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OF UNDERDEVELOPMENT:  
INSTITUTIONS, HUMAN CAPITAL  
OR CONSTITUENCIES**

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***FINANCIAL ECONOMICS, INDUSTRIAL  
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# **THE PERSISTENCE OF UNDERDEVELOPMENT: INSTITUTIONS, HUMAN CAPITAL OR CONSTITUENCIES**

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## **ABSTRACT**

### **The Persistence of Underdevelopment: Institutions, Human Capital or Constituencies\***

Why is underdevelopment so persistent? One explanation is that poor countries do not have institutions that can support growth. Because institutions (both good and bad) are persistent, underdevelopment is persistent. An alternative view is that underdevelopment comes from poor education. Neither explanation is fully satisfactory, the first because it does not explain why poor economic institutions persist even in fairly democratic but poor societies, and the second because it does not explain why poor education is so persistent. This paper tries to reconcile these two views by arguing that the underlying cause of underdevelopment is the initial distribution of factor endowments. Under certain circumstances, this leads to self-interested constituencies that, in equilibrium, perpetuate the status quo. In other words, poor education policy might well be the proximate cause of underdevelopment, but the deeper (and more long lasting cause) are the initial conditions (like the initial distribution of education) that determine political constituencies, their power, and their incentives. Though the initial conditions may well be a legacy of the colonial past, and may well create a perverse political equilibrium of stagnation, persistence does not require the presence of coercive political institutions. We present some suggestive empirical evidence. On the one hand, such an analysis offers hope that the destiny of societies is not preordained by the institutions they inherited through historical accident. On the other hand, it suggests we need to understand better how to alter factor endowments when societies may not have the internal will to do so.

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Why is underdevelopment so persistent? A growing consensus in recent years suggests this is because poor countries lack the institutions needed or, worse, have the wrong institutions, for economic growth. Indeed, recent work suggests that better institutions seem to accompany economic growth.<sup>2</sup> There is, however, controversy about what exactly to make of the empirical findings. As suggested by Glaeser et al. (2004), what is typically measured by this literature is not what most people would understand to be institutions (such as constitutions, laws, organizations, religion, and culture) but outcomes such as the rule of law or absence of corruption. We do not know whether these outcomes result from good institutions or something else, such as a better-educated population. Of course, one way to address this concern is to use instruments that are correlated with institutions but uncorrelated with the “something else”.

The most persuasive effort has been by Acemogulu, Robinson, and Johnson (2001), who argue that the extent of settler mortality caused by the disease environment in colonies resulted in settler populations of differing sizes. Settler populations of smaller size (that is, in high disease colonies) tended to be more exploitative, and this was reflected in the institutions they created. Thus settler mortality, they suggest, can be used as an instrument for institutions. However, even this approach is not without controversy. Glaeser et al. (2004), for instance, argue that the colonizers did not bring with them just their institutions, but “guns germs, and steel” and, of course, their human capital. It could be this differential endowment of human capital –they argue—that accounts for the different path some colonies took. In a similar vein, Engerman and Sokoloff (1997, 2002) suggest that colonies with a small settler population (which, parenthetically, they attribute to other factors than settler mortality, such as the size of the existing local population) tended to suppress education

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<sup>2</sup> See, for example, Acemogulu, Johnson, and Robinson (2001), Dollar and Kraay (2003), Easterly and Levine (2003), Engerman and Sokoloff (2002), Hall and Jones (1999), Knack and Keefer (1995), Mauro (1995), North (1981,1990), Rodrik, Subramanian, and Trebbi (2002), WDR (2003), WEO(2003).

possibilities for the native population. Is it therefore the lack of education or the lack of sound institutions that results in slower growth? If it is the lack of education, why is the lack of education so persistent? Or if it is the lack of sound institutions, why cannot they be created (and bad ones suppressed)?

Let us start with this last question. Easterly and Levine (2003) describe the institutional view of development thus:

“The environment’s main impact on economic development runs through long-lasting institutions. For example, environments where crops are most effectively produced using large plantations will quickly develop political and legal institutions that protect the few landholders from the many peasants (Engerman and Sokoloff (1997,2002)). Even when agriculture recedes from the economic spotlight, enduring institutions will continue to thwart competition and hence economic development. Similarly, many countries’ institutions were shaped during colonization, so that examining colonies is a natural experiment (Acemoglu, Johnson, and Robinson (2001,2002)).”

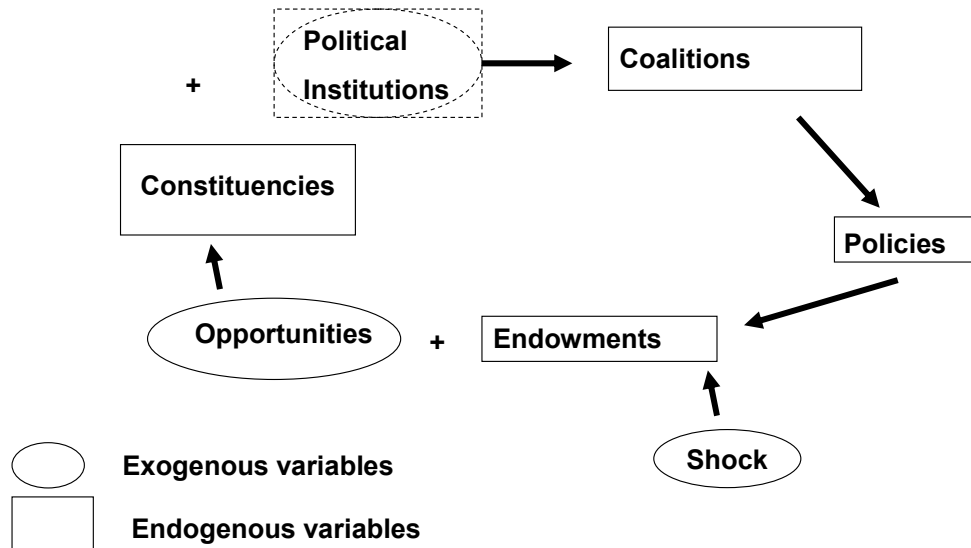
The notion that bad political and legal institutions, created in the historical past to support an exploitative mode of production and surviving into the present, explain underdevelopment is implicit in much recent work. Yet underdevelopment appears to have survived both independence and democratization. This is puzzling because the empowered citizenry could simply vote out bad institutions if they appear to be holding back development. Perhaps the problem is oppressed citizens may have the vote, but may suffer from collective action problems that prevent them from overturning the institutions that hold them in thrall. Yet mechanisms to express the collective democratic will of the citizenry, such as constituent assemblies formed upon independence, do not seem to have overcome the colonial legacy. Moreover, organizing through parties, or even through armies, does not seem to have helped the poor. Perhaps then we need something other than just bad institutions to explain persistent underdevelopment.

Similarly, if as argued by Glaeser et al. (2004), low levels of human capital cause underdevelopment, the question immediately arises: Why are bad education policies so persistent?

After all, as Singapore and South Korea have shown, education levels can be improved substantially in a relatively short period of time. Why are they not improved more widely? It is these questions that we address in this paper.

Perhaps a graphical overview of our model will be useful to fix ideas. We start with agents possessing different initial endowments of human capital and physical capital, possibly influenced by exogenous shocks like colonization. Agents' preferences are determined by their endowments and the available opportunities, which will lead them to group into different constituencies. These constituencies will vote for policies (and possibly economic institutions) that will affect future endowments, and therefore future constituencies.

## The model



We identify the essence of a development trap as an initial allocation of endowments such that the constituencies created by those endowments successfully support bad policies that reproduce

those initial constituencies over time. In doing so, we minimize the role of political institutions (hence the dotted lines surrounding them, and the ambiguity over whether they are endogenous or exogenous). This is not because we think these are unimportant, but simply because we want to show that persistence of bad policies is possible without perverse political institutions (in the sense of constitutional rules aggregating preferences in a skewed or perverse way) and regardless of their ability to produce a supporting ideology (cultural hegemony in Gramsci's (1937) terms). There is thus a subtle but vital difference between our approach and that of Engerman and Sokoloff (1997, 2005) or Acemoglu and Robinson (2003) – which is that bad political institutions play a minimal role in our model in ensuring the persistence of underdevelopment. Furthermore, it is not a dominant group imposing its preferences on others, but a bad configuration of interests that leads to underdevelopment. In fact, we will show in our model that a democracy can sometimes be worse than a dictatorship in promoting development, and that the underprivileged can oppose reform as strongly as the privileged – an otherwise puzzling real-life phenomenon.

Specifically, let a constituency be a group where each member has the same factor endowments, and therefore similar preferences over policies.<sup>3</sup> We model an economy with three possible constituencies: oligopolists (or oligarchs), the educated (or a middle class), and the uneducated (or the poor). Each oligopolist owns a firm, which needs two types of workers: managers and laborers. Laborers and managers are complementary (so that a manager is more productive when he has more laborers working with him and vice versa) and face diminishing marginal productivity (so that the marginal laborer (manager) is less productive as the number of laborers (managers) increase). While anyone can be a laborer, only the educated can work as managers.

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<sup>3</sup> We prefer the term constituency rather than interest group or class. Interest groups (e.g., textile workers) typically are much narrower than our notion of constituency (e.g., the uneducated), while the term “class” has prior associations (e.g., linked to the ownership of the means of production) that may confuse rather than enlighten.



In this simple framework, we examine the support for two kinds of policies: ones that increase competition (broadly termed pro market reforms, including a strengthening of property rights, expansion of access to finance, and opening to foreign competition) and ones that increase access to education. We assume that, because of a combination of money power and numbers, each constituency has one vote. Reforms that get a majority (that is, two out of three votes) are enacted – so the oligopolist does not have a monopoly over political power, unlike previous work. Also, unlike prior work, we do not assume that reforms directly affect political participation and thus voting power. Instead, they affect economic outcomes and thus incentives. The interesting result is that comprehensive reforms (that is, enacting both reforms) is extremely unlikely, but equally unlikely is reforms increasing access to education only, even though a majority may be in support.

The reason is simple. The uneducated are always for more education because it will give them access to better opportunities. The educated are against it because it will increase competition for their rents. The oligopolists would prefer a more educated work force, because it can help them reduce the rents currently obtained by the educated. However, the oligopolists know that if they do vote for education, they will have a workforce (formerly uneducated and the formerly educated) that is united in interests. This enlarged constituency will then push for pro-market reforms. To forestall the greater loss from pro-market reforms, the oligopolist will vote with the educated against expanding education.

If education reforms are unlikely to be enacted, the uneducated may turn against pro-market reforms, preferring the status quo instead, because while pro-market reforms expand opportunities for the educated, and create new employment opportunities for the uneducated, there is also a dark side. The greater freedom of the educated may worsen the conditions of the uneducated: The uneducated benefit from the oligopolistic environment where the educated are forced to work for the oligopolist as managers, thus enhancing laborer productivity (and thus wages). With fewer managers working for

the oligopolist post pro-market reforms, the productivity of uneducated labor may fall, thus depressing its wages. More generally, everyone typically enjoys some rents in an uncompetitive environment. More competition typically creates more opportunities for the well-endowed, which compensates them for their foregone rents. But for others who are less well endowed, more competition may mean a loss of existing rents with no compensating increase in opportunities.

In sum, regardless of the formal political rules to aggregate preferences, no reforms will take place under a wide variety of initial conditions, leading to the persistence of underdevelopment. If a society starts out with a small educated constituency that enjoys substantial rents, this constituency will make common cause with oligopolists (who fear a unified constituency for comprehensive reforms) in keeping human capital endowments the way they are. The uneducated will make common cause with the oligopolist in opposing pro-market reforms, because these are unattractive to the uneducated when unaccompanied by endowment enhancing reforms. Thus neither reform is likely to take place despite their positive effect on output. Reforms are unlikely even if we consider the possibility of logrolling, because of the difficulty of committing to the compensating transfer on the one hand, and the fear of additional rent-seeking generated by the transfer on the other (see Dixit and Londregan (1995), Rajan and Zingales (2000), or Acemoglu (2003)).

We characterize the narrow circumstances under which the polity is favorable to comprehensive reforms, the only circumstances in which education reforms have a chance. Typically, comprehensive reform occurs when the number of educated relative to uneducated is high so that the rents from the status quo are small – that is, when the economy has a substantial middle class – and when the oligopolist is reasonably efficient. One measure of a relatively homogenous, well-educated constituency is the percentage of European settlers in a colony's population in 1900. We find that this measure predicts post 1960 levels of education, even after controlling for the initial level of education and the level of democracy. In fact, after partialling out the effect of European settlers, there is no

correlation between democracy (perhaps the clearest form of a political institution) and growth. We also show that once one controls for the percentage of European settlers in 1900, neither education levels in 1900 nor the extent of democracy in 1900 are correlated with per capita income in 2000 (a proxy for long term growth rates).

Changes in endowment can break the vicious circle and spur growth, but these will often have roots elsewhere (an exogenous shock) than in economic interests. Three come immediately to mind to explain changes in educational endowments. Religion has often been a strong factor – for example, Protestant leaders like Calvin and Luther emphasized literacy because “the eternal welfare of every individual depends upon the application of his own reason to the revelation contained in the Scriptures”.<sup>4</sup> Nationalism has been a second factor, with France promoting universal education as a way to strengthen the army after the 1870 defeat and Korea emphasizing widespread education to counteract the effects of Japanese colonialism and create a national consciousness (see Weiner (1991)). And, interestingly, communism has promoted mass education, partly for ideological reasons, and partly because it has been an instrument of political socialization (Easterlin (1981)).

Whether institutions, policies, or constituencies are the ultimate source of persistence, is not just a matter of semantics. First, to the extent that the persistence of bad institutions is not the explanation for underdevelopment, there is potentially greater hope for poor countries because their fate is not sealed as a result of their colonial legacy of institutions. While it may be difficult to alter factor endowments, it is certainly far easier to do so than to alter history. Second, the focus of development action changes, from attempting to impose blue prints on societies such as liberal constitutions, to changing the underlying endowments and hence the balance of interests and power. Third, the focus of research changes – from clubbing Mobutu Sese Seko and Lee Kuan Yew in the

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<sup>4</sup> Paul Monroe, *A Text-Book in the History of Education* (London, 1907), p 407.

same box because the explicit constitutional limits on their power were similar, to putting them in very different boxes because the constituencies that afforded them power were very different.

Once we accept that institutions, especially bad ones, may not be very persistent without the underlying power structures holding them in place, it becomes easier to understand why we have seen such extraordinary change in countries that were under the yoke of communism. While the years spent under communism may have affected peoples' attitudes somewhat (see Alesina and Fuchs-Schudel (2005)), the speed with which socialist institutions were replaced by market institutions does not speak highly of the durability of the former. We would argue that one of the virtues of communism is a very strong emphasis on education, and this creates the broad constituencies that can press for market reforms once the stranglehold of the nomenklatura is broken. Ironically, instead of capitalism containing the seeds of its own destruction, the seeds for flourishing capitalism have been nurtured in the soil of communism. Capitalism may well be the final stage of communism!

Our analysis also suggests why reforms have been so difficult in Africa and Latin America, where a relatively small, educated urban middle class has often sided with a small ruling clique in opposing wider, deeper, reform. In a sense, this echoes an older literature (see, for example, Bates (1983) or Krueger (1974), and more recently Shleifer and Vishny (2002)), which sees the roots of underdevelopment not so much in the lack of institutions (which may be a proximate rather than a deep cause) but in the natural self preservation of a rent-oriented society. In such a situation, our paper raises the possibility that reforms emphasizing competition should perhaps have come after reforms that spread endowments like education or land more evenly across society. With pro-market reforms coming first, the poor may well have been made worse off in some countries, making them turn against reforms. In addition, once the opportunities for the middle class were liberalized, they too may have withdrawn their support for further reform of endowments. Perhaps comprehensive reform

in a number of these countries is possible only when serious attention is paid to increasing the endowments of the poor.

Finally, our demonstration that good political institutions are not sufficient to prevent the persistence of bad outcomes (or equivalently, that you do not need bad political institutions to explain the persistence of underdevelopment) is not to say that good institutions cannot, through use, acquire a life of their own and be greater than any of the constituencies composing the country. Good institutions, like the U.S. constitution, can for all practical purposes become exogenous. Yet one should not go to the other extreme and neglect the role of supporting constituencies – a constitution can also be simply a piece of paper, as suggested by the very different effects of much the same U.S. constitution, when transplanted to Liberia. Similarly, the very same institutional environment and leadership that gave rise to a Chiang Kai-shek, who was deemed too corrupt to be supported by the United States against the Communists, with a different set of constituencies, set the foundation for Taiwan's prosperity.

In sum, our paper tries to reconcile the insights in Glaeser et al. (2004,2005) and those in Acemoglu, Robinson and Johnson (2001) and Engerman and Sokoloff (1997,2002). Following Glaeser et al. (2004), we argue that institutions may only have a proximate (but probably material) role in fostering economic growth, with bad policies such as inadequate provision for education playing a bigger role. Indeed, we claim that underlying constituencies rather than poor institutions may perpetuate such policies. But like AJR and ES, we argue those constituencies may have historical origins. The channel of transmission into modern day outcomes is, however, not through persistent institutions but through the persistence of constituencies. We present some suggestive empirical evidence.

The rest of the paper is as follows. In section I, we present a framework for our model, in section II, we analyze outcomes under different reform scenarios, in section III we determine the voting equilibria, in section V we present some empirical evidence, in section V we discuss the policy implications and section VI concludes.

## I. The Framework

### 1.1. Technology and endowments

Consider an economy with three types of agents: incumbent oligopolists denoted by superscript O, educated workers (superscript E), and uneducated workers (superscript U). The economy starts out with each oligopolist having a production technology that enables him to produce  $\theta m^\alpha l^\beta$  where  $m$  indicates the number of workers in managerial positions and  $l$  is the number of workers employed as laborers, and  $\theta$  is an efficiency parameter. We assume

Assumption 1: (i)  $0 < \alpha < 1$ ,  $0 < \beta < 1$  (ii)  $\alpha + \beta < 1$  (iii)  $\alpha > \beta$

In words, (i) ensures diminishing marginal productivity of both managers and laborers, and (ii) implies decreasing returns to scale. Managerial positions are more productive than laborer positions – as in a production hierarchy where managers supervise workers (see Rosen (1983)), hence (iii).

In what follows, we normalize the number of oligopolists to one (knowing that there are competing oligopolists with the same technology of production in the background). The total number of educated workers initially (henceforth, all quantities are per oligopolist) is  $\bar{e}$  and the number of uneducated is  $\bar{u}$ . It is reasonable that for a developing country, the number of uneducated workers vastly outnumber the educated. We make the milder assumption that

$$\frac{\bar{e}}{\bar{u}} < \frac{\alpha}{\beta} \tag{1.1}$$

An educated worker can occupy either a managerial position or a laborer's position or divide his time between the two (though he is not more productive in the laborer's position than an uneducated

worker), while an uneducated person can only occupy a laborer's position. The oligopolist is a pure rentier and does not work, though results would be largely unchanged if we assumed he did.

## 1.2. Reforms

Without reforms, only the oligopolist can produce, everyone else has to work for him. We consider two reforms. The first expands *access* to factor endowments. Specifically, *education* reforms allow all uneducated workers to receive an education. For simplicity, we assume there are no costs to this reform, and the uneducated bear no cost in getting an education.<sup>5</sup>

The second reform expands *opportunities* by increasing the ease with which new businesses can be set up. The precise nature of this reform can range from a strengthening of property rights or an expansion of access to finance to a removal of licensing laws and other bureaucratic barriers to entry. Such *pro-market* reforms allow the educated to set up new businesses, and produce  $m^\alpha l^\beta$ . Uneducated workers do not have the capacity to open their own businesses, but they can quit their jobs with the oligopolist and work as laborers in these new businesses. When they do so, however, they lose a fraction  $s$  of their existing human capital, which was specific to the old firm. As a result, their marginal productivity in their new employment is  $(1-s)\beta m^\alpha l^{\beta-1}$ .<sup>6</sup>

Note that each reform could improve total output, education reforms because the marginal productivity of a manager is higher than that of a laborer, and pro-market reforms because, with decreasing returns to scale, more entry implies higher output.<sup>7</sup> Hence, the model is structured so that

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<sup>5</sup> In practice, education is costly and disagreement on how this cost should be allocated may block an education reform. In this model we show that education reform might not be approved even if we ignore these costs.

<sup>6</sup> The educated, who start a new business, do not face any loss in their human capital. This is for simplicity, but can be supported by the notion that they set up business in an area conveniently close to their expertise.

<sup>7</sup> Of course, if the oligopolist is extremely efficient, entry may not take place, and pro-market reforms do not add (but neither do they subtract) value.

it is always efficient to have a comprehensive reform. The question, then, is whether the constituencies will allow it.

To abstract from problems relating to the transition phase, we assume that reforms can be implemented immediately. In practice, it takes time to educate large segments of society, which may further hamper the consensus for reforms. It is remarkable, thus, that we find an underdevelopment trap even abstracting from these.

### **1.3. Preferences**

Agents do not have different preferences from anyone else of their type (that is, the initially uneducated, the educated, and the oligopolist), hence it is reasonable to assume that individuals of a type (or, equivalently, constituency) express their voting preferences as a single collective. In voting, each constituency chooses the option that maximizes the present value of their future payoffs, where  $\delta$  is their discount rate.

### **1.4. Voting on Reforms**

We will consider three possible reform strategies – education only, pro-market only, or both, that is, comprehensive reforms. In the basic model we assume that each strategy (amongst the reform strategies and status quo) is placed in pair-wise comparison with every other strategy, and the constituencies vote on which one they prefer. Each constituency has one vote for each comparison. A strategy is implemented only if it is preferred by a simple majority (that is, by at least two constituencies) in every pair-wise comparison it features in. If only partial reforms are implemented (e.g., education only), further reforms can be voted on in future periods (of course, if no reforms are implemented, next period will be just like this one). All votes take place at the beginning of each period.

The assumption of equal votes could subsume a variety of situations. If this is a democracy, the equal weight of each constituency could result from a combination of money, organization, and numbers. Oligopolists are few in number but have tremendous money power and ease of



organization, while the uneducated have little money power or organization but are large in numbers. The educated are in between. If this is not a democracy, the vote each constituency possesses could be thought of more broadly as its influence over policies. Importantly, we have not given any constituency either absolute power or veto power, so political institutions do not necessarily entrench anyone's preferences.

Even with this very simple structure we find that under a variety of parameter values, the status quo is the preferred choice, even though it is a clearly inferior option. For other parameter values, we get Condorcet cycles. We will later place more structure on the decision making process (that is, reasonable constitutional rules) and show that comprehensive reforms take place under a very narrow set of circumstances.

## II. Outcomes under various strategies

Let us first examine outcomes under various strategies.

### 2.1. Status Quo.

When no reforms take place, per period production is  $\theta (\bar{e})^\alpha (\bar{u})^\beta$ , with the educated working as managers and the uneducated working as laborers.<sup>8</sup> Because the labor market is competitive (between oligopolists), each worker gets his marginal product as wage. Each manager gets  $\theta\alpha (\bar{e})^{\alpha-1} (\bar{u})^\beta$  while each laborer gets  $\theta\beta (\bar{e})^\alpha (\bar{u})^{\beta-1}$ . The oligopolist gets the residual, which is positive and increasing in the managers and laborers he uses because the technology is diminishing returns to scale.

### 2.2. Partial Reforms: Education but no Competition

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<sup>8</sup> The educated would work as laborers only if their marginal product is below that of laborers. This would require  $\frac{\bar{e}}{\bar{u}} \geq \frac{\alpha}{\beta}$ , which is not possible by assumption.

When only educational reforms are implemented, all the uneducated become educated. The oligopolist is still the only producer. Let  $m^E$  be the number of workers he employs in managerial positions and  $l^E$  be the number in laborer positions. Since workers are all educated, they must divide themselves into these positions so that marginal products in the manager and laborer position are equal. This implies  $\theta\alpha(m^E)^{\alpha-1}(l^E)^\beta = \theta\beta(m^E)^\alpha(l^E)^{\beta-1}$ , which simplifies to  $\frac{m^E}{l^E} = \frac{\alpha}{\beta}$ . Also, we know that the total workers employed should equal the total available so  $m^E + l^E = \bar{e} + \bar{u}$ . From these two equations, we can solve for  $l^E$  and  $m^E$ . We have

**Lemma 1:** Total production increases with education. In the first period after the reform, both the oligopolist and the uneducated are better off with education and no competition than with no reforms. The educated are worse off.

**Proof:** See appendix.

It is worth noting that education is a reform that enhances the incomes of a voting majority of the population. The oligopolist likes it because it improves the quality of his workforce and the rents he can extract. The uneducated like it because it improves their productivity and their wages. However, the educated do not like it because it subjects them to greater competition from the currently uneducated, diminishing the positional rents they enjoy.

Interestingly, despite improving the lot of a majority of effective voters, an endowment-enhancing reform like education will rarely be undertaken alone. In fact, the oligopolist will never vote for it. We will see why shortly.

### 2.3. Partial Reform: Competition but no Education.

When only pro-market reforms are enacted, the educated can open their own businesses. The uneducated can leave their jobs with the oligopolist, and after incurring search costs, can work for one

of the businesses started by the educated. Note that while an educated worker may work for the oligopolist because of the latter's greater efficiency  $\theta$ , diminishing returns ensure he will never work for another educated worker. This is because he can always get more by opening his own firm (which has the same technology as the firm opened by any other educated worker) and get both the wage of a manager as well as the rents of a proprietor.

So post-reform, all newly opened firms will have at most one full-time manager. To save space, we examine only the case where the marginal productivity of managing is high enough that the manager does not also work part-time as a laborer – a sufficient condition is that given all other parameters, the number of uneducated is high enough relative to the educated (see footnote 4 for the exact condition).

Let  $l_E^C$  be the number of laborers employed in each new firm,  $l_O^C$  be the number of laborers and  $m_O^C$  be the number of managers employed by the oligopolist. In equilibrium, it must be that the wages an uneducated person earns as a laborer in a new firm, after incurring transportation costs, equal his wages with the oligopolist. So

$$(1-s)\beta (l_E^C)^{\beta-1} = \theta\beta (m_O^C)^\alpha (l_O^C)^{\beta-1} \quad (1.2)$$

Also, in equilibrium, an educated person who starts his own firm receives the difference between output and the wages of labor which is  $(l_E^C)^\beta - l_E^C \beta (l_E^C)^{\beta-1} = (1-\beta)(l_E^C)^\beta$ . So, in equilibrium, he should be indifferent between working for the oligopolist and working for himself, and

$$\theta\alpha (m_O^C)^{\alpha-1} (l_O^C) = (1-\beta)(l_E^C)^\beta \quad (1.3)$$

Finally, market clearing requires the total number of laborers equal the number of uneducated workers so

$$(\bar{e} - m_O^C)l_E^C + l_O^C = \bar{u} \quad (1.4)$$

These three equations can be solved to obtain all the variables of interest.<sup>9</sup>

**Lemma 2:** (i) There is a level of efficiency,  $\theta^c$ , such that pro-market reforms have no effect on outcomes if the oligopolist's efficiency is greater than  $\theta^c$ . (ii) If  $\theta < \theta^c$ , the educated are better off with only pro-market reforms than under the status quo, the oligopolist is worse off, and the uneducated may be better off or worse off depending on parameters.

**Proof:** See appendix.

The intuition for why the uneducated may be worse off with pro-market reforms is important to understand. On the one hand, new firms started by the educated open up employment opportunities for the uneducated, potentially increasing their wage. On the other hand, there are fewer managers now working for the oligopolist. Since laborers are more productive working for the oligopolist when more managers supervise them, the loss of educated managers has a depressing effect on laborer wages. The net effect determines how the uneducated think about more competition. More generally, pro-market reforms create opportunities but destroy old rents. Because endowments are needed to take full advantage of opportunities, the uneducated may lose the small rents they enjoyed (because the educated were forced to work for the oligopolist) without a commensurate gain in new opportunities.

**Corollary 1:** If  $s$  is small and  $\theta < \theta^c$ , (i) a decrease in the efficiency of the incumbent oligopolist,  $\theta$ , or (ii) an increase in the number of educated,  $\bar{e}$ , increases the preference of the uneducated for pro-market reforms over the status quo.

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<sup>9</sup> For instance,  $l_E^C = \frac{\bar{u}}{\bar{e} + \left( \frac{1 - \alpha(1-s) - \beta}{1 - \beta} \right) \theta^{\frac{1}{1-(\alpha+\beta)}} \left( \frac{\alpha}{1 - \beta} \right)^{\frac{\alpha}{1-(\alpha+\beta)}} (1-s)^{\frac{\alpha-1}{1-(\alpha+\beta)}}$ . Also, the condition that the educated work only as managers in new firms is  $\frac{1}{l_E^C} < \frac{\alpha}{\beta}$ , which is true if  $\bar{u}$  is large enough relative to  $\bar{e}$ .

**Proof:** See appendix.

Intuitively, for very low values of the oligopolist's efficiency relative to new entrants, the cost to the uneducated of the departure of managers from the oligopolist's employment is more than made up by the attractiveness of the new jobs these managers create by opening competing new ventures. By contrast, when the oligopolist is very efficient, the uneducated find staying in the oligopolist's employment very attractive, and the loss of the educated managers as a result of the opening of outside competitive opportunities is very damaging to their productivity and wages.

Similarly, when there are more educated relative to the uneducated, the loss of some managers – as a result of the outside opportunities emerging from pro-market reforms -- is less costly to the productivity of the uneducated employed by the oligopolist. Also, more outside jobs are created for the uneducated (given technology). As a result of both these effects, the preference of the uneducated for competition increases.

*Example:* Let  $\alpha = 0.5$ ,  $\beta = 0.3$ ,  $\bar{u} = 100$ ,  $s=0.2$ . In Figure 1, we plot for different values of  $\theta$  and  $\bar{e}$  the line that separates the region where the uneducated prefer competition to the status quo from the region where they prefer the status quo. Note that the line slopes upward, consistent with corollary 1.<sup>10</sup>

In short, even though the uncompetitive status quo limits opportunities, it forces both the educated and the uneducated to work together. Reforms enhancing competition enhance opportunities, but primarily for the educated. The uneducated may be made worse off, as they face the still limiting environment, post-reform, but without the support of the educated. Hence they may oppose pro-market reforms.

#### **2.4. Comprehensive Reforms.**

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<sup>10</sup> For all parameter values used for this example, the outcome under both partial and comprehensive reforms is (weakly) superior to the outcome under the status quo.

Now consider both education and pro-market reforms, that is, comprehensive reforms. Since workers are all now educated, they can open their own firms. Since no one wants to work for anyone else (except perhaps for the possibly more efficient oligopolist), each new firm will have only one self-employed worker, dividing time between managerial and labor activities.

In equilibrium, the educated worker's wage in any job with the oligopolist must equal his production from the outside option of self-employed production. Let  $m_e^{CE}$  be the time the self-employed worker spends on managerial tasks and  $l_e^{CE}$  be the time he spends on labor. Then it must be that if his marginal productivity at both tasks are equalized,  $m_e^{CE} = \frac{\alpha}{\beta} l_e^{CE}$ . Also, his time must be

divided only between the two tasks, so  $m_e^{CE} + l_e^{CE} = 1$ . Solving, he produces  $\left(\frac{\alpha}{\alpha + \beta}\right)^\alpha \left(\frac{\beta}{\alpha + \beta}\right)^\beta$

through self-employment, which must be the wage the oligopolist has to pay any educated worker.

**Lemma 3** (i) The uneducated worker always (weakly) prefers comprehensive reforms over the status quo. The preferences of the oligopolist or the educated are parameter specific (see corollary below). (ii) The uneducated worker prefers comprehensive reforms to partial reform (that is, only education or only pro-market reforms). The educated worker prefers comprehensive reforms to only education reforms, but prefers only pro-market reforms to comprehensive reforms. The oligopolist prefers only educational reforms to comprehensive reforms, while his preference between only pro-market and comprehensive reforms is parameter specific.

**Proof:** See appendix.

**Corollary 2:** (i) An increase in the number of the educated,  $\bar{e}$ , a decrease in the efficiency of the incumbent's production technology,  $\theta$ , or a decrease in the productivity gap between the educated and the uneducated ( $\alpha - \beta$ ) increases the educated's preference for comprehensive reforms over no reforms. (ii) A decrease in the number of the educated,  $\bar{e}$ , or the number of the uneducated,  $\bar{u}$ , or an

increase in the efficiency of the incumbent's production technology,  $\theta$ , increases the oligopolist's preference for comprehensive reforms over no reforms.

**Proof:** See appendix

Intuitively, the educated especially benefit from the outside opportunities created by pro-market reforms if the number of educated is high (so that employment with the incumbent is not attractive because of competition with other educated). Furthermore, these outside opportunities are relatively more valuable if the oligopolist's efficiency is low. Finally, the educated do not lose as much through reforms if the uneducated are almost as productive even prior to reforms. Turning to (ii), the number of managers and laborers employed by the oligopolist post-reforms depends only on technological parameters, and not on how many he had pre-reform. Thus the more he had of either to start with, the more profitable the status quo would have been, and the more reluctant he will be to choose comprehensive reforms over the status quo. Finally, the costs of increased competition are relatively lower if the oligopolist's efficiency is high so that fewer workers leave him for employment outside.

*Example:*

Let  $\alpha = 0.5$ ,  $\beta = 0.3$ ,  $\bar{u} = 100$ ,  $s=0.2$ . In Figure 2, we plot for different values of  $\theta$  and  $\bar{e}$  the line that separates the region where the educated prefer comprehensive reforms (to no reforms) from the region where they prefer no reforms (to comprehensive reforms). To illustrate that the oligopolist's preferences are parameter dependent, consider first  $\bar{e} = 10$ ,  $\theta = 3.2$ . Not only does the oligopolist's high efficiency allow him to retain all his employees, but with comprehensive reforms, he also has more educated to employ in managerial positions. Thus he likes comprehensive reforms. The oligopolist's preference switches to the status quo (over comprehensive reforms) as soon as  $\theta$  falls below 2.68.

## 2.5. Dynamic effects

Thus far, we have analyzed only the immediate consequences that a reform has on the payoff of each constituency. But reforms also impact the endowment of each group in the next period and, therefore, their preferences. Consider first education reforms. If it is implemented, the uneducated will receive education and the following period will make common cause with the initial educated constituency to vote for pro-market reforms. As a result, a reform program that starts with education will always end up in comprehensive reforms.

So long as the discount rate  $\delta$  is not too high, and so long as the oligopolist prefers the status quo to comprehensive reforms, he will also prefer the status quo to voting for one period of education then an eternity of comprehensive reforms.

The dynamic effects of pro-market reform are different. The educated do not want to promote education after a pro-market reform because this will generate more competition.<sup>11</sup> Typically, neither does the oligopolist. So pro-market reforms will stop reforms in their tracks.

### III. Electoral Choice and Reform Outcomes

Having seen the payoffs of the three constituencies in the different scenarios possible (see Table 1<sup>12</sup>), we now look at how these translate into different equilibrium outcomes. We start with the least amount of structure and identify the set of parameter values for which one choice dominates all the others in pair wise comparison. This will be the likely outcome in plausible voting games.

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<sup>11</sup> Two assumptions are important here. The decreasing return to scales and the fact there are no technological barriers to entry (not even a minimum efficient scale). If we were to drop one of these assumptions, then the educated, once entrenched in the new industry, might trade off the costs of increased competition against the benefits of having more skilled workers, much as the oligopolist does. The net effect may still be that they oppose education, especially if they do not have much of a competitive advantage over potential newcomers.

<sup>12</sup> In arriving at the preferences in Table 1, we have assumed that the future is discounted but not too highly. If the future is not discounted at all, then preferences over the education reform move very close to preferences over comprehensive reforms. It turns out that comprehensive reforms are never chosen in such a case.



The uneducated like education reforms, as well as pro-market reforms once they become educated. The oligopolist prefers the status quo to pro-market reforms, and education reforms to the status quo. For the reasonable parameter values we consider, any additional competition induced by reforms outweighs any enhancement in the labor pool – so he prefers the status quo or just pro-market reforms to comprehensive reforms.

What is left ambiguous is (i) whether the educated prefer comprehensive reforms to the status quo, and (ii) whether the uneducated prefer competition to the status quo.<sup>13</sup> We alter  $\bar{e}$  and  $\theta$  to get representative cases. As before,  $\alpha = 0.5$ ,  $\beta = 0.3$ ,  $\bar{u} = 100$ ,  $s=0.2$ .

### **3.1. Trapped in the status-quo.**

Let the number of educated (relative to the uneducated) be small and the oligopolist be relatively efficient (area A on figure 3.). Because they are few, and the oligopolist is tolerably efficient, the educated earn substantial rents from the status quo, and are against comprehensive reforms. As always, though, they would prefer partial, pro-market reforms, to anything else. The uneducated dislike pro-market reforms because employment under the efficient oligopolist is quite attractive, and the departure of even a few of the small numbers of the educated from the ranks of management to start competing firms would erode the productivity of the uneducated.

In this situation, there is a majority against comprehensive reforms (the educated and the oligopolist), and against pro-market reforms (the uneducated and the oligopolist), relative to the status quo. Unless the discount rate is very high, there is also a majority against education reforms, because both the educated and the oligopolist are against it. Hence, the status quo will be maintained, in spite of the benefits of reforms.

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<sup>13</sup> The oligopolist's preferences can also be parameter specific. The oligopolist prefers comprehensive reforms to the status quo or pro-market reforms only when  $\bar{e}$  (the number of educated) is very low and  $\theta$  (the relative efficiency of the oligopolist) is very high. For the parameters we will consider, the required level of efficiency of the oligopolist is implausibly high. Therefore, we focus on conditions (i) and (ii) only.

Interestingly, in all the other areas of Figure 3 there is no clear winner. Depending on the order the various strategies are voted, one or the other can emerge, generating the so called Condorcet cycles (pair wise comparisons in Table 1 suggest that in regions B,C, and D, no strategy wins over the others).

### **3.2. Political Institutions**

To determine a unique solution, we need to impose more structure on the voting game. This might be thought of as the role of political institutions (over and above any role they play in conferring equal voting power to the three constituencies). However, we want to pick institutions that do not necessarily skew outcomes in one direction or the other, to show that constituencies themselves can create persistence. Let's assume, therefore, that all the reform strategies are ranked by each constituency. The strategy that has the lowest sum of ranks is chosen. If two strategies tie, a final vote between the two is held. The status quo continues to be preferred in area A (see Table 2). However, we now get unique outcomes in the other regions also.

### **3.3. Partial reforms**

If the oligopolist is not efficient and there is commensurately a large number of the educated (area B in Figure 3), the uneducated prefer pro-market reforms to the status quo, and the educated prefer comprehensive reforms to the status quo, so the highest ranked alternatives are pro-market reforms and comprehensive reforms. Between these two, the former prevails because it is supported by the coalition of the oligopolist and the educated.

By contrast, if the oligopolist is moderately efficient and there are relatively few educated enjoying substantial rents, the educated prefer the status quo to comprehensive reforms and the uneducated prefer pro-market reforms to the status quo (area C in Figure 3). The two highest ranked alternatives are status quo and pro-market reforms. Between these two, the latter prevails, thanks to the support of the uneducated and the educated.

### **3.4. Comprehensive Reforms**

Finally, if the oligopolist is moderately efficient and the number of educated is large (area D in Figure 3 ), the uneducated prefer the status quo to pro-market reforms while the educated prefer comprehensive reforms to the status quo. The highest ranked alternatives are the status quo and comprehensive reforms. Between these two the latter prevails, with the support of the educated and the uneducated. Interestingly, it is because the uneducated dislike the partial, pro-market reforms that the educated are forced to compromise and opt for comprehensive reforms in order to get any reform at all.

Figure 3 presents a very bleak picture about the feasibility of comprehensive reform. Even in this rather simple framework, we find that comprehensive reforms are undertaken in only a very small subset of the situations (the small triangular area D in the upper corner). Instead, the status quo or partial reform seems to be the norm even in situations such as area B where comprehensive reforms have majority support over the status quo. The partial pro-market reforms increase opportunities for the already well-endowed. By contrast, reforms that expand access to endowments and expand the opportunities of the very poor, seem to be particularly difficult, and typically emerge as a package of reforms rather than on a stand-alone basis. The extremely privileged oligopolist fears them because they broaden solidarity and could lead to comprehensive reforms, the less privileged educated fear them because they create direct competition to their interests.<sup>14</sup>

### **3.5. Compensating Transfers.**

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<sup>14</sup> Note that if the constituencies discount the future very little, comprehensive reforms are not possible even in this region – only pro-market reforms are the outcome here, implying education reforms never take place. Also note that one situation where education reforms will take place is when the oligopolist is so efficient that no one breaks away to compete even with comprehensive reforms. Since expanding competition is irrelevant in this extreme case, we have not considered this case in the example. We do consider the practical implications of this situation later.

Thus far, we have ignored the possibility of compensating transfers to facilitate the approval of value-enhancing reforms. For instance, the educated might attempt to get support for pro-competition reforms in area A by indemnifying the uneducated for the loss they suffer as a result of the increased competition. However, as Rajan and Zingales (2000) argue, such transfers are easy only if the parties have no further political interaction. In practice, however, the parties will be in continued interaction over time.

Without formal modeling for reasons of space, consider ways in which any agreement could break down. The indemnifying transfers, amounting to the present value of all the losses the uneducated suffer over time, will need to be large. If they are made immediately and in a fungible form, then the uneducated can use these resources to obtain more political power, and use the power to push for comprehensive reforms. In other words, a transfer of fungible resources, in practice, also amounts to a transfer of political power. Since the educated prefer the status quo to comprehensive reforms in region A, the compensating transfer to buy support for pro-market reforms is unlikely to take place if it further tilts the balance of power (or if it overly escalates the level of dissipative political activity). More generally, Rajan and Zingales (2000) point out that agreements are hardest to seal through compensating transfers when the recipient is very poorly endowed, as is the case with the uneducated.

An alternative would be for the educated to not offer a lump sum transfer, but instead offer a steady compensatory payment over time, contingent on the uneducated not borrowing against this compensatory payment to gain political power (or perhaps offer compensation in a non-fungible, hard-to-borrow-against form). Here, however, the reverse problem might emerge. What is to stop the educated from renegeing on their commitment to pay, once the agreed upon reform catches on (also see Dixit and Londregan (1995) and Acemoglu (2003) of other variants on how the inability to commit can lead to difficulty in concluding Coasian bargains)?

Even the process of negotiating over reforms may be fraught with difficulty in a democracy. The oligopolist and the educated do not have formal legal rights to the rents they obtain by limiting competition or access to education. The moment they admit to these rents in a negotiation, they lose the moral high ground in the court of public opinion, which again could affect their political power and their ability to obtain compensation for the rents. In short, it might be hard for them to negotiate indemnification for the loss of rights they were not “supposed” to enjoy to begin with.

In sum, compensating transfers may advance reforms under some circumstances, but they are no panaceas. A detailed investigation of their consequences are, however, left to further research.

### **3.6. A Simple Extension**

The phenomenon we have identified is not specific to education reform and competition. It occurs every time reforms not only have major efficiency and redistributive effects, but also can change the political preferences of an entire constituency.

Consider, for instance, a variant of the model, couched in terms of access to finance and land reform instead of education and market reforms. Suppose the economy consists of a landlord (oligopolist), the liquidity unconstrained (educated), and the liquidity constrained (uneducated). Suppose also that it takes financial liquidity to run a small farm – for example, to buy fertilizer inputs and seeds – as also to obtain the health and education to be an overseer in a large farm. Thus prior to financial sector and land reform, both the liquidity constrained and the liquidity unconstrained work for the landlord, the former as laborer, the latter as overseer. Land reforms alone (even if the land is not expropriated from the landlord but is distributed from government holdings) will lead landlords to lose supervisory talent as overseers leave to run their own farms. The liquidity constrained may also lose because they cannot run farms, and their marginal product goes down as overseers leave. So the liquidity constrained and the landlord may both be against land reform.

Financial sector reforms alone will allow the liquidity constrained to upgrade their human capital and compete with the liquidity unconstrained for overseer jobs. But it will also make them

more favorable to land reforms, which the landlord opposes. Hence, the very same structure of preferences arises in this case, with a similar impasse in reforms.

### **3.7. The Institutional View of Development**

Consider now what this model implies for the “institutional” view of development, that is, the notion that underdevelopment persists in countries because they have the wrong political, and consequently wrong economic, institutions. The view that inherited political institutions fully determine a nation’s destiny is extreme. More moderate views, for example, Acemoglu, Johnson, and Robinson (2004, p5), argue that the tendency for persistence stems from the fact that political institutions allocate de jure political power, and those who hold political power influence the evolution of political institutions, and they will generally opt to maintain the political institutions that give them political power.

Or as Engerman and Sokoloff (2002) put it,

...societies in the Americas that began with more extreme inequality or heterogeneity in the population were more likely to develop institutional structures that greatly advantaged members of the elite classes (and disadvantaging the bulk of the population) by providing them with more political influence and access to economic opportunities.

While political institutions in this view are more endogenous, they are an essential source of power to the elite, and thus are important in explaining the persistence of bad policies and underdevelopment.

Our point is that you don’t need the persistence of oppressive political institutions to explain the persistence of underdevelopment. A bad initial configuration of constituencies, even in a democracy, can produce persistent bad policies. While indeed some colonial political institutions were exploitative and may have projected the power of the elite, our model suggests why their effects persist even today when political institutions in many countries have become far more liberal. Thus good political institutions may not create good outcomes unless the underlying constituencies are

conducive to the outcomes.<sup>15</sup> Perhaps then, the way to create the “right” functioning institutions is not to set liberal constitutions down on an unready society, but instead to focus on policies that will create the necessary constituencies (and that will demand such a constitution).

How then does this argument square with North and Weingast’s (1989) canonical paper on the importance of political institutions in economic development. In their view, the checks and balances placed by Parliament on the British sovereign following the Glorious Revolution of 1688 allowed the sovereign to commit to respect the rights of investors. This, in turn, reduced the British government’s cost of borrowing, a major factor in its subsequent military successes.

One concern with their paper is that they attribute the curbs in the monarch’s power to constitutional elements like the Declaration of Rights by Parliament in 1689. But were these elements effective or were they simply evidence that Parliament, which had beheaded one king and just deposed another, had become powerful enough to constrain the monarch (see Rajan and Zingales (2003a, Chapter 6)). Or put another way, was it the institution or the constituency backing it that mattered?

North and Weingast’s claim that the British government’s borrowing costs fell quickly after the Glorious Revolution appears to support the view that it was the rapid change in institutions, rather than the steadily increasing power of Parliament that mattered. Yet, as Sussman and Yafeh (2005) suggest, better estimates of the government’s borrowing costs indicate they remained high for decades after the Glorious Revolution, and came down only after military victories and political events assured the stability, policies, and creditworthiness of the British government. Rapid change in political institutions may not be all that it is cut out to be, economic development may require the

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<sup>15</sup> Indeed, taken literally the model suggests that even though the status quo is the equilibrium in our “democracy”, a dictatorship by the oligopolist may allow education reforms because the dictator can prevent these from cascading further into pro-market reforms. Of course, in a model where political participation rates increase with education, a dictator may not be so eager to promote education.

slower and steadier emergence of the right constituencies. Consistent with this, Papaioannou and Siourounis (2005) find that the short run effect of democratization is a drop in output growth, but permanent democratizations are accompanied with higher growth rates, especially in countries with high levels of human capital.

Consider next how our paper pertains to the seminal work by Acemoglu, Johnson, and Robinson (2001) or Engerman and Sokoloff (1997, 2002) on the colonial origins of modern development. In our model, comprehensive reforms are possible only when the educated prefer them to the status quo. According to Corollary 2, this is more likely to occur when the number of educated is relatively large, when the efficiency of the oligopolist is relatively low, and when the productivity gap between the educated and the uneducated ( $\alpha - \beta$ ) is small. One empirical proxy for the productivity gap is the differential in the level of education between the educated and the uneducated.

How did these conditions differ in the former colonies? Those with a more favorable climate, less indigenous population, and no easily extractible natural resources were settled by ordinary Europeans, with fairly similar means and levels of educations. By contrast, those with a less favorable climate, more indigenous population, and more (immediately visible) natural resources attracted small groups of privileged Europeans, who focused on extracting the resources (or creating plantation economies) and exploiting the indigenous people. Hence, the first type of colonies started with a very homogenous endowment of human capital (low  $\alpha - \beta$  difference). By contrast, the second type of colonies started with a very asymmetric endowment of education (very large  $\alpha - \beta$  difference), and a very small number of the well-educated. In light of our model, the second type of colonies do not have a good environment for reform today, not just or even because they inherited exploitative institutions, but because of the persistence of the initial configuration of constituencies.<sup>16</sup>

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<sup>16</sup> Rodrik (1993) and Wei (1997) offer a different rationale for why comprehensive reform may be opposed even when a majority benefits (ex post) from it. Essentially, if the benefits of reform are uncertain, and spread

(continued)



Consistent with Glaeser et al (2004), then, the reason why certain colonies have failed to develop is partly because they did not foster education. To Glaeser et al. (2004), our model adds an explanation for why these initial unequal conditions (as proxied for by settler mortality) created a more persistent difference in the accumulation of human capital.<sup>17</sup> Specifically, in our model a small, educated constituency typically sides with the oligopolist in opposing comprehensive reform, while a large educated constituency is far less obstructionist. It is in this sense that low average educational endowments are self-perpetuating, and anti-reform constituencies survive in poor countries even in an era of increasing democratization.

To the extent that the educated can be thought of as the middle class, the evidence in Easterly (2002) that a higher share of income for the middle class in a country is associated with better schooling, as well as better developmental outcomes is consistent with our model. One should, however, be wary of simply equating the middle class with more reforms, for our model suggests it is not supportive of them when small and privileged.

Moreover, Pritchett (2001) finds little evidence of positive effects of educational attainments on the rate of growth of output per worker. Over a range, increases in education may increase the size and the political weight of a small middle class – we take the political weight of the educated as given in the model -- giving it the power to acquire more rents. In a society with very unequal distribution of endowments or very limited opportunities, education may expand rent seeking rather than the size of the pie – a possibility Pritchett sees as an explanation for his findings.<sup>18</sup> Indeed, an extension of our

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unevenly across the population, one can create examples where the electorate will vote against them even though more people benefit (ex post) from the reform than lose.

<sup>17</sup> See Galor et al, 2005 for differences between the North and the South of the United States related to initial differences in human capital.

<sup>18</sup> Pritchett (2001, p383) cites the possibly apocryphal story of a West African nation, where in a year that the exchange rate was heavily overvalued (thus creating a large premium for evading customs controls), 60 percent

(continued)

model could allow for a rent seeking opportunity for the educated which is inferior to opening one's own firm. In the absence of pro-market reforms, more education will depress the wages the educated obtain from working for the oligopolist, leading some to choose rent-seeking. Overall, the societal returns to education alone, when unaccompanied by reforms that enhance opportunities, could indeed be small.

However, to the extent that opportunities are a function of policies that are adopted, our model would suggest that as access to education broadens and educational differences narrow, the effects of education on output should be more discernible. Thus one might expect a non-linear relationship between education levels and output instead of a linear one. Moreover, if we take the model very seriously, it also implies that we should see few countries with moderate amounts of education – once there is enough of an educated constituency, it will give up opposition to universal education. It is critical for development policy then to get the country above the threshold.<sup>19</sup>

### **3.8. Related literature**

The model highlights the difficulty of enacting reforms that expand educational or financial endowments, thus imperiling all reforms, even when the economy is not dominated by an all powerful oligarchy. Unlike Bourguignon and Verdier (2000), where education tends to increase the political participation of the poor, and thus threatens to subject the rich to redistribution, education in our model has no direct effect on political power. In fact, the oligopolist values the more skilled workforce he will have as a result of education. However, education does give the poor the ability to

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of university graduates in all fields designated the customs service as their preference for government employment.

<sup>19</sup> Clearly, our model speaks to both the level and the distribution of education. A high average level, but distributed very unevenly across the population, is unlikely to foster reform. In fact, because pro-market reforms can be tailored to the educational qualifications of the population, the distribution of education matters more than the level.

take advantage of pro-market reforms, and thus makes them predisposed to further reform. It is the fear of comprehensive reforms that makes the oligopolist oppose education reforms.

Glaeser et al. (2005) also emphasize political participation when they argue that high levels of education make democracy more stable because the educated face lower costs of political participation. The educated are consequently more likely to support democracy even when it offers weak personal rewards. Glaeser et al.'s focus is not on the factors driving education. By contrast, our focus is not on the effect of education on political power or participation, but on incentives and the resulting support for reforms. Broader education builds more support for further education reforms as well as pro-market reforms because individuals perceive greater rewards from reforms.

Our model is also related to Galor et al. (2005). In their model, however, the differential marginal productivity of human capital between the agricultural and the non agricultural sector creates the friction. Since education will increase the cost of labor more than its productivity in agriculture, the landed aristocracy will oppose universal education. The more unequal the distribution of land is, the more powerful will be the landowners in preventing universal education. In our model, instead, it is the inequality in the initial endowment of human capital that makes the difference.

Finally, others like Przeworski (2003) have criticized the notion that institutions are the primary cause of economic development. We share with them skepticism about the primacy of the role accorded to institutions, certainly in transmitting underdevelopment through the ages, but also in being an useful exogenous lever through which outsiders can affect growth.

#### **IV. Some empirical evidence on the importance of endowment on preferences**

There are two aspects of our model that naturally lead to testing. First, we can test the key assumption that educational attainments change a person's preferences toward competition. Second, we can test the model's implication that strong initial inequalities in educational endowment are likely to generate an underdevelopment trap, where the average education level, and possibly growth, is low.

#### 4.1 Effect of education on preferences

To test the first aspect, we use the World Value Survey (WVS), a cross-country project coordinated by the University of Michigan examining the basic values and beliefs of individuals in a large cross-section of countries over a number of years.<sup>20</sup>

To identify people's preferences toward competition we focus on the following question:

*“How would you place your views on this scale? 1 means you agree completely with the statement on the left; 10 means you agree completely with the statement on the right; and if your views fall somewhere in between, you can choose any number in between.”*

The statement on the left is *“Competition is harmful. It brings out the worst in people”*, the one on the right is *“Competition is good. It stimulates people to work hard and develop new ideas”*. As Table 3 indicates, the mean response is 7.3 while the median is 8. We also report the demographic characteristics of the respondents in Table 3.

Given that the quantitative weight of the constituency we call oligopolists is likely to be small in these surveys, educated/high-status/high income people are likely to proxy for the educated class in our model – they are the constituency that can take most advantage of the opportunities that competition opens up.

We test whether, *ceteris paribus*, attitudes toward competition are affected by characteristics that represent the ability to take advantage of opportunities – education, status, and income. As control variables, we use those in Guiso et al. (2003). As Table 4 shows more educated, higher status,

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<sup>20</sup> This questionnaire contains information about demographics (sex, age, education, etc.), self-reported economic characteristics (income, social class), and answers to specific questions about religion, political preferences, and attitudes. We use the last three waves that are available (1981-4, 1990-3 and 1995-7). Respondents come from 66 independent countries. These countries include almost 80 percent of the world's population. The coverage of countries varies across surveys. The 1981-3 survey covered 22 independent countries and Northern Ireland; the 1990-3 survey expanded to cover 42 independent countries, Northern Ireland, and greater Moscow; the 1995-7 survey covered 54 independent countries.

and higher income are all characteristics that are associated with a greater pre-disposition towards competition.<sup>21</sup>

If the rich already enjoy opportunities, the marginal improvement in opportunities through education should be greatest for the poor. To test this, we interact the level of education with the five quintiles of the income distribution. As Table 5 shows, education seems to enhance the predisposition towards competition more in the lowest quintile of income than in the highest quintile. The two coefficients are statistically different at the 2% level.<sup>22</sup>

#### **4.2 Education and the persistence of underdevelopment**

One fairly exogenous measure of initial distributions of educational endowments across countries is the percentage of European settlers in former colonies. As Acemoglu et al. (2001 and 2002) have shown, the presence of European settlers was driven by geographic and historical factors such as the mortality rate of white settlers because of the prevailing disease environment and the density of preexisting populations. Since at the beginning of the 1900s the Europeans were much better educated than the locals, the percentage of European settlers is a good measure of the size of the educated constituency in our model, and should be positively correlated with educational attainments.

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<sup>21</sup> A standard prediction of the Heckscher-Ohlin Theorem is that the skilled should be more pre-disposed to trade in rich countries. So our result could be explained by trade theory if respondents conflate competition with trade, and come predominantly from rich countries. Interestingly, however, this pattern of the educated preferring competition holds even in very poor countries like India.

<sup>22</sup> One possible objection is that low income people are of two types: low skill workers, who stand to lose from competition and young students, who in the future will benefit from competition. To test whether the results are driven by students, we interact the income quintile with our variable young (less than 30 years old). As column 2 in Table 5 shows, the results are substantially the same.

The regressions reported in Table 7 offer considerable support for this view. As a measure of schooling in 1900 we use data from Benavot and Ridle (1988) on gross primary enrollment rates.<sup>23</sup> In column 1, we regress this measure of schooling on the percentage of European settlers in the population in 1900. Not only is the coefficient positive and highly significant, this variable alone can explain more than 50% of the variation. If we add the two main determinants of European settlement (settler mortality and population density), we notice that settler mortality also has a direct negative correlation with educational levels, but the log of population density does not. Gallego (2005) attributes differences in educational levels to the level of democracy. To test how important this factor independently is, in column III we include a measure of democracy in 1900 (from Polity IV). It adds no additional explanatory power to the variables we already include.<sup>24</sup>

If the percentage of European settlers is a good proxy not only of the primary enrollment rates but also of broader differences in educational levels, then Corollary 2 predicts that countries with a lower percentage of European settlers should exhibit lower educational levels in the future also. This is what we show in Table 8.

In Table 8, we regress different measures of educational attainments in the second half of the 20<sup>th</sup> century on the percentage of European settlers in 1900. In all cases, the percentage of European settlers in 1900 has a very strong correlation with current educational levels even after accounting for the educational level in 1900. The strength of this positive correlation can be seen in Figure 4, where the residuals of regressing educational levels in 2000 on educational levels in 1900 are plotted against the residuals of regressing of the percentage of European settlers in 1900 on the educational level in 1900. So the percentage of European settlers is correlated, not only with the contemporaneous level of

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<sup>23</sup> For why data on gross enrollment are more reliable even if sometimes are above 1005 see Benavot and Ridle (1988) .

<sup>24</sup> In arriving at his results, Gallego (2005) instruments democracy with settler mortality and population density. But if democracy itself is important, it should add additional explanatory power, which it does not.

education, but also the persistence of this level over time. We do not find evidence, however, of an effect of democracy on persistence, as hypothesized by Gallego (2005). In fact, when we add the level of democracy in 1900 to these regressions, it is always insignificant, as can also be seen when we graph residuals in Figure 5.

Finally, in Table 9 we look at the impact of these measures on the long term growth rate of a country, which following Glaeser et al. (2004) we measure as the per capita income in year 2000. Consistent with Glaeser et al. (2004), we find that low initial levels of education are correlated with low levels of subsequent per capita income, even controlling for geographic conditions, such as the percentage of population living in temperate areas (column I). If we control for the percentage of European settlers, however, the initial educational level has no significant incremental partial correlation with growth (column II). This suggests that, consistent with the model's prediction, more important than education per se is the underlying constituencies that determined the low education level to begin with. Note yet again that democracy levels in 1900 have no significant correlation with per capita income, once the percentage of European settlers is included (column III).

## **V. Implications for Development**

Our main point is that perhaps far too much faith at the current conjuncture is reposed in the healing power of political (and economic) institutions and far too little attention is paid to the underlying structure of economic power and incentives in a country – what we term constituencies. In a sense, our message is a more hopeful one than that offered by those who believe a country's institutions are deeply ingrained through the weight of history. At the same time, we believe simply parachuting institutions down on to a country that is unready for them may do little for the cause of development. A far more “bottom-up” approach is needed. The role external agents can play is very limited, though at certain junctures, critical. Let us now turn to the circumstances under which the forces that reinforce pre-existing distributions can be overcome.

### **5.1 Favorable Economic Circumstances**

In our model the oligopolists are against education, despite the short term benefits this brings to them, because of the long term consequences it will have on the competitive environment. But oligopolists fear the change only if it can make a difference to their position. This is unlikely to occur in at least two cases.

First, if the oligopolist enjoys some technological advantage which makes him much more efficient than potential entrants, then the pro-market reform will have little impact and hence the oligopolist will not fear education.

Second, the model we have outlined thus far is a closed economy model. To some extent, this is without loss of generality, because openness is often a choice, an aspect of the competition policy. In particular, periods of growth in the world economy offers the oligopolist tremendous opportunities because the benefit of having an educated workforce and becoming more competitive worldwide might more than offset the cost of added domestic competition this may result in. For example, Galor and Moav (2006) document that English industrialists supported universal education at the end of the 19<sup>th</sup> century as a way to increase their ability to compete with French and German companies. In other cases, for example when the country is very small, openness is not really a choice. This might explain the economic success of small city states such as Singapore and Hong Kong, where domestic producers have to export a large fraction of their production. This effect is similar to the beneficial effect of openness on financial development (Rajan and Zingales, 2003).

Finally, the oligopolist might not oppose education when he has an extremely high discount rate (for the benefits of a better educated population are front-loaded) such as when his country faces a military threat. This naturally leads to a discussion of non economic forces that might push changes in endowment.

### **5.2 Non economic reasons to promote education mass-education**



Forces outside economics have played an important part in helping some countries overcome the natural incentives of interest groups. Perhaps the strongest force has been religion. As suggested in the introduction, Protestant leaders believed strongly in the value of personal knowledge of the Scriptures, unmediated by the Church, and hence emphasized education. As early as 1524, Martin Luther sent a letter to German municipalities insisting it was their duty to provide schools and the duty of parents to educate their children. In 1647, Massachusetts passed the Old Deluder Satan Law requiring local authorities to set up compulsory elementary schools. The law was so-called because the preamble said the old deluder Satan kept men from knowledge of the Scriptures (Wiener, 1991).

Nationalism seems to have been a second factor. For example, after the Revolution the French government tried to break the hold of the Catholic church on education by creating state-run primary schools, forcing religious schools to follow an official curriculum, and employing teachers as civil servants. In Japan, the Tokugawa elite believed education would make the masses more moral and more obedient (see Dore (1965)). In fact, a high level of literacy on the eve of the Meiji Restoration facilitated the introduction of compulsory education by the state in 1872 (Wiener (1991)). The Japanese concern for education also made its way into its colonies, Korea and Taiwan, though the Korean emphasis on mass education may have been spurred in part as a way of building national consciousness against Japanese influence (Wiener (1991)).

Communism has also been a strong force. Wiener (1991, p163) argues that while the rulers of imperial China regarded mass education as a political threat, the post-imperial regimes saw it as a way to bridge the differences between the elite and the masses, and of developing China as an industrial and military power. The Communists may also have been more confident of their hold on power. The Chinese were not uninfluenced by Japan, whose success they saw as due to its emphasis on education. Thus again, national rivalry can help in breaking the hold of narrower domestic interest groups.

Finally, and briefly, successful land reforms also appear to have been undertaken under circumstances of political change. The rise of the gentry in Britain, the force behind the growing power of Parliament, accompanied the taming of the power of great lords and the Church by Henry VII and Henry VIII and the sale of their lands (see Tawney (1949), Rajan and Zingales (2003a), Acemoglu et al (2005)). Similarly, the desire of the Allied occupiers to reduce the power of the Japanese landlords who backed the prior militaristic regime (see, for example, Nelson (1993)), or of Koreans to cut landlords who had been too cozy with Japanese occupiers down to size (see Jeon and Kim (2000)), led to successful land reforms in these countries.

### **5.3 Sequencing, Government policies, and External Intervention.**

In suggesting reforms, sequencing is very important. Often, it is felt that the strengthening of property rights and the expansion of competition and associated opportunities will help the very poor (see, for example, De Soto (1989,2002)). But the lack of endowments, especially of education, may leave the poor unprepared for the market economy. In a second best world, the expansion in opportunities for the middle class may come at the expense of the poor. Perhaps then, in some situations of extreme inequality, it may be wiser to focus first on broadening the access to endowments. If market oriented reforms follow soon after, they may fall on more fertile ground.

Land reforms and education reforms in a number of Asian economies laid the groundwork for faster growth. Financial sector reforms should also be seen as part of the toolkit of reforms that enhance access to factor endowments.

Apart from putting pressure on governments to reorient expenditure towards these goals (an oft-overlooked item in the much-reviled Washington Consensus) external governments and agencies can help with their own resources. For instance, in a number of developing countries, the facilities for tertiary education simply do not exist. By opening their universities to immigrants, developed countries can help create a potential middle class for the poor countries. In practice, however, this has

led to a brain drain with the best and the brightest fleeing the poor countries and leaving them with even less capable constituencies to sustain reforms.<sup>25</sup>

At the same time, however, the diaspora has created a strong group that, if the conditions in the mother country improve sufficiently, could return and accelerate the pace of change. Thus while the brain drain may have contributed to a vicious cycle of development collapse in the past, it could help sustain a virtuous cycle of growth in the future.

Finally, consider external advice. As international organizations have increasingly realized, the problem in many countries is not so much identifying necessary reforms but instead obtaining political support for them. One extreme reaction is to throw up one's hands and blame the historic weight of institutions – that way lies paralysis. A second approach is to pressure a country into adopting reforms that do not have the underlying consensus, perhaps through the threat of withdrawing foreign assistance. As the international organizations have learnt, this approach will typically be met with subtle sabotage as domestic constituencies subvert the reforms. This is why the recent focus of international agencies on requiring country authorities to demonstrate ownership of reform programs is so important. This is not to say that the agencies are irrelevant. International agencies can have some impact at the margin, especially if they can strengthen the hand of an emerging reformist constituency in the government.

In particular, they can play a role by encouraging reforms that produce growth. Clearly, economic growth can create greater opportunities, which in turn reduces the incentives of the privileged to defend their turf, and instead makes them focus on reforms that remove impediments to taking advantage of opportunities. More generally, the improvement in institutional outcomes

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<sup>25</sup> Programs like the U.S. Fulbright fellowship, where foreigners are paid to study in the United States but *have* to go back to their own country after their studies, could be contemplated. However, it is not clear whether these programs permanently increase the number of educated in a poor country or increase them only temporarily as the educated take the first opportunity to leave their mother country again.

documented in Johnson, Ostry, and Subramanian (2005) as a result of growth spurts for poor countries with high initial education and a competitive external sector, is consistent with the implications of the model. But such evidence suggests that one way to change factor endowments (and, as a result, constituencies and institutions) is through good policies that create growth and opportunities. Clearly, this is a more feasible agenda than one that demands a change in institutions to begin with.

The reader will notice we have had few magic policy bullets to suggest. This reflects our belief that development is a process of muddling through with no easy and well-trodden paths. It depends on a country taking advantage of fleeting opportunities, as well as enjoying considerable luck. The sooner we recognize all this, the less development will be a creature of the latest fads.

### **Conclusion**

Plus que ca change, plus que c'est la meme chose. The development literature used to be focused on endowments, especially on the role of education in development (see, for example, Easterlin (1981)). This approach, however, had a hard time explaining persistence in underdevelopment. Cameroon more than doubled its rate of adult literacy in the three decades after 1970 (from 30% to 71%) and Libya was able to do even better in absolute terms (from 36% to 80%). Why was India, a flourishing democracy, that started in the 1970s with 33% of adults literate, still lagging behind with a rate of 57% in 2000?

Our paper suggests the persistence of underdevelopment is not necessarily due to the existence of bad political, and consequently economic, institutions. Institutions may often be only the proximate cause. The deeper reason is the existence of self-perpetuating constituencies. Changing explicit institutions without changing the constituencies backing them is likely to be a futile exercise, for the constituencies against change will find a way around the constraints imposed by the institutions.

The main message of this paper is that rather than development policy focusing on the absence of institutions, it should focus on the absence of constituencies that demand them. Such a focus shifts the debate, we believe, back to factor endowments and the following question: How do we change factor endowments in a poor society, especially if dominant interest groups oppose such change? From the perspective of development, this may be a more fruitful question than the question of how we create or change institutions.

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Appendix

**Proof of Lemma 1:** We have shown  $\frac{m^E}{l^E} = \frac{\alpha}{\beta}$ . But by assumption  $\frac{\alpha}{\beta} > \frac{\bar{e}}{\bar{u}}$ . Therefore,  $\frac{m^E}{l^E} > \frac{\bar{e}}{\bar{u}}$ ,

and since all workers are used in both situations, it must be that  $\bar{e} < m^E$  and  $\bar{u} > l^E$ . Given diminishing marginal productivity of both managerial and labor input, it must be that managers get a lower wage than in the status quo while laborers get a higher wage than in the status quo. As a result, managers are worse off while laborers are better off. It is easy to check that total production increases because more workers can now be deployed in the higher marginal productivity activity of management. The oligopolist's profit is

$$\theta(m)^\alpha (l)^\beta - \alpha m \theta(m)^{\alpha-1} (l)^\beta - \beta l \theta(m)^\alpha (l)^{\beta-1} = (1 - \alpha - \beta) \theta(m)^\alpha (l)^\beta.$$

Substituting  $l = k - m$  where  $k$  is the (constant) total number of workers, differentiating w.r.t.  $m$ , and collecting terms, we get the oligopolist's profits increasing in the number of managers (and hence education) if  $(1 - \alpha - \beta)[\alpha l - \beta m] \theta(m)^{\alpha-1} (l)^{\beta-1} > 0$ . But the first term in parentheses is positive because of diminishing returns to scale and the term in the square brackets is positive so long as the marginal manager is more productive than the marginal laborer (and zero when the profit maximizing point of equal productivity is reached). Hence, the oligopolist is better off with education than in the status quo. Q.E.D.

**Proof of Lemma 2:**

(i) We can solve for  $m_o^C$ , the managers employed by the oligopolist, which is increasing in  $\theta$ . The level of  $\theta$  at which  $m_o^C$  equals  $\bar{e}$  is the level beyond which all the educated stay employed with the oligopolist because their pay from doing so is higher than from starting their competing, but less

efficient firms. It is easily checked that  $\theta^c = (1 - s)^\beta \left( \frac{\alpha}{1 - \beta} \right)^{\beta-1} (\bar{e})^{1-\alpha-\beta}$ .

(ii) The opportunities of the educated expand with competition, so their wage must increase. The oligopolist loses workers and has to pay the remaining ones more as a result of competition, so he is worse off. An example (see later) establishes that the uneducated may be better or worse off depending on parameters. Q.E.D.

**Proof of Corollary 1:** (i) Under the status quo, the uneducated get  $\theta\beta(\bar{e})^\alpha(\bar{u})^{\beta-1}$ . With competition, they get  $(1-s)\beta(l_E^C)^{\beta-1}$ . Therefore, the difference in income they get between competition and the status quo decreases with  $\theta$  if  $\frac{(l_E^C)^{\beta-1}}{\theta}$ , or equivalently, if

$$\frac{1}{\theta^{1-\beta}l_E^C} \quad (1.5)$$

decreases with  $\theta$ .

We know from solving the equations in the text that

$$l_E^C = \frac{\bar{u}}{\bar{e} + \left(\frac{1-\alpha(1-s)-\beta}{1-\beta}\right)\theta^{\frac{1}{1-(\alpha+\beta)}}\left(\frac{\alpha}{1-\beta}\right)^{\frac{\alpha}{1-(\alpha+\beta)}}(1-s)^{\frac{\alpha-1}{1-(\alpha+\beta)}}} \quad (1.6)$$

Substituting (1.6) in (1.5), differentiating w.r.t.  $\theta$  and simplifying, we get (1.5) decreases in  $\theta$  if

$$-\frac{1}{1-\beta}\frac{\bar{e}}{\bar{u}} + \frac{1}{\bar{u}}\left(\frac{1-\alpha(1-s)-\beta}{1-\beta}\right)\left(\frac{\alpha}{1-\beta}\right)^{\frac{1-\beta}{1-(\alpha+\beta)}}(1-s)^{\frac{\alpha-1}{1-(\alpha+\beta)}}\theta^{\frac{1}{1-(\alpha+\beta)}} \quad (1.7)$$

Clearly the sign of (1.7) can be positive if  $\theta$  gets large. However, we know that the maximum value of  $\theta$  where competition creates jobs outside the oligopolist is  $\theta^c$  (see lemma 1) where

$$\theta^c = (1-s)^\beta \left(\frac{\alpha}{1-\beta}\right)^{\beta-1} (\bar{e})^{1-\alpha-\beta} \quad (1.8)$$

If (1.7) is negative even when  $\theta = \theta^c$ , then (1.5) decreases in  $\theta$ . Substituting (1.8) for  $\theta$  in (1.7), and simplifying, we get

$$\frac{\bar{e}}{\bar{u}}\left(\frac{1}{1-s} - \frac{1}{1-\beta} - \frac{\alpha}{1-\beta}\right) \quad (1.9)$$

Where the term in parentheses is negative when  $s$  is small (more precisely, smaller than  $\frac{\alpha+\beta}{\alpha+1}$ ).

(ii) Following a similar methodology, the difference in income the uneducated get between competition and the status quo increases with  $\bar{e}$  if

$$\frac{1}{l_E^C(\bar{e})^{\frac{\alpha}{1-\beta}}} \quad (1.10)$$

increases with  $\bar{e}$ . Differentiating (1.10) w.r.t.  $\bar{e}$ , and substituting

$$m_O^C = \theta^{\frac{1}{1-(\alpha+\beta)}}\left(\frac{\alpha}{1-\beta}\right)^{\frac{1-\beta}{1-(\alpha+\beta)}}(1-s)^{\frac{-\beta}{1-(\alpha+\beta)}}, \text{ we get a positive number if}$$

$$(1-\alpha-\beta)\bar{e} - \left(\frac{1-\alpha(1-s)-\beta}{(1-s)}\right)m_O^C > 0 \quad (1.11)$$

But the number of managers is bounded above by the number of educated so  $m_o^C < \bar{e}$  when  $\theta < \theta^c$ , so when  $s$  is small, the inequality always holds. Q.E.D.

**Proof of Lemma 3: (sketch)**

(i) We have shown earlier that the uneducated worker prefers education to the status quo. Pro-market reforms further enhance his opportunities, and thus must increase his income. We show with an example that the preferences of the oligopolist and the educated worker are parameter specific.

(ii) It is clear that relative to partial reform, comprehensive reform enhances the uneducated worker's opportunities or abilities, and hence is preferred. Similarly, relative to a state where only educational reforms have taken place, the educated worker prefers comprehensive reforms because his opportunities are enhanced. However, relative to a state where pro-market reforms have taken place, the educated worker only faces more competition if educational reforms now take place (and loses the ability to employ uneducated workers), so he prefers to stop at pro-market reform. Finally, the oligopolist faces more competition if pro-market reforms follow educational reforms, so he prefers to stop at educational reforms. If educational reforms follow pro-market reforms, however, the supply of educated labor increases. On the one hand, he benefits from the greater supply of fungible educated labor, on the other hand, even the formerly uneducated workers can open new firms. The net effects are ambiguous.

**Proof of Corollary 2.**

(i) With education and competition reforms, the manager's (or laborer's) income is

$$\left(\frac{\alpha}{\alpha + \beta}\right)^\alpha \left(\frac{\beta}{\alpha + \beta}\right)^\beta \tag{1.12}$$

which is independent of  $\theta$  and  $\bar{e}$ . By contrast, the educated manager's income with no reforms under the status quo is  $\theta\alpha (\bar{e})^{\alpha-1} (\bar{u})^\beta$  which increases in  $\theta$  and decreases in  $\bar{e}$ . Thus the educated's preference for the status quo increases in  $\theta$  and decreases in  $\bar{e}$ .

Similarly, the educated manager's income under the status quo increases with  $\alpha$  since

$$\frac{\partial[\theta\alpha (\bar{e})^{\alpha-1} (\bar{u})^\beta]}{\partial\alpha} = (\bar{e})^{\alpha-1} + \alpha \log \bar{e} (\bar{e})^{\alpha-1} > 0$$

and his payoff under comprehensive reform decreases in  $\alpha$  since differentiating the logarithm of (1.12) with respect to  $\alpha$  we obtain

$\log\left(\frac{\alpha}{\alpha + \beta}\right) < 0$ . Hence, a reduction in  $\alpha$  will make the educated more favorable to comprehensive reforms.

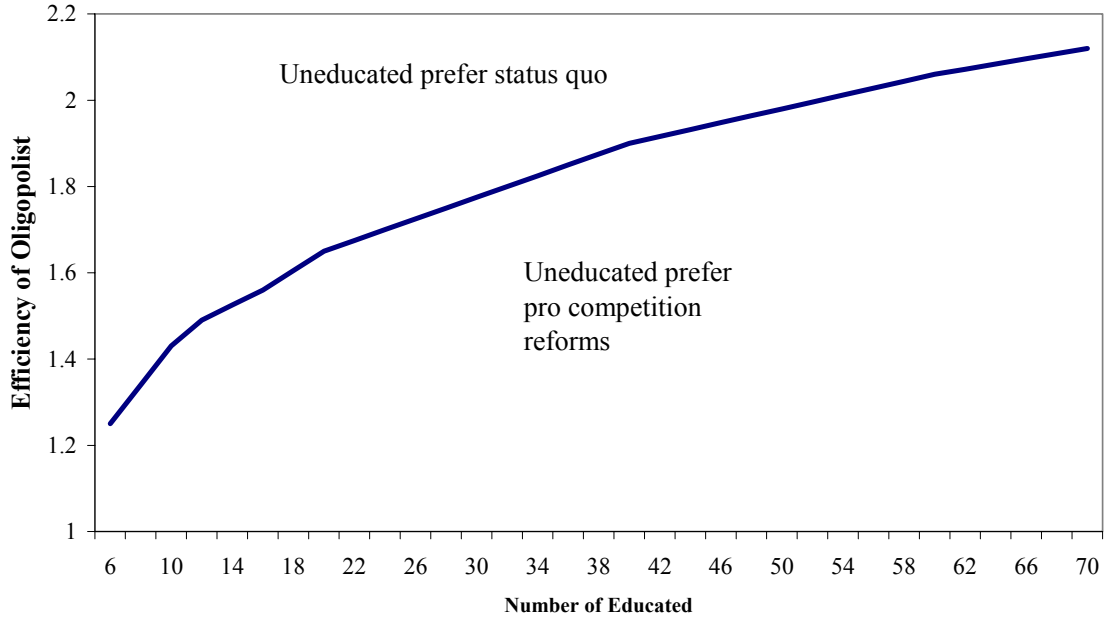
(ii) The oligopolist's income with no reform is given by  $(1 - \alpha - \beta)\theta (\bar{e})^\alpha (\bar{u})^\beta$ , while with reforms it is  $(1 - \alpha - \beta)\theta (m_o^{ce})^\alpha (l_o^{ce})^\beta$ . Therefore, their preference for comprehensive reforms over no reforms increases as  $(m_o^{ce})^\alpha (l_o^{ce})^\beta - (\bar{e})^\alpha (\bar{u})^\beta$  increases. We know by solving for  $m_o^{ce}$  and  $l_o^{ce}$  that

$$m_o^{ce} = \alpha \theta^{\frac{1}{1-(\alpha+\beta)}} (\alpha + \beta)^{\frac{\alpha+\beta}{1-(\alpha+\beta)}}, \quad l_o^{ce} = \beta \theta^{\frac{1}{1-(\alpha+\beta)}} (\alpha + \beta)^{\frac{\alpha+\beta}{1-(\alpha+\beta)}}$$

which increase in  $\theta$ , while  $\bar{e}$  and  $\bar{u}$  are obviously constant in  $\theta$ . Thus the oligopolist's preference for comprehensive reforms increase in  $\theta$ . By contrast,  $m_o^{ce}$  and  $l_o^{ce}$  do not vary with  $\bar{e}$  or  $\bar{u}$  while  $(\bar{e})^\alpha (\bar{u})^\beta$  increases. Hence the oligopolist's preference for comprehensive reforms decreases in  $\bar{e}$  and  $\bar{u}$ . Q.E.D.

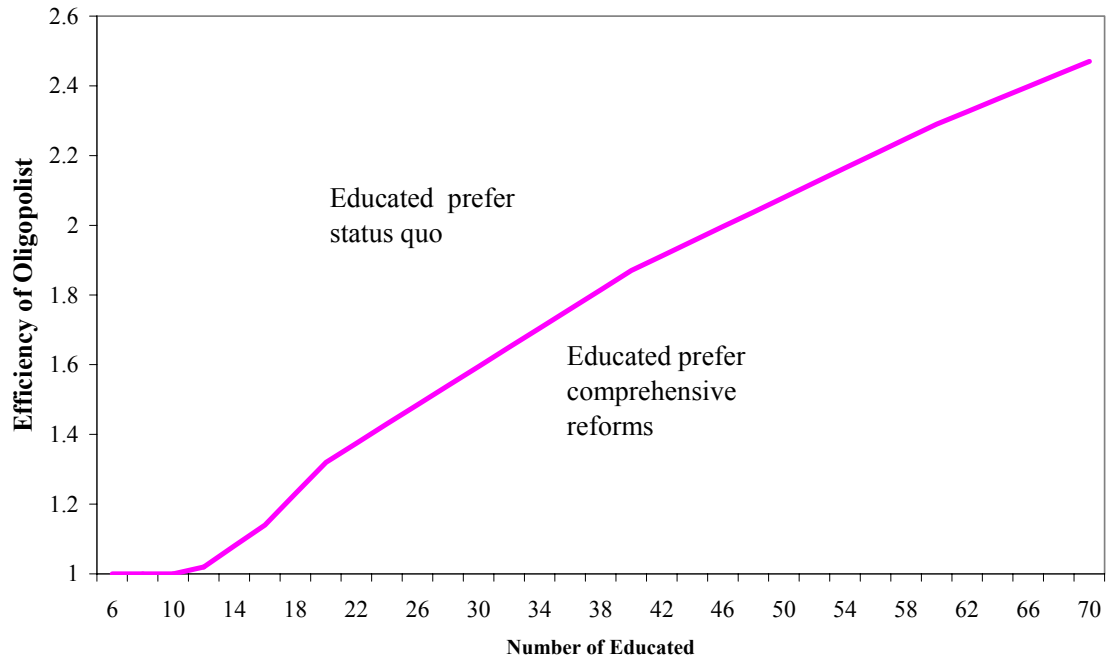
**Figure 1: Preferences of Uneducated -- Status Quo vs Pro-market Reforms**

This example is plot assuming  $\alpha = 0.5$ ,  $\beta = 0.3$ ,  $\bar{u} = 100$ ,  $s=0.2$ .



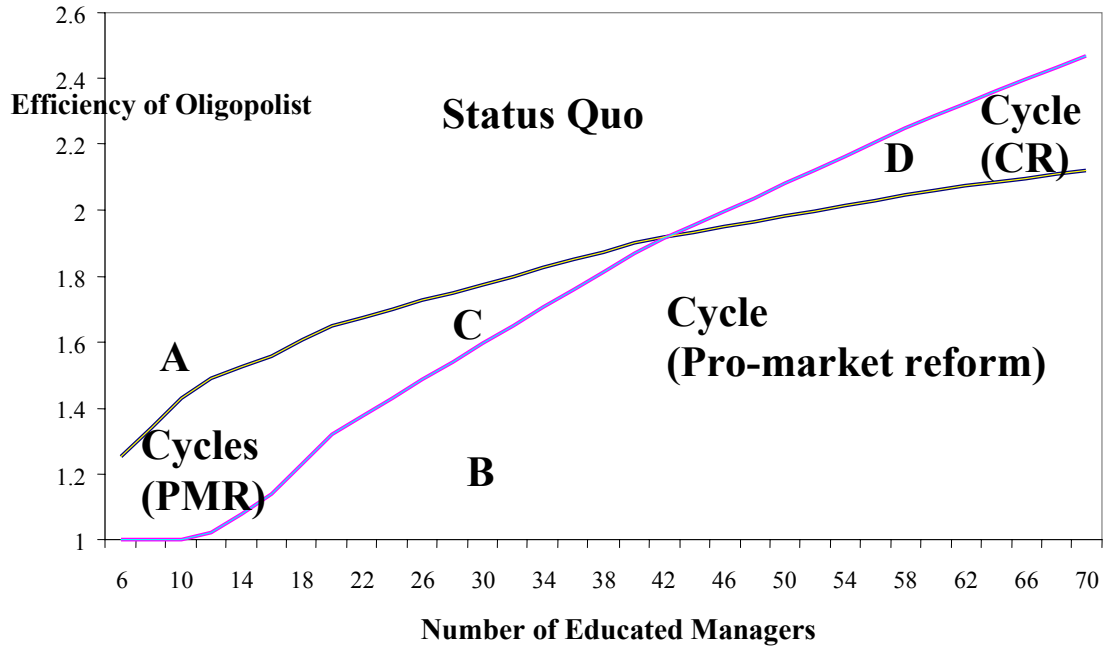
**Figure 2: Preferences of Educated: Comprehensive Reforms vs Status Quo**

This example is plot assuming  $\alpha = 0.5$ ,  $\beta = 0.3$ ,  $\bar{u} = 100$ ,  $s=0.2$ .



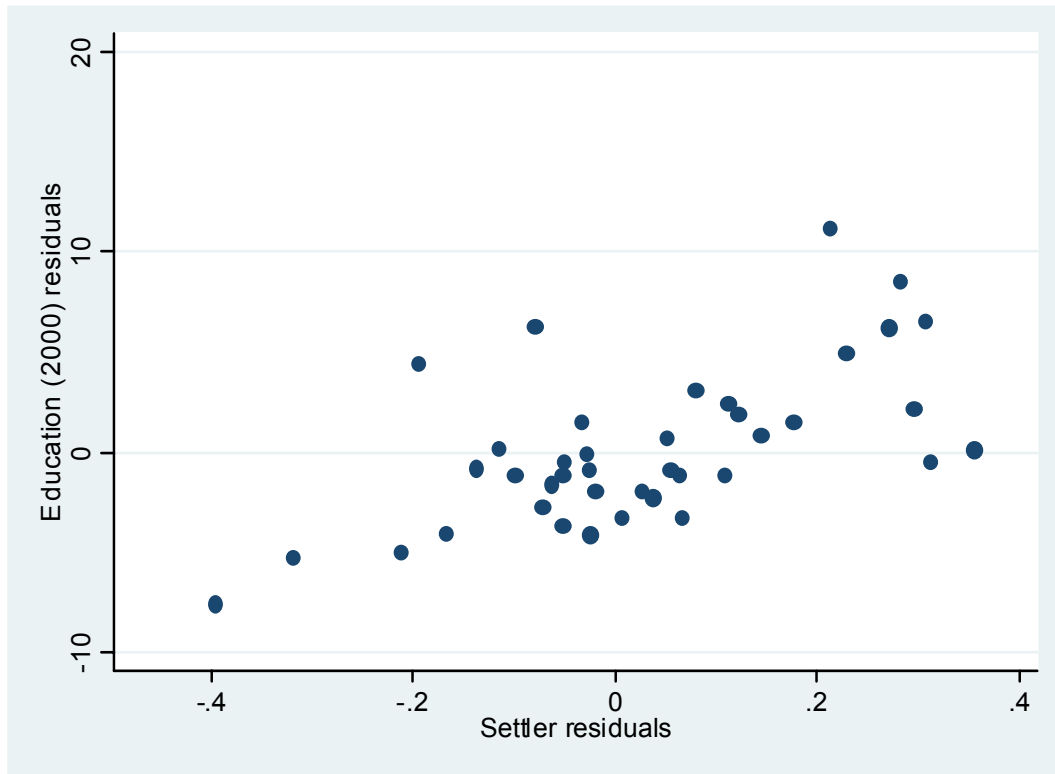
**Figure 3: Reform Outcomes**

This example is plot assuming  $\alpha = 0.5$ ,  $\beta = 0.3$ ,  $\bar{u} = 100$ ,  $s=0.2$ .



**Figure 4: Plot of education in 2000 on European settlers in 1900**

In the figure, we plot the residuals of educational achievement in 2000 regressed on primary enrollment in 1900 against the residuals of European settlers in 1900 regressed on primary enrollment in 1900. The level of education in 2000 is the percentage of population with a completed secondary degree as a fraction of the population over 15, source: Barro and Lee, 2000. European settlers is the percentage of population of European descent in 1900, source: Acemoglu, et al. (2001). Primary enrollment in 1900 is measured as the percentage of children from 5 to 14 enrolled in primary school from Benavot and Riddle (1988).





**Figure 5: Plot of education in 2000 on democracy in 1900**

In the figure, we plot the residuals of educational achievement in 2000 regressed on primary enrollment in 1900 against levels of democracy in 1900 regressed on primary enrollment in 1900. The level of education in 2000 is the percentage of population with a completed secondary degree as a fraction of the population over 15, source: Barro and Lee, 2000. Primary enrollment in 1900 is measured as the percentage of children from 5 to 14 enrolled in primary school from Benavot and Riddle (1988). Institutionalized democracy in 1900 is a 0-10 index from the Polity IV data set.

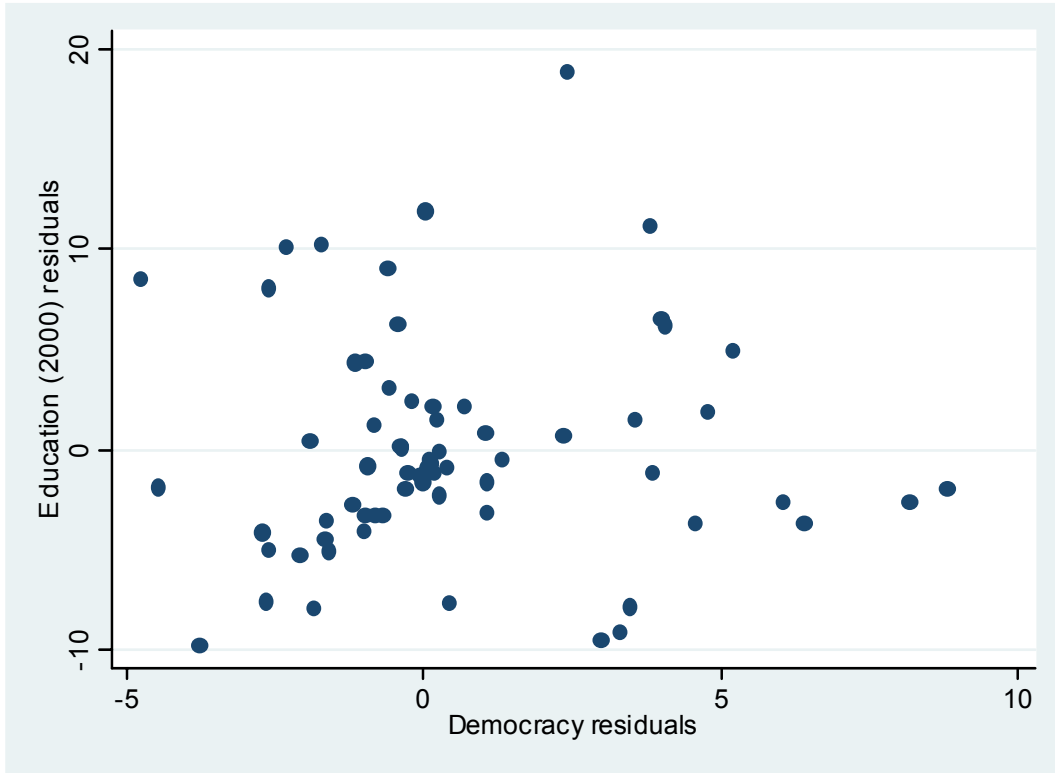


Table 1: Preferences of agents in different regions

		<b>Oligopolists</b>	<b>Educated</b>	<b>Unskilled</b>
Area A	Best	SQ E PMR	PMR SQ CR	CR E SQ
	Worst	CR	E	PMR
Area C	Best	<b>Oligopolists</b> SQ E PMR	<b>Educated</b> PMR SQ CR	<b>Unskilled</b> CR E PMR
	Worst	CR	E	SQ
Area B	Best	<b>Oligopolists</b> SQ E PMR	<b>Educated</b> PMR CR SQ	<b>Unskilled</b> CR E PMR
	Worst	CR	E	SQ
Area D	Best	<b>Oligopolists</b> SQ E PMR	<b>Educated</b> PMR CR SQ	<b>Unskilled</b> CR E SQ
	Worst	CR	E	PMR

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SQ	Status quo
PMR	Pro market reforms
E	Education reforms
CR	Comprehensive reforms

Table 2: Scores Based on Voting Game

	Strategy	Score	Winning strategy
Area A	SQ	6	SQ
	E	8	
	PMR	8	
	CR	8	
Area C	SQ	7	PMR
	E	8	
	PMR	7	
	CR	8	
Area B	SQ	8	PMR
	E	8	
	PMR	7	
	CR	7	
Area D	SQ	7	CR
	E	8	
	PMR	8	
	CR	7	

**Table 3: Summary statistics**

“Health” is coded based on the question: *“All in all, how would you describe your state of health these days?”* (1=Very poor; 2=Poor, 3=Fair, 4=Good, 5=Very good). “Education” is the age in years at which the respondent completed his or her highest education (excluding apprenticeships). Social class is coded based on the response to the question: *“People sometimes describe themselves as belonging to the working class, the middle class, or the upper or lower class. Would you describe yourself as belonging to the: 1=Lower class, 2=Working class, 3=Lower middle class, 4=Upper middle class, 5=Upper class.”* “Income” is coded based on the response to the question: *“Here is a scale of incomes. We would like to know in what group your household is, counting all wages, salaries, pensions, and other income that comes in. Just give the letter of the group your household falls into, before taxes and other deductions”* (income categories are coded by decile for each society, 1=lowest decile, 10=highest decile). Religious denomination is coded based on the answers to the question: *“Do you belong to a religious denomination? IF YES: Which one?”* Atheists are people who respond no to the question *“Do you believe in God?”*

	Mean	Median	St. Dev	Min	Max
Competition	7.40	8	2.51	1	10
Health	2.69	3	0.92	0	4
Male	0.49	0	0.50	0	1
Young (<30)	0.29	0	0.46	0	1
Old (>60)	0.17	0	0.38	0	1
Education	18.11	18	4.89	6	35
Upper class	0.06	0	0.23	0	1
Middle class	0.63	1	0.48	0	1
Atheist (0,1)	0.15	0	0.36	0	1
Catholic (0,1):	0.42	0	0.49	0	1
Protestant(0,1)	0.11	0	0.32	0	1
Jewish (0,1)	0.00	0	0.05	0	1
Muslim (0,1)	0.08	0	0.26	0	1

**Table 4: Determinants of the attitudes toward competition**

The dependent variable is the attitude toward competition (a 1-10 measure of agreement with the statement “*Competition is good. It stimulates people to work hard and develop new ideas*”). The coefficients presented below come from an OLS regression. All the other variables are defined in Table1. Standard errors, which are reported in brackets, are heteroskedasticity adjusted. (\*\*\*): coefficient significant at less than 1%; (\*\*): coefficient significant at the 5%; (\*): coefficient significant at the 10%.

Dependent var.	Attitude toward competition
Health status (0,4)	0.1176*** (0.0119)
Male (0,1):	0.2957*** (0.0199)
Young (18-30)	-0.1238*** (0.0232)
Old (over 60)	0.0266 (0.0310)
Education (year at which one stc	0.0114*** (0.0024)
Upper class	0.3758*** (0.0498)
Middle class	0.2429*** (0.0240)
Second quintile of income	0.0808*** (0.0284)
Third quintile of income	0.1681*** (0.0313)
Fourth quintile of income	0.2146*** (0.0370)
Fifth quintile of income	0.5287*** (0.0443)
Atheist (0,1)	-0.1211*** (0.0311)
Catholic (0,1):	0.1833*** (0.0321)
Protestant(0,1)	0.2215*** (0.0444)
Jewish (0,1)	0.4353** (0.2088)
Muslim (0,1)	-0.1866** (0.0731)
Year dummies	Yes
Country fixed effects	Yes
Observations	61798
R-squared	0.067

**Table 5: Effect of education on the attitude toward competition of the lower income people**

The dependent variable is the attitude toward competition (a 1-10 measure of agreement with the statement “*Competition is good. It stimulates people to work hard and develop new ideas*”). The coefficients presented below come from an OLS regression identical to the one in Table 2 except for the presence of an interaction term between level of education and income quintile. In column 2 we also add an interaction between income quintile and young age (a dummy equal to 1 if the person is below 30). Standard errors, which are reported in brackets, are heteroschedasticity adjusted. (\*\*\*): coefficient significant at less than 1%; (\*\*): coefficient significant at the 5%; (\*): coefficient significant at the 10%.

	<b>Attitude toward competition</b>	<b>Attitude toward competition</b>
Level of education *	0.0215***	0.0212***
first quintile of income	(0.004)	(0.004)
Level of education *	0.0044	0.0037
second quintile of income	(0.004)	(0.004)
Level of education *	0.0134***	0.0143***
third quintile of income	(0.005)	(0.005)
Level of education *	0.0114*	0.0116**
fourth quintile of income	(0.006)	(0.006)
Level of education *	0.0015	0.0016
fifth quintile of income	(0.007)	(0.007)
Income quintiles interacted with young (< 30)	No	Yes
Demographics (see Table 2)	Yes	Yes
Year dummies	Yes	Yes
Country fixed effects	Yes	Yes
Observations	61,798	61,798
R-Squared	0.067	0.067

**Table 6: Summary statistics of the cross country data**

Primary enrollment in 1900 is the percentage of children from 5 to 14 enrolled in primary school from Benavot and Riddle (1988). European settlers is the percentage of population of European descent in 1900. Source: Acemoglu, et al. (2001). Log settler mortality is the log of the mortality rate faced by European settlers at the time of colonization. Source: Acemoglu, et al. (2001). Population density in 1500 is the total population divided by total arable land in 1500 A.D. Source: McEvedy and Jones (1978) as cited in Acemoglu, et al. (2002). Institutionalized democracy in 1900 is a 0-10 index from the Polity IV data set. Share of population living in temperate zone is the percentage of a country's population in Koeppen-Geiger temperate zone in 1995. Source: Center for International Development, Geography Data Sets as cited in Glaeser et al.. Years of schooling in 1960 is the years of schooling of the total population aged over 25 in 1960. Source: Barro, Robert J. and Jong-Wha Lee, International Data on Educational Attainment: Updates and Implications. Source: Barro and Lee (2000) as cited in Glaeser et al.. (2004). Log school attainment (60-85) is the average over three five year periods (1960-65, 1970-75, and 1980-85) of the logarithm of (1+ average years of school attainment during the respective period). Source: Barro and Lee, 1994 as cited in La Porta et al. (1999). % of pop. with secondary degree is the fraction of the population over 15 with a secondary degree completed. Source: Barro and Lee, 2000. Log of GDP per capita in 2000 is the log of the gross domestic product over population. Source: Aten et al. (2002) as cited in Glaeser et al.. (2004).

	Mean	St dev	Min	Max	N
Primary enrollment in 1900	24.583	25.049	0.100	95.000	50
Percentage of European settlers in 1900	0.135	0.231	0.000	0.990	83
Log of populaiton density in 1500	0.571	1.570	-3.831	4.610	79
Log of settlers mortality	4.741	1.193	2.146	7.986	73
Democracy level in 1900	1.463	2.786	0.000	10.000	54
share of pop. living in temperate zones	0.135	0.298	0.000	1.000	74
Years of schooling in 1960	3.567	2.473	0.402	10.902	64
Log of school attainment 1960-85	1.212	0.552	0.231	2.436	63
% of pop. with secondary degree	3.484	5.033	0.000	22.100	61
log per capita Gdp in 2000	8.050	1.087	6.178	10.414	68

**Table 7: Determinants of primary enrollment in 1900**

The dependent variable is primary enrollment in 1900, measured as the percentage of children from 5 to 14 enrolled in primary school from Benavot and Riddle (1988). European settlers is the percentage of population of European descendents in 1900. Source: Acemoglu, et al. (2001). Log settler mortality is the log of the mortality rate faced by European settlers at the time of colonization. Source: Acemoglu, et al. (2001). Population density in 1500 is the total population divided by total arable land in 1500 A.D. Source: McEvedy and Jones (1978) as cited in Acemoglu, et al. (2002). Institutionalized democracy in 1900 is a 0-10 index from the Polity IV data set. Standard errors, which are reported in brackets, are heteroskedasticity adjusted. (\*\*\*) : coefficient significant at less than 1%; (\*\*): coefficient significant at the 5%; (\*): coefficient significant at the 10%.

	I	II	III
Percentage of European settlers in 1900	68.052*** (9.214)	54.303*** (15.278)	51.132*** (15.671)
Log of population density in 1500		-0.241 (1.877)	-0.35 (1.873)
Log of settlers mortality		-6.445** (2.572)	-6.385** (2.568)
Democracy level in 1900			0.408 (0.816)
Observations	50	46	46
R-squared	0.524	0.587	0.588



**Table 8: Determinants of educational levels in the second half of the 20<sup>th</sup> century**

The dependent variables are different measures of schooling in the second half of the 20<sup>th</sup> century. Years of schooling in 1960 is the years of schooling of the total population aged over 25 in 1960. Source: Barro, Robert J. and Jong-Wha Lee, International Data on Educational Attainment: Updates and Implications. Source: Barro and Lee (2000) as cited in Glaeser et al. (2004). Log School attainment (60-85) is the average over three five year periods (1960-65, 1970-75, and 1980-85) of the logarithm of (1+ average years of school attainment during the respective period). Source: Barro and Lee, 1994 as cited in La Porta et al. (1999). % of pop. with secondary degree is the fraction of the population over 15 with a secondary degree completed. Source: Barro and Lee, 2000. European settlers is the percentage of population of European descent in 1900. Source: Acemoglu, et al. (2001). Primary enrollment in 1900 is measured as the percentage of children from 5 to 14 enrolled in primary school from Benavot and Riddle (1988). Institutionalized democracy in 1900 is a 0-10 index from the Polity IV data set. Standard errors, which are reported in brackets, are heteroskedasticity adjusted. (\*\*\*) : coefficient significant at less than 1%; (\*\*): coefficient significant at the 5%; (\*): coefficient significant at the 10%.

	Years of schooling in 1960	Log of school attainment 1960-85	% of pop. with secondary degree	Years of schooling in 1960	Log of school attainment 1960-85	% of pop. with secondary degree
Percentage of European settlers in 1900	4.214*** (1.015)	0.798*** (0.241)	13.804*** (3.343)	4.124*** (1.031)	0.800*** (0.245)	13.218*** (3.721)
Primary enrollment in 1900	0.046*** (0.011)	0.008*** (0.003)	0.042 (0.034)	0.046*** (0.012)	0.008*** (0.003)	0.041 (0.034)
Democracy level in 1900				0.016 (0.057)	0 (0.014)	0.103 (0.249)
Observations	43	42	40	43	42	40
R-squared	0.777	0.644	0.71	0.777	0.644	0.712

**Table 9: Long term growth: Education vs. constituencies**

The dependent variable is the log of the gross domestic product in 2000 over population. Source: Aten et al. (2002) as cited in Glaeser et al.. (2004). Primary enrollment in 1900 is measured as the percentage of children from 5 to 14 enrolled in primary school. Source: Benavot and Riddle (1988). Share of population living in temperate zone is the percentage of a country's population in Koeppen-Geiger temperate zone in 1995. Source: Center for International Development, Geography Data Sets as cited in Glaeser et al.. European settlers is the percentage of population of European descendents in 1900. Source: Acemoglu, et al. (2001). Standard errors, which are reported in brackets, are heteroskedasticity adjusted. (\*\*\*) : coefficient significant at less than 1%; (\*\*) : coefficient significant at the 5%; (\*) : coefficient significant at the 10%.

	log per capita Gdp in 2000	log per capita Gdp in 2000	log per capita Gdp in 2000
Primary enrollment in 1900	0.017*** (0.005)	0.003 (0.005)	0.003 (0.005)
Share of population living in temperate areas	0.62 (0.451)	-0.027 (0.482)	-0.046 (0.49)
Percentage of European settlers in 1900		2.216*** (0.706)	2.300*** (0.722)
Democracy level in 1900			-0.013 (0.029)
Observations	38	38	38
R-squared	0.507	0.617	0.619

