptomatic of a **major shift in political power** and associated ideology in a direction conducive to greater upward mobility for a wider segment of the population*

Easterlin 1981, cited in A&R

Germany as an example

- Social unrest as large as in England.
- But universal male suffrage came later
 - Although after 1870 all males over 25 had the right to vote formally. Voting was controlled in the rural areas by the landlords.
 - Final emergence of democracy first in 1919
- The country with the most developed socialist party did not extend the franchise, but instituted the welfare state.

Germany as an example

The main aim of [Bismarck's] welfare program was to avoid revolution through timely social reform and to reconcile the working classes to the authority of the state.

Williamson, 1998, cited in A&R.

Germany as an example

The final emergence of German democracy, the Weimar Republic, in 1919, was in response to the very severe threat of social disorder and revolution triggered by the collapse of the German armies on the Western Front in August 1918

A&R.

What about Norway? (source: Wikipedia)

- [grunnloven](#) av 1814:
- § 50. Stemmeberettigede ere kun de norske Borgere, som have fyldt 25 Aar, have været bosatte i Landet i 5 Aar, og enten
 - a. ere, eller have været Embedsmænd,
 - b. paa Landet eie eller paa længere Tid end 5 Aar have byxlet matriculeret Jord,
 - c. ere Kjøbstadborgere, eller i Kjøbstad eller Ladested eie Gaard eller Grund, hvis Værdie i det mindste er 300 Rigsbankdaler Sølvværdie.
- **Around 10% of the population had the right to vote.**
- 1884: Mannlige borgere som har en inntekt på 500 kroner (på landet) og byborgere med en inntekt på 800 kroner og som betaler skatt oppnår stemmerett.
- 1898: Alle menn over 25 år om har bodd 5 år i landet får stemmerett.
- 1907: Kvinner over 25 år med en inntekt over 300 kroner (på landet) eller 400 kroner i byene eller var gift med en mann som betalte slik skatt og var over 25 år fikk stemmerett.
- 1913: Almen stemmerett for kvinner innført.
- 1923: Alder for stemmrett senket til 23 år.
- 1946: Alder for stemmrett senket til 21 år.
- 1948: Alder for valgbarhet senket fra 30 til 21 år
- 1967: De som har fylt 20 år valgdagen oppnår stemmrett.
- 1972: De som i løpet av valgåret fyller 20 år oppnår stemmrett.
- 1978: Alder for stemmrett senket til 18 år.
- Dagens tekst i grunnloven: *Stemmeberettigede ere de norske Borgere, Mænd, og Kvinder som senest i det Aar Valgthinget holdes have fyldt 18 Aar.*

Norway

- While most other European countries were run by aristocracy and monarchs, was the impact of the 'academic elite' (and landowners) stronger in Norway ('Embetsmannsstaten').
- Heterogeneous elite.
- Struggle for independence in 19th century.
- The theory of A&R probably less important here than in Sweden.

Sweden

*Swedish democracy had triumphed without a revolution –
but not without the threat of revolution*

Tilton, 1974, cited in A&R.

Institutions as commitment devices

Political dilemma (Weingast, 1995)

- Fundamental political dilemma of economic systems:
 - Government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens.
- How do one limit the ability of the state to confiscate wealth?
 - Need political institutions that credibly commit the state to honor economic and political rights
 - Limits on future discretion with respect to the economy that are in the interest of the political officials.

North and Weingast, 1989

- A&R draws on the ideas by North and Weingast.
 - N&W: *Constitutions and commitment: The evolution of institutions governing public choice in the seventeenth-century England* (J Ec. History, 1989)
 - N&W stresses the importance of institutions in 17th century England.
 - Institutions as commitment devices
 - Self-enforcing institutions

Historical starting point

- The crown passed from the Tudors to the Stuarts in 1603.
 - King was supposed to 'live of his own'.
 - Considerably discretionary power over revenue collection and spending.
 - Taxation without Parliament' consent
 - Endemic revenue problems.
 - Had to sell of land.
 - Search for new revenues
 - New customs
 - Forced loans (under threat), which they later reneged on.
 - Sale of monopolies
 - Sale of peerage, hereditary titles
 - Title of baronet for £1.095 promising fixed number (in 1614)
 - When all the titles were allocated, new titles were announced– price fell to £220 (in 1622)
- Very limited checks and balances to the crown
- "Arbitrary government"

Conflict

- Conflict between the Stuart monarchs intent on maintaining and expanding their absolutist powers
 - 'the divine right of kings'
- ... and a Parliament that intended to reduce them.
- Parliament eventually won leading to the Glorious Revolution of 1688.

Glorious revolution 1688

- Initiated the era of "parliamentary supremacy"
 - "King in parliament" rather than "king alone"
 - King no longer above the law
 - Direct check on the Crown.
 - Parliament gained
 - Exclusive right to tax
 - Right to audit how the government spent money
 - Veto right over expenditures

Glorious revolution 1688

- Independence of the judiciary from the Crown.
 - Crown could no longer unilaterally legislate
- A credible threat to the Crown regarding future irresponsible behavior.
 - Dethroning of Charles I (during the civil war in 1649) and James II (in 1688).
- In return for greater Parliamentary power, the parliament agreed to put the government back on sound financial footing.
 - This removed the underlying source of the financial crisis
- This changes greatly enhanced the predictability of governmental decisions.

Empirics from capital market

Not only the rules governing economic exchange, but also the institutions how these rules are enforced and how they may be changed affect functioning of markets.

The more likely that sovereign will alter property rights for own benefit: lower expected return from invest.

Empirics from capital market

Pre –revolution: was only to borrow about £1mill. At 6-30% interest
(in comparison Holland: £5 mill. at 4% interest)

Post-revolution: figures immediately grew fourfold. And interest rates also fell. Risk was substantially lower.

TABLE 3
GROWTH OF GOVERNMENT DEBT, 1618–1740
(£ million)

Year	Governmental Expenditure ¹	Debt ²	Prices ³ (1701 = 100)
Stuart England			
1618 ⁴	£0.5	£0.8	
mid-1630s ⁵	1.0	1.0	
1680 ⁶	1.4		113
1688 ⁶	1.8	1.0 ⁷	99
Post Glorious Revolution			
1695	6.2	8.4	116
1697	7.9	16.7	122
1700	3.2	14.2	115
1710	9.8	21.4	122
1714	6.2	36.2	103
1720	6.0	54.0	102
1730	5.6	51.4	95
1740	6.2	47.4	100
1750	7.2	78.0	95

Conclusion

- Change in institutions in 1688 allowed
 - property rights to be secured,
 - wealth to be protected,
 - and confiscatory behavior by the government to be eliminated.
- Increased reliance on common law courts rather than royal discretion.
- Institutional reform can be a way for the elite to commit to future policies by delegating their enactment to interests that will not reverse them ex-post.

References

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