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WHY NATIONS FAIL?

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

What explains the enormous differences in income per capita that exist across the world today? The question has been posed many times over. The gaps in prosperity that surround us in the modern age are much wider than those that motivated Adam Smith to write *The Wealth of Nations* in 1776, which of course is where the modern discipline of economics began. Whereas back then the gap between the richest and poorest nations was 4- or 5-fold, today it is over 40-fold. Why is it, then, that certain nations are distinguished from others in terms of wealth and poverty, health and sickness, food and famine?

Theories abound. If you turn to the popular media—or even some respectable journals such as *Science* and *Nature*—you will most likely come across articles that argue that geographic factors are what explain these differences. Climate, soil quality, disease, and the environment have all been put forth as the determining elements of prosperity. Yet, when you look at the evidence, these geographic factors don't seem to be all that important. The same countries that are very rich today were once poorer than others with the same soil quality, for instance.

An even more popular explanation is the importance of cultural factors. You will hear, for example, that it is the difference between Catholics and Protestants (as Max Weber argued), or perhaps between Christians and Muslims and Judeo-Christians that lead economic differences. Others have focused on Asian versus non-Asian values, or the problem with African attitudes toward work. The significance of cultural factors is a popular explanation for the differences that exist between North America and the Iberian cultures of Latin America, as well.

Popular among academics and journalists is the notion that "enlightened leadership" is what matters—meaning that either leaders or their advisers have the right ideas about what drives prosperity. It's no surprise that this has some appeal to economists, who, of course, are in the business of developing the best micro- and macroeconomic policies—ones believed to be so critical to a nation's ultimate success.

However, once again, these all seem to have relatively little explanatory power. Remember that it was only four decades ago that many scholars were talking about the deleterious effects of Confucian values—the same cultural traits that are now touted as the foundation upon which Chinese growth has been built. And while economic policies that condemn nations to poverty abound, it will soon become clear that those policies are not adopted by mistake. They are adopted by design. It is not in the ignorance of leaders, in other words, that we should look for the causes of poverty. *It is in their incentives*. Let me explain.

Institutions: Inclusive versus Extractive

Our theory rests upon the nature of institutions—meaning the rules, both formal and informal, that govern our economic and political life. It should not come as any surprise that there are certain sets of economic institutions—property rights, enforcement of contracts, and so on—that create incentives for investment and innovation. Those institutions that create a level playing field through which a nation can best deploy its talent are referred to as "inclusive economic institutions."

Inclusive economic institutions, however, are the exception rather than the rule. That holds true throughout history as well as around the world today. Instead, many nations today and in the past operate under extractive institutions, which do not create property rights, generate law and order, create secure contract environments, or reward innovation. They certainly do not create a level playing field, and therefore they do not encourage sustained economic growth.

As I have already mentioned, however, these extractive institutions do not develop by mistake. They are designed by the politically powerful to extract resources from the mass of society for the benefit of the few. Such institutions are in turn sustained by extractive political institutions, which concentrate power and opportunity in the hands of an elite. This elite, in essence, designs, maintains, and benefits from these extractive institutions.

So the question is: Why do these extractive institutions emerge and persist? This is where politics enters into the equation. When extractive political institutions concentrate power in the hands of the few, those groups that monopolize political power can maintain these institutions in spite of the fact that they fail to create incentives for economic growth. Let me offer an example.

Case Study: South America

There is no better laboratory that demonstrates how extractive institutions emerge and persist than the New World. The Americas provide a brilliant example for understanding how different institutions form, how they become supported within different political frameworks, and how that, in turn, leads to huge economic divergences.

The economic and political institutions in the New World have been largely shaped by their colonization experience starting at the beginning of the 16th century. While the tales of Francisco Pizarro and Hernán Cortés are quite familiar, I'd like to start with Juan Díaz de Solís—a Spaniard who in 1516 initiated the colonization of the southern cone of South America, in what is today Argentina and Uruguay. Under de Solís's leadership, three ships and a crew of 70 men founded the city of Buenos Aires, meaning good airs. Argentina and Uruguay have very fertile lands, with a climate that then became the basis of nearly a century of very high-income per capita because of the productivity of these areas.

The colonization of these areas itself, however, was a total failure—and the reason was that the Spaniards arrived with a given model of colonization. This model was to find gold, silver, and, perhaps most importantly, capture and enslave the Indians so that they could do the work for them.

Unfortunately, from the colonists' point of view, the native populations of the area, known as the Charrúas and the Querandí, consisted of small bands of mobile hunter gatherers. Their sparse population density made it difficult for the Spaniards to capture them. They also do not have established hierarchy, so were difficult to coerce the work. Instead, Indians fought back, in fact capturing de Solís and clubbing him to death before he could make it into the history books as one of the famous conquistadors. For those that remained, there were not enough Indians to act as workhorses, and one-by-one the Spaniards began to die as starvation set in.

The rest of the crew moved up the perimeter to what is now known as Asunción, Paraguay. There the conquistadors encountered another band of Indians, who on the surface looked a little similar to the Charrúas and the Querandí. The Guaraní, however, were a little different. They were more densely settled and already sent you. They had also established a hierarchical society with an elite class of princes and princesses, while the rest of the population worked for the benefit of the elite.

The conquistadors immediately took over this hierarchy, setting themselves up as the elite. Some of them married the princesses. They put the Guarani to work producing food, and ultimately the remainder of de Solís's original crew led a successful colonization effort that survived for many centuries to come.

The institutions established among the Guaraní were the same types of institutions that were established throughout other parts of Latin America: forced labor institutions with land grants for the elite Spaniards. The Indians were forced to work for whatever wages the elites would pay them. They were under constant coercive pressure—forced not only to work but also to buy what the elites offered up for sale. It is no surprise that these economic institutions did not promote economic growth. Yet it's also no surprise that the political institutions underpinning this system persisted, created, and continuously recreated a ruling class of elites that did not encourage economic development in Latin America.

The question still remains: Was it geography, culture, or enlightened leadership—rather than institutional factors—that played a critical role in the fates of the two teams of explorers?

Case Study: North America

Meanwhile, a thousand miles north, at the beginning of the 17th century, the model of the Virginia Company—made up of the elite captains and aristocrats who were sent to North America—was actually remarkably similar to the model of the conquistadors. The Virginia Company also wanted gold. They also thought that they would be able to capture the Indians and put them to work. But unfortunately for them, the situation they encountered was also quite similar to what the conquistadors witnessed in Argentina and Uruguay.

The joint stock companies found a sparsely populated, very mobile band of Indians who were, once again, unwilling to work in order to provide food for the settlers. The settlers therefore went through a period of starvation. However, while the Spaniards had the option of moving up north, the captains of the Virginia Company did not have this option. No such civilization existed.

They therefore came up with a second strategy. Without the ability to enslave the Indians and put them to work, they decided to import their own lower strata of society, which they brought to the New World under a system of indentured servitude. To give you a sense of this, let me quote directly from the laws of the Jamestown colony, promulgated by the governor Sir Thomas Gates and his deputy Sir Thomas Dale:

> No man or woman shall run away from the colony to the Indians upon pain of death. Anyone who robs a garden, public or private or a vineyard or who steals ears of corn shall be punished with death. No member of the colony will sell or give any commodity of this country to a captain, mariner, master, or sailor to transport out of the colony or for his own private use upon pain of death.

Two things become immediately apparent in reading these laws. First, contrary to the image that English colonies sometimes garner, the Jamestown colony that the Virginia Company was chartered to establish was not a happy, consensual place. Pretty much anything the settlers could do would be punished by death. Second, the company encountered real problems that were cause for concern—namely, that it was extraordinarily difficult to prevent the settlers they brought to form the lower strata of society from running away or engaging in outside trade. The Virginia Company therefore fought to enforce this system for a few more years, but in the end they decided that there was no practical way to inject this lower stratum into their society.

Finally, they devised a third strategy—a very radical one in which the only option left was to offer economic incentives to the settlers. This led to what is known as the headright system, which was established in Jamestown in 1618. In essence, each settler was given a legal grant of land, which they were then required to work in exchange for secure property rights to that plot. But there was one problem. How could the settlers be sure that they had secure rights to that property, particularly in an environment in which a stolen ear of corn was punishable by death?

The very next year, in order to make these economic incentives credible, the General Assembly offered the settlers political rights as well. This, in effect, allowed them to advance above the lower strata of society, to a position in which they would be making their own decisions through more inclusive political institutions.

Lessons

These historical examples illustrate several important lessons. The first is that there is a clear positive feedback between inclusive economic and political institutions. Inclusive economic institutions that enforce property rights, create a level playing field, and encourage investments in new skills are not only more conducive to economic growth than extractive economic institutions that are structured to extract resources from the many by the few. They are also supported by, and support, inclusive political institutions, which distribute political power widely in a pluralistic manner and are able to achieve some amount of political centralization so as to establish law and order, the foundations of secure property rights, and an inclusive market economy.

The second important idea is that this example illustrates how none of the alternative theories has much explanatory power for understanding the big disparities in prosperity that exist around us. These disparities formed mostly in the 19th and early 20th centuries. But why did they form?

The examples we have considered give us several insights. It wasn't geography that caused the divergence between South and North America. If anything, much of South America had higher agricultural productivity, supporting a greater population density, at the time of colonization. But South America ended up poorer than North America. This reversal cannot be accounted for by the impact of geographic factors.

It wasn't some sort of culture either. In fact, it's remarkable how similar the objectives and chosen methods of the Spanish and English colonialists were. Even if their religion and culture were different, they were after the same thing and they had the same way of going about it. But the conditions on the ground meant that the Spanish could succeed in what they wished to achieve and the English could not. And the divergence wasn't related to enlightened leadership. If anything, the Spanish leaders were more successful because they could achieve what they wanted. The Virginia Company, Sir Thomas Dale and Sir Thomas Gates couldn't.

Instead, the root cause of the divergence between South and North America is in the different economic and political institutions that developed in these territories. Because the Spanish were successful in setting up extractive institutions to enrich themselves and their king, the long-run economic development of most of their empire was hampered. Because the English failed in setting up similar extractive institutions, and instead inclusive institutions started developing there, the United States would be much better placed to take advantage of new technologies and economic opportunities come the 19th century.

Of course the story is more complicated. Colonial institutions have long disappeared and many of them were already replaced even by the 19th century. A major part of the argument in *Why Nations Fail* is to devoted to explaining how the process of institutional change is path dependent, so that new institutions that are created are influenced by how extractive existing institutions are. So it's no surprise that how independence came to the United States and say Mexico differ sharply. In the former, this was part of the development of inclusive institutions. In the latter, it was a way of solidifying extractive institutions, when colonial elites feared that political changes in Spain would restrict their ability to dominate society and coerce the native population. The nature of independence was very different also. Mexico, for example, Mexico suffered decades of civil wars and instability following independence. Who formed businesses and invested, and what sort of business is formed and investments were made is also very different in the United States and say Mexico. In the United States, for example, there was fairly free entry into most dynamic areas of the economy in the 19th century, as witnessed by the diverse backgrounds of leading businessmen of the era. In Mexico, when finally society reached some stability and businesses started forming in the second half of the 19th century, this was led by elites allied with the government, protected by regulations and the monopolized banking system. As a result, it was the United States, not Mexico, that grew rapidly in the 19th and early 20th centuries. And it was during this period that the biggest gap between these two countries, and between North and South America, opened up.

It is also important to emphasize that inclusive economic institutions are not just made of secure and enforced property rights for a narrow elite, but require both such rights to be available to the majority of the population and a level playing field in society so that the majority of the population have the opportunity to take part in economic activities to realize their comparative advantage. This can again be illustrated with an example from the Americas, this time from the Caribbean. In 1680, the English government conducted a census of the population of its West Indian colony of Barbados. It revealed that of the total population on the island of around 60,000, almost 39,000 were African slaves who were the property of the remaining one third of the population. Indeed, they were mostly the property of the largest 175 sugar planters who also owned most of the land. These large planters had secure and well enforced property rights over their land and even over their slaves. If one planter wanted to sell slaves to another, he could do so and expect a court to enforce such a sale or any other contract he was a party of. This was partly because these planters were also the top judges, military officials and politicians of the island. Despite well-defined, secure and enforced property rights and contracts for the island's elite, Barbados had highly extractive economic institutions since two thirds of the population were slaves with no access to education, economic opportunities and no ability or incentive to use their talents or skills. Inclusive economic institutions require secure property rights and economic opportunities not just for the elite but for a broad cross-section of society.

The history of the Americas is illustrative because it shows how the trajectory of institutions and economic development depends on whether elites bent on setting up extractive institutions succeed or fail. But the Americas are not fully representative of the rest of the world. In many other parts of the world, extractive institutions are not so much imposed from the outside, but are created by domestic elites. What distinguished Spain and England in the 17th century, for example, was the persistence of absolutist extractive institutions in Spain, and their gradual collapse to be replaced by more inclusive institutions in England. So the crucial part of the story, which *Why Nations Fail* tries to explain in detail, is the process of institutional change.

Perhaps the most challenging question concerns understanding how extractive institutions become more inclusive over time. Though the answer to this question is complex, certain aspects of it are clear. Most of the time, elites will not willingly create more inclusive institutions because they tend to benefit from the extractive ones. They do so, as the example of the Virginia Company illustrates, when they are forced by the demands of those excluded from political power. Institutional change tends to take place in a more predictable manner when the elite finds it beneficial to make such concessions. But as illustrated by the recent events in Libya and Syria, in many cases, such transitions are not possible because the elite would prefer to fight it out. In this case, institutional change results revolutionary changes, which also create the danger of instability and another group taking the reins and exploiting extractive institutions for their own benefit, for example, as the Bolsheviks did after overthrowing the Russian Czar.

Conclusion

A key lesson of the framework we present in *Why Nations Fail* is the importance of politics. Of course, it is economic institutions that determine economic incentives and the resulting allocation of resources, investment and innovation. But it is politics that shapes how economic institutions work and how they have evolve. Most societies suffering under extractive economic institutions do so because political power is concentrated in the hands of an elite ruling under extractive political institutions.

The recent events in the Middle East and North Africa also highlight the role of politics. The 'Arab spring' has shaken not only Tunisia, where it started, but Egypt, Libya, Yemen, Bahrain and Syria, even if the governments in the latter two countries are still holding onto power. The roots of discontent in these countries are economic and social, but those are in turn shaped by political factors. The general population has been repressed and excluded from political power for generations. The protesters in Tahrir Square in Egypt understood this and this is why they demanded not just handouts or concessions from the existing regime, but fundamental political change.

This all implies a simple but critical conclusion: You can't get your economics right if you don't get your politics right. And that's where the difficulty lies, because there is no formula for getting politics right. This is again illustrated by the challenges lying ahead for the Middle East and North Africa, in particular, Egypt and Tunisia. Do we expect democracy or extremism to triumph in Egypt? Have the events in Tahrir Square changed the nature of politics irrevocably or will a similar economic and political structure reemerge under a different guise? Have they opened the way to a new authoritarian regime under the auspices of the Muslim Brotherhood? Central though these questions are for understanding the economic trajectory of the region, unequivocal answers are not possible. It's only the details of politics and how the contingent path of history will play out that will determine how successful politically and thus economically these nations will be.