

## Book reviews

*“Why Nations Fail,” by Daron Acemoglu and James A. Robinson,*

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### **Why Nations Fail**

(WNF) by Daron Acemoglu and James Robinson (AR) is a highly praised book, perhaps the most praised in the social sciences in recent years. If one looks at the book jacket and the first few pages inside, one will find accolades from Nobel Prize economists (Akerlof, Arrow, Becker, Diamond, P. , Spence and Solow); from other well-known economists (Levitt, Johnson, S. and Rodrik) and from prominent social scientists (Diamond, J. Fukuyama, and Ferguson). If one goes to the Amazon website, one will find readers giving it a high rating and pages and pages of glowing reviews.

In this review, I will add to this inventory of praise, but with some reservations. I wish this book had come out several decades ago. It would have made my thinking much clearer and would have made my career as an economist significantly more productive. The book is a comprehensive romp across hundreds of years of economic history, explaining the development experience of many different regions, economic systems and cultures. AR’s key insights are: (1) political and economic institutions are critical for economic development; and (2) at any point in time, institutions are the product of the country’s experience and the fact that powerful groups have an interest in keeping them that way. Seemingly simple and obvious points but they provide guidance in answering questions that have bothered economists for years, such as why has the economic development experience varied so much between different regions and different countries?; why do countries fail to adopt economic policies which appear clearly in their

interest?; and why has foreign aid had such a limited impact? In this review I will also state some reservations about AR's methodology which can be briefly summarized as: the analytical variables that AR employ are too vague and hence can quite flexibly be employed *ex post* to explain whatever happened.

### **Alternative Explanations of Divergent Development Experience**

AR reject three alternative explanations of why the experience of various countries has been so different: geography, culture, and ignorance of correct policies. The geographical school holds that tropical climates predispose their peoples to be lazy and lack acquisitiveness or, in a more modern variant, tropical climates lead to debilitating diseases and/or soils more subject to erosion and nutrient loss. These explanations break down when in the face of unchanged geographical conditions, formerly stagnant countries begin to grow or countries in the same geographical areas grow at sharply different rates or seemingly geographically disadvantaged countries grow at rates faster than better endowed countries.

The culture school holds that prevailing values and attitudes – e. g. work ethic, superstition versus empirical thought processes, faith in the future, trust, and sometimes the superiority of European value systems that explain why performance varies. These theories have problems explaining why areas with the same cultures have different economic outcomes (such as West and East Germany, North and South Korea, or the areas just north and just south of the Mexico-USA border) or why countries suddenly start growing in the face of an unchanged, or slowly evolving, culture.

The economic ignorance view, beloved of economists and international aid agencies, holds that countries are failing because they are following the wrong policies and if they can be shown the light, they will start to grow. Markets, incentives, property rights, and fiscal discipline are what generates prosperity and countries that interfere with them will end up in stagnation or poverty. Get rid of monopolies, high tariffs, price controls, and tax disincentives, and countries will prosper. Economists fail to grasp the political reality behind these policies. Governments do

not exist to maximize the general welfare but to protect the interests of powerful groups. Progress depends on rearranging power as well as finding the correct economic policies.

### **AR's Hypothesis on Why Countries Fail or Succeed**

Nations are poor because they do not have institutions which allow them to generate growth potential. They have political institutions in which power is heavily concentrated. Their economic institutions do not create an environment in which a large proportion of the population can share in the benefits. Societies with these characteristics, AR call "extractive." They do not possess a framework in which sustained improvements in prosperity is possible. Sustained improvements in well-being require technological change, which involves producing more with less or the replacement of the old by the new. Such creative destruction threatens the advantages and the political power of certain groups. Political power is based on restricted access; newcomers and increased competition threaten this.

Contrast the above with what AR call "inclusive institutions." Inclusive political institutions are those in which power is widely shared and many groups can participate in the decisions which affect their prosperity and access to public services. Inclusive economic institutions are those which generate widespread opportunities to make investments, opportunities to create new or better products, or opportunities for self-improvement. This depends on secure property rights, an objective system of law, and limited monopoly privileges. Exclusiveness versus inclusiveness is the result of conscious choice. Countries may shun changes which would appear to offer the prospect of improvements in general welfare because they threaten the economic advantages of powerful interests or they might increase the political power of outside groups (think of North Korea or Myanmar until recently as two obvious examples).

### **Illustrative Examples of AR's Analytical Approach**

WNF is rich in analyses of different regions, cultures and time periods. I will outline just a few cases to illustrate AR's approach and to illustrate some important points.

AR feel that England was the earliest participant in the Industrial Revolution because of its progress in creating inclusive political and economic institutions. Striking evidence of this is found in the Glorious Revolution (1688) which greatly expanded the powers which the king could exercise only with the consent of parliament and made government more responsive to a wider set of groups in society. This revolution gave parliaments a greater say over successions to the throne, limited the right of kings to suspend laws, made monopolies and taxation subject to parliamentary approval, created a broader and more stable tax base allowing the expansion of public services, and created the Bank of England which became a great source of financing for industry. The opening up of England's political and economic institutions was a product of hundreds of years of struggle to curb absolutism and extend political power to a wider range of groups. Slowly powers were shifted from kings to the aristocracy, thence to landed gentry (commercial farmers), further to other rural groups and finally to industrialists and urban areas. By the start of the Industrial Revolution, England was not a democracy in the modern sense, since many groups such as woman and the landless had no political power. But the power of the crown had been considerably curbed and many groups were competing for influence. This created an environment in which investments and innovations in textiles, metallurgy, steam power, and transport which drove the early revolution could take place.

AR take up the question of why the development experience of North and South America has been so different. Six hundred years ago, South America was much richer and more densely populated than the North. Spanish (and Portuguese) colonization of the area was based on the search for resources to exploit and labor to subjugate. Their methods were effective: seize the indigenous ruler, force him to turn over his riches, and coerce his population into providing tribute and food. A system of forced labor, head taxes, and inflated prices for Spanish goods kept the native population poor and enriched the conquerors. English colonization lagged behind that of Spain by about one hundred years and was directed at North America, the only remaining area not touched by European powers. Their methods at first attempted to follow the apparently successful Spanish model. But this was not possible: there were no minerals to exploit and the dispersed population was difficult to subjugate. England then tried exploiting settlers, but forcing settlers to

provide labor proved equally fruitless. While it took decades for this struggle to be resolved, the authorities came to realize the only system that would work would be where settlers owned land and had incentives to invest and provide labor services where rewards were the highest. Overseeing this process was a political system where settlers had considerable freedom of expression and male property owners had the right to vote.

Within five decades of each other in the late eighteenth and early nineteenth centuries, colonies in both North and South America became independent of European powers. Subsequent constitutional development in the two regions very much reflected the colonial experience and diverged considerably. Political development in the USA granted free expression and the right to vote (but not for women or slaves) and eased general land ownership, the granting of patents, the creation of a relatively competitive banking system, and the formation of new businesses. Political developments in Latin America continued to favor the elite: political influence restricted to the wealthier classes, limited protection for property, monopoly privileges for favored persons, and a narrowly owned banking systems. This pattern of political and economic development generated stagnation, civil wars, and persistent political instability as competing groups fought for control of resources. The divergence generated dynamism and prosperity in the North and slower and more sporadic growth and much more unequal incomes in the South.

Are nations characterized by extractive institutions condemned to stagnation and poverty? Clearly not according to AR. Limited progress is possible where a strong state has been created which can establish law and order and provide the security for investments or the extraction of valuable natural resources which benefit the few. Extractive societies need something to extract. Soviet Russia was able to generate significant growth for decades by collectivizing agriculture, creating a command and control economy which controlled prices and the allocation of labor and capital, and driving resources out of agriculture into a more productive industrial sector. Years of relatively spectacular growth were created. The system collapsed because it did not offer citizens incentives to save and invest and technological change was thwarted because it threatened existing structures and bureaucrats by requiring that more be produced with less resources. The system could not generate long-term growth on a sustainable basis.

The coming to power of the Chinese Communist Party in 1949 failed to bring about significant improvements in general prosperity. The temporary advantages of a command and control economy were offset by the economic disasters caused by political initiatives like the Great Leap Forward and the Cultural Revolution. Growth experience was poor compared with the rapid growth achieved in the Soviet Union during its first five decades. In the late 1970s, Chinese leaders came to the belief that significant economic growth could be achieved without endangering the political power of the Communist Party. Reforms began in agriculture with some loosening of compulsory marketing and the control over prices. State enterprises were given more leeway in decisions, and some cities were allowed to attract foreign investment. Labor was allowed some freedom to move into rural industries, the Township Village Enterprises. Introducing more incentives in agriculture and industry, followed by introducing more foreign investment and technology set China on a path of more rapid growth. These reforms were followed by more secure property rights, allowance for the creation of private enterprises and opening up to foreign trade. The result was that China had one of the world's fastest growth rates over the past three decades.

AR's key insight is that China's success will not last. It has been based on increasing inclusiveness in economic institutions, but under continuing extractive political institutions. Rapid growth was made possible by the opportunity to reduce inefficiencies in agriculture, move resources from agriculture to industry and from rural to urban areas, introduce catch-up technologies, and export cheap labor-intensive products. The pervasiveness of favored state enterprises, the dependence of private enterprise on Party goodwill and often on partnerships with state enterprises, the pervasiveness of Party control over the mass media and over political processes mean that the openness and creative destruction that underlie sustained productivity increases will not take place. Growth will inevitably slow.

### **My Reservations about AR's Methodology**

While agreeing with the basic thrust of AR's analysis (I think they are on to something), I have some reservations about their methodology which should give readers something to think

about. The concepts of extractiveness and inclusiveness seem terribly vague. Neither is a 0,1 choice and each is subject to a wide range of possible meanings. The distinction seems to involve such things as property rights, court systems, mass media, and democracy/pluralism and how extensive they are or how well they are working. These then are connected with the ability of groups in society to invest, acquire education, provide labor services, and introduce innovations. But precisely what is the connection? AR are never clear about this. Does it matter which of the variables is moving in a more favorable direction? Again, AR provide no guidance. Since they are dealing with history and already know the development/growth outcomes, they have great leeway in what variables they choose to emphasize in explaining what happened.

Try the following thought experiment. Suppose that we could describe each of the variables in exclusiveness/inclusiveness more precisely and distinguish favorable from unfavorable characteristics more clearly; we take this method and apply it to the situations of various key countries of the world in the year 1750, thus rating them (at least qualitatively) by degrees of exclusiveness or inclusiveness. How well would these ratings explain the development/growth that took place in these countries in the years following 1750? Relatedly, since social scientists are always interested in what factors are critical for economic growth, as countries' political systems evolve over time (say) from less to more inclusiveness, does it matter which institutions change? Do changes in property rights, or quality of the court system, or degree of pluralism all matter equally for economic development and does sequencing matter? What characteristics would determine when a country has moved from being extractive to being inclusive? These questions are important, but AR provide no guidance.

Analysts emphasizing the importance of institutions ascribe poor economic performance to inferior institutions and AR would add that this is not accidental: institutions underperform because powerful groups gain from this by maintaining control, and obtaining rents. This seems plausible enough, but its implications are pessimistic. While policies can be changed relatively quickly (for example, by tariff reductions, exchange rate changes, or slower monetary growth), improving the quality of institutions could take decades even if powerful groups acquiesce (Thailand will not become like Denmark overnight). For the four decades up to 2000, the

performance of virtually all African countries was poor; stagnant or even falling GNP per capita was the result. Suddenly since 2000, a sub-group of about 15-20 of these countries has begun growing very rapidly relative to the past and even relative to Asia. A typical economist would attribute this to better policies being followed in these countries, such as lower inflation, an opening up to external trade, less reliance on state enterprises, and a drastic reduction in external indebtedness. Institutional explanations which AR would use, would emphasize the opening up of political systems, with more reliance on elections, fewer restrictions on entry of new businesses and greater press freedom. Which explanation better accounts for what happened? I would tend toward thinking the economic explanation will do better, because I doubt that institutions have changed so much in such a short period.

AR are confident in their prediction that Chinese economic growth will slow. While past growth was based on a shift in economic institutions from command and control to one with more reliance on markets, more involvement of private enterprise, and more external trade, future growth will be stymied because it will threaten the power of the Communist Party and state enterprises. While I take their point, I would not be so sure of rigidities in the political system. This system has already adapted enormously since 1980: private investment and private property (no doubt quite qualified) have been introduced; there is more engagement with the outside world; and there are more reformers in positions of authority in government and in the Party. All of these changes show up in China's attitude toward foreign trade and financial arrangements, toward the need for environmental policies, and in its realization that its growth model will need to change from dependence on exports to one more dependent on domestic consumption. So long as the required changes are incremental, I do not see why this kind of adaptation cannot continue.

Nonetheless I suspect that AR's prediction of a growth slowdown in China is quite safe but for different reasons. Economic history shows us that rapid growth episodes do not last indefinitely (think of Japan, Singapore, Taiwan, Korea, and Botswana). China will face problems when it shifts its growth strategy from dependence on exports to dependence on domestic demand and it finds it can no longer rely on borrowed technology, but must generate its own innovations.

## Conclusion

My recommendation: READ THIS BOOK. It is informative and highly engaging, almost a page-turner. Economists, other social scientists, and general readers will find that their understanding of what happened in large areas of world history has suddenly become much clearer. Economists in particular will learn that institutional settings are critical for development and that they need to take political circumstances more into account when giving policy advice. Yet I have reservations about this book. I think the AR hypothesis needs more precision in the variables it is employing. It is the nature of great books that they raise many interesting questions and set off a veritable cottage industry in follow-up papers and Ph.D. theses.