How Nations Succeed - A Review of the Reversal of Fortune Thesis

By Ingrid Harvold Kvangraven and Collin Constantine

Abstract

This paper reviews the methodology and theory supporting Acemoglu, Johnson and Robinson's (2001) famous "Reversal of Fortune" thesis. Their thesis provides a simple and linear explanation to why some countries are rich today, while some are poor. It argues that European colonialists settled and introduced "good" institutions in countries that were poor in 1500, while they did not settle in countries that were rich in 1500, and "extractive" institutions were introduced instead. AJR argue that the types of institutions introduced had persistent effects on economic growth in the countries colonized. They argue that countries where "good institutions" were introduced, meaning private property rights for a large section of society, were able to take advantage of industrialization opportunities, and develop, whereas those countries with extractive institutions are poor today.

This paper finds significant flaws in the methodology employed by Acemoglu et al., both with the proxies used for wealth in 1500 and with the oversimplified historical framework employed. Strikingly, re-running their regressions with better data causes much of the reversal to disappear.

Furthermore, by examining the development trajectories of countries of countries in the West, East Asia and Africa, suggests that it is the creation of a nurturing environment for industrial development that has allowed countries to develop, and institutions of private property only come into place after countries have reached a certain level of development. Thus, this paper recommends a closer examination of how countries have managed to successfully develop throughout history. Although this paper does not launch a thesis as simple and appealing as Acemoglu et al.'s, it uncovers important weaknesses in the reversal of fortune thesis, and suggests alternative policy recommendations.

Introduction

The "reversal of fortune" (RF) thesis as presented by Acemoglu, Johnson and Robinson (2001), henceforth AJR, is the most discussed contribution to development economics today (Austin 2008). Their thesis, which can be read in more detail in their book titled *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*, provides some important

insights to the role of institutions in development, building on Douglass North's Nobel Prize winning work on institutional economics (Bardhan 2010).

By and large, the RF thesis provides a simple and linear explanation to why some countries are rich, while some are poor. In short, it argues that differences in institutions established by European colonialists led poorer parts of the pre-colonial world to become rich, while it transformed some of the more prosperous parts into poor economies. AJR argue that the reason for this is that in colonies that were relatively poor, the colonizers were more likely to settle, and to introduce institutions that encourage investment. On the other hand, in societies that were relatively rich when colonized, the colonizers were more likely to impose extractive institutions. Societies with good institutions were able to take advantage of industrialization opportunities in the 19th century. The RF thesis fits well into the widely accepted neoliberal framework, where the state's role is considered to be to provide public goods such as infrastructure, and a stable macroeconomic framework for the market to operate freely and efficiently.

This paper starts by assessing the validity of AJR's methodology, before evaluating their central argument, namely that institutions such as private property rights are the fundamental driver of economic development. The paper discusses what a successful development trajectory involves, and explores some alternative theories. Finally, some policy implications are discussed before the paper concludes.

Flawed methodology

Studying long-term income trends poses several challenges, such as how to measure data and how to determine causality. AJR argue that their measures of urbanization and population density represent valid proxies for wealth in the 1500s. In the past decade, many scholars have questioned the validity of AJR's use of data, however. While some (e.g. Bayly 2008, Diamond 2012, Nunn 2012) have attempted to adjust or adapt the RF thesis to other settings, others outright reject it (e.g. Sachs 2012). Economic historian Gareth Austin (2008) argues that empirical evidence for African economies around 1500 is very limited; Glaeser et al. (2004), and Fukuyama (2012) criticize AJR's measure of political institutions for being inaccurate. Notably, if the data employed is unreliable or inaccurate, the RF thesis stands on shaky ground.

Sanghamitra Bandyopadhyay and Elliott Green (2012) from the London School of Economics are among a growing number of scholars that question AJR's empirical tests. They provide an alternative measure of urbanization with 71 observations from both Africa and the Americas, instead of the 41 observations AJR employ, whereof none of them are

from Africa. Strikingly, when they replicate AJR's regressions with the more accurate data, the significant and negative correlation between pre-modern and temporary income disappears, suggesting that no reversal has taken place. Furthermore, they find flaws in the way that AJR measure population density, as it fails to measure density on arable land. When they correct the measure with more accurate data, the relationship is no longer robust.

Bandyopadhyay and Green (2012) and Austin (2008) argue that the data that exists on Africa suggests that the continent was poor even before formal colonization in the 18th century. Thus, there was no reversal of fortune for Sub-Saharan Africa, but rather a deepening of relative poverty. In fact, in replications of AJR's regressions without the Neo-Europes (US, Canada, Australia and New Zealand), the negative correlation between pre-colonial income and contemporary GDP disappears (Bandyopadhyay and Green 2012, Olsson 2004). Thereby, the thesis has little explanatory power for changes in income within Latin America and Africa.

Furthermore, AJR's bundling of colonies compresses history drastically (Austin 2008). Although the period of colonization lasted for 500 years, Nigeria, for example, was only under colonial rule from 1903-1960. Latin American countries, on the other hand, were colonized between 1500 and 1830, while African countries were colonized after 1885 (Olsson 2004). What's more, the ways the continents were colonized were very different, with the first round being mercantilist and the second more imperialist. Between those two waves came the gradual colonization of the more developed Asian countries and the Neo-Europes.

Notably, dividing colonies into just two camps, settler and non-settler, creates an oversimplified picture of history, and AJR ignore that there was a clear distinction between settler and non-settler in African colonies as well (Austin 2008). Additionally, AJR's assumption that colonial rule was purely extractive in Africa and Latin America, does not correspond with historical facts. On the contrary, it was often in the economic and political interests of the colonial administrations, even in the non-settler colonies (with extractive institutions) to encourage local enterprise. Meanwhile, in the South of the United States settled Europeans promoted slavery, and in South Africa they established apartheid (Sachs 2012). The picture is clearly more complex than what AJR present. Although a reversal may have taken place for some countries, it does not appear to have been a generalized global phenomenon.

How nations succeed

Inherent in the RF thesis is the argument that private property rights are essential for economic development. The argument for a strong link between private property rights and economic development fits well into the vast economic literature on effects of competition on innovation and growth, which has been studied by many economists. For example, Schumpeter (1947) argues that competition hurts growth because it reduces the monopoly rents that induce firms to innovate, while Aghion and Howitt (1988) argue that growth increases with property rights protection, as the profit accruing to a successful innovator would increase with stronger protection of property rights. Meanwhile, Aghion *et al.* (2006) argue that trade liberalization may discourage innovation in backward firms, whereas it encourages innovation in advanced firms that are able to compete with foreign companies.

The argument of AJR is that societies with institutions of private property will be able to take advantage of industrialization opportunities, while societies with extractive institutions, where political power is concentrated in the hands of the small elite, will fail to do so. AJR (2001:9) define good institutions as those that "provide secure property rights…for a broad cross section of the society". This is a common definition of institutions in much of the institutional economics literature (Bardhan 2010). In the standard institutions view, institutions constrain the government or others from intervening in someone's property rights. The alternative view is that "enabling institutions" incentivize people and companies to make investments they otherwise would not have been able to make. Although private properties may be a part of the enabling institutions, this alternative view also requires a more active government. Examples could be social networks, community organizations, government services or a national innovation system facilitating training and technology absorption. Bardhan (2006) futher argues that constraining and enabling institutions often work together, and that even if private property rights are secure, enabling institutions might be necessary in order to overcome coordination failures. Moreover, various institutions may play different roles in different stages of development, depending on the context.

Meanwhile, economic historian Erik Reinert (2006) argues that it is a country's productive structure determines the type of institutions that emerge in society, and not vice versa. He finds that through history, only societies that have already achieved a certain level of manufacturing, or other activities of increasing return, have achieved what AJR call good institutions. Furthermore, he argues that institutions and economic activities co-evolve with causality in both directions, and finds that new institutional economists are exaggerating one direction of causality.

Similarly, Ha-Joon Chang (2002) finds that Western countries that are now developed acquired most of their institutions of private property after they had developed economically, thereby directly contradicting AJR's theory. While AJR argue that the reversal of fortune took place from the 18th to early in the 19th century, most developed countries established their intellectual property rights in the early 19th century, and trademark laws were established well into the second half of the 19th century. In fact, Chang *et al.* (2002) find that instead of property being protected, industrial espionage and pouching workers were all a part of a technology policy during the late 18th and early 19th centuries when Western countries were developing.

Notably, although Western governments did not enforce property rights before they developed, their governments made other types of interventions to promote industrial development (Chang 2002). The United States had the second highest industrial tariffs in 1820 and the highest tariff rates from 1875 – 1931. Notably, all developed countries used public support for domestic industry, including trade protection, until their industries became strong enough to compete in conditions of more or less free trade (Wood and Lall 2003). Even today, developed countries pursue active industrial policies to ensure that they retain capacity to produce top-end products, exemplified by the subsidization of the Airbus industry in Europe.

Next, consider the East Asian countries that grew at a miraculous pace in the 20th century. Strikingly, none of them had what AJR dub good institutions, but the states acted as catalysts, by creating environments conducive to development (Rodrik 2011). The governments assured heavy investments in key sectors, such as education, infrastructure and technological upgrading, which made economic development in East Asia in the 1960s and 70s possible. Notably, these countries also enjoyed access to technology, capital and global markets (Amsden 1991).

The evidence presented suggests a problem of reverse causality in AJR's thesis, as private property rights have not generally been a precursor to economic development in Western and East Asian countries. In other words, good institutions may be correlated with high levels of per capita income but not high rates of growth. Instead, history suggests that industries took advantage of the lack of private property laws in order to innovate and grow. This is consistent with Khan (2004) and Austin's (2008) argument that growth and rent seeking have been complementary forces through most countries' development processes. In fact, according to Austin (2008), the market imperfections that produce rents were often the means by which growth was achieved. Similarly, Khan (2004) argues that although

secure property rights facilitate exchange in capitalist societies, in developing countries with small capitalist sectors, these policies are largely ineffective, and may hamper growth.

Having explored how advanced countries developed, it is worth also taking a glance at growth processes in today's developing countries, or what AJR call failed nations. While the colonizers could benefit from cheap inputs from its colonies, the colonized did not have this luxury. Although the African continent is often referred to as a “growth tragedy”, Chang (2010), Austin (2008) and Easterly (2006) present evidence to illustrate that Africa has not always been stagnant. Many African countries grew respectably after independence to the mid-1970s. However, with the introduction of structural adjustment programs in the 1980s, which aimed at strengthening private property rights as well as introducing free market policies, African countries' industries collapsed. Notably, the SAPs policies were more focused on institutions in the sense that AJR understands them, and not “enabling institutions” as defined by Bardhan (2006).

Policy recommendations

Now, to perhaps the most important question in the field of development – what policy lessons can be drawn from the RF thesis? Two policy routes immediately become apparent, either reform political institutions to establish property rights for all, or do nothing, because political institutions are deeply rooted in the past anyway. The latter is misleading, as countries have clearly managed to develop economically through history, by carrying out purposeful economic reforms and providing incentives for innovation and businesses. The former is a route tried and failed, as Easterly (2006:60) finds, “…free markets work, but free-market reforms often don't”. An investigation of SAPs being introduced in African countries provides ample evidence of how imposing what AJR call good institutions does not lead to economic development (Easterly 2006, Austin 2008, Chang 2010). What’s more, evidence from developed nations illustrates that enforced property rights has not been a precursor to economic development.

Times are changing, however, and there is less policy space for industrial policies today, compared to the 18th and 19th centuries, and even compared to the 1960s and 70s when the East Asian miracle countries had considerable room to maneuver to pursue national goals such as full employment and growth (Lall 2003). Notably, the current trade regime is a significant constraining factor for development today, as the leverage of governments over the economy is restricted by WTO-rules, bilateral and multilateral agreements and conditionality imposed by the international financial institutions (Mkandawire 2005). Rodrik (2004) suggests, however, that it is possible to get away with defying WTO rules.

For example, China demands local content requirement of foreign companies (similar to Taiwan's industrialization strategy) although this is no longer allowed under WTO rules. As investors are eager to invest in China anyway, they accept it.

Notably, there existed a range of restriction under the old regime too (Chang 2003). Korea often exploited gray areas in the GATT, for example by using the balance-of-payments clause, which allows countries to impose emergency tariffs on the grounds of balance of payments problems. This clause still exists under WTO, and almost all low-income countries can be seen to qualify for this today. Finally, WTO restriction only covers trade-related policies. Thus, countries can still pursue many domestic policies which can be used for infant industry protection purposes, such as subsidies for equipment investment, support for start-up enterprises and subsidies for investment in particular skills.

Conclusion

This paper presents serious flaws both with AJR's theory and their methodology. To critics who accuse AJR of oversimplification, Acemoglu and Robinson (2012) respond that a framework with too many important factors is no framework at all. It is certainly true that a simple framework is more appealing than a complicated one. However, evidence presented illustrates that AJR's framework does not explain differences in economic growth through history, and it does not provide useful answers for countries that seek appropriate tools to achieve economic development.

First, replication of AJR's regressions with improved data shows that a reversal has in fact not taken place, at least not on a global scale. Their method of taking a snap shot of the world in 1500, and comparing it to a snapshot in 2000 hides important developments within the continents of Africa and Latin America.

Second, AJR's idea that private property rights institutions is the main determinant of economic development is incorrect. Evidence presented from countries that have managed to successfully develop illustrates that they developed before private property institutions were introduced. Instead, the state's ability to create an environment conducive to investments has been key, but this requires enabling institutions and a facilitating state, as well as private property rights. Attributing successful development to private property rights obscures the complexity of development processes through history. Notably, AJR's understanding of good institutions fails to capture the type of institutions that existed in Western and East Asian countries before they industrialized. There is clearly a need to revise the mainstream understanding of what “good institutions” are.

Finally, economic development must be understood as a multi-dimensional dynamic process, in which political, institutional, and historical factors all play a role. Countries that have developed have followed their own paths and pursued different policies, but common to most is that they have had institutions that actively enable investment in place. Although this analysis is not as simple, and perhaps not as appealing as the RF thesis, it is more accurate.

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