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# WHY SOME COUNTRIES ARE RICH AND SOME ARE POOR

DOUGLASS C. NORTH\*

## INTRODUCTION

My subject is why some countries are rich and why some are poor. Let me begin with some dry facts. If you look at the way we economists measure the well-being of people in different countries, you find we usually talk about per capita income: we take the income of a country and we divide it by the population and come up with a number. This is not the best way to measure well-being, but it gives you some notion of the enormous disparities. Using these measures, we find that in the United States per capita income is around \$25,000 per person; in Mozambique it may be \$120 per person. Now, that is an extraordinary difference. In fact, it is hard to imagine how anybody could live on \$110 or \$120 a year.

The data, of course, are misleading. It is clear that we understate the well-being of people in Mozambique—whether we overstate the well-being of people in the United States is something else. But understated or not, if you visit a third world country, it is easy to see that we are talking about something very real. We are talking about human beings living in dire straits that are staggering compared to standards of living in high-income countries. It is not that we do not have poor people in our country; we do, and that is another problem. But on average, the level of material well-being is enormously different as between the developed countries, such as the United States, Japan, and the countries of Western Europe, and countries like Haiti and the countries of sub-Saharan Africa.

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Five or six hundred years ago, everyone was poor by present standards, but the difference between countries was much smaller. What has happened is that some countries, beginning with the Netherlands, then England, then some of Western Europe, and then the overseas colonies of Britain, developed. The gap between those countries and others widened and is still widening today. In fact, living standards in sub-Saharan Africa have been falling for most of the last twenty-five years, and so the disparities not only are immense but are getting worse.

Now this is puzzling; and it is puzzling because we know what makes countries rich and what makes them poor. There is no secret to it at all. What makes a country rich, very simply, is productivity. And what makes a country productive is that output per unit of input, to use the technical jargon of economics, keeps increasing. Achieving productivity growth is easy. Productivity growth comes from investing in new technology, investing in human capital for people—that is, getting people to be better educated, to be better trained, and to have better knowledge. It comes from putting those together and putting them to work.

In fact there is a new area in economics called the new growth economics, which has with great sophistication—all kinds of mathematical, wonderful formulas—shown sources of economic growth. The question is, if we know about what makes countries rich and what makes them poor, why do we have poverty in the world? The new growth economics does not answer that question. Indeed, this is one of the reasons why I continue to be such a critic of economics: if we all know what the causes of economic growth are and yet cannot produce it, something very fundamental is missing.

## I

That fundamental thing is incentives. If you go to a poor country and you look at the incentives for people to invest in knowledge, to invest in new technology, to build efficient firms, they are not there. I will give you a simple illustration. The first time I went to Peru, in the 1980s, I asked a simple question to start with. Peru, like lots of places in the world, produces textiles. I went to a textile factory and asked how long it would take to get a spare part for a particular machine. The factory owner said that if he did it legally it would take about eighteen months to obtain the permits and go through the necessary red tape. If he did it illegally and paid three or four bribes to the

customs officials, he could probably get it within two weeks. The bribes, you will notice, are the real cost of transacting and they turned out to be big numbers. The reason I use this particular illustration is because a factory in Tampa, Florida, gets the same spare part in twelve hours.

Another test is how long it takes to get a telephone installed. In most Third World countries it takes anywhere from twenty to forty months, and the telephone may not work when it is installed. You can get telephones installed in a few weeks in the United States. In a poor country, the cost of transacting and the cost of simply getting and producing things is enormously high.

From there we ask why the cost of transacting is so high, and we find that it all goes back to the rules of the game that define the way the society works—the institutions. We must, then, understand what institutions are, and why they work or do not work. Institutions are, first, the formal rules of the game. You are familiar with rules, laws, constitutions: they are written parts of the game, and they define formally the way the game is played. But institutions are much more than formal rules; they are also informal norms of behavior. We live by informal constraints, conventions, codes of conduct. Informal norms are a lot tougher to deal with because it is hard to define them, hard to measure them, and hard to see how they work. And, particularly, it is hard to change them. You can change formal rules—and I will come back to this at some length—by getting the political system to enact a new law. But how do you change norms of behavior, or codes of conduct? It is very hard to do, but is also extremely important. Institutions, thought of as just being the formal rules of the game, do not produce results very well. To take one simple illustration: when the Latin American countries became independent from Spain in the early nineteenth century, most of them adopted the United States Constitution or something very close to it. They adopted, in other words, the same formal rules. The results, however, were very different from those in the United States.

There were two reasons for the different results. First, the informal norms were very different. Second, the enforcement characteristics—what it is that institutions are—were different. To the extent that the formal rules and informal norms are not enforced, obviously they are ineffective. If you have a rule on the books that says nobody should steal, but you do not have any enforcement mechanisms, then the rule is ineffective. When you want to know

what the consequences of a set of institutions are, you are interested in the interaction between formal rules, informal norms, and the enforcement characteristics of both.

If you have on the books formal rules that define the way that the game should be played, well-defined property rights and so on, but the informal norms of behavior run counter to them, the odds are that those institutions are not going to work very well. When you have a set of institutions that work well in producing the outcomes you want, they are a mixture of formal rules that are complemented by norms of behavior and codes of conduct that extend those formal rules into everyday contexts, as well as enforcement characteristics that largely ensure that the rules and norms are lived up to.

For an analogy we can look at professional football. Professional football has formal rules that define what you can and cannot do. There are also informal norms—codes of conduct you should live up to, such as not deliberately trying to maim the quarterback on the other team. And there are enforcement characteristics: referees attempt to see that those rules are lived up to. Now, anybody who knows and watches professional football, or hockey—hockey is worse than football—or basketball, knows that you sometimes win by evading the rules, by massacring the quarterback on the other football team and so on. If the refereeing is bad, if the informal norms are such that you really do try to maim the quarterback all the time, or if the formal rules can be evaded easily, the game will be of a very different sort than a game in which you have well-defined rules that are enforced fairly effectively.

## II

You can think of the way in which institutions determine how a political and economic system works as being analogous to my description of how professional football is played. Therefore, of course, we want to have a set of institutions—rules of the game—that encourage people to be productive and creative. The question is, how do we get institutions that will provide incentives for people to be productive and creative? To find out, we must look at why human beings believe what they believe and how those beliefs get translated into institutions. After all, institutions are really the embodiment of the beliefs of those individuals who are in the position to make the rules of the game—both the formal and the informal ones.

So we ought to ask ourselves not only how do beliefs evolve, but how do they affect the way the game is played and what determines the way the game is played. Max Weber asked himself this question in the late nineteenth and early twentieth centuries. In his very famous work, *The Protestant Ethic and the Spirit of Capitalism*, Weber argued that Protestantism, as it evolved from Luther and Calvin, provided a set of attitudes and beliefs that were consistent with what he called capitalism. While it did not turn out to be that simple, there was a lot to it, particularly the notion that beliefs historically have for the most part had their origins in religion. Indeed, the religious beliefs of Confucianism in Asia and Christianity or Judeo-Christian traditions in Western Europe were carried over into other kinds of beliefs.

But the issue was broader than that. Empirical research testing the degree to which Protestantism was coextensive with the development of efficient markets has found that there certainly was a correlation in England and the Netherlands, both of which were early developers of modern economic growth. However, many other places in the world that had Catholicism—such as the Italian city-states Venice and Genoa—also developed efficient markets. So it was a broad set of religious beliefs that evolved as the Judeo-Christian tradition from about the ninth and tenth centuries on, which gradually, in different settings, provided a framework that was conducive to efficient markets. What leads to the rise of religions? How do beliefs change? I still have not answered these questions. What we are interested in is where the beliefs come from, why they have the characteristics they do, how they form, and how they change over time.

Ongoing experiments contrast belief systems that have evolved in sub-Saharan Africa and in Asia. Experimenters have found that in sub-Saharan Africa there has evolved a set of beliefs in redistributive norms—that is, beliefs that assets ought to be divided equally among people. Why did such a belief system evolve? The closest we yet have to an answer is that there is such an enormous contrast between performance characteristics of people in different settings that the acquisition of assets cannot be traced directly to deliberate effort. In such settings it was widely held that if you got rich it was because of luck and not because of skill; norms tend to evolve that lucky people ought to share their luck with everybody else. This is in contrast to the Judeo-Christian tradition or the Protestant ethic of Weber, which

viewed outcomes such as getting rich as the product of hard work, prudence, and the like.

We are beginning to understand the reasons for widely varying norms of behavior, for different belief systems and their impact. They have a direct impact: ultimately, people's beliefs determine the performance of an economy, and the degree to which we can create and put into place efficient institutions.

Economics does not have much to say about beliefs. In economics we assume everyone is rational. By rational, in its pure sense, we mean that people know what is in their self-interest and act accordingly. If that were so, we would live in a very different world. Instead, societies have stagnated; people have gotten poorer, not better off; chaos and confusion and war have led to losers over and over again throughout history. It is clear that we need to have something more than the rationality calculus to be able to make sense out of what happens to people. The rationality calculus assumes a world of enough certainty that it is possible to make choices, to confront problems and dilemmas with the ability to determine what works and what does not work and then to make choices that will improve your lot.

We live in a world full of uncertainty. That is, we have a world in which we know so little about what is going to happen that we cannot arrive at a calculus of what will happen and why—we cannot make a probability distribution of outcomes. Uncertainty differs from risk; risk means you can make a probability distribution of outcomes. We think of a world in which we have converted uncertainty into risk as one in which, for instance, we have learned enough about the environment so that we can make it probabilistic, and we can insure against the likelihood of loss, damage, or whatever it is that we are concerned with. How do we make choices in the face of uncertainty? We do it all the time. Yet when economists are confronted with making choices in the face of uncertainty, we say we cannot theorize in the face of uncertainty.

Now, I am giving you this as a dry background because what we are interested in is trying to figure out how human beings, in the face of pervasive uncertainty, go about making choices and creating the kind of institutions that will produce the results that we want. To do so, we have to understand how we learn and how the mind works. To go back to my illustration about Weber and *The Protestant Ethic* and belief systems, we must ask: how did beliefs evolve?

We say that redistributive norms evolved in Africa because the land-to-man ratio was so vast and because the climate and habitat were so uncertain that people could not figure out what would work and what would not work. Therefore, they attributed everything to luck, good fortune or bad fortune, which led to the redistributive norms. In contrast, when we think of the Protestant ethic, we think that somehow or other we evolved an understanding of the world around us so that we knew what we were doing.

### III

Again we are faced with the question of how human beings learn. There are two contrasting views about learning. One is the artificial intelligence view, which holds that the mind works like a computer—efficient, logical, and consistent. The trouble with that view is that it has no place for imagination or creativity—qualities to be seen even in four-year-old children. The second view, involved with cognitive science, is the connectionist theory view. Connectionism suggests that the mind really evolves in some sort of pattern-based reasoning. That is, the mind learns by doing. Good outcomes provide reinforcement and patterns gradually evolve. If outcomes are not good they are discarded. From this trial and error process of learning through experience, we can argue that a belief system evolves as an interplay between existing beliefs and the degree to which those existing beliefs make sense out of new problems, ideas, and experiences. That interplay is the key to the way that both individual human beings and cultures evolve. In a society that has evolved successfully, let us say the Netherlands, we see an initial set of beliefs which were receptive to new ideas and to new problems, and experiences that forced new, creative solutions. Successful economies in the Western world evolved in this way.

Avner Greif tells this story in his study of the way medieval Genoese and Magribe traders developed different ways of structuring exchange. Both were successful in the early period and both relied on personal exchange. Repetitive dealings with and personal knowledge of people meant they could be trusted to live up to their name. But then the market got bigger: both groups of traders went to Constantinople where they dealt with people in another country, with an unknown culture; further, these people would be seen only seldom.

The Genoese traders and the Magribe traders differed in their treatment of these people. The Genoese traders developed formal



rules and laws with respect to them; they held the individuals in these places liable; through notaries public they attempted to build up ways to be able to ascertain what people did in exchange, to develop formal rules with respect to liability, and indeed also to get law merchants to develop mechanisms by which to ascertain the reliability of merchants in different settings. The Magrabe traders tried to extend personal contact. This led to a dead end. Personal exchange can be successful if everybody knows each other. But as trade and commerce expanded, impersonal replaced personal exchange, and it necessitated finding ways by which to trade with people one did not know and would never see again.

Game theory illustrates the contrasting consequences of the traders. Game theory tells you that if you have a game that the players play continually, there is no end game, and they continually interact in the small numbers, then it pays to cooperate. That is, it pays to live up to the rules, to exchange fairly and honestly and so on. Conversely, if you have a game that you never play again, it is only played once, or there is an end game to it, and you have a large number of players who do not know each other's background, then it pays to lie, cheat, and steal.

The game theory story replicates the problems of getting from personal exchange, which is characterized by small-scale and relatively inefficient economies, to impersonal exchange and large-scale markets that are necessary for economic growth. Getting there is a gigantic step. The successful countries in the Western world evolved out of a mixture of beliefs and experiences that forced them to think differently from countries like the sub-Saharan African ones, where the structure of the game was one that reinforced self-sufficiency and redistributive norms—the reverse of what makes for economic growth.

We have begun to learn something about the fact that the beliefs and the way they have evolved can translate into a set of institutions, and rules of the game, that lead people to more productive and creative results.

#### IV

Now let me complicate the story in a big way. Let us consider how we move a country from being poor to getting richer. Here the story is infinitely more complicated because we have to consider path dependence. When the economy and society evolve they evolve

incrementally; the culture, which is the set of beliefs and norms and institutions that evolve, gradually changes, but in doing so it builds up a structure which is so highly articulated that it is very hard to change.

Indeed, one of the reasons that economists have not looked so brilliant in the last ten years is that they had a set of very simple definitions of what made for productivity and attempted to impose them on various countries. If the economists' views were inconsistent with the culture, values, norms, and beliefs of a society, the views were rejected, or those who ran the polity were quickly out of office—something that happened in many cases.

The problem is thus not that we do not know what makes for productivity, but how to change beliefs. That is a much more difficult task because once you are on a particular path the degree to which you can alter that path is very limited. It is limited because most of the things you want to do are inconsistent with the heritage, and culture, and beliefs in that society.

So the trick, and it is a trick, is to learn enough about the culture of a society so that you understand the way it operates, and then to look for windows of opportunity to alter the way the game is played, so that you can introduce, consistent with the culture and beliefs, new rules and norms that will encourage productive and creative activity.

Let me give you two extreme examples to show how difficult that is. The first is from Russia and the second from the Czech Republic. The Soviet Union never had a heritage of a background of beliefs or institutions that was congenial either to a market economy or to democracy. Long before Peter the Great, a society had evolved which had none of these characteristics in either beliefs or institutions. When the Soviet Union disintegrated between 1989 and 1991, the rules of the game that did exist were wiped out; all that was left was a void.

In this setting, what formal economics said to do was to introduce the rules of the game that work in developed countries. But formal rules, unaccompanied by norms of behavior that go with them, are not going to work. If they cannot be enforced they will produce very different results. When we put formal rules in what became Russia, private Mafias sprang up to enforce them. The existing norms of conduct were inconsistent with the formal rules, and the norms that gradually evolved looked more like a kleptocracy than any kind of a market economy.

Contrast Russia with the Czech Republic, which before 1948 had a thriving market economy and was a democracy. After the Soviet withdrawal in 1991, Austrian law, which had been the law before 1948, was reintroduced with modifications to effect desired changes in the legal structure and in the property rights structure. It was possible to reintroduce rules that made markets work efficiently, and it was easy to redevelop norms of behavior that were complementary to the rules, because the rules resonated with the country's past heritage.

I do not mean to tell you that the Czech Republic is an unmitigated success, although I can tell you that Russia is an unmitigated failure. But together they illustrate the tough and the easy stories we have with respect to the problems of development. We do not know how to create a political system that will produce and put into place property rights that will provide incentives for people to be productive, and put into place a judicial system that will make for low-cost enforcement of agreements and contracts, both of which are necessary conditions for getting a viable polity. We do not know how to create such a polity. We do not even know how we did it ourselves.

Here in the United States, *The Federalist* papers are probably the most interesting and thoughtful analysis of the problems of creating a polity that has ever been written. But you can put those formal rules in place and you will not necessarily get a polity that works like that at all. You have to have the formal rules, and informal norms, and enforcement characteristics together; and we do not know how to create them in the short run. When we go to Third World countries we are immediately struck by the difficulty. Sub-Saharan Africa, which is a "basket case" everywhere, is going to continue to be a "basket case" until we can create political systems that somehow or other can put into place something that will work. And while we have some clues about it and are learning a lot, we still do not know how to do it. So that is point one.

Point two is that path dependence and culture matter. Economists do not understand this. They think that path dependence and culture are neutral. But the beliefs, institutions, and norms that have evolved in society over time and the way they have evolved are enormous constraints on the way in which people today and tomorrow are going to think about problems. Therefore, there are

constraints on the degree to which the way the game is played can be changed.

Point three is a straightforward one. The only thing we can actually alter is the formal rules of the game. While it is the formal rules, the informal norms, and the enforcement characters that together define the way the game is played, we have direct control over only one—the formal rules. Therefore, we have very limited ability to make the system work better. We may change the formal rules; but unless we recognize the complex interdependence between the informal norms and enforcement characteristics and the formal rules, usually the results are unanticipated.

The final point is also very straightforward: that is, most of the time there is very little you can do in the short run. The time span in which a politician has to operate in terms of survival is maybe one or two years at most, or until the next election; the time span within which any intelligent level of reform is going to start to work is anywhere from five to fifteen years. Now it is true you may get some immediate results, but to really get fundamental reform going is a big job.

I will conclude with a brief story about a particular country to illustrate all of these problems. I have been involved with Venezuela off and on for the last five years. Venezuela is an interesting case for a very simple reason. It should be the richest country in the world, or very nearly that: it is sitting on more oil than any other country in the world except Saudi Arabia and may even have more than Saudi Arabia. It has, or had, a very efficient oil industry, which was nationalized in the 1970s and became an efficiently-run government monopoly. Yet Venezuela has remained a poor country—and the inequality in income is one of the highest in the world. It has remained a poor country partly because people tried to capture rents from the oil industry and did very little else.

The interesting part of the story begins in 1990 when a man named Perez was elected president. He introduced liberal market reforms in Venezuela. The rate of growth in the economy, which had been negative in 1988–1989, grew to seven percent in 1990, and to nine percent in 1991. Success story? In 1993, Perez was out of office and under house arrest. What had happened was that in 1991, the price of gasoline was raised from eight cents to twelve cents a gallon. The result was riots in which three hundred people were killed. In 1992 the military undertook a coup to replace Perez. A man named

Chavez led this military coup; while the coup failed and Chavez went to jail, nevertheless it had an effect. Another coup in late 1992 ended the Perez regime and Perez was under house arrest for corruption.

That is not the end of the story. Chavez got out of prison after three years; in 1998, he ran for president of Venezuela and was elected with a sixty-eight percent majority. Since then he has wiped out political institutions; but he must put in place a whole new structure. Now he is in the fortunate position of having oil as a base on which to be able to build this structure. But without an understanding of the very difficult problem of implementing and creating a set of new institutions that will complement the historical traditions of Venezuela, put in place productive activity, and use oil as a fulcrum by which one can start to make the economy work again, he is bound to fail.

Can he be successful? Well, he probably could be if he is given ten to fifteen years. The reason why I am ending with this story is because you can all watch for yourselves and see what happens. Chavez probably has a better chance of success than a leader in any other place that I know of because he has, initially, the potential income from oil to be able to use as a lever—unlike Haiti, for example, which has nothing to build on. In the next few years he will either take an economy that should, by any rights, be good and restructure the game so that it can be viable, or he will not.

The reason Venezuela is particularly interesting is that Chavez does have a window of opportunity. His popularity is unequalled in the history of politics, so he has political moxie to be able to restructure the game. He claims that he understands the basic kinds of institutions that must be created to make the society more productive. We will see whether in fact he succeeds.

### CONCLUSION

We know what makes for rich countries. We know the characteristics of productivity. We even know the kinds of institutions that must be put in place. The rule of law, property rights that provide incentives for people to be productive, and investment in human capital: all of these are necessary. We know all of this; but we do not know how to put in place the formal rules of the game accompanied by the informal rules and enforcement characteristics that are necessary for success.