
The Mystery of Wealth

Why are the citizens of some nations rich while the inhabitants of others are poor? Your initial answer might be, "Because of differences in the **natural-resource endowments** of the nations." It is surely true that ample endowments of energy, timber, and fertile land all help raise wealth. But natural resources can be only a very small part of the answer, as witnessed by many counterexamples. Switzerland and Luxembourg, for example, are nearly devoid of key natural resources, yet the real incomes of citizens of those lands are among the world's highest. Similarly, Hong Kong, which consists of but a few square miles of rock and hillside, is one of the economic miracles of the last century, while in Russia, a land amply endowed with vast quantities of virtually every important resource, most people remain mired in economic misery.

A number of studies have begun to unravel the mystery of **economic growth**. Repeatedly, they have found that it is the fundamental political and legal **institutions** of society that are conducive to growth. Of these, political stability, secure private property rights, and legal systems based on the **rule of law** are among the most important. Such institutions encourage people to make long-lived investments in improving land and in all forms of physical and human capital. These investments raise the **capital stock**, which in turn provides for more growth long into the future. And the cumulative effects of this growth over time eventually yield much higher standards of living.

Professor Paul Mahoney of the University of Virginia has studied the contrasting effects of different legal systems on economic growth. Many legal systems around the world today are based on one of two basic models: the English **common law system**

TABLE 4-1 Differing Legal Systems

<i>Common Law Nations</i>	<i>Civil Law Nations</i>
Australia	Brazil
Canada	Egypt
India	France
Israel	Greece
New Zealand	Italy
United Kingdom	Mexico
United States	Sweden

and the French **civil law system**. Common law systems reflect a conscious decision in favor of a limited role for government and emphasize the importance of the judiciary in constraining the power of the executive and legislative branches of government. In contrast, civil law systems favor the creation of a strong centralized government in which the legislature and the executive branches have the power to grant preferential treatment to special interests. Table 4-1 shows a sample of common law and civil law countries

Mahoney found that the security of property rights is much stronger in common law systems, such as observed in England and her former colonies, including the United States. In nations such as France and its former colonies, the civil law systems are much more likely to yield unpredictable changes in the rules of the game—the structure of **property and contract rights**. This unpredictability makes people reluctant to make long-term fixed investments, a fact that ultimately slows the economic growth of these nations and lowers the standard of living for their citizens.

The reasoning here is simple. If you know that the police will not help you protect your rights to a home or car, you are less likely to acquire those assets. Similarly, if you cannot easily enforce business or employment contracts that you make, you are less likely to make those contracts—and thus less likely to produce as many goods or services. And if you cannot plan for the future because you don't know what the rules of the game will be in ten years, or perhaps even one year from now, you are less likely to make the productive long-term investments that require years to

pay off. Common law systems seem to do a better job at enforcing contracts and securing property rights, and thus would be expected to promote economic activity now and economic growth over time.

When Mahoney examined the economic performance of nations around the world from 1960 until the 1990s, he found that economic growth was one-third higher in the common law nations, with their strong property rights, than in civil law nations. Over the 30-plus years covered by his study, the result was that the standard of living—measured by real per capita income—jumped more than 20 percent in common law nations compared to civil law nations. If such a pattern persisted over the span of a century, it would produce a staggering 80 percent real per capita income differential in favor of nations with secure property rights.

William Easterly and Ross Levine recently have taken a much broader view, both across time and across institutions, in assessing the economic growth of a variety of nations since their days as colonies. These economists examined how institutions such as political stability, protection against violence or theft, security of contracts, and freedom from regulatory burdens all contribute to sustained economic growth. They found that it is key institutions such as these, rather than natural-resource endowments, that explain long-term differences in economic growth, and thus present-day differences in levels of real income. To illustrate the powerful effect of institutions, consider the contrast between Mexico, with per capita real income of about \$9400 today, and the United States, with a per capita real income of about \$38,200. Easterly and Levine concluded that if Mexico had developed with the same political and legal institutions that the United States has enjoyed, per capita income in Mexico would today be *equal* to that in the United States!

Given the great importance of such institutions in determining long-term growth, Easterly and Levine went on to ask another important question: How have countries gotten the political and legal institutions they have today? The answer has to do with disease, of all things. The 72 countries studied by Easterly and Levine are all former European colonies, where a variety of colonial strategies were pursued. In Australia, New Zealand, and North America, the colonists found geography and climate that

were conducive to good health. Permanent settlement was attractive, so colonists created institutions to protect private property and curb the power of the state. But when Europeans arrived in Africa and South America, they encountered tropical diseases, such as malaria and yellow fever, that produced high mortality rates. This discouraged permanent settlement and encouraged a mentality focused on extracting metals, cash crops, and other resources. As a result, there was little incentive to promote democratic institutions or stable long-term property rights systems. The differing initial institutions helped shape economic growth over the years and, because of the broad persistence of those institutions, continue to shape the political and legal character and the standard of living in these nations today.

Recent events illustrate also that the effects of political and legal institutions can be drastically accelerated—in either direction. Consider China, which in 1979 began to change its institutions in two key ways. First, as we discuss more fully in Chapter 32, on a very limited basis China began to experiment with private property rights for a few of its citizens, and under narrow circumstances. (This experiment even included amending its constitution to strengthen private property protections.) Second, the Chinese government began to clear away obstacles to foreign investment, making China a more secure place for Western companies to do business in. Although the institutional changes have been modest, their combined effects have been substantial. Over the past 25 years, economic growth in China has accelerated, averaging better than 6 percent per year. And if that doesn't sound like much, keep in mind that it has been enough over that period to raise real per capita income in China by a factor of nearly *five*.

For an example of the potential *destructive* impact of institutional change, we need look no further than Zimbabwe. When that country won its independence from Britain in 1980, it was one of the most prosperous nations in Africa. Soon after taking power as Zimbabwe's first (and thus far only) president, Robert Mugabe began disassembling that nation's rule of law, tearing apart the institutions that had helped it grow rich. He reduced the security of property rights in land, and eventually confiscated those rights altogether. Mugabe also has gradually taken control of the prices of most goods and services in his nation, and he even controls the

price of its national currency, at least the price at which Zimbabweans are allowed to trade it. Moreover, the Mugabe government has confiscated large stocks of food and much of the value of anything that might be exported out of or imported into Zimbabwe. In short, anything that is produced or saved has become subject to confiscation, so the incentives to do either are—to put it mildly—reduced.

As a result, between 1980 and 1996, real per capita income in Zimbabwe fell by one-third, and since 1996 it has fallen by an additional one-third. Unemployment is rampant, investment nonexistent, and the inflation rate in Zimbabwe has exceeded 400 percent in recent years. In only 25 years, the fruit of many decades of labor and capital investment has been destroyed, because the very institutions that made that fruit possible have been eliminated. It is a lesson we ignore at our peril.

DISCUSSION QUESTIONS

1. Consider two countries, A and B, and suppose that both have identical *physical* endowments of, say, iron ore. But suppose that in country A, any profits that are made from mining the ore are subject to confiscation by the government of A, while in country B, there is no such risk. How does the risk of expropriation affect the *economic* endowment of the two nations? In which nation are people richer?
2. In light of your answer to the previous question, how do you explain the fact that in some countries there is widespread political support for government policies that expropriate resources from some groups for the purpose of handing them out to other groups?
3. If the crucial factor determining a country's low standard of living is the adverse set of legal and cultural institutions it possesses, can you offer suggestions for how the other nations of the world might be helpful in permanently raising that country's standard of living?