The wealth of nations

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Review by Martin Wolf

Do political institutions hold the key to a country's economic success?

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Edward Matthew Ward's 'King James II Receiving the News of the Landing of William of Orange in 1688' (c1851)

Why Nations Fail: The Origins of Power, Prosperity and Poverty, by James A Robinson and Daron Acemoglu, *Profile RRP£25, 464 pages*

Why are some societies democratic, prosperous and stable and others autocratic, poor and unstable? These are perhaps the most important questions in social science.

The authors of this thought-provoking book are certain the answer lies in politics. Thus, Daron Acemoglu of the Massachusetts Institute of Technology and James Robinson of Harvard argue that "countries differ in their economic success because of their different institutions, the rules influencing how the economy works, and the incentives that motivate people". These are all ultimately the product of politics.

The distinction *Why Nations Fail* draws is between "extractive" and "inclusive" economic institutions. The purpose of the former is to ensure the prosperity of the few at the expense of the many. The aim of the latter is to allow everybody to engage in the economy, on an equal footing. Slavery and feudalism are extractive economic institutions. Law-governed market economies are inclusive economic institutions.

What determines these economic institutions? To answer this question, the book offers a parallel distinction between "extractive" and "inclusive" political institutions. The defining characteristics of inclusive institutions are the combination of centralisation with pluralism: the state must be strong enough to keep private power in check and yet be controlled by widely shared political authority. All other political arrangements are extractive.

The thesis of the book, then, is that extractive political institutions will create extractive economic institutions, while inclusive political institutions will create inclusive economic institutions.

Moreover, both of these alternatives are subject to positive feedback. If a few people control political institutions, they will rig the economic game in their favour. This, in turn, gives the holders an incentive to fight to preserve power and others an incentive to displace them. The political game will be far less fraught and so more stable under inclusive political institutions, since people can obtain a high standard of living from voluntary exchange.

Like the English Whigs and liberals of the 18th and 19th centuries, the authors regard England's "Glorious Revolution" of 1689 as the moment when the country shifted decisively towards inclusive political and economic institutions. From this, they argue, came the industrial revolution and so the transformation of the world.

Yet the authors do not adopt the supposed Whig view that progress is inevitable. Certain critical junctures do occur in history. But the outcome is "never certain, and even if in hindsight we see many historical events as inevitable, the path of history is contingent. Nevertheless, once in place, inclusive economic and political institutions tend to create a virtuous circle, a process of positive feedback, making it more likely that these institutions will persist and even expand." This, then, is a contingent version of the Whig view of history.

Economists will find the underlying thesis familiar and appealing. But is it true? If so, is it the whole truth? The answer to the first of these questions is: yes. The answer to the second is no.

Economic institutions are indeed decisive for prosperity. The examples given by the authors are persuasive on this. They begin with Nogales, a city cut in half by the fence that divides Mexico from the US. The American Nogales is roughly three times as rich as the Mexican one. Such examples can be repeated: contrast South and North Korea, for example.

It is also correct that political institutions shape economic institutions and are shaped by the latter in turn. Contrast the fortunes made by creative entrepreneurship in law-governed countries with those made by corruption, extortion and privilege in others.

Thus, the thesis contains substantial truth. But it certainly does not contain the whole truth: it omits too much for that. Indeed, the book contains a surprisingly cursory discussion of rival theories. These it summarises as "geography", "culture" and "ignorance" of policymakers. The authors argue that none of these explain current poverty.

There is much truth in this, yet it is not convincing that geography and resources are as unimportant as they argue. Did the discovery of the Americas have nothing to do with the subsequent rise to wealth and power of the British Isles? Would the same results have followed if England had been a landlocked country in central Asia? Equally, was it feasible for countries that lacked copious running water or access to iron and coal to have started an industrial revolution in the 18th century?

Similar points apply to the limited opportunities available to today's small landlocked countries surrounded by war-torn neighbours. Again, the authors argue that disease is not a cause of poverty, but a consequence. Yet the heavy disease-load of parts of the tropics, notably in Africa, must be an obstacle to development, at least in the medium term.

I agree, too, that cultural explanations can be highly misleading. Yet can one make sense of the progress of European industry and technology without the shift towards scientific explanations of the world?

Furthermore, the most economically successful emerging economies of the past five decades were Hong Kong, Singapore, Taiwan and South Korea. In none of these places did rapid development begin under inclusive political institutions, as the thesis would demand.

Whatever one's doubts, the book raises three important issues. First, what can external assistance achieve? The argument here is that in the presence of extractive political and economic institutions, all outsiders do is reinforce the plunder machine. For similar reasons, the exploitation of mineral resources may make development prospects worse, not better. Obvious possibilities for outsiders include publishing the proceeds of resource exports, eliminating overseas havens for illegally acquired wealth and supporting independent media.

Second, although the authors do not discuss this possibility, might developments in advanced democracies shift the economy away from inclusive institutions? An obvious threat is the interconnection between big banks and the state; another is the role of money in politics.

Finally, the authors argue that China has an extractive political system, which militates against necessary innovation and creative destruction. China's rapid development is driven, instead, by import of foreign technologies and extraordinarily high investment. Such strategies, they argue, will reach their limits long before China catches up with the current advanced economies.

Many today expect China to liberalise, democratise and move towards an economy grounded in the rule of law. It is just as possible that, threatened by a loss of political control, the Chinese authorities would let the economy stagnate instead. The important prediction is that the current combination of a communist state with a market economy will enter serious crisis.

This is an intellectually rich book that develops an important thesis with verve. It should be widely read. But it is not the last word on the hugely important questions it raises. Simplification is necessary in research. But it has limitations in providing a grand theory of everything.

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Acemoglu EconTalk Interview Transcript [Recording date: March 14, 2012.]

Russ: Your book is an unbelievably ambitious and sweeping account of historical economic issues. What are you trying to explain? What are you trying to understand and illuminate with this book?
Daron Acemoglu (co-author, with James Robinson of *Why Nations Fail*): I think one of the key questions that gets many people into social science is the same one that Adam Smith pulls: *The Wealth of Nations*, why some countries are poor, why some countries are rich. Two hundred and fifty years or so after Adam Smith wrote the book that shaped economics, the puzzle is deeper. The gaps between rich and poor nations have widened, even though we live in a very integrated world. And we haven't developed a satisfactory and comprehensive answer to what factors are at the root of these differences and why there are such glaring gaps in prosperity across nations. That's the question that we are trying to answer in this book.
Russ: There are a number of attempts that have been made to explain it. And of course it's possible there isn't one theory that explains everything. But we, as human beings, seem to be drawn to single-idea theories. Talk about some of the alternative explanations that you reject in the book that have been prominent and used to explain growth and poverty.
Daron Acemoglu: So, there are a huge number of them. But there are a couple of those that are very influential when you look at the writings of academics or pundits or journalists. One of them that perhaps is the least favorite among academics but still kind of has a presence is the geography hypothesis, that some places are rich because they have a favorable climate or--
Russ: Natural resources--
Daron Acemoglu: Yeah, good natural resources. And so on. And I think the evidence doesn't support that. There's a very interesting thesis that Jared Diamond's *Guns, Germs, and Steel* sort of formulated, which is that really the geographic factors determined where early civilizations blossomed, and that, almost in a deterministic way, shaped which societies are more developed today. And we go in detail about why we sort of disagree with the thesis and why it's not really capable of explaining the patterns of what we see around us today; but they are interesting sort of variants of this.
But the one that I think is more kind of popular among journalists and academics is a sort of cultural hypothesis. Max Weber was the person who developed the most famous example of this, or the Protestant ethic and constructive process; and Catholics. That's not as popular perhaps today. But if you sort of ask people why China is doing so well: Well, it is about Chinese culture. Why the Mexicans aren't doing so well or why sub-Saharan Africa is poor: It's all about national cultures or some cultural traits shared by a variety of individuals; or it would be Muslim versus non-Muslim. And again, we try to explain why such explanations are very limited. China has had the same Chinese culture but it did extremely badly under Mao
Russ: They did extremely badly for a few centuries.
Daron Acemoglu: Yes, but even more recently, they did extremely badly 40 years ago when they had terrible incentives under Mao, and suddenly started doing well when the incentives changed. And all the while the same people in Hong Kong were doing very well. That should tell you something. But the one I think is most popular among perhaps the listeners to this podcast, or more broadly among economists, is what we call in the book the Ignorance Hypothesis. And we are sort of naturally drawn to that as academics because our business is to think of good policies and judge which policies are bad, and so we think that that's really important. Many of us--not me--but many of us do advise governments so we think that the advice that governments get is really important. So, if only Greece listened to the right advice, or if only Ireland did the right policy, or the U.S. President had the right policy.
Russ: There's something to that.
Daron Acemoglu: Yes. Obviously we, as economists, know, can analyze policy better; there's good policy and there's bad policy. But what we try to articulate in the book is when you look at the policies and choices that are most consequential for economic development, they don't get it wrong by mistake. They get it wrong by design. It's not that people don't know what's good or what's bad, but just like Mugabe choosing policies that would destroy the economy with 100,000% inflation, and total chaotic land grabs--they are not about achieving prosperity for the nation. They are either clinging to power at any cost or enriching a specific group of people, including themselves, at the expense of the rest of society. So, that's the sense in which we say they get it wrong not by mistake, not by ignorance, but by design.