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Inequality and Institutions

A Review Essay on *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* by Daron Acemoglu and James A. Robinson (Random House, 2012)

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The degree of economic inequality in the world today is truly staggering. The nominal GDP per capita of the richest country in the world, Luxembourg, is many hundreds of times greater than that of the poorest, the Democratic Republic of the Congo (Figure 1)(International Monetary Fund, 2011). Rich countries provide services such as law and order, schools, and transport infrastructure to their populations and foster healthier citizens, with increased longevity. Those of us fortunate enough to live in such countries take for granted having such things as electricity, and running water in our houses. In contrast to many poorer countries, the governments of rich countries tend not to persecute their own citizens. Furthermore, there is a striking correlation between GDP and a state's stability (Figure 1); poorer nations are likely to have states that fail to meet the needs of their people and are at greater risk of collapse.

The causes of these global inequalities are the subject of the new book, *Why Nations Fail,* by Daron Acemoglu (Professor of Economics, Massachusetts Institute of Technology) and James A. Robinson (Professor of Government at Harvard University). Acemoglu and Robinson's (A&R) argument is that variation in institutions between societies is key to explaining differences in national wealth in the modern world. This focus on institutions is contrasted with other theories that have stressed geographical or ecological factors (e.g. parasite loads, or antiquity of agriculture), cultural factors (e.g. Weberian ideas about the Protestant work ethic), or lack of knowledge about the best course of action (what they label, the *ignorance hypothesis*). I shall return to these alternative explanations later, but I shall first outline the role institutions play in creating economic growth according to A&R. Choosing between these alternatives is not just of academic importance; issues of income inequality and political stability are some of the most important practical

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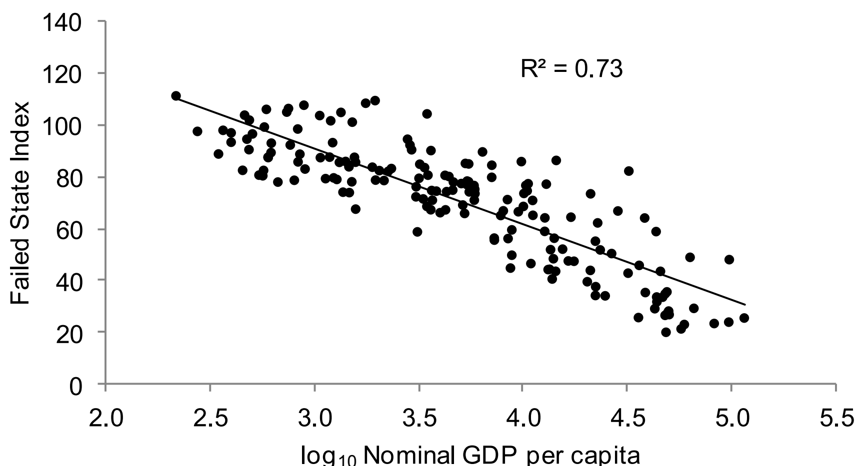

Figure 1. State instability decreases with increasing GDP (International Monetary Fund, 2011). The Failed State Index (Fund for Peace, 2012) is based on range of indicators including Mounting Demographic Pressures, Uneven Economic Development along Group Lines, and Suspension or Arbitrary Application of the Rule of Law and Widespread Human Rights Abuse. The straight line is the OLS regression line.

issues facing us today. As well as directly affecting the lives of people in afflicted countries, in our increasingly globalised world the problems created by state failure in one part of the world can have far reaching consequences. Any attempts to create a more equitable world and raise standards of living for everyone will rely on us understanding the causes of inequality, and, as the sub-title of this book puts it, *the origins of power, prosperity and poverty*.

For A&R, economic institutions provide the engine of economic growth by enabling individuals to trade and start businesses easily, and by creating incentives for them to commit to longer-term investments, to develop and take up new technologies, and improve their skills and knowledge through education. In turn the effectiveness of economic institutions is determined by political institutions and the factors that govern how political power is spread across members of a society. A&R classify political and economic institutions as being either *inclusive* or *extractive*. Inclusive economic institutions are those that enable and encourage the majority of the population to participate freely and securely in economic activities that suit them. Such institutions remove barriers to entry for new ideas and businesses, and facilitate a level

economic playing field. These inclusive economic institutions are supported and made possible by inclusive political institutions. These institutions are pluralistic, meaning that political power is not concentrated solely in a limited number of individuals, but is spread more broadly.

Extractive institutions, on the other hand, are those that are designed to benefit a few, privileged elites, even though any wealth generated is based on the hard work of the majority of the population. For example, in Guatemala since 1500 political power has been concentrated in the hands of 50 or so families, who represent only around 1% of the population. In Uzbekistan 2.7 million children are forced to spend several months away from school picking cotton. Children are only paid a few cents for the 20-60 kg of cotton they have to pick each day, even though the world price for a kilogram of cotton was approximately $1.40 (US) in 2006, and any child failing to meet their quota is punished in front of their class mates. Every farmer must devote 35% of his land to cotton, but the government does not provide incentives for farmers to invest in the mechanization of harvesting via combine harvesters; forced child labour is a much cheaper option. The average income is only around $1000 per year, and one-third of the country lives in poverty, yet the ruling elites, who control the cotton trade, have become extremely wealthy. Extractive institutions are not conducive to economic growth because they do not provide the necessary incentives for most individuals to act in ways that would generate wealth. Furthermore, elites may focus on protecting their own power base even if it is not in the interest of the majority of the population. Under inclusive institutions older technologies or production systems can be replaced by newer, more efficient innovations. This process is described as creative destruction, and is most dramatically illustrated by the industrial revolution. However, under extractive institutions the elites may have a vested interest in maintaining the status quo as their power is intimately linked to the older technology. For example, while Western Europe was investing heavily in developing steam railways in the nineteenth century the absolutist regimes in the Habsburg Empire and Russia opposed the development of large rail networks because they feared it would bring the developments of the industrial revolution, and threaten the agrarian and feudal system that was the source of their power.

A&R flesh out these ideas with a large number of further examples from history and the present-day that illustrate their thesis. Particularly compelling are those that represent natural experiments, where certain conditions allow for other non-institutional factors to be held constant.[1] For example, the book

[1] Robinson has co-edited a book (Diamond & Robinson, 2010) on the use of natural experiments in history that illustrates this approach with several quantitative and qualitative examples, and which I have previously reviewed here (Currie 2010).

opens with a description of the city of Nogales, which straddles the border of the US and Mexico. Despite the identical geographical backdrop, and cultural makeup of the population the residents of the northern, US part of the city have average incomes three times higher than that of their counterparts in the southern, Mexican part of the city. Levels of education, public health, and law and order are also much worse on the Mexican side of the border. The difference is down to the more inclusive institutions of the US, which have fostered much greater economic growth and well-being for its citizens. A similar situation can be witnessed on a much larger scale on either side of the demilitarized zone on the Korean peninsula.

Throughout the book A&R stress historical contingency and path dependence. Societies either develop or do not develop inclusive institutions because of the institutions they already possess, and the particular historical circumstances they find themselves in. For example, the situation in Nogales, and the countries of North and South America in general, is explained by differences in early colonial practices. These policies and institutions were forged as a result of the different forms of socio-political organization and resources of the native societies the early colonists encountered. In South America the conquistadors found sedentary, agricultural societies, wealthy with gold and with high degrees of social stratification. The Spanish were able to insert themselves at the top of the hierarchies of these societies and take advantage of existing extractive institutions and add their own. For example, in the late 1500s the Spanish were able to displace large numbers of men and set them to work in the mines at Potosí (in modern-day Bolivia) by reinstituting the *mita,* which was an Inca institution of forced labour for running plantations. In North America, by contrast, there was no gold, and agriculture was more difficult. Native population densities were low and strong hierarchical organization was generally absent, making the populations less easy to control. Even attempts to import hierarchical organization from Europe did not work in the immigrant population as those at the bottom were no longer willing to accept their position in society. As a result the US developed land ownership laws that were quite egalitarian, and a patent system (open to all members of society) that allowed ownership of intellectual property, and competitive banking institutions that kept interest rates low and allowed people access to capital to start businesses. So, while the institutions developed in the US allowed for sustained economic growth and widespread prosperity, the institutions in South America did not and only the privileged few benefited from the wealth that was generated.

A&R also talk about how small differences in initially similar societies may lead to institutional arrangements to drift apart, this combined with differing responses to certain key events, or critical junctures, can result in dramatically different outcomes. For example, in the 14th Century, feudalism was

widespread across Europe. A&R argue that in Western Europe the demographic consequences of the Black Death, which wiped out up to 50% of the population in Britain, increased the power of workers to demand rights (as demand for labour now outstripped supply), creating a more inclusive labour market, and eventually the end of serfdom. In Eastern Europe, however, small differences in terms of the greater size of land holdings, and the weaker and less populous state of towns, meant that feudal lords could more effectively control the serf population after the Black Death. By 1800 serfdom had disappeared from Western Europe, but was still practised in Germany, Eastern Europe and Russia. As discussed earlier these institutional differences later had implications for the ease of spread of the Industrial Revolution and its economic benefits.

A&R arguments about the importance of inclusive economic and political institutions in driving economic growth, and conversely the role of extractive institutions in preventing it, are convincing. The strengths and weaknesses of A&R's analysis can be seen by examining how it relates to other theories of economic inequality. A&R's arguments serve as a compelling antidote to the ignorance hypothesis, and their historically informed analyses help to illustrate how economic development does and does not occur. However, in contrasting their ideas with other theories I argue that A&R have set-up a number of false dichotomies. Despite A&R's focus on historical contingency and path dependence, their theory is actually logically compatible with other ideas that stress the role of other factors that drive the evolution of inclusive institutions, favouring their development in some regions but not others.

The value of A&R's analysis is best highlighted by comparing it to an alternate view of the reasons for the lack of development in some countries. According to A&R the assumption of most economists is that rulers in poor economies are well-meaning but lack sufficient knowledge about what to do to improve their nation's performance. In contrast, A&R's analysis of extractive political and economic institutions illustrates clearly how those who hold power can actively prevent beneficial changes because they interfere with their own vested interests. Their historically informed approach also highlights the need to think differently about concepts such as the dual-economy; in many developing countries there are modern, urban sectors using advanced technologies, and more rural, agricultural sectors with 'backward' institutions and technologies. For development economists the task has been to understand how to get people to transfer from the traditional to the modern sector. A&R argue that rather than being an inevitable outcome of development the dual-economy is actually an artefact of extractive colonial practices. The success of the modern sector in developing countries is based on the cheap labour of the deprived, backward sector, and there is actually little or no movement of people from the 'traditional' to the modern sector. These

insights obviously have important consequences for policy decisions about the most appropriate way to help poor countries. One conclusion is that foreign aid (of which only 10–20% ever reaches its target due to corruption and incompetence) is unlikely to be of much help unless it is linked to institutional change, particularly the kind that empowers broader segments of these societies.

A&R also argue that their analysis is an alternative to other theories that stress the role of geographical or ecological factors. Ideas such as those of Jeffrey Sachs and Jared Diamond, who argue that some regions of the world have had geographical and ecological conditions that favour the development of wealthy societies, either through the effects of disease and soil quality on agricultural productivity (particularly in the tropics)(Sachs & Malaney, 2002), or through historical endowments that gave societies a head start in the development of agriculture and other technologies (Diamond, 1997). These hypotheses are dismissed rather too readily either through recourse to the natural experiment examples, where geographical differences are held constant but economic conditions are still very divergent, or through the selection of examples that don't appear to conform to the predictions of these theories. This highlights two problems with A&R's analysis as it currently stands: 1) The descriptive, case study approach adopted here makes the systematic appraisal of alternative hypotheses difficult, 2) The focus on historical contingency of the development of certain types of institutions overlooks or down-plays more general patterns about where and when these institutions have tended to develop.

The case studies presented by A&R are certainly compelling and do a great job of describing the kinds of institutions that enable large numbers of people to participate in economic activities, or those that exploit the work of the many for the benefit of the few. However, the lack of quantitative analyses or a systematic approach to the analysis of different societies means that it is not possible to assess how well this hypothesis explains the data in comparison to the alternatives. As A&R point out, there are examples of economic growth under extractive institutions. For example, the Soviet Union achieved remarkable economic growth from the 1930s to the 1970s due to the state facilitated switch from agricultural to industrial modes of production. A&R argue, quite cogently, that such cases only occur when elites can allocate resources to highly productive activities, and that any growth is short-lived as the economic incentives and processes of creative destruction are not present to enable sustained growth. What would be needed to assess this as a general claim, though, is comparable data on the amount and duration of economic growth under different institutional arrangements. Furthermore, the selection of a few cases that do not fit a competing hypothesis cannot be taken as a strong rejection of that hypothesis, as it is open to the possibility of cherry-

picking. For example, A&R argue that the development of wealthy, complex societies such as the Incas and the Aztecs in the tropical regions of the Americas refutes Sachs' hypothesis. However, this does not disprove the idea that *in general* tropical regions face conditions that make development less likely. Indeed, quantitative analyses show that, for whatever reason, more hierarchically complex societies are indeed generally found at higher latitudes (Currie & Mace, 2009).

In dismissing the role of ecological and geographical factors and stressing, more or less, that institutions are the only things that matter, A&R are also setting-up a false dichotomy between geography and institutions as causes of economic performance. The economic behaviour of individuals is of course going to be governed by institutions as these set the rules by which individuals cooperate and interact. However, the historical development of these institutions may ultimately be linked to other factors, which can be geographical or ecological in character. This distinction between proximate and ultimate causes is well-established in evolutionary theory, and helps avoid conflating logically distinct levels of explanation (Mayr, 1961; Tinbergen, 1963). Under A&R's analysis the main ultimate cause of institutions is the presence of other institutions, and this thinking underlies their discussion of virtuous and vicious circles. The development of certain institutions, such as the 'rule of law,' is seen as particularly important as they act as a kind of 'gateway drug' that aids the development of further inclusive institutions. Implicit in this view is that there are no background factors making it more or less likely that favourable institutions will develop. However, this view is somewhat contradicted by some of the examples that A&R employ. For example, their analysis of the causes of the economic disparity between North American countries and South American countries rests on differences in native populations that can be plausibly linked to underlying ecological conditions. It is therefore important to understand the role that ecology and geography have had in shaping the development of the institutions that enable better functioning societies. For example, having a long history of political complexity and centralization is linked to political stability, and the rate of economic growth (Bockstette, Chanda, & Putterman, 2002), and there are a number of theories that link the long-term evolution of socio-political complexity to ecological or geographical factors such as the long-term presence of agriculture (Diamond, 1997) or the interaction between the nomadic pastoralists of Steppe regions and settled agriculturalists (Turchin, 2009). Geographical and ecological factors should not be dismissed too readily, and an understanding of the ecological context in which societies evolve may help guide efforts to establish better institutions in less developed countries.

Overall, *Why Nations Fail* is an impressive work. The case studies are well chosen and drawn from a wide range of geographical and historical contexts,

which lends support to the generality of the argument. The authors' clear and engaging writing style means that their arguments should be intelligible to a wide audience. The narrative approach favoured here does a good job of describing the kinds of institutions that either aid or hinder economic growth. The distinctions made between inclusive and extractive institutions, and the role of political institutions setting the scene for economic activities are well-made points that could potentially have important practical applications for economic development policies. However, the distinctiveness of the large number of narrative examples can tend to get diminished, particularly as the examples are often of the form, *society X did well because they possessed inclusive institutions, society Y fared badly because they had extractive institutions*. Also, the focus on historical contingency in these narratives makes A&R's theory feel descriptive rather than truly explanatory at times. From a personal point of view, I would have preferred that this pattern was broken somewhat with the use of some more quantitative examples to illustrate their arguments (as indeed A&R themselves have provided in previous work, e.g. Acemoglu, Johnson, & Robinson, 2001). The lack of quantitative analyses also means that the book works best as a showcase of their own thesis of the role of institutions in economic development rather than a refutation of "*theories that don't work*" (the title of chapter 2 of the book). The long-term historical perspective employed by A&R is likely to be of particular interest to the readers of this journal, and does a good job of highlighting the value of comparative approaches in the historical and social sciences. The means are there to put this approach on a more systematic and quantitative footing in order to test between competing hypotheses about the processes affecting economic performance (Turchin et al. 2012). In synthesizing a large amount of information across time and space, and clearly laying out a hypothesis about why some nations fail and some succeed this book represents an important step in this process. I would thoroughly recommend this book to anyone interested in understanding the historical factors that have shaped inequality in the modern world, and what can potentially be done to bring the benefits of economic growth and political stability to everyone.

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