Glimpses of the Political Economy: Extractive and Inclusive Institutions[1]

Why Nations Fail?

The research of Acemoglu and Robinson answers the question that has stumped the experts for centuries: Why are some nations rich and others poor, divided by wealth and poverty, health and sickness, food and famine? Is it culture, the weather, geography? Perhaps ignorance of what the right policies are? Simply, no. None of these factors is either definitive or destiny.

Otherwise, how to explain why Botswana has become one of the fastest-growing countries in the world, while other African nations, such as Zimbabwe, the Congo, and Sierra Leone, are mired in poverty and violence? The authors conclusively show that it is **man-made political and economic institutions** that underlie economic success. Korea, to take just one example, is a remarkably homogeneous nation, yet the people of North Korea are among the poorest on earth while their brothers and sisters in South Korea are among the richest. The south forged a society that created incentives, rewarded innovation, and allowed everyone to participate in economic opportunities. The economic success thus spurred was sustained because the government became accountable and responsive to citizens and the great mass of people. Sadly, the people of the north have endured decades of famine, political repression, and very different economic institutions, with no end in sight. The differences between the Koreas is due to completely different institutional trajectories.

Based on broad research, Acemoglu and Robinson marshal extraordinary historical evidence from the Roman Empire, the Mayan city-states, medieval Venice, the Soviet Union, Latin America, Europe, the United States, and Africa to build a new approach to political economy with great relevance for the big questions of today, including:

- What is the most effective way to help move millions of people from poverty to prosperity?
- China has built a successful growth machine in an authoritarian setting. Will it continue to grow at such high speed and how will the Chinese institutions change to enable a more equitable and environmentally sustainable development?
- Are the American and European societies moving to more inequality, enriching a small group and concentrating political power in few hands?

Acemoglu and Robinson emphasize how important the **capacity and effectiveness of the state** is in providing the political prerequisites for economic development, poverty reduction, and distribution of economic resources. State capacity is multidimensional. The German sociologist Max Weber defined a state as a human community that successfully claims the monopoly of the legitimate use of physical force within a given territory (Weber, 1946). Achieving a monopoly of violence seems to be a basic prerequisite which enables the state to do other things. These other things include having an efficient and meritocratic bureaucracy (Evans and Rauch, 2000) and to be able to enforce laws and raise taxes. In the context of development issues and state capacity other and additional attributes are emphasized such as civil society participation, accountability, and equal access to rights, resources and opportunities.

[1] Sources: / Daron Acemoglu & James A. Robinson: Why Nations Fail. The origins of power, prosperity, and poverty. Random House N.Y. 2012. / Douglass C. North, John Joseph Wallis, Steven B. Webb, and Barry R. Weingast: Limited Access Orders. An Introduction to the Conceptual Framework. June 2010.

Based on a critical review of power resources and state building, the social anthropologist James C. Scott[2] has made a fundamental contribution to the institutional perspective by looking closely at the ways how power is exercised. In *Domination and the Arts of Resistance*, Scott uses the term *public transcript* to describe the open, public interactions between dominators and oppressed and the term *hidden transcript* for the critique of power that goes on offstage, which power holders do not see or hear. Different interrelated systems of power and domination, including political, economic, cultural, or religious, have aspects that are not heard that go along with their public dimensions. In order to study the systems of domination, careful attention is paid to what lies beneath the surface of evident, public behaviour. In public, those that are oppressed accept their domination, but they always question (or at least undermine ironically) their domination offstage. These hidden narratives and discourses constitute the order of things (post-structuralist Michel Foucault), facilitate organizing daily experience in a rigid frame (Erving Goffman, *Frame Analysis*), justify a pragmatic muddling-through-attitude and provide identity in a rigidly defined framework of domination and dependencies. On the event of voicing and exchanging the hidden transcript, oppressed classes openly assume their speech, and become conscious of its common status.

In a second research *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed* Scott unfolds the rise of the state as the attempt to control and force *legibility* on their subjects. By standardizing and administrating the population, the state fails to see complex, valuable forms of local social order and knowledge. Scott uses examples like the introduction of permanent last names, cadastral surveys, rigid central planning procedures, and standard units of measure across Europe to argue that uniform examination and state scrutiny subjugate and reconfigure social orders. Simplification, registration, full coverage and uniform bureaucratic control helped the central government to keep track of its subjects, but it lost local information. Scott argues that in order for schemes to improve the human condition to succeed, they must take into account local conditions, and that the technological beliefs of modern ideologies of the 20th century have prevented this. Scott sets out to understand the logic behind what he calls *state simplifications* as the major form to install domination: the acts and beliefs that lead to well-intentioned efforts to improve the human conditions through the creation of social order, rationalization and scientific administration. He argues that a few factors are necessary for this logic to become operational:

- The administrative ordering and administration *(legibility)* of the citizen as well as of nature and natural resources.
- A modernist ideology and beliefs shared among elites, implemented through central planning, legal coverage, central planning and technocratic management.
- Authoritarian state institutions and a prostrate civil society.

What are Institutions? Towards a theory of institutions

While both culture (religion, attitudes, values) and geography (climate, topography, demography, disease, environments etc.) are important for the ability of humans to form well-functioning societies, they are not the main source of this divergence. Much of Latin America was likely richer than North America as late as mid-18th century. There is a mix of historical roots of institutional differences and the logic of institutions that did not unleash sustainable growth in Latin America. The divergence resulted from the ability of the United States, just like Britain, to take advantage of new economic opportunities while the Hispanic colonization followed the logic of social arrangements leading to relative poverty, based on forced labour and repressive regimes. The colonial administration was

[2] James C. Scott: Domination and the Art of Resistance. Hidden Transcripts. Yale University Press, 1992 / James C. Scott: Seeing like a State. How Certain Schemes to Improve the Human Condition Have Failed. Yale University Press, 1998

extractive and politically ignorant about the implications of centralized rule and the preferences in favour of a small dominant coalition of colonial and local nobility.

Douglass North (1990) offers the following definition: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." Three important features of institutions are apparent in this definition: (i) that they are humanly devised, which contrasts with other potential fundamental causes, like geographic factors, which are outside human control; (ii) that they are the rules of the game setting constraints on human behaviour; (iii) that their major effect will be through incentives. The notion that incentives matter and institutions are a key determinant of incentives, should have a major effect on thinking about economic development and growth, including inequality, and poverty.

Are institutions key determinants of economic outcomes or secondary arrangements that respond to other, perhaps geographic or cultural, determinants of human and economic interactions? Much empirical research attempts to answer this question. Before discussing some of this research, it is useful to emphasize an important point: ultimately, the aim of the research on institutions is to pinpoint specific institutional characteristics that are responsible for economic outcomes in specific situations (for example, the effect of legal institutions on the types of business contracts). However, the starting point is often the impact of a **broader notion of institutions** on a variety of economic outcomes. This broader notion, in line with Douglass North's conception, incorporates many aspects of economics and the political and social organization of society.

First, institutions can differ between societies because of their formal methods of collective decision-making through, for example, democratic procedures and accountability or dictatorship, participation rights and civil society organizations. This is the **political side of institutions**. For example, the institutions may differ between two societies that are democratic because the distribution of political power lies with different groups or social classes, or because in one society, democracy is expected to collapse while in the other it is consolidated.

Second, economic institutions differ because they enable or hamper economic activities. This is the **economic side of institutions**, which may include, for example, security of property rights, entry barriers to production and markets, the set of contracts available to businessmen, generating incentives for some privileged and dominant groups or for all people.

The Impact of Institutions

There are tremendous cross-country differences in the way that economic and political life is organized. A voluminous literature documents large cross-country differences in economic institutions, and a strong correlation between these institutions and economic performance. Knack and Keefer (1995), for instance, looked at measures of property rights enforcement compiled by international business organizations, Mauro (1995) looked at measures of corruption, and Djankov et al. (2002) compiled measures of entry barriers across countries. Many other studies look at variation in educational institutions and the corresponding differences in human capital. All of these authors find substantial differences in these measures of economic institutions, and significant correlation between these measures and various indicators of economic performance. For example, Djankov et al. found that, while the total cost of opening a medium-size business in the United States was less than 0.02 percent of GDP per capita in 1999, the same cost was 2.7 percent of GDP per capita in Nigeria, and 4.95 percent in the Dominican Republic. These entry barriers are highly correlated with various economic outcomes, including the rate of economic growth and the level of development.

European colonization of the rest of the world provides a potential laboratory to investigate the issues whether institutions are important determinants of economic outcomes. From the late fifteenth century, Europeans dominated and colonized much of the rest of the globe. Together with European dominance came the imposition of very different institutions and social power structures in different parts of the world. Acemoglu, Johnson, and Robinson (2001) document that in a large number of colonies, especially those in Africa, Central America, the Caribbean, and South Asia, In essence, European powers set up *extractive states*. These institutions, broadly construed, did not introduce much protection for private property, nor did they provide checks and balances against the colonial administration and later on against government. The explicit aim of the European in these colonies was extraction of resources, in one form or another.

This colonization strategy and the associated institutions contrast with the institutions Europeans set up in other colonies, especially in colonies where they settled in large numbers, for example, the United States, Canada, Australia, and New Zealand. In these colonies the emphasis was on the enforcement of property rights for a broad cross section of the society, especially smallholders, merchants, and entrepreneurs. European settlements led to more *inclusive states* which provided the framework for economic development.

Modelling Institutional Differences

As already mentioned above, **economic institutions** matter for economic growth and distribution of economic resources because they shape the incentives of key economic actors in society. In particular, they influence investments in physical and human capital and technology and the organization of production. Economic institutions not only determine the aggregate economic growth potential of the economy, but also the distribution of resources in the society, and herein lies part of the problem: different institutions will not only be associated with different degrees of efficiency and potential for economic growth, but also with different distribution of the gains across different individuals and social groups.

How are economic institutions determined? Although various factors play a role here, including history and chance, at the end of the day, economic institutions are collective choices of the society. And because of their influence on the distribution of economic gains, not all individuals and groups typically prefer the same set of economic institutions. This leads to a **conflict of interest** among various groups and individuals over the choice of economic institutions, and the political power of the different groups will be the deciding factor. The distribution of **political power** in society is also endogenous. To make more progress here, let us distinguish between two components of political power - de jure and de facto political power.

De jure political power refers to power that originates from the political institutions in society. Political institutions, similar to economic institutions, determine the constraints on and the incentives of the key actors, but this time in the political sphere. Examples of political institutions include the form of government, for example, democracy versus dictatorship or autocracy, and the extent of constraints on politicians and political elites.

A group of individuals, even if they are not allocated power by political institutions, may possess political power; for example, they can revolt, use arms, hire mercenaries, co-opt the military, or undertake protests in order to impose their wishes on society. This type of **de facto political power** originates from both the ability of the group in question to solve its collective action problem and from the economic resources available to the group (which determines their capacity to use force against other groups). This discussion highlights that we can think of political institutions and the distribution of economic resources in society as two state variables, affecting how political power will be distributed and how economic institutions will be chosen.

Institution	Economy	Politics
Extractive	Lack of rule of law and protection of public goods. Insecure property rights. Entry barriers and regulations preventing functioning of markets and equal access to rights, resources, and opportunities. Dominant groups benefit the public good through contracts and licenses. Regressive tax system. Entry barriers that prevent the functioning of markets, creating an uneven playing field. Market manipulation powerful economic groups. Persistence of clienteles, monopolies and cartels. High risks for investment and economic initiative. Unbounded exploitation of work force. High income disparities.	Political institutions concentrating power in the hands of a few, without constraints, checks and balances. Lack of legal security and rule of law. Authoritarian government and lack of citizen participation. Impunity of influential groups and manipulation of the courts. Confusing rules and arbitrariness of justice. Endemic corruption, favouritism and nepotism. State lacks the monopoly of the use of force. Electoral fraud and vote buying. Fear of authority. Powerful groups control the media. Weak civil society organizations. Regulation and supervision of labour markets. Persisting inequality in access to rights and basic services
Inclusive	Secure property rights, law and order, transparent markets, prohibition of monopolies and market distortion. State regulates and provides public services. Markets are open to relatively free entry of new businesses. Access to resources, education and opportunity for the great majority of citizens. Progressive Tax system. State provides a favorable environment for entrepreneurship and civil society framework. Free and open entry for new businesses. Systems of social protection. Values of achievement and merit.	Political institutions allowing broad public debate and participation. Pluralism of opinion and parties. Well organized civil society organizations. Effective public administration. Constraints and checks on politicians. Rule of law (closely related to pluralism). Public spending with re-distributive and equality effects. Some degree of political centralization for the states to be able to effectively enforce law and order. Financial instruments of regional balance. Citizen values and incentives for political participation.

The main thesis is that growth is much more likely under inclusive institutions than extractive institutions. North, Acemoglu et al. argue that inclusive economic and political institutions (or inclusive institutions for short) create powerful forces towards economic growth by (i) encouraging investment (because of well-enforced property rights), (ii) harnessing the power of markets (better allocation of resources, entry of more efficient actors, ability to starting businesses etc.), and (iii) generating broad-based participation (political pluralism and public debate, power of evidence based arguments, education, free entry to association building, and broad-based property rights). In addition, investment in new technology (and consequently creative destruction) is a key aspect of growth under inclusive institutions. It remains a central question: Why are extractive institutions so prevalent throughout history and even today?

A further important notion is that of persistence; the distribution of resources and political institutions is relatively slow-changing and persistent. Since, like economic institutions, political institutions are collective choices, the distribution of political power in society is the key determinant of their evolution. This creates a **central mechanism of persistence**: political institutions allocate de jure political power, and those who hold political power influence the evolution of political institutions, and they will generally opt to maintain the political institutions that give them political power.

A second mechanism of persistence comes from the distribution of resources: when a particular group is rich relative to others, this will increase its de facto political power and enable it to push for economic and political institutions favourable to its interests, reproducing the initial disparity. This behavioural pattern is powerful in developing ideas about why reform is so difficult. Reform comes with pitfalls because either de facto or de jure power may persist even if other things change. Despite these tendencies for persistence, the framework also emphasizes the potential for change. In particular, shocks to the balance of de facto political power, including changes in technologies and the international environment, have the potential to generate major changes in political institutions, and consequently in economic institutions and economic growth.

The intrinsic logic of extractive institutions is that they have an in-built mechanism to persist over time. Growth, and inclusive institutions that will support it, will create both winners and losers. Dominant powerful groups use to resist any change that could limit or even endanger their power and privileges. Thus there is a logic supporting extractive institutions and stagnation:

- Economic losers: those who will lose their incomes, rents and privileges, for example their monopolies and state contracts, because of changes in institutions or introduction of new technologies.
- Political losers: those who will lose their politically privileged position, for example their unconstrained monopoly of power, their political clientele system and their influence on mass media, because of growth and its supporting institutions.

Both, economic and political losers, are important in practice, but particularly political losers among dominant elite coalitions are a major barrier against the emergence of inclusive institutions and economic growth. However, under certain historic conditions different competing factions among the dominant groups realize that – at least on the long run - their benefits from growth under inclusive institutions could be a better option than persisting, unpredictable and high cost repression under extractive institutions.

odcp.2015/2021