American Economic Review: Papers & Proceedings 2009, 99:2, 261–267
http://www.aeaweb.org/articles.php?doi=10.1257/aer.99.2.261

MACROECONOMIC NARRATIVES FROM AFRICA AND THE DIASPORA[†]

Institutions versus Policies: A Tale of Two Islands

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A long line of work emphasizes the correlation between institutions and economic performance (Adam Smith 1776; W. Arthur Lewis 1955; Douglass C. North 1990). Rich countries have laws that provide incentives to engage in productive economic activity. Investors rely on secure property rights, facilitating investment in human and physical capital; government power is balanced and restricted by an independent judiciary; contracts are enforced effectively, supporting private economic transactions.

Recent research moves from correlation to causation by observing that countries whose colonizers established strong property rights hundreds of years ago have, on average, much higher levels of income today than countries whose colonizers did not (Daron Acemoglu, Simon Johnson, and James A. Robinson 2001). Since a country's colonial origin—literally determined centuries ago—can in no meaningful way be said to be caused by its present-day level of income, the nature of countries' colonial origins enables researchers to estimate the causal impact of property rights on long-run economic outcomes. Differences in the legal tradition that countries inherited from their colonial masters also have a long-run impact on economic outcomes. Countries with English common law origins provide investors with stronger protection and are less prone to government ownership and regulation than countries with civil law origins (Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer 2008). In turn, common law countries have greater financial development, less corruption, smaller informal economies, and lower unemployment.

Case studies seem to suggest that institutions also exert a causal influence on economic outcomes over periods of time somewhat shorter than the centuries-long span emphasized by the colonial and legal origins literature. For instance, following the Armistice of 1953, Korea broke into two separate nations with similar levels of income, almost identical ethnic and cultural makeup, but starkly different institutional arrangements of the economy. North Korea resorted to central planning while South Korea relied on property rights and markets (with a healthy dose of state intervention). More than 50 years later South Korea's income per capita is more than ten times as large as North Korea's. The divergence of the East and West German economies following the partition of Germany after World War II ostensibly provides another piece of evidence in favor of the view that institutions play the dominant role.

While institutions undoubtedly affect economic outcomes, the macroeconomic policies that governments choose to implement may exert just as much influence on the trajectory of their economies as the broader institutional framework within which those policy decisions take place. As a matter of arithmetic, long-run

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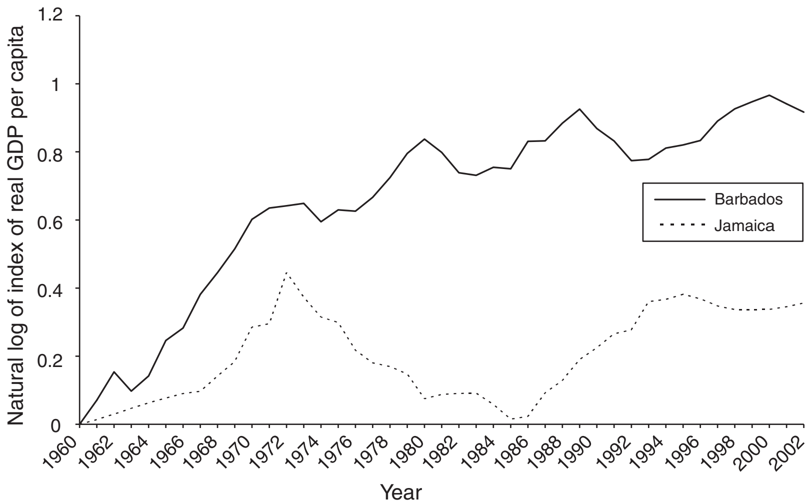

Figure 1. Standards of Living in Barbados and Jamaica Diverge after Independence

income levels are the sum of a series of short- and medium-run growth rates that are heavily influenced by fiscal, monetary, and exchange rate policy (to name a few). This article demonstrates the relevance of the point by examining a very different kind of policy experiment from the ones in the existing literature on institutions and growth.

In contrast to the examples of North and South Korea and East and West Germany, we examine a pair of countries—Barbados and Jamaica—whose income levels diverge over a 40-year stretch in spite of no obvious differences in the institutional arrangements of their economies at the beginning of the observation period.

I. Standards of Living in Barbados and Jamaica

Barbados and Jamaica are both former British colonies, small island economies, and predominantly inhabited by the descendants of Africans who were brought to the Caribbean to cultivate sugar. As former British colonies, Barbados and Jamaica inherited almost identical political, economic, and legal institutions: Westminster Parliamentary democracy, constitutional protection of property rights, and legal systems rooted in English common law. Yet, as Figure 1 demonstrates, the standard of living in the two countries diverged in the roughly 40-year period following their independence from Great Britain.

Figure 1 plots the natural logarithm of an index of real GDP per capita (measured in US dollars) in Barbados and Jamaica from 1960 through 2002. By construction, the value of the index is one in 1960 so that the natural log of the index is zero in 1960. While Barbados has not exactly experienced a growth miracle, its economy performed reasonably well over the 42-year period and substantially better than Jamaica's. To be exact, by 2002, the natural log of the index is 0.917 for Barbados and 0.356 for Jamaica, so that the average growth rate of real GDP per capita for Barbados over the entire sample is 2.2 percent per year (0.917 divided by 42) versus 0.8 percent per year for Jamaica (0.356 divided by 42).

One particularly striking feature of Figure 1 is the sharp decline in Jamaica's standard of living that sets in after 1972. Of course, the first oil price shock in 1973 precipitated a general slowdown in world economic growth, but the central point (laid out in more detail later in the paper) is that growth in Jamaica slowed more dramatically than it did in Barbados. While Jamaica's economy contracted at a rate of 2.3 percent per year from 1972 to 1987, Barbados, whose economy has a similar structure (see Table 1) and was subject to the same external shocks, grew by 1.2 percent per year. In other words, for a 15-year period income per head in Barbados grew by 3.5 percentage points faster than it did in Jamaica.

Table 1—Barbados and Jamaica Have Similar Economies

	Barbados	Jamaica
Exports as percent GDP	58.4	50.0
Imports as percent GDP	68.6	60.7
Agriculture as percent GDP	3.7	5.7
Industry as percent GDP	18.0	33.1
Services as percent GDP	78.3	61.2
Population	300,000	2,700,000
Area (square miles)	166	4,244

Turning from growth rates to levels gives a tangible sense of the impact of these growth-rate differentials on long-run standards of living. In 1960 real GDP per capita was \$3,395 in Barbados and \$2,208 in Jamaica. In 2002 Barbados's GDP per capita was \$8,434 while Jamaica's was \$3,165. The \$1,187 income *gap* that existed between Barbados and Jamaica around the time of independence now stands at \$5,269 dollars. Put another way, the income gap between the two countries now exceeds Jamaica's level of GDP per capita.

Since their initial conditions were similar at the time of independence, it stretches credulity to argue that Barbados and Jamaica diverged because of differences in colonial origins, legal origins, geography, or some other exogenous feature of their economies. We argue below that the explanation for the divergence lies not with differences in institutions but differences in macroeconomic policy.

II. Institutions

Jamaica won its independence from Britain in 1962, Barbados in 1966. At the time they became sovereign nations, both countries possessed the two institutional characteristics that the literature identifies as critical to long-run prosperity: strong constitutional protection of private property and English common law. A brief review of the islands' colonial histories verifies the statement in the preceding sentence.

The English settled Barbados in 1627 and wrested Jamaica from the Spanish in 1655. Both islands entered the modern era as plantation economies that produced sugar and other agricultural commodities using slave labor (Eric Williams 1970). By the end of the eighteenth century, African slaves comprised more than 85 percent of the populations of Barbados and Jamaica. Slavery was abolished in the British West Indies in 1834, and following World War I the region began a process of "constitutional decolonization" that led the islands down a gradual, if difficult, path toward greater self-government (Trevor Munroe 1972). Reporting on his visit to the region in 1922, Major E. F. L. Wood, Britain's Under Secretary of State for Colonies wrote:

> "The whole history of the African population of the West Indies inevitably drives them towards representational institutions fashioned after the British Model. Transplanted by the slave trade or other circumstances to foreign soil, losing in the process their social system, language and traditions.…Small wonder if they look for political growth to be the only course and pattern that they know, and aspire to share in what has been the particularly British gift of representational institutions" (Wood 1921).

Three subsequent empirical observations demonstrate the accuracy of Wood's prediction that the British West Indies (Barbados and Jamaica in particular) were destined to establish institutions that mirrored the mother country.

First, as sovereign nations, both Barbados and Jamaica organized their governments as parliamentary democracies in the Westminster-Whitehall tradition (Anthony Payne 1993). Since independence, Barbados and Jamaica have maintained two-party political systems and consistently held free and fair elections with no unconstitutional transfers of power. While sporadic violence often accompanies elections in Jamaica, neither Barbados nor Jamaica has suffered a coup or civil war, and both countries have a free and vocal press. Four postindependence elections in Jamaica resulted in the ruling party peacefully turning over power to the opposition. Three such transitions occurred in Barbados.

Second, the constitutions of Barbados and Jamaica explicitly protect private property. The joint parliamentary committee that drafted Jamaica's constitution was chaired by Norman Manley—a lawyer, Rhodes Scholar, and father of the nation's future prime minister. Discussing the constitution in front of Jamaica's House of Parliament on 23 January 1962, Manley says:

> "We have put into this constitution a clause which provides that property may not be, in effect, arbitrarily acquired. Property is protected in that it can only be taken under a law which has been passed. And when so taken, it must be taken in accordance with the terms of that law. What the law provides for compensation, you must get. …[I]t is of the highest importance for a country like Jamaica to let the world know that…people can come here to invest… fully protected by the laws of the land…" (Manley 1962, 306).

Barbados, which attained full independence four years after Jamaica, adopted a constitution with an effectively identical coverage of private property. Both constitutions assert that property cannot be compulsorily acquired except under written law that describes a procedure for determining and providing compensation and grants claimants the right of appeal to a court (Chapter 3, Section 16, of Barbadian Constitution; Chapter 3, Section 18, of Jamaican Constitution). The constitutions also delineate similar sets of exceptions to this clause, such as cases where property is acquired in satisfaction of a tax, property is in a condition dangerous to the health of others, or property is acquired to pay debt of the insolvent.

Third, Barbados and Jamaica adopted legal systems based on English common law (Rose-Marie Antoine 1999). Describing the essence of this adoption to the Philadelphia Bar Association in 1967, Manley says: "As to the law, we took over the English common law holus bolus. But what was more important we took over the structure and machinery which England built up for the administration of justice" (Manley 1967, 340). For most of their histories, both countries shared the Judicial Committee of the Privy Council in England as their highest court of appeals.

Because Barbados and Jamaica possess similar economic institutions and legal systems, neither the property-rights nor legal-origins theory of long-run income determination can explain their postindependence divergence. Although the institutional structures of Barbados and Jamaica are very close, the same cannot be said of their approaches to macroeconomic policy.

III. Macroeconomic Policies

When Jamaica gained independence in 1962 the Jamaican Labor Party (JLP) held a parliamentary majority. For the next ten years the JLP remained in power and GDP per capita grew at a rate of 5.4 percent per year, with the lion's share of growth stemming from two principal sources: strong US growth in the 1960s created a robust export market for Jamaican bauxite; and rising incomes in North America boosted growth in Jamaica's tourism industry.

But all was not well. In classic Dutch Disease fashion, growth in the bauxite sector drove up the relative price of nontradeables, reducing the competitiveness of Jamaica's agricultural sector and precipitating an exodus of workers from the countryside to the cities (Carl Stone and Stanislaw Wellisz 1993). Because of strong unions, wages in other sectors did not adjust downward to absorb the excess labor released from agriculture (Caribbean Policy Research Institute 2005). Consequently, during its first decade of independence Jamaica experienced the odd combination of strong growth coupled with an unemployment rate that rose from 13 percent in 1962 to 23.2 percent in 1972.

Rising unemployment, income inequality, and the attendant societal tensions proved too much for the JLP at the ballot box. In 1972 the People's National Party (PNP) rose to power under the leadership of Prime Minister Michael Manley (son of Norman) and the promise of "democratic socialism." The two cornerstones of democratic socialism and the PNP's economic policies were "self-reliance" and "social justice." Self-reliance translated as extensive state intervention in the economy. The PNP nationalized companies, erected import barriers, and imposed strict exchange controls (R. DeLisle Worrell 1987). Social justice meant income

TABLE 2—ECONOMIC POLICY AND PERFORMANCE IN BARBADOS AND JAMAICA DIVERGE AFTER 1973

	Barbados		Jamaica	
	1966–1972	1973–1980	1962–1972	1973–1980
Growth rate of GDP per capita	6.0	2.7	4.2	−4.3
Fiscal deficit, percentage of GDP	2.7	5.3	2.3	15.5
Inflation	6.0	14.8	4.4	23.0

redistribution through job creation programs, housing development schemes, and subsidies on basic food items.

Whatever merits the PNP's economic program may have had, it was expensive. Government spending rose from 23 percent of GDP in 1972 to 45 percent in 1978. Revenue did not keep pace with the rise in expenditure. From 1962 through 1972 Jamaica's average fiscal deficit was 2.3 percent of GDP (see Table 2). In contrast, from 1973 to 1980 the average fiscal deficit was 15.5 percent of GDP! The PNP financed much of the deficit by borrowing directly from the Bank of Jamaica. Predictably, inflation rose. From 1962 to 1972 inflation averaged 4.4 percent per year. By 1980 inflation was 27 percent per year, investment had collapsed (to 14 percent of GDP down from 26 percent in 1972), and the PNP was voted out of power.

Because Jamaica's reversal of fortune coincided with the oil price shock of 1973 and the onset of worldwide stagflation, it is tempting to blame the country's downward spiral on external events. While many have done so (see Manley 1987), even a cursory comparison with Barbados makes it difficult for an objective observer to embrace that conclusion.

The inflation rate in Barbados also spiked in the early 1970s, hitting a peak of 39 percent in 1975, but Barbados's policy response to the external shocks that precipitated the spike could not have been more different from Jamaica's. First of all, Barbados avoided nationalization, kept state ownership to a minimum, and adopted an outward-looking growth strategy (Courtney Blackman 2006, 390). Second, instead of taking an accommodative stance that delayed the inevitable retrenchment needed to adjust to higher energy prices, policymakers in Barbados kept government spending under control. While the fiscal deficit in Barbados did climb to 7.7 percent of GDP in 1973, by 1978 that number was down to 2.9 percent. Since much of deficit financing comes from the central bank, by extension, Barbados also ran a tighter monetary ship than Jamaica. Table 2 summarizes the net result of the difference in macroeconomic policy in Barbados and Jamaica over the two periods.

IV. Exchange Rate Policies

In 1975 Barbados pegged its currency to the US dollar at a parity of B$2: US$1. The parity came under threat when Barbados suffered a deep recession in the early 1990s and real GDP per capita contracted by 5.1 percent per year from 1989 to 1992. In the midst of the crisis in 1991, Barbados entered formal negotiations with the International Monetary Fund (IMF) to request financial assistance. Among other things, the IMF recommended devaluation to stimulate production and return the economy to full employment. Deeply attached to the stability of their currency, the Barbadians resisted the recommendation. Instead of devaluing, the government began a set of negotiations with employers, unions, and workers that culminated with a tripartite protocol on wages and prices in 1993.

Under the 1993 Wage and Price Protocol, workers and unions assented to a one-time cut in real wages of about 9 percent and agreed to keep their demands for future pay raises in line with increases in productivity. Firms promised to moderate their price increases, the government maintained the parity of the currency, and all parties agreed to the creation of a national productivity board to provide better data on which to base future negotiations.

To be sure, the protocol involved costly bargaining. When negotiations began, public demonstrations broke out and the government's wage-cut proposal was challenged in court, all the way up to the Privy Council (Alvin Wint

2004, ch. 3). Nevertheless, the center held. The fall in real wages helped restore external competitiveness and profitability, thereby achieving the same result as a devaluation but without the risk of triggering an inflationary spiral. The economy recovered quickly. From 1993 to 2000 GDP per capita grew by 2.7 percent per year.

Unlike Barbados, Jamaica devalued its currency several times between 1975 and 2002. From this fact, many observers draw the specious conclusion that the difference in exchange rate policy accounts for Barbados's superior economic performance[1]. But Barbados's fixed exchange rate did not cause its economy to outperform Jamaica's. Rather, the proximate source of Barbados' superior performance was a set of growth-facilitating policies—monetary restraint, fiscal discipline, openness to trade, and ultimately wage cuts to restore competitive unit labor costs—that had the side effect of enabling the monetary authority to maintain the exchange-rate parity without losing external competitiveness. In contrast, Jamaica's policies were never consistent with maintaining commitment to any parity the government might have wanted to adopt.

The differences in exchange rate policy do, however, raise an important issue. Faced with a scenario like that of Barbados in 1991, would Jamaica be able to achieve the social consensus needed to adopt the measures required to avoid a competitive devaluation? As stated in the previous paragraph, we think the Jamaican record speaks for itself. Answering the deeper question—why do some democratic societies (of which Barbados is just one example) manage to reach constructive policy compromises while others (such as Jamaica) do not?—remains an important research challenge.[2]

V. Conclusion

It may be tempting for readers to regard this paper as a quaint tale of two exotic islands better known for their beaches, music, and Olympic sprinters than their significance in the global economy. On the contrary, we think that important general lessons lie at the heart of this Caribbean parable. Recent work focuses on the very long-run effects of institutions to the point of exclusion of almost all other factors. But the macroeconomic decisions of governments can exert just as much influence on the trajectory of the economy as the institutional framework within which those decisions take place. Countries have no control over their geographic location, colonial heritage, or legal origin, but they do have agency over the policies that they implement. Of particular importance for small open economies (i.e., most countries in the world) is the response of policy to macroeconomic shocks such as a fall in the terms of trade. Pedestrian as it may seem, changes in policy, even those that do not have a permanent effect on growth rates of GDP per capita, can have a significant impact on a country's standard of living within a single generation.

[1] Hon. Edward Seaga, "The Caribbean Single Market: Beneficial Path or Wayward Journey," *Jamaica Observer*, February 10, 2006.

[2] See Donald Robotham (1998) for clues about answers to this question for Barbados and Jamaica.

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