

Growth For All?
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GROWTH FOR ALL?

A central question of economics and social science is to understand why some countries are much poorer than others. Differences in living standards across countries are simply astounding. Those at the top of the world income distribution are more than thirty times as rich as those at the bottom once we make adjustments for differences in purchasing power parity (the fact that the same bundle of goods is cheaper in poorer countries than in rich countries). For example, in 2000, income per capita in the United States was over \$33000 (valued at 1996 US dollar prices). In contrast, after the purchasing power parity adjustment, income per capita was less than \$9000 in Mexico, less than \$4000 in China, less than \$2500 in India, and only about \$700 in Nigeria. If we forgo the purchasing power parity adjustments, the gap between the richest and poorest nations is even larger, almost fifty-fold. Inequality among the inhabitants of our world is even larger, since within each of these societies there are those who are much richer than the rest. Therefore, the overwhelming picture of the world economy today is one of inequality, both among nations and among the citizens of each nation.

How could societies in such a globalized world, sharing information, technology, and capital, have such different living standards? And how did we get here? Answering the second question indirectly answers the first one as well. The answer to the second question is growth. Remarkably, 200 or 300 years ago, income gaps between the richest and poorest countries were much more muted. While lack of systematic national account statistics make it impossible to be certain on this point, best estimates, for example, the data compiled by the economic historian Angus Maddison, suggest that the richest parts of the world at the time were three or four times as rich as the poorest parts of the world. Today's striking differences are the result of the fact that a number of economies have grown at steady rates (approximately 2% per annum) over the past 200 years, while others have stagnated or have grown only during limited periods. The past 200 years, in turn, are special in world history, because they were the era of the spread of a new growth-enhancing technology, industrialization. Therefore, to a first approximation, the rich countries today are those that have taken advantage of this new technology and industrialized over the past 200 years.

Overall, understanding today's income gaps is the same as understanding the causes of economic growth in some societies and lack thereof in others.

Proximate Versus Fundamental Causes of Economic

Growth The discipline of economics has made considerable progress in understanding sources of economic growth. Growth results from the process of accumulating physical capital (e.g., machines), human capital (e.g., skills, education), and improving the productivity of all factors of production (e.g., by improving technology). Correspondingly, richer countries are rich as they have much more human and physical capital and much better technologies than poorer ones. Nevertheless, these differences are only proximate causes in the sense that they pose the next question of why some countries have less human capital, physical capital and technology and make worse use of their factors and opportunities.

We therefore need to look for potential fundamental causes, which may be underlying these proximate differences across countries. A large body of research suggests that at the root of the differences in proximate causes of growth and income differences across countries are institutional differences.

At some level, the term of institutions is an unfortunate one in economics discourse. "Institutions" means many different things in different contexts. Nevertheless, this term has by now such widespread usage that this is not the right forum for looking for better terminology. So what are institutions? The Nobel prize-winning economic historian Douglass North offers the following definition: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."

Three important features of institutions are apparent in this definition:

(1) that they are "humanly devised," which contrasts with other potential fundamental causes, like geographic factors, which are outside human control; (2) that they are "the rules of the game" setting "constraints" on human behavior; (3) that their major effect will be through incentives. There are two important ideas here to emphasize. First, we should look at the sources of physical capital, human capital and technology across countries in the incentives that the economic agents (and often also the political agents) face. Second, institutions matter because they determine the organization of society and thus shape these incentives.

What types of institutions provide the incentives to invest in machines, skills and technology and foster growth? A large body of work shows that growth-enhancing institutions should protect the property rights of a broad cross-section of society and provide an environment in which productivity-enhancing contractual relationships can form. By property rights, we refer to the guarantee that if an individual undertakes productivity-enhancing investments, he will be able to enjoy the returns of these investments. Without such a guarantee, most individuals and firms will be deterred from undertaking productivity-enhancing investments. But it is not sufficient to enforce the property rights of a small elite.

Consider, for example, the Caribbean islands during the 17th and 18th centuries, which formed plantation economies based on slavery. The property rights of plantation owners were relatively secure, since they dominated politics and had their own army (security force), but the majority of the population were slaves, without any economic or civil rights. Not only were the slaves unable to open businesses or sell their labor in a free labor market, but they were even forbidden from investing in their human capital. The example of the Caribbean plantation economies highlights that property rights for a narrow elite or for a few large firm owners is not the right type of institution for sustained economic growth. Consistent with this view, today many of the former plantation economies are among the poorer nations of the world.

Property rights for a broad cross-section of the society imply that not only the elite, but any citizen can undertake productivity-enhancing investments. We will see below why this is important. Property rights are not the only institutional feature that could matter for successful economic outcomes. Once individuals have secure property rights, they may also want to enter into potentially complex economic arrangements with other agents, for example, as borrowers or buyers of inputs. Another important aspect of the institutional structure of a society is contracting institutions, which regulate what types of contracts can be written and how well-enforced these contracts are.

Institutions, Growth and Stagnation

But why do some societies choose institutions that do not encourage growth? After all, if some institutions, such as those providing secure property rights, lead to growth and much higher living standards, why would some societies choose different types of institutions that do not foster economic growth? In fact, the puzzle is deeper than this question suggests. Some societies not only fail to adopt institutions that secure property rights for a broad cross-section of the society, but often take actions that directly block the adoption of new technologies. So do why institutions that fail to encourage or even those that block technological progress emerge and persist? The answer to this question is related to the fact that not all individuals and groups in society benefit equally from economic growth.

The famous Austrian economist Joseph Schumpeter coined the term creative destruction to describe a process which he viewed as essential for capitalist economic growth, the process of new firms entering and displacing existing firms. Schumpeter argued that creative destruction was a major engine of economic growth. While we may debate how important creative destruction is relative to other types of growth (which create complementary processes or take place within existing firms), one point is beyond doubt: economic growth creates winners and losers.

If economic growth is a beneficial process for the society as a whole, we would expect there to be more winners than losers, or at the very least, the gains to more than to offset the losses that some incur. But this is no guarantee that the institutions will encourage economic growth. The presence of winners and losers implies that there will be political conflict over the form of institutions. Those who will be the winners from economic growth and technological progress will prefer institutions encouraging growth, those who will be the losers prefer institutions blocking technological progress. Whose wishes will be implemented? The answer to this question depends on which group has more political power. If political power rests in the hands of those who stand to lose from technological progress, then institutions discouraging economic growth and blocking technological progress are likely to emerge.

Schumpeter's creative destruction notion therefore gives us a way of envisaging why in many situations institutions that are not conducive to economic growth emerge and persist. Quite often, those who will be the losers from technological progress are the existing economic elite, for example, the firms currently making profits. These firms will not only have economic resources to be influential, but often will be organically or financially linked with politicians. They stand to lose from technological progress because creative destruction implies that much of the technological progress will be brought by new firms that will perform the same tasks as these incumbents more efficiently. In other situations more reminiscent of the situation in the 19th century, existing firms and elites may be concentrated in a specific sector, for example in agriculture, while new growth opportunities lie elsewhere, for example in industry. In this case, the increased demand for labor and for other factors of production coming from new entrants and economic growth will imply lower profits or bankruptcy for the existing economic elite.

Therefore, at the simplest level, the explanation for stagnation lies in the entrenched power of existing economic elites that block the introduction of new technologies, and create and maintain institutions that do not encourage economic growth and entry by new firms. In such situations the growth potential of the society is not realized and stagnation results.

Political Regimes and Economic Growth

Where does the political power of the economic elite to block technological progress come from? As noted above, part of this power comes from the current profits and wealth that they enjoy. But political power is not only a function of money, but also a feature of the political regime of the society. In a monarchy, political power is concentrated in the hands of the monarch and the groups around the crown. In a dictatorship, a junta, the political elite or sometimes the economic elite that are able to capture the process of non-democratic decision-making are particularly powerful. In contrast, in a democracy, political power is more equally distributed. While no country reaches the perfect democratic ideal, a

functioning democracy allows free entry by parties, free and fair elections in which one person has one vote, and even though lobbying and bribery can have some effect, at the end democracy ensures that political power is more equally distributed than it would be in a dictatorship or in a monarchy.

Does democracy make growth more likely? The postwar experiences of democratic societies is not particularly encouraging. While there are a number of democratic societies that have grown rapidly, there are many non-democratic societies that have grown much faster, such as South Korea in the 1960s, Singapore or China today, and many democracies that have had disappointing growth performances, including India for 30 years after its independence and many young Latin American democracies. Overall, the available evidence suggests that over the postwar era the average growth rate of democracies, with or without controlling for a range of other factors, is similar to the average growth rate of dictatorships. This is puzzling, especially since there are some dictatorships, such as Zaire under Mobutu or Haiti under the Duvaliers, which have pursued the worst possible economic policies and have created an environment with very weak property rights and widespread corruption. Given the presence of such regimes and their disastrous economic performances, one may have expected democracies to have outperformed dictatorships.

There are two major reasons why democracies may not always encourage economic growth. First, democracies, especially in highly unequal societies such as those in Latin America, may pursue populist policies, redistributing resources from the rich to the poor. Such redistribution comes with economic costs, especially when redistributive fiscal policies also discourage firms' investments in physical capital and technology. In such cases, democracies may not maximize the rate of economic growth, but they may still lead to economic allocations that are desirable according to the value judgments of many, since the allocation of resources that results will be more egalitarian than in non-democratic regimes. The second reason why democracies may have disappointing performances has even more adverse consequences, since it does not even secure a more egalitarian distribution of resources in the society. In many newly-created democracies, the existing elites do not give up power but try to use other, sometimes more inefficient, means to influence policy-making. The use of intimidation, rigged elections, and repression by paramilitaries are too common occurrences in many newly-emerging democracies in Central America and elsewhere. The economic and political instability created by the attempts of the economic elite to maintain their political power is another potential reason for inefficient outcomes in democracies.

Nevertheless, despite these potential inefficiencies, democracy is still the best political regime to ensure sustained long-run growth. As the above discussion suggests, democracies can pursue distortionary policies, especially in the immediate aftermath of their creation. Dictatorships can also lead to economic

growth, for example, when the interests of the political elites that are dominant in a dictatorship are aligned with those of existing firms that can exploit a certain niche or invest in existing technologies to increase output. But growth under dictatorships is likely to be short lived, because dictatorships, by their very nature, are not going to create an environment conducive to creative destruction. To the extent that creative destruction, that is, entry of new firms, introduction of new technologies, and the process of renewal of economic system, is important, growth under dictatorships will ultimately come to an end and give way to stagnation. Democracy, by its relatively egalitarian distribution of political power, is less likely to create an environment favoring the incumbents. On the contrary, the egalitarian distribution of political power is likely to translate into a relatively level playing field, encouraging entry and facilitating the process of creative destruction.

Growth for All?

A notable trend in the world economy is towards greater democratization. The process of non-democratic regimes being replaced by democracies that started in Europe and North America in the 19th century has recently gained speed, with the so-called

Third Wave of democratization, which started with the collapse of many Latin American and Asian dictatorships and the end of Communist rule. Perhaps not surprisingly, many of these new democracies have had economic and political problems following their transitions from authoritarian regimes. Establishing functioning democratic institutions takes time. Moreover, as discussed above, existing elites will try to capture democratic policy-making, with potentially negative consequences, at least in the medium run. Nevertheless, to the extent that democracy is the best guarantor for institutions encouraging creative destruction, the greater trend towards democratization promises a greater likelihood that many countries will embark upon a path of sustained economic development.

If many of the societies that have recently transitioned to democracy manage to consolidate their new regimes, policies and institutions that encourage creative destruction and entry are likely to follow. The political developments of the past 25 years then promise the possibility of more widespread growth in the world economy. Recall that it was the unequal growth of the past 200 years in the context of the rise of industry that has led to the great iniquities across nations today. Societies that took advantage of industrialization opportunities of the 19th century have grown, while others have stagnated. There are many parallels between the economy we live in today and that of the 19th century. The world is becoming globalized again, just as it was reaching its highly integrated market structure towards the end of the 19th century. Even more important, growth today is being driven by a generation of new technologies, in same way that 19th-century growth was driven by industrial technology. But in the 19th century, there

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were only a few societies with the institutions to take advantage of these new technologies.

The hope is that the political landscape today is different. Many more societies, by consolidating their democratic institutions, will be able to create an environment for new technologies to spread, new firms to enter the economic scene and the process of creative destruction to act as the engine of economic growth. Democracy holds another promise: if democracy is not captured by existing elites and it does not degenerate into instability or extreme populism, it will not only create institutions facilitating the adoption of new technologies, but it will also ensure a relatively egalitarian distribution of the gains from growth within countries.

Therefore, we are today at the crossroads, where the process of world economic growth that has been unequalizing over the past 200 years may be the engine that closes the gap between the rich and poor nations in the next 50 years or so. There are many reasons to be hopeful, but this should not translate into complacency. Since growth, even at the best of times, will create losers as well as winners, the losers, often the previously powerful, will fight to resist the process of creative destruction and the progress that it brings. They will fight democracy, they will attempt to capture whichever political institutions are in place. The hope is that the newly emerging democracies will be resilient enough to withstand these challenges and wise enough to refrain from populism to create the environment for the spread of new technologies and wealth around the world.