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

Morishima Lecture, LSE June 8, 2011

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Harvard

June 6, 2011

The Lay of the Land

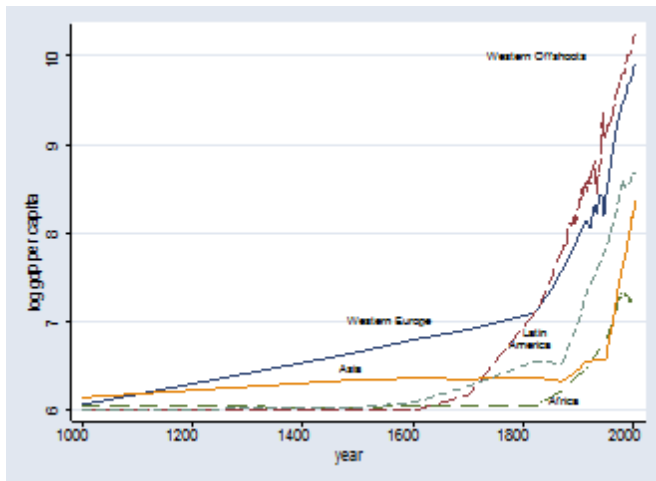


Figure: The evolution of average GDP per capita in Western Offshoots, Western Europe, Latin America, Asia and Africa, 1000-2000.

The Beginning—Latin America

- Juan Díaz de Solís explores Río de la Plata ('River of Silver') in 1516, and Pedro de Mendoza founds Buenos Aires in 1534.
- But Solís and de Mendoza unable to enslave and put to work the hunter gatherer Indians of the area, Charrúas and the Querandí. Starving Spaniards soon left the area.
- In 1537, Juan de Ayolas found the sedentary and more densely settled Guaraní up the Paraná river, in Paraguay. The Spaniards could successfully take over the Guaraní hierarchy, enslave them and put them to work to produce food for them.
- A very similar pattern to the colonization of the Aztecs and the Incas.

The Beginning—United States

- Colonization attempts of Virginia Company in Jamestown in early 17th century, attempting to re-create an authoritarian, “extractive” regime:

“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, for his own private uses, upon pain of death.”
[from the laws passed by Sir Thomas Gates and Sir Thomas Dale].

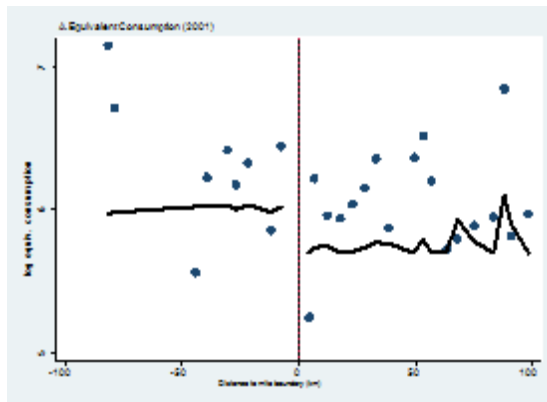
- But the Company was unsuccessful—it could not force the English settlers into gang labor and low wages.

The Beginning—United States (continued)

- The Company switched to the 'headright system' giving all settlers 50 acres of land and then shortly thereafter also political rights, in the form of it General Assembly in 1619.
- Similar events unfolded in Pennsylvania, Maryland and the Carolinas.
- The chain of events that ultimately leading to the Declaration of Independence and the U.S. Constitution.
- The differences in the ways Latin America and North America were organized historically explain the differences in the ways they are organized today and their different levels of prosperity.

Legacy of Colonial Times Today

- Effects today of the *Mita* the largest system of forced labor in colonial Latin America (from *Dell (2010)* “Persistent Effects of Peru’s Mining Mita”)



Making Sense of the Divergence

- While both culture (religion, attitudes, values) and geography (climate, topography, disease environments etc.) are important for the ability of humans to form well functioning societies, they are not the “main” source of this divergence.
 - Much of Latin America likely richer than North America as late as mid-18th century.
 - Divergence due to the ability of the United States, just like Britain, to take advantage of new economic opportunities.
- An “ignorance hypothesis” also unable to explain the logic of social arrangements leading to relative poverty—Cortes, Pizarro and Ayolas did not set up forced labor and repressive regimes because they were “ignorant” about their implications.
- Instead, central role of “institutions” broadly defined as the rules that govern economic and political behavior.
- **Key questions:** historical roots of institutional differences and the logic of institutions that do not unleash growth.

Towards a Theory of Institutions

- **Extractive economic institutions:** Lack of law and order. Insecure property rights; entry barriers and regulations preventing functioning of markets and creating a nonlevel playing field.
- **Extractive political institutions**—in the limit “absolutism”: Political institutions concentrating power in the hands of a few, without constraints, checks and balances or “rule of law”.
- **Inclusive economic institutions:** Secure property rights, law and order, markets and state support (public services and regulation) for markets; open to relatively free entry of new businesses; uphold contracts; access to education and opportunity for the great majority of citizens.
- **Inclusive political institutions:** Political institutions allowing broad participation—*pluralism*—and placing constraints and checks on politicians; rule of law (closely related to pluralism).
 - But also some degree of *political centralization* for the states to be able to effectively enforce law and order.

Synergies

		Economic Institutions	
		Inclusive	Extractive
Political Institutions	Inclusive		
	Extractive		

Growth under Inclusive Institutions

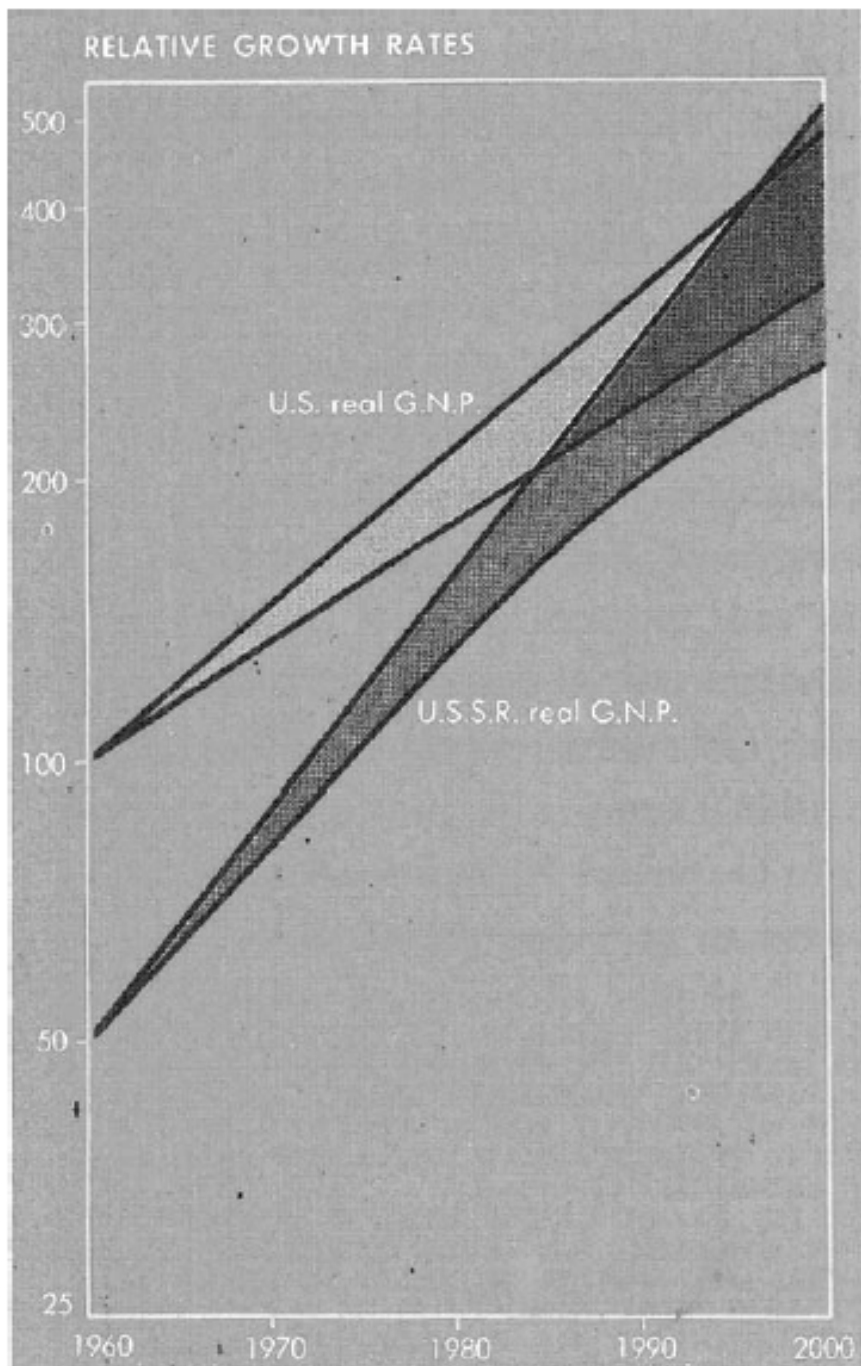
- Inclusive economic and political institutions (or inclusive institutions for short) create powerful forces towards economic growth by:
 - encouraging investment (because of well-enforced property rights)
 - harnessing the power of markets (better allocation of resources, entry of more efficient firms, ability to finance for starting businesses etc.)
 - generating broad-based participation (education, again free entry, and broad-based property rights).
- Key aspect of growth under inclusive institutions: investment in new technology and **creative destruction**.
- *Central question*: why are extractive institutions so prevalent throughout history and even today?

The Logic of Extractive Institutions

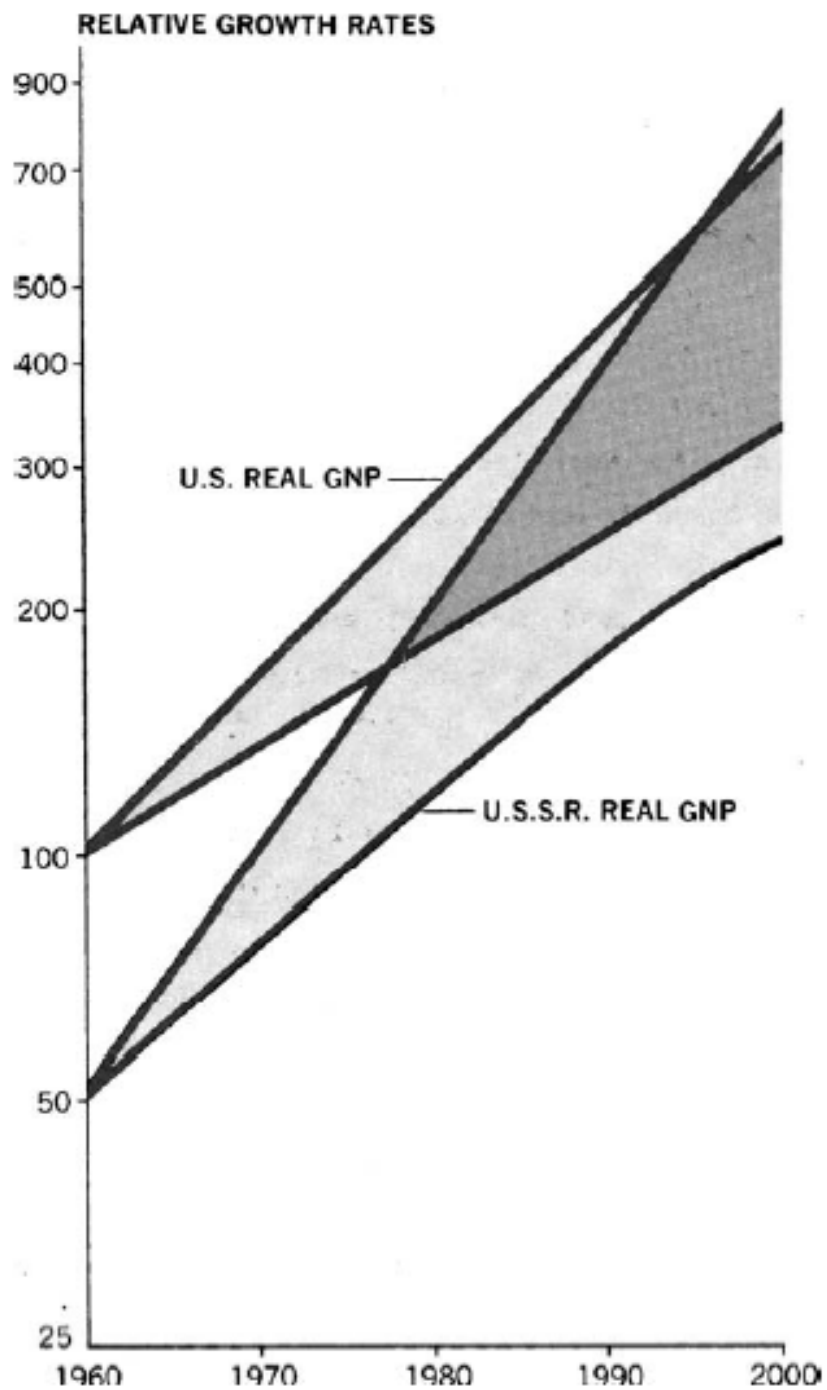
- Main thesis is that growth is much more likely under inclusive institutions than extractive institutions.
- Growth, and inclusive institutions that will support it, will create both winners and losers. Thus there is a logic supporting extractive institutions and stagnation:
 - **economic losers:** those who will lose their incomes, for example their monopolies, because of changes in institutions or introduction of new technologies
 - **political losers:** those who will lose their politically privileged position, their unconstrained monopoly of power, because of growth and its supporting institutions—**fear of creative destruction.**
 - both are important in practice, but particularly political losers are a major barrier against the emergence of inclusive institutions and economic growth.

Growth under Extractive Political Institutions

- Though growth is much more likely under inclusive institutions, it is still possible under extractive institutions.
- Why? → Generate output and resources to extract.
- Two types of growth under extractive political institutions:
 - ① extractive economic institutions allocating resources to high productivity activities controlled by the elites (e.g., Barbados, Soviet Union)
 - ② when relatively secure in their position, the elites may wish to allow the emergence of relatively inclusive economic institutions under their control (e.g., South Korea under General Park, China today).
- But big difference from growth under inclusive institutions: no creative destruction and dynamics very different. Consequently, even though growth is possible under extractive institutions, this will not be **sustained growth**.

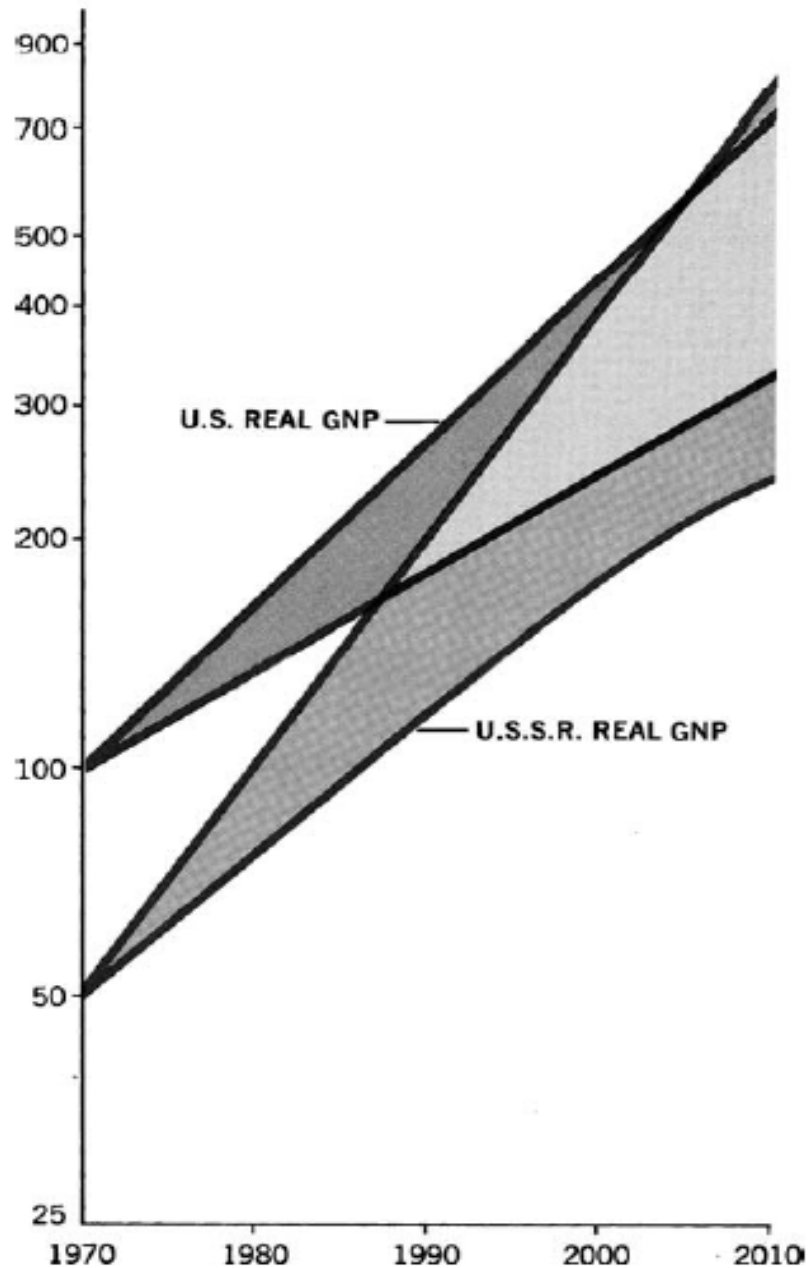


Paul Samuelson's forecast
For US and USSR relative
economic growth
in the 1961 edition of his
textbook.



The 1967 Version

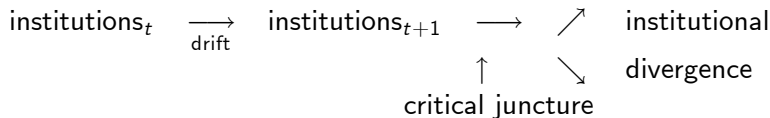
RELATIVE GROWTH RATES, U.S.A. AND U.S.S.R.



The 1970 Version
Overtaking delayed!

Towards a Theory of Institutional Change

- As a consequence of the distributional consequences of institutions **conflict** pervasive in society.
- In the context of **differential institutional drift** → small but notable differences in institutions across nations
- Small differences that matter when **critical junctures** arise - confluence of factors which can undermine the status quo



- But outcomes not historically determined, partly **contingent**.
- The changes that happen as a result of this interaction then become the background institutional differences upon which new critical junctures act.

Transition to Inclusive Institutions

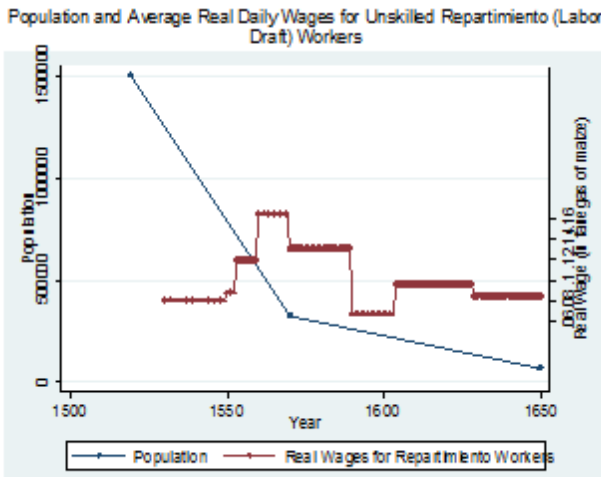
- Extractive institutions have been the norm in world history.
- Where do inclusive institutions come from?
 - Earlier moves towards inclusive institutions resulting from conflict and institutional drift— Roman Republic, Venice, but ultimately reversed.
- Crucial turning point: the **Glorious Revolution** in England in 1688.
 - The Glorious Revolution brought much more inclusive, pluralistic political institutions which then led to a transition towards much more inclusive economic institutions.
- This created the conditions which led to the **Industrial Revolution**.
- Growth in the 19th century and dissemination of industry were conditioned by interactions between initial institutional differences and the critical junctures created by political events and the Industrial Revolution itself.

Institutional Divergence at Critical Junctures: Black Death and Feudalism

- The divergence of Western and Eastern Europe after the Black Death—in the West the power of landlords declines and feudalism withers away, in the East the power of landlords intensifies leading to the Second Serfdom in the 16th century.
- This institutional divergence driven by a large demographic shock interacting with initial institutional differences (organization of peasant communities, distribution of landholdings).
- Key mechanism: increases in wages following population decline (e.g., Phelps Brown and Hopkins, 1956).

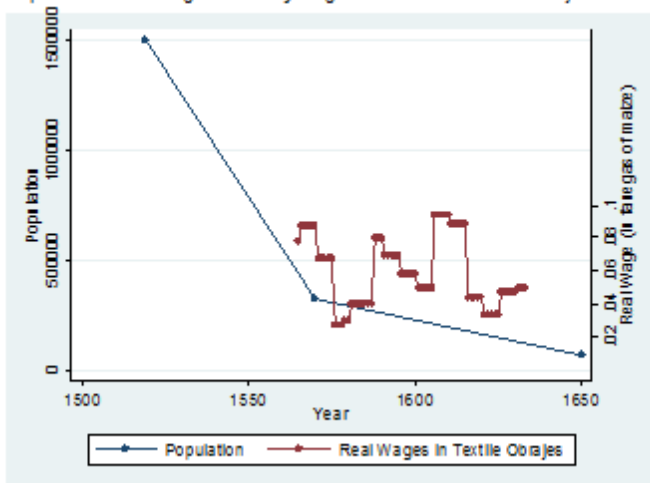
Meanwhile in Mexico: Implications of Coercion

- The effects of lower population very different when there is coercion. Another instance of institutional divergence.



Meanwhile in Mexico (continued)

Population and Average Real Daily Wages for Unskilled Textile Obraje Workers



Source: Own Calculations based on Smith and Cook (1999), Gibson (1964) and Aguilar and Ugulida (1980)

The Emergence of Inclusive Institutions in Britain

- Driven by the interaction of initial institutions and critical junctures:
 - **Initial institutional drift:** Britain was the beneficiary of a long history of gradual institutional change from the Magna Carta of 1215 onwards, through the creation of a monopoly of violence by Henry VII after 1485, nascent state under Henry VIII, Civil War of the 1640s.
 - **Critical juncture:** Development of the Atlantic economy after 1492 led to the emergence of a broad and powerful coalition in society in favor of reforming political institutions and removing absolutism.
 - Owing to the context created by the initial institutional drift, this coalition triumphed in 1688.
 - **Small difference:** Initial institutions in Spain somewhat different, especially in allowing the crown to monopolize colonization and Atlantic trade → critical junctures leading to greater wealth and political power of the monarchy.

The Emergence of World Inequality

- The Industrial Revolution disseminated very unevenly because different parts of the world have very different institutions:
 - ① European settler colonies in North America and Australasia had developed inclusive institutions by a different route (but still conflictual).
 - ② Western European institutions diverged from Britain in the 17th Century but were not too different where it mattered.
 - ③ Many nations (e.g., Eastern Europe, Ottoman Empire) had long existing extractive institutions.
 - ④ Others had extractive institutions imposed upon them by European colonial powers (creation of 'Dual economies' in Southern Africa).

Divergence in Europe

- In Eastern Europe regimes in charge of extractive economic institutions such as Austria-Hungary and Russia feared industrialization.
- Industrialization and railways blocked in both because emperors and elites afraid of political change.
- Francis I and Metternich's approach:

"We do not desire at all that the great masses shall become well off and independent ... How could we otherwise rule over them?"

- Nicholas I and Count Kankrin's approach in Russia:

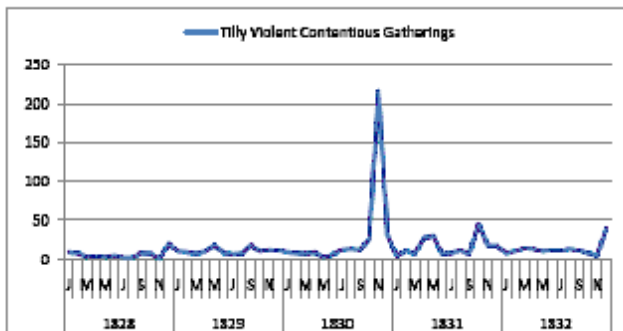
"Railways do not always result from natural necessity, but are more an object of artificial need or luxury. They encourage unnecessary travel from place to place, which is entirely typical of our time."

Why Didn't the Ottoman Empire Catch-Up?

- In 1445 in the German city of Mainz, Johannes Gutenberg invented the printing press based on movable type. Spread rapidly throughout Western Europe.
- In 1485, the Ottoman Sultan Bayezid II issued an edict to the effect that Muslims were expressly forbidden from printing in Arabic.
- Sultan Selim I in 1515 strengthened this edict.
- Only in 1727, the first printing press is allowed in the Ottoman lands. Then Sultan Ahmed III issued a decree granting İbrahim Müteferrika permission to set up a press, but under close supervision and censorship. Müteferrika printed few books in the end, only seventeen between 1729, when the press began to operate, and 1743 when he stopped.

Persistence: The Virtuous Circle in Britain

- Modern world inequality heavily influenced by the nature of institutions 250 years ago because strong forces leading institutions (inclusive and extractive) to persist over time.
- In the British case the institutions created after 1688 responded to challenges by becoming more inclusive. Conflict leading up to the First Reform Act:



Persistence: The Vicious Circle in the US South

- In the antebellum period, the South run by plantation owners, and the system of slavery and labor-intensive cotton production.
- Relatively poor (about 70% of the national level of GDP per-capita). Little manufacturing industry, much lower urbanization and density of canals and railroads than the North.
- Civil War: major change in economic and political institutions; the abolition of slavery and the enfranchisement of the freed slaves.
- One might have anticipated a dramatic change in economic institutions.
- But what emerged was a labor-intensive, low wage, low education and repressive economy—just like the antebellum South.

Persistence of the Southern Equilibrium

- Despite losing the Civil War, traditional landed elites could sustain their political control of the South, particularly after Reconstruction ended in 1877 and the Union army was withdrawn.
- Blocking of economic reforms that might have undermined their power, such as the distribution of 50 acres and a mule to each freed slave.
- Were able to use their local political power to disenfranchise blacks and re-exert control over the labor force.
- Use of Black Codes, Vagrancy Laws, Ku Klux Klan and Jim Crow.
- Specific economic and political institutions changed, but the underlying distribution of political power did not and neither did the interests of the elite. They were able to use different institutions to achieve the same goal. The incentive environment for the mass of the population did persist.

Persistence of the Southern Equilibrium (continued)

The persistence of the landed elite in three "Black Belt" counties of Alabama

Name	County	Real estate holdings ^a		
		1870	1900	1930
Mingo, G.	Montgomery	\$ 15,000		30,000
Lyon, F.	Montgomery	75,000	115,000	38,000
Peeling, William	Montgomery	72,000	150,000	29,000
Martin, Alfred	Mobile	70,000	130,000	40,000
Alexander, J.	Montgomery	65,000	38,000	10,000 ^b
Whitefield, B.	Montgomery	45,000	300,000 ^b	100,000
Taft, J.	Montgomery	42,000	95,000	
Taylor, E.	Montgomery	41,000		
Robertson, B.	Montgomery	40,000		
Dr. Dawson	Greene	32,000	300,000 ^b	41,000
Walker, John	Montgomery	30,000	250,000	25,000
Collins, Charles	Mobile	30,000	301,000 ^b	30,000
May, Claude	Greene	20,000	113,000	
Scott, John	Seale	50,000	89,000	13,000
Pickens, Michael	Montgomery	30,000	42,000	15,000
Wilcox, May	Mobile	20,000	40,000	75,000 ^b
Jones, Madison	Mobile	50,000	36,000 ^b	27,000
Nichols, A.	Mobile	45,000		10,000 ^b
Taylor, J.	Mobile	40,000		
Pickens, Wm.	Mobile	45,000	210,000 ^b	51,000
Brewer, Henry	Montgomery	45,000	52,000	24,000
Walker, R.	Mobile	40,000	55,000	
Scott, W.	Greene	40,000	32,000	
Blacks, E.	Montgomery	41,000		
Walker, Moses	Montgomery	41,000		
Number of planters		25	18	14
Percent present in 1870			72%	64%

^a Rounded off to the nearest thousand as reported in the U.S. Census of Population, marriage, statistics. To convert to constant gold prices, see p. 34, note 10.

^b Excludes all taxes on land.

Source: Weiner (1978, Table 2, p. 12)

Why Nations Fail Today

- Extractive institutions.
- These come in different varieties.

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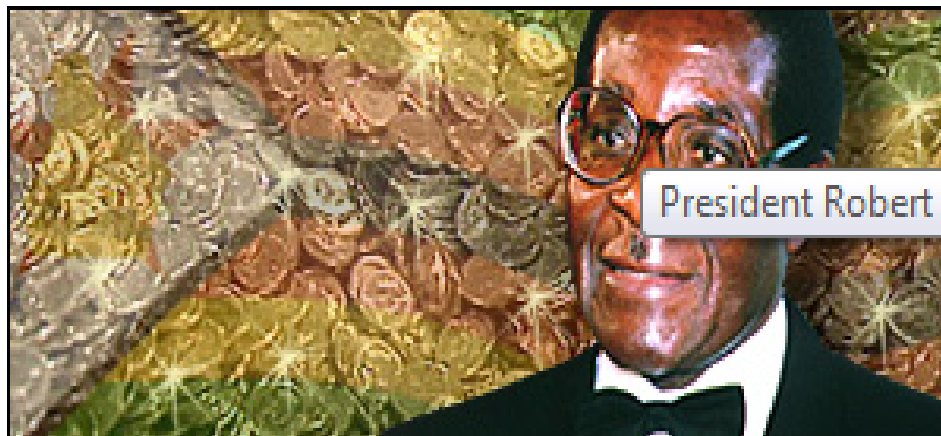
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Mugabe hits the jackpot



President Robert Mugabe

Mugabe: "Name drawn from thousands of customers"

Zimbabwean President Robert Mugabe has won the top prize in a lottery organised by a partly state-owned bank.

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The Pact of Sante Fé de Ralito, 23 July 2001

En este documento queda constancia de los asistentes a esta reunión, firman a voluntad propia.

Santander Losada *Adolfo Paz*

Santander Losada
Estado Mayor AUC

Adolfo Paz
Estado Mayor AUC

Jorge 40

Jorge 40
Jorge 40
Estado Mayor ACCU

Diego Vecino
Diego Vecino
Estado Mayor AUC

José María López
José María López
Gobernador Córdoba

Salvador Arana Sus
Salvador Arana Sus
Gobernador Sucre

Reginaldo Montes
Reginaldo Montes
Representante a la Cámara (Córdoba)

Luis Álvarez
Luis Álvarez
Suplente Cámara de Representantes
Córdoba

Jaime García

Jaime García
Gerente CVS

Alvaro Cabrales
Alvaro Cabrales
Ex -Diputado

Sigilfredo Señor
Sigilfredo Señor
Alcalde Terralta

Alfonso Campo Escobar
Alfonso Campo Escobar
Representante a la Cámara

Jose Maria Imbat
Jose Maria Imbat
Representante a la Cámara

William Montes
William Montes
Senador (Bolívar)

Don Berna



Labor Coercion in Uzbekistan

- On September 6 2006, schools in Uzbekistan were emptied of 2.7 million children. A mother of two explains:

"At the beginning of each school year, approximately at the beginning of September, the classes in school are suspended, and instead of classes children are sent to the cotton harvest. Nobody asks for the consent of parents. They don't have weekend holidays [during the harvesting season]. If a child is for any reason left at home, his teacher or class curator comes over and denounces the parents. They assign a plan to each child, from 20 to 60 kg per day depending on the child's age.

- Why? Uzbekistan under the corrupt regime of Ismail Karimov.
- Cotton farmers are forced to sell at very low prices. Lack of incentives and running down of machinery. Use of forced labor as a substitute for incentives for farmers.

Breaking the Mold

- History is not destiny.
- Effective reforms towards inclusive institutions possible.
- But it often necessitates a minor or major political revolution.
- Two examples:
 - 1 End of Southern equilibrium in the United States
 - 2 Botswana

“Political Revolution” in the South

Figure 3: Incidence of Different Types of Collective Action, 1955-62

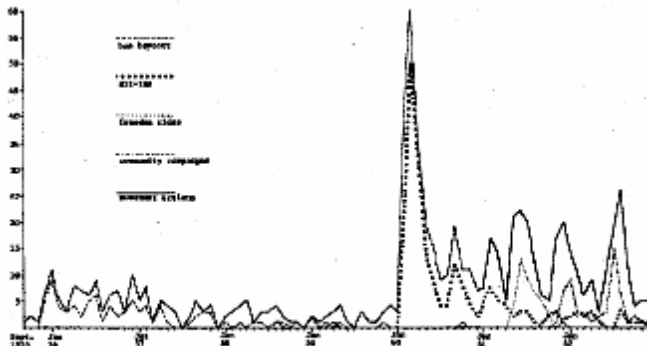


Figure 2. Movement-Initiated Actions, September 1955 through December 1962

Source: Annual Index of the New York Times, 1955-1962.

Source: McAdam (1983)

Edwin Lloyd

Rev. W.C. Willoughby



Khama

Bathoen

Sebele

The Chiefs in London

Why Nations have and Do Fail

- Because they have extractive political and economic institutions.
- These are difficult to change though they can be successfully challenged and altered during critical junctures.
- The roots of modern world inequality lie in the emergence of inclusive institutions in Britain and the fruits of this - the industrial revolution - spread to those parts of the world that had similar institutions (settler colonies) or quickly developed them (Western Europe).
- Other parts of the world languished with extractive institutions which have persisted over time and thus remain poor today.