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Book review

Institutions and prosperity
A review of Timothy Besley and Torsten Persson, *Pillars of Prosperity: The Political Economics of Development Clusters*, Princeton University Press, Princeton, 2011, pp. 375 and Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty*, Profile Books, London 2012, pp. 529

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ABSTRACT

This article reviews 'Pillars of Prosperity' by Timothy Besley and Torsten Persson and 'Why Nations Fail' by Daron Acemoglu and James Robinson. Both books are focussed on the role of institutions in determining the wealth of nations and the review compares and contrasts the different approaches contained in the two texts. The review also attempts to locate the texts within the broader literature in development and political economics and to link them to other recent work in these areas.

Ever tried. Ever failed. No matter. Try again. Fail again. Fail better. Samuel Beckett, *Worstward Ho*, 1983

1. Introduction

It would seem clear that an institutional explanation for the wealth of nations is now the leading one within economics. Institutions encompass the set of political and legal arrangements that provide the environment in which economic activity takes place. This contrasts sharply with the dominant tradition in 20th century economics which attempted to understand prosperity as a technical problem, to work out the best means of improving social welfare under the assumption that the political elite would wish to

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do so. Along with the largely hidden assumption of a complete set of property rights, economics was thus largely divorced from institutional analysis. Under this approach, where clear disparities in the wealth of nations appear it would be tempting to conclude that is due to a lack of enlightenment. Improved knowledge of economics should provide the platform for future prosperity. Politics and law do not seem to matter. This, of course, is a caricature. Very few economists would have argued that politics does not matter, but they might have said that political analysis was not the remit of the trained economist.

The publication of the two books to be reviewed here confirms that this perspective is no longer that of the mainstream economics profession. The authors are four of the most prominent economists in the world and they place political analysis at the centre of the economist's approach to understanding the sources of prosperity. Failure to improve institutions generally results in a failure to implement welfare improving policies and thus it is crucial to understand why it has been difficult for poor nations to construct good institutions. Both books should accelerate the deeper inclusion of political analysis in various economics courses, but particularly in public and development economics. While there was an awareness of the public choice argument that the *rules* of the game determined the *play* of the game, public choice analysis has generally been viewed as non-mainstream by the economics profession (even after the award of the Nobel prize to James Buchanan in 1986). These authors are from the very heart of the mainstream. The two books share the same theme, but they are dissimilar in that Besley and Persson's book is written primarily for an academic audience and Acemoglu and Robinson's book is aimed at the general reader, although this is to a large extent a popular follow-up to their well-known academic text from 2006.

2. Pillars of prosperity

I will begin with the Besley and Persson text. The book gathers and expands upon a number of academic papers that they have published in the last four years. In a very clear opening chapter (which also provides a useful summary of the whole book), they begin with a quote from Adam Smith who identified '*peace, easy taxes and a tolerable administration of justice*', as the requirements that '*carry a state to the highest degree of opulence from the lowest barbarism*'. So from the start we are reminded that modern *political economics* with its focus on politics is in many ways a return to the concerns of the founders of economics who distinguished the discipline as *political economy*. The authors are careful to clarify what they take Smith's three pillars of prosperity to mean; 'easy taxes' are for them administratively easy to collect and they are not primarily concerned with constraints imposed by the standard concerns of incentives and political competition; 'peace' means internal to a nation rather than external and 'justice' is primarily concerned with security of contract and property rights. In the period when economics was more divorced from politics, issues such as the underlying ability of the state to tax or the security of property rights were simply assumed. A society that can achieve these capacities will form an 'effective' state from which prosperity can emerge. They define a development cluster as one that exhibits a positive correlation between income per capita, state capacity (a combination of fiscal and legal capacity) and absence of political violence. They demonstrate empirically these correlations and while some readers may be fussy regarding how they measure these features, the evidence does seem fairly compelling. They explain that each subsequent chapter builds upon the one before to expand the core model so as to endogenise previously exogenous variables and to introduce new variables of interest, so that by the end of book a full typology of different kinds of state is provided and by extension gives an explanation for the inequality in prosperity of nations across the globe.

Chapter 2 constructs the core model that is used throughout the book. It presents the conditions required for costly investments in fiscal capacity to be made. The model consists of two periods and two groups consisting of an incumbent and opposition, such that in each period the incumbent (the opposition could become the incumbent in period two) gets to choose spending in public goods and makes transfers to the two groups given the constraints created by income, current fiscal capacity and resource income. In period one, the incumbent can choose to invest in fiscal capacity. They will do so if they foresee the benefits created by an increased tax base in period two as compensating for reduced spending on public goods and/or transfers in period one. With this simple set-up, three types of state are identified dependent on whether two conditions hold or not. These are the cohesiveness and the stability conditions. Cohesiveness arises if there are likely to be highly valued public goods and/or if the incumbent knows that if they are removed from power they would still receive a large share of any transfers the new incumbent might make. This may relate to a strong system of checks and balances in the political institutions. The stability condition relates to the likelihood of the incumbent retaining power. If cohesiveness holds, the incumbent will invest in fiscal capacity and this is called a *common-interest state*. If it does not hold they will still invest if political stability is high. This is a *redistributive state* where the incumbent is not worried about losing power and increases fiscal capacity to potentially extract larger transfers from the opposition. If neither condition holds, the state is defined as *weak* and no investment is made in fiscal capacity. Compared with the behaviour of an idealised Pigouvian planner, a common-interest state is efficient; a redistributive state is efficient (though not in a standard utilitarian sense) and a weak state is inefficient. This implies a central problem of commitment in politics. A set of mutually welfare-enhancing institutions often cannot credibly be devised to prevent abuse of power at a later stage. Microfoundations for the model are discussed, various extensions are made and empirical evidence is provided which shows correlations between proxies for parameters in the model that measure cohesiveness and stability and the measure for fiscal capacity (share of total taxes in GDP). Some of the proxies for the parameters are very interesting. For example, a measure of common-interest spending is the proportion of years in external war from 1816 to 2000. The authors openly admit that the empirical work is purely illustrative, but it is convincing. It also goes against a commonly made argument that a low tax economy is a wealthy economy.

In chapter 3 the authors move on to the second pillar of prosperity; legal capacity. Here the legal system is viewed as 'market-supporting regulation' such as protection of property rights. As a result, investments in legal capacity lead to higher incomes. The key finding in this chapter is that investments in fiscal and legal capacity tend to be complementary. Increases in