Why Rich Countries Got Rich And Poor Countries Stay Poor?

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Abstract
International analysis of economic growth has confirmed the theoretical assumption that international variations in per capita income can to a large extent be explained by differences in the accumulation of physical capital, human capital and by differing rates of technological progress. However, these results do not provide an answer to the question as to what causes trans-national variations in accumulation rates and technological progress. In searching for the ultimate drivers of economic growth, four competing lines of explanation have emerged. The geography-hypothesis which assumes that economic growth is ultimately determined by geographical characteristics whereas the institutions-hypothesis which views the quality of institutions as a fundamental driver of growth while the culture-hypothesis which focuses on the relevance of culture for economic growth. The policy-hypothesis which emphasizes the importance of economic policy. This paper provides an overview over these four hypotheses and revisits the debate over their empirical relevance. Comparing the four approaches leads to the conclusion that it is the quality of institutions that matters to create long run economic growth differences among nations. Hence, the reason that rich countries got rich is their inclusive institutions and poor countries stay poor is because of their extractive institutions they established. Furthermore, the other hypotheses such as geography, culture and policy hypotheses have indirect effect on economic growth but are indeed interconnected and complementary.
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1. INTRODUCTION

1.1. Back Ground

Economic development is the primary objective of all nations, and some important non-economic factors that determine the nature and the rate of economic development are institutions, which are generally defined as the 'constraints that human beings impose on themselves' (North, 1990). The relationship between institutions and economic growth have been an important issue for both developed and developing countries. The debate over the role of institutions in economic growth has resulted in conducting many researches, and has become one of the most dynamic areas of the empirical work in economics. Over the last three decades, institutions have received an increasing attention from the scholars, policymakers, and development practitioners. Both theoretical and empirical studies have shown that institutions have an effect on the economic development (Hall and Jones, 1999; North, 1981; Mauro, 1995; Rodrik et al., 2004; Acemoglu and Robinson, 2010; Iqbal and Daly, 2014). Such studies have corroborated Douglass North (1990) hypothesis that institutions are the underlying determinants of the long-run economic performance of nations. Therefore, countries with better institutions, not only invest more in physical and human capital, but also use these factors more efficiently. Empirical literature has identified numerous institutions that influence the economic growth, including assessments of the quality of the government bureaucracy, absence of corruption, and constraints on powers of the executive branch, law enforcement, justice, regulations, tax administration, and institutions that manage monetary and fiscal Policies.

1.2. Rationale of the Paper

The most crucial question in the field of economic growth and development is that why some countries are much poorer than others. Traditional neoclassical growth models, following Solow (1956), Cass (1965) and Koopmans (1965), explain differences in income per capita in terms of different paths of factor accumulation, since Romer (1986) and Lucas (1988) differed in the sense that they emphasized that externalities from physical and human capital accumulation could induce sustained steady-state growth. Though this theoretical tradition is still vibrant in economics and has provided many insights about the mechanics of economic growth, it has for a long time seemed unable to provide a fundamental explanation for economic growth. As North and Thomas (1973) put it: "the factors we have listed (innovation, economies of scale, education, capital accumulation, etc.) are not causes of growth; they are outcomes of growth". Factor accumulation and innovation are only proximate causes of growth that can create economic growth disparities. If these factors are so important in generating cross-country income differences and causing the takeoff into modern economic growth, why do certain societies fail to improve their technologies, invest more in physical capital, and accumulate more human capital? The question is; how did developed nations manage to grow, while less developed nations failed to take advantage of its growth

opportunities? If physical capital accumulation is so important, why did third world countries fail to invest more in physical capital? If education is so important, why are education levels in less developed countries still so low, and why is existing human capital not being used more effectively? Despite the fact that growth corelates are contributing much to economic growth, the turning point of economic growth differences is fundamental causes of economic growth such as geography, history, culture, and luck. In North and Thomas's view, perhaps these are other potential fundamental causes of economic growth, the fundamental explanation of comparative growth that most matters is differences in their institutions.

It is because of the above contemporary debates that didn't harness yet is that this paper try to identify the most delinquent cause for the poor to be poorer and the rich to be richer where the later have opportunities to catch up the rich.

Therefore, the rationale of this paper is to support or refute the fundamental causes of economic growth that made poor countries more poorer and rich countries becoming richer is because of the nature of institutions being established by various countries on the basis of empirical evidences from countries' experience of different nations so as to get policy implications for the syncope of poverty trap.

1.3. Objective of the Paper

For the past century there were dozens of arguments about the fundamental causes of economic growth that made some countries become richer and others to become poorer. Some economists argue that the justification behind the poor countries become poorer is that the conspiracy made by rich countries imposing their policy without any consideration of the poor countries social, cultural, political and the entire context of that particular nation to pass through the steps that they passed through but failed to succeed (H. J. Chang, 2002). Other economists argued that luck and history (or multiple equilibria) that lead to divergent paths among societies with identical opportunities, preferences, and market structures *(Landes, David S., 1998)* are source of discrepancy. Others are arguing that geographic differences that affect the environment in which individuals live and influence the productivity of agriculture, the availability of natural resources, certain constraints on individual behavior, or even individual attitudes (Robinson et al, 2001) while (Guiso et al. 2004; Harison et al 2000) argued that cultural differences are key determinants of individuals' values, preferences, and beliefs that can create economic growth differences. But the contemporary argument that came to pervasive and matters most is institutional differences that affect the laws and regulations under which individuals and firms function and shape the incentives they have for accumulation, investment, and trade (North, Douglas C., 1990; Acemoglu and Robinson, 2012).

Therefore, the objective of this paper is to reveal how institutions affect economic growth and as a result, the reason behind economic discrepancies where the poor is becoming poorer and the rich becomes richer is due to institutional set ups they established where the former have extractive and the later have inclusive institutions.

1.4. Methodology

The methodological approach to summarize this seminar paper is solely of secondary sources through reviewing different articles published in reputable journals, proceedings, books and online internet uploads. The specific approach is reviewing and analyzing the theoretical, conceptual and empirical findings about how institutions matter for economic growth and development from the perspective of various scholars that support or refute theories. First it was attempted to highlight the meaning of the term institutions from different perspectives, which is then followed by a discussion and analyzing of the context in which the theory developed. Then it engrossed on some basic concepts embedded in the theory that offer backings of different countries growth experience that substantiates many development studies scholars. Finally, up on the analysis of different perspectives, drawing of important conclusion remarks and concrete arguments that works for all developing and developed nations where economic discrepancies is emanated from institutional differences is the utmost endeavor culminated indeed.

2. LITERATURE REVIEW

2.1. Theoretical Review

2.1.1. Definition and Concepts

Institutions can be defined as habits that bring limitations to our actions through rules and organizations settled in social life, direct us on how we should behave, and lead social life (Yildirim, 2015: 5-6). According to North (1990: 4): "Institutions are the rules of the game in a society, the humanly devised constraints that shape human interaction. They structure incentives in human exchange, whether political, social or economic". 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. Institutions comprise for example contracts and contract enforcement, protection of property

rights, the rule of law, government bureaucracies, and financial markets. They also, however, include habits and beliefs, norms, social cleavages and traditions in education (so-called informal institutions). Formal institutions typically tend to be the crystallization of informal institutions (North, 1990), as social norms in the realms of gender, class and caste, for example, determine rules of political participation and representation, methods of economic exchange, and inclusion of different groups in society (Pateman, 1988).

Institutions conducive to economic development reduce the costs of economic activity. The costs include transaction costs such as search and information costs, bargaining and decision costs, policing and enforcement costs (Coase, 1992: 197; Dahlman, 1979: 149). On the other hand, such institutions increase the security that the risk of incurring in an economic transaction is matched by the full appropriation of its eventual benefits. This includes the presence of individual private property rights. If property is protected, individuals will be more willing to invest and incur sunk costs. Recounting the land-ownership system particularly in LDCs, Pande and Udry (2005) showed that where individual perception of security of land tenure is low, investment in the land is significantly reduced, and output consequently drops. In fact, in the few cases in which land is obtained through commercial transactions (as opposed to the traditional informal system of land redistribution), there ceases to be any difference in levels of investment because security of tenure is assured. This increases output and thus is conducive to economic development. Therefore, Institutions determine the costs of economic transactions: they spur development in the form of contracts and contract enforcement, common commercial codes, and increased availability of information, all of which reduce the costs of transactions, risk, and uncertainty.

Institutions determine the degree of being appropriate of return to investment: protection of property rights and the rule of law spur investment and thus increase incomes. Institutions also determine the scope for oppression and expropriation of resources by elites: unequal institutions which allow the dominance of powerful elites over economic, exchange strongly limit development, as can be seen in the case of many ex-colonial countries.

Lastly, institutions determine the degree to which the environment is conducive to cooperation and increased social capital. Also, inclusive and participatory institutions increase the flow of information and the extent to which resources can be pooled to reduce risk and ensure sustained levels of wealth.

2.1.2. Arguments against/for Institutions

The wealth and poverty of nations has long been accepted as a normal phenomenon in economic development. However, questions have been ceaseless with regards to the rationale behind these inequalities. Well-known economists and political economists, such as Kuznets, Frank and Wallerstein, have delved into these international discrepancies, yet economic principles and practices have continued to exacerbate the huge divide. Many economists and political economists have tried to explain and proffer solutions on catch-up strategies, raising questions about the interplay of uneven distribution in living standards and the relative shares of industry and trade in determining national wealth and poverty. Yet, instead of witnessing economic growth and development, countries have continued to be enmeshed in intense economic growth discrepancies (N. Ibrahim, 2010). This provides the avenue to question economic orthodoxy which has been strategically designed to create winners and losers in the global economy (ebid).

The contemplation seems to be unfair principles and practices imposed by rich countries on poor ones, enhancing the “development of underdevelopment” among nations (H. J. Chang, 2002). The production and export of manufactured goods by rich countries and the export of raw materials from poor countries is one of many examples of the mechanisms that provides rich countries with enormous economic preponderance over poor countries which is simply a premeditated strategy to keep the poor poorer and to make the rich even richer (A. Reinert, --------).

On the contrary, there are other debates that argued where the sources of economic disparities are because of growth correlate such as physical capital, human capital and technology despite the fact that these are only proximate causes of economic growth and economic success (even if we convince ourselves that there is an element of causality in the correlations (Romer; 1986 and Lucas; 1988)). It would not be entirely satisfactory to explain the process of economic growth and cross-country differences with technology, physical capital and human capital; since presumably there are reasons where technology, physical capital, and human capital differ across countries. If these factors are so important in generating cross-country income differences and causing the takeoff into modern economic growth, why do certain societies fail to improve their technologies, invest more in physical capital, and accumulate more human capital? This brought another contemporary debate on the issue of economic differences where the above reasons are not sufficient to justify the agony. Therefore, it is not the proximate causes that matters economic growth much but it is related to the *fundamental causes* of economic growth—the factors potentially affecting why societies make different technology and accumulation choices.

Fundamental causes are the factors that enable us to link the questions of economic growth to the concerns of the rest of the social sciences and ask questions about the roles of geography, institutions, culture, natural resource endowments and exogenous environmental factors.

2.1.3. Institutions and Macro Economic Performance Relationship

Institutions can be defined as habits that bring limitations to our actions through rules and organizations settled in social life, direct us on how we should behave, and lead social life (Yildirim, 2015: 5-6). According to definitions that try to explain the concept of institution, formal and informal rules existing in a society form the institutional structure of the society. In this sense, the institutional structure expresses thought habits, behavior, social habits, traditions, rituals along with laws, constitution, contracts and property rights (North, 2010).

The trust factor that makes up the informal aspect of corporate structure of society forms the basis of social order, individual life and economic and political development through resulting effects in the form of growing business scales, industrial structure flexibility and increased social strength to external shocks (Gokalp, 2003). Trust increases the effectiveness of the economic and social system and makes it possible to produce more goods. The economic value of trust is understood better if a world without trust is imagined. For example, a very serious time will be spent to avoid a legal gap in business relations, and this will prevent development and entrepreneurship (Fukuyama, 2005:167). Low trust discourages innovations in the society (Knack & Keefer, 1997:1252). While entrepreneurs in a low trust society spend more time to accommodate a new technology or a new product, the exact opposite applies to high trust societies. This allows more investment in high trust societies and so the economy can grow faster. Accordingly, low level of trust in a society decrease productivity and deactivate economic decisions whereas in the presence of trust, basic economic activities revive, consumption and investment levels increase. Therefore, it can be said that the trust factor has important effects on economic performance. Confidence among the members of a society will reduce the transaction costs by reducing the necessity for formal arrangements. Decrease in the transaction costs will reflect positively on the economy. However, in cases where individuals have low levels of trust against each other, formal regulations such as laws, contracts will be needed to compensate this lack of trust. Thus, as a result of more frequent recourse to formal regulatory, transaction costs will increase. In addition, if issues rise during the implementation of those regulations, individuals will lose confidence in formal regulations in problems they might face during economic activity, therefore their courage to invest will be broken and they will narrow their scope of action during their economic activity. There is a very close relationship between transaction costs and property rights. The relationship between the protection of property rights and economic growth is established by means of transaction costs. Property acquisition, preservation and transfer costs are defined as transaction costs. Reduction of transaction costs requires the protection and a good definition of property rights. Individuals trusting their property rights are protected and that law rules will cause a decrease in transaction costs (Borrmann, Buse & Neuhaus, 2006: 346; Opper, 2008: 392). A well protection of property rights will cause an efficient use of human and physical capital or factors of production, which in turn will have a positive effect on economic performance. The motivation that directs human capital to productive activities is a property rights system which protects the expected returns efficiently (Khan & Sokolof, 2001). According to them, the patent system that provides the protection of property rights will enhance innovations and technology. For this reason, protection of private ownership rights will have a positive effect on economic growth. A good definition of property rights will reduce uncertainty which in turn will ensure efficient use or allocation of resources (Furubotn & Pejovich, 1972). As in a society where property rights are recognized and protected, individuals will make their own decisions about their ownerships, efficiency in resource allocation will be possible, and this will increase life standards and contribute to the economic growth of the country (IPRI, 2009:12). In societies where property rights are not defined clearly, individuals or firm owners will not be able to trade their products or resources in a right manner. In this case, individuals who cannot get the return they deserve on the worth they produce will be reluctant in producing new worth or developing their skills. Besides, in an environment where the worth they produce can easily be stolen by others, individuals will use their sources not for production or innovation, but for protecting their existing property. In this case, transaction costs of commercial activities will increase (Parkin, Powell & Matthews, 2000; Stroup, 2003). Institutions may cause both an increase or a decrease in productivity. To get hold of a stable economic performance, countries need institutions which will encourage organizations in productive activities. In developing countries due to the low quality of institutions, the opportunities in front of the political and economic entrepreneurs are complicated. The institutions in those countries are mainly of a nature developing redistribution activities instead of production activities, creating monopolies instead of competitive conditions, restricting opportunities instead of developing them. These institutions rarely lead to investments that will increase productivity.

In developing countries, despite low levels of social trust, the existing institutional structure does not have a sufficient level of legal regulations and sanctions to compensate for the absence of this trust. Africa and Latin America, where developing countries are located intensely, draws attraction as society with low-confidence level. In low trust societies such as Africa and Latin America, universal programs are likely to fail due to the lack of potential support. Lack of trust made it difficult to encourage entrepreneurship in Africa and Latin America, and limited the opportunities for economic growth and innovation (Fellner, 2008: 11-24).

2.1.4. Properties of Institutional Structure in Developing Countries

The institutions in developing countries have usually lack the sufficient activity in supporting productive investments and solving the low efficiency problem. In those societies, legal principles discriminate among individuals, the property rights are not valid for the majority of the population, the elite have unlimited economic and political power, only a lucky part of the citizens can benefit from the quality education, have access to credit and production opportunities. The effect of institutions on economic performance take shape according to the qualifications they have (Edison, 2003). For this reason, in developing countries, bad institutions that do not function well, affect adversely the economic growth and performance of those countries. In developing countries, the quality of bureaucratic services is low due to the weaknesses in the structure of society. The immaturity of the official institutions performing economic operations increases the cost of doing business. Governments are unstable and populist approaches are intense.

Particularly in Africa and Latin America, the basic flaw in terms of economic growth and development is the arrangements political institutions do which are generally inconsistent with the interests of citizens. This results with providing bad public services. In those countries, the reliability and the applicability of contracts are limited. The uncertainty and manipulation whitespaces in the judicial system, corruption, bribery, tax evasion, ill-defined property rights and the existence of inefficient institutions as ill-conceived arrangements cause those countries to be risky and unattractive (Luiz, 2009: 65-70; Fosu, Bates & Hoeffler, 2006:2; Baliamoune,2005; Birdsall, 2007:578- 589; Charnock, 2009:77).

Many African and Latin American countries, have the weakest legislation authority in the world. If the legislature cannot be effective in the process of policy making (cannot serve as the guardian of the policy making process), it will be possible for the executive branch to act without control, and the political environment of the country will not be trustable (Pereira, Singh & Mueller, 2011: 78-80).

In recent years in Africa and Latin America corruption spreading in all areas of society has been seen. A serious level of corruption is found to exist in Latin American. This case ended up with the economy performing a low growth performance. The public data in Colombia and Venezuela as Latin America countries and Egypt, Senegal, Central Africa, DRC, Eritrea, and Ethiopia suggests that in all these countries, democracy is in serious danger. In Latin America countries where political corruption is a major problem, nine presidents were investigated and were unseated because of corruption. Brazil’s president Fernando Collor de Mello’s being forced to resign after the wake of some scandals about how he financed a luxury life through corruption during the election campaign; Ecuador President Bucaram’s publication of corruption evidence in the media about the money collected for the poor in a television program on a new year’s night; the Presidency of Carlos Andres Perez being suspended during a lawsuit about embezzling money from public funds in Venezuela can all be shown as examples to this situation (Fellner, 2008).

In Egypt, having lived in a period of political uncertainty for many years, the government started in 1981 has continued performing for 30 years until the Egypt revolution in 2011. In contrast to the promise of a more moderate government, an authoritarian was regime strengthened, Egypt was transformed to a one-party State for the realization of all the goals. Economic and social policies that supports corruption, abuse of office and bribery strengthened the rich and the corrupt ruling elite while weakening the middle class (Owen & Pamuk, 2002; Vatikiotis, 1991; Pryce-Jones, 2011; Saikal, 2011; Marsot, 2010: 142). With the Egypt revolution in 2011 triggered by these factors, transition to democracy process has begun, a new president has been brought to the task through democratic ways (Pryce-Jones, 2011; Saikal, 2011; Marsot, 2010; Vaitiokis, 1991). But this process was interrupted with military blows in 3 July 2013, the elected President Mursi was taken from his post with the military coup d’état. So, Egypt, where transition to democracy is terminated, continues to draw a country profile referred to with government inefficiency, corruption, political instability, public demonstrations, disturbances and unrest.

Senegal, which is just another African country, despite having a multi-party-political structure and having never formally a single-party system, was governed by a single political party for forty years from 1960 when gained independence, until 2000 when a change was made (Dakar commercial Counsellor Senegal Report, 2012: 15).

A Latin America country Argentina is also another country which could not achieve permanent economic growth since the 1950’s because of crisis she cannot get out of caused by political unrest and political instability (Dogruel, 2006; TMMOB, 2007: 16).

In case of developing countries having an autocratic structure, the state trying to gain power over the society causes a competition between the state and the society, leading to the weakening and crash of production. If ethnic diversity is involved in developing countries (Ethiopia is typical example) which lack strong institutions, poor development of political rights and failing to determine and apply successful policies results in ethnic conflicts and harms the economic structure of those countries (Luiz, 2009; Fosu, Bates & Hoeffler, 2006).

2.2. Empirical Evidences that Refute Various Hypothesises

As the debate is ceaselessly continued about why rich countries got rich and poor countries stay poor, there are different evidences come in to picture that abjures the various hypothesises which were believed to the source of economic disparities across countries for the past few centuries. The contemporary and extra ordinary evidence to justify the above debate is the institutional set ups that countries can create matters for their prosperities. Despite the fact that there are diverse hypotheses which were accepted for the last many decades considered to be the source for poor countries to be poor or rich to be richer, in reality these hypothesises didn't going to work and empirical evidences had come to in picture to refute these hypotheses. The new approach is due to the institutions that countries had established where economic growth differences had created among nations (Robinson and Acemoglu, 2012). Some of the arguments that institutions are the limiting factor than the others factors which were believed and hypothesized but failed to justify the reality where many countries are evident how institutions matter.

2.2.1. The Geography Hypothesis

One widely accepted theory of the causes of world inequality is the geography hypothesis developed by Adam Smith, 1970, which claims that the great divide between rich and poor countries is created by geographical differences. Many poor countries, such as those of Africa, Central America, and South Asia, are between the tropics of Cancer and Capricorn. Rich nations, in contrast, tend to be in temperate latitudes. This geographic concentration of poverty and prosperity gives a superficial appeal to the geography hypothesis, which is the starting point of the theories and views of many social scientists and pundits alike. But this doesn't make it any less wrong.

As early as the late eighteenth century, the great French political philosopher Montesquieu noted the geographic concentration of prosperity and poverty, and proposed an explanation for it. He argued that people in tropical climates tended to be lazy and to lack inquisitiveness. As a consequence, they didn't work hard and were not innovative, and this was the reason why they were poor.

Daron Acemoglu and Robinson 2010, had written a detailed analysis in their book "why nations fail" about the issue of the geography hypothesis is failed to answer that it is the source of economic growth creating significant differences among nations by discovering various countries evidences as follows.

The theory that hot countries are intrinsically poor, though contradicted by the recent rapid economic advance of countries such as Singapore, Malaysia, and Botswana, is still forcefully advocated by some, such as the economist Jeffrey Sachs. The modern version of this view emphasizes not the direct effects of climate on work effort or thought processes, but two additional arguments: first, that tropical diseases, particularly malaria, have very adverse consequences for health and therefore labor productivity; and second, that tropical soils do not allow for productive agriculture. The conclusion, though, is the same: temperate climates have a relative advantage over tropical and semitropical areas. World inequality, however, cannot be explained by climate or diseases, or any version of the geography hypothesis. Just think of Nogales. What separates the two parts is not climate, geography, or disease environment, but the U.S.-Mexico border.

If the geography hypothesis cannot explain differences between the north and south of Nogales, or North and South Korea, or those between East and West Germany before the fall of the Berlin Wall, could it still be a useful theory for explaining differences between North and South America? Between Europe and Africa? Simply, no. History illustrates that there is no simple or enduring connection between climate or geography and economic success.

The other part of the geography hypothesis is that the tropics are poor because tropical agriculture is intrinsically unproductive. Tropical soils are thin and unable to maintain nutrients, the argument goes, and emphasizes how quickly these soils are eroded by torrential rains. There certainly is some merit in this argument, but the prime determinant of why agricultural productivity—agricultural output per acre—is so low in many poor countries, particularly in sub-Saharan Africa, has little to do with soil quality. Rather, it is a consequence of the ownership structure of the land and the incentives that are created for farmers by the governments and institutions under which they live. The world inequality cannot be explained by differences in agricultural productivity. The great inequality of the modern world that emerged in the nineteenth century was caused by the uneven dissemination of industrial technologies and manufacturing production. It was not caused by divergence in agricultural performance.

Finally, geographic factors are unhelpful for explaining not only the differences we see across various parts of the world today but also why many nations such as Japan or China stagnate for long periods and then start a rapid growth process. We need another, better theory.

2.2.2. The Culture Hypothesis

The second widely accepted theory, the culture hypothesis developed by Max Weber (1805 – 1904) protestant ethic thesis and later substantiated by empirical evidences of McClelland 1953; McClelland 1961; Harrison 1992, relates prosperity to culture. The culture hypothesis, just like the geography hypothesis, has a distinguished lineage, going back at least to the great German sociologist Max Weber, who argued that the Protestant

Reformation and the Protestant ethic it spurred played a key role in facilitating the rise of modern industrial society in Western Europe. The culture hypothesis no longer relies solely on religion, but stresses other types of beliefs, values, and ethics as well (Acemoglu et al 2002).

According to Acemoglu et al, though it is not politically correct to articulate in public, many people still maintain that Africans are poor because they lack a good work ethic, still believe in witchcraft and magic, or resist new Western technologies. Many also believe that Latin America will never be rich because its people are intrinsically profligate and impecunious, and because they suffer from some "Iberian" or *"mañana"* culture. Of course, many once believed that the Chinese culture and Confucian values were hostile to economic growth, though now the importance of the Chinese work ethic as the engine of growth in China, Hong Kong, and Singapore is trumpeted. Is the culture hypothesis useful for understanding world inequality? Yes and no. Yes, in the sense that social norms, which are related to culture, matter and can be hard to change, and they also sometimes support institutional differences for world inequality. But mostly no, because those aspects of culture often emphasized religion, national ethics, African or Latin values are just not important for understanding how we got here and why the inequalities in the world persist. Other aspects, such as the extent to which people trust each other or are able to cooperate, are important but they are mostly an outcome of institutions, not an independent cause.

Let us go back to Nogales for empirical evidence. As we noted earlier, many aspects of culture are the same north and south of the fence. Nevertheless, there may be some marked differences in practices, norms, and values, though these are not causing but outcomes of the two places' divergent development paths. For example, in surveys Mexicans typically say they trust other people less than the citizens of the United States say they trust others. But it is not a surprise that Mexicans lack trust when their government cannot eliminate drug cartels or provide a functioning unbiased legal system. The same is true with North and South Korea. The South is one of the richest countries in the world, while the North grapples with periodic famine and abject poverty. While "culture" is very different between the South and the North today, it played no role in causing the diverging economic fortunes of these two half nations. The Korean peninsula has a long period of common history. Before the Korean War and the division at the 38th parallel, it had an unprecedented homogeneity in terms of language, ethnicity, and culture. Just as in Nogales, what matters is the border. To the north is a different regime, imposing different institutions, creating different incentives. Any difference in culture between south and north of the border cutting through the two parts of Nogales or the two parts of Korea is thus not a cause of the differences in prosperity but, rather, a consequence.

What about Africa and African culture? Historically, sub- Saharan Africa was poorer than most other parts of the world, and its ancient civilizations did not develop the wheel, writing, or the plow (Robinson, 2002). Though these technologies were not widely used until the advent of formal European colonization in the late nineteenth and early twentieth century, African societies knew about them much earlier. Europeans began sailing around the west coast in the late fifteenth century, and Asians were continually sailing to East Africa from much earlier times. We can understand why these technologies were not adopted from the history of the Kingdom of Kongo at the mouth of the Congo River, which has given its name to the modern Democratic Republic of Congo. Kongo was along with another important central African state, the Kuba Kingdom, Kongo came into intense contact with the Portuguese after it was first visited by the mariner Diogo Cão in 1483. At the time, Kongo was a highly centralized polity by African standards, whose capital, Mbanza, had a population of sixty thousand, which made it about the same size as the Portuguese capital of Lisbon and larger than London, which had a population of about fifty thousand in 1500. The king of Kongo, Nzinga a Nkuwu, converted to Catholicism and changed his name to João I. Later Mbanza's name was changed to São Salvador. Thanks to the Portuguese, the Kongolese learned about the wheel and the plow, and the Portuguese even encouraged their adoption with agricultural missions in 1491 and 1512. But all these initiatives failed. Still, the Kongolese were far from averse to modern technologies in general. They were very quick to adopt one venerable Western innovation: the gun. They used this new and powerful tool to respond to market incentives: to capture and export slaves. There is no sign here that African values or culture prevented the adoption of new technologies and practices. As their contacts with Europeans deepened, the Kongolese adopted other Western practices: literacy, dress styles, and house designs. In the nineteenth century, many African societies also took advantage of the rising economic opportunities created by the Industrial Revolution by changing their production patterns. In West Africa there was rapid economic development based on the export of palm oil and ground nuts; throughout southern Africa, Africans developed exports to the rapidly expanding industrial and mining areas of the Rand in South Africa. Yet these promising economic experiments were obliterated not by African culture or the inability of ordinary Africans to act in their own self-interest, but first by European colonialism and then by post-independence African governments.

The real reason that the Kongolese did not adopt superior technology was because they lacked any incentives to do so. They faced a high risk of all their output being expropriated and taxed by the all-powerful king, whether or not he had converted to Catholicism. In fact, it wasn't only their property that was insecure. Their continued existence was held by a thread. Many of them were captured and sold as slaves hardly the

environment to encourage investment to increase long-term productivity. Neither did the king have incentives to adopt the plow on a large scale or to make increasing agricultural productivity his main priority; exporting slaves was so much more profitable. It might be true today that Africans trust each other less than people in other parts of the world. But this is an outcome of a long history of institutions which have undermined human and property rights in Africa. The potential to be captured and sold as a slave no doubt influenced the extent to which Africans trusted others historically. What about Max Weber's Protestant ethic? Though it may be true that predominantly Protestant countries, such as the Netherlands and England, were the first economic successes of the modern era, there is little relationship between religion and economic success. France, a predominantly Catholic country, quickly mimicked the economic performance of the Dutch and English in the nineteenth century, and Italy is as prosperous as any of these nations today. Looking farther east, you'll see that none of the economic successes of East Asia have anything to do with any form of Christian religion, so there is not much support for a special relationship between Protestantism and economic success there, either.

Let's turn to a favorite area for the enthusiasts of the culture hypothesis: the Middle East. Middle Eastern countries are primarily Islamic, and the non–oil producers among them are very poor. Oil producers are richer, but this windfall of wealth has done little to create diversified modern economies in Saudi Arabia or Kuwait. Don't these facts show convincingly that religion matters? Though plausible, this argument is not right, either. Yes, countries such as Syria and Egypt are poor, and their populations are primarily Muslim. But these countries also systemically differ in other ways that are far more important for prosperity. For one, they were all provinces of the Ottoman Empire, which heavily, and adversely, shaped the way they developed. After Ottoman rule collapsed, the Middle East was absorbed into the English and French colonial empires, which, again, stunted their possibilities. After independence, they followed much of the former colonial world by developing hierarchical, authoritarian political regimes with few of the political and economic institutions that, we will argue, are crucial for generating economic success. This development path was forged largely by the history of Ottoman and European rule. The relationship between the Islamic religion and poverty in the Middle East is largely spurious. The role of these historical events, rather than cultural factors, in shaping the Middle East's economic trajectory is also seen in the fact that the parts of the Middle East that temporarily broke away from the hold of the Ottoman Empire and the European powers, such as Egypt between 1805 and 1848 under Muhammad Ali, could embark on a path of rapid economic change.

Muhammad Ali's reforms, though coercive, did bring growth to Egypt as the state bureaucracy, the army, and the tax system were modernized and there was growth in agriculture and industry. Nevertheless, this process of modernization and growth came to an end after Ali's death, as Egypt fell under European influence. But perhaps this is the wrong way to think about culture. Maybe the cultural factors that matter are not tied to religion but rather to particular "national cultures." Perhaps it is the influence of English culture that is important and explains why countries such as the United States, Canada, and Australia are so prosperous? Though this idea sounds initially appealing, it doesn't work, either. Yes, Canada and the United States were English colonies, but so were Sierra Leone and Nigeria. The variation in prosperity within former English colonies is as great as that in the entire world. The English legacy is not the reason for the success of North America.

There is yet one more version of the culture hypothesis: perhaps it is not English versus non-English that matters but, rather, European versus non-European. Could it be that Europeans are superior somehow because of their work ethic, outlook on life, Judeo-Christian values, or Roman heritage? It is true that Western Europe and North America, filled primarily by people of European descent, are the most prosperous parts of the world. Perhaps it is the superior European cultural legacy that is at the root of prosperity and the last refuge of the culture hypothesis. Alas, this version of the culture hypothesis has as little explanatory potential as the others. A greater proportion of the population of Argentina and Uruguay, compared with the population of Canada and the United States, is of European descent, but Argentina's and Uruguay's economic performance leaves much to be desired. Japan and Singapore never had more than a sprinkling of inhabitants of European descent, yet they are as prosperous as many parts of Western Europe.

China, despite many imperfections in its economic and political system, has been the most rapidly growing nation of the past three decades. Chinese poverty until Mao Zedong's death had nothing to do with Chinese culture; it was due to the disastrous way Mao organized the economy and conducted politics. Current Chinese growth has nothing to do with Chinese values or changes in Chinese culture; it results from a process of economic transformation unleashed by the reforms implemented by Deng Xiaoping and his allies, who, after Mao Zedong's death, gradually abandoned socialist economic policies and institutions, first in agriculture and then in industry.

Just like the geography hypothesis, the culture hypothesis is also unhelpful for explaining other aspects of the lay of the land around us today. There are of course differences in beliefs, cultural attitudes, and values between the United States and Latin America, but just like those that exist between Nogales, Arizona, and Nogales, Sonora, or those between South and North Korea, these differences are a consequence of the two places' different institutions and institutional histories. Finally, cultural attitudes, which are in general slow to

change, are unlikely to account by themselves for the growth miracles in East Asia and China. Though institutions are persistent, too, in certain circumstances they do change rapidly.

2.2.3. The Policy Hypothesis

In contrast to the other hypotheses, the policy-hypothesis sees the reason for different growth experiences solely in terms of different approaches to economic policy. This view is central to the development strategies of many international organizations and appears, for example, in the Washington Consensus or in the structural adjustment programmes pursued in the 1980s. What is emphasized as a decisive prerequisite for economic growth are those policy measures which promote the creation of a stable macroeconomic framework. According to the policy-hypothesis, an adequate economic policy can enhance welfare even when set against the background of detrimental geographical and institutional characteristics.

Central to the policy-hypothesis are the positive effects of a liberal trade regime. International trade facilitates the realization of economies of scale, intensifies competition in domestic markets and supports the creation, diffusion and absorption of foreign technologies. Thus, international trade has a number of positive effects on economic growth. Frankel and Romer (1999) try to assess empirically the income effects of international trade and use geographical characteristics as instrumental variables to measure the extent of international trade integration. Their results show that the natural trade volume is determined by geographical characteristics such as the distance between two markets, and furthermore that trade indeed has positive effects on income. This confirms the hypothesis that trade can exert a positive influence on economic development. At the same time, it can be assumed that geographical characteristics again have only indirect effects on economic growth by influencing the trade volume. This interpretation contrasts once more with the assumptions of the geography-hypothesis. Frankel and Romer note that:

“More generally, it is difficult to think of reasons that a country’s geographic characteristics could have important effects on its income except through their impact on trade” [Frankel/Romer (1999), p.380]

In contrast to Frankel and Romer, Rodrik et al. (2002) are unable to find empirical evidence for direct positive effects of international trade on growth. However, they do not exclude the possibility that an open trade regime is dependent on the quality of institutions [Rodrik et al. (2002), p.4]. From that point of view, economic policy would only indirectly influence economic growth. Two other papers by Rodriguez and Rodrik (2001) and by Irwin and Tervio (2002) also find that international trade exerts no influence on per capita income once institutional variables were controlled for. On the other hand, Alcalá and Ciccone (2004) find that the positive growth-effects of international trade do not lose significance even after controlling for geography and institutions as long as alternative instruments are used to measure international trade. Thus, it becomes obvious that the empirical evidence regarding the policy-hypothesis is as mixed as the evidence for or against the institution hypothesis. One reason for the differing results is econometric difficulties, namely the potential endogeneity of political actions and the intensive interaction between institutions and politics in general and between institutions and trade policy in particular. The main problem of the policy view is that policy measures usually provoke short-term effects while the institutions-hypothesis aim at explaining the fundamental reasons for long-term growth.

It has been shown that an adequate economic policy is capable of compensating for the negative consequences of the resource curse and of freeing the development potential of large endowments of resources but without the establishment of inclusive institutions is absurd. Due to the close connection between the institutional framework and the political sphere, it seems possible that a consistent reform policy is able to influence the former in a positive way. Rodrik et al. (2002) even regard institutions as the cumulated outcome of past policy decisions and point to the improvement in institutional quality which has taken place in many countries over the past 30 years [Rodrik et al. (2002), pp.20]. Even if it does seem a little too simplistic to attribute the actual shape of institutions solely to past policies, institutional change is possible. However, the question remains as to what extent good policy contributes to institutional change and how far institutional change alters policy development.

2.2.4. The Institutions Hypothesis

In contrast to the other-hypotheses, the institutions-hypothesis assumes that the economic growth path of a country is mainly determined by the quality of its institutions. Geographical characteristics exert only an indirect effect in as much as they might be a factor in shaping institutions. The term “institutions” encompasses all the normative rules which have to be followed in transactions. Institutions can be formal (like laws) or of an informal nature (like cultural habits). With reference to North (1990), institutions can be described as a society’s rules of the game. The main purpose of institutions is to provide a stable framework for economic transactions and thus reduce transaction costs. The most relevant aspects of the institutional framework are property rights and the existence of a strong legal system to protect them. One of the biggest problems in this context is the risk of expropriation which has a negative effect on investment decisions and the allocation of resources [Knack/Keefer (1995)].

Accordingly, the institutions-hypothesis endeavors to explain the underdevelopment of the tropics entirely

through the low quality of the prevailing institutions, which in turn are seen as a legacy of the colonial era. This view is justified by the observation that most colonies initially showed a relatively high level of development which deteriorated during the colonial era [Sokoloff/Engermann (2000), Acemoglu et al. (2002)]. Acemoglu et al. (2001) base an empirical analysis of the relationship between colonialism and development on the fact that Europeans pursued different strategies of colonization. On the one hand, they installed settler colonies such as North America while on the other, they set up colonies which served the sole purpose of providing the colonial power with natural resources. This latter type of colony was mainly found in Africa and Latin America. While institutions in the settler colonies were shaped to enable the emergence of a stable society of European settlers, institutions in the extractive colonies were molded in such a way as to allow a small elite to benefit from the most efficient extraction of resources. Acemoglu et al. suggest that the reason for the existence of the two types of colonization strategies lay in the living conditions of the individual regions. In regions with a high prevalence of deadly diseases, European settlers preferred the extractive variant while in regions with suitable living conditions they chose to settle. Allowing for the fact that most institutions show a high degree of path dependence, this would explain how the tropics with their unfavorable living conditions were underdeveloped.

To test their hypothesis, Acemoglu et al. use data on settler mortality in different colonies as an instrumental variable for the quality of institutions and find a significant effect on the level of per capita income. At the same time, geographical characteristics lose their significance altogether when institutions are introduced as an explanatory variable. Acemoglu et al. saw this as evidence of the assumption that geographical characteristics have only an indirect effect on economic growth through their shaping of institutions.

A similar approach is pursued by Sokoloff and Engerman (1997 and 2000) who focus on Latin America and place an even stronger emphasis on the role of geography in shaping institutions. According to Sokoloff and Engerman, the geographical conditions in Latin America favored the cultivation of agricultural products (such as sugar cane or rice) which were most efficiently produced on a large scale. This led to the emergence of large plantations and the extensive use of slave labour. The political power was therefore concentrated in a relatively small elite who deliberately created institutions whose main purpose was the preservation of its power. Due to their path dependence, these institutions still influence Latin America's development in a negative way. This point of view also allows an alternative explanation of different colonization strategies. It could be argued that European settlers avoided regions in which a high concentration of power prevailed and where the living conditions would have been correspondingly unfavourable. According to Sokoloff and Engerman's thesis, geography has a comparatively strong indirect effect on development by shaping institutions.

Hall and Jones (1999) do not explicitly refer to colonialism but nonetheless focused on the extent of European influence. They regard Western Europe as the region where a development-promoting social infrastructure was first introduced. Consequently, countries which are located within Western Europe's sphere of influence should possess institutions of higher quality than other countries. This line of argument resembles the thesis of Max Weber (1904) who assumed a close connection between modern growth and capitalism and in turn saw capitalism closely linked to European culture. To assess their hypothesis empirically, Hall and Jones use linguistic characteristics as a direct indicator for European influence and latitude as an indirect hint for European influence. The use of latitude is justified by the assumption that European settlers preferred regions with low population density and climatic conditions which resembled those of the European continent. Both these elements can be captured by latitude [Hall/Jones (1999), p.101]. The results of their empirical test confirm the institutions-hypothesis while geography is again shown to have only indirect effects on growth by influencing institutions. To conclude, there have also been various empirical studies which have found evidence for a direct influence of institutions on economic growth but which were unable to confirm that other hypothesizes such as geography, culture and natural resource and climate has no direct influence on economic growth.

2.3. Conceptual Frame Work of Institutions and Economic Growth

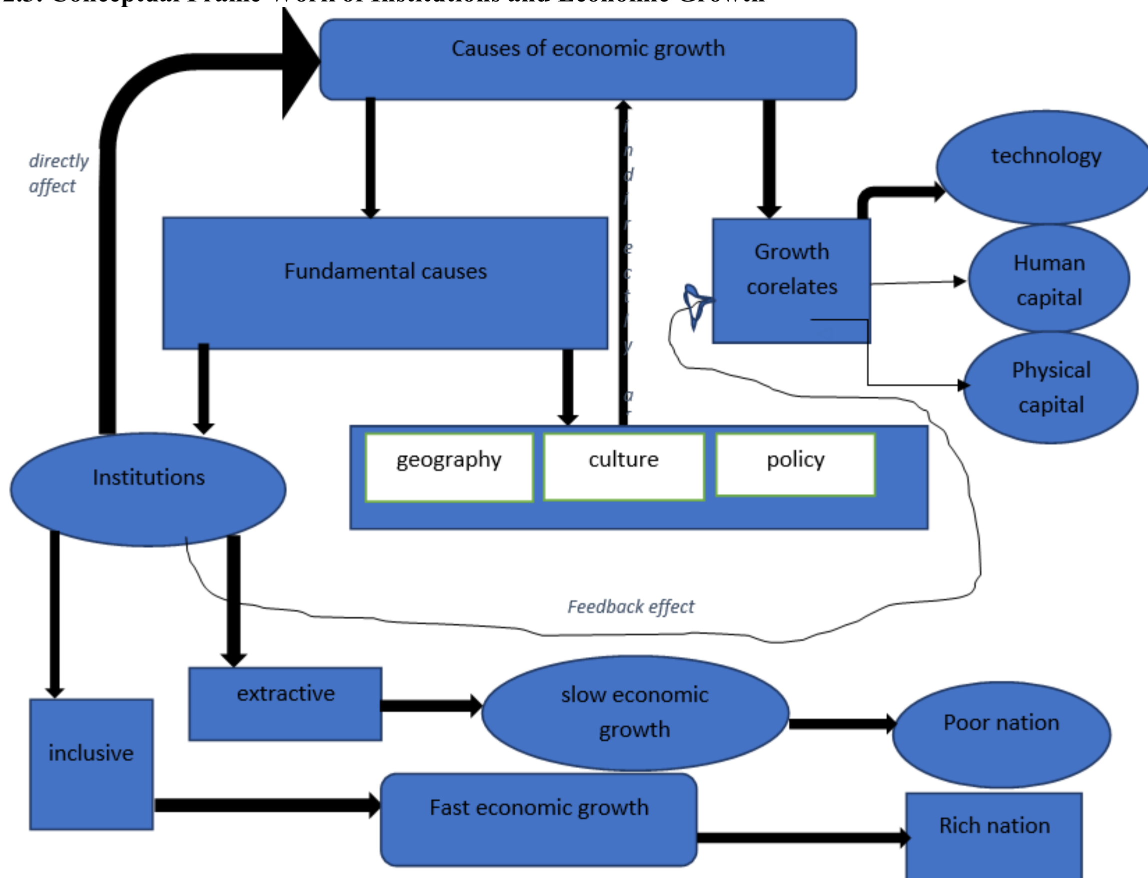

Fig 1: conceptual frame work of institutions and economic growth

3. RESULT AND DISCUSSION

The city of Nogales is cut in half by a fence. If you stand by it and look north, you'll see Nogales, Arizona, located in Santa Cruz County. The income of the average household there is about $30,000 a year. Most teenagers are in school, and the majority of the adults are high school graduates. Despite all the arguments people make about how deficient the U.S. health care system is, the population is relatively healthy, with high life expectancy by global standards. Many of the residents are above age sixty-five and have access to Medicare. It's just one of the many services the government provides that most take for granted, such as electricity, telephones, a sewage system, public health, a road network linking them to other cities in the area and to the rest of the United States, and, last but not least, law and order. The people of Nogales, Arizona, can go about their daily activities without fear for life or safety and not constantly afraid of theft, expropriation, or other things that might jeopardize their investments in their businesses and houses. Equally important, the residents of Nogales, Arizona, take it for granted that, with all its inefficiency and occasional corruption, the government is their agent. They can vote to replace their mayor, congressmen, and senators; they vote in the presidential elections that determine who will lead their country. Democracy is second nature to them. Life south of the fence, just a few feet away, is rather different. While the residents of Nogales, Sonora, live in a relatively prosperous part of Mexico, the income of the average household there is about one-third that in Nogales, Arizona. Most adults in Nogales, Sonora, do not have a high school degree, and many teenagers are not in school. Mothers have to worry about high rates of infant mortality. Poor public health conditions mean it's no surprise that the residents of Nogales, Sonora, do not live as long as their northern neighbors. They also don't have access to many public amenities. Roads are in bad condition south of the fence. Law and order is in worse condition. Crime is high, and opening a business is a risky activity. Not only do you risk robbery, but getting all the permissions and greasing all the palms just to open is no easy endeavor. Residents of Nogales, Sonora, live with politicians' corruption and ineptitude every day.

In contrast to their northern neighbors, democracy is a very recent experience for them. Until the political reforms of 2000, Nogales, Sonora, just like the rest of Mexico, was under the corrupt control of the Institutional Revolutionary Party, or Partido Revolucionario Institucional (PRI).

How could the two halves of what is essentially the same city be so different? There is no difference in

geography, culture, climate, or the types of diseases prevalent in the area, since germs do not face any restrictions crossing back and forth between the United States and Mexico. Of course, health conditions are very different, but this has nothing to do with the disease environment; it is because the people south of the border live with inferior sanitary conditions and lack decent health care. But perhaps the residents are very different. Could it be that the residents of Nogales, Arizona, are grandchildren of migrants from Europe, while those in the south are descendants of Aztecs? Not so. The backgrounds of people on both sides of the border are quite similar. After Mexico became independent from Spain in 1821, the area around "Los dos Nogales" was part of the Mexican state of Vieja California and remained so even after the Mexican- American War of 1846–1848. Indeed, it was only after the Gadsden Purchase of 1853 that the U.S. border was extended into this area. It was Lieutenant N. Michler who, while surveying the border, noted the presence of the "pretty little valley of Los Nogales." Here, on either side of the border, the two cities rose up. The inhabitants of Nogales, Arizona, and Nogales, Sonora, share ancestors, enjoy the same food and the same music, and, we would hazard to say, have the same "culture."

Of course, there is a very simple and obvious explanation for the differences between the two halves of Nogales that you've probably long since guessed: the very border that defines the two halves. Nogales, Arizona, is in the United States. Its inhabitants have access to the economic institutions of the United States, which enable them to choose their occupations freely, acquire schooling and skills, and encourage their employers to invest in the best technology, which leads to higher wages for them. They also have access to political institutions that allow them to take part in the democratic process, to elect their representatives, and replace them if they misbehave. In consequence, politicians provide the basic services (ranging from public health to roads to law and order) that the citizens demand. Those of Nogales, Sonora, are not so lucky. They live in a different world shaped by different institutions. These different institutions create very disparate incentives for the inhabitants of the two Nogaleses and for the entrepreneurs and businesses willing to invest there. These incentives created by the different institutions of the Nogaleses and the countries in which they are situated are the main reason for the differences in economic prosperity on the two sides of the border.

This theory needs to delineate both the factors that create and retard prosperity and their historical origins. A theory proposed by Robinson and Acemoglu, 2012; suggested that any complex social phenomenon, such as the origins of the different economic and political trajectories of hundreds of polities around the world, likely has a multitude of causes, making most social scientists shun monocausal, simple, and broadly applicable theories and instead seek different explanations for seemingly similar outcomes emerging in different times and areas. Instead, they offered a simple theory and used it to explain the main contours of economic and political development around the world since the Neolithic Revolution. Their theory has attempted to achieve this by operating on two levels. The first is the distinction between extractive and inclusive economic and political institutions. Their second explanation is why inclusive institutions emerged in some parts of the world and not in others. While the first level of their theory is about an institutional interpretation of history, the second level is about how history has shaped institutional trajectories of nations. Central to their theory is the link between inclusive economic and political institutions and prosperity. Inclusive economic institutions that enforce property rights, create a level playing field, and encourage investments in new technologies and skills are more conducive to economic growth than extractive economic institutions that are structured to extract resources from the many by the few and that fail to protect property rights or provide incentives for economic activity (Acemoglu and Robinson, 2012). Inclusive economic institutions are in turn supported by, and support, inclusive political institutions, that is, those that distribute political power widely in a pluralistic manner and are able to achieve some amount of political centralization so as to establish law and order, the foundations of secure property rights, and an inclusive market economy. Similarly, extractive economic institutions are synergistically linked to extractive political institutions, which concentrate power in the hands of a few, who will then have incentives to maintain and develop extractive economic institutions for their benefit and use the resources they obtain to cement their hold on political power (ebid).

These tendencies do not imply that extractive economic and political institutions are inconsistent with economic growth. On the contrary, every elite would, all else being equal, like to encourage as much growth as possible in order to have more to extract. Extractive institutions that have achieved at least a minimal degree of political centralization are often able to generate some amount of growth. According to Acemoglu and Robinson 2012, what is crucial, however, is that growth under extractive institutions will not be sustained, for two key reasons. First, sustained economic growth requires innovation, and innovation cannot be decoupled from creative destruction, which replaces the old with the new in the economic realm and also destabilizes established power relations in politics. Because elites dominating extractive institutions fear creative destruction, they will resist it, and any growth that germinates under extractive institutions will be ultimately short lived.

Second, the ability of those who dominate extractive institutions to benefit greatly at the expense of the rest of society implies that political power under extractive institutions is highly coveted, making many groups and individuals fight to obtain it. As a consequence, there will be powerful forces pushing societies under extractive

institutions toward political instability. The synergies between extractive economic and political institutions create a vicious circle, where extractive institutions, once in place, tend to persist. Similarly, there is a virtuous circle associated with inclusive economic and political institutions. But neither the vicious nor the virtuous circle is absolute. In fact, some nations live under inclusive institutions today because, though extractive institutions have been the norm in history, some societies have been able to break the mold and transition toward inclusive institutions. Their explanation for these transitions is historical, but not historically predetermined. Major institutional change, the requisite for major economic change, takes place as a result of the interaction between existing institutions and critical junctures.

Critical junctures are major events that disrupt the existing political and economic balance in one or many societies, such as the Black Death, which killed possibly as much as half the population of most areas in Europe during the fourteenth century; the opening of Atlantic trade routes, which created enormous profit opportunities for many in Western Europe; and the Industrial Revolution, which offered the potential for rapid but also disruptive changes in the structure of economies around the world (Horrox, Rosemary, ed. 1994).

Existing institutional differences among societies themselves are a result of past institutional changes. Why does the path of institutional change differ across societies? The answer to this question lies in institutional drift. In the same way that the genes of two isolated populations of organisms will drift apart slowly because of random mutations in the so-called process of evolutionary or genetic drift, two otherwise similar societies will also drift apart institutionally—albeit, again, slowly. Conflict over income and power, and indirectly over institutions, is a constant in all societies. This conflict often has a contingent outcome, even if the playing field over which it transpires is not level. The outcome of this conflict leads to institutional drift. But this is not necessarily a cumulative process. It does not imply that the small differences that emerge at some point will necessarily become larger over time.

4. CONCLUSION

"Why nations fail?" is a quest that is yet ceaselessly argued. But why? The contemporary consensus that nations fail economically because of extractive institutions (Acemoglu et al 2002). According to them, these institutions keep poor countries poor and prevent them from embarking on a path to economic growth. This is true today in Africa, South America, in countries such as Colombia and Argentina; in Asia, in countries such as North Korea and Uzbekistan; and in the Middle East. There are notable differences among these countries. Some are tropical, some are in temperate latitudes. Some were colonies of Britain; others, of Japan, Spain, and Russia. They have very different histories, languages, and cultures. What they all share is extractive institutions. In all these cases the basis of these institutions is an elite who design economic institutions in order to enrich themselves and perpetuate their power at the expense of the vast majority of people in society. The different histories and social structures of the countries lead to the differences in the nature of the elites and in the details of the extractive institutions. But the reason why these extractive institutions persist is always related to the vicious circle, and the implications of these institutions in terms of impoverishing their citizens are similar even if their intensity differs. Just as different histories and structures mean that the identity of elites and the details of extractive political institutions differ, so do the details of the extractive economic institutions that the elites set up. Though these details are all important and interesting, the more critical lessons are in the big picture, which reveals that in each of these cases, extractive political institutions have created extractive economic institutions, transferring wealth and power toward the elite. Hence, countries which established inclusive institutions become rich while those which created extractive institutions are becoming poorer and poorer. So, the source of countries economic discrepancies is due to institutions, institutions and also institutions. So, institutions matter!

5. RECOMMENDATION

Successful development policy entails an understanding of the dynamics of economic change if the policies pursued are to have the desired consequences. And a dynamic model of economic change entails as an integral part of that model analysis of the polity since it is the polity that specifies and enforces the formal rules. While we are still some distance from having such a model the structure that is evolving in the new institutional economics, even though incomplete, suggests radically different development policies than those of either traditional development economists or orthodox neo-classical economists. Development economists have typically treated the state as either exogenous or as a benign actor in the development process. Neo-classical economists have implicitly assumed that institutions (economic as well as political) don't matter and that the static analysis embodied in allocative-efficiency models should be the guide to policy; that is "getting the prices right" by eliminating exchange and price controls. In fact, the state can never be treated as an exogenous actor in development policy and getting the prices right only has the desired consequences when you already have in place a set of property rights and enforcement that will then produce the competitive conditions that will result in efficient markets.

The key to efficient markets is low costs of transacting. Transaction costs are the costs involved in

measuring what is being exchanged and in enforcing agreements. Goods and services or the performance of agents have multiple valuable attributes and the ability to measure those attributes at low cost is a necessary condition for capturing the gains from trade that were the keys to Adam Smith's Wealth of Nations. But a sufficient condition requires in addition that the contracts embodying the exchange process can be enforced at low cost. Those conditions are not met in third world countries and in consequence markets either do not exist or are beset by very high costs of transacting. Because transaction costs will influence the technology employed both transaction and transformation costs will be higher in the factor and product markets of such economies. The inability to have low-cost specification of the attributes being exchanged and enforcement of agreements in economic markets is ultimately a function of the political markets of such economies because it is the polity that specifies the property rights and provides the instruments and resources to enforce contracts.

For developing countries to be able to get out of this cycle, it is recommended that:

- adopting policies of their own country and making the necessary reforms in the institutional structure is a stipulation facing them.
- The level of trust that is missing in these countries should be compensated by contracts and legal rules.
- Realistic regulation and efficient implementation of the contracts must be supplied, and poise of people in these countries in the legal system, laws, property rights must be built up.

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