

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

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The central thesis of this book is that economic growth and prosperity are associated with inclusive economic and political institutions, while extractive institutions typically lead to stagnation and poverty. The majority of the book examines most of the different societies over the last 600 years – and some more ancient ones – to determine whether this hypothesis is valid. The information is interesting and extensive, but this synopsis will only cover the basic hypothesis and corollaries that result from it.

The making of prosperity and poverty

Most societies throughout history have been ruled by extractive institutions. A corollary to this is there was very little sustained progress in living standards between the establishment of farming and the Industrial Revolution – because of the fear of *creative destruction*.

- Countries differ in their economic success because of their different institutions, the rules influencing how the economy works, and the incentives that motivate people.
 - Inclusive economic institutions allow and encourage participation by the great mass of people and make best use of their talents and skills by allowing the people themselves to make the choices they wish.
 - Inclusive economic institutions pave the way for two other engines of prosperity: technology and education.
 - Extractive economic institutions are designed to extract incomes and wealth from one subset of society in order to benefit a different subset.
- Politics is the process by which a society chooses the rules that will govern it.
 - Political institutions are the rules that govern incentives; they determine how the government is chosen, and which part of the government can do what.
- Nations with inclusive economic institutions are not only pluralistic, but they are sufficiently politically centralized and powerful.
 - The state must have a monopoly of the legitimate violence in society (law and order).
 - Political institutions must be both centralized and pluralistic to be inclusive, otherwise they become extractive.
- The concept of *creative destruction* (Joseph Schumpeter) dictates that new technologies and companies will replace old ones during broad economic expansion, with the result that political and economic power may shift away from existing elites.
 - Since the current elite in any economy do not want to be replaced, they will attempt to gain a monopoly and use the power of the state to restrain economic change.
 - In an extractive society, these elite have control of all levers of the state and are better able to restrain growth, therefore, there is no natural path for an extractive society to become pluralistic – there must be unique circumstances along with an opportunity for this to happen.
- Growth is possible under extractive political institutions
 - When elites can directly allocate resources (people) to high-productivity activities growth can occur for limited periods of time, i.e. Soviet Union (1928-1970s) moved people from the rural farms to heavy industry.
 - When political elites allow the development of somewhat inclusive economic institutions growth will occur until there is a conflict with the political structure. At that point, change must be made in the extractive political model to continue further growth and prosperity.
 - Examples are England in the late 16th century, South Korea, and the current China expansion.
 - In both England and South Korea the elites found more advantage for themselves in an inclusive political structure and the change was made. How China will progress is yet to be determined, but the historical norm is for the elites to use their power to limit competition, thereby halting further growth.

Small differences and critical junctures: the weight of history

Small differences in different cultures and critical events often determine whether a society develops an inclusive or exclusive mindset. The default is always to have extractive political and/or economic institutions as that most benefits those currently in power.

- The bubonic plague killed about half the population of any area it appeared in, creating a tremendous shortage of labor and shaking the foundations of the feudal order present when it appeared – this is a critical juncture in history.
 - In England politically more inclusive institutions had been previously formed to limit the power of the monarchy and the subsequent labor revolt resulted in more inclusive economic institutions being established.
 - In other parts of Europe the elites were able to maintain control of the economic institutions and these areas remained in general poverty.
 - As a result, the Industrial Revolution started in England and was resisted in most of the rest of the world. England was unable to control the American colonies and the inclusive ideas, as well as the Industrial Revolution, spread there.
 - Spain was able to control their population and their colonies and the societies remained extractive, with the result that poverty and a general lack of technology was a characteristic of Spain and their colonies in the New World.
- The defeat of the Spanish Armada in 1588 was another critical juncture and insured that England's inclusive political and economic institutions would survive.
 - Interestingly, England would become a sea power and world-wide colonizer, but their method of colonization was entirely extractive and it was only in North America and Australia, where there was no gold to be removed, that inclusive institutions were able to be established.
- The failure of nations today is heavily influenced by their institutional histories and their actions at the critical juncture in their development.

Growth under extractive institutions

While institutional differences play the critical role in explaining economic growth throughout the ages, extractive institutions can introduce some degree of law and order with a system of rules that will stimulate economic activity.

- This growth is based on existing technologies and is not sustainable over the long term, due to leaders' fear of *creative destruction*.
- Extractive systems create internal rivalries for control and these eventually destroy the society, if it hasn't already deteriorated to the point another society conquers it.
- The development of farming – happening several places around the world at around the same time – is one development that probably happened under an extractive society.
 - Farming or herding – as opposed to hunter-gathering – is based on the domestication of plant and animal species.
 - Societies first had to become somewhat sedentary before they could evolve these skills and the decision to stop moving and settle was most likely a decision made by an elite group in the tribes and enforced through a central law and order structure.
- Extractive institutions are so common because they have a powerful logic: They can generate some limited prosperity while at the same time distributing it into the hands of a small elite.
 - They require political centralization.
 - Their growth is limited by the lack of innovation and *creative destruction*.
 - Instability is inherent because infighting increases over time to replace the current elite.

Bars to development

Both absolutist regimes and a lack of political centralization are kept in place by a fear of *creative destruction*.

- The printing press was invented in 1445, but prohibited in the Ottoman Empire until 1727; then heavily restricted until well into the 2nd half of the 19th century. China was another absolutist regime that actively blocked the spread of printing and literacy.
 - Books spread ideas and increase literacy, both feared by sultans and the religious establishment.
- Areas without a centralized state to enforce rules and property rights cannot develop inclusive institutions, therefore industrialization cannot take place.
- India is a country where the English actually reversed development because an extractive culture was beneficial for English merchants.
- Venice introduced a partnership (commenda) where one person financed all or part of a trade mission while another managed the actual mission and both shared in the profits.
 - This allowed new blood to manage missions to gain wealth and become the investor partner – becoming part of the elite.
 - The elite did not want to share their wealth and this practice was eventually outlawed, resulting in the downfall of the Venice merchant class.
- The fact that inclusive institutions can evolve to become extractive ones shows that there is no simple, cumulative process of institutional improvement.

- Extractive political institutions create few constraints on the exercise of power, so there are no institutions to restrain the use and abuse of power by those overthrowing previous dictators.
- Infighting present in extractive institutions also paves the way for a process of descent into lawlessness, state failure, and political chaos.

Reinforcing inclusive institutions

- A powerful process of positive feedback preserves inclusive institutions and results in respect for laws intended to be applied equally to all men.
- Pluralism also creates a more open system and allows independent media to flourish.
- Education becomes more inclusive as the need for educated workers grows.
- The most common restraint against extractive institutions is a broad coalition that can stand up against absolutism and replace the absolutist institutions by more inclusive, pluralistic ones.
- Markets, left to their own devices, can cease to be inclusive; therefore inclusive markets must create a level playing field and economic opportunities for the majority of the people.

Breaking the mold

- History is not destiny, but inclusive change is neither automatic nor easy.
- A confluence of factors, in particular a critical juncture coupled with a broad coalition of those pushing for reform is often necessary to bring about inclusive institutions.
- History unfolds in a contingent way, therefore luck is always necessary.