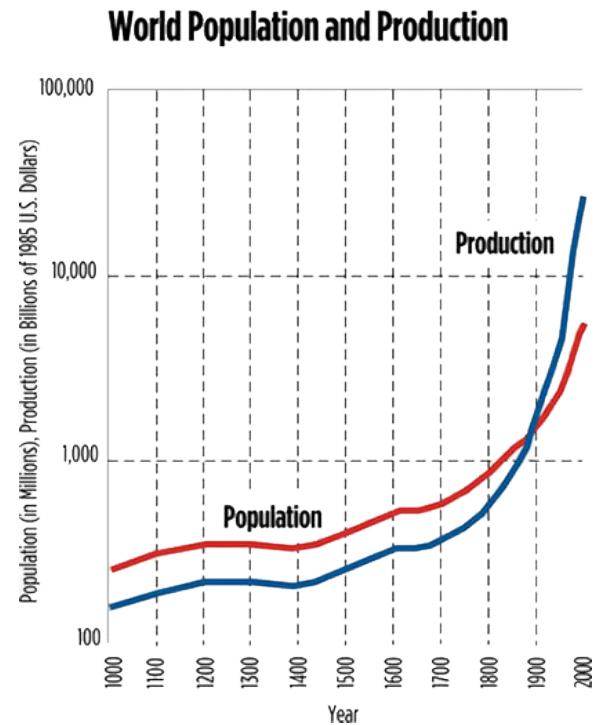


Institutions and Economic Development (20694475)

Defined by Douglass North as the “humanly devised constraints that shape human interaction,” institutions understandably affect many aspects of society, and as such they are often placed at the center of studies regarding the causes of economic development. Indeed, institutions play a strong, if not causal role in economic growth. Though their influence alone cannot explain all economic development, institutions in its various forms are, at the very least, one of the necessary pre-conditions of economic growth and key accomplices of economic stagnation.

Economists have attempted to explain unprecedented national economic growth rates as a product of good institutions. According to Malthusian theory, such continuous economic growth as seen over the last 250 years should not occur because population grows geometrically while the production of goods needed to sustain that population can only increase arithmetically. To break this cycle of subsistence and to provide a continuously increasing population a continually increasing standard of living, production growth must increase to the point where it outstrips population growth. As the

graphic below illustrates, this occurred worldwide around the turn of the 20th century.



This observation is significant because it implies that institutions, which cannot account for continued year-on-year production rate growth, could not have been the primary cause of the escape from the Malthusian trap and subsequent sustained economic growth. Rather, production growth was likely influenced by technological advancement. For example, the cotton gin, one of the most notable inventions of the Industrial Revolution, caused cotton production in the American South to increase from

750,000 bales in 1830 to 2.85 million bales just twenty years later.

This is not to say that that institutions did not play a vital role in the take-off of economic growth. Institutions crafted a suitable environment in which technology and innovation could flourish by providing proper incentives like free markets, personal ownership rights, and open trade and communications with foreigners with whom to exchange goods and knowledge. By all means, technological advancement could not have spawned in the way that it did without the right institutions. This, however, does not imply a direction of causation from institutions to innovation. For example, the environment of the Caribbean facilitated the growth of sugar crops, which are generally grown in a plantation system, but it would be incorrect to conclude that geography caused slavery. Strictly speaking, proper institutions served as a pre-condition to breaking from the Malthusian trap – their absence stymied productivity growth while their presence promoted it.

Japan is a textbook example of the influence of institutions on economic growth. Its institutions directly affected technological advancement and thus the

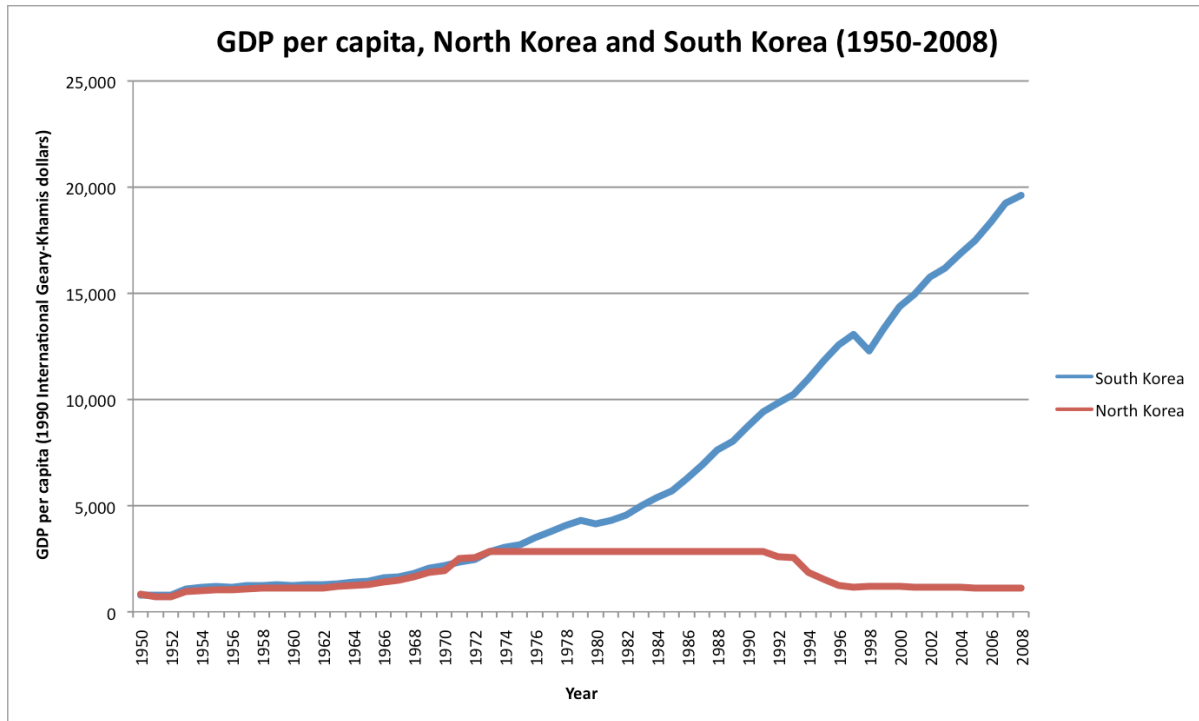
productivity growth that ensued. From 1641 to 1853, the Japanese government practiced a form of isolationism called *kaikin*, which prohibited contact with most foreign countries. As a result, Japan was not able to benefit from foreign technology and knowledge, and when American Commodore Matthew C. Perry arrived in Japan at the helm of an impressive arsenal of battleships, the country recognized the disadvantages of its foreign policy. This realization marked the beginning of the Meiji restoration, a period in which Japan adopted an open foreign policy and pursued rapid industrialization and modernization. The government built up its textiles, shipping, and iron industries and its domestic companies utilized Western technology to produce items at low cost for sale on an international market. The construction of a national railway system and modern communications also accompanied the rapid industrialization. During this period, Japan experienced remarkable industrial and economic growth – for example, in the first decade of the 20th century, silk and coal production and export doubled, while the number of steamships and miles of railroad tracks experienced similar progress. Japan's example illustrates the role of proper

institutions as a pre-condition for technological advancement, productivity growth, and continued economic development.

In a post-Malthusian trap world, the role of technological advancement as a cause of economic development grows smaller because economic well-being is no longer bound by the production of subsistence goods. As a result, economic development is free to be influenced and increased by other factors, namely, institutions. The bifurcation of Korea into two separate countries in the mid-20th

century provides a clear demonstration of the effects of institutions on the ‘great divergence’ in income levels between developed and developing countries. The chart below graphs GDP per capita for North Korea and South Korea post-Korean War. While the measurements for the two countries remain similar up to the early 1970s, after that point South Korea’s GDP per capita follows an upward curve while North Korea’s GDP per capita lays stagnant.

The two Koreas are a good case study because at the time of their division in the 1950s, the two countries were roughly



the same in terms of demographics, culture, and geography. These three potential factors of economic development can thus be ruled out as primary determinants of a 'great divergence' because they remained fairly similar in both countries while the two economies followed very different paths. The main difference between the two countries, the difference most likely to contribute to their economic fates, lies in their institutions. Post-Korean War, South Korea pursued an aggressive export strategy to take advantage of foreign markets to drive demand and increase production. This resulted in an influx of foreign capital to help further sustain South Korea's markets until domestic demand had risen enough to allow South Korea to place more reliance on itself. Today, South Korea is a G-20 nation with a GDP per capita of around 20 times its neighbor to the north. By contrast, North Korea adopted a completely isolationist policy that led to, among other things, widespread famine and a GDP per capita barely greater than the same statistic fifty years prior. The sharp contrast between the fates of the two Koreas demonstrates how institutions can shape income levels and

economic development. This paper maintains that in a post-Malthusian trap world, institutions can affect a country's economic growth to a greater degree, but that other factors like technological advancement can still play a significant role.

This study has attempted to establish a body of evidence to prove that institutions alone cannot explain historical economic performance. Institutions can explain the take-off in economic growth in the past 250 years insofar as they, properly administered, serve as a pre-condition for the technological advancement that pushes countries out of the Malthusian trap. Later in the 20th century, as evidenced by the two Koreas, the dynamic shifts such that institutions and technology play more equal roles in influence economic growth. Finally, while this paper has focused on the interaction between institutions and technology, these are by no means the only two possible determinants of economic performance. Further analysis might include other countries or study the complex interactions between institutions, geography, and culture more closely.