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Good geography, good institutions? Historical evidence from nineteenth-century British colonies[☆]

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ABSTRACT

This paper uses a historical natural experiment – the opening of the Suez Canal – to investigate the relationship between geography and the formation of institutions. While the conventional view is that good geography (commodity endowment) inevitably favours the creation of extractive institutions, we discover that a second aspect of geography – location – may in fact encourage the establishment of non-extractive institutions when rent extraction by elites depends on the productivity of non-elites. Specifically, we find that entrepôt colonies (Hong Kong and the Straits Settlements) received larger public investments in the post-Suez period than resource colonies (British India, Ceylon, and West Africa), after accounting for year effects and permanent differences across colonies. We demonstrate, using supplementary data, that the entrepôt colonies' locational advantage, coupled with their lack of extractable resources, plays a key role in explaining our empirical findings.

1. Introduction

What is the effect of geography on institutional formation? Conventional wisdom in the existing literature suggests that having an abundance of geographical endowments generally provides incentives for the ruling elites to build extractive institutions. For example, elites may establish institutions that deny non-elites of property and voting rights, and equal access to education, to fully exploit gains from extracting natural resources (Engerman and Sokoloff, 1997; Acemoglu et al., 2001).

While concurring that geography plays a vital role in the creation of institutions, we believe that as the existing literature focuses on resource economies in which extractive policies guarantee maximal rent extraction, they invariably conclude that good geography engenders bad institutions. In this paper, we highlight a second aspect of geography – location – which may in fact encourage the establishment of non-extractive institutions, in situations where elites are unable to extract rents unless they raise the productivity of the non-elites (through investments in education, for example); in that case, geographical endowments can actually be a blessing.[1]

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[1] That location is an important aspect of geography is not a new idea, as previous work by renowned scholars have already emphasised the role of location (Fujita and Mori, 1996; Diamond, 1999; Hall and Jones, 1999; Gallup et al., 2001; Bosker et al., 2013).

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Specifically, we examine a set of British colonies – British India, Ceylon, West Africa, Hong Kong, and the Straits Settlements – that were located along the East-West shipping trade routes in the late nineteenth century. British India, Ceylon, and West Africa were resource economies whose role was to produce tradable commodities for the British Empire, while Hong Kong and the Straits Settlements were entrepôt economies that acted primarily as trading posts, thanks to their proximity to the maritime trade routes. We find that colonial investments in the post-Suez period grew substantially more in Hong Kong and the Straits Settlements, relative to British India, Ceylon, and West Africa, after controlling for year effects and permanent colony-specific characteristics. We argue that these differences emerged because those colonial investments enhanced the profitability of entrepôt activities whereas exploitative rent-extraction would have been ineffective. We go on to show that the entrepôt colonies' locational advantage, coupled with their lack of extractable resources, plays a key role in explaining our empirical findings, even after accounting for other possible confounding factors such as initial European settlements or baseline social hierarchies.

This research makes two contributions. First, we assemble a unique data set, never before constructed on this scale in the context of the late nineteenth-century global trade boom, and use it to highlight the importance of location in determining institutions. The evidence we describe here augments the existing literature that examines the role of commodity endowments (Engerman and Sokoloff, 1997; Acemoglu et al., 2001) and speaks indirectly to the literature that examines the effects of institutions on economic growth (Acemoglu et al., 2001, 2005; Rodrik et al., 2004). In particular, our paper highlights the role of historic events – in this case, the opening of the Suez Canal in November 1869 – and joins a growing literature on the subject (see Nunn (2009), for a review). Second, we use the opening of the Suez Canal as a novel natural experiment to establish a causal relationship between geography and institutions. Our empirical results highlight (i) the possible establishment of a non-exploitative type of rent-extraction, and (ii) the importance of distinguishing different aspects of geography in determining the type of institutions, both of which are rarely studied in the existing literature.

The rest of this paper is organised as follows. Section 2 constitutes a background discussion on our research design. Section 3 describes the data. Section 4 offers an overview of the colonial investments, especially highlighting their differences across resources and entrepôt colonies. Section 5 provides the main empirical results, while an investigation into mechanisms and the robustness checks are discussed in Sections 6 and 7 respectively. Section 8 concludes.

2. Background

In this paper, we compare two sets of British colonies in the late nineteenth century.[2] British India, Ceylon, and West Africa were important British settlements because they were key producers of natural commodities, such as coffee, cotton, ground nuts, indigo dye, opium, palm oil, silk, and tea (Chaudhuri, 1983; Wenzlhuemer, 2008), all of which were in strong demand, particularly from Europe, at the time.[3] In this regard, we treat them as resource colonies.

On the other hand, Hong Kong and the Straits Settlements did not possess natural resources that could be exploited with considerable scale, but were desired for their entrepôt trading potential.[4] Hong Kong was strategically located on China's south coast, and was therefore vital for protecting the maritime trade route to China. In particular, it was the key intermediary between China and Europe for commodities such as opium, cotton and woollen textiles, metals, minerals, tea, and silk.[5] The Strait Settlements, on the other hand, were situated at a natural choke point – the Straits of Malacca – along the shortest East-West shipping route. They functioned as key hubs where goods between Asia and Europe were imported and re-exported: manufactures from the West to the East (textiles, weapons, ammunitions, iron, copper, and lead), and primary goods from the East to the West (gambier, rice, pepper, raw silk, sugar, tobacco, and tin).[6] Hong Kong and the Straits Settlements also possessed natural harbours which cemented their positions as ideal transit ports. Apart from their

[2] In general, our choice of colonies is constrained by (i) their geographic location (along the East-West shipping route); (ii) their founding year as a British colony (to be significantly before 1869 so that we can observe sufficient pre- and post-Suez variation); and (iii) their demographic composition (to exhibit a low share of white settlers, since the incentives for institutional formation in settler colonies were no doubt very different at the outset). For example, we exclude Labuan (because its entry into the Straits Settlements in 1906 postdates the period of our study), Nigeria (because it joined British West Africa in 1885), and the Cape of Good Hope, Australia, and New Zealand (because they were clearly settler colonies). Moreover, we sidestep potentially-confounding influences that are related to colonial identity by focusing on colonies belonging to a single (British) coloniser. Colonial identity has important effects on investments, for example, through differences between British common law and French, German, or Scandinavian civil law (La Porta et al., 1997). Like us, several other authors have limited themselves to a single coloniser in order to locate the source of difference between colonies (Berger, 2008; Huillery, 2009; Iyer, 2010).

[3] For example, British India grew into one of the largest exporter of cotton in the nineteenth century. In fact, the commercialisation of agriculture was so intense that food production declined to the extent that there was mass impoverishment, destitution of farmers, and even famines (Sarkar, 1989). Correspondingly, coffee plantations in Ceylon provided the British with soaring revenues (Wenzlhuemer, 2008, p. 31).

[4] To be more accurate, the Straits Settlements' hinterland, Malaya, did have a large tin mining industry since the 1820s; however, its tin-producing states were under the control of their respective Sultans until the Pangkor Treaty of 1874 paved the way for British involvement in the Malaya states. Also, large-scale rubber tapping did occur but it only started in the early 1900s. Singapore was also a producer of pepper and gambier, albeit at a very small scale.

[5] Specifically, 41% of China's imports and 27% of its exports were channelled through Hong Kong from the 1850s, of which only a small fraction was produced and consumed in Hong Kong. In fact, Hong Kong's role in Sino-European trade persisted throughout the nineteenth century despite the opening of other Chinese ports after the Treaty of Nanjin (1842), due to better accessibility and to European exporters' limited knowledge of China (Keller et al., 2011).

[6] Within the Straits Settlements, Malacca's role was also vital for the redistribution of essential regional consumption goods such as rice, opium, tobacco, and tapioca.