A *NEW YORK TIMES* AND *WALL STREET JOURNAL* BESTSELLER

THE ORIGINS OF
POWER, PROSPERITY, AND POVERTY

WHY NATIONS FAIL

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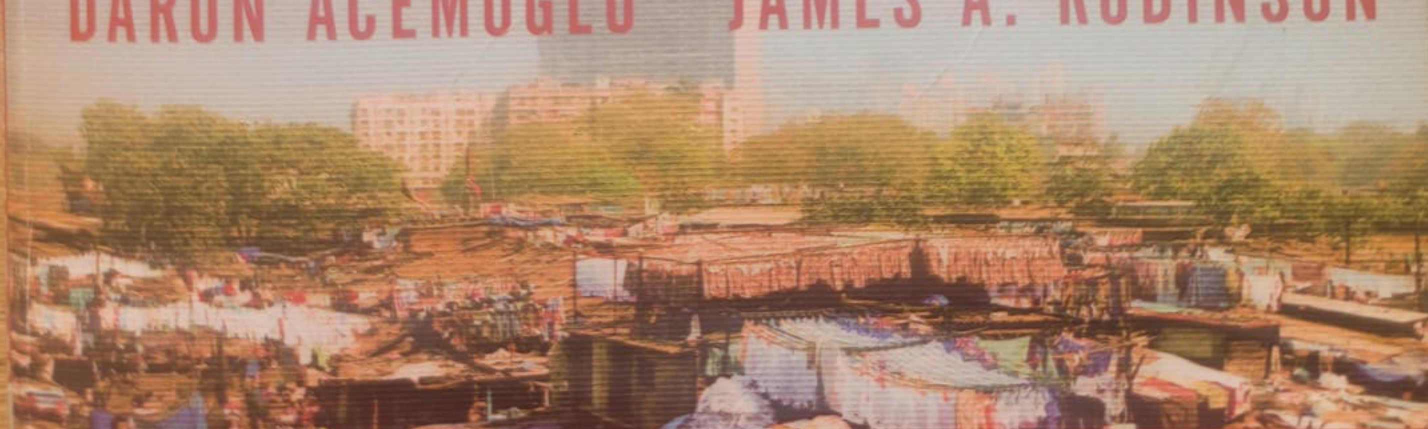

"A wildly ambitious work that hopscotches through history and around the world to answer the very big question of why some countries get rich and others don't."
—*NEW YORK TIMES*

By the 1720s, all the thirteen colonies of what was to become the United States had similar structures of government. In all cases there was a governor, and an assembly based on a franchise of male property holders. They were not democracies; women, slaves, and the propertyless could not vote. But political rights were very broad compared with contemporary societies elsewhere. It was these assemblies and their leaders that coalesced to form the First Continental Congress in 1774, the prelude to the independence of the United States. The assemblies believed they had the right to determine both their own membership and the right to taxation. This, as we know, created problems for the English colonial government.

A Tale of Two Constitutions

It should now be apparent that it is not a coincidence that the United States, and not Mexico, adopted and enforced a constitution that espoused democratic principles, created limitations on the use of political power, and distributed that power broadly in society. The document that the delegates sat down to write in Philadelphia in May 1787 was the outcome of a long process initiated by the formation of the General Assembly in Jamestown in 1619.

The contrast between the constitutional process that took place at the time of the independence of the United States and the one that took place a little afterward in Mexico is stark. In February 1808, Napoleon Bonaparte's French armies invaded Spain. By May they had taken Madrid, the Spanish capital. By September the Spanish king Ferdinand had been captured and had abdicated. A national junta, the Junta Central, took his place, taking the torch in the fight against the French. The Junta met first at Aranjuez, but retreated south in the face of the French armies. Finally it reached the port of Cádiz, which, though besieged by Napoleonic forces, held out. Here the Junta formed a parliament, called the Cortes. In 1812 the Cortes produced what became known as the Cádiz Constitution, which called for the introduction of a constitutional monarchy based on notions of popular sovereignty. It also called for the end of special privileges and the introduction of equality before the law. These demands were all

anathema to the elites of South America, who were still ruling an institutional environment shaped by the *encomienda,* forced labor, and absolute power vested in them and the colonial state.

The collapse of the Spanish state with the Napoleonic invasion created a constitutional crisis throughout colonial Latin America. There was much dispute about whether to recognize the authority of the Junta Central, and in response, many Latin Americans began to form their own juntas. It was only a matter of time before they began to sense the possibility of becoming truly independent from Spain. The first declaration of independence took place in La Paz, Bolivia, in 1809, though it was quickly crushed by Spanish troops sent from Peru. In Mexico the political attitudes of the elite had been shaped by the 1810 Hidalgo Revolt, led by a priest, Father Miguel Hidalgo. When Hidalgo's army sacked Guanajuato on September 23, they killed the intendant, the senior colonial official, and then started indiscriminately to kill white people. It was more like class or even ethnic warfare than an independence movement, and it united all the elites in opposition. If independence allowed popular participation in politics, the local elites, not just Spaniards, were against it. Consequentially, Mexican elites viewed the Cádiz Constitution, which opened the way to popular participation, with extreme skepticism; they would never recognize its legitimacy.

In 1815, as Napoleon's European empire collapsed, King Ferdinand VII returned to power and the Cádiz Constitution was abrogated. As the Spanish Crown began trying to reclaim its American colonies, it did not face a problem with loyalist Mexico. Yet, in 1820, a Spanish army that had assembled in Cádiz to sail to the Americas to help restore Spanish authority mutinied against Ferdinand VII. They were soon joined by army units throughout the country, and Ferdinand was forced to restore the Cádiz Constitution and recall the Cortes. This Cortes was even more radical than the one that had written the Cádiz Constitution, and it proposed abolishing all forms of labor coercion. It also attacked special privileges—for example, the right of the military to be tried for crimes in their own courts. Faced finally with the imposition of this document in Mexico, the elites there decided that it was better to go it alone and declare independence.

This independence movement was led by Augustín de Iturbide, who had been an officer in the Spanish army. On February 24, 1821, he published the Plan de Iguala, his vision for an independent Mexico. The plan featured a constitutional monarchy with a Mexican emperor, and removed the provisions of the Cádiz Constitution that Mexican elites found so threatening to their status and privileges. It received instantaneous support, and Spain quickly realized that it could not stop the inevitable. But Iturbide did not just organize Mexican secession. Recognizing the power vacuum, he quickly took advantage of his military backing to have himself declared emperor, a position that the great leader of South American independence Simón Bolivar described as "by the grace of God and of bayonets." Iturbide was not constrained by the same political institutions that constrained presidents of the United States; he quickly made himself a dictator, and by October 1822 he had dismissed the constitutionally sanctioned congress and replaced it with a junta of his choosing. Though Iturbide did not last long, this pattern of events was to be repeated time and time again in nineteenth-century Mexico.

The Constitution of the United States did not create a democracy by modern standards. Who could vote in elections was left up to the individual states to determine. While northern states quickly conceded the vote to all white men irrespective of how much income they earned or property they owned, southern states did so only gradually. No state enfranchised women or slaves, and as property and wealth restrictions were lifted on white men, racial franchises explicitly disenfranchising black men were introduced. Slavery, of course, was deemed constitutional when the Constitution of the United States was written in Philadelphia, and the most sordid negotiation concerned the division of the seats in the House of Representatives among the states. These were to be allocated on the basis of a state's population, but the congressional representatives of southern states then demanded that the slaves be counted. Northerners objected. The compromise was that in apportioning seats to the House of Representatives, a slave would count as three-fifths of a free person. The conflicts between the North and South of the United States were repressed during the constitutional process as the three-fifths

rule and other compromises were worked out. New fixes were added over time—for example, the Missouri Compromise, an arrangement where one proslavery and one antislavery state were always added to the union together, to keep the balance in the Senate between those for and those against slavery. These fudges kept the political institutions of the United States working peacefully until the Civil War finally resolved the conflicts in favor of the North.

The Civil War was bloody and destructive. But both before and after it there were ample economic opportunities for a large fraction of the population, especially in the northern and western United States. The situation in Mexico was very different. If the United States experienced five years of political instability between 1860 and 1865, Mexico experienced almost nonstop instability for the first fifty years of independence. This is best illustrated via the career of Antonio López de Santa Ana.

Santa Ana, son of a colonial official in Veracruz, came to prominence as a soldier fighting for the Spanish in the independence wars. In 1821 he switched sides with Iturbide and never looked back. He became president of Mexico for the first time in May of 1833, though he exercised power for less than a month, preferring to let Valentín Gómez Farías act as president. Gómez Farías's presidency lasted fifteen days, after which Santa Ana retook power. This was as brief as his first spell, however, and he was again replaced by Gómez Farías, in early July. Santa Ana and Gómez Farías continued this dance until the middle of 1835, when Santa Ana was replaced by Miguel Barragán. But Santa Ana was not a quitter. He was back as president in 1839, 1841, 1844, 1847, and, finally, between 1853 and 1855. In all, he was president eleven times, during which he presided over the loss of the Alamo and Texas and the disastrous Mexican-American War, which led to the loss of what became New Mexico and Arizona. Between 1824 and 1867 there were fifty-two presidents in Mexico, few of whom assumed power according to any constitutionally sanctioned procedure.

The consequence of this unprecedented political instability for economic institutions and incentives should be obvious. Such instability led to highly insecure property rights. It also led to a severe weakening of the Mexican state, which now had little authority and little ability to raise taxes or provide public services. Indeed, even though Santa Ana was president in Mexico, large parts of the country were not under his control, which enabled the annexation of Texas by the United States. In addition, as we just saw, the motivation behind the Mexican declaration of independence was to protect the set of economic institutions developed during the colonial period, which had made Mexico, in the words of the great German explorer and geographer of Latin America Alexander von Humbolt, "the country of inequality." These institutions, by basing the society on the exploitation of indigenous people and the creation of monopolies, blocked the economic incentives and initiatives of the great mass of the population. As the United States began to experience the Industrial Revolution in the first half of the nineteenth century, Mexico got poorer.

HAVING AN IDEA, STARTING A FIRM, AND GETTING A LOAN

The Industrial Revolution started in England. Its first success was to revolutionize the production of cotton cloth using new machines powered by water wheels and later by steam engines. Mechanization of cotton production massively increased the productivity of workers in, first, textiles and, subsequently, other industries. The engine of technological breakthroughs throughout the economy was innovation, spearheaded by new entrepreneurs and businessmen eager to apply their new ideas. This initial flowering soon spread across the North Atlantic to the United States. People saw the great economic opportunities available in adopting the new technologies developed in England. They were also inspired to develop their own inventions.

We can try to understand the nature of these inventions by looking at who was granted patents. The patent system, which protects property rights in ideas, was systematized in the Statute of Monopolies legislated by the English Parliament in 1623, partially as an attempt to stop the king from arbitrarily granting "letters patent" to whomever he wanted—effectively granting exclusive rights to undertake certain activities or businesses. The striking thing about the evidence on patenting in the United States is that people who were granted patents came from all sorts of backgrounds and all walks of life, not just the rich and the elite. Many made fortunes based on their patents. Take Thomas Edison, the inventor of the phonogram and the lightbulb and the founder of General Electric, still one of the world's largest companies. Edison was the last of seven children. His father, Samuel Edison, followed many occupations, from splitting shingles for roofs to tailoring to keeping a tavern. Thomas had little formal schooling but was homeschooled by his mother.

Between 1820 and 1845, only 19 percent of patentees in the United States had parents who were professionals or were from recognizable major landowning families. During the same period, 40 percent of those who took out patents had only primary schooling or less, just like Edison. Moreover, they often exploited their patent by starting a firm, again like Edison. Just as the United States in the nineteenth century was more democratic politically than almost any other nation in the world at the time, it was also more democratic than others when it came to innovation. This was critical to its path to becoming the most economically innovative nation in the world.

If you were poor with a good idea, it was one thing to take out a patent, which was not so expensive, after all. It was another thing entirely to use that patent to make money. One way, of course, was to sell the patent to someone else. This is what Edison did early on, to raise some capital, when he sold his Quadruplex telegraph to Western Union for $10,000. But selling patents was a good idea only for someone like Edison, who had ideas faster than he could put them to practice. (He had a world-record 1,093 patents issued to him in the United States and 1,500 worldwide.) The real way to make money from a patent was to start your own business. But to start a business, you need capital, and you need banks to lend the capital to you.

Inventors in the United States were once again fortunate. During the nineteenth century there was a rapid expansion of financial intermediation and banking that was a crucial facilitator of the rapid growth and industrialization that the economy experienced. While in 1818 there were 338 banks in operation in the United States, with total assets of $160 million, by 1914 there were 27,864 banks, with total assets of $27.3 billion. Potential inventors in the United States had ready access to capital to start their businesses. Moreover, the intense competition among banks and financial institutions in the United States meant that this capital was available at fairly low interest rates.

The same was not true in Mexico. In fact, in 1910, the year in which the Mexican Revolution started, there were only forty-two banks in Mexico, and two of these controlled 60 percent of total banking assets. Unlike in the United States, where competition was fierce, there was practically no competition among Mexican banks. This lack of competition meant that the banks were able to charge their customers very high interest rates, and typically confined lending to the privileged and the already wealthy, who would then use their access to credit to increase their grip over the various sectors of the economy.

The form that the Mexican banking industry took in the nineteenth and twentieth centuries was a direct result of the postindependence political institutions of the country. The chaos of the Santa Ana era was followed by an abortive attempt by the French government of Emperor Napoleon III to create a colonial regime in Mexico under Emperor Maximilian between 1864 and 1867. The French were expelled, and a new constitution was written. But the government formed first by Benito Juárez and, after his death, by Sebastián Lerdo de Tejada was soon challenged by a young military man named Porfirio Díaz. Díaz had been a victorious general in the war against the French and had developed aspirations of power. He formed a rebel army and, in November of 1876, defeated the army of the government at the Battle of Tecoac. In May of the next year, he had himself elected president. He went on to rule Mexico in a more or less unbroken and increasingly authoritarian fashion until his overthrow at the outbreak of the revolution thirty-four years later.

Like Iturbide and Santa Ana before him, Díaz started life as a military commander. Such a career path into politics was certainly known in the United States. The first president of the United States, George Washington, was also a successful general in the War of Independence. Ulysses S. Grant, one of the victorious Union generals of the Civil War, became president in 1869, and Dwight D. Eisenhower, the

supreme commander of the Allied Forces in Europe during the Second World War, was president of the United States between 1953 and 1961. Unlike Iturbide, Santa Ana, and Díaz, however, none of these military men used force to get into power. Nor did they use force to avoid having to relinquish power. They abided by the Constitution. Though Mexico had constitutions in the nineteenth century, they put few constraints on what Iturbide, Santa Ana, and Díaz could do. These men could be removed from power only the same way they had attained it: by the use of force.

Díaz violated people's property rights, facilitating the expropriation of vast amounts of land, and he granted monopolies and favors to his supporters in all lines of business, including banking. There was nothing new about this behavior. This is exactly what Spanish conquistadors had done, and what Santa Ana did in their footsteps.

The reason that the United States had a banking industry that was radically better for the economic prosperity of the country had nothing to do with differences in the motivation of those who owned the banks. Indeed, the profit motive, which underpinned the monopolistic nature of the banking industry in Mexico, was present in the United States, too. But this profit motive was channeled differently because of the radically different U.S. institutions. The bankers faced different economic institutions, institutions that subjected them to much greater competition. And this was largely because the politicians who wrote the rules for the bankers faced very different incentives themselves, forged by different political institutions. Indeed, in the late eighteenth century, shortly after the Constitution of the United States came into operation, a banking system looking similar to that which subsequently dominated Mexico began to emerge. Politicians tried to set up state banking monopolies, which they could give to their friends and partners in exchange for part of the monopoly profits. The banks also quickly got into the business of lending money to the politicians who regulated them, just as in Mexico. But this situation was not sustainable in the United States, because the politicians who attempted to create these banking monopolies, unlike their Mexican counterparts, were subject to election and reelection. Creating banking monopolies and giving loans to politicians is good business for politicians, if they can get away with it. It is not particularly good for the citizens, however. Unlike in Mexico, in the United States the citizens could keep politicians in check and get rid of ones who would use their offices to enrich themselves or create monopolies for their cronies. In consequence, the banking monopolies crumbled. The broad distribution of political rights in the United States, especially when compared to Mexico, guaranteed equal access to finance and loans. This in turn ensured that those with ideas and inventions could benefit from them.

PATH-DEPENDENT CHANGE

The world was changing in the 1870s and '80s. Latin America was no exception. The institutions that Porfirio Díaz established were not identical to those of Santa Ana or the Spanish colonial state. The world economy boomed in the second half of the nineteenth century, and innovations in transportation such as the steamship and the railway led to a huge expansion of international trade. This wave of globalization meant that resource-rich countries such as Mexico—or, more appropriately, the elites in such countries—could enrich themselves by exporting raw materials and natural resources to industrializing North America or Western Europe. Díaz and his cronies thus found themselves in a different and rapidly evolving world. They realized that Mexico had to change, too. But this didn't mean uprooting the colonial institutions and replacing them with institutions similar to those in the United States. Instead, theirs was "path-dependent" change leading only to the next stage of the institutions that had already made much of Latin America poor and unequal.

Globalization made the large open spaces of the Americas, its "open frontiers," valuable. Often these frontiers were only mythically open, since they were inhabited by indigenous peoples who were brutally dispossessed. All the same, the scramble for this newly valuable resource was one of the defining processes of the Americas in the second half of the nineteenth century. The sudden opening of this valuable frontier led not to parallel processes in the United States and Latin America, but to a further divergence, shaped by the existing institutional differences, especially those concerning who had access to

the land. In the United States a long series of legislative acts, ranging from the Land Ordinance of 1785 to the Homestead Act of 1862, gave broad access to frontier lands. Though indigenous peoples had been sidelined, this created an egalitarian and economically dynamic frontier. In most Latin American countries, however, the political institutions there created a very different outcome. Frontier lands were allocated to the politically powerful and those with wealth and contacts, making such people even more powerful.

Díaz also started to dismantle many of the specific colonial institutional legacies preventing international trade, which he anticipated could greatly enrich him and his supporters. His model, however, continued to be not the type of economic development he saw north of the Rio Grande but that of Cortés, Pizarro, and de Toledo, where the elite would make huge fortunes while the rest were excluded. When the elite invested, the economy would grow a little, but such economic growth was always going to be disappointing. It also came at the expense of those lacking rights in this new order, such as the Yaqui people of Sonora, in the hinterland of Nogales. Between 1900 and 1910, possibly thirty thousand Yaqui were deported, essentially enslaved, and sent to work in the henequen plantations of Yucatán. (The fibers of the henequen plant were a valuable export, since they could be used to make rope and twine.)

The persistence into the twentieth century of a specific institutional pattern inimical to growth in Mexico and Latin America is well illustrated by the fact that, just as in the nineteenth century, the pattern generated economic stagnation and political instability, civil wars and coups, as groups struggled for the benefits of power. Díaz finally lost power to revolutionary forces in 1910. The Mexican Revolution was followed by others in Bolivia in 1952, Cuba in 1959, and Nicaragua in 1979. Meanwhile, sustained civil wars raged in Colombia, El Salvador, Guatemala, and Peru. Expropriation or the threat of expropriation of assets continued apace, with mass agrarian reforms (or attempted reforms) in Bolivia, Brazil, Chile, Colombia, Guatemala, Peru, and Venezuela. Revolutions, expropriations, and political instability came along with military governments and various types of dictatorships. Though there was also a gradual drift toward greater political rights, it was only in the 1990s that most Latin American countries became democracies, and even then they remained mired in instability.

This instability was accompanied by mass repression and murder. The 1991 National Commission for Truth and Reconciliation Report in Chile determined that 2,279 persons were killed for political reasons during the Pinochet dictatorship between 1973 and 1990. Possibly 50,000 were imprisoned and tortured, and hundreds of thousands of people were fired from their jobs. The Guatemalan Commission for Historical Clarification Report in 1999 identified a total of 42,275 named victims, though others have claimed that as many as 200,000 were murdered in Guatemala between 1962 and 1996, 70,000 during the regime of General Efrain Ríos Montt, who was able to commit these crimes with such impunity that he could run for president in 2003; fortunately he did not win. The National Commission on the Disappearance of Persons in Argentina put the number of people murdered by the military there at 9,000 persons from 1976 to 1983, although it noted that the actual number could be higher. (Estimates by human rights organizations usually place it at 30,000.)

Making a Billion or Two

The enduring implications of the organization of colonial society and those societies' institutional legacies shape the modern differences between the United States and Mexico, and thus the two parts of Nogales. The contrast between how Bill Gates and Carlos Slim became the two richest men in the world—Warren Buffett is also a contender—illustrates the forces at work. The rise of Gates and Microsoft is well known, but Gates's status as the world's richest person and the founder of one of the most technologically innovative companies did not stop the U.S. Department of Justice from filing civil actions against the Microsoft Corporation on May 8, 1998, claiming that Microsoft had abused monopoly power. Particularly at issue was the way that Microsoft had tied its Web browser, Internet Explorer, to its Windows operating system. The government had been keeping an eye on Gates for quite some time, and as early as 1991, the Federal Trade Commission had launched an inquiry into whether Microsoft was abusing its

monopoly on PC operating systems. In November 2001, Microsoft reached a deal with the Justice Department. It had its wings clipped, even if the penalties were less than many demanded.

In Mexico, Carlos Slim did not make his money by innovation. Initially he excelled in stock market deals, and in buying and revamping unprofitable firms. His major coup was the acquisition of Telmex, the Mexican telecommunications monopoly that was privatized by President Carlos Salinas in 1990. The government announced its intention to sell 51 percent of the voting stock (20.4 percent of total stock) in the company in September 1989 and received bids in November 1990. A consortium led by Slim's Grupo Carso won the auction. Instead of paying for the shares right away, Slim managed to delay payment, using the dividends of Telmex itself to pay for the stock. What was once a public monopoly now became Slim's monopoly, and it was hugely profitable.

The economic institutions that made Carlos Slim who he is are very different from those in the United States. If you're a Mexican entrepreneur, entry barriers will play a crucial role at every stage of your career. These barriers include expensive licenses you have to obtain, red tape you have to cut through, politicians and incumbents who will stand in your way, and the difficulty of getting funding from a financial sector often in cahoots with the incumbents you're trying to compete against. These barriers can be either insurmountable, keeping you out of lucrative areas, or your greatest friend, keeping your competitors at bay. The difference between the two scenarios is of course whom you know and whom you can influence—and yes, whom you can bribe. Carlos Slim, a talented, ambitious man from a relatively modest background of Lebanese immigrants, has been a master at obtaining exclusive contracts; he managed to monopolize the lucrative telecommunications market in Mexico, and then to extend his reach to the rest of Latin America.

There have been challenges to Slim's Telmex monopoly. But they have not been successful. In 1996 Avantel, a long-distance phone provider, petitioned the Mexican Competition Commission to check whether Telmex had a dominant position in the telecommunications market. In 1997 the commission declared that Telmex had substantial monopoly power with respect to local telephony, national long-distance calls, and international long-distance calls, among other things. But attempts by the regulatory authorities in Mexico to limit these monopolies have come to nothing. One reason is that Slim and Telmex can use what is known as a *recurso de amparo,* literally an "appeal for protection." An *amparo* is in effect a petition to argue that a particular law does not apply to you. The idea of the *amparo* dates back to the Mexican constitution of 1857 and was originally intended as a safeguard of individual rights and freedoms. In the hands of Telmex and other Mexican monopolies, however, it has become a formidable tool for cementing monopoly power. Rather than protecting people's rights, the *amparo* provides a loophole in equality before the law.

Slim has made his money in the Mexican economy in large part thanks to his political connections. When he has ventured into the United States, he has not been successful. In 1999 his Grupo Carso bought the computer retailer CompUSA. At the time, CompUSA had given a franchise to a firm called COC Services to sell its merchandise in Mexico. Slim immediately violated this contract with the intention of setting up his own chain of stores, without any competition from COC. But COC sued CompUSA in a Dallas court. There are no *amparos* in Dallas, so Slim lost, and was fined $454 million. The lawyer for COC, Mark Werner, noted afterward that "the message of this verdict is that in this global economy, firms have to respect the rules of the United States if they want to come here." On appeal, however, the verdict was overturned because the judge took the view that there was insufficient evidence.

Toward a Theory of World Inequality

We live in an unequal world. The differences among nations are similar to those between the two parts of Nogales, just on a larger scale. In rich countries, individuals are healthier, live longer, and are much better educated. They also have access to a range of amenities and options in life, from vacations to career paths, that people in poor

countries can only dream of. People in rich countries also drive on roads without potholes, and enjoy toilets, electricity, and running water in their houses. They also typically have governments that do not arbitrarily arrest or harass them; on the contrary, the governments provide services, including education, health care, roads, and law and order. Notable, too, is the fact that the citizens vote in elections and have some voice in the political direction their countries take.

The great differences in world inequality are evident to everyone, even to those in poor countries, though many lack access to television or the Internet. It is the perception and reality of these differences that drive people to cross the Rio Grande or the Mediterranean Sea illegally to have the chance to experience rich-country living standards and opportunities. This inequality doesn't just have consequences for the lives of individual people in poor countries; it also causes grievances and resentment, with huge political consequences in the United States and elsewhere. Understanding why these differences exist and what causes them is our focus in this book. Developing such an understanding is not just an end in itself, but also a first step toward generating better ideas about how to improve the lives of billions who still live in poverty.

The disparities on the two sides of the fence in Nogales are just the tip of the iceberg. As in the rest of northern Mexico, which benefits from trade with the United States, even if not all of it is legal, the residents of Nogales are more prosperous than other Mexicans, whose average annual household income is around $5,000. This greater relative prosperity of Nogales, Sonora, comes from maquiladora manufacturing plants centered in industrial parks, the first of which was started by Richard Campbell, Jr., a California basket manufacturer. The first tenant was Coin-Art, a musical instrument company owned by Richard Bosse, owner of the Artley flute and saxophone company in Nogales, Arizona. Coin-Art was followed by Memorex (computer wiring); Avent (hospital clothing); Grant (sunglasses); Chamberlain (a manufacturer of garage door openers for Sears); and Samsonite (suitcases). Significantly, all are U.S.-based businesses and businessmen, using U.S. capital and know-how. The greater prosperity of Nogales, Sonora, relative to the rest of Mexico, therefore, comes from outside.

The differences between the United States and Mexico are in turn small compared with those across the entire globe. The average citizen of the United States is seven times as prosperous as the average Mexican and more than ten times as the resident of Peru or Central America. She is about twenty times as prosperous as the average inhabitant of sub-Saharan Africa, and almost forty times as those living in the poorest African countries such as Mali, Ethiopia, and Sierra Leone. And it's not just the United States. There is a small but growing group of rich countries—mostly in Europe and North America, joined by Australia, Japan, New Zealand, Singapore, South Korea, and Taiwan—whose citizens enjoy very different lives from those of the inhabitants of the rest of the globe.

The reason that Nogales, Arizona, is much richer than Nogales, Sonora, is simple; it is because of the very different institutions on the two sides of the border, which create very different incentives for the inhabitants of Nogales, Arizona, versus Nogales, Sonora. The United States is also far richer today than either Mexico or Peru because of the way its institutions, both economic and political, shape the incentives of businesses, individuals, and politicians. Each society functions with a set of economic and political rules created and enforced by the state and the citizens collectively. Economic institutions shape economic incentives: the incentives to become educated, to save and invest, to innovate and adopt new technologies, and so on. It is the political process that determines what economic institutions people live under, and it is the political institutions that determine how this process works. For example, it is the political institutions of a nation that determine the ability of citizens to control politicians and influence how they behave. This in turn determines whether politicians are agents of the citizens, albeit imperfect, or are able to abuse the power entrusted to them, or that they have usurped, to amass their own fortunes and to pursue their own agendas, ones detrimental to those of the citizens. Political institutions include but are not limited to written constitutions and to whether the society is a democracy. They include the power and capacity of the state to regulate and govern society. It is also necessary to consider more broadly the factors that determine how political power is distributed in society, particularly the ability of different groups to act collectively to pursue their objectives or to stop other people from pursuing theirs.

As institutions influence behavior and incentives in real life, they forge the success or failure of nations. Individual talent matters at every level of society, but even that needs an institutional framework to transform it into a positive force. Bill Gates, like other legendary figures in the information technology industry (such as Paul Allen, Steve Ballmer, Steve Jobs, Larry Page, Sergey Brin, and Jeff Bezos), had immense talent and ambition. But he ultimately responded to incentives. The schooling system in the United States enabled Gates and others like him to acquire a unique set of skills to complement their talents. The economic institutions in the United States enabled these men to start companies with ease, without facing insurmountable barriers. Those institutions also made the financing of their projects feasible. The U.S. labor markets enabled them to hire qualified personnel, and the relatively competitive market environment enabled them to expand their companies and market their products. These entrepreneurs were confident from the beginning that their dream projects could be implemented: they trusted the institutions and the rule of law that these generated and they did not worry about the security of their property rights. Finally, the political institutions ensured stability and continuity. For one thing, they made sure that there was no risk of a dictator taking power and changing the rules of the game, expropriating their wealth, imprisoning them, or threatening their lives and livelihoods. They also made sure that no particular interest in society could warp the government in an economically disastrous direction, because political power was both limited and distributed sufficiently broadly that a set of economic institutions that created the incentives for prosperity could emerge.

This book will show that while economic institutions are critical for determining whether a country is poor or prosperous, it is politics and political institutions that determine what economic institutions a country has. Ultimately the good economic institutions of the United States resulted from the political institutions that gradually emerged after 1619. Our theory for world inequality shows how political and economic institutions interact in causing poverty or prosperity, and how different parts of the world ended up with such different sets of institutions. Our brief review of the history of the Americas begins to give a sense of the forces that shape political and economic institutions. Different patterns of institutions today are deeply rooted in the past because once society gets organized in a particular way, this tends to persist. We'll show that this fact comes from the way that political and economic institutions interact.

This persistence and the forces that create it also explain why it is so difficult to remove world inequality and to make poor countries prosperous. Though institutions are the key to the differences between the two Nogaleses and between Mexico and the United States, that doesn't mean there will be a consensus in Mexico to change institutions. There is no necessity for a society to develop or adopt the institutions that are best for economic growth or the welfare of its citizens, because other institutions may be even better for those who control politics and political institutions. The powerful and the rest of society will often disagree about which set of institutions should remain in place and which ones should be changed. Carlos Slim would not have been happy to see his political connections disappear and the entry barriers protecting his businesses fizzle—no matter that the entry of new businesses would enrich millions of Mexicans. Because there is no such consensus, what rules society ends up with is determined by politics: who has power and how this power can be exercised. Carlos Slim has the power to get what he wants. Bill Gates's power is far more limited. That's why our theory is about not just economics but also politics. It is about the effects of institutions on the success and failure of nations—thus the economics of poverty and prosperity; it is also about how institutions are determined and change over time, and how they fail to change even when they create poverty and misery for millions—thus the politics of poverty and prosperity.

2.

Theories That Don't Work

The Lay of the Land

The focus of our book is on explaining world inequality and also some of the easily visible broad patterns that nest within it. The first country to experience sustained economic growth was England—or Great Britain, usually just Britain, as the union of England, Wales, and Scotland after 1707 is known. Growth emerged slowly in the second half of the eighteenth century as the Industrial Revolution, based on major technological breakthroughs and their application in industry, took root. Industrialization in England was soon followed by industrialization in most of Western Europe and the United States. English prosperity also spread rapidly to Britain's "settler colonies" of Canada, Australia, and New Zealand. A list of the thirty richest countries today would include them, plus Japan, Singapore, and South Korea. The prosperity of these latter three is in turn part of a broader pattern in which many East Asian nations, including Taiwan and subsequently China, have experienced recent rapid growth.

The bottom of the world income distribution paints as sharp and as distinctive a picture as the top. If you instead make a list of the poorest thirty countries in the world today, you will find almost all of them in sub-Saharan Africa. They are joined by countries such as Afghanistan, Haiti, and Nepal, which, though not in Africa, all share something critical with African nations, as we'll explain. If you went back fifty years, the countries in the top and bottom thirty wouldn't be greatly different. Singapore and South Korea would not be among the richest countries, and there would be several different countries