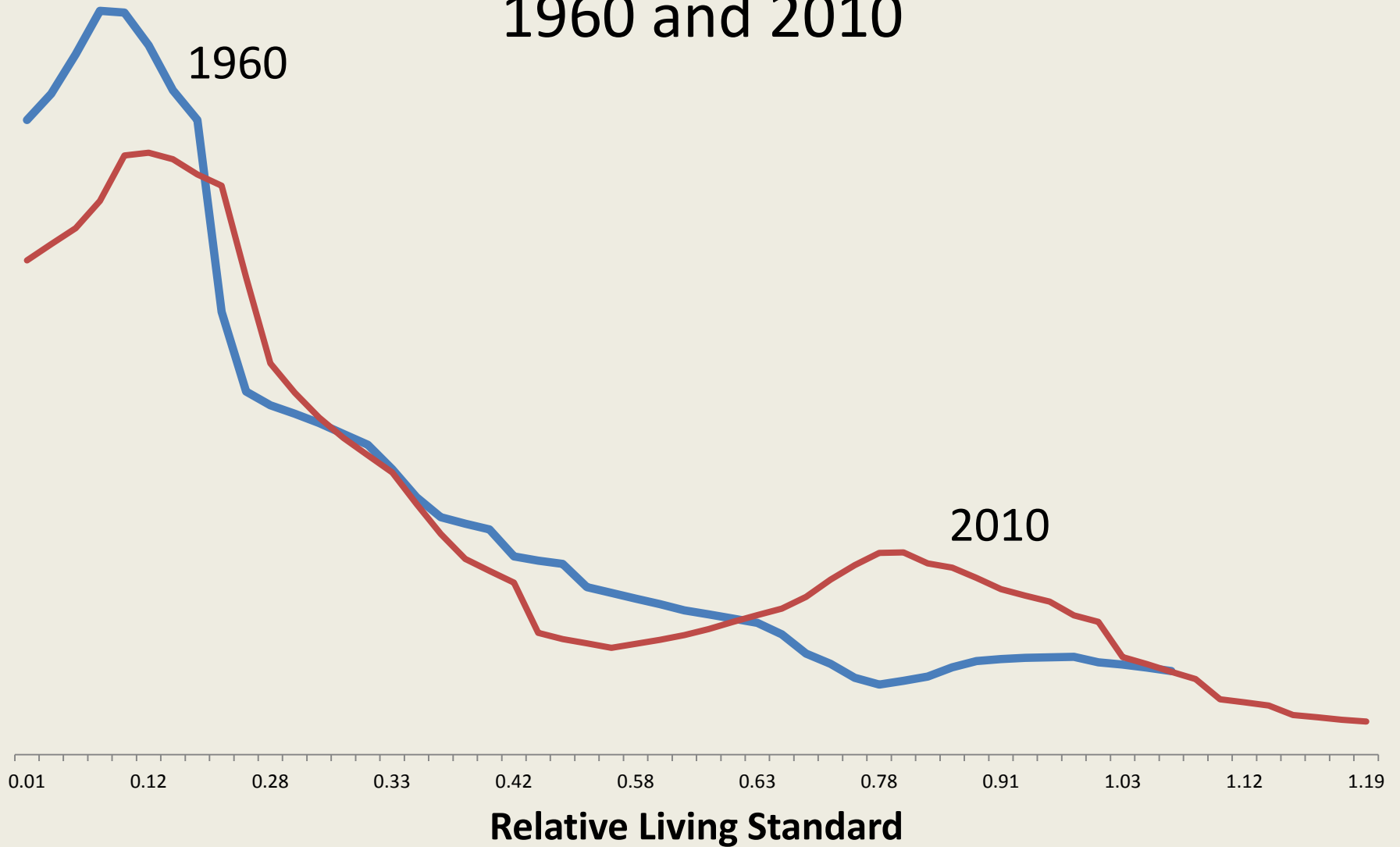


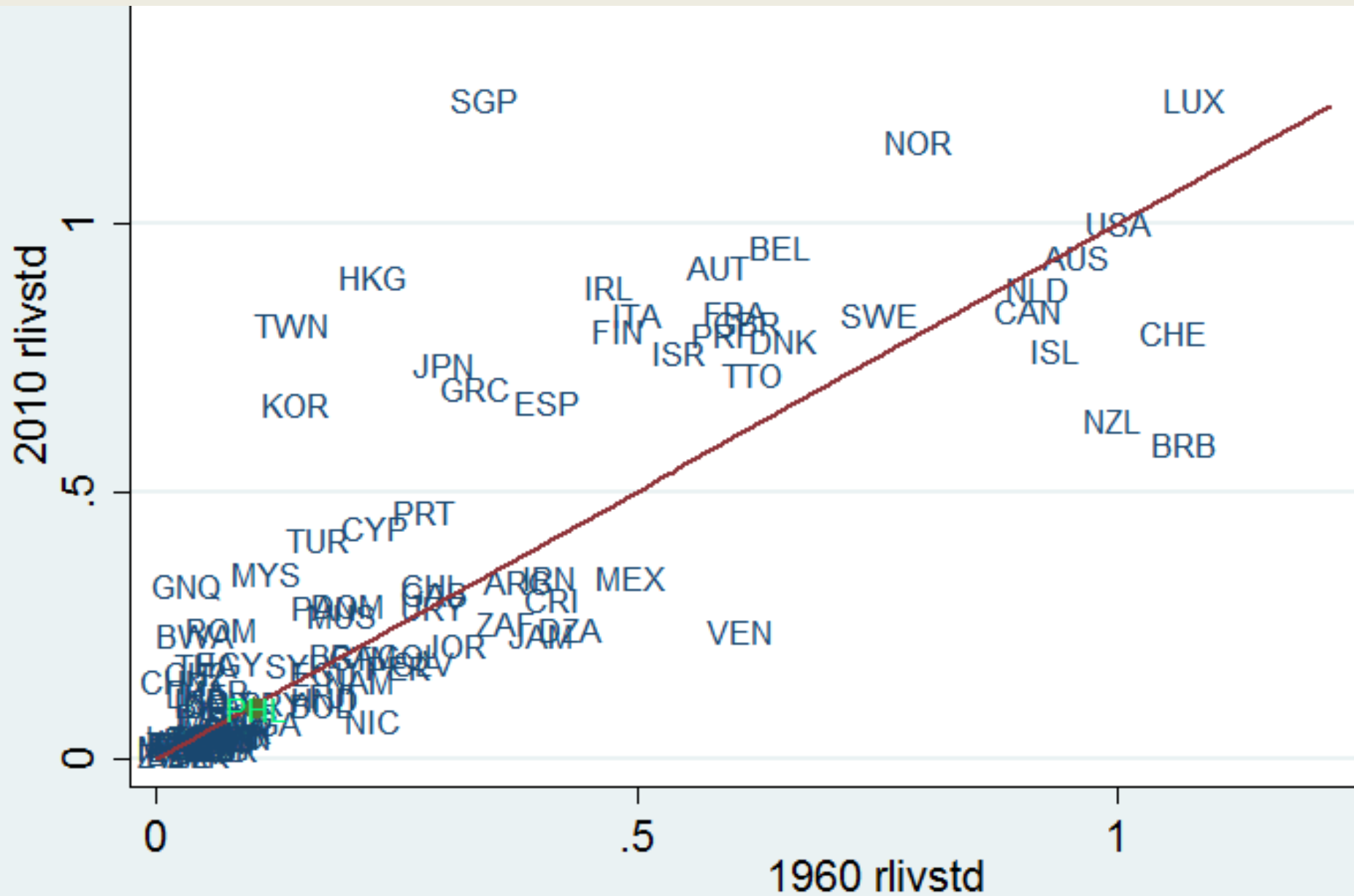
# The Social Conflict Hypothesis of Institutional Change Part I

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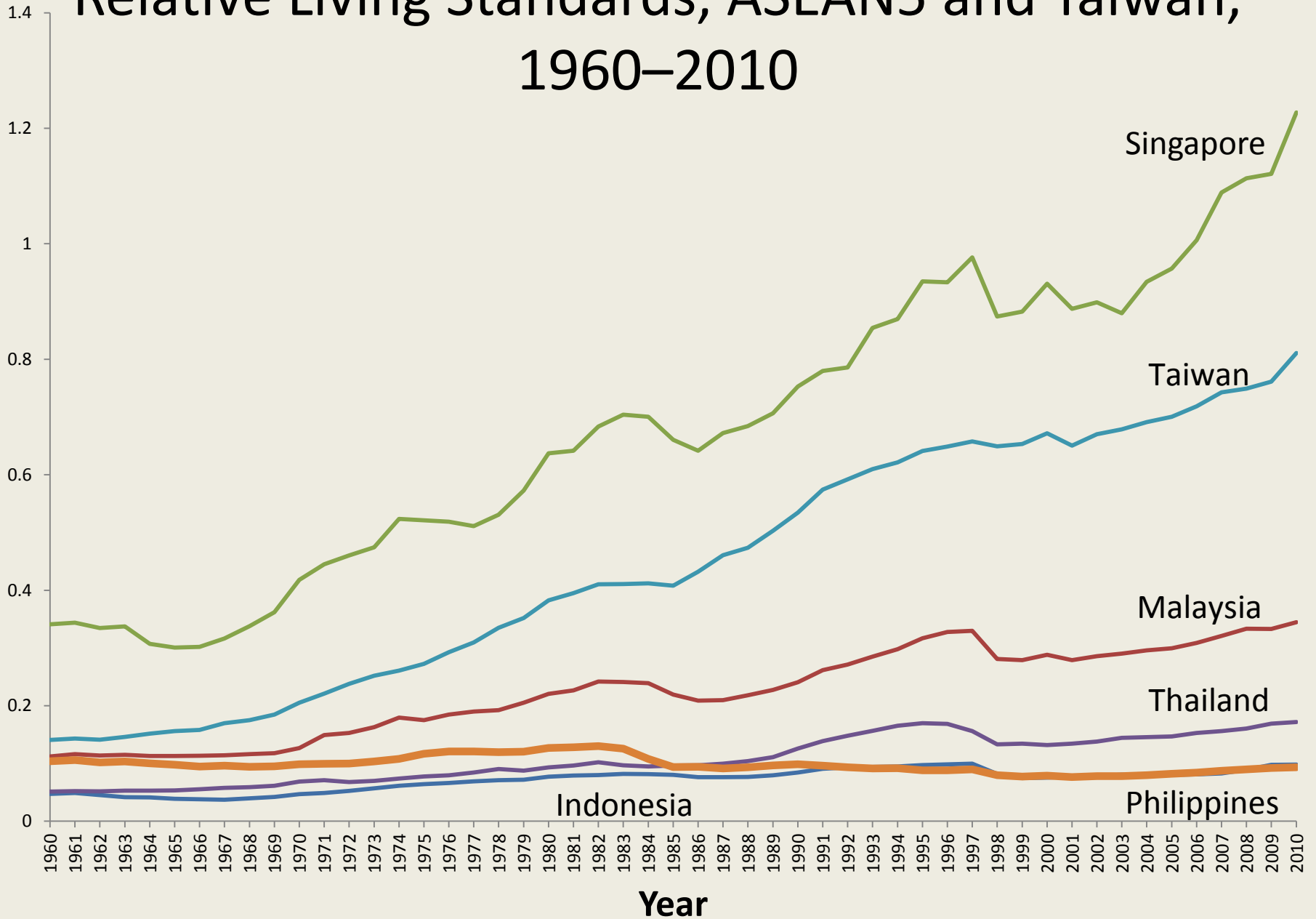
# World Distribution of Relative Living Standards, 1960 and 2010



# Relative Living Standards (2010 v 1960)



# Relative Living Standards, ASEAN5 and Taiwan, 1960–2010



The most important question(s) in economics

- Why are some countries rich and others poor?
- Why are some countries becoming rich, while others remain poor?

“The consequences for human welfare involved ... are simply staggering: Once one starts to think of them, it is hard to think of anything else.”

—Robert E. Lucas, Jr.  
Nobel Laureate for Economics, 1995

Why are a few countries rich and many others poor?

- Cross-country differences in long-term economic performance are due to cross-country differences in **institutions**.
- Cross-country differences in institutions are determined by differences in the histories of **how conflicting political and economic interests** within each country **are resolved**.

# Why are a few countries rich and many others poor?

- People have conflicting interests because they have different endowments, values, beliefs, preferences, and experiences.
- They advance these interests against those of their rivals through institutional set-ups that favor their interests.

# Why are a few countries rich and many others poor?

- So what ultimately determines the long-term economic performance of a country are the **interests of those who control political power.**
- If these interests are consistent with **institutions that protect broad-based property rights,** long-term economic growth and prosperity ensue.
- Otherwise, the economy languishes as the elites would rather maintain themselves in power, content with a large piece of a small economic pie.



# Presentation Outline

- Institutions as the fundamental determinants of long-run economic performance
- Douglass North's theory of the evolution of states or social orders
- Daron Acemoglu's social conflict hypothesis
- The social conflict hypothesis as one way to understand episodes in Philippine history and current events

**Institutions as the fundamental  
determinants of long-run economic  
performance**

# What are institutions?

- “the rules of the game in a society” or “the humanly devised constraints that shape human interactions” (Douglass North)
  - People can interact with each other in many different ways.
  - This taxes the limited “computing” capabilities of people.
  - The absence of rules or constraints on behavior is likely to cause misunderstandings or give rise to uncertainties, which may have dire consequences.

# Money as an example of an institution

- 4 uses of money
  - unit of account
    - money as the numeraire good
  - medium of exchange
    - procure goods in exchange for money
    - solves the double-coincidence-of-wants problem
  - store of value
    - money as the means of translating the worth of things across time
  - means of making deferred payments
    - acquisition or use rights are temporally separated from the payment component of a transaction

# Money as an example of an institution

- Money is an institution because, in a modern economy, we have adopted the arbitrary rule that money is our unit of account, medium of exchange, store of value, and means of making deferred payments.

# Money as an example of an institution

- Money as an institution has been a great convenience and benefit.
  - as unit of account, problems of relative valuations are easier to solve.
  - as medium of exchange, expands the scope of trade and allows specialization in production
  - as store of value, makes wealth accumulation easier
  - as means of deferred payments, allows consumption smoothing across time periods

# Money as an example of an institution

- But money is only a “**social contrivance**,” i.e., an **artificial** arrangement (Samuelson).
- Why do we accept paper money?
  - **Only because everyone does so!!!**
- What happens with news that there are fake P100 bills in circulation?
  - Implies that the rule of using P100 bills for the 4 uses of money is broken
  - People avoid transacting in P100 bills (no longer acceptable)
  - Time and other resources are used to distinguish the real from the fake P100 bills

# Money as an example of an institution

- Our take-away:

Institutions are arbitrary rules that society adopts to make interactions between its members easier, more convenient, and beneficial (i.e., welfare-improving).



But why are institutions the fundamental determinants of long-run economic performance?

- Institutions influence the incentives of economic agents.

In a command economy organized on Marx's rule, "from each according to his ability to each according to his need," agents have the incentive to demonstrate to the social planner that they have the least ability and the greatest need.

But why are institutions the fundamental determinants of long-run economic performance?

- What institutions promote economic growth and prosperity?
  - Those that enforce property rights for a broad segment of the population.
  - When property rights are protected in an economy, individuals are encouraged to acquire skills and firms are motivated to invest, innovate, or adopt new technology to add value to their productive activities.

But why are institutions the fundamental determinants of long-run economic performance?

- What institutions **do not** promote economic growth and prosperity?
  - When institutions allow predation (e.g., thievery, extortion, and expropriation), scarce resources are diverted to
    - unproductive uses (e.g., rents [Napoles and her legislators], booty from protection rackets)
    - defensive outlays (e.g., building tall fences, hiring security guards, putting up CCTV systems)
    - fending off predators (e.g., litigation fees, testifying in court)

So why do countries have different institutional configurations?

Why do some countries have institutions that promote economic growth and prosperity, while others do not?

- answered by the Acemoglu's social conflict hypothesis
- use North's theory of the evolution of the state as a springboard

**Douglas North's theory of the  
evolution of the state or of social orders**

Why are human societies organized as states or social orders?

- North's answer: to solve the problem of violence

# Three forms of social orders

- Primitive order of hunters-gatherers
- Limited access order (LAO)
  - Fragile LAO
  - Basic LAO
  - Mature LAO
- Open access order (OAO)

# The explanation behind the theory

- Violence is endemic where there is no state.
- Some individuals or groups become violence specialists.
- The possibility of a LAO emerges when the gains from peace to the violence specialists (or warrior class) become large enough so that mutual commitments not to wage violence become credible.



# The explanation behind the theory

- Once an arrangement for peaceful (but alert) coexistence is established, the top dog of each group can start to exploit economic rents by assigning favored individuals exclusive rights to trade, production, education, and even worship.
- In time, an elite class is formed, which has complete control over the political, economic, educational, religious, and military affairs of the society.

# The explanation behind the theory

- So in a LAO, the threat of violence is contained by the formation of an elite coalition that
  - manipulates the **political system** to limit entry and access (by non-elites) to activities that generate **economic rents** and
  - allocates the **economic rents** among elites to induce support for the **political system**
- The interlocking nature of politics and the economy in an LAO makes it a very stable system, which is why North calls it the **natural state**.

# Three types of LAOs

- Fragile LAO
  - can hardly keep itself together against internal or external strife
  - Examples: Afghanistan, Iraq, Somalia
- Basic LAO
  - The state is the only durable organization in society; all elite organizations are extensions of the state
  - Examples: Burma, Cuba, North Korea

# Three types of LAOs

- Mature LAO
  - allows organizations not connected to the state (civil society), but which are sanctioned by the state to limit entry and to ensure that economic rents are consistent with the preservation of the dominant coalition.
  - Examples: India, the Philippines

# The OAO

- characterized by open access and entry by citizens to political and economic organizations, fostering competition for rents both in politics and the economy
- rents come from technological and institutional innovations (rather than restrictions to entry and access)
- the competition for rents pushes markets and the political system to efficient outcomes
- Examples: USA, Canada, Western European countries

# Movements across social orders

- Movement by a state over the LAO spectrum (to and from the fragile, basic, and mature LAO) is easy
  - the logic of the social order remains the same.
- Transiting out of mature LAO status to OAO status is a lot harder
  - involves transforming the internal logic of the social order

# Two part movement from mature LAO to OAO

- Door-step conditions:
  - a mature LAO evolves institutional arrangements that allow impersonal exchanges between elites to take place
    - a rule of law for elites
    - perpetually-lived organizations
    - political control of the military
- The elite class finds it in its interest to expand the scope of impersonal exchanges so that access and entry conditions are lifted marginally (but eventually become inclusive of all citizens).

But how the transition process happens is still poorly understood.

- 3 logic requirements of the transition process (from mature LAO to OAO)
  - At the start of the transition process, the institutional arrangements, organizations, and behaviors of individuals are consistent with the natural state.
  - During the transition process, changes in institutions, organizations, and individual behavior are (intended or unintended) consequences of actions that are presumed to be consistent with elite interests.
  - The transition causes reinforcing changes to institutions and individual behavior that are consistent with the political and economic system at each step.



# Critique of North's theory

- breadth and sweep of the theory is impressive.
- observation that the LAO (with its interlocking political and economic systems) is the natural state is deeply insightful.
- But
  - no road map for the transition from a mature LAO to OAO
  - The elite class is not monolithic; its interests may not be mutually consistent.