Development Policy

Lecture Note 4

Inclusive Institutions

Today we continue our discussion of growth and development over the very long run. In the last lecture we considered the proposition that some countries are rich and others are poor largely because of accidents of geography and ecology. Jared Diamond argues that the answer to Yali's question ("why is it that you white people developed much cargo and brought it to New Guinea, but we black people had little cargo of our own?") is that highly productive civilizations arose in latitudes that were able to take advantage of the best crops and livestock. They developed complex civilizations because they were able to escape the day to day struggle for survival that characterizes life in places where crops are less nutritious and animal power is not readily available.

Many economists disagree with this answer. They propose a different view that assigns greater explanatory power to institutions—defined as the rules that govern economic behavior—than than to geography and ecology. They do not completely dismiss the role of geography: they accept, for example, that land-locked countries are at a disadvantage, and that tropical diseases can hold back development progress. However, they argue that countries with similar geographical and agro-ecological characteristics have obtained different development outcomes. Countries that protect property rights, rely primarily on the market mechanism to allocate goods and services and remove political obstacles to economic initiative perform better than countries that do not. So South Korea is more prosperous than North Korea, and the United States is richer than Mexico.

A recent and influential statement of this point of view appeared last year in the form of the best-selling book *Why Nations Fail* by Daren Acemoglu, an economics professor at MIT, and James Robinson, a Harvard political scientist. According to the authors, nations fail because their economic institutions are "extractive," meaning the rules of the game are designed to extract income from some groups in society in order to give it to other groups. When politically power people create institutions to extract wealth from everyone else, the majority of people do not have an incentive to create wealth. They also do not have the ability to make the most of their potential, because of lack of education or access to other kinds of public goods.

Acemoglu and Robinson contrast extractive institutions with "inclusive institutions," or institutions "that allow and encourage participation by the great mass of people in economic activities that make best use of their talents and skills and that enable individuals to make the choices they wish." Successful countries protect property rights, establish the rule of law and an unbiased judicial system and provide public services like roads and regulations that enable people to compete on an equal footing. They also make it easy for new businesses to compete with incumbents and for people to choose their own careers, so that they can work in a fields in which they have a comparative advantage. Innovation is rewarded because the best ideas will succeed in the marketplace. This drives the entire economy forward. Thus South Korea is a rich market economy, while North Korea has remained poor under central planning. North Koreans are not allowed to benefit personally from hard work and innovation. They cannot acquire the means to produce and innovate on their own. Everything is decided by the government, and the government allocates resources to strengthen its own power rather than the economic well-being of society.

Acemoglu and Robinson stress the importance of technological change to long run economic success. This is one of the main lessons from growth theory: adding more capital and labor is ultimately less important than learning new technologies that increase productivity per person and per unit of capital. Inclusive economic institutions promote innovation: for example, providing everyone with access to education and ensuring that individuals benefit from their own hard work and creativity.

Why Nations Fail contains many stories about poor countries that have failed to create inclusive economic institutions. But there is not much new here. Economists have long emphasized the importance of market allocation, rule of law, property rights and education. What makes Acemoglu and Robinson's book different is their claim that extractive (bad) *economic* institutions persist because of extractive *political* institutions. When the distribution of political power in society is very narrow, small groups of powerful people may prefer extractive economic institutions *even if these institutions are bad for growth*. A small political elite prefers extractive economic institutions because they can use these institutions to enrich themselves and strengthen their hold on power. Thus, extractive political institutions tend to go along with extractive economic institutions. When political institutions become inclusive, extractive economic institutions are unstable. Similarly, when political institutions become less inclusive, it is difficult for inclusive economic institutions to survive.

In addition to inclusiveness, political institutions must be sufficiently centralized to prevent political fragmentation. Fragmentation makes it difficult to achieve a consistent application of rule of law and equal access to public services. For example, tribal factions in Somalia have undermined efforts to establish the rule of law and deliver public services. The country is divided and violence routinely breaks out of the distribution of assets and income flows.

According to the authors, inclusive political institutions are also important because they adjust better to technological innovation. The economist Joseph Schumpeter famously described the process of innovation as "creative destruction." What he meant was that innovation creates new products and better ways of making things. But it also destroys old products and production methods. The advent of the personal computer has helped make society more productive, and has generated millions of jobs. But it has also destroyed the typewriter industry. Innovation creates winners and losers. Inclusive political institutions are better able to cope with these frequent and difficult transitions than extractive political institutions. Political elites in extractive systems resist changes that reallocate incomes away from themselves and towards new companies and individuals.

Where do inclusive political institutions come from? Why do some countries have them and other do not? This is a difficult question, and it takes up many pages in *Why Nations Fail*. Acemoglu and Robinson argue that small changes over long periods of time create the potential for inclusive political institutions. England was the first country to achieve inclusive political institutions because of small changes that constituted an "institutional drift" over time away from extractive institutions. In 1215 King John of England signed the Magna Carta, which was the first written guarantee of basic rights of royal subjects vis-à-vis the monarchy. The feudal lords in England at this time wanted to limit King John's power after some unsuccessful wars and heavy taxation. Another change came with the English Civil Wars of 1642 to 1660, when parliament challenged the authority of King Charles I, eventually convicting him of treason. The Glorious Revolution followed in 1688, and the first Bill of Rights in 1689. These changes limited the power of the monarch and established civil liberties in England that were not in existence in the rest of Europe. When the cross-Atlantic trade developed in the 18th century, English institutions were better able to take advantage of these commercial opportunities than traditional monarchies like Spain that continued to enforce royal monopolies on trade.

Thus for Acemoglu and Robinson inclusive institutions are decisive. Geography certainly plays a role in long run outcomes: countries with poor soils, insufficient supplies of water or a heavy burden of disease will do less well than countries with high productivity agriculture, plenty of fresh water and a less disease. However, countries with similar geographical endowments have had very different growth performance: for example, North and South Korea, of Costa Rica and Guatemala. Culture also plays a role, but like geography it cannot explain why countries with a similar cultural heritage perform differently.

Why Nations Fail is an important book that scholars and policy makers will be reading for years to come. However, it has also been criticized for giving just one side of the story. The evidence that the book offers in support of its main thesis is mostly anecdotal. The stories help explain the main ideas presented in the book, but these are not the only possible explanations for the outcomes reported by the authors.

In fact, economists have for many years attempted to find some statistical relationship between the nature of political regimes and economic performance. The vast majority of these studies have found no relationship. For example, Tavares and Wacziarg (2000) use data from 65 countries over the period 1965 to 1994 to test the relationship between democracy and growth. They find that while democracy is associated with more rapid human capital formation and less inequality, it also associated with a lower investment rate. The overall effect on growth is mildly negative.

The absence of a well-established relationship between inclusive political institutions and growth makes sense if we think about the relatively poor performance of Latin America since the 1980s, and India before 1995. We should also remember that South Korea did not have an open political system prior to 1987. The Philippines has had inclusive political institutions since 1986 but its economy has not performed well.

Mushtaq Khan (2007) shows that rapidly growing developing countries do not have better governance indicators on average than slow growing countries. This includes World Bank indicators on "voice and accountability," which is probably the best approximation of the idea of inclusive political institutions. While rich countries generally have very inclusive political institutions, developing countries range from very good to poor. But these differences in voice and accountability are not related to economic performance.

This finding raises the possibility that it is not necessarily inclusiveness that is most important. Bockstette, Chanda and Putterman (2002) make the case that older, more established states perform better regardless of how inclusive they are. This is consistent with Acemoglu and Robinson's idea that some degree is centralization is necessary to implement the rule of law, protect property rights and ensure political stability. It is also consistent with Jared Diamond's assertion that the most successful countries have a long history of productive agriculture, since these are the countries that also have the longest surviving and most coherent states. China is more successful than the Congo in part because China has many hundreds of years of experience in public administration, providing public services and building complex institutions.

Another possibility is that Acemoglu and Robinson have identified an important relationship but they have reversed the direction of causality. That is to say, inclusive political systems are associated with wealth, but it is wealth that creates inclusive political institutions, not the other way around. Perhaps poor countries cannot afford expensive legal and educational systems. Or inclusive political institutions only come into being when the middle classes are large enough to create them.

Khan (2007) helps us sort through these theories with a very useful distinction between market enhancing and growth enhancing governance. Acemoglu and Robinson are mostly concerned with institutions that make markets work better: property rights, rule of law and public goods. These institutions help make markets more efficient, and few people would suggest that more efficient markets are not good for growth. The question that Khan asks is whether market enhancing institutions are *sufficient* for rapid growth. His answer is that they are not: in addition to more efficient markets, developing countries need institutions to accelerate the rate of technological learning and the transfer of resources from lower to higher productivity activities. These are the kinds of institutions that we normally associate with industrial policy: directed credit, export subsidies, directed credit and state-financed or led research and development capabilities.

The problem is that growth enhancing institutions like these open up many opportunities for rent seeking and corruption. Therefore, countries need to match the selection of growth enhancing institutions with their own political capabilities. If political power is fragmented, it is generally not practical to use the kind of growth enhancing strategies adopted successfully by Korea. Hence Malaysia relied more heavily on foreign direct investment than Korea, but will good outcomes relative to its internal capabilities. Malaysia was not in a position to impose discipline on domestic enterprises, as demonstrated by the failure of the various national car projects launched by the government.

In conclusion, what can we say about growth over the long period? Why are some countries so rich while others are so poor? We have reviewed the evidence for geographical, ecological and institutional explanations. Most reasonable people would agree that geography and institutions have both played a role. Europe's advantages were not just luck or an accumulation of small institutional changes. Strong states first emerged in Europe on the basis of thousands of years of progress that was made possible by agro-ecological opportunities that were not present elsewhere. Tropical countries also suffered disadvantages relative to temperate zones, most notably the burden of diseases like smallpox and malaria. But it is also true that geography is not destiny. Some tropical countries have performed better than others, and some temperate zone countries have performed worse than Europe and North America.

The most important question is what are the policy implications of these various theories of economic change over the very long period? Overcoming the disadvantages of geography by controlling diseases and promoting agricultural productivity are certainly priorities. Institutional change is also important. Market enhancing economic institutions create opportunities for people to innovate and derive personal benefit from their hard work. Institutions that redistribute income away from innovators and towards the politically powerful are to be avoided. Making markets work better is important but not enough: we also need institutions that promote innovation and shift resources from low to high productivity activities. These growth enhancing institutions have played a decisive role in places like Korea and China. However, countries are not equal in their political capacity to create these institutions.