The Wealth of Nations: Why Isn't the Whole World Developed?

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Introduction

Are tropical and semitropical areas condemned to poverty by their geographies?

You can notice a striking regularity: many of the poorest nations are close to the equator in the tropical and semitropical areas of the world. Conversely, countries in the temperate areas away from the equator are much more prosperous.

Introduction

The Democratic Republic of the Congo, for example, is cut in the middle by the equator. In 2018, its PPP-adjusted GDP per capita was $859 (in 2011 constant dollars). Move up along the map all the way to the sixtieth parallel, and you will find Finland. In that same year, its PPP-adjusted GDP per capita was $38,897 (in 2011 constant dollars).

You can do the same exercise for almost all countries around the equator. Almost always you will see that the ones farther away from the equator are considerably richer than the ones nearest it.

This pattern has led many social scientists to conjecture that there is something particularly pernicious about the economic and social conditions in the areas around the equator. Many have gone so far as to assert that tropical and semitropical geographies condemn a nation to poverty.

Introduction

In this lecture, we'll study why the whole world isn't developed, why some countries have fallen behind others, and how political and institutional factors shape long-run development and can help us explain the wide disparities in GDP per capita across countries.

Outline

1. Proximate Versus Fundamental Causes of Prosperity
2. Institutions and Economic Development
3. Is Foreign Aid the Solution to World Poverty?

Key ideas

- Proximate causes of prosperity link prosperity and poverty of nations to the levels of inputs, whereas fundamental causes look for the reasons there are such differences in the levels of inputs.
- The geography, culture, and institutions hypotheses advance different fundamental causes of prosperity.
- Inclusive and extractive economic institutions affect economic development.
- Creative destruction is integral to economic growth through technological change.
- Reversal of fortune evidence provides support for the institutions hypothesis

1. Proximate Versus Fundamental Causes of Prosperity

- We have documented the huge differences in GDP per capita and living standards across countries.
- You may recall the huge gap in PPP-adjusted GDP per capita between the United States and the Democratic Republic of the Congo, Ghana, or Haiti.
- In that lecture, we emphasized **how these gaps can be explained in terms of cross-country differences in physical capital, human capital, and technology**.

1. Proximate Versus Fundamental Causes of Prosperity

- *Why some countries have accumulated more physical capital, invested more in human capital, and developed and adopted better technologies than other countries?*
- After all, if investing in physical and human capital and adopting cutting-edge technologies can lead to **major** improvements in GDP, **wouldn't all countries in the world wish to do so? Why isn't the whole world as developed as the United States or Western European nations?**

1. Proximate Versus Fundamental Causes of Prosperity

- These deeper questions make us realize that differences in physical capital, human capital, and technology are only *proximate causes of economic performance*.
- We call them proximate causes of prosperity because they link high levels of prosperity to high levels of the inputs to production but **without** providing an explanation for why the levels of those inputs are high.

1. Proximate Versus Fundamental Causes of Prosperity

- To get at the reasons some countries are either unable or unwilling to invest in different amounts of physical capital, human capital, and technology, we have to dig **deeper**.
- **Causation can be complex**. We sometimes have to see what lies beneath the surface to understand the true causes of an observed phenomenon.
- We refer to these underlying factors as the **fundamental causes of prosperity**, which are defined as those causes that are at the *root* of the differences in the proximate causes of prosperity.
- The relationship between the fundamental and the proximate causes of prosperity is shown in the following Figure:

1. Proximate Versus Fundamental Causes of Prosperity

Figure: Fundamental and Proximate Causes of Prosperity

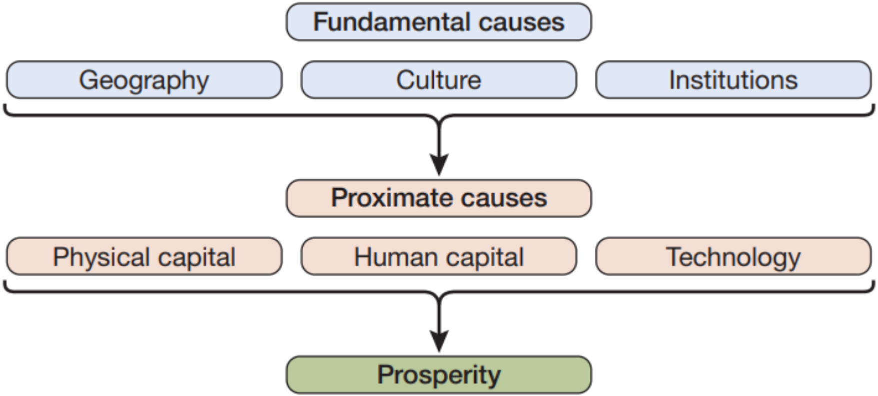

Figure: Macroeconomics (Acemoglu, Laibson, List 2022), Page 212

1. Proximate Versus Fundamental Causes of Prosperity

- Societies become prosperous when they have abundant human and physical capital and use advanced technology efficiently in production.
- But these are proximate causes because they are in turn shaped by other, deeper factors.
- Fundamental causes, such as geographic, cultural, and institutional factors, have an impact on prosperity by affecting proximate causes, such as investment in human capital, physical capital, and technology

1. Proximate Versus Fundamental Causes of Prosperity

- To see the distinction between proximate and fundamental causes more clearly, it is useful to consider an analogy.
- Say you are experiencing some symptoms of flu—sore throat, fever, and headache—that might motivate you to take drugs, such as throat decongestants or aspirin.
- In this example, the proximate cause of why you take these drugs is that you have a sore throat, a high fever, and a headache. But the fundamental cause – the reason you have the symptoms in the first place – is that you have the flu. The flu thus induces both the symptoms and your response of taking drugs.

1. Proximate Versus Fundamental Causes of Prosperity

- Similarly, if a country underinvests in human capital, physical capital, and/or technology, we should ask **why**. Both proximate and fundamental causes have to be considered for a complete understanding of why some nations are prosperous and others aren't.
- Although there are many different theories about the fundamental causes of poverty and prosperity — theories about why poorer nations around the world have worse technologies and do not invest in physical and human capital as much as rich ones — it is useful to classify them into three categories: *theories of geography, culture, and institutions*. We next describe these hypotheses and then discuss whether they are consistent with empirical evidence.

1. Proximate Versus Fundamental Causes of Prosperity

GEOGRAPHY

- One approach, which we will refer to as the **geography hypothesis**, claims that differences in geography, climate, and ecology ultimately determine the large differences in prosperity across the world.
- According to this hypothesis, some countries have highly unfavorable geographical, climatic, or ecological circumstances that are beyond their control.
- Some are situated in areas where much of the soil may be inhospitable for agriculture, daytime temperatures are very high, or a lack of navigable rivers makes transport prohibitively costly.
- These conditions, some argue, make it impossible or unlikely for such countries to accumulate or effectively use the factors of production.

1. Proximate Versus Fundamental Causes of Prosperity

- Today, many believe that geographic characteristics determine the technology available to a society, especially in agriculture.
- The economist Jeffrey Sachs has been a strong proponent of this view in his academic writings.
- Using it as the basis of his influential policy recommendations to the United Nations and the World Health Organization, Sachs, for example, argues:

By the start of the era of modern economic growth, if not much earlier, temperate-zone technologies were more productive than tropical-zone technologies.

1. Proximate Versus Fundamental Causes of Prosperity

- Jeffrey Sachs and others also argue that many parts of the world, particularly sub-Saharan Africa, are disadvantaged economically because infectious diseases, such as malaria and dengue fever, spread there more easily.
- When it is serious and widespread, an illness can indeed destroy a large amount of a country's human capital.

1. Proximate Versus Fundamental Causes of Prosperity

- If geography is the major fundamental cause of prosperity (or its absence), then the poor nations of the world have little reason to expect much improvement in living standards. They are permanently disadvantaged, and we should not expect them to catch up with the rest of the world and become economically developed anytime soon — or so the thinking goes.
- Not all variations of the geography hypothesis are equally pessimistic. In some, large-scale investments in transport technology or disease eradication may partially redress these geographic disadvantages.

1. Proximate Versus Fundamental Causes of Prosperity

CULTURE

- Another potential fundamental cause of differences in economic performance has to do with cultural differences.
- According to the **culture hypothesis**, different societies respond differently to incentives because of specific shared experiences, religious teachings, the strength of family ties, or unspoken social norms.
- Culture is viewed as a key determinant of the values, preferences, and beliefs of individuals and societies and, the argument goes, these differences play a key role in shaping economic performance.
- For example, some societies may have values that encourage investment, hard work, and the adoption of new technologies, while others may nurture superstition and suspicion of new technologies and discourage hard work.

1. Proximate Versus Fundamental Causes of Prosperity

- Almost 20 years ago, the Harvard political scientist Samuel Huntington coined the term clash of civilizations to capture what he thought would be the defining conflict of the twenty-first century—the conflict between the West and Islam.
- More broadly, Huntington has supported the view that culture plays a central role in shaping prosperity. For example, his explanation for why South Korea grew rapidly in the twentieth century and Ghana did not summarizes his overall approach:

  Culture had to be a large part of the explanation. South Koreans valued thrift, investment, hard work, education, organization, and discipline. Ghanaians had different values.
- Of course, a society's culture is not immutable: cultures change, though they do so slowly.

1. Proximate Versus Fundamental Causes of Prosperity

INSTITUTIONS

- A third potential fundamental cause for the differences in prosperity involves institutions, the formal and informal rules governing the organization of a society, including its laws and regulations. For example, economic historian Douglass North, who was awarded the Nobel Prize in economics largely because of his work emphasizing the importance of institutions in the historical development process, offers the following definition of institutions:

Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.

1. Proximate Versus Fundamental Causes of Prosperity

- This definition captures three important elements that define institutions:

1. They are determined by individuals as members of a society.
2. They place constraints on behavior.
3. They shape behavior by determining incentives

1. Proximate Versus Fundamental Causes of Prosperity

- First, institutions are humanly devised. In contrast to geography, which is largely outside of human control, and culture, which changes very slowly, institutions are determined by human-made factors. That is, institutions do not just appear out of thin air, but develop due to the choices members of a society make about how to organize their interactions.
- Second, institutions place constraints on individual behavior. On the positive side, institutions constrain the ability of an individual to steal from others or to walk away from debts that he has built up. On the negative side, they might prevent people from entering into occupations or opening new businesses.
- This observation leads us to the third important element in North's definition — institutions affect incentives. The constraints that institutions place on individuals — whether formal constraints (such as banning certain activities) or informal ones (discouraging certain types of behavior through customs and social norms) — shape human interaction and affect incentives. In some sense, institutions, much more than the other candidate fundamental causes, are about the importance of incentives.

1. Proximate Versus Fundamental Causes of Prosperity

- The **institutions hypothesis** maintains that the differences in the way that humans have chosen to organize their societies — differences that shape the incentives that individuals and businesses in the society face — are at the root of the differences in their relative prosperity.
- For example, the economy will generate higher GDP and achieve greater prosperity when markets allocate individuals to the occupations in which their productivity is highest, when laws and regulations encourage firms to invest in physical capital and technology, and when the educational system enables and encourages people to invest in their human capital.

1. Proximate Versus Fundamental Causes of Prosperity

- To sum up, the institutions hypothesis relies on the following chain of reasoning:

1. Different societies typically have different institutions.
2. These different institutions create different types of incentives.
3. The incentives help determine the degree to which societies accumulate the factors of production and adopt new technology

1. Proximate Versus Fundamental Causes of Prosperity

- The geography, culture, and institutions hypotheses are not mutually exclusive. But they are competing explanations in that if the bulk of the gaps in GDP across countries were due to geography, there would be little for culture or institutions to explain.
- **So which one of these broad explanations accounts for most of the differences in prosperity we observe around us?**

1. Proximate Versus Fundamental Causes of Prosperity

A NATURAL EXPERIMENT OF HISTORY

- The Korean peninsula is divided in two by the thirty-eighth parallel. To the south is the Republic of Korea, also known as South Korea. We saw in last lecture how South Korea has had one of the fastest-growing economies in the past 60 years and has by now achieved living standards comparable to those in many countries in Europe.
- To the north of the thirty-eighth parallel there is another Korea: the Democratic People's Republic of Korea, or simply North Korea. Living standards in North Korea are similar to those in a sub-Saharan African country. The best estimate suggests that in 2015, real GDP per capita (in PPP-adjusted 2011 constant dollars) was $1,720 in the North, making its inhabitants worse off than the citizens of Sudan or Yemen. In contrast, in that same year, real GDP per capita (in PPP-adjusted 2011 constant dollars) in the South was $35,316.

1. Proximate Versus Fundamental Causes of Prosperity

What explains these large differences? Could it be geography? Culture?

1. Proximate Versus Fundamental Causes of Prosperity

- Highly unlikely.
- The North and South share the same geography, essentially the same climate, the same access to the ocean, and the same disease environments.
- There are also no noticeable differences between their cultures, certainly not before 1947 when the country was split into two. Korea was at that point an unusually homogeneous country, both ethnically and culturally.
- If we were to believe that geography or culture were important factors in determining South Korea's economic development after 1947, we would then expect a similar process of economic development in North Korea.
- **Nothing of the sort happened.**

1. Proximate Versus Fundamental Causes of Prosperity

- In fact, the great disparities between the two nations did not exist before World War II, when the two parts of Korea were united. They emerged only when the two were separated and adopted very **different institutions**.

1. Proximate Versus Fundamental Causes of Prosperity

- The separation of Korea into two halves was not something to which its citizens willingly agreed. It was an outcome of a geopolitical deal between the Soviet Union and the United States, who agreed at the end of World War II that the thirty-eighth parallel would be the dividing line for their spheres of influence in Korea and **set up different governments in the North and the South**.

1. Proximate Versus Fundamental Causes of Prosperity

- **These governments adopted very different ways of organizing their economies**.
- In North Korea, Kim Il-Sung, a leader of anti-Japanese communist partisans during World War II, established himself as dictator. With the help of the Soviet Union, Kim Il-Sung introduced a rigid form of communism, the Juche system. Resources in North Korea were allocated through central planning, private property was outlawed, and markets were banned. Freedoms were curtailed not only in the marketplace but also 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. This cronyism persisted under his son Kim Jong-Il, who ruled until his death in 2011, and continues today under Kim Il-Sung's grandson, Kim Jong-Un.

1. Proximate Versus Fundamental Causes of Prosperity

- In the South, institutions were shaped by the Harvard- and Princeton-educated, staunchly anticommunist Syngman Rhee, with significant support from the United States. Though Rhee and his successor, General Park Chung-Hee, were autocrats, they supported a market-based economy, providing incentives to businesses for investment and industrialization and investing in the education of South Koreans. South Korea did eventually become democratic in the 1990s and further liberalized its economy.

1. Proximate Versus Fundamental Causes of Prosperity

- If institutions are a major determinant of economic prosperity, then the sharply divergent institutions of the two Koreas should have led to divergent economic fortunes.
- And that's exactly what happened.
- Next Figure shows how PPP-adjusted GDP per capita in North and South Korea has sharply diverged over the past 60 years to arrive at the great disparities that we observe today.

1. Proximate Versus Fundamental Causes of Prosperity

Figure: GDP per Capita in North and South Korea (in PPP-adjusted 2011 Constant Dollars)

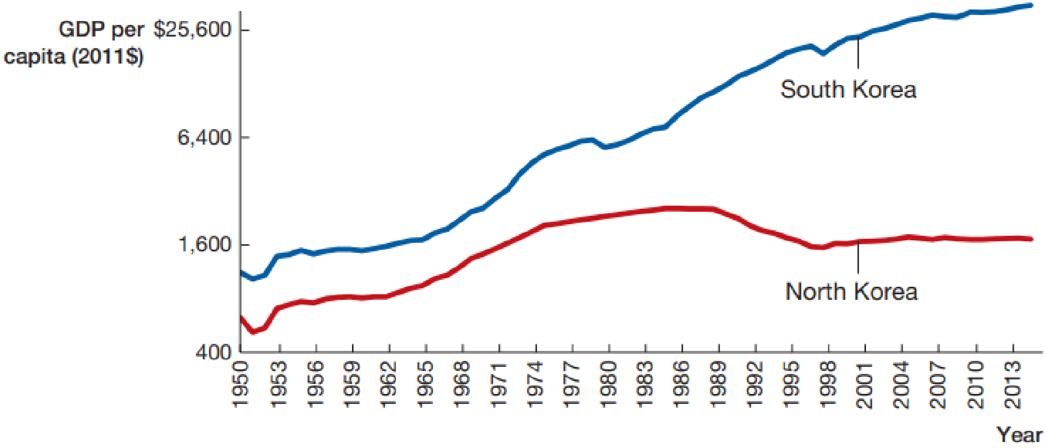

Figure: Macroeconomics (Acemoglu, Laibson, List 2022), Page 216

1. Proximate Versus Fundamental Causes of Prosperity

- The Korean case depicts what we often call a natural experiment or an experiment of history. A country was split in half by a military outcome. The two newly formed, culturally identical, and geographically similar countries proceeded to develop very different institutions.
- **While the South remained a market economy, the North adopted a very rigid form of communist rule with little room for markets, private property, or entrepreneurship.**
- The reason this episode approximates a natural experiment is that **while institutions were changing in this radical way, geography and culture remained largely unchange**d.
- It was the **changes in institutions** that led to massive changes in economic prosperity.
- The Korean example thus provides strong support for the institutions hypothesis (but it does not provide direct evidence against geography and culture because these were held fixed in this comparison)

2. Institutions and Economic Development

- Teenagers in South Korea grow up just like American teens. Many obtain a good education and face incentives that encourage them to exert effort and excel in their chosen vocations.
- South Korea is a market economy. South Korean teenagers know that, if successful, one day they can enjoy the fruits of their investments and efforts. They can buy computers, clothes, cars, houses, and healthcare. They can start businesses and bequeath their property to their offspring.
- This is in large part because the South has well-enforced **private property rights**, meaning that its citizens can hold property like businesses, houses, cars, and many other things without fearing that the government or anyone else will arbitrarily take it away from them.

2. Institutions and Economic Development

- Teenagers in North Korea face vastly different lives from those in the South.
- They grow up in poverty, without high-quality education to prepare them for skilled work or entrepreneurship. Much of the education they receive at school is pure propaganda about foreign threats against North Korea and the benevolent leadership of their supreme leader and the North Korean military.
- But these teenagers know that they will not be able to own property, start businesses, or make much money because there is no private property in North Korea. They also know that they will not have access to markets where they can deploy their skills or use their earnings to purchase the goods that they need and desire.

2. Institutions and Economic Development

INCLUSIVE AND EXTRACTIVE ECONOMIC INSTITUTIONS

- The enforcement of private property rights, which differs so sharply between South and North Korea, is one aspect of what we refer to as **economic institutions**. Economic institutions are those aspects of a society's rules that concern economic transactions.
- Besides the protection of property rights, economic institutions include such things as the functioning and impartiality of the judicial system, the financial arrangements that determine how individuals and businesses can borrow money, and the regulations that shape how costly it is to enter into a new line of business or a new occupation.

2. Institutions and Economic Development

- When a society's economic institutions provide secure property rights, set up a judicial system that enforces contracts and upholds the law, allow private parties to sign contracts for economic or financial transactions, maintain relatively open and free entry into different businesses and occupations, and enable people to acquire the education and skills to take part in such businesses and occupations, we say that they are **inclusive economic institutions**.
- The economic institutions in South Korea approximate these types of inclusive economic institutions. They are inclusive in the sense that they encourage the participation of the great majority of the population in economic activities in a way that best makes use of their talents and skills.

2. Institutions and Economic Development

- As we have seen, inclusive economic institutions do not describe the situation in North Korea. Economic institutions to the north of the thirty-eighth parallel fail to enforce property rights or contracts, erect prohibitive entry barriers, and all but destroy the workings of the markets.
- We refer to such arrangements as **extractive economic institutions**. This terminology stems from the fact that such institutions are often shaped by those who control political power to *extract resources from the rest of the society*.
- Extractive economic institutions are not just associated with communist North Korea. Societies ruled by monarchs, dictators, and juntas as well as several that hold elections for their parliaments and presidents have had, and still have, extractive economic institutions.
- In fact, most societies throughout history have had economic institutions that are closer to the extreme extractive economic institutions of North Korea than to the ideal of inclusive economic institutions we have defined here.

2. Institutions and Economic Development

- Examples of market economies that have extractive economic institutions include former Soviet republics (such as Azerbaijan, Turkmenistan, and Uzbekistan), Myanmar, and Pakistan in Asia; Argentina, Guatemala, and Peru in Latin America; and the Democratic Republic of the Congo, Egypt, and Kenya in Africa.
- Even if the specific forms of these institutions differ from the extreme form of central planning in North Korea, they share the fact that they fail to enforce property rights and instead privilege a few at the expense of the many.

2. Institutions and Economic Development

- Extractive economic institutions do not exist in a vacuum. It is no accident that North Korea is a repressive dictatorship. Without the political elite’s tight control of the state, North Korea would not be able to maintain a system that condemns tens of millions to poverty.
- This meshing of political and economic power underscores the important role of **political institutions**, which determine who holds political power and what types of constraints exist on the exercise of that power.
- Extractive economic institutions tend to be supported by certain types of political institutions, which concentrate political power in the hands of the political elite and put little constraint on how political power can be used.
- Similarly, inclusive economic institutions tend to coexist with different types of political institutions that tend to distribute political power more equally in society, so that no single individual or group is able to use that political power for its own benefit at the expense of the rest of society

2. Institutions and Economic Development

HOW ECONOMIC INSTITUTIONS AFFECT ECONOMIC OUTCOMES

- The contrast between South Korea and North Korea illustrates a general principle: **inclusive economic institutions foster economic activity, productivity growth, and economic prosperity, whereas extractive economic institutions generally fail to do so.**
- Property rights are central to this principle because only those individuals who have secure property rights will be willing to invest and increase productivity.

2. Institutions and Economic Development

- A farmer who expects his output to be expropriated — meaning stolen, taken away, or entirely taxed away — will have little incentive to work, let alone any incentive to undertake investments and innovations.
- Extractive economic institutions distort incentives in exactly this fashion. Farmers, traders, business-people, and workers will be discouraged from investing and producing when they have no property rights. On top of that, firms will not be able to form the trust-based relationships that are necessary to productively do business when private contracts are worth little more than the paper they are written on or when some contractual agreements are banned outright.
- Finally, because they erect barriers to market entry rather than create an environment that would encourage entry, extractive economic institutions tend to support inefficient firms and prevent entrepreneurs with new ideas from entering into the right lines of business and workers from working in occupations to which their skills are best suited.

2. Institutions and Economic Development

- In the followinf Figure, we illustrate why extractive economic institutions discourage economic activity.
- There, in a hypothetical economy, we rank potential entrepreneurs in descending order according to the return they will make if they enter and start a business.
- The return-to-entrepreneurship curve in the exhibit (shown in blue) plots these returns.
- The y-axis shows the return, while the x-axis depicts the number of entrepreneurs who have at least the given rate of return (or higher).

2. Institutions and Economic Development

Figure: How Extractive Economic Institutions Reduce the Number of Entrepreneurs

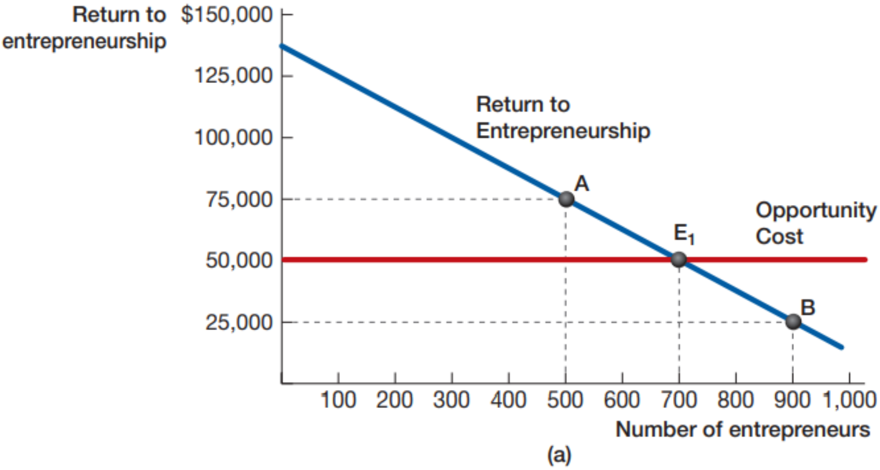

Figure: Macroeconomics (Acemoglu, Laibson, List 2022), Page 221

2. Institutions and Economic Development

- To understand the figure, consider point *A* in panel (a). The y-axis shows that we are looking at a return to entrepreneurship of $75,000. The x-axis, in turn, indicates that the number of entrepreneurs with at least this return to entrepreneurship is 500.
- As we consider a point with a lower return to entrepreneurship, such as point *B*, which corresponds to a return of $25,000, naturally there will be more entrepreneurs with at least this return — in this figure 900 of them.
- This is because, in addition to the 500 entrepreneurs with a return greater than $75,000, there are also 400 entrepreneurs with a return between $25,000 and $75,000, so the total number of entrepreneurs with a return greater than or equal to $25,000 is 900.
- This reasoning immediately implies that the return-to-entrepreneurship curve is downward sloping — as we consider a lower return, there will be more entrepreneurs with at least that return.
- The horizontal line in red shows the opportunity cost of entrepreneurship, which is assumed to be the same for all potential entrepreneurs. This could be, for example, how much they would earn if they were to choose another occupation.

2. Institutions and Economic Development

- Panel (a) of the previous Figure considers the general question of entry into entrepreneurship, which is determined by whether one's returns to entrepreneurship are above or below one's opportunity cost.
- Consider an entrepreneur in panel (a) with a return given by point A, whom we will call Entrepreneur A. Because this point is above the horizontal line, this individual has a greater return from entrepreneurship ($75,000) than her opportunity cost, which is at $50,000 in this exhibit. Therefore, she will choose to become an entrepreneur.
- In contrast, an entrepreneur with a return given by point B (Entrepreneur B) will not do so because this point is below the horizontal line, and thus the return ($25,000) falls short of her opportunity cost ($50,000).
- This reasoning establishes that there will be entry into entrepreneurship until the point marked E_1 is reached. At this point, the return to entrepreneurship and the opportunity cost are both $50,000, so any additional entrepreneur will be indifferent between entering into or exiting entrepreneurship.
- Thus, point E_1 determines the equilibrium level of entrepreneurship in our economy.

2. Institutions and Economic Development

- How do extractive economic institutions change this picture?
- First consider the implications of insecure property rights, which are investigated in panel (b), in the following Figure.

2. Institutions and Economic Development

Figure: How Extractive Economic Institutions Reduce the Number of Entrepreneurs

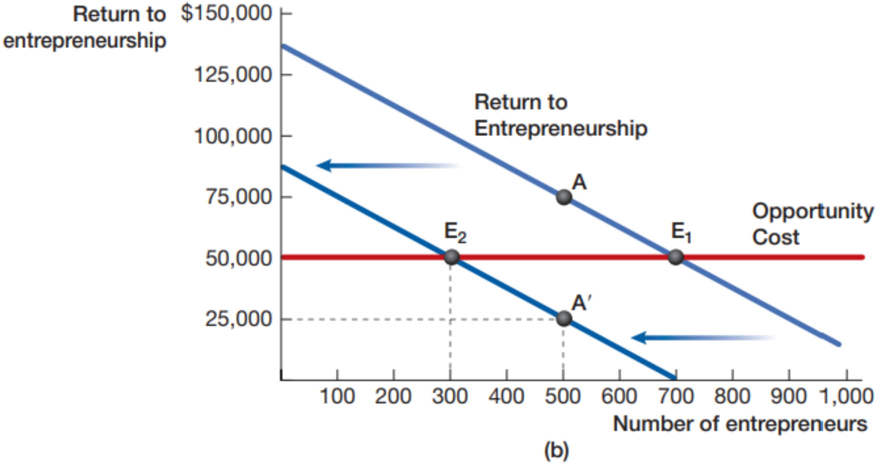

Figure: Macroeconomics (Acemoglu, Laibson, List 2022), Page 221

2. Institutions and Economic Development

- Under insecure property rights, an entrepreneur will not be able to capture all the returns that he or she creates; for example, the government or some other group may expropriate the returns of his or her enterprise.
- Suppose, for example, that insecure property rights imply that Entrepreneur A will be able to keep only $25,000 out of her $75,000 return, and that the remaining $50,000 will be expropriated or paid as bribes.
- Because all entrepreneurs similarly can keep less of what they make under insecure property rights, the return-to-entrepreneurship schedule will shift to the left.

2. Institutions and Economic Development

- Entrepreneur A also illustrates how extractive economic institutions affect overall entrepreneurship in the economy.
- This individual's return to entrepreneurship, \$75,000, was initially above the opportunity cost schedule. But with insecure property rights, she can make only \$25,000, which is less than her opportunity cost of \$50,000, as indicated by the fact that the new point describing Entrepreneur *A*'s situation, point *A*', now lies below the opportunity cost line.

2. Institutions and Economic Development

- We can then see that as a result of the shift, the new equilibrium will be at point E_2, which involves strictly less entrepreneurship.
- Less entrepreneurship implies less business creation, less technology adoption, lower returns to education and capital accumulation, and therefore a lower level of GDP. Thus one effect of extractive economic institutions, working in this instance through insecure property rights, is to reduce entrepreneurship and GDP.

2. Institutions and Economic Development

- Extractive economic institutions distort economic activity not only by creating insecure property rights but also by making it more costly or impossible to write contracts with suppliers, to borrow money, or to use the courts to uphold business arrangements.
- For example, say that an entrepreneur would make $75,000 if she could engage the right supplies for her business. But without courts to uphold her contracts, she cannot make the deals necessary for obtaining supplies, and this lack of legal backup will reduce her returns from entrepreneurship by $50,000. These effects will also shift the return-to-entrepreneurship schedule to the left, as shown in panel (b), with the same result of depressing entrepreneurship and GDP in the economy.

2. Institutions and Economic Development

- Finally, extractive economic, institutions can create entry barriers, preventing otherwise profitable businesses from being founded, and may also encourage entrepreneurs to engage in other, nonproductive activities rather than entrepreneurship (for example, joining the underground economy).
- These factors thus increase the opportunity cost of entrepreneurship, as shown in panel (c) of the following Figure.

2. Institutions and Economic Development

Figure: How Extractive Economic Institutions Reduce the Number of Entrepreneurs

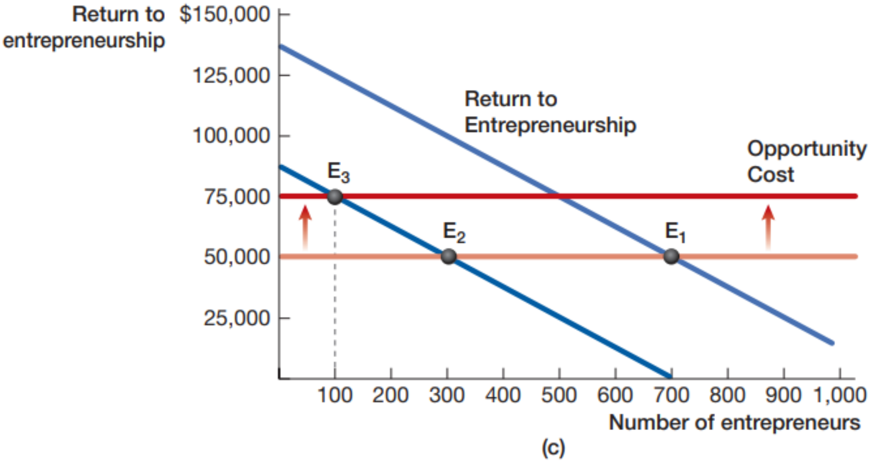

Figure: Macroeconomics (Acemoglu, Laibson, List 2022), Page 221

2. Institutions and Economic Development

- Using the same numerical example as in panel (b), we can see that without entry barriers, entrepreneurs who can generate returns greater than \$50,000 will open businesses (see the light red line on the graph).
- But if each entrepreneur also has to get a license that costs \$25,000, only entrepreneurs who have returns greater than \$75,000 will find it profitable to enter (see the dark red line on the graph, now shifted upward).
- We interpret this additional \$25,000 as shifting the opportunity cost upward because it is a cost that entrepreneurs have to pay before they enter, therefore making their second-best alternative more attractive by \$25,000. Thus panel (c) simultaneously shows two possible implications of extractive economic institutions:

1. By creating insecure property rights and limiting legal backup, they make entrepreneurship less profitable and shift the return-to-entrepreneurship schedule to the left.
2. By erecting entry barriers, they make entry more costly and shift the opportunity cost schedule upward.

2. Institutions and Economic Development

- The resulting equilibrium, shown at E_3, now corresponds to even less entrepreneurship. As before, an economy at point E_3, with less entrepreneurship, will have lower prosperity than an economy at point E_1 because — as more potential entrepreneurs are discouraged — investment, business creation, and technological development are held back, and the economy generates a lower level of GDP.

THE LOGIC OF EXTRACTIVE ECONOMIC INSTITUTIONS

- We have just seen how extractive economic institutions tend to reduce entrepreneurship and economic activity, thus adversely affecting economic outcomes.
- It clarifies how there may be large differences in prosperity between two otherwise similar societies that differ in terms of their institutions—one having inclusive economic institutions similar to those in South Korea, and the other one having extractive economic institutions as in North Korea.

2. Institutions and Economic Development

- **But why would a society adopt extractive economic institutions in the first place, particularly as these institutions seem to lead to relative poverty and a lack of economic development?**
- 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 their countries as wealthy as they could?**

2. Institutions and Economic Development

- Unfortunately for the citizens of many countries in the world, the answer is no.
- To understand why, we turn to a concept first proposed by the famous Austrian economist Joseph Schumpeter.
- **Schumpeter emphasized the notion of creative destruction as a central element of technological change**.
- Creative destruction refers to the process by which new technologies replace old ones, new businesses replace established companies, and new skills make old ones redundant.
- The process of creative destruction implies that technological change, which is the main driver of economic growth, also creates economic losers as it replaces otherwise profitable firms or technologies with new ones.
- Because creative destruction is an inseparable part of the process of technological change and economic growth, there will be firms and individuals that will lose as a result of this process and will be opposed to it, and this opposition to technological change can provide support for the continuation of extractive economic institutions.

2. Institutions and Economic Development

- Extending Schumpeter's ideas, we can also introduce the notion of **political creative destruction**, which refers to the process by which economic growth destabilizes existing regimes and reduces the political power of rulers.
- This might be because new technologies will also bring new actors on the scene who will make political demands, or because new economic activities may fall outside of the control of existing rulers.
- If the process of economic growth is also associated with political creative destruction, then we would expect that the politically powerful who fear losing their privileged positions will be opposed to this process.

INCLUSIVE ECONOMIC INSTITUTIONS AND THE INDUSTRIAL REVOLUTION

- We saw how the process of technological change gathered speed during the Industrial Revolution in Britain, which first involved a series of major innovations in textiles that then spread to other industries, resulting in the famous advances in the steam engine, which laid the foundation of modern production as well as the railroad.
- Economic historians have long debated why the Industrial Revolution took place in Britain rather than in France or some other European nation or in China, and why it started in the second half of the eighteenth century instead of some other time in history.

2. Institutions and Economic Development

- A complex social and economic process such as the Industrial Revolution seldom has a single cause. Economic historians have come up with scores of explanations for why and where it occurred.
- Despite this variety, though, many of these explanations either depend on **Britain's relatively inclusive economic institutions** or simply take them as given.
- This is because it would be next to impossible to imagine how the Industrial Revolution could have taken place in Britain without such inclusive economic institutions.
- The defining characteristic of the Industrial Revolution was that new technologies were being developed and implemented by businessmen for profit.
- Without secure property rights, these businessmen would not have been encouraged to seek and undertake such innovations.
- The innovations were profitable, in turn, because Britain already had a well-developed market system, and those who could adopt new technologies to improve quality and reduce costs in textiles and other areas could reach a larger market and make sizable profits.

2. Institutions and Economic Development

- Notably, British economic institutions were also supported by the appropriate political institutions. The development of these economic institutions was preceded by major political reforms, in particular the Glorious Revolution of 1688, which introduced a constitutional monarchy and considerable constraints on the political powers of the monarch.
- The political institutions enshrined in the Glorious Revolution and further developed in the subsequent century were the bulwarks upon which the inclusive economic institutions that underpinned the Industrial Revolution were built.

3. Is Foreign Aid the Solution to World Poverty?

- Many in the Western world think that, if at all feasible, we should take steps toward improving the lives of the hundreds of millions of people who live in poverty.
- This conviction has led to a substantial effort over the past 60 years to provide foreign aid – in fact, "development aid" – to poor nations.
- Development aid, given by charitable organizations, the World Bank, and the United Nations, or sometimes by bilateral deals between countries, is meant to alleviate or even fundamentally eradicate poverty around the world.
- Many in the international community—for example, high-level officials of the World Bank and the United Nations, and various journalists and commentators—have much hope pinned on development aid. **But has this type of foreign aid been effective in reducing poverty around the world?**

3. Is Foreign Aid the Solution to World Poverty?

- You might at first be surprised, but economists' overall verdict is that foreign aid has been on the whole ineffective in alleviating poverty.
- For example, over the past 50 years, hundreds of billions of dollars have been given to Africa as development aid, but as we have seen, African nations are still much poorer than the United States or Western Europe.
- **Why is that the case?**

3. Is Foreign Aid the Solution to World Poverty?

- Though surprising at first, once we use economics to understand how foreign aid might work and recognize the difficulties faced, this conclusion turns out to be quite reasonable for three reasons.
- First, we know from our analysis so far that GDP per capita can be increased and economic growth can be triggered if the levels of a country's physical capital, human capital, and/or technology can be increased significantly.
- Although generous from the viewpoint of the donor nations, the amount of foreign aid given to even the poorest countries is not large enough to lead to a sizable increase in physical capital or to significantly increase the educational attainment of the countries' population.
- It also generally does not have an impact on technology or the efficiency of production.
- In view of this, the fact that foreign aid has not made significant progress in increasing GDP per capita among the poorest nations in the world shouldn't be too surprising.

3. Is Foreign Aid the Solution to World Poverty?

- Second, in practice, much of foreign aid does not even get invested in new technology or education.
- Problems related to corruption and political economy imply that money given to governments or other organizations in poor countries is often captured and distributed to corrupt officials.
- Studies indicate that only about 15 percent of any money given to foreign aid actually reaches its intended destination, and often it does so in a rather distorted manner.

3. Is Foreign Aid the Solution to World Poverty?

- There is also a third, and a more fundamental, reason for why foreign aid has a limited impact in alleviating poverty.
- If the root of poverty is the extractive economic institutions of many countries around the world, then foreign aid working within the framework of these same institutions will not fix the fundamental causes.
- In fact, in some instances, foreign aid funneled to dictators sitting atop of these extractive economic institutions might strengthen or enrich them, as suggested by the Choice Consequence box.

3. Is Foreign Aid the Solution to World Poverty?

- All the evidence on the costs and limits of foreign aid does not mean that foreign aid is bad or useless.
- Often, foreign aid is a transfer to some of the poorest people in the world and helps alleviate their hardships, albeit temporarily, and as such serves a useful, even if limited, role.
- But we must also devote energy to developing policies that address the fundamental causes of prosperity — like institutions — if we wish to enduringly improve living conditions in the world's impoverished countries

Summary

- Physical capital, human capital, and technology are proximate causes of prosperity in the sense that, though they determine whether a nation is prosperous, they are themselves determined by other, deeper factors. Put differently, if we want to understand why some nations are poor, we have to ask why they do not sufficiently invest in physical capital or human capital and why they do not adopt the best technologies and organize their production efficiently.
- The fundamental causes of prosperity include factors that potentially influence the physical and human capital investment and technology choices of nations and, via this channel, shape their prosperity

Summary

- Three leading hypotheses about the fundamental causes of prosperity are geography, culture, and institutions. According to the geography hypothesis, geographic aspects (such as climate, topography, or disease environment) determine whether a nation can be prosperous. According to the culture hypothesis, it is the cultural values of the country's people that powerfully determine its potential for prosperity. According to the institutions hypothesis, it is the institutions (in particular, the formal and informal rules governing the organization of society and economic interactions therein) that are central to prosperity.

Summary

- Inclusive economic institutions are those that (1) provide secure property rights, (2) establish a judicial system that allows and facilitates private contracting and financial transactions, and (3) maintain relatively open and free entry into different businesses and occupations. In contrast, extractive economic institutions create insecure property rights, a partial judicial system, and entry barriers that protect the businesses and incomes of a small segment of society at the expense of the rest. According to the institutions hypothesis, inclusive economic institutions tend to generate prosperity, while extractive economic institutions do not.

Summary

- Though the inequalities in GDP per capita around the world have multiple causes, the evidence from the economic experiences of former European colonies suggests that institutional factors, and not geography, are central to explaining these disparities. In fact, the major patterns—for example, the reversal of fortune, whereby areas that were relatively prosperous became relatively less prosperous after European colonization—cannot be explained by geographic factors.
- Foreign aid can be useful to temporarily alleviate extreme poverty or manage crises but is unlikely to be a solution to poor economic development in many parts of the world. This is because aid largely fails to address the institutional roots of poverty.