Why Nations Fail: The Origins of Power, Prosperity, and Poverty

DARON ACEMOGLU and JAMES A. ROBINSON
Profile Books, London, UK, 2012, pp. 529

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doi: 10.3326/fintp.36.3.5

* Received: May 28, 2012
Accepted: June 4, 2012

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FINANCIAL THEORY AND PRACTICE
36 (3) 321-328 (2012)

What makes countries end up in persistent and permanent poverty? Why is Mexico much poorer than the United States? Why is Latin America so fundamentally different to North America? How is it possible that an average American is 40 times richer than an average Sierra Leonean? Is it climate, geography, culture, or could it be the ignorance of domestic leaders? Acemoglu and Robinson suggest it's none of these – rather, the real reason behind the poverty trap and significant between-nation differences lies in the role of political and economic institutions. Politics and the formation of political institutions take centre stage in their book, which formulates the thesis that only within an inclusive political system it is possible for nations to achieve prosperity. The opposite scenario will occur under extractive political institutions where wealth will be accumulated within a narrow ruling elite which will aim to preserve its power thus sentencing a nation to persistent poverty.

In the very beginning of the book the authors hint to the reader how it will be organized – through a series of historical case studies uponwhich they illustrate their theory of institutional change and the consequential success or failure of nations. It starts with the example of Nogales, a city on the US-Mexican border, which is split in half by a fence. One city, in the same geographical position, characterized by the same cultural upbringings, same population, same diseases, but one part three times richer, much healthier, safer, and with higher living standards. The crucial difference is the very border separating the two parts of the city depicting the different institutional settings within them.

The authors make a strong claim that this great divergence on a localized level had its roots in the very start of colonization of North and South America. As the Spaniards came to the Aztec, Mayan and Inca empires they had a single aim of conquering the indigenous population and extracting their wealth. By founding their settlements the colonizers designed a system that would coerce the indigenous people to work for them and extractresources while enriching only the small ruling Spanish elite. This made the Spanish Crown quite rich at the time, as massive amounts of gold and other resources flooded into the country.

The colonization strategy of the English was the same as of the Spaniards – extract the resources and force the indigenous population to work for the colonial elite, which would, along with the Crown, obtain maximum benefits from it. This strategy worked well in India and Africa, but it failed in North America. First of all, they were late. North America was less attractive and much scarcer in gold than South America. In addition, the Native Americans put up far greater resistance and more importantly didn't allow themselves to become enslaved and forced into manual labour for the newcomers. It was up to the settlers to work themselves. At first they were coerced into working by the colony's rulers but this strategy failed due to a range of possibilities for the coerced to escape to the Indians. As a result, the colony needed to create different institutions to create incentives for the set-

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tlers. With more personal freedom came demands for more political freedom. In fact, the authors claim that the historical prelude to the monumental 1774 US Constitution and the colonists' fight for liberty was the formation of the General Assembly in colonial Jamestown in 1619.

It was these initial institutional differences manifested through the limitation of political power, democratic principles, and economic incentives that paved the different development paths of US and Mexico, generating the crucial difference between the two parts of the city of Nogales.

An intriguing case study approach analyzed through the lens of institutional formation is the framework used throughout the book.The emphasis is on how inclusive political institutions can lead to inclusive economic institutions which will lay the foundations of wealth creation and sustainable growth. The combination of inclusive political and economic institutions shapes the incentives needed for a society to prosper. If people have their wealth expropriated, they will lack the incentives to create or sustain it. They will fail to innovate and fail to achieve progress. People need an initial set of institutions to reduce uncertainty and maintain stability.

This initial set of inclusive economic institutions includes secure property rights, rule of law, public services and freedom to contract. The state is relied upon to provide all of these. It is the role of the state to impose law and order, enforce contracts and prevent theft and fraud. When the state fails to provide such a set of institutions it becomes extractive, where its main objective is to satisfy a small powerful elite (whether the ruler of the country, a set of rulers or prevalent interest groups).

Acemoglu and Robinson formulate their central hypothesis around the fact that a strong set of economic institutions which will guide incentives towards creating wealth can only be achieved through more political freedom. Political inclusiveness and the distribution of political power within a society are the key elements that will determine the success or the failure of nations.

To understand and prove this insightful thesis originating from the works of Adam Smith, Acemoglu and Robinson tackle a variety of historical stories of success and failure by applying their robust framework. Very often, as they claim, random historical events can be useful in understanding current outcomes. They refer to these as the critical junctures of history that exploited the initial small institutional differences and led to diverging development paths of nations. One interesting example of a critical juncture that probably contributed to the divergence between Western and Eastern Europe was the bubonic plague, better known as the Black Death, in the 14th century. Another example is the aforementioned different colonization pattern in many countries, the most notable one being between North and South America.

In their pursuit of an explanation for the role of politics in development, the authors touch upon other dominant theories that have tried to explain poor growth and under-development. They stress three approaches: (1) the geographical position of the country (countries in the sub-tropical area), which blames exposure to rough climate, barren land and tropical diseases; (2) the cultural attribute, where the population is to be blamed for not being hard-working (less productive) due to their ethical, religious or cultural boundaries (a famous example here is Max Weber's Protestant ethic argument); and (3) the ignorance of the country's ruling elites, implying that if they had better economic advice, they would be able to emerge from poverty. They also touch upon the dual economy paradigm that blamed African underdevelopment on the co-existence of two sectors within an economy between which social mobility was almost impossible.

Each of these arguments is found faulty by the authors. The rule of a narrow elite that organizes the society for its own rent-extracting interest is a common trajectory every nation followed on its road to poverty.The differences between the two parts of Nogales, two Koreas, or East and West Germany cannot be explained by geography, culture, diseases or ignorance – it could only be explained by a different set of political institutions that resulted in different economic outcomes. As for the African dual economy paradigm, the dual economy was artificially created by the ruling (white) elite that maintained extractive political institutions.

The problem isn't that poor nations remain poor because of outside (or inside) exploitation, economic ignorance or laziness of the population. It lies in the role of politics, and how the ruling elite will organize the country's political and economic institutions. If political institutions are organized as extractive and concentrated in the hands of a narrow elite, then economic institutions will only serve the purpose of the ruling elites extracting the maximum wealth for themselves. If they are organized as inclusive, power being dispersed among the many rather than concentrated among the few, then this institutional environment will create incentives of inclusive economic institutions, where innovation and creative destruction will ensure the creation of sustainable economic growth and development. Becoming a rich nation necessitates the overthrow of the ruling elites and the distribution of power and political rights evenly within a society. The government has to become accountable and responsive to its people, who can then use this security and stability to advance on the economic opportunities available to them.

However, the authors do admit that growth can be achieved within a set of extractive political institutions. The elites can simply reallocate resources into temporary highly productive activities under their control (e.g. from agriculture to industry). But the problem is that this growth is unsustainable in the long run. When the economy runs out of steam, so will rapid growth and the country will first be exposed to an economic and ultimately to a political crisis. The example of the rapid growth of Soviet Russia illustrates this point. It wasn't driven by innovation, but state control and when the foundations for growth were exhausted, nothing came to replace it. The authors predict the same thing happening to China. Even though China is different than Soviet Russia, as it deploys some inclusive economic institutions, the political elites still constrain creative destruction. They mention the example of a Chinese entrepreneur who wanted to compete with big, inefficient state-owned steel companies and ended up in prison as a result. The Chinese anti-entrepreneurship climate, censorship of the media, and technological growth based on adoption of technologies rather than innovation are all signals of an extractive political system in which growth is not sustainable. China can overcome this and reach sustainable growth if it manages to undergo a political reform that will introduce more individual and political freedom. Until then, they are destined to repeat the Soviet scenario.

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The book develops as a fascinating storyline comprising of a multitude of vivid historical examples that support the central thesis of the authors. After identifying the main framework of the analysis in the first four chapters, it takes the reader on a journey through history featuring a number of famous historical and more recent stories of success and failure. This gives the reader an opportunity to see how politics can indeed play an important part in the development of a society.

We see the same historical pattern reoccurring in Venice and Ancient Rome, in Ethiopia and Mayan city-states, in Soviet Russia and Congo, in 18th century Spain, absolutist Austro-Hungary or tsarist Russia. The common characteristic that led them to failure was the extractiveness of their political institutions. Even if they did briefly experience rapid growth (such as the absolutist monarchies or Soviet Russia), this growth was temporary and unsustainable, unless a path towards inclusiveness followed. When Ancient Rome, Venice and the Mayan city-states had even partially inclusive institutions that offered the proper incentives for growth, they managed to experience it. However, when they switched to authoritarianism and usurpation of power by the elites, conflicts emerged and the downfall of their societies began. Inclusiveness was replaced by extractiveness and consequently development was reversed.

In England, something different happened. Whilst in other countries repression was the dominant type of social order, in England the demand for more property rights and a greater political voice set the stage for sustained growth and prosperity.

Creative destruction and technological innovation made people richer, led to a new distribution of wealth, and more importantly new distribution of power in the society. The elites, afraid of losing their privileges, opposed this process. They felt threatened and formed barriers to innovation. But in England, through political conflict, the rising wealth of merchants and manufactures was able to overcome this opposition and constrain the power of the sovereign, initiating the beginning of a new historical era.

This is precisely why the Industrial Revolution started in England, not anywhere else in the World. The Industrial Revolution developed on the trails of the Glorious Revolution. It was the importance of a broad coalition representing the people that succeeded. If there had not been such a broad coalition, one elite would have simply overtaken the other and continued with extractive institutions (as happened briefly during the dictatorship of Oliver Cromwell). Irreversible political change and the switch to inclusiveness transformed the economic incentives in the society and created enormous wealth and prosperity.

But not all countries followed this rapid development and not all countries embraced the benefits of the Industrial Revolution, some even for a long time. It is due to these defining moments of history (critical junctures) where the authors explain why all those countries that developed on the ruins of the Ottoman Empire tend to be relatively impoverished (provided that they are not oil exporters). The Ottoman Empire, instead of embracing change, felt threatened by it and sentenced its minions to another 200 years of extraction and poverty. The opposition to the elites in the Ottoman Empire never grew as strong as it did in England, which is why inclusive institutions never developed there. The same is true for a multitude of countries at the time, including Spain, Austro-Hungary, Russia or China.

Wherever those with political power felt threatened by technology and innovation, they prevented it, and by doing so they effectively prevented wealth creation and prosperity.

The summing-up of their analysis is through explaining the vicious and the virtuous cycles of prosperity. Whenever inclusive institutions are present, the virtuous cycle will create positive feedback loops that will prevent the elites overcoming them. It will make sure that inclusive institutions expand and become persistent. Similarly, in the case of extractive institutions vicious cycles will generate negative feedback loops that will prevent progress.

In order for the virtuous cycle to work the first precondition is to have pluralism, which will constitute the rule of law and lead to more inclusive economic institutions. Inclusive economic institutions will remove the need for extraction since those in power will gain little but lose a lot if engaged in a repression and constraining democracy. Finally, they also recognize the importance of free media to provide information on threats against inclusive institutions.

The virtuous cycle explains how the reforms of the political system in England or the US became irreversible, since those in power understood that any possible deviation would endanger their own position. The examples of British consolidation and its slow, contingent path to democracy in which the people gradually demanded and gradually received more rights; or the trust-busting in the US in the beginning of the 20th century; or the failed attempts of President Roosevelt to limit the power of the US Supreme Court illustrate this point.

Pluralism and the rule of law were critical conditions leading to the limits of political power that made the virtuous cycle possible in the US and Britain. And this was precisely why Fujimori's Peru, Chavez's Venezuela or Peron's Argentina failed. They failed to create institutions to limit political power. These systems developed extractive institutions and generated a vicious cycle in which the ruling elite had no constraints on power and had great incentives for expropriation and wealth extraction. Even if this elite were to be overthrown by a revolution, the "iron law of oligarchy" implied that a new elite would simply replace the old one and continue in its extraction, sometimes even worse than under the old elite. This is why the authors are somewhat sceptical of the ability of the Arab Spring to produce the necessary shift towards inclusiveness.

Once again the authors convince the reader in the mechanism of the negative feedback loop and the iron law of oligarchy through a multitude of cases ranging from Sierra Leone, Guatemala, Ethiopia, Zimbabwe, Uzbekistan, Columbia, Argentina, Egypt and even slavery in the US South. However, the vicious cycle in the US South was easier to break due to the existence of inclusive institutions on the federal level. The Civil Rights Movement generated equality in the South and paved the way for economic growth.

Another good example of "breaking the mould" is Botswana, where the natural resource course didn't lead to extraction from colonists or usurpation of power over who gets to control resource extraction and enrich upon it. They have managed to seize their critical juncture – postcolonial independence – and used it to develop inclusive institutions.

The authors refrain from trying to write a recipe for development since there is no such thing. Their theory based on critical junctures and specific historical paths loses predictive power since it is hard to tell which countries could break the mould anytime soon. The theory can say which countries are likely to stay poor for a long time but it cannot really answer the question on what will follow after events like the Arab Spring. A range of factors will decide whether the Arab countries undergo a gradual path towards inclusiveness or whether the iron rule of oligarchy prevails.

Finally, prosperity cannot be engineered by international institutions with a recipe for reform or foreign aid; it has to come from empowerment to the people and their inclusiveness in the political process. Once a broad coalition is formed this will enable the inclusive institutions to persist and the political reforms to become irreversible. One can conclude that based on this approach, inclusive economic and political institutions develop spontaneously, while extractive institutions are imposed by outside coercion. The road to prosperity is thus always achieved through more political, individual and economic freedom.

The only part the authors did not cover in more detail is what happens after political and economic inclusiveness are attained, when certain elites or organized interest groups try to obtain political support to serve their own self-interest. An answer from the book would probably be that this scenario falls out of the general definition of inclusive political institutions, where the media is (partially) captured and where narrow self-interests can curtail the system in order to extract certain benefit. It is here that their framework could be extended, but the already large scope and size of the book prevent the authors from engaging so deeply into the subject.

The framework used in the book is based on a rigorous fifteen-year research process conducted by the authors and examined previously in some of their earlier, more analytical work. Regular readers of their work will recognize many of the ideas on the consolidation of democracies and political transitions coming from their 2006 book, *Origins of Dictatorships and Democracy*, along with many academic articles. *Why Nations Fail* builds on these findings thus providing the crowning achievement in their political economy theory. It is a recommended read to all professions and anyone interested in finding out why some nations are rich while others are poor.

Even though the book lacks academic rigour in supporting the theory and proving the causality of certain events and their further manifestation, such virtues were probably not the authors' objectives.

For anyone interested in the academic proofs behind certain historical events, I recommend their earlier work in which the analytical framework can be thoroughly analyzed. This book had different goals. Its emphasis on historical case studies to make it more interesting to the general reader succeeds in transferring the idea to all those outside the economic and political science profession. They have managed to summarize their theory and make the case for institutional change, while presenting it in an understandable, yet brilliant way for all those who are not economists. That alone marks the book as a success.