Jakob de Haan Recommends "Why Nations Fail: The Origins of Power, Prosperity, and Poverty" by Daron Acemoglu and James Robinson

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Economists have for some time recognized that institutions play an important role in explaining differences in the wealth and poverty of nations. But whereas most previous research focuses either on economic or political institutions, this book offers an excellent framework explaining how both economic and political institutions drive long-run economic development. Whereas economic institutions shape incentives to become educated, to save and invest, and to innovate and adopt new technologies, political institutions determine what economic institutions a country has.

Institutions can be either inclusive, expanding the political and economic opportunities to the broad cross-section of society, or extractive, allowing the elites to extract rents and resources from the rest of the society. Inclusive economic institutions 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. Inclusive political institutions have two features: they are (1) pluralistic and (2) centralistic and powerful. The first part of the definition captures what is usually called democracy. But this is not enough: the state needs a sufficiently high level of political centralization, as society otherwise sooner or later descends into chaos.

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Extractive economic institutions depend on extractive political institutions for their survival. Extractive economic institutions, in turn, enrich the elites, and their economic wealth and power and help consolidate their political dominance. Unfortunately, societies do not necessarily adopt institutions that are best for economic growth or the welfare of its citizens, simply because other institutions may better foster the interests of those who control politics and political institutions. Notably, fear of "creative destruction" is often at the root of the opposition to inclusive economic and political institutions.

Still, institutions do change. So what drives institutional change? A key role is played by "critical junctures": "During critical junctures, a major event or confluence of factors disrupts the existing balance of political or economic power in a nation" (p. 106). One such critical junction that affected institutional change is European colonialism. Based on their level of urbanization, several countries that were relatively rich in 1500 are now poor. This reversal in fortune reflects changes in the institutions resulting from European colonialism. And this reversal in fortune is, so the argument goes, mostly a late eighteenth- and early nineteenth-century phenomenon and is closely related to industrialization. It is not related to the extraction of resources from the former colonies, or to the direct effect of the diseases Europeans brought to the New World, as in that case the reversal should have taken place shortly after colonization. But the type of colonization matters: Europeans were more likely to introduce institutions encouraging investment ("institutions of private property") in regions with low population density and low urbanization, while they introduced extractive, investment-depressing institutions in richer regions. And such extractive institutions turned out to be inappropriate with the arrival of new technologies during the Industrial Revolution.

Literature

Acemoglu, D., & Robinson, J. A. (2012). *Why nations fail. The origins of power, prosperity and poverty*. London: Profile Books.