Political Economic Digest Series 35

Dear Political Economic Digest Series Participant,

Welcome to the thirty fifth issue of Political Economic Digest Series. In the last issue of Political Economic Digest Series we had readings on Trade and Growth which is a chapter from the book International Trade Free, Fair and Open by Patrick Love and Ralph Lattimore. This issue will cover extracts from the book **Why Nations Fail** by Daron Acemoglu and James A. Robinson.

The first extract Understanding Prosperity and Poverty talks about how some countries developed while some stayed poor. The second extract Why Nations Fail today talks about how Robert Mugabe single handedly destroyed the economy of Zimbabwe.

We hope you enjoy the reading.

UNDERSTANDING PROSPERITY AND POVERTY

HISTORICAL ORIGINS

THERE ARE HUGE DIFFERENCES in living standards around the world. Even the poorest citizens of the United States have incomes and access to health care, education, public services, and economic and social opportunities that are far superior to those available to the vast mass of people living in sub-Saharan Africa, South Asia, and Central America. The contrast of South and North Korea, the two Nogaleses, and the United States and Mexico reminds us that these are relatively recent phenomena. Five hundred years ago, Mexico, home to the Aztec state, was certainly richer than the polities to the north, and the United States did not pull ahead of Mexico until the nineteenth century. The gap between the two Nogaleses is even more recent. South and North Korea were economically, as well as socially and culturally, indistinguishable before the country was divided at the 38th parallel after the Second World War. Similarly, most of the huge economic differences we observe around us today emerged over the last two hundred years.

Did this all need to be so? Was it historically—or geographically or culturally or ethnically—predetermined that Western Europe, the United States, and Japan would become so much richer than sub-Saharan Africa, Latin America, and China over the last two hundred years or so? Was it inevitable that the Industrial Revolution would get under way in the eighteenth century in Britain, and then spread to Western Europe and Europe's offshoots in North America and Australasia? Is a counterfactual world where the Glorious Revolution and the Industrial Revolution take place in Peru, which then colonizes Western Europe and enslaves whites, possible, or is it just a form of historical science fiction?

To answer—in fact, even to reason about—these questions, we need a theory of why some nations are prosperous while others fail and are poor. This theory needs to delineate both the factors that create and retard prosperity and their historical origins. This book has proposed such a theory. Any complex social phenomenon, such as the origins of the different economic and political trajectories of hundreds of polities around the world, likely has a multitude of causes, making most social scientists shun monocausal, simple, and broadly applicable theories and instead seek different explanations for seemingly similar outcomes emerging in different times and areas. Instead we've offered a simple theory and used it to explain the main contours of economic and political development around the world since the Neolithic Revolution. Our choice was motivated not by a naïve belief that such a theory could explain everything, but by the belief that a theory should enable us to focus on the parallels, sometimes at the expense of abstracting from many interesting details. A successful theory, then, does not faithfully reproduce details, but provides a useful and empirically well-grounded explanation for a range of processes while also clarifying the main forces at work.

Our theory has attempted to achieve this by operating on two levels. The first is the distinction between extractive and inclusive economic and political institutions. The second is our explanation for why inclusive institutions emerged in some parts of the world and not in others. While the first level of our theory is about an institutional interpretation of history, the second level is about how history has shaped institutional trajectories of nations.

Central to our theory is the link between inclusive economic and political institutions and prosperity. Inclusive economic institutions that enforce property rights, create a level playing field, and encourage investments in new technologies and skills are more conducive to economic growth than extractive economic institutions that are structured to extract resources from the many by the few and that fail to protect property rights or provide incentives for economic activity. Inclusive economic institutions are in turn supported by, and support, inclusive political institutions, that is, those that 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. Similarly, extractive economic institutions are synergistically linked to extractive political institutions, which concentrate power in the hands of a few, who will then have incentives to maintain and develop extractive economic institutions for their benefit and use the resources they obtain to cement their hold on political power.

These tendencies do not imply that extractive economic and political institutions are inconsistent with economic growth. On the contrary, every elite would, all else being equal, like to encourage as much growth as possible in order to have more to extract. Extractive institutions that have achieved at least a minimal degree of political centralization are often able to generate some amount of growth. What is crucial, however, is that growth under extractive institutions will not be sustained, for two key reasons. First, sustained economic growth requires innovation, and innovation cannot be decoupled from creative destruction, which replaces the old with the new in the economic realm and also destabilizes established power relations in politics. Because elites dominating extractive institutions fear creative destruction, they will resist it, and any growth that germinates under extractive institutions will be ultimately short lived. Second, the ability of those who dominate extractive institutions to benefit greatly at the expense of the rest of society implies that political power under extractive institutions is highly coveted, making many groups and individuals fight to obtain it. As a consequence, there will be powerful forces pushing societies under extractive institutions toward political instability.

The synergies between extractive economic and political institutions create a vicious circle, where extractive institutions, once in place, tend to persist. Similarly, there is a virtuous circle associated with inclusive economic and political institutions. But neither the vicious nor the virtuous circle is absolute. In fact, some nations live under inclusive institutions today because, though extractive institutions have been the norm in history, some societies have been able to break the mold and transition toward inclusive institutions. Our explanation for these transitions is historical, but not historically predetermined. Major institutional change, the requisite for major economic change, takes place as a result of the interaction between existing institutions and critical junctures. Critical junctures are major events that disrupt the existing political and economic balance in one or many societies, such as the Black Death, which killed possibly as much as half the population of most areas in Europe during the fourteenth century; the opening of Atlantic trade routes, which created enormous profit opportunities for many in Western Europe; and the Industrial Revolution, which offered the potential for rapid but also disruptive changes in the structure of economies around the world.

Existing institutional differences among societies themselves are a result of past institutional changes. Why does the path of institutional change differ across societies? The answer to this question lies in institutional drift. In the same way that the genes of two isolated populations of organisms will drift apart slowly because of random mutations in the so-called process of evolutionary or genetic drift, two otherwise similar societies will also drift apart institutionally—albeit, again, slowly. Conflict over income and power, and indirectly over institutions, is a constant in all societies. This conflict often has a contingent outcome, even if the playing field over which it transpires is not level. The outcome of this conflict leads to institutional drift. But this is not necessarily a cumulative process. It does not imply that the small differences that emerge at some point will necessarily become larger over time. On the contrary, as our discussion of Roman Britain in chapter 6 illustrates, small differences open up, and then disappear, and then reappear again. However, when a critical juncture arrives, these small differences that have emerged as a result of institutional drift may be the small differences that matter in leading otherwise quite similar societies to diverge radically.

We saw in chapters 7 and 8 that despite the many similarities between England, France, and Spain, the critical juncture of the Atlantic trade had the most transformative impact on England because of such small differences—the fact that because of developments during the fifteenth and sixteenth centuries, the English Crown could not control all overseas trade, as this trade was mostly under Crown monopoly in France and Spain. As a result, in France and Spain, it was the monarchy and the groups allied with it who were the main beneficiaries of the large profits created by Atlantic trade and colonial expansion, while in England it was groups strongly opposed to the monarchy who gained from economic opportunities thrown open by this critical juncture. Though institutional drift leads to small differences, its interplay with critical junctures leads to institutional divergence, and thus this divergence then creates the now more major institutional differences that the next critical juncture will affect.

History is key, since it is historical processes that, via institutional drift, create the differences that may become consequential during critical junctures. Critical junctures themselves are historical turning points. And the vicious and virtuous circles imply that we have to study history to understand the nature of institutional differences that have been historically structured. Yet our theory does not imply historical determinism—or any other kind of determinism. It is for this reason that the answer to the question we started with in this chapter is no: there was no historical necessity that Peru end up so much poorer than Western Europe or the United States.

To start with, in contrast with the geography and culture hypotheses, Peru is not condemned to poverty because of its geography or culture. In our theory, Peru is so much poorer than Western Europe and the United States today because of its institutions, and to understand the reasons for this, we need to understand the historical process of institutional development in Peru. As we saw in the second chapter, five hundred years ago the Inca Empire, which occupied contemporary Peru, was richer, more technologically sophisticated, and more politically centralized than the smaller polities occupying North America. The turning point was the way in which this area was colonized and how this contrasted with the colonization of North America. This resulted not from a historically predetermined process but as the contingent outcome of several pivotal institutional developments during critical junctures. At least three factors could have changed this trajectory and led to very different long-run patterns.

First, institutional differences within the Americas during the fifteenth century shaped how these areas were colonized. North America followed a different institutional trajectory than Peru because it was sparsely settled before colonization and attracted European settlers who then successfully rose up against the elite whom entities such as the Virginia Company and the English Crown had tried to create. In contrast, Spanish conquistadors found a centralized, extractive state in Peru they could take over and a large population they could put to work in mines and plantations. There was also nothing geographically predetermined about the lay of the land within the Americas at the time the Europeans arrived. In the same way that the emergence of a centralized state led by King Shyaam among the Bushong was a result of a major institutional innovation, or perhaps even of political revolution, as we saw in chapter 5, the Inca civilization in Peru and the large populations in this area resulted from major institutional innovations. These could instead have taken place in North America, in places such as the Mississippi Valley or even the northeastern United States. Had this been the case, Europeans might have encountered empty lands in the Andes and centralized states in North America, and the roles of Peru and the United States could have been reversed. Europeans would then have settled in areas around Peru, and the conflict between the majority of settlers and the elite could have led to the creation of inclusive institutions there instead of in North America. The subsequent paths of economic development would then likely have been different.

Second, the Inca Empire might have resisted European colonialism, as Japan did when Commodore Perry's ships arrived in Edo Bay. Though the greater extractiveness of the Inca Empire in contrast with Tokugawa, Japan, certainly made a political revolution akin to the Meiji Restoration less likely in Peru, there was no historical necessity that the Inca completely succumb to European domination. If they had been able to resist and even institutionally modernize in response to the threats, the whole path of the history of the New World, and with it the entire history of the world, could have been different.

Third and most radically, it is not even historically or geographically or culturally predetermined that Europeans should have been the ones colonizing the world. It could have been the Chinese or even the Incas. Of course, such an outcome is impossible when we look at the world from the vantage point of the fifteenth century, by which time Western Europe had pulled ahead of the Americas, and China had already turned inward. But Western Europe of the fifteenth century was itself an outcome of a contingent process of institutional drift punctuated by critical junctures, and nothing about it was inevitable. Western European powers could not have surged ahead and conquered the world without several historic turning points. These included the specific path that feudalism took, replacing slavery and weakening the power of monarchs on the way; the fact that the centuries following the turn of the first millennium in Europe witnessed the development of independent and commercially autonomous cities; the fact that European monarchs were not as threatened by, and consequently did not try to discourage, overseas trade as the Chinese emperors did during the Ming dynasty; and the arrival of the Black Death, which shook up the foundations of the feudal order. If these events had transpired differently, we could be living in a very different world today, one in which Peru might be richer than Western Europe or the United States.

NATURALLY, THE PREDICTIVE POWER of a theory where both small differences and contingency play key roles will be limited. Few would have predicted in the fifteenth or even the sixteenth centuries, let alone in the many centuries following the fall of the Roman Empire, that the major breakthrough toward inclusive institutions would happen in Britain. It was only the specific process of institutional drift and the nature of the critical juncture created by the opening of Atlantic trade that made this possible. Neither would many have believed in the midst of the Cultural Revolution during the 1970s that China would soon be on a path toward radical changes in its economic institutions and subsequently on a breakneck growth trajectory. It is similarly impossible to predict with any certainty what the lay of the land will be in five hundred years. Yet these are not shortcomings of our theory. The historical account we have presented so far indicates that any approach based on historical determinism—based on geography, culture, or even other historical factors—is inadequate. Small differences and contingency are not just part of our theory; they are part of the shape of history.

Even if making precise predictions about which societies will prosper relative to others is difficult, we have seen throughout the book that our theory explains the broad differences in the prosperity and poverty of nations around the world fairly well. We will see in the rest of this chapter that it also provides some guidelines as to what types of societies are more likely to achieve economic growth over the next several decades.

First, vicious and virtuous circles generate a lot of persistence and sluggishness. There should be little doubt that in fifty or even a hundred years, the United States and Western Europe, based on their inclusive economic and political institutions, will be richer, most likely considerably richer, than sub-Saharan Africa, the Middle East, Central America, or Southeast Asia. However, within these broad patterns there will be major institutional changes in the next century, with some countries breaking the mold and transitioning from poor to rich.

Nations that have achieved almost no political centralization, such as Somalia and Afghanistan, or those that have undergone a collapse of the state, such as Haiti did over the last several decades—long before the massive earthquake there in 2010 led to the devastation of the country's infrastructure—are unlikely either to achieve growth under extractive political institutions or to make major changes toward inclusive institutions. Instead, nations likely to grow over the next several decades—albeit probably under extractive institutions—are those that have attained some degree of political centralization. In sub- Saharan Africa this includes Burundi, Ethiopia, Rwanda, nations with long histories of centralized states, and Tanzania, which has managed to build such centralization, or at least put in place some of the prerequisites for centralization, since independence. In Latin America, it includes Brazil, Chile, and Mexico, which have not only achieved political centralization but also made significant strides toward nascent pluralism. Our theory would suggest that sustained economic growth is very unlikely in Colombia.

Our theory also suggests that growth under extractive political institutions, as in China, will not bring sustained growth, and is likely to run out of steam. Beyond these cases, there is much uncertainty. Cuba, for example, might transition toward inclusive institutions and experience a major economic transformation, or it may linger on under extractive political and economic institutions. The same is true of North Korea and Burma (Myanmar) in Asia. Thus, while our theory provides the tools for thinking about how institutions change and the consequences of such changes, the nature of this change—the role of small differences and contingency—makes more precise predictions difficult.

Even greater caution is necessary in drawing policy recommendations from this broad account of the origins of prosperity and poverty. In the same way that the impact of critical junctures depends on existing institutions, how a society will respond to the same policy intervention depends on the institutions that are in place. Of course, our theory is all about how nations can take steps toward prosperity—by transforming their institutions from extractive to inclusive. But it also makes it very clear from the outset that there are no easy recipes for achieving such a transition. First, the vicious circle implies that changing institutions is much harder than it first appears. In particular, extractive institutions can re-create themselves under different guises, as we saw with the iron law of oligarchy in chapter 12. Thus the fact that the extractive regime of President Mubarak was overturned by popular protest in February 2011 does not guarantee that Egypt will move onto a path to more inclusive institutions. Instead extractive institutions may re-create themselves despite the vibrant and hopeful pro-democracy movement. Second, because the contingent path of history implies that it is difficult to know whether a particular interplay of critical junctures and existing institutional differences will lead toward more inclusive or extractive institutions, it would be heroic to formulate general policy recommendations to encourage change toward inclusive institutions. Nevertheless, our theory is still useful for policy analysis, as it enables us to recognize bad policy advice, based on either incorrect hypotheses or inadequate understanding of how institutions can change. In this, as in most things, avoiding the worst mistakes is as important as—and more realistic than— attempting to develop simple solutions. Perhaps this is most clearly visible when we consider current policy recommendations encouraging "authoritarian growth" based on the successful Chinese growth experience of the last several decades. We next explain why these policy recommendations are misleading and why Chinese growth, as it has unfolded so far, is just another form of growth under extractive political institutions, unlikely to translate into sustained economic development.

WHY NATIONS FAIL TODAY

HOW TO WIN THE LOTTERY IN ZIMBABWE

IT WAS JANUARY 2000 in Harare, Zimbabwe. Master of Ceremonies Fallot Chawawa was in charge of drawing the winning ticket for the national lottery organized by a partly state-owned bank, the Zimbabwe Banking Corporation (Zimbank). The lottery was open to all clients who had kept five thousand or more Zimbabwe dollars in their accounts during December 1999. When Chawawa drew the ticket, he was dumfounded. As the public statement of Zimbank put it, "Master of Ceremonies Fallot Chawawa could hardly believe his eyes when the ticket drawn for the Z$100,000 prize was handed to him and he saw His Excellency RG Mugabe written on it."

President Robert Mugabe, who had ruled Zimbabwe by hook or by crook, and usually with an iron fist, since 1980, had won the lottery, which was worth a hundred thousand Zimbabwe dollars, about five times the annual per capita income of the country. Zimbank claimed that Mr. Mugabe's name had been drawn from among thousands of eligible customers. What a lucky man! Needless to say he didn't really need the money. Mugabe had in fact only recently awarded himself and his cabinet salary hikes of up to 200 percent.

The lottery ticket was just one more indication of Zimbabwe's extractive institutions. One could call this corruption, but it is just a symptom of the institutional malaise in Zimbabwe. The fact that Mugabe could even win the lottery if he wanted showed how much control he had over matters in Zimbabwe, and gave the world a glimpse of the extent of the country's extractive institutions.

The most common reason why nations fail today is because they have extractive institutions. Zimbabwe under Mugabe's regime vividly illustrates the economic and socialconsequences. Though the national statistics in Zimbabwe are very unreliable, the best estimate is that by 2008, Zimbabwe's per capita income was about half of what it was when the country gained its independence in 1980. Dramatic as this sounds, it does not in fact begin to capture the deterioration in living standards in Zimbabwe. The state has collapsed and more or less stopped providing any basic public services. In 2008–2009 the deterioration in the health systems led to an outbreak of cholera across the country. As of January 10, 2010, there have been 98,741 reported cases and 4,293 deaths, making it the deadliest cholera outbreak inAfrica over the previous fifteen years. In the meantime, mass unemployment has also reached unprecedented levels. In early 2009, the UN Office for the Coordination of Humanitarian Affairs claimed that the unemployment rate had hit an incredible 94 percent.

The roots of many economic and political institutions in Zimbabwe, as is the case for much of sub-Saharan Africa, can be traced back to the colonial period. In 1890 Cecil Rhodes's British South Africa Company sent a military expedition into the then-kingdom of the Ndebele, based in Matabeleland, and also into the neighboring Mashonaland. Their superior weaponry quickly suppressed African resistance, and by 1901 the colony of Southern Rhodesia, named after Rhodes, had been formed in the area that is currently Zimbabwe. Now that the area was a privately owned concession of the British South Africa Company, Rhodes anticipated making money there through prospecting and mining for precious minerals. The ventures never got off the ground, but the very rich farmlands began attracting white migration. These settlers soon annexed much of the land. By 1923 they had freed themselves from the rule of the British South Africa Company and persuaded the British government to grant them self government. What then occurred is very similar to what had happened in South Africa a decade or so previously. The 1913 Natives Land Act created a dual economy in South Africa. Rhodesia passed very similar laws, and inspired by the South African model, a white-only apartheid state was constructed soon after 1923.

As the European colonial empires collapsed in the late 1950s and early 1960s, the white elite in Rhodesia, led by Ian Smith, comprising possibly 5 percent of the population, declared independence from Britain in 1965. Few international governments recognized Rhodesia's independence, and the United Nations levied economic and political sanctions against it. The black citizens organized a guerrilla war from bases in the neighboring countries of Mozambique and Zambia. International pressure and the rebellion waged by the two main groups, Mugabe's ZANU (the Zimbabwe African National Union) and

ZAPU (the Zimbabwe African People's Union), led by Joshua Nkomo, resulted in a negotiated end to white rule. The state of Zimbabwe was created in 1980.

After independence, Mugabe quickly established his personal control. He either violently eliminated his opponents or co-opted them. The most egregious acts of violence happened in Matabeleland, the heartland of support for ZAPU, where as many as twenty thousand people were killed in the early 1980s. By 1987 ZAPU had merged with ZANU to create ZANU-PF, and Joshua Nkomo was sidelined politically. Mugabe was able to rewrite the constitution he had inherited as a part of the independence negotiation, making himself president (he had started as prime minister), abolishing white voter rolls that were part of the independence agreement, and eventually, in 1990, getting rid of the Senate altogether and introducing positions in the legislature that he could nominate. A de facto one-party state headed by Mugabe was the result.

Upon independence, Mugabe took over a set of extractive economic institutions created by the white regime. These included a host of regulations on prices and international trade, state-run industries, and the obligatory agricultural marketing boards. State employment expanded rapidly, with jobs given to supporters of ZANU-PF. The tight government regulation of the economy suited the ZANU-PF elites because it made it difficult for an independent class of African businessmen, who might then have challenged the former's political monopoly, to emerge. This was very similar to the situation we saw in Ghana in the 1960s in chapter 2. Ironically, of course, this left whites as the main business class. During this period the main strengths of the white economy, particularly the highly productive agricultural export sector, was left untouched. But this would last only until Mugabe became unpopular.

The model of regulation and market intervention gradually became unsustainable, and a process of institutional change, with the support of the World Bank and the International Monetary Fund, began in 1991 after a severe fiscal crisis. The deteriorating economic performance finally led to the emergence of a serious political opposition to ZANU-PF's one-party rule: the Movement for Democratic Change (MDC). The 1995 parliamentary elections were far from competitive. ZANU- PF won 81 percent of the vote and 118 out of the 120 seats. Fifty-five of these members of Parliament were elected unopposed. The presidential election the following year showed even more signs of irregularities and fraud. Mugabe won 93 percent of the vote, but his two opponents, Abel Muzorewa and Ndabaningi Sithole, had already withdrawn their candidacy prior to the election, accusing the government of coercion and fraud.

After 2000, despite all the corruption, ZANU-PF's grip was weakening. It took only 49 percent of the popular vote, and only 63 seats. All were contested by the MDC, who took every seat in the capital, Harare. In the presidential election of 2002, Mugabe scraped home with only 56 percent of the vote. Both sets of elections went ZANU-PF's way only because of violence and intimidation, coupled with electoral fraud.

The response of Mugabe to the breakdown of his political control was to intensify both the repression and the use of government policies to buy support. He unleashed a full-scale assault on white landowners. Starting in 2000, he encouraged and supported an extensive series of land occupations and expropriations. They were often led by war veterans' associations, groups supposedly comprised of former combatants in the war of independence. Some of the expropriated land was given to these groups, but much of it also went to the ZANU-PF elites. The insecurity of property rights wrought by Mugabe and ZANU-PF led to a collapse of agricultural output and productivity. As the economy crumbled, the only thing left was to print money to buy support, which led to enormous hyperinflation. In January 2009, it became legal to use other currencies, such as the SouthAfrican rand, and the Zimbabwean dollar vanished from circulation, a worthless piece of paper.

What happened in Zimbabwe after 1980 was commonplace in sub-Saharan Africa since independence. Zimbabwe inherited a set of highly extractive political and economic institutions in 1980. For the first decade and a half, these were maintained relatively untouched. While elections took place, political institutions were anything but inclusive. Economic institutions changed somewhat; for example, there was no longer explicit discrimination against blacks. But on the whole the institutions remained extractive, with the only difference being that instead of Ian Smith and the whites doing the extracting, it was Robert Mugabe and the ZANU-PF elites filling their pockets. Over time the institutions became even more extractive, and incomes in Zimbabwe collapsed. The economic and political failure in Zimbabwe is yet another manifestation of the iron law of oligarchy—in this instance, with the extractive and repressive regime of Ian Smith being replaced by the extractive, corrupt, and repressive regime of Robert Mugabe. Mugabe's fake lottery win in 2000 was then simply the tip of a very corrupt and historically shaped iceberg.

NATIONS FAIL TODAY because their extractive economic institutions do not create the incentives needed for people to save, invest, and innovate. Extractive political institutions support these economic institutions by cementing the power of those who benefit from the extraction. Extractive economic and political institutions, though their details vary under different circumstances, are always at the root of this failure. In many cases, for example, as we will see in Argentina, Colombia, and Egypt, this failure takes the form of lack of sufficient economic activity, because the politicians are just too happy to extract resources or quash any type of independent economic activity that threatens themselves and the economic elites. In some extreme cases, as in Zimbabwe and Sierra Leone, which we discuss next, extractive institutions pave the way for complete state failure, destroying not only law and order but also even the most basic economic incentives. The result is economic stagnation and—as the recent history of Angola, Cameroon, Chad, the Democratic Republic of Congo, Haiti, Liberia, Nepal, Sierra Leone, Sudan, and Zimbabwe illustrates—civil wars, mass displacements, famines, and epidemics, making many of these countries poorer today than they were in the 1960s.

Extracted from: http://norayr.arnet.am/collections/books/Why-Nations-Fail-Daron-Acemoglu.pdf

Overview of Why Nations Fail by the author can be found at http://libertyandresponsibility.blogspot.com/2012/08/4-minute-overview-of-why-nations-fail.html