

## **Why Nations Fail? Daron Acemoglu: The Role of Inclusive and Extractive Institutions on Shaping Technological Change, Innovation, and Prosperity**

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**Abstract:** Professor Daron Acemoglu argues in his book *Why Nations Fail? The Origin of Power, Prosperity, and Poverty* (2012), coauthored with James A. Robinson that the role played by inclusive and extractive institution is the main reason behind the huge gap in the standards of living between poor and rich nations. Such institutions emerge within the contextual political, economic, and social environment and they shape technological progress and innovation. By taking the United States as an example, Acemoglu argues that extractive institutions are enabling both economic and political inequality and contribute to the negative consequences of such types of inequality.

**Keywords:** Inclusive Institutions, Extractive Institutions, Inequality, Institutional Change.

### **1. Introduction**

Described by Francis Fukuyama as one “of the world’s leading experts on development”, Professor Daron Acemoglu argues in his book *Why Nations Fail? The Origin of Power, Prosperity, and Poverty* (2012), coauthored with James A. Robinson that the massive gap in the standards of living between rich and poor nations is attributed to the different implications of the role that the inclusive and extractive economic institutions play in shaping the technological changes, innovations, prosperity in a given economy.

In his presentation at the Starr Forum conducted in Massachusetts Institute of Technology (MIT) on October 22<sup>nd</sup>, 2012, Acemoglu emphasizes that the main point of his book is to state how inclusive and extractive institutions differently impact the process of technological change and innovation, henceforth, the economic welfare of the societies in the developed and the developing economies. Acemoglu attempts to explain how inclusive and extractive economic institutions interact with inclusive and extractive political institutions. He also discuss how such institutions persist, under which circumstances they change, the process and mechanisms of this change, and the hopes for change under some circumstances.

The gap in living standards between rich and poor nations was first addressed in Adam Smith’s *The Wealth of Nations* (1776), published in the Great Britain whose economy was described as the most powerful economy therein, in the times when “the gaps between the rich and poor countries were quite small relative to what they are today” (Acemoglu, 2012). The gaps were about 4 to 5 folds among poor

and rich nations; meanwhile, it is around 50 folds nowadays. Many alternative theories were developed to explain these gaps. They were attributed to many factors. Geographical factors, like natural resources, diseases, environment, climate, and access to navigable rivers and seashores, were assumed to make some nations destined to succeed and some doomed to failure. Cultural differences were also addressed. For example, protestant work ethics were emphasized by Max Weber. Other theories in the 20<sup>th</sup> century emphasized the Judean and Christian values in business practices. Some other intellectuals, mostly economists and social scientists, argue that nations' success is attributed to the practices of their enlightened leader. These enlightened leaders, who are equipped with good advisors and consultants providing clever solutions for cases of disturbances, will be conducting the correct policies in the correct timing, consequently their nations succeed. If this theory on the nations' success or failure is constructed upon the policies implemented by leaders and solution advised by advisors, some nations' failure could be explained by policy mistakes.

## **2. Economic and Political Incentives and the Role of Inclusive and Extractive Institutions**

Acemoglu's theory on the nations' success or failure takes into consideration the economic and political incentives. These incentives are shaped by institutions, by the rules of the game in the society within the contextual economic, social, and political spheres.

In the economic sphere, the role of inclusive economic institutions that enhance democratic practices is emphasized. Sustained, long-run growth is based on technological change, innovation, creative destruction. Any society that uses only the energy and creativity of one fraction of the population will not be significantly prosperous on the long run. The catch is that most societies throughout history or even today are not ruled by inclusive institution but by extractive institutions. Extractive institutions create a biased environment where the politically powerful are protected by entry barriers. The advantaged groups dispose all the resources, the education, and confiscate from the public the right to occupy political positions, lucrative occupations and businesses.

Acemoglu differentiates between the contextual circumstances that inclusive and extractive institutions provide. For him, inclusive institutions are those institutions that enforce property rights, have judicial and contracting institutions that uphold contracts and enable individuals to develop mutually beneficial agreements, and most importantly, they provide a level playing field, both in terms of regulations that do not prevent people from entering businesses and occupations that are the best for themselves, and providing the right form of investments, infrastructure, and education that make it possible for the population at large to participate in the economic game. Inclusive institutions are likely to be supported by political inclusive institutions that work to create political equality. Meanwhile, extractive institutions do the opposite. They do not secure property rights for the majority of the population. They do not create legal environment that upholds contracts, they create a tilted playing field that suits the interest of status quo, and are supported by political extractive institutions that enable contra-democratic practices that allow the coercion of the majority by the prominent and benefited elites.

Such institutions exist and are designed for a purpose; to reallocate and redistribute resources for the interest of the political elites at the expense of the majority. The reason that extractive institutions do not support sustained economic growth is that they do not generate the course of innovation required for long-run economic growth. They block innovation and technological change for the majority of the

population, so the public can no longer take advantage of their talents, skills, and potentials. They create a tilted playing field in which much of the population coerced for the benefit of the minority. Coercive systems, like slavery, feudal-labor relations, and servile-labor relations make good examples of extractive institutions.

Usually, extractive economic institutions are supported by a set of extractive political institutions that concentrate the power in the hand of a minority of political elites, and do not allow political equality. They do not allow practices of checks and balances or constraints on the exercise of power.

### **3. Slavery and Colonization of the New World**

Acemoglu refers to what happened in Barbados in the 17<sup>th</sup> century as a good example of the concentration of the economic and political extractive institutions to preserve the interests of the status quo. In Barbados, an Island of a well-constructed rich economy depending on sugar industry, the economic system was organized around slavery which is a coercive institution per se. The extreme form of political inequality allowed for the minority to exploit the efforts and to extract the resources that belong to the majority of the population. Starting by the judgeships that was dominated by the top 1% minority that constituted of the major landowners in the Island, then to military power where the major commandants descending from the same families that owned the big plantations, ending by the political power that was dominated by politicians that belong to the same families. The elite leaders that will hold all the political, judicial, and military power should belong to the same families that hold the same interests, otherwise, they would be calling for a change in the system. They would be holding incentives to change the economic institutions for a more equal distribution of the resources in the society.

Acemoglu refers to another example to elaborate on the meanings of inclusive and extractive institutions, and on why they emerge in some countries rather than others. He used the “New World, the American continent by the 15<sup>th</sup> century, to explain why he made the claim that the alternative theories to explain nations’ prosperity are not the correct approach to follow to in order explain the gap among the rich and poor countries. The institutions in this continent have been shaped by the European Colonization starting at the end of 15<sup>th</sup> century. In South America, Spanish Royal colonial systems targeted Native Americans and Amerinds through coercive military actions in order to exploit their resources and manpower efforts to achieve economic gains. The continent conquerors were encountered with reaction of the Amerinds who were spatially scattered and could not be tamed easily as their communities were not used to agriculture and hierarchal labor systems. However, conqueror in both North and South America dominated the social institutions through their mixed marriages with the lands princesses and landowners dissents. Using such policies, they could confiscate the ownership of properties and plantations. Thus, they could develop eventually a set of coercive institutions that are backed with political authority and military power. Such economic institutions developed in Latin America did not create a hosting environment for industrialization that was developing in the other parts of the world, the thing that did not boost economic growth. Unlike the South, the Northern part of the continent that was colonized by the English with their protestant values, was more fortunate, and according to the alternative theories, a major part of this is because of the more-opened institutions that are developed in the North upon protestant values by people who were fleeing their country because of religious discrimination policies.

The Jamestown colony was led by the Virginia Company, a profit-maximizing corporation founded in London inspired by the wealth of the Spanish Royal system. As a lucrative business that extended to the New World on the hope of economic gains constructed on developing coercive institutions to exploit the resources and efforts of the native people, the conquerors were encountered by the same misfortune so they started looking for an alternative strategy. Rather than exploiting native people, the high-end work elites could bring their own homeland fellows, called the settlers, who are on the lower social strata to work on the bottom-end works. The business elites started developing harsh and coercive regulations on the settlers. So Virginia Company was eventually confronted with the fears of the runaway settlers and workers who may flee due to the coercive actions where the company may end up losing workers that it needs to nourish the business. So the second strategy was also doomed to failure.

The third strategy Virginia Company followed is the Headright System. This new system provides settlers with plots of lands and secures their property rights where they do the correct investment, grow their own lands, and sell their products to the market. In 1690, this Headright System was followed by another innovation, Virginia Company created the General Assembly by which it convinced settlers that the political power is transferred to them and that they are capable of deciding the political direction of Jamestown colony. So the circumstances made the way for this institutional transformation.

In conclusion, the institutions which emerged in each part of the continent were different and emerged because of the conflict between the conquerors or the Virginia Company's elite on the one side, and the population on the other. Therefore, the economic and political interests that shape the circumstances are the reason that such economic institutions emerge and persist in a society. The divergence between the North and the South is attributed to the differences among the economic and political institutions that emerged in each part, not the geography, culture, or enlightened leaders as the alternative theories assume. In one case, this conflict between the conquerors or the Virginia Company's elite led to the establishment of extractive institutions in one part, that were not that successful, and inclusive institutions in the other part that proved to be stronger and more persistent over time. These different models of political institutions benefitted different sets of players. How the political and economic conflict resolve is the factor that decides the development of those institutions. It decides on how one of these two models would persist on the expense on the other one.

In the 19<sup>th</sup> century, the United States became industrialized due to a set of innovations and technological changes. The big innovators were not descendents or members of rich, prominent, industrialized or influential families themselves, but they were people who were motivated by factors that helped them invest into their innovations. The secured property rights and the patent system which encouraged innovators in the United States constituted the first incentive for innovators. It enabled inventors to claim the property of their own invention, to develop it, to invest on the invention and to scale it up.

Another incentive is the inventors' belief that they can produce and scale up their invention with the available labor market through mutually beneficial contracts with other parties. Such incentives to the inventors are guaranteed by the inclusive institutions that enable property rights and patent systems. In that time, the US inclusive institutions were strong enough to overcome their challenges and threats.

The long-run failure of the extractive institutions in some countries was the reason behind the resistance of technological change and innovation in those countries. In the United States, the political power was

not fully monopolized so not all the initiatives for innovation and technological change were blocked. However, that was not the case in other countries in Eastern Europe like Austrian Hungary, and Russia. In Austrian-Hungary which was ruled by the Austro-Hungarian emperor Francis I, who was strongly opposed to the industrialization that was taking place all over the place in France, Great Britain, alongside the flourishing railway industry in New World. Francis I considered both industrialization and railway industry as destabilizing factors. It would allow an industrial wealthy class to emerge, thus such class will sustain political power. It would also allow the emergence of labor power class that would start lobbying for a change.

#### **4. Conclusion: Shaping the Change in the United States**

For Acemoglu, the US is in the middle of an institutional storm. There are many changes having their origins in disparate places that created economic and political inequality in the United States. The first one is technological change and globalization that have been at the root of a very large increase in equality in the United States. The US income distribution and wage distribution from the 1950s, 1960s, and early 1970s, wage was increasing in tandem for almost all the population strata. But, by the late 1970s to today, the gap in wage distribution started to appear. The wage of lower-income stratum was falling out, middle-income was stationary, and higher-income was going up. Moreover, the highest increase in wages was in the high-end top 1% of the minority. The huge inequality gap appeared with top families of the society becoming very wealthy.

The second change is institutional. Many of the institutional arrangements in the United States such as unions and minimum wage, though created some economic inefficiencies, they limited the extent of inequality. Some would argue that inequality could be beneficial in terms that it incentivizes entrepreneurial initiatives, yet, one of the dangers of economic inequality that when it increases, it will translate into political inequality. Thus, the US is becoming more politically unequal. Economic inequality holds another danger. For Acemoglu, it opens the way to what he calls “the bad sort of populism”. The kind exhibited in Venezuela where on the basis of the discontent created by this kind of unfair inequality, there will be a political support of dismantling secured property rights or market institutions that are essential for economic growth and innovation.

Another cause of political inequality in the United States is the educational institutions. Acemoglu argues that the educational system in the United States is enabling the political inequality. Major part of the US economic success in the 19<sup>th</sup> century was due to the fact that it was globally ahead in terms of investing on human capital. Education system should be revolving around institutions that enable innovation and technological advances. Yet, except for few universities like MIT and Stanford, not as many universities hold innovation-friendly environment any more. Even the quality of high school and college education has been declining lately during the last decades of the past century and the current century. Thus, the educational system is turning the universities and colleges into institutions that enable extractive institutions rather the inclusive ones.

Money also matters in terms of political inequality. Money has been playing much more role in politics. The modern political campaigns are more money-intensive than before. There are many evidences that show that money matters much more in politics. Politicians listen much more to the wealthy, they also influence much more to the wealthy. The US patent system which was underpinning technological

change in the 19<sup>th</sup> century became an impediment to economic growth. Patents are becoming entry barriers to many companies as companies nowadays are not bought and sold for their ideas or productive capacity but for their patent treasures.

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