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Keynote Video Lecture

Why Nations Fail?

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First of all, it is a great pleasure to be here. Thank you for inviting me. Given that communicating from a far is not the easiest thing to do, what I have decided to do is to give a quick overview of the arguments that have emerged from the book that James and I wrote. In fact, this book is a synthesis of about 16 years of research that James and I did. I think it is fair to say that a lot of economic development and economic growth is motivated by patterns that are reported in the book. In particular, this is data from Angus Madison's life's work, which is not entirely uncontroversial, but the overall pattern here is fairly uncontroversial.

The patterns that we observe have actually been in the background of many attempts to understand long patterns of economic development. I think they also point out that it is going to be very difficult to understand why certain parts of the world that were either on par with, say, Asia, in particular the Indian Subcontinent and China, have increased their income per capita and their prosperity so much in 500 years leading to today, particularly from the period around early 1800s to essentially to the end of the World War II, where there is this big divergence taking place. The trends in economic development show that United States of America, Canada, New Zealand and Australia have pulled so much ahead of, say, Asia, where both India, the Indian Subcontinent in this case, and China more or less show the same picture, where there is not much growth going on until the end of the World War II.

I think, the sort of the approaches that economists have made a lot of mileage with, which is trying to understand that economic growth is a process of physical capital accumulation, human capital accumulation, and technological change are obviously a part of the story. When you look at the details, for example in the 19th century United Kingdom or the United States, there is capital intensive, human capital intensive, and technology intensive growth where people are taking up patents, coming up with new technologies, and rationalising production. However, the question is, why? Why is it that this process is taking place at this specific point in time and in these specific countries and not in the rest of the world? Moreover, then why as a result of this, it has been associated with such a huge increase in inequality around the world, both across people and between countries? There are numerous theories on this and it would be totally disingenuous to say that people have not thought about it at all. Indeed, they have been thinking about it, one way or another, although perhaps sometimes the economic growth literature going in some other direction may not pay as much attention.

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But these sorts of questions have been at the background of many social science inquires, including many economic theories. But I think, still by and large, the theories that have been influential over the last, say, 40, 50 years are not entirely satisfactory. That was the starting point that James and I had in our thinking about this question, in particular, this question about the evolution of prosperity. In addition, we also had the question of the evolution of institutions, which are the formal and informal rules of the society, how they function economically, politically, and socially. However, the emphasis often is on things like geography and it is very common both among economists and other social scientists, and even physical scientists, to see things like climate topography, resource and disease environment as important determinants of long-run economic development.

Other views go back to Max Weber's seminal work on contrasting protestant and catholic values as foundation for capitalist development, where Max Weber argued that protestant values were much more conducive to capitalist development than catholic ones. The catholic-protestant distinction is perhaps not the most popular one today but if you want to look at both popular and somewhat scientific articles, you will see them full of statements about how to understand different paths between Africa and Europe, or between Latin and North America, or between India and Pakistan and Western Europe—all of those statements sometimes come to the role of religion, attitudes and values. I think, when you dig deep, you see some aspect of social, economic, and political life that of course interact with these factors. To say that religion plays no social, economic, and political role in Pakistan, for example, would be a laughable statement.

However, the question is that does the interest Pakistan has in religion compared to, say, Switzerland, is that the reason why Pakistan is much poorer than Switzerland? Again, I think just like geography, this does not seem to be fully relevant for understanding the big picture, or for understanding questions, why there are 30, 40, or even 50-fold differences between the richest and the poorest nations in the world today.

The one view that is perhaps more popular among economists is what we call the ignorance hypothesis in the book. Or you can call it good and ignorant leadership hypothesis, which is that policies are important. Of course, if you adopt a policy that discourages innovation and also discourages investment, that is going to have an impact, but it could also be the case that perhaps those policies are adopted by leaders that are largely unconstrained, which means that the leaders have the capability and freedom to choose good and bad policies. According to this view, prosperity follows from good policies and poverty follows from bad policies. However, the leaders sometimes end up choosing good polices and sometimes bad policies. The reason why this view is so ingrained into economics is that economics as a science has developed both as a positive and normative science. On the positive side, we have many of the crowning achievements of the economics discipline, for example, trying to analyse how markets work. However, on the normative side, there is always talk of things like market failure and solution of the market failures. Therefore, economics naturally is inclined to the sort of view that if there are bad decisions, we can solve them, we have capability to do it. And of course, there is another bias for us to like this view, which is that it is not really leadership, economists often play the role of advisors, and we tend to think that good advisors matter a lot, so this view that prosperity and poverty follow from good and bad advice, I think, is quite appealing. However, again, I am going to argue, this is not very relevant.

What I want to do today is not go so much into the details of the argument that we lay out in the book; rather I want to try to explain, where we come from. Put another way, I want to explain why we think these particular approaches are not so convincing and in the process I will also mention a little bit about the statistical work. I want to do it through a story. Therefore, let me first explain the alternative that James and I have proposed and, of course, this is not just our view. It builds on research by others, particularly on the research of Douglas C. North, who was one of the influential economic historians who have developed similar ideas, on which we build and extend. The best way of thinking about that is actually going back to our first ever economics class or you could just go back to the economic classes that you teach in introductory courses.

Therefore, in that first principles of economics course we do not really talk so much about institutions. I have done this myself as I have taught such classes and have also written books about principles of economics. If you think about it, you would realise that there are very specific types of institutions embedded in our rhetoric about how markets work. In particular, we start with an idealised view of the market, where there are no entry barriers or political connections that help you have a monopoly in any industry. Similarly, in standard textbooks, there are very secure property rights because firms can sell stuff and enjoy all the profits they make, they can undertake investments, and benefit from those investments. Sometimes you even might be adventurous enough to talk about innovation and patents in a principles course, which again is totally undergirded by set of institutions, such as patents or intellectual property rights that make it worthwhile for innovators to innovate. There is also an underlying set of institutions that we take as given. They are often insured by the state and the public institutions that underpin a legal system. We have a legal system that will actually enforce contracts that we write. And we can actually write a contract with our supplier, or with our workers, or with the bank. In the standard rhetoric, we have a level-playing field, whereby people can actually choose their occupations, their vocations based on their comparative advantage. We have an education system, a state that provides roads and other amenities that will enable people to take part in economic activities. All of those are implicit; we do not even question them in our basic principles courses.

All of these things present in an idealised way, James and I call, "inclusive" economic institutions. The key thing here is that inclusive economic institutions, and the word inclusive is supposed to emphasise that good institutions are not only those that provide secure property rights and such things, but they provide them in a way that is inclusive, that is, they are broad based. The access to opportunity for participating in economic activities, opening business, going and taking patents, etc. all of those are a part of the inclusive economic institutions. But, the catch is that the most societies throughout history and even today, if we look around, we would find that are not really ruled by inclusive economic institutions. Therefore, I think, at some level, the principles of economics courses get it right about what these economic institutions should be but they do not get it quite right about what they really are in the world. In the world around us, things are more complicated. If you go back in history and in some societies today, they are in fact pretty close to the polar opposite of the inclusive economic institutions. They are, I am going to call them, "extractive" economic institutions and not just exclusive economic institutions because I want to emphasise that these things—insecure property rights, entry barriers, regulations preventing functioning of markets, individuals choosing occupations that are lucrative, creating a non-level playing field and so on and so forth—are the opposite of inclusive economic institutions.

All of these things, I will argue, are not there by mistake, they are not the brainchild of some deluded economist or a bad leader. They are there for a reason of creating a society, which is unequal in a specific way. Unequal in a way in which the elite and the politically powerful actors in the society are benefiting, directly or indirectly, by extracting resources from the rest of society. Benefiting directly involves, for example, sometimes grabbing the property right of others; think of how early colonisation went in much of the world. The colonisers went there and grabbed valuable metals, grabbed land, pushed away the native populations that were located on that land. The powerful actors also sometimes benefit directly. For example, think of how apartheid state worked in South Africa. It worked by excluding 80 percent of the population that was black from most of the occupations that were lucrative; the black were exclude, or they were excluded from skilled labour, engineering, artisanship, craftsmanship, etc. As a result, and also because of particular organisation of the township places that also made it impossible for them to have valuable agricultural output, pushed the black to have low wages and that indirectly benefited the politically powerful. So, that is just a very quick overview of what we try to mean by extractive economic institutions.

I want to give a relatively short, brief speech here and open it up for questions and discussion but if I have time, I will come back and try to illustrate that extractive economic institutions, by virtue of being in the negation of inclusive economic institutions, often sometimes come in different forms. As I have already indicated, you can have extractive economic institutions where there is direct grabbing or you can have extractive economic institutions where what is going on is that you are not grabbing anybody's output, anybody's innovation, or anybody's investment but you are manipulating market prices and benefiting from them. Let us think of a specific case of extractive economic institutions that would hopefully not only slightly clarify what I have in mind but would also lead to a very important point that I want to make.

Let us pick an example of Barbados. In the 17th century, Barbados is one of many societies that are based on quintessential extractive economic institutions, such as slavery. Slavery has all of the features that I have indicated as defining characteristics of extractive economic institutions, such as insecure property rights. In Barbados, more than 80 percent of the population was slave. They did not even have property rights on their own bodies or, alternatively, on their human capital, let alone on physical property. It absolutely created non-level playing field as these slaves were not give education nor the healthcare. In fact, most of them died before the age of 30 because of the gruelling work that they were given, combined with undernourishment. The lives of the slaves were characterised by total inability to have any sort of incentive or access to security of any sort that would encourage them to increase their productivity or increase the productivity of their activities. In fact, slaves in Barbados and many other slave societies were explicitly banned from investing in their human capital. Indeed, all of this is based on a very non-market mechanism and coercion. The slaves were not allowed to choose their occupation on the basis of their comparative advantage or their wishes. They did not even have any ability to negotiate or decide anything on their wages. Rather, they were coerced to work on sugar plantations and their wages were set by their masters by coercion at the level that would just as be essentially at the level of some subsistence. It is safe to say that the slaves were not the one who were choosing that system. Needless to say, this was not a very happy slave society where slaves were in a paternalistic relationship with their owners. There was no such society, although the US South sometimes created the myth perpetrated by the slave-owners that that was such a society. We do not believe it.

At any rate, Barbados certainly was not such a society. You could see that from simple statistics. There were slave revolts with great regularity. How did Barbados really maintain a system like that for almost over 100 or 200 years? Barbados was able to maintain a system like that because it was built on military coercion or at the barrel of a gun. You see the political force but how does that political force is exercised? Let us think about how the Barbadian society actually looked like. The first thing you should actually know is that, as I said that more than 80 percent of the population was slaves, you might think that the remaining 19 or 17 percent, or whatever it was, were the slave-owners and were living the good life. Well, actually that was not quite true. Most of the fraction of the remaining population was actually either small artisans or middling occupations that were supporting the slavery system or soldiers. The real beneficiaries of this system were not even majority of the slave owners; many of them were quite small, holding a few acres of land. But only a few families, perhaps 40 or so families, were the largest plantation owners that employed the great majority of slaves and were paid almost all of the profits and that is why they became some of the richest families in Britain in later decades when they returned [to the Great Britain]. Therefore, this was an extremely distorted society with a very, very small fraction benefiting from the slavery system at the expense of at least 80 percent of the Island.

How did this system actually survive? It survived because that small fraction actually controlled all of the political power. The military as an institution was very important, as that was the institution that put down all of the slave revolts. The military was led by the people from these families mentioned before. The members of these families were top commanders. The laws of Barbados were the basis of the society's very non-level playing field, putting down the slaves and always finding them guilty of a lot of infractions. Unsurprisingly, the top judges on the Island also came from the same families. And perhaps, what is the most important, governors and the top politicians of the Island came from the same families. Therefore, those sort of political institutions, which concentrate economic power [in a few hands], I am going to call extractive political institutions. In particular, under such institutions, there is a monopoly of political power in the hands of a few and extreme lack of constraints and checks and balances on how that power is exercised. At the other extreme, I am going to call the other ideal type inclusive political institutions, where the political power is distributed in a broad way, and in an inclusive way.

Of course, all of these are very great simplifications. No society has a perfect set of distributional political power with great pluralism. However, these ideal types help us think about the issues and give us things to compare with. The key thing is that even though you will find societies that have extractive and inclusive institutions mixed in various different ways. In particular, there are societies around us today that have types of extractive political institutions that concentrate political power but are making certain moves towards inclusive economic institutions. At the end, inclusive economic and inclusive political institutions create positive feedbacks on each other and support each other. As the Barbadian example illustrates, the extractive political institutions and extractive economic institutions support each other. In the case of Barbados that is fairly clear. If they did not have the extractive political institutions and had some voice for the slaves, the last thing they would have done is to choose to their own slavery.

The same thing goes for inclusive economic and political institutions, political institutions in particular and this is an important point, which is that if you have extractive political institutions but inclusive economic institutions, there will always be some forces pulling you towards the diagonal. This is because with the broad distribution of economic power there will be demands for more inclusivity on the political front. On the other hand, as is more often the case, those who dominate political power, slowly but surely, would start using their political power to create a more tilted playing field for their own benefit. It can only go so far by relying on various different implicit mechanisms or the goodness of the heart of the dictator so that they do not actually start messing about with the economic institutions of society.

The main thesis of the book is that the inclusive economic and political institutions create powerful forces towards economic growth, or towards inclusive economic growth, by encouraging investment because of well-enforced property rights; enabling a better allocation of resources in the right way. However, it does not mean totally unfettered competition on the market; rather it means that markets allocate resources much better than central planning but with the right sort of regulation and background for the markets. For example, the markets are not going to work very well if you make all allocations market-based but in such a way that only the very rich can get allocation. It means, in fact, supporting the market with allocations, or with other infrastructure, and with the right type of allocations, for example, limit risk-taking in the finance industry. Then markets have power to achieve better allocations as part of the inclusive growth. And what is the most important, in my opinion, is generating broad-based participation, education, free entry, growth-based property rights, property rights not for just a few but for many and enabling people to take part in occupations in a way they wish. For example, South Africa under apartheid could never have inclusive economic growth even if it encouraged investment by the Western firms or firms in the mining industry. Even if it had markets playing important rule in some consumer goods and other services, it could never have inclusive economic growth because it did not generate broad-based participation. On the contrary, it was excluding 80 percent of the population from many of the valuable economic activities. The key aspect of growth under inclusive institutions is that investment in new technology will create creative destruction, the term coined by Joseph Schumpeter. It means that there will be a constant process of new technology replacing or new firms replacing old or new skills replacing old. I will come back to that later.

One important thing I should highlight is that, and I am going to come back to it again, James and I are not claiming that economic growth is only possible under inclusive institutions. The claim is that inclusive economic growth, which tends to be the more sustained type of economic growth, is possible under inclusive institutions. We are going to talk about growth under extractive institutions but we are going to see that it has a very different character. In general, it is not going to be long lasting; rather it is not only going to go in bouts but it also contains seeds of its own destruction, so to speak.

I think that perhaps the best way of trying to make an argument is going through a historical example, which I am going to make quickly. In particular, a lot of the book is devoted to how to apply this theory to today and I will not get into that for the lack of time. I think there is no better place to understand some of these things than look at the beginning of the colonisation of Americas. There look at the *consquistador*, Juan Diaz de Solis, who was not very famous. He started the colonisation of the southern end of the continent, where is Argentina today, in 1516. It was at the same time as Cortés was ruling Mexico. However, the colonisation effort by de Solis was a huge failure. Solis, actually, was duly put to death by a band of Charruas. The Charruas and the Querandi, which were the bands of Indians in Argentina, were not what the Spaniards were expecting. They were sparsely settled, highly mobile, non-sedentary, non-hierarchical, bands of Indians. They were very combative but most importantly, they were unable to be captured easily or in great numbers so that they could be put to work.

This was not what the Spaniards were expecting. They were actually hoping that they would be able to capture all the gold and the silver and put the native Indians to work. When the plans did not work, the period of starvation started, so they left the area and were just about to throw in the towel when another of the conquistadors, by the name of Juan de Ayolas, traveled up the Parana River, which takes it to Paraguay and found another band of Indians, known as the Guarani. The Guarani are not the Aztecs or the Incas but they were already quite different from the Charruas and the Querandi. They were what the Spaniards expected the Indians to be like as they were sedentary, they were more densely populated, and they had their own hierarchy with kings and prices. This was the sort of proposition that the Spaniards could deal with and immediately overpowered them. They declared themselves the elite, married their princesses, and put the Guarani to work, using the indigenous institutions, which were extractive, adapting them to their needs. The things like that would develop into *encomienda*—things such as land grants with forced labour, *mita*, coerced labour in the mines,—all of these things were starting to being developed at the same time in the Guarani, the Incas, and the Aztecs.

The economic institutions were extractive but they were also built on force. It was not only the ability of the Spaniards to use overwhelming force but then also to overtake the extractive political institutions, the very hierarchical institutions, with military power at the top that came from the Guarani, the Aztecs, and the Incas that enabled them to set up these things. But what about the United States? Was it the culture, was it the geography, or was it good leadership in the United States that led to its growth? To find the answers, let us look at the history. The key colonisation attempt, at some level, in the United States is the Virginia Company in Jamestown, Virginia, that started exactly 90 years after the colonisation of Juan Diaz de Solis. The Virginia Company itself was a profit-making enterprise in London, in which people put money so that they would actually make profits. They thought they would make profits because they were learning from the Spanish experience. The Spanish experience was that, as we saw, you could go there (although now nobody remembers Juan Diaz de Solis, they remember the Aztecs and Incas) to exploit vast riches, such silver and gold and the hordes of people who would work for you for growing food and creating agricultural surplus. That is exactly what the Virginia Company had in mind and that is why they sent three ships in 1607 to Jamestown. These three ships were filled with the same type of people that Juan Diaz de Solis took with himself, which included soldiers and goldsmiths. Soldiers were needed to overpower the Indians and the native population and goldsmiths were needed to use the gold and silver found there.

However, again, just like the Spaniards in Argentina, they had a rude awakening. They came up against bands of sparsely settled, non-sedentary, non-hierarchical, and mobile Indians that would not cooperate with them. They went through their own starving time and almost all of them died. It was apparent that it was not going to work. The key reason that the same strategy did not work in the United States was that there were nothing like the Aztecs or the Incas, or the people like Guarani around that they could go to and get the place abandoned from them. Therefore, they thought they would totally abandon Jamestown in order to cut down the losses. Then they came up with a different idea. They thought that if they cannot capture and put to work the native population, they should bring their own low-skilled, coerced labour force to produce in very fertile areas around them. It would create surplus for the elite of the Jamestown as well as profits for the shareholders of the Virginia Company. It was the beginning of bringing in the indentured labour into the Americas. These people signed a contract for coming to America that the Virginia Company would bear their expenses and they would in return be obligated to work for a certain number of years for very low wages, under the control of the Jamestown colony.

This was not the sort of colony that you have in mind now when you read about the United States and pilgrims, etc. and such other things. Just to give you an idea of that, here is a quote by Sir Thomas Gates and Sir Thomas Dale, who were the governor and deputy governor of the colony, respectively: “No man or woman shall run away from the colony to the Indians, upon pain of death. Anyone who robs a garden, public or private, or a vineyard, or who steals ears of corn shall be punished with death. No member of the colony will sell or give any commodity of this country to a captain, mariner, master or sailor to transport out of the colony, for his own private uses upon pain of death”. Therefore, this was not a happy, shiny colony and pretty much anything you did was punishable by death. However, more importantly, what was punishable by death was something you did to hurt the profits of the Virginia Company, which included running away, because the slaves were very valuable asset to the Company as an indentured labour. Even worse was if someone traded with others on their own behalf because the Virginia Company told you what to produce and wanted to take away the entire surplus that was produced and that is how they were going to make money.

However, the open frontier, living with the Indians, and trading on the side were all much more attractive than the yoke of Sir Thomas Gates and Sir Thomas Dale. A mere 11 years after the founding of the colony, they threw in the towel. They realised that they were not going to be able to use either the native population or indentured servants, as it was simply not working. Therefore, they came up with a huge innovation, albeit unwillingly, as it was not their great intention. However, they had no other choice. They thought they could not run this colony, so they did what had never been done in the Americas – North or South – before. The innovation was the introduction of private property. They let the people take the land based on the head-right system. Every indentured labour and every settler would be given some land and could do whatever they wanted to do with that land. There was one catch, however. Sir Thomas Gates and Sir Thomas Dale were threatening that if you sold the ear of corn that you produced you would be punished but now they were telling the people that they had property rights and they were the guarantors of that. Anybody would be excused if they were not fully credulous in such a situation. In short, in the year 1618, there was a disconnect between the economic and political institutions. The economic institutions were moving in the inclusive direction and now for the first time there was a move towards the inclusive political institutions and general assembly. These events are so eerily repeated in several other colonies as in Maryland and North Carolina, for example, exactly the same pattern is observed. The company that had a grant to set up a monopoly tried to set up extractive institutions but because the conditions were different than in South America they failed and were forced to concede more inclusive economic and political institutions.

Why did I go through this story, i.e. second hand history, as this is not a history lecture but it is an economics lecture? I went through this story because I think it is very important as it really illustrates that this is a pattern that you can see it in statistics, econometrics, and other historical evidence; the pattern is really there if you want to see. The pattern shows that it is not about culture and it is not about geography. The geography was not what distinguished the Jamestown colony, as the areas around Buenos Aires—the famous Pampas—were as productive, or perhaps were more productive, and that is the why there was so much population there. In fact, this is the basis of some econometric work that Simon Johnson, James Robinson and I did on the reversal of fortune, for example. Also, it certainly was not the leadership. Sir Thomas Gates and Sir Thomas Dale were failed leaders; they ran home with their tails between their legs. They did not plan with brilliance of leadership to introduce inclusive economic and political institutions. Rather, they were forced to do so. And they were failures because that is not what the Virginia Company wanted. The Virginia Company wanted political and economic power so that they could have a lot of people working for low wages. Therefore, this, James and I claim, is the beginning of the divergence.

These events, of course, did not last. It is not that you have a small holder society in the United States run by a general assembly of a few people. Neither do you have an encomiendum or the mita as in Latin America. However, it created a path of divergence between the two parts of the continent. You can see that in a very simple way. Look at what went on, for example, in the 19th century in Mexico and United States. The United States and Mexico, it looks very similar initially as there is a small gap between the two in 1700, perhaps slightly larger in 1800 but thereafter this gap becomes a huge one in the course of the 19th century. What is going on here is that there are industrialisation opportunities and the United States is taking care of them in a very inclusive way. It should be stressed that not everything is inclusive as there are many things going on, such as grabbing of land from the native Indians and creation of monopolies later towards the end of the 19th century. However, at the core of it has a very inclusive element and you can see that from a lot of new people coming up and taking patents, creating new technologies, opening businesses, and opening new factories. However, you do not see a huge amount of continuity in who are the big industrialists, who are the big technologists of, say, the second half of the 19th century and the earlier part. It is this openness to new ideas that is really at the root of the United States American economic growth.

On the other hand, what is going on in the South? Let us look at Mexico, for example. Mexico is having a long period of stagnation under colonialism. Then colonialism comes to an end but it does not come to an end because of a popular revolution to create inclusive institutions. It is because of an elite coup wanting to create even more extractive economic institutions. The elite is lead by the soldiers. In Mexico, there was a period in which 45 presidents changed, sometimes the same people becoming a president again, and most of them belonged to the military. During this period, the military might is creating instability and there is a total collapse of the Mexican economy. Then there is a period of economic growth under Porfirio Diaz but it is a very different type of economic growth, which I call “extractive growth”, which leads to the last point I want to make. It is extractive growth because it takes place under extractive institutions, especially under extractive political institutions. What we see in Mexico under Porfirio Diaz is that there is rapid industrialisation by Mexican standards. For the first time in the 19th century in Mexico after Diaz comes to power, following on about 50 years of stagnation, there is economic growth because of some stability and law and order.

However, if we look at the details, it is extremely different from what is going on in the United States of America. The economic growth in Mexico is based on monopoly as few companies dominate their respective sectors. For example, at that particular time, there are 20,000 banks competing in the United States but in Mexico there are only 2 banks operating, for all practical purposes and these two bank lend to politically connected firms, which means that everything goes back to Porfirio Diaz. The monopolies spearhead industrialisation and the monopolies are granted by Porfirio Diaz. Therefore, there is economic growth in Mexico but no productivity growth as it is the case in the United States. There is no productivity growth because such a growth does not lead to innovation and technological change. Most importantly, this extractive growth does indeed contain the seeds of its own destruction. This contends with unequally distributed gains of that economic growth. The fact that it comes at the expense of the people and benefits some people not because they are being innovative but it benefits them unfairly. Such a situation then leads to things like Mexican revolution and the Civil War.

This is a general pattern, which shows that sustained extractive economic growth is very difficult. There are much more examples of countries in history with extractive economic growth than countries with inclusive economic growth. The reason is that extractive economic institutions are much more common in history than inclusive ones. However, the economic growth under such institutions does not last. The Barbadian society, for example, was very rich because sugar was very valuable but it did not last, however, and it became a very anaemic economy once the sugar prices fell. It did not become industrialised, neither did it become technologically dynamic, and nor did it become human capital-intensive economy until way into the second half of the 20th century. Another example of extractive economic growth is that of Russia, both in the 19th century and under Stalin.

Some preconditions are needed, such as political centralisation to have extractive economic growth. There could not be extractive economic growth, for example, while 25 military generals were fighting each other in Mexico. On the other hand, extractive economic growth was possible under Porfirio Diaz because of political centralisation. The key thing is, however, that is only possible when political power holders in society deem it in their interest and this is where creative destruction comes in. Creative destruction means that they are not going to find it to be in their interest forever. I think the best case for that is China today. China is a typical example of what we have called growth under extractive institutions. It has grown as a poster child of institutional transformation. If you want to understand the Chinese economic growth, you have to start with colonist economic institutions that provided no incentive for anything, be it investment, productivity improvement, and even choice of crop in agriculture. It slowly transformed to the community responsibility system, partnership in village enterprises and ultimately private property in agriculture, entry of private firms, and restructuring of some of the state-owned firms in the industry. Today, you see widespread market incentives in China and anyone visiting China cannot help but be struck with how dynamic China is economically as the people are profit-driven, they are trying to be innovative and risk-taking but it is all within limits. It is all taking place under politically extractive institutions. The big concern of the leadership of the Chinese Communist Party is creative destruction and this is what we call in the book, "fear of creative destruction".

Part of the reason why extractive institutions do not last is that they do not transform themselves into inclusive institutions. Ultimately, they are not a conducive set of arrangements for long run sustained economic growth because of fear of economic creative destruction. If we look at the speeches and behaviour of every single dictator, they would talk about stability and stability above all means that they do not want changes that would transform society in a way that destabilises their own power. Stability, however, is sometimes good as is the case in growth under extractive institutions; people would much rather have Porfirio Diaz's dictatorship rather than military dictators killing each other and creating instability. However, it is not a recipe for long-run economic growth, which does need creative destruction and form of a society that is open to change and does not give the political power to tilt the level playing field.

In the end, I will give a brief introduction of the things that I have not talked about in the lecture. I have not talked about why is that such institutions exist. I told you about path-dependant change but that is very central. I talked about a very simple example of how is it that extractive and inclusive institutions emerge by colonial powers trying to impose the extractive institutions, working in some cases and not working in the North American case. However, if you want to have a view about long-run economic development from this viewpoint, you really need to have a theory of institutional change. We have tried to develop such a view in the book, which we know is not perfect. It is based on what we call conflict differential institutional drift, i.e. small differences that create divergence during particularly important political periods and critical junctures, which are economic and social events that destabilise the existing structure. We emphasise both the historically determined, i.e. path-dependant change and the contingent nature, which create small differences that matter.

The other things that I have not talked about is how to actually apply these ideas to the present. Because if we look at the simplest examples of the extractive institutions, such as slavery, much of these are not around; there is coercion, for example in Nepal and few other places, such as Uzbekistan but no country looks like Barbados today. However, the perspective in the book is that you can still identify these extractive institutions, or the extractive elements of these many institutions. If we look at Colombia, it has a core around Bogota and in Pakistan there is a core around Lahore and Islamabad, which looks very well-functioning. However, if we look at the outlying areas of Colombia, we find that one-third of the country is under paramilitary or guerrilla control and the elites rule everything, both politically and economically. Similarly, if we look at Pakistan, most of the country is very much different from what goes on in Lahore and Islamabad. Therefore, we have these mixtures of extractive and inclusive institutions.

At the same time, it is also important to think about how to actually chart a course of getting out of extractive institutions and getting into inclusive institutions. The perspective in the book it is much like taking one step towards that. We also have somewhat detailed discussion of how societies are able to break the chain of extractive institutions. But why does it not work sometimes? Why do we have a pattern of what we call "iron law of oligarchy"? People try to take one step towards inclusive institutions but something pushes them back and they may go further into extractive institutions. Finally, we have an extensive discussion, which is partly based on on-going research and partly on the book, that why it is that growth under extractive institutions is very different and does not create the same sort of innovation and technological change that would make economic growth more sustained. We also have some discussion on pitfalls of policy rather than clear, silver-bullet recommendations of how you can create inclusive institutions. It is a political process and there is not a formula of easy way of doing this. Lastly, there are some new ideas that are not in the book but are relevant and that is that you can also apply these things to questions like why is there middle-income institutional trap, which is relevant for many societies, including Pakistan, Turkey, Chile, Colombia, etc., some parts of which have become more inclusive but have huge economic and political structures that are maintaining each other.

The last thing that James and I want to imply is that we have the answers; we do not have the answers and "Why Nations Fail" is not the book that claims to have the answers. However, what the book does, and what I try to do, is that we claim that we have useful framework, which is much better than harping about geography, culture, leadership and market-failures, without taking into account the political institutional aspect. In a nutshell, it is a framework based on ideas that have come out of research. Many of these ideas build on econometric, theoretical and game-theoretic work and it is a framework that you can build upon. There are many things that James and I are ignorant about. For example, we do not understand the Pakistani society since it is not our expertise but I think that real question is that whether our framework gives us a better perspective for understanding Pakistan, or what is going on in Africa; and we think that this is the case. However, at the same time, it is very much a work in progress and research direction for the future.