Institution Building and Political Accountability

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Abstract

The paper examines the role of policy intervention in catalyzing institutional change. We identify two effects of development policy as a tool for institutional change. By increasing political accountability, it may encourage nascent democratic governments to invest in good institutions. However, it also increases incentives of the rentier elite to tighten their grip on political institutions. Which of these effects dominate determine if development policy will lead to democratic consolidation and economic improvement or to the worsening of existing institutions. If the elite are deeply entrenched, then modernization may require combining development policy with subsidies.
1 Introduction

There has been much emphasis on the importance of institutions and good governance for development.\textsuperscript{1} However, the adoption of new institutions has had a rather mixed record. For example, introduction of democratic institutions has failed to deliver a sustained economic improvement in many countries.\textsuperscript{2} Indeed, even within democratic countries such as India and Mexico and in the Americas, there are large differences in the quality of economic institutions across regions.\textsuperscript{3} In this context, we ask when does the adoption of democratic institutions improve economic institutions and when may they get subverted by entrenched interests? In addressing this question, we also throw light on the role of development policy in catalyzing positive economic and political change.

We develop a model in which economic institutions such as the degree of property rights protection, enforcement of contracts etc. are influenced by the government’s deliberate effort at improving such institutions within a region. While most countries have a federal constitution and legal system, local governments often have considerable authority in formulating local laws or at least in their enforcement. Through their allocation (or not) of resources towards these areas of governance, the regional government can have a significant impact on the quality of economic institutions that get realized, and consequently on investment and welfare in the region. Our focus is on the forces that affect the government’s decision-making on this important dimension. In our framework, there are two groups in this region, with the majority group consisting primarily of wage-earners. They stand to benefit from better economic institutions attracting investment into the region, thereby resulting in a rise in their wages. The other group is an economic “elite” that enjoys monopoly rents in the current (backward) institutional structure. Any change/improvement to the existing institutional set-up that may encourage other entrepreneurs to invest is likely to adversely affect their rents. It is this potential for an adverse distributional outcome that underlies the elite’s desire to control the political levers of government.

These two groups with conflicting interests seek to influence government policy with respect to economic institutions such as property rights. The citizens voice their favor or disfavor of the government at the polls by either re-electing or ousting an incumbent. In contrast, the traditional elite directly influence governmental decision-making through active lobbying for the implementation of their preferred outcome, namely that of a low level of property rights protection. Whether in fact the elite can do so successfully depends on the nature of the region’s economic and political

\textsuperscript{1} See for example, Rodrik, Subramaniam and Trebbi (2004), and Acemoglu, Johnson and Robinson (2005).
\textsuperscript{2} See for example, Barro (1997), Rodrik (1999). In Latin America, according to the 2003 Latinobarometro poll, 15 of 18 countries witnessed a significant erosion of support for democracy. Over 71% of the respondents felt that democracy had been captured by special interests. Similar results are also observed in the Eastern Europe barometer.
\textsuperscript{3} Dash and Raja (2009) document big differences in indices of institutional quality across Indian states. On a -5 to +5 scale, for the property rights index, they find that it ranges from a worst of -2.68 to a best of 5. Acemoglu and Dell (2010) find that (for the Americas) within-country differences in labor income are larger than differences across countries, and a significant portion of this disparity is due to institutional differences at the sub-national level.
fundamentals. We show that for a region plagued with weak economic fundamentals or riveted by conflict on non-economic issues, elections do not provide enough of a reward for a democratic government to escape the clutches of influence by the elite. Thus despite free and regular elections, democracy remains imperfect as government policy remains “captured” by the economic elite. As a result, economic institutions remain dysfunctional and income for the majority remains low.

For a region stuck with such inefficient institutions, intervention by a policymaker who is external to the region or country provides the prospect of institutional change and economic improvement within a shorter time frame. Consider for instance, a development policy which encourages investment, be it through investment in infrastructure (thereby reducing the cost of doing business there), or by tax-breaks and subsidies for those whose invest in the region. We identify two channels through which such a policy can impact both political and economic institutions in the region. One, the incentive effect of development policy: by raising accountability and rewarding good governance, such a policy encourages the government to strengthen economic institutions and improve property rights. Indeed by doing so the government also simultaneously improves the strength of its political institutions. However, by encouraging outside investment, development policy gives rise to the spectre of a large loss in economic rents by the elite. This prospect of an erosion in economic rents gives the elite greater incentive to tighten its grip and deploy additional resources to control the levers of government. Through this channel of a political control effect, development policy may therefore also have the adverse effect of potentially undermining political institutions.

This double-edged aspect of policy intervention is worth emphasizing. In our model, under some conditions the incentive effect is strong enough to ensure that development policy results in not just better protection of property rights, but also transforms democracy by freeing government policy-making from the elites’ grip. However, when the political control effect outweighs the incentive effect, a benign development policy can backfire by resulting in an overall deterioration in governance and the quality of the economic institutions. This result thus provides an important cautionary note in the use of development policy as a tool to transform institutions.

In an extension of the basic model, we show that development policy may also have the secondary effect of prompting the elite to change their technology closer to the frontier so as to be less dependent on an insular institutional setup for their profits. Thus it may lead to modernization indirectly. If however the elites are deeply entrenched, in that their traditional technology is very far from the technological frontier or the costs of reorganization for them are too large, development

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4This formulation captures a number of plausible scenarios. For instance, this “external” policymaker may be the federal government attempting to improve both the quality of economic and political institutions in a backward province. Alternately, it could be a foreign country or an international agency such as the U.N. confronting the task of transforming institutions in Afghanistan or East Timor.

5In Mexico, Fox (1994) cites the case of development policy in the Michoacan province. This increased political participation of the individuals native to the region. At the same time, cases of election malpractice and booth capturing by the landed elite also dramatically increased.
policy is unlikely to erode their “political control” of government. In such cases, democratic elections may need to be combined with developmental policy and subsidies to the elite in order to bring about comprehensive institutional change in the region.

Related literature: Our paper is clearly related to much of the recent work on voluntary elite-led democratization (Acemoglu and Robinson, 2000, Lizzeri and Persico, 2004). However, especially since World War II, there have been many instances where the spur to democracy has been from direct and indirect forms of external influence (see Dobbins et. al., 2007 for a discussion). In this paper we take a first step in exploring the effects of policies aimed at bringing about comprehensive institutional change. The closest paper to ours is Acemoglu and Robinson (2008), who also explore conditions under which the introduction of democracy need not result in an improvement in economic institutions. Similarly, Acemoglu and Robinson (2000) look at conditions under which elites would seek to prevent development from occurring. While our analysis also derives conditions under which democracy is effectively captured by the elite, our focus is on the impact of different policies that can help mitigate or exacerbate this problem and their interaction with the local conditions, thereby helping understand which policies are more likely to succeed under what conditions. Finally, our work is complementary to Myerson (2006) who emphasizes the building of political institutions to encourage political competition for successful democratization.

Our analysis is also related to the literature examining issues of policy persistence, corruption and lobbying in countries with weak institutions. It is also related to the literature on foreign aid and corruption (Svensson, 2000), which argues that the prospect of an increase in foreign aid may make it harder to sustain the cooperative low rent-seeking equilibria among different social groups, and thereby result in worsening of productive public investment. We focus instead on the impact of aid on the incentives provided through elections versus the lobbying incentives of elites and the effect of different types of aid policies on these incentives.

The rest of the paper is organized as follows. In the next section, we describe the basic model of the political process, and characterize its effect on institutions, and consequently on the economy. Section 3 describes the model in the context of landowning elites, while Section 4 concludes.

2 Description of the Model

We outline below a simple model of government capture and its effect on underlying institutions.

Investors in a particular region/province fear that their output or returns from investment may get appropriated or stolen. Factors such as the effectiveness of institutions to enforce property rights, efficacy of the administrative machinery, and the law and order situation is crucial to their decision on whether or not to invest in this province. The quality of these factors can be heavily

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6 See Mishra (2005), Majumdar and Mukand (2004) and Jain et. al. (2013) for a discussion of these issues.
influenced by initiatives taken (or not) by the regional government. For example, while constitutional law maybe the same across a country, its implementation may vary widely across regions, depending on investment by the government in “state capacity” in the form of hiring inspectors, judicial officers etc. and overall promoting a climate where legal contracts are honored.

Policies: For simplicity we assume that there are two possible levels of protection: 0 or $p$. This gives the probability that a particular investor can reap the complete returns from his or her investment. Thus, a 0 level of protection represents a regime without any significant property rights protection, and which is unlikely to attract much investment.

The level of protection in a province is assumed to be a function of the government’s ability, resources devoted and experience in such matters of effective governance. Specifically, we assume that the level of protection in a province is $p$ with probability $a(e + xy)$, and is 0 otherwise.

Here, $a$ is the government’s ability at good governance and is assumed to be either high ability $H$, or low ability $L = 0$. Similarly, $e \in \{0, 1\}$ represents the regional government’s efforts/resources devoted on governance. Thus, $e = 1$ represents the regional government’s initiative/policy-choice in enforcing a good investment climate in the province. However, doing so is costly, and we assume that the cost of implementing $e = 1$ is given by (with an abuse of notation) $e$. Apart from real resources, this could also be interpreted as the opportunity cost of channeling resources or moving attention and energy from other favored policies of the government. Here $x$ denotes the value of experience at governance matters, and is acquired only by putting in high effort (i.e. $e = 1$) at governance; if the government puts in no effort, then $x = 0$. We assume that a government can be in office for at most two terms; thus the years of experience in office $y = 0$ for new governments, and $y = 1$ for governments who get reelected for a second term.

In this particular set-up, low ability governments are always ineffective. Only high ability governments can bring about a good investment climate, either by putting in the requisite effort, or by virtue of their experience at good governance. Note that in the above structure, if a high ability government puts in effort $e = 1$ during its first term of office and is then reelected, the effects of good governance persist to some extent during its second term as well. This degree of persistence is represented by the parameter $x$. We relax this assumption in section 2.2.

Investment: Investment into this region is dependent on the level of protection that exists for investors. If it is 0, then returns to all investors get appropriated with probability 1, and thus no investment is attracted. On the other hand, if the level of protection is $p$, then whether or not investors find investing in this province attractive depends on their investment returns, what other opportunities are available for them, and what are the costs and hassles of investing here. We summarize all of this by a parameter $\theta$ which gives the probability that investment occurs in this province if the level of protection is $p$. In a latter section, we delineate the effect of various types of policies on $\theta$ by deriving this probability from an explicit model of investment.

While potential investors can observe the level of protection and thus infer the investment
climate in the province, ordinary citizens are unable to judge the nitty-gritty details of the overall level of security. However, by observing whether or not investors have decided to put down their capital in the province, citizens can infer the level of property rights protection, and thereby judge the ability and policies adopted by the incumbent government.

**Political Structure:** Although it may be a region with poorly developed property rights, we assume that it is part of a larger nation in which the basic structure of democracy, namely regular elections, gets implemented. As is often observed in developing countries, while the central government may not be able to directly yield influence over the day to day activities of provincial governments, it may at least be forceful enough to uphold the conduct of regular elections. We thus assume that at the end of every period, the incumbent government comes up for re-election where it faces a randomly drawn challenger in an election and the regional electorate may decide to retain or oust it. Each government can remain in power for at most two periods.

The political structure here is simple and focuses on the incumbent government’s desire to maximize its overall rents. These rents could be the salary, the prestige and other (legal) perks $R$ enjoyed from remaining in office, or from payoffs that interested agents may pay the government in order to influence its policies.

The electorate here consists of identical agents whose objective is to choose the government that is most likely to gain them the maximum welfare. The majority of the electorate are wage-earners who benefit from investment occurring in the region. Since chances of that are greater with a high ability government in power, they would like to choose a government who is more likely to be of ability $H$. While citizens cannot directly tell the ability of the government in power, they can infer it from their observations about whether or not investment has occurred.

All incumbents are assumed to be ex-ante identical: with probability $h$ it is of high ability, and with probability $1 - h$ of low ability. Governance being a complex, multi-faceted task, this is also assumed to be unknown to the government itself. Thus, the structure here is that of a career-concerns framework (e.g. Holmstrom, 1982, Majumdar, Mani and Mukand, 2004 or Mani and Mukand, 2007), in which an increased allocation of resources, by raising the chances of a higher output, can enhance the voter’s perception of government ability thus its chances of re-election.

We make the following assumption on the experience factor $x$. It ensures that proven high ability incumbents are preferred to unproven challengers, and get re-elected to their second term in office, even though it is anticipated that it being their last term, they will then choose $\varepsilon = 0$.

**Assumption 1:** $x > h$

Politics can sometimes also get dominated by non-economic issues such as ethnic, religious and social discord. We model the prevalence of non-economic issues in politics in a simple manner by assuming that in each election, with probability $\varepsilon$, politics is determined solely by economic issues as described above, while with probability $1 - \varepsilon$, it is dominated by non-economic issues. In the
latter case, the chances of re-election for the incumbent government, irrespective of its economic performance, is given (exogenously) by $\rho$. Thus, regions with a low $\varepsilon$ are those in which economic issues take a back-seat to other orthogonal issues in determining electoral outcomes. This can differ widely among countries or regions within a country, depending on the distributional make-up of the region and its history. Which particular issue is salient for the current election is only determined just prior to the election; it is not known to the government at the time of deciding $e$.

**Traditional Elite:** While investment in the province improves employment opportunities, and thus welfare, of majority of citizens in the province, there are some whose traditional rents may be imperiled. We term this (small) group as “elites”. For example, this could be a group who fear their monopoly rents in some sectors of the provincial economy getting eroded in the face of competition. They could also be a group who make heavy use of a labor-intensive technology in their production, and thus their profits would fall if wages were to go up in the economy due to a greater demand for labor stemming from increased investment in the region. Per se these provincial elite, either by virtue of their information or enforcement advantage, do not require state-enforced protection to operate, and would thus like to maintain the current status-quo of a low level of property rights which dissuades outside investors from investing in the province.\(^7\)

These elite would like to influence the government to not devote resources into property rights protection. We model the influence game in a simple manner. All elite are assumed identical and together lose rents $M$ if outside investment occurs in the province. Thus they would be interested in bribing the government $b$ to prevent it from enforcing a regime of good property rights protection. We assume that the elites are organized into a lobby group that takes into account the gains and losses of all the elites in deciding how much total bribe to offer to the government. The elites are infinitely lived, and discount each electoral period by a factor $\delta$.

### 2.1 Equilibrium:

In the above political structure, there are two groups of agents who seek to influence policies adopted by the government. The citizens voice their favor or disfavor of the government at the polls by either re-electing or ousting the incumbent. On the other hand, the traditional elites’ lobby seeks to directly influence governmental decisions through the offer of bribes in exchange for the government implementing their preferred outcome of a low level of property rights protection. The government, in making its decision of whether or not to put in effort $e = 1$ into property rights enforcement weighs the potential benefits that the two groups offer.

We focus on Markov perfect equilibria (MPE) for the game, where the state of the world $s \in \{0, 1\}$ in any period consists of whether the government is newly in power (denoted by $s = 0$)

\(^7\)Here we have directly assumed that there is a conflict of interest vis-a-vis property rights protection between the elites and the majority of citizens in the province. However, this need not always be the case. Footnote 10 discusses the incorporation and impact of this issue in our analysis.
or has been re-elected from the previous period (denoted by $s = 1$). A MPE here consists of strategies $b(s)$ for the elites’ lobby on how much bribe to offer to the government for implementing a policy of $e = 0$, the government’s strategy on what bribes to accept (associated with the decision $e(s)$ on whether or not to put in effort), and the citizens’ voting strategy $v(s, i)$ as a function of their observation on whether or not investment occurred (i.e. $i = 1$ or $0$) in the province. A strategy profile $(b, e, v)$ is a MPE if, after any history, each player’s strategy under the profile is optimal, given that he expects all other players to use their equilibrium strategies.

Consider a government in its second term in office. Given that it is its last period in office, it will put in effort $e(s = 1) = 0$. The more interesting part of the analysis is the decision-making in the first period $e(s = 0)$ i.e. by a new government. This is what we study now.

Consider the decision of the majority citizen-workers in the event when the election is based on economic issues. If they observe investment in the province, they infer that the level of protection must be $p$, and therefore the government must be one of high ability who has put in effort $e = 1$. Since $x > h$ from assumption 1, the electorate will thus reelect any government that is able to demonstrate competence by bringing in investment i.e. $v(s = 0, i = 1) = 1$.

From a new government’s perspective, if it chooses effort $e = 1$, then with probability $q_{inv} = \theta H h$ investment occurs, and then if economic issues dominate the election, it is re-elected for a second term during which it earns rents $R$. Thus, its payoff from putting in high effort is $(\varepsilon q_{inv} + (1 - \varepsilon)\rho) \delta R - e$. We assume that $e$ is small enough so that this value is positive. On the other hand, if it accepts a bribe $b$ from the elite and chooses $e = 0$, no investment comes in, and it gets ousted from power in the event that the election is determined by economic issues. The difference between the two payoffs gives the minimum bribe level that is required for the government to be influenced into adopting a policy of no protection: $b_{\text{min}} = \varepsilon q_{inv} \delta R - e$.

From the elites’ perspective, if they do not offer a bribe to the new government, it will put in resources into property rights protection, and therefore with probability $q_{inv}$ investment will occur and it will lose its monopoly rents $M$. Thus, the elites’ payoff from offering no bribe is given by:

$$W_{\text{no\ tribe}} = (1 - q_{inv}) M + (\varepsilon q_{inv} + (1 - \varepsilon)\rho) \{\delta (1 - \theta H x) M + \delta^2 W_{\text{new}}\} + (1 - [\varepsilon q_{inv} + (1 - \varepsilon)\rho]) \delta W_{\text{new}}$$

where $W_{\text{new}}$ is the value (to the elite) of having a new, untried government in power. In the event that investment does occur, the elite not only lose their rents this period, but also the proven high ability government gets re-elected for a second term, during which it cannot be influenced by the elite. The dynamic structure of the model brings this second effect into consideration, and as we show below, will be an important influence in determining the equilibrium policy.

If the elite offer a bribe which the incumbent accepts and in return chooses effort $e = 0$ on law and order, then the overall payoff for the elite, gross of the bribe paid, is given by:

$$W_{\text{tribe}} = M + (1 - \varepsilon)\rho \{\delta M + \delta^2 W_{\text{new}}\} + (\varepsilon + (1 - \varepsilon)(1 - \rho)) \delta W_{\text{new}}$$
Now the elite retain their monopoly rents $M$ for sure, while the second and third terms give their payoffs when the government is reelected (on non-economic issues) and when it is not, respectively.

Thus, from the elites’ perspective, the difference between influencing the government and not is given by $D = W_{\text{bribe}} - W_{\text{no bribe}} = (1 - \varepsilon\delta)q_{\text{inv}}M + \delta\theta HxM(\varepsilon q_{\text{inv}} + (1 - \varepsilon)\rho) + \varepsilon q_{\text{inv}}\delta(1 - \delta)W_{\text{new}}$. Therefore, the maximum bribe that the elite will be willing to pay is $b_{\text{max}} = D$.

Let us consider a stationary equilibrium of the game in which the elite pay a fixed bribe $b$ to the government every period, and in return the government does not put in effort into property rights enforcement, no investment occurs and therefore in every election that is determined by economic considerations alone, a new government gets elected to power replacing the incumbent. We consider conditions under which this can be an equilibrium of the game. The set-up here is of a short lived agent, namely the incumbent government, playing against a long-lived opponent, the infinitely-lived elite. We are interested in seeing whether the maximum that one player is willing to pay is enough to influence the action of the other (as in Coate and Morris, 1999) i.e. whether the maximum bribe that the elite are willing to pay, $b_{\text{max}}$, is larger than the minimum that the government is willing to accept, $b_{\text{min}}$. If so, then under any reasonable bargaining protocol, the two will agree to this bargain, and thus implement the policy $e = 0$.

In this stationary equilibrium, the value to the elite from a new government in power is given by $W_{\text{new}} - b$. Inserting this into $D$ above gives the expression for the maximum level of bribe that the elite would be willing to pay in a stationary equilibrium with persistent bribing:

$$b_{\text{max}} = M\{q_{\text{inv}} + \delta\theta Hx(\varepsilon q_{\text{inv}} + (1 - \varepsilon)\rho)\}rac{1 + \delta\rho(1 - \varepsilon)}{1 + \delta\rho(1 - \varepsilon) + \delta\varepsilon q_{\text{inv}}} \tag{1}$$

This stationary equilibrium is therefore sustainable whenever this maximum willingness to pay by the elite exceeds the minimum level of bribe $b_{\text{min}}$ that is required to influence the incumbent government to adopt a policy of $e = 0$. This is summarized in the proposition below.

**Proposition 1** The government is influenceable and thus no protection/enforcement of property rights takes place if the following condition holds:

$$b_{\text{min}} = \varepsilon q_{\text{inv}}\delta R - e \leq M\{q_{\text{inv}} + \delta\theta Hx(\varepsilon q_{\text{inv}} + (1 - \varepsilon)\rho)\}rac{1 + \delta\rho(1 - \varepsilon)}{1 + \delta\rho(1 - \varepsilon) + \delta\varepsilon q_{\text{inv}}} = b_{\text{max}} \tag{2}$$

In this case, democracy is effectively captured by the elite. If condition (2) does not hold, then democracy works in the sense that the stationary equilibrium involves a new government putting in effort into effective property rights protection.

When condition (2) is not satisfied, the discussion preceding the proposition shows that the stationary equilibrium cannot involve $e = 0$. It can be shown that in a stationary equilibrium involving $e = 1$, the maximum bribing willingness for the elite is again given by (1). Thus the stationary equilibrium will involve no bribing and $e = 1$ precisely in the case when (2) does not
Figure 1: Characterization of the Markov-perfect equilibrium

hold. Hence condition (2) exactly delineates the set of parameters under which the stationary equilibrium involves $e = 0$; in the complementary set, the equilibrium involves $e = 1$. In the latter case, democracy works in the sense that all new governments put in effort towards good governance and there is a high probability of investment occurring, resulting in gains for the general populace. In the former case, even though decision-making rests formally in the hands of a democratically elected government, the process is effectively controlled by the elite, resulting in a low level of property rights protection, a low level of outside investment and low welfare for the masses in the province. We are interested in analyzing the role of the different parameters on this condition of “government-capture” and thereby understanding the effects of different policies on it.

Investment promoting policies: Consider the effects of an investment-promoting policy for this region, for example by bettering the infrastructure or more directly by reducing the cost of investment through subsidies, tax-breaks or other incentives for investors. In the context of the model, consider an increase in $\theta$, the probability that investment occurs when there is protection for property rights in the province. Firstly, it has the effect of rewarding good governance. As $\theta$ rises, the probability of investment in the presence of effective property rights increases. Since the government gets re-elected when the electorate perceives the benefits of better protection through increased investment, this increases the government’s incentive in putting in effort $e = 1$, raising $b^{\min}$. At the same time however, the elite too fear the increased chance of their monopoly rents getting eroded due to the increased possibility of investment, thereby raising $b^{\max}$. The following corollary to proposition 1 determines which of these two effects dominate.

**Corollary 1** There exists $\theta_1, \theta_2 \in (0, 1]$, with $\theta_1 < \theta_2$ such that for $\theta < \theta_1$ and for $\theta > \theta_2$,
$b^{\min} > b^{\max}$, and therefore the elite effectively bribing the government to implement $e = 0$ is a stationary equilibrium of the game. For $\theta \in [\theta_1, \theta_2]$, democracy works to provide enough incentive to a new government to put in effort $e = 1$.

**Proof.** Let us rewrite the condition for effective bribing (2) as (with $q_{ine} = \theta Hh$):

$$\varepsilon \delta R \leq \frac{e}{\theta Hh} + M(1 + \delta \rho(1 - \varepsilon)) \frac{1 + \delta(\varepsilon \theta H x + (1 - \varepsilon)\rho \theta)}{1 + \delta \rho(1 - \varepsilon) + \delta \varepsilon \theta H h}$$

(3)

When $\theta = 0$, the right-hand side (RHS) of the above inequality is infinite and thus exceeds the left-hand side. The derivative of the RHS of the inequality with respect to $\theta$ is given by: $-\frac{e}{\theta^2 H h} + \frac{M(1 + \delta \rho(1 - \varepsilon)) \delta H (x - h)}{[1 + \delta \rho(1 - \varepsilon) + \delta \varepsilon \theta H h]^2}$. This is negative at $\theta$ close to 0, and then (since $x > h$ by assumption 1) changes sign and becomes positive beyond a certain level of $\theta$ i.e. the RHS of (3) is U-shaped in $\theta$, as shown in figure (1). Thus, either for very small or very large values of $\theta$, the RHS of (3) exceeds $\varepsilon \delta R$, and thus in those regions the equilibrium involves effective bribing by the elite.

An increase in the probability $\theta$ of attracting investment under property rights protection has two effects. One, by making governmental effort on institution building more visible, it rewards good governance (by raising the chances of getting reelected) and thus increases the incumbent government’s incentive for putting in effort $e = 1$. This is the incentive effect, and serves to reduce the moral hazard problem inherent in the political set-up.

At the same time, by raising the chances of a government of high ability being re-elected, an increase in $\theta$ serves to also raise the efficacy of the system in re-electing able governments. Due to their experience factor $x$, the probability of continuing with a regime of good property rights is higher for reelected high-ability governments than a randomly chosen new government. This could be due to persistence in the type of framework that has already been put in place by such a government during its first term in office, which maybe linked to the type of bureaucrats and other administrative setup that it may have chosen to enforce good property rights in the first place. As $\theta$ increases, this fear of the increased chances of re-election of a high ability uninfluenceable government causes the elite to raise their bribe $b^{\max}$. This is the political control effect.

Corollary 1 shows that the incentive effect dominates for low values of $\theta$. Thus for a province that is initially not an investment-attracting region i.e. one with a very low $\theta$ (i.e. below $\theta_1$) any policy that lowers the cost of investment or increases the gains from investment i.e. by raising $\theta$, can serve to improve matters. It can help to change the equilibrium from one with persistent bribing and low property rights to one where the government is uninfluenceable by the traditional elite and makes a concerted effort $e = 1$ to improve investor protection.

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8 If the cost $\varepsilon$ were zero, condition (2) in proposition 1 would still characterize the equilibrium. But for corollary 1, it would imply that effective bribing would be the equilibrium only in the range where $\theta$ exceeds $\theta_2$. In this case, the "incentive effect" i.e. a higher $\theta$ increasing the incentives of the government to putting in effort into better governance, would no longer have any bite. We are grateful to a referee for bringing up this aspect of our analysis.
For provinces with a relatively high level of $\theta$ (i.e. close to but below $\theta_2$), a rise in $\theta$ can sometimes adversely affect a previously well-functioning political system. While it enhances the government’s incentives here too, at the same time it also raises the elites’ fear that high ability governments beyond their sphere of influence are more likely to get recognized and thus re-elected by the electorate. This causes an increase in the bribe that the elite are willing to pay.\(^9\) At such ranges, the political control effect dominates; thus any policy initiative that pushes $\theta$ beyond $\theta_2$ can change the equilibrium from one where governments are uninfluenced and put in effort $\varepsilon = 1$ to one where the elites are willing to pay a high enough bribe to get the government to put in no effort into property rights protection. In this case, well-intentioned policy to promote investment can in fact have a debilitating effect on governance. It thus highlights the importance of local knowledge (about the effect of $\theta$) in implementing policy even by a benevolent external agency.\(^10\)

To develop a framework for thinking about specific policies to promote $\theta$, let us assume that there are many potential investment opportunities in the province, each yielding output valued at $I$. To develop any of them requires the investment of $k$ units of capital and $\phi$ units of labor (at wage $w$). Thus if the level of protection is $p$, a potential investor will compare the expected returns $pI - \phi w$ from investing in the province with that from investing elsewhere. Suppose returns to each unit of capital elsewhere is $r$, and ex-ante these are distributed uniformly over the range $[0, U]$, then the probability of investment occurring in this province in the presence of protection level $p$ is given by: $\frac{pI - \phi w}{r_k}$. This identifies with the parameter $\theta$ in our analysis so far. In this framework, investment can be promoted by lowering the capital cost of investment $k$, which can be done either through providing a direct subsidy on such investment or by bettering the infrastructure (e.g. the transportation or power generation framework) in the province, thereby lowering $k$. In terms of their impact on $\theta$, both types of policies are equivalent, and their choice maybe dictated by cost factors. However, if dynamic considerations are taken into account, the effect on the equilibrium outcome of improvements in $\theta$ through a policy of subsidizing investment costs will depend on expectations about how long such a policy is expected to continue into the future. On the other hand, improvements in infrastructure are more likely to be permanent and if it results in pushing $\theta$ above $\theta_1$, is likely to result in a permanent change in the equilibrium outcome from $\varepsilon = 0$ to $\varepsilon = 1$. Even though infrastructure improvements may be more costly, this additional benefit needs to be

\(^9\)In addition to the Mexican example in footnote 5, Crost and Johnston (2012) find that in Philippines, the effect of a large development program KALAHI-CIDSS was to increase conflict violence in those areas.

\(^10\)By taking $M$ to be positive we have directly assumed a conflict of interest vis-a-vis property rights protection between the elites and the majority of citizens in the province. However, there can be cases where better protection of property rights benefit both the citizens and the elite. This would be the case where $M$ is negative.

In this case, the right-hand side of (3) is always decreasing in $\theta$, implying that the equilibrium will involve $\varepsilon = 0$ only for very low values of $\theta$. Thus, even the lining up of the citizens’ and the elites’ interests is not enough to overcome the government’s incentive problem only when the initial probability of investment is very low.

We are grateful to a referee for pointing out this aspect of our model.
taken into account in comparing its effectiveness against a policy of direct subsidy to investors.

The following corollary examines the effects of the different characteristics of the region’s economic and political structure on the equilibrium structure.

**Corollary 2** The region of elite-capture $[0, \theta_1) \cup (\theta_1, \infty)$ shrinks as (i) the rents for the elite, $M$, decrease, or (ii) the cost of good governance, $e$, decreases, or the official rents from being in office, $R$, increase, or (iii) the quality of candidates, $h$, improves, or (iv) economic factors get more salient in determining electoral outcomes i.e. $\varepsilon$ increases.

**Proof.** Let us rewrite condition (2) as: $\delta R \leq \frac{\rho}{\theta H e} + M \frac{1 + \delta(\theta H x + \frac{1 - e}{\rho \varepsilon})}{1 + \frac{\theta H e}{\phi(1 - \varepsilon)}}$. An increase in $R$ raises the LHS and has no effect on the RHS. From figure 1, it implies that this will lower $\theta_1$ and increase $\theta_2$, implying that the region where $e = 0$ shrinks. Similarly, for the effect of $e, M, h, \varepsilon$.

The above corollary shows that when the costs for an incumbent in enforcing good governance are low, or the official returns from being in office, $R$, are high, resulting in strong incentive effects, the democratic process is more likely to generate a regime of good governance. Thus, for example, in regions with a strong history of property right protection, the incremental initiative required by a new government to ensure their continuation is likely to be small. In such regions, it will be difficult for the elite to capture the government. Similarly, in regions where the prestige from democratic office is high, resulting in a high $R$ or attracting a pool of good quality candidates for office i.e. a high $h$, the democratic system should work well in ensuring good governance.

Conversely, the corollary shows that when non-economic issues dominate electoral politics, it is easier for the elite to capture a democratically elected government. Thus, for example, regions riveted with social or religious conflict are more likely to see elites dominating the policy-making process on the economic front. In such regions, the electoral payoff to the government from investing in bettering economic outcomes for the populace is low, and hence it is not in their incentive to invest in property right protection and other features of good economic governance.

### 2.2 Robustness of results

In the model so far, for simplicity, decision-making by a high quality government who is re-elected for a second term was preordained. Due to the experience factor $x$, effective protection was provided with probability $H x$, bereft of any governmental policy decision. In this section, we explore robustness of the basic result by extending the model to allow for the possibility that a second period government can also freely choose the degree of property rights protection.

The protection level in any period is determined by a combination of the government’s ability $a$ and its policy choice $e : p$ occurs with probability $ae$, and is 0 otherwise. We assume that the cost of implementing $e_2 = 1$ in the second period is given by (with an abuse of notation) $e_2$.

For a re-elected government, the second period is its last period in office and thus without any incentives for the future, it would clearly choose to maximize its income by accepting a bribe. As
is often done in finite-period games, we assume that at this stage, the government cares about its legacy or track-record in office. It receives an additional utility benefit \( Z \) from having outside investment occurring in the region (with associated benefits for the populace) in both periods of its governance. This benefit could either be a psychological utility of leaving behind a positive historical legacy from good governance during its reign or the indirect future electoral gains for the political party of the government. The rest of the game is as before.

Again, we analyze the game starting from period \( T = 2 \) for a government re-elected on economic grounds. It weighs between accepting the elite lobby’s bribe (and choosing \( e_2 = 0 \)) versus cementing its legacy with continued good governance. The latter yields the government a utility level \( \theta HZ - e_2 \), which is the minimum bribe required to influence it. The maximum bribe that the elite are willing to offer is their expected loss that period from \( e_2 = 1 \) and is given by \( \theta HM \). We now make the following assumption (similar to assumption 1) to ensure that in equilibrium, the elites will not be able to influence a re-elected high ability government in the second period:

**Assumption 2**: \( \theta HZ - e_2 > \theta HM \)

Moving back to period \( T = 1 \), for a newly elected government, the payoff from accepting a bribe \( b \) is \( b + (1 - \varepsilon)\rho dR \). On the other hand, implementing property rights \( e_1 = 1 \) in the first period gives it a payoff of \( (\varepsilon q_{inv} + (1 - \varepsilon)\rho)\delta R - e_1 + q_{inv}(\varepsilon + (1 - \varepsilon)\rho)\delta(\theta HZ - e_2) \). The difference between the two gives the minimum bribe level that is required for the government to be influenced:

\[
b_{1}^{\text{min}} = q_{inv}\delta[\varepsilon R + (\varepsilon + (1 - \varepsilon)\rho)(\theta HZ - e_2)] - e_1.
\]

For the elites, the maximum willingness can again be derived as \( b_{1}^{\text{max}} = W_{\text{bribe}} - W_{\text{no bribe}} = q_{inv}M[1 + \delta(1 - \varepsilon)\rho] + q_{inv}\varepsilon\delta(1 - \delta)W_{\text{new}} - q_{inv}(\varepsilon + (1 - \varepsilon)\rho)\delta v_{\text{old}} \)

where \( v_{\text{old}} \) is the elites’ payoff from having a (re-elected) high ability government in office in the second period and is given by \( v_{\text{old}} = (1 - \theta H)M \).

In a stationary equilibrium involving persistent bribing \( b \) and no property rights protection, the value of having a new government in power \( W_{\text{new}} \) is given by \( W_{\text{bribe}} - b \). Using this and (4) gives the maximum bribing willingness for the elite, \( b_{1}^{\text{max}} \). Similar to proposition 1 and corollary 1, the following proposition characterizes the equilibrium over the parameter range.

**Proposition 2** In the modified model, democracy is effectively captured by the elite and no protection/enforcement of property rights takes place if the following condition holds:

\[
\delta[\varepsilon R + (\varepsilon + (1 - \varepsilon)\rho)(\theta HZ - e_2)] \leq \frac{e_1}{q_{inv}} + M(1 + \delta\rho(1 - \varepsilon)) \frac{1 + \delta H(\varepsilon + (1 - \varepsilon)\rho)}{1 + \delta\rho(1 - \varepsilon) + \delta q_{inv}}
\]

There exists \( \theta_1, \theta_2 \in (0, 1) \), with \( \theta_1 < \theta_2 \) such that for \( \theta < \theta_1 \) and for \( \theta > \theta_2 \), the elite effectively bribing the government to implement \( e_1 = 0 \) is a stationary equilibrium of the game; for \( \theta \in [\theta_1, \theta_2] \), democracy works to provide enough incentive to the government to put in effort \( e_1 = 1 \) and \( e_2 = 1 \).
Proof. The first part of the proposition is already derived above. To prove the second part, as in proposition 1, it can be shown that the RHS of (5) is U-shaped in $\theta$. The LHS is increasing in $\theta$. Thus, either for very small or very large values of $\theta$ the RHS of (5) exceeds the LHS, and thus only in those regions the equilibrium involves effective bribing by the elite.

This proposition establishes that the basic result of the possibility of government capture when $\theta$ is either very small or very large holds in this modified model. Again, it is due to the incentive effect dominating for low values of $\theta$, while the political control effect becomes more prominent for high values of $\theta$. In this modified model, a successful government in the first period has a much greater incentive to enact good property rights protection in the second period too. Fear of this possibility induces the elite to lobby even more aggressively a new government in period $T = 1$.

3 A Model of Landowning Elites

In this section, we begin by casting the basic framework into a simple model of landowning elites who use a labor-intensive technology to reap profits. Entry of investors will raise the demand for labor leading to an increase in wages, thereby eroding profits of the traditional elite. Exploring the model in this framework helps analyze some additional effects of investment-promoting policies.

Consider $E$ traditional elites who each own one plot of land. They currently use a technology under which each plot requires $l_0$ units of labor to produce output valued at $A$. If the only demand for labor is from the land-owning elites, then the wage is $w_0 = L^{-1}(El_0)$, where $L(w)$ is the labor supply function in this economy. If there are other investors who also have a demand for labor, then wages rise and the wage-earning general populace gains from it. The elites’ interests are of course diametrically opposite: being dependent on an labor-intensive technology, their profits diminish when investment occurs and they would thus prefer an atmosphere that is inimical to investment.\footnote{Here, we have assumed that the only effect of outside investment on the elites occurs (negatively) through a rise in the wage-rate for labor in the province. There can however also be channels through which this effect can be positive. For example, outside investment can bring access to modern technology that maybe complementary to the elites’ production technology or can lower prices in a sector that is used as an input into the elites’ production. As implied by footnote 10, in such cases the effect of development policy in lowering $\theta$ is unambiguously good.}

For simplicity, here we take $\varepsilon = 1$ i.e. economic issues are always salient in elections.

As before, we assume that for an outside investor to develop any of the many potential investment opportunities in the province requires the investment of $k$ units of capital and the use of $\phi$ units of labor, while the output from the project is valued at $I$. If the return to each unit of capital elsewhere is $r$, investment will occur in this province until the returns get equated with those elsewhere: \[(i) \text{ [capital arbitrage] } pI - \phi w(r) - kr = 0,\]

where the wage $w(r)$ is determined from the labor supply function: \[(ii) \text{ [labor market clearing] } n\phi + El_0 = L(w(r)) \] with $n$ being the number of investment opportunities developed.

If investment does occur, it will push up wages above $w_0$ and will thus indicate to the electorate
that the investment climate in the province is good enough to attract investment, and the government will be rewarded by reelection. Suppose ex-ante, $r$ is assumed to be uniformly distributed over the range $[0, U]$. This corresponds exactly to the model of the previous section, with $\theta$, the probability of investment occurring in the presence of protection level $p$ given by $\frac{pl - \phi w_0}{U k}$, and $M$, the elites’ loss in profits conditional on investment occurring being:

$$E_l \int_0^{r_{\text{max}}} (w(r) - w_0) \frac{1}{r_{\text{max}}} dr = E_l \frac{pl - \phi w_0}{2\phi}.$$ 

Thus from (2), government decision-making on property rights is captured by the elite when:

$$E_l \geq (\delta R - \frac{eUk}{Hk(pI - \phi w_0)}) \frac{2\phi}{Uk + \delta Hx(pI - \phi w_0)} = G \text{ (say)} \quad (6)$$

From this condition, it is easy to see that elite capture of government policy-making (resulting in poor governance) is more likely when elites’ interests are particularly strong, either due to their size $E$ or due to their significant dependence on labor, as represented by a high $l_0$. As before, due to the interplay of the incentive effect and the political control effect, we see that provinces with very high or very low investment returns $I$, and/or very high and very low costs of investment $k$, are more prone to capture by the traditional elite.

Development policies resulting in an increase in $\theta = \frac{pl - \phi w_0}{U k}$ can result in reducing directly the chance of government capture through the incentive effect. However, there is an additional issue that arises here. A higher $\theta$ leads to an increase in $l_{\min}$, the minimum amount of bribe that is required to influence the government. Thus the costs to the elite of controlling the government increase. Recall that it is the elites’ dependence on a labor intensive technology that causes them to fear a rise in wages and results in their desire to prevent investment occurring in the province. Suppose there exist alternative technologies which use less labor, and thus makes the elite less sensitive to increases in the wage-rate. How do changes in $\theta$ affect their willingness to incur the required reorganization cost to modernize their technology? This is the question we explore next.

### 3.1 Modernization by the Elite?

Consider alternative technologies that require less than $l_0$ units of labor per plot of land to produce output. Adopting such a new technology for any plot involves a fixed cost $F$, as well as per unit costs depending on how different the new mode of production is from the present one. We assume that for each plot, moving from the current technology of $l_0$ to a labor-saving technology that uses $l_1$ ($l_1 < l_0$) units of labor involves a total cost of $F + c(l_0 - l_1)^2$. This may include the cost of purchase of machinery etc. as well as the cost of reorganization of the entire production process.

In the absence of any other motive for change, each elite landowner in deciding whether to choose a different technology with a lower labor requirement makes the following cost calculation:

$$\max_{l_1 \leq l_0} \frac{(l_0 - l_1)w_0}{1 - \theta} - c(l_0 - l_1)^2 - F.$$ 

Given that the current steady state is $l_0$, it must mean that the
costs of reorganization are so high that in the absence of any other compulsions the elite have no incentive for change. We accordingly make the following assumption about these costs:

**Assumption 3:** \( 4cF(1 - \delta)^2 > w_0 \)

Under this assumption, the value from the above maximization is negative, which means that it is optimal for the landowner to not modernize in the absence of any other force.

Consider the introduction of an electoral process in the region, either due to the region’s integration with a larger nation or due to the intervention and coercive imposition of an electoral process by an external agent. This results in de facto political power moving out of the hands of the elite and to the masses. The question is whether or not such first order political intervention results in an improvement in economic institutions and incomes for the general population.

With the advent of democracy, elites now face the additional burden of costs required to influence government policies in order to keep additional investment out and thereby maintain wages at the low level of \( w_0 \). Is this enough to get the elites to modernize?

**Case I: Strong Fundamentals and Democratic Success.** Consider first the case when the mere introduction of democracy is sufficient to provide elected leaders with the right incentives. This happens if the minimum bribe required to successfully influence the government is beyond what the elite are willing to pay i.e. from (6), when \( E_1 < G \). In this case, governance is no longer captured by the elite, and economic institutions improve. This will be when either the mass of elites is small or their dependence on labor is low or the underlying infrastructure and economic conditions are relatively good.

In this case the elites realize that reelection is a powerful enough tool to influence the government into exerting effort into ensuring good property rights. Thus there is a high probability that investment will get attracted. Consequently expected wages in the province increase and is now given by: \( w^e = w_0 + \frac{Hh}{2\phi} \int_0^{\max} (w(r) - w_0) dr = w_0 + \Delta w \) where \( \Delta w = Hh\frac{(pI - \phi w_0)}{2\phi} \). Facing these wages, the elites’ problem of choosing the optimal technology is the same as before, but with \( w^e \) replacing \( w_0 \). Thus the elites will choose to modernize to a labor-saving technology only if:

\[
w_0 + Hh\frac{(pI - \phi w_0)}{2\phi} > 4cF(1 - \delta)^2
\]

**IA: Democratic success and modernization by the elite.** Inequality (7) implies that it is in regions where the initial wage is already fairly high, as well as where the returns from investment \( I \) are large, that modernization is likely to take place, especially if the marginal and fixed costs of doing so, \( c \) and \( F \), are not too big. Here, the advent of democratic elections results in large-scale change on multiple dimensions: governance is freed from elite capture, property rights for outside investors improve and wage-incomes for the masses increase; the elite also invest in modernizing their technology, thereby eliminating their need to influence government policy on this front.
Figure 2: Potential for modernization and institutional outcomes

IB: Democratic success and traditional elite. If (7) fails, the elite remain traditional, but introduction of a democratic political process removes both their de facto and de jure political power and they do not pose any threat to good governance. These cases are depicted in figure 2.

The pattern described above, wherein the introduction of democratic elections set in motion a process of institution building and economic progress has sometimes been observed. With the collapse of the Soviet Union, free and fair elections in much of Eastern Europe be it Poland, the Czech republic, Slovenia or Hungary were sufficient to economically transform these regions. However, despite these examples, instances of successful institution building are relatively infrequent.

Case II: Resistant elites. More common is the scenario where free and fair elections coexist with elite capture. Here the introduction of elections results in a superficial change in power, but at a more fundamental level, (bad) institutions persist. Government policy continues to serve minority elite interests and the majority group’s incomes remain low.

This situation arises when \( b^{\text{min}} < b^{\text{max}} \) i.e. where inequality (6) holds. Here the incumbent leader’s incentives arising from the electoral process are too weak (represented by a low \( b^{\text{min}} \)) or the interests of the elite are too strong (a high \( b^{\text{max}} \)) so that the elite still maintain de facto control over the government’s policy process. However, maintaining political control comes at a cost to the elite. What if they instead adopted a technology that was less reliant on labor and thus less dependent on the need to enforce a low level of property rights?

In their decision on modernization, elites take into account the additional gain from not having to bribe the elected government i.e. they choose \( l_1 \) to maximize \( \frac{(l_0-l_1)w_0 - b^{\text{min}}}{1-\delta} - c(l_0 - l_1)^2 - F \), where their optimal choice is given by \( l_1 = l_0 - \frac{w_0}{2c(1-\delta)} \). Two questions arise in whether the elites
would in fact wish to choose such modernization. One, at this level $l_1$, is it no longer in their interest to bribe the government to put in effort $e = 0$ at good governance i.e. whether inequality (6) is satisfied at this level $l_1$ i.e. whether $E l_1 \leq G$? Two, are their total gains from modernization positive? The elites’ gains from modernization here are given by

$$V_{\text{modern}} - V_{\text{trad}} = \max_{l_1} \frac{w_0 l_0 + \frac{\mu_{\text{min}}}{E} - w^e l_1}{1 - \delta} - c(l_0 - l_1)^2 - F = \frac{\mu_{\text{min}} - E l_0 \Delta w}{E(1 - \delta)} + \frac{(w^e)^2}{4c(1 - \delta)^2} - F$$

### IIA: Democratic success with initially resistant elites.

If $E l_1 \leq G$ or equivalently if $E l_0 \leq G + \frac{\Delta w}{c(1 - \delta)}$ and the gain $V_{\text{modern}} - V_{\text{trad}} > 0$, the elite will decide to modernize by choosing a labor-saving technology with $l_1 = l_0 - \frac{w^e}{2c(1 - \delta)}$ and thereby implicitly commit to not influencing the government. In this case, structural changes, when they take place, are multidimensional and dramatic: the elites modernize and democracy also thrives, as governments put in effort into enforcing property rights, investment occurs, wages rise and thus welfare of the general population improves.

### IIB: Democratic Failure and Institutional Persistence.

If $E l_1 \leq G$, but $V_{\text{modern}} - V_{\text{trad}} < 0$, the high fixed costs of upgrading their technology mean that the elites do not find it worthwhile to do so. Consequently, the province remains stuck with elites employing a traditional technology and aiming to control the government in order to retain their rents from employing labor at low wages.

Interestingly, in this case, if the elites were to modernize, their choice of technology $l_1$ would obviate their need to influence the government. The major bottleneck in this case are the fixed costs of reorganization $F$. Policies aimed at lowering $F$, say through easier access to modern technology, could thus indirectly effect change by making it easier for elites to modernize.

Realizing the vulnerability of nascent democracies to elite capture, external policymakers have often attempted to co-opt elites in a country’s nation building. It underlies the emphasis of recent developmental efforts in Afghanistan aimed at giving landowners/opium producers incentives to switch production to other crops and engage in other economic activity (Goodson, 2005).

### IIC: Democratic Failure and Elite entrenchment.

Lastly consider the case when $E l_1 > G$. Here, even if the elites were to choose a less labor-intensive technology $l_1$, they would still wish to (and find it feasible to) influence the government into not enacting a good standard of property rights protection. This is the case when either the elites are so entrenched in a labor-intensive technology (i.e. $l_0$ is very high so that $l_1 = l_0 - \frac{w^e}{2c(1 - \delta)}$ is still high) that even with modernization they still are significantly dependent on labor, and/or the electoral incentives of the government are very poor.

This is the situation which is likely to see the most persistence in traditional inefficient institutions. Here, although there is a change in the de facto political process, nothing changes in terms of economic outcomes for the general populace. It is also the situation which is perhaps the most difficult to rectify and would require both developmental policy to raise $\theta$ (and thereby improve the government’s incentives), as well as subsidies for the marginal cost $c$ of adoption of labor-saving technology by the elites in order to significantly reduce their dependence on labor.
Of course, depending on the degree of the elites’ entrenchment, it is possible that only forcible modernization of the elite or removing their source of monopoly rents is necessary for democracy to work. In practice, this would require the external policymaker to use some kind of coercive policy which results in a large scale redistribution of land and other assets. The necessity of such coercive policy is clear in many instances of nation building – from postwar Germany to Bosnia, Kosovo and East Timor and the classic instance of postwar Japan (Dobbins et al, 2003).

4 Conclusion

In this paper, we analyze a model of endogenous institutional quality and the role of policy intervention in effecting institutional change. We identify two opposing effects of developmental policies; which of them dominate determine if such policies will lead to democratic consolidation and economic improvement or to the worsening of existing institutions. If the elite are deeply entrenched, then modernization may require combining development policy with subsidies for the elite.

There is now a large literature studying the impact of foreign aid on economic growth. The evidence has been mixed, with wide variation in the effect on economic outcomes across countries (Mekasha and Tarp, 2013). As our model implies, this is to be expected, with differences in local institutional realities playing an important role in determining this impact. Furthermore, even if such differences in institutional quality are accounted for (as in some studies), the impact of different types of aid can vary widely from one situation to another. In some cases, aid for infrastructure development and investment subsidies will have a big impact, while in others, aiding technology adoption is likely to be more important. Thus, the paper calls for isolating between different types of aid and their interaction with local conditions in assessing the overall impact.

Several facets of our analysis warrant future exploration. The identity/objectives of the external/internal agent who facilitates institution building will in many instances be important. Such factors as the agent’s credibility, preferences, resource constraints etc. are likely to play an important role in the process. We have assumed the elites here to be monolithic. How would differences among them or a subsidy policy aimed at a subgroup of elites influence change in the equilibrium?

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