Why Nations Fail

THE ORIGINS OF POWER,

PROSPERITY, AND POVERTY

Daron Acemoglu and

James A. Robinson

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PROFILE BOOKS

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The Making of Prosperity and Poverty

The Economics of the 38th Parallel

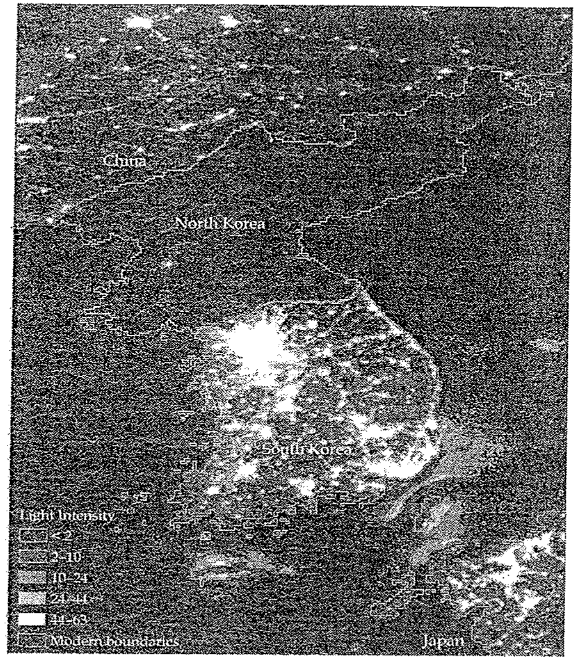
In the summer of 1945, as the Second World War was drawing to a close, the Japanese colony in Korea began to collapse. Within a month of Japan's August 15 unconditional surrender, Korea was divided at the 38th parallel into two spheres of influence. The South was administered by the United States. The North, by Russia. The uneasy peace of the cold war was shattered in June 1950 when the North Korean army invaded the South. Though initially the North Koreans made large inroads, capturing the capital city, Seoul, by the autumn, they were in full retreat. It was then that Hwang Pyŏng-Wŏn and his brother were separated. Hwang Pyŏng-Wŏn managed to hide and avoid being drafted into the North Korean army. He stayed in the South and worked as a pharmacist. His brother, a doctor working in Seoul treating wounded soldiers from the South Korean army, was taken north as the North Korean army retreated. Dragged apart in 1950, they met again in 2000 in Seoul for the first time in fifty years, after the two governments finally agreed to initiate a limited program of family reunification.

As a doctor, Hwang Pyŏng-Wŏn's brother had ended up working for the air force, a good job in a military dictatorship. But even those with privileges in North Korea don't do that well. When the brothers met, Hwang Pyŏng-Wŏn asked about how life was north of the 38th parallel. He had a car, but his brother didn't. "Do you have a telephone?" he asked his brother. "No," said his brother. "My daughter, who works at the Foreign Ministry, has a phone, but if you don't

know the code you can't call." Hwang Pyŏng-Wŏn recalled how all the people from the North at the reunion were asking for money, so he offered some to his brother. But his brother said, "If I go back with money the government will say, 'Give that money to us,' so keep it." Hwang Pyŏng-Wŏn noticed his brother's coat was threadbare: "Take off that coat and leave it, and when you go back wear this one," he suggested. "I can't do that," his brother replied. "This is just borrowed from the government to come here." Hwang Pyŏng-Wŏn recalled how when they parted, his brother was ill at ease and always nervous as though someone were listening. He was poorer than Hwang Pyŏng-Wŏn imagined. His brother said he lived well, but Hwang Pyŏng-Wŏn thought he looked awful and was thin as a rake.

The people of South Korea have living standards similar to those of Portugal and Spain. To the north, in the so-called Democratic People's Republic of Korea, or North Korea, living standards are akin to those of a sub-Saharan African country, about one-tenth of average living standards in South Korea. The health of North Koreans is in an even worse state; the average North Korean can expect to live ten years less than his cousins south of the 38th parallel. Map 7 (page 72) illustrates in a dramatic way the economic gap between the Koreas. It plots data on the intensity of light at night from satellite images. North Korea is almost completely dark due to lack of electricity; South Korea is blazing with light.

These striking differences are not ancient. In fact, they did not exist prior to the end of the Second World War. But after 1945, the different governments in the North and the South adopted very different ways of organizing their economies. South Korea was led, and its early economic and political institutions were shaped, by the Harvard- and Princeton-educated, staunchly anticommunist Syngman Rhee, with significant support from the United States. Rhee was elected president in 1948. Forged in the midst of the Korean War and against the threat of communism spreading to the south of the 38th parallel, South Korea was no democracy. Both Rhee and his equally famous successor, General Park Chung-Hee, secured their places in history as authoritarian presidents. But both governed a market economy where



Map 7: Lights in South Korea and darkness in the North

private property was recognized, and after 1961, Park effectively threw the weight of the state behind rapid economic growth, channeling credit and subsidies to firms that were successful.

The situation north of the 38th parallel was different. Kim Il-Sung, a leader of anti-Japanese communist partisans during the Second World War, established himself as dictator by 1947 and, with the help of the Soviet Union, introduced a rigid form of centrally planned economy as part of the so-called Juche system. Private property was outlawed, and markets were banned. Freedoms were curtailed not only in the marketplace, but in every sphere of North Koreans' lives—except for those who happened to be part of the very small ruling elite around Kim Il-Sung and, later, his son and successor Kim Jong-Il.

It should not surprise us that the economic fortunes of South and North Korea diverged sharply. Kim Il-Sung's command economy and the Juche system soon proved to be a disaster. Detailed statistics are not available from North Korea, which is a secretive state, to say the least. Nonetheless, available evidence confirms what we know from the all-too-often recurring famines: not only did industrial production fail to take off, but North Korea in fact experienced a collapse in agricultural productivity. Lack of private property meant that few people had incentives to invest or to exert effort to increase or even maintain productivity. The stifling, repressive regime was inimical to innovation and the adoption of new technologies. But Kim Il-Sung, Kim Jong-Il, and their cronies had no intention of reforming the system, or introducing private property, markets, private contracts, or changing economic and political institutions. North Korea continues to stagnate economically.

Meanwhile, in the South, economic institutions encouraged investment and trade. South Korean politicians invested in education, achieving high rates of literacy and schooling. South Korean companies were quick to take advantage of the relatively educated population, the policies encouraging investment and industrialization, exports, and the transfer of technology. South Korea quickly became one of East Asia's "Miracle Economies," one of the most rapidly growing nations in the world.

By the late 1990s, in just about half a century, South Korean growth and North Korean stagnation led to a tenfold gap between the two halves of this once-united country—imagine what a difference a couple of centuries could make. The economic disaster of North Korea, which led to the starvation of millions, when placed against the South Korean economic success, is striking: neither culture nor geography nor ignorance can explain the divergent paths of North and South Korea. We have to look at institutions for an answer.

EXTRACTIVE AND INCLUSIVE ECONOMIC INSTITUTIONS

Countries differ in their economic success because of their different institutions, the rules influencing how the economy works, and the incentives that motivate people. Imagine teenagers in North and South

Korea and what they expect from life. Those in the North grow up in poverty, without entrepreneurial initiative, creativity, or adequate education to prepare them for skilled work. Much of the education they receive at school is pure propaganda, meant to shore up the legitimacy of the regime; there are few books, let alone computers. After finishing school, everyone has to go into the army for ten years. These teenagers know that they will not be able to own property, start a business, or become more prosperous even if many people engage illegally in private economic activities to make a living. They also know that they will not have legal access to markets where they can use their skills or their earnings to purchase the goods they need and desire. They are even unsure about what kind of human rights they will have.

Those in the South obtain a good education, and face incentives that encourage them to exert effort and excel in their chosen vocation. South Korea is a market economy, built on private property. South Korean teenagers know that, if successful as entrepreneurs or workers, they can one day enjoy the fruits of their investments and efforts; they can improve their standard of living and buy cars, houses, and health care.

In the South the state supports economic activity. So it is possible for entrepreneurs to borrow money from banks and financial markets, for foreign companies to enter into partnerships with South Korean firms, for individuals to take up mortgages to buy houses. In the South, by and large, you are free to open any business you like. In the North, you are not. In the South, you can hire workers, sell your products or services, and spend your money in the marketplace in whichever way you want. In the North, there are only black markets. These different rules are the institutions under which North and South Koreans live.

Inclusive economic institutions, such as those in South Korea or in the United States, are those 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. To be inclusive, economic institutions must feature secure private property, an unbiased system of law, and a provision

of public services that provides a level playing field in which people can exchange and contract; it also must permit the entry of new businesses and allow people to choose their careers.

The contrast of South and North Korea, and of the United States and Latin America, illustrates a general principle. Inclusive economic institutions foster economic activity, productivity growth, and economic prosperity. Secure private property rights are central, since only those with such rights will be willing to invest and increase productivity. A businessman who expects his output to be stolen, expropriated, or entirely taxed away will have little incentive to work, let alone any incentive to undertake investments and innovations. But such rights must exist for the majority of people in society.

In 1680 the English government conducted a census of the population of its West Indian colony of Barbados. The census revealed that of the total population on the island of around 60,000, almost 39,000 were African slaves who were the property of the remaining one-third of the population. Indeed, they were mostly the property of the largest 175 sugar planters, who also owned most of the land. These large planters had secure and well-enforced property rights over their land and even over their slaves. If one planter wanted to sell slaves to another, he could do so and expect a court to enforce such a sale or any other contract he wrote. Why? Of the forty judges and justices of the peace on the island, twenty-nine of them were large planters. Also, the eight most senior military officials were all large planters. Despite well-defined, secure, and enforced property rights and contracts for the island's elite, Barbados did not have inclusive economic institutions, since two-thirds of the population were slaves with no access to education or economic opportunities, and no ability or incentive to use their talents or skills. Inclusive economic institutions require secure property rights and economic opportunities not just for the elite but for a broad cross-section of society.

Secure property rights, the law, public services, and the freedom to contract and exchange all rely on the state, the institution with the coercive capacity to impose order, prevent theft and fraud, and enforce contracts between private parties. To function well, society also needs other public services: roads and a transport network so that goods can be transported; a public infrastructure so that economic activity can flourish; and some type of basic regulation to prevent fraud and malfeasance. Though many of these public services can be provided by markets and private citizens, the degree of coordination necessary to do so on a large scale often eludes all but a central authority. The state is thus inexorably intertwined with economic institutions, as the enforcer of law and order, private property, and contracts, and often as a key provider of public services. Inclusive economic institutions need and use the state.

The economic institutions of North Korea or of colonial Latin America—the *mita, encomienda,* or *repartimiento* described earlier—do not have these properties. Private property is nonexistent in North Korea. In colonial Latin America there was private property for Spaniards, but the property of the indigenous peoples was highly insecure. In neither type of society was the vast mass of people able to make the economic decisions they wanted to; they were subject to mass coercion. In neither type of society was the power of the state used to provide key public services that promoted prosperity. In North Korea, the state built an education system to inculcate propaganda, but was unable to prevent famine. In colonial Latin America, the state focused on coercing indigenous peoples. In neither type of society was there a level playing field or an unbiased legal system. In North Korea, the legal system is an arm of the ruling Communist Party, and in Latin America it was a tool of discrimination against the mass of people. We call such institutions, which have opposite properties to those we call inclusive, extractive economic institutions—extractive because such institutions are designed to extract incomes and wealth from one subset of society to benefit a different subset.

ENGINES OF PROSPERITY

Inclusive economic institutions create inclusive markets, which not only give people freedom to pursue the vocations in life that best suit their talents but also provide a level playing field that gives them the

opportunity to do so. Those who have good ideas will be able to start businesses, workers will tend to go to activities where their productivity is greater, and less efficient firms can be replaced by more efficient ones. Contrast how people choose their occupations under inclusive markets to colonial Peru and Bolivia, where under the *mita,* many were forced to work in silver and mercury mines, regardless of their skills or whether they wanted to. Inclusive markets are not just free markets. Barbados in the seventeenth century also had markets. But in the same way that it lacked property rights for all but the narrow planter elite, its markets were far from inclusive; markets in slaves were in fact one part of the economic institutions systematically coercing the majority of the population and robbing them of the ability to choose their occupations and how they should utilize their talents.

Inclusive economic institutions also pave the way for two other engines of prosperity: technology and education. Sustained economic growth is almost always accompanied by technological improvements that enable people (labor), land, and existing capital (buildings, existing machines, and so on) to become more productive. Think of our great-great-grandparents, just over a century ago, who did not have access to planes or automobiles or most of the drugs and health care we now take for granted, not to mention indoor plumbing, air-conditioning, shopping malls, radio, or motion pictures; let alone information technology, robotics, or computer-controlled machinery. And going back a few more generations, the technological know-how and living standards were even more backward, so much so that we would find it hard to imagine how most people struggled through life. These improvements follow from science and from entrepreneurs such as Thomas Edison, who applied science to create profitable businesses. This process of innovation is made possible by economic institutions that encourage private property, uphold contracts, create a level playing field, and encourage and allow the entry of new businesses that can bring new technologies to life. It should therefore be no surprise that it was U.S. society, not Mexico or Peru, that produced Thomas Edison, and that it was South Korea, not North Korea, that today produces technologically innovative companies such as Samsung and Hyundai.

Intimately linked to technology are the education, skills, competencies, and know-how of the workforce, acquired in schools, at home, and on the job. We are so much more productive than a century ago not just because of better technology embodied in machines but also because of the greater know-how that workers possess. All the technology in the world would be of little use without workers who knew how to operate it. But there is more to skills and competencies than just the ability to run machines. It is the education and skills of the workforce that generate the scientific knowledge upon which our progress is built and that enable the adaptation and adoption of these technologies in diverse lines of business. Though we saw in chapter 1 that many of the innovators of the Industrial Revolution and afterward, like Thomas Edison, were not highly educated, these innovations were much simpler than modern technology. Today technological change requires education both for the innovator and the worker. And here we see the importance of economic institutions that create a level playing field. The United States could produce, or attract from foreign lands, the likes of Bill Gates, Steve Jobs, Sergey Brin, Larry Page, and Jeff Bezos, and the hundreds of scientists who made fundamental discoveries in information technology, nuclear power, biotech, and other fields upon which these entrepreneurs built their businesses. The supply of talent was there to be harnessed because most teenagers in the United States have access to as much schooling as they wish or are capable of attaining. Now imagine a different society, for example the Congo or Haiti, where a large fraction of the population has no means of attending school, or where, if they manage to go to school, the quality of teaching is lamentable, where teachers do not show up for work, and even if they do, there may not be any books.

The low education level of poor countries is caused by economic institutions that fail to create incentives for parents to educate their children and by political institutions that fail to induce the government to build, finance, and support schools and the wishes of parents and children. The price these nations pay for low education of their population and lack of inclusive markets is high. They fail to mobilize their nascent talent. They have many potential Bill Gateses and perhaps one or two Albert Einsteins who are now working as poor, uneducated farmers, being coerced to do what they don't want to do or being drafted into the army, because they never had the opportunity to realize their vocation in life.

The ability of economic institutions to harness the potential of inclusive markets, encourage technological innovation, invest in people, and mobilize the talents and skills of a large number of individuals is critical for economic growth. Explaining why so many economic institutions fail to meet these simple objectives is the central theme of this book.

EXTRACTIVE AND INCLUSIVE POLITICAL INSTITUTIONS

All economic institutions are created by society. Those of North Korea, for example, were forced on its citizens by the communists who took over the country in the 1940s, while those of colonial Latin America were imposed by Spanish conquistadors. South Korea ended up with very different economic institutions than the North because different people with different interests and objectives made the decisions about how to structure society. In other words, South Korea had different politics.

Politics is the process by which a society chooses the rules that will govern it. Politics surrounds institutions for the simple reason that while inclusive institutions may be good for the economic prosperity of a nation, some people or groups, such as the elite of the Communist Party of North Korea or the sugar planters of colonial Barbados, will be much better off by setting up institutions that are extractive. When there is conflict over institutions, what happens depends on which people or group wins out in the game of politics—who can get more support, obtain additional resources, and form more effective alliances. In short, who wins depends on the distribution of political power in society.

The political institutions of a society are a key determinant of the outcome of this game. They are the rules that govern incentives in politics. They determine how the government is chosen and which part of the government has the right to do what. Political institutions determine who has power in society and to what ends that power can be used. If the distribution of power is narrow and unconstrained, then the political institutions are absolutist, as exemplified by the absolutist monarchies reigning throughout the world during much of history. Under absolutist political institutions such as those in North Korea and colonial Latin America, those who can wield this power will be able to set up economic institutions to enrich themselves and augment their power at the expense of society. In contrast, political institutions that distribute power broadly in society and subject it to constraints are pluralistic. Instead of being vested in a single individual or a narrow group, political power rests with a broad coalition or a plurality of groups.

There is obviously a close connection between pluralism and inclusive economic institutions. But the key to understanding why South Korea and the United States have inclusive economic institutions is not just their pluralistic political institutions but also their sufficiently centralized and powerful states. A telling contrast is with the East African nation of Somalia. As we will see later in the book, political power in Somalia has long been widely distributed—almost pluralistic. Indeed there is no real authority that can control or sanction what anyone does. Society is divided into deeply antagonistic clans that cannot dominate one another. The power of one clan is constrained only by the guns of another. This distribution of power leads not to inclusive institutions but to chaos, and at the root of it is the Somali state's lack of any kind of political centralization, or state centralization, and its inability to enforce even the minimal amount of law and order to support economic activity, trade, or even the basic security of its citizens.

Max Weber, who we met in the previous chapter, provided the most famous and widely accepted definition of the state, identifying it with the "monopoly of legitimate violence" in society. Without such a monopoly and the degree of centralization that it entails, the state cannot play its role as enforcer of law and order, let alone provide public services and encourage and regulate economic activity. When

the state fails to achieve almost any political centralization, society sooner or later descends into chaos, as did Somalia.

We will refer to political institutions that are sufficiently centralized and pluralistic as inclusive political institutions. When either of these conditions fails, we will refer to the institutions as extractive political institutions.

There is strong synergy between economic and political institutions. Extractive political institutions concentrate power in the hands of a narrow elite and place few constraints on the exercise of this power. Economic institutions are then often structured by this elite to extract resources from the rest of the society. Extractive economic institutions thus naturally accompany extractive political institutions. In fact, they must inherently depend on extractive political institutions for their survival. Inclusive political institutions, vesting power broadly, would tend to uproot economic institutions that expropriate the resources of the many, erect entry barriers, and suppress the functioning of markets so that only a few benefit.

In Barbados, for example, the plantation system based on the exploitation of slaves could not have survived without political institutions that suppressed and completely excluded the slaves from the political process. The economic system impoverishing millions for the benefit of a narrow communist elite in North Korea would also be unthinkable without the total political domination of the Communist Party.

This synergistic relationship between extractive economic and political institutions introduces a strong feedback loop: political institutions enable the elites controlling political power to choose economic institutions with few constraints or opposing forces. They also enable the elites to structure future political institutions and their evolution. Extractive economic institutions, in turn, enrich the same elites, and their economic wealth and power help consolidate their political dominance. In Barbados or in Latin America, for example, the colonists were able to use their political power to impose a set of economic institutions that made them huge fortunes at the expense of the rest of the population. The resources these economic institutions generated enabled these elites to build armies and security forces to defend their absolutist monopoly of political power. The implication of course is that extractive political and economic institutions support each other and tend to persist.

There is in fact more to the synergy between extractive economic and political institutions. When existing elites are challenged under extractive political institutions and the newcomers break through, the newcomers are likewise subject to only a few constraints. They thus have incentives to maintain these political institutions and create a similar set of economic institutions, as Porfirio Díaz and the elite surrounding him did at the end of the nineteenth century in Mexico.

Inclusive economic institutions, in turn, are forged on foundations laid by inclusive political institutions, which make power broadly distributed in society and constrain its arbitrary exercise. Such political institutions also make it harder for others to usurp power and undermine the foundations of inclusive institutions. Those controlling political power cannot easily use it to set up extractive economic institutions for their own benefit. Inclusive economic institutions, in turn, create a more equitable distribution of resources, facilitating the persistence of inclusive political institutions.

It was not a coincidence that when, in 1618, the Virginia Company gave land, and freedom from their draconian contracts, to the colonists it had previously tried to coerce, the General Assembly in the following year allowed the colonists to begin governing themselves. Economic rights without political rights would not have been trusted by the colonists, who had seen the persistent efforts of the Virginia Company to coerce them. Neither would these economies have been stable and durable. In fact, combinations of extractive and inclusive institutions are generally unstable. Extractive economic institutions under inclusive political institutions are unlikely to survive for long, as our discussion of Barbados suggests.

Similarly, inclusive economic institutions will neither support nor be supported by extractive political ones. Either they will be transformed into extractive economic institutions to the benefit of the narrow interests that hold power, or the economic dynamism they create will destabilize the extractive political institutions, opening the way for the emergence of inclusive political institutions. Inclusive economic institutions also tend to reduce the benefits the elites can enjoy by ruling over extractive political institutions, since those institutions face competition in the marketplace and are constrained by the contracts and property rights of the rest of society.

Why Not Always Choose Prosperity?

Political and economic institutions, which are ultimately the choice of society, can be inclusive and encourage economic growth. Or they can be extractive and become impediments to economic growth. Nations fail when they have extractive economic institutions, supported by extractive political institutions that impede and even block economic growth. But this means that the choice of institutions—that is, the politics of institutions—is central to our quest for understanding the reasons for the success and failure of nations. We have to understand why the politics of some societies lead to inclusive institutions that foster economic growth, while the politics of the vast majority of societies throughout history has led, and still leads today, to extractive institutions that hamper economic growth.

It might seem obvious that everyone should have an interest in creating the type of economic institutions that will bring prosperity. Wouldn't every citizen, every politician, and even a predatory dictator want to make his country as wealthy as possible?

Let's return to the Kingdom of Kongo we discussed earlier. Though this kingdom collapsed in the seventeenth century, it provided the name for the modern country that became independent from Belgian colonial rule in 1960. As an independent polity, Congo experienced almost unbroken economic decline and mounting poverty under the rule of Joseph Mobutu between 1965 and 1997. This decline continued after Mobutu was overthrown by Laurent Kabila. Mobutu created a highly extractive set of economic institutions. The citizens were impoverished, but Mobutu and the elite surrounding him, known as Les Grosses Légumes (the Big Vegetables), became fabulously wealthy. Mobutu built himself a palace at his birthplace, Gbadolite, in the north of the country, with an airport large enough to land a supersonic Concord jet, a plane he frequently rented from Air France for travel to Europe. In Europe he bought castles and owned large tracts of the Belgian capital of Brussels.

Wouldn't it have been better for Mobutu to set up economic institutions that increased the wealth of the Congolese rather than deepening their poverty? If Mobutu had managed to increase the prosperity of his nation, would he not have been able to appropriate even more money, buy a Concord instead of renting one, have more castles and mansions, possibly a bigger and more powerful army? Unfortunately for the citizens of many countries in the world, the answer is no. Economic institutions that create incentives for economic progress may simultaneously redistribute income and power in such a way that a predatory dictator and others with political power may become worse off.

The fundamental problem is that there will necessarily be disputes and conflict over economic institutions. Different institutions have different consequences for the prosperity of a nation, how that prosperity is distributed, and who has power. The economic growth which can be induced by institutions creates both winners and losers. This was clear during the Industrial Revolution in England, which laid the foundations of the prosperity we see in the rich countries of the world today. It centered on a series of pathbreaking technological changes in steam power, transportation, and textile production. Even though mechanization led to enormous increases in total incomes and ultimately became the foundation of modern industrial society, it was bitterly opposed by many. Not because of ignorance or shortsightedness; quite the opposite. Rather, such opposition to economic growth has its own, unfortunately coherent, logic. Economic growth and technological change are accompanied by what the great economist Joseph Schumpeter called creative destruction. They replace the old with the new. New sectors attract resources away from old ones. New firms take business away from established ones. New technologies make existing skills and machines obsolete. The process of economic growth and the inclusive institutions upon which it is based create losers as well as winners in the political arena and in the economic marketplace. Fear of creative destruction is often at the root of the opposition to inclusive economic and political institutions.

European history provides a vivid example of the consequences of creative destruction. On the eve of the Industrial Revolution in the eighteenth century, the governments of most European countries were controlled by aristocracies and traditional elites, whose major source of income was from landholdings or from trading privileges they enjoyed thanks to monopólies granted and entry barriers imposed by monarchs. Consistent with the idea of creative destruction, the spread of industries, factories, and towns took resources away from the land, reduced land rents, and increased the wages that landowners had to pay their workers. These elites also saw the emergence of new businessmen and merchants eroding their trading privileges. All in all, they were the clear economic losers from industrialization. Urbanization and the emergence of a socially conscious middle and working class also challenged the political monopoly of landed aristocracies. So with the spread of the Industrial Revolution the aristocracies weren't just the economic losers; they also risked becoming political losers, losing their hold on political power. With their economic and political power under threat, these elites often formed a formidable opposition against industrialization.

The aristocracy was not the only loser from industrialization. Artisans whose manual skills were being replaced by mechanization likewise opposed the spread of industry. Many organized against it, rioting and destroying the machines they saw as responsible for the decline of their livelihood. They were the Luddites, a word that has today become synonymous with resistance to technological change. John Kay, English inventor of the "flying shuttle" in 1733, one of the first significant improvements in the mechanization of weaving, had his house burned down by Luddites in 1753. James Hargreaves, inventor of the "spinning jenny," a complementary revolutionary improvement in spinning, got similar treatment.

In reality, the artisans were much less effective than the landowners and elites in opposing industrialization. The Luddites did not possess the political power—the ability to affect political outcomes against the wishes of other groups—of the landed aristocracy. In England, industrialization marched on, despite the Luddites' opposition, because aristocratic opposition, though real, was muted. In the Austro-

Hungarian and the Russian empires, where the absolutist monarchs and aristocrats had far more to lose, industrialization was blocked. In consequence, the economies of Austria-Hungary and Russia stalled. They fell behind other European nations, where economic growth took off during the nineteenth century.

The success and failure of specific groups notwithstanding, one lesson is clear: powerful groups often stand against economic progress and against the engines of prosperity. Economic growth is not just a process of more and better machines, and more and better educated people, but also a transformative and destabilizing process associated with widespread creative destruction. Growth thus moves forward only if not blocked by the economic losers who anticipate that their economic privileges will be lost and by the political losers who fear that their political power will be eroded.

Conflict over scarce resources, income and power, translates into conflict over the rules of the game, the economic institutions, which will determine the economic activities and who will benefit from them. When there is a conflict, the wishes of all parties cannot be simultaneously met. Some will be defeated and frustrated, while others will succeed in securing outcomes they like. Who the winners of this conflict are has fundamental implications for a nation's economic trajectory. If the groups standing against growth are the winners, they can successfully block economic growth, and the economy will stagnate.

The logic of why the powerful would not necessarily want to set up the economic institutions that promote economic success extends easily to the choice of political institutions. In an absolutist regime, some elites can wield power to set up economic institutions they prefer. Would they be interested in changing political institutions to make them more pluralistic? In general not, since this would only dilute their political power, making it more difficult, maybe impossible, for them to structure economic institutions to further their own interests. Here again we see a ready source of conflict. The people who suffer from the extractive economic institutions cannot hope for absolutist rulers to voluntarily change political institutions and redistribute power in

society. The only way to change these political institutions is to force the elite to create more pluralistic institutions.

In the same way that there is no reason why political institutions should automatically become pluralistic, there is no natural tendency toward political centralization. There would certainly be incentives to create more centralized state institutions in any society, particularly in those with no such centralization whatsoever. For example, in Somalia, if one clan created a centralized state capable of imposing order on the country, this could lead to economic benefits and make this clan richer. What stops this? The main barrier to political centralization is again a form of fear from change: any clan, group, or politician attempting to centralize power in the state will also be centralizing power in their own hands, and this is likely to meet the ire of other clans, groups, and individuals, who would be the political losers of this process. Lack of political centralization means not only lack of law and order in much of a territory but also there being many actors with sufficient powers to block or disrupt things, and the fear of their opposition and violent reaction will often deter many would-be centralizers. Political centralization is likely only when one group of people is sufficiently more powerful than others to build a state. In Somalia, power is evenly balanced, and no one clan can impose its will on any other. Therefore, the lack of political centralization persists.

The Long Agony of the Congo

There are few better, or more depressing, examples of the forces that explain the logic of why economic prosperity is so persistently rare under extractive institutions or that illustrate the synergy between extractive economic and political institutions than the Congo. Portuguese and Dutch visitors to Kongo in the fifteenth and sixteenth centuries remarked on the "miserable poverty" there. Technology was rudimentary by European standards, with the Kongolese having neither writing, the wheel, nor the plow. The reason for this poverty, and the reluctance of Kongolese farmers to adopt better technologies when they learned of them, is clear from existing historical accounts. It was due to the extractive nature of the country's economic institutions.

As we have seen, the Kingdom of Kongo was governed by the king in Mbanza, subsequently São Salvador. Areas away from the capital were ruled by an elite who played the roles of governors of different parts of the kingdom. The wealth of this elite was based on slave plantations around São Salvador and the extraction of taxes from the rest of the country. Slavery was central to the economy, used by the elite to supply their own plantations and by Europeans on the coast. Taxes were arbitrary; one tax was even collected every time the king's beret fell off. To become more prosperous, the Kongolese people would have had to save and invest—for example, by buying plows. But it would not have been worthwhile, since any extra output that they produced using better technology would have been subject to expropriation by the king and his elite. Instead of investing to increase their productivity and selling their products in markets, the Kongolese moved their villages away from the market; they were trying to be as far away from the roads as possible, in order to reduce the incidence of plunder and to escape the reach of slave traders.

The poverty of the Kongo was therefore the result of extractive economic institutions that blocked all the engines of prosperity or even made them work in reverse. The Kongo's government provided very few public services to its citizens, not even basic ones, such as secure property rights or law and order. On the contrary, the government was itself the biggest threat to its subjects' property and human rights. The institution of slavery meant that the most fundamental market of all, an inclusive labor market where people can choose their occupation or jobs in ways that are so crucial for a prosperous economy, did not exist. Moreover, long-distance trade and mercantile activities were controlled by the king and were open only to those associated with him. Though the elite quickly became literate after the Portuguese introduced writing, the king made no attempt to spread literacy to the great mass of the population.

Nevertheless, though "miserable poverty" was widespread, the Kongolese extractive institutions had their own impeccable logic:

they made a few people, those with political power, very rich. In the sixteenth century, the king of Kongo and the aristocracy were able to import European luxury goods and were surrounded by servants and slaves.

The roots of the economic institutions of Kongolese society flowed from the distribution of political power in society and thus from the nature of political institutions. There was nothing to stop the king from taking people's possessions or bodies, other than the threat of revolt. Though this threat was real, it was not enough to make people or their wealth secure. The political institutions of Kongo were truly absolutist, making the king and the elite subject to essentially no constraints, and it gave no say to the citizens in the way their society was organized.

Of course, it is not difficult to see that the political institutions of Kongo contrast sharply with inclusive political institutions where power is constrained and broadly distributed. The absolutist institutions of Kongo were kept in place by the army. The king had a standing army of five thousand troops in the mid-seventeenth century, with a core of five hundred musketeers—a formidable force for its time. Why the king and the aristocracy so eagerly adopted European firearms is thus easy to understand.

There was no chance of sustained economic growth under this set of economic institutions and even incentives for generating temporary growth were highly limited. Reforming economic institutions to improve individual property rights would have made the Kongolese society at large more prosperous. But it is unlikely that the elite would have benefited from this wider prosperity. First, such reforms would have made the elite economic losers, by undermining the wealth that the slave trade and slave plantations brought them. Second, such reforms would have been possible only if the political power of the king and the elite were curtailed. For instance, if the king continued to command his five hundred musketeers, who would have believed an announcement that slavery had been abolished? What would have stopped the king from changing his mind later on? The only real guarantee would have been a change in political institutions so that citizens gained some countervailing political power, giving them some say over taxation or what the musketeers did. But in this case it is dubious that sustaining the consumption and lifestyle of the king and the elite would have been high on their list of priorities. In this scenario, changes that would have created better economic institutions in society would have made the king and aristocracy political as well as economic losers.

The interaction of economic and political institutions five hundred years ago is still relevant for understanding why the modern state of Congo is still miserably poor today. The advent of European rule in this area, and deeper into the basin of the River Congo at the time of the "scramble for Africa" in the late nineteenth century, led to an insecurity of human and property rights even more egregious than that which characterized the precolonial Kongo. In addition, it reproduced the pattern of extractive institutions and political absolutism that empowered and enriched a few at the expense of the masses, though the few now were Belgian colonialists, most notably King Leopold II.

When Congo became independent in 1960, the same pattern of economic institutions, incentives, and performance reproduced itself. These Congolese extractive economic institutions were again supported by highly extractive political institutions. The situation was worsened because European colonialism created a polity, Congo, made up of many different precolonial states and societies that the national state, run from Kinshasa, had little control over. Though President Mobutu used the state to enrich himself and his cronies—for example, through the Zairianization program of 1973, which involved the mass expropriation of foreign economic interests—he presided over a noncentralized state with little authority over much of the country, and had to appeal to foreign assistance to stop the provinces of Katanga and Kasai from seceding in the 1960s. This lack of political centralization, almost to the point of total collapse of the state, is a feature that Congo shares with much of sub-Saharan Africa.

The modern Democratic Republic of Congo remains poor because its citizens still lack the economic institutions that create the basic incentives that make a society prosperous. It is not geography, culture, or the ignorance of its citizens or politicians that keep the Congo poor, but its extractive economic institutions. These are still in place after all these centuries because political power continues to be narrowly concentrated in the hands of an elite who have little incentive to enforce secure property rights for the people, to provide the basic public services that would improve the quality of life, or to encourage economic progress. Rather, their interests are to extract income and sustain their power. They have not used this power to build a centralized state, for to do so would create the same problems of opposition and political challenges that promoting economic growth would. Moreover, as in much of the rest of sub-Saharan Africa, infighting triggered by rival groups attempting to take control of extractive institutions destroyed any tendency for state centralization that might have existed.

The history of the Kingdom of Kongo, and the more recent history of the Congo, vividly illustrates how political institutions determine economic institutions and, through these, the economic incentives and the scope for economic growth. It also illustrates the symbiotic relationship between political absolutism and economic institutions that empower and enrich a few at the expense of many.

Growth Under Extractive Political Institutions

Congo today is an extreme example, with lawlessness and highly insecure property rights. However, in most cases such extremism would not serve the interest of the elite, since it would destroy all economic incentives and generate few resources to be extracted. 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. But this implies neither that extractive institutions can never generate growth nor that all extractive institutions are created equal.

There are two distinct but complementary ways in which growth under extractive political institutions can emerge. First, even if economic institutions are extractive, growth is possible when elites can directly allocate resources to high-productivity activities that they themselves control. A prominent example of this type of growth under extractive institutions was the Caribbean Islands between the sixteenth and eighteenth centuries. Most people were slaves, working under gruesome conditions in plantations, living barely above subsistence level. Many died from malnutrition and exhaustion. In Barbados, Cuba, Haiti, and Jamaica in the seventeenth and eighteenth centuries, a small minority, the planter elite, controlled all political power and owned all the assets, including all the slaves. While the majority had no rights, the planter elite's property and assets were well protected. Despite the extractive economic institutions that savagely exploited the majority of the population, these islands were among the richest places in the world, because they could produce sugar and sell it in world markets. The economy of the islands stagnated only when there was a need to shift to new economic activities, which threatened both the incomes and the political power of the planter elite.

Another example is the economic growth and industrialization of the Soviet Union from the first Five-Year Plan in 1928 until the 1970s. Political and economic institutions were highly extractive, and markets were heavily constrained. Nevertheless, the Soviet Union was able to achieve rapid economic growth because it could use the power of the state to move resources from agriculture, where they were very inefficiently used, into industry.

The second type of growth under extractive political institutions arises when the institutions permit the development of somewhat, even if not completely, inclusive economic institutions. Many societies with extractive political institutions will shy away from inclusive economic institutions because of fear of creative destruction. But the degree to which the elite manage to monopolize power varies across societies. In some, the position of the elite could be sufficiently secure that they may permit some moves toward inclusive economic institutions when they are fairly certain that this will not threaten their political power. Alternatively, the historical situation could be such as to endow an extractive political regime with rather inclusive economic institutions, which they decide not to block. These provide the second way in which growth can take place under extractive political institutions.

The rapid industrialization of South Korea under General Park is an example. Park came to power via a military coup in 1961, but he did so in a society heavily supported by the United States and with an economy where economic institutions were essentially inclusive. Though Park's regime was authoritarian, it felt secure enough to promote economic growth, and in fact did so very actively—perhaps partly because the regime was not directly supported by extractive economic institutions. Differently from the Soviet Union and most other cases of growth under extractive institutions, South Korea transitioned from extractive political institutions toward inclusive political institutions in the 1980s. This successful transition was due to a confluence of factors.

By the 1970s, economic institutions in South Korea had become sufficiently inclusive that they reduced one of the strong rationales for extractive political institutions—the economic elite had little to gain from their own or the military's dominance of politics. The relative equality of income in South Korea also meant that the elite had less to fear from pluralism and democracy. The key influence of the United States, particularly given the threat from North Korea, also meant that the strong democracy movement that challenged the military dictatorship could not be repressed for long. Though General Park's assassination in 1979 was followed by another military coup, led by Chun Doo-hwan, Chun's chosen successor, Roh Tae-woo, initiated a process of political reforms that led to the consolidation of a pluralistic democracy after 1992. Of course, no transition of this sort took place in the Soviet Union. In consequence, Soviet growth ran out of steam, and the economy began to collapse in the 1980s and then totally fell apart in the 1990s.

Chinese economic growth today also has several commonalities with both the Soviet and South Korean experiences. While the early stages of Chinese growth were spearheaded by radical market reforms in the agricultural sector, reforms in the industrial sector have been more muted. Even today, the state and the Communist Party play a central role in deciding which sectors and which companies will receive additional capital and will expand—in the process, making and breaking fortunes. As in the Soviet Union in its heyday, China is growing rapidly, but this is still growth under extractive institutions, under the control of the state, with little sign of a transition to inclusive political institutions. The fact that Chinese economic institutions are still far from fully inclusive also suggests that a South Korean–style transition is less likely, though of course not impossible.

It is worth noting that political centralization is key to both ways in which growth under extractive political institutions can occur. Without some degree of political centralization, the planter elite in Barbados, Cuba, Haiti, and Jamaica would not have been able to keep law and order and defend their own assets and property. Without significant political centralization and a firm grip on political power, neither the South Korean military élites nor the Chinese Communist Party would have felt secure enough to manufacture significant economic reforms and still manage to cling to power. And without such centralization, the state in the Soviet Union or China could not have been able to coordinate economic activity to channel resources toward high productivity areas. A major dividing line between extractive political institutions is therefore their degree of political centralization. Those without it, such as many in sub-Saharan Africa, will find it difficult to achieve even limited growth.

Even though extractive institutions can generate some growth, they will usually not generate sustained economic growth, and certainly not the type of growth that is accompanied by creative destruction. When both political and economic institutions are extractive, the incentives will not be there for creative destruction and technological change. For a while the state may be able to create rapid economic growth by allocating resources and people by fiat, but this process is intrinsically limited. When the limits are hit, growth stops, as it did in the Soviet Union in the 1970s. Even when the Soviets achieved rapid economic growth, there was little technological change in most of the economy, though by pouring massive resources into the military they were able to develop military technologies and even pull ahead of the United States in the space and nuclear race for a short while. But this growth without creative destruction and without broad-based technological innovation was not sustainable and came to an abrupt end.

In addition, the arrangements that support economic growth under

extractive political institutions are, by their nature, fragile—they can collapse or can be easily destroyed by the infighting that the extractive institutions themselves generate. In fact, extractive political and economic institutions create a general tendency for infighting, because they lead to the concentration of wealth and power in the hands of a narrow elite. If another group can overwhelm and outmaneuver this elite and take control of the state, they will be the ones enjoying this wealth and power. Consequently, as our discussion of the collapse of the later Roman Empire and the Maya cities will illustrate (pages 166–172 and 143–149), fighting to control the all-powerful state is always latent, and it will periodically intensify and bring the undoing of these regimes, as it turns into civil war and sometimes into total breakdown and collapse of the state. One implication of this is that even if a society under extractive institutions initially achieves some degree of state centralization, it will not last. In fact, the infighting to take control of extractive institutions often leads to civil wars and widespread lawlessness, enshrining a persistent absence of state centralization as in many nations in sub-Saharan Africa and some in Latin America and South Asia.

Finally, when growth comes under extractive political institutions but where economic institutions have inclusive aspects, as they did in South Korea, there is always the danger that economic institutions become more extractive and growth stops. Those controlling political power will eventually find it more beneficial to use their power to limit competition, to increase their share of the pie, or even to steal and loot from others rather than support economic progress. The distribution and ability to exercise power will ultimately undermine the very foundations of economic prosperity, unless political institutions are transformed from extractive to inclusive.