1 Introduction

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Why do some nations become rich while others remain poor? This has been a central question in economics since at least the time of Adam Smith. China, India, and Botswana are booming and in the process lifting hundreds of millions of people out of wretched poverty, while most of sub-Saharan Africa not only fails to get rich but is instead actually getting poorer.

Traditional mainstream economic growth theory doesn't help us much to answer this question—through most of the twentieth century it focused on models that assumed growth is a simple function of labor, capital, and technology. The new growth theory, of which this book is part, looks more to institutions and policy. How well does a nation protect its entrepreneurs? In what countries do you get rich by inventing a new product, and in what countries do you get rich by wresting control of government from your rivals?

Entrepreneurs drive the market toward efficient outcomes by exploiting profit opportunities and causing the market process to tend toward equilibrium (Kirzner 1973). Entrepreneurs also play a central role in the market's process of creative destruction, whereby new innovations constantly replace old technologies and send the market on a path toward a new equilibrium (Schumpeter 1934). The interaction of these two roles of the entrepreneur drives the process of economic development.

Entrepreneurs exist in almost all cultures and historical contexts. Why, then, doesn't the process of economic development occur in all countries equally? Human decision making responds to perceived costs and benefits, and not all societies have an environment that rewards productive entrepreneurship. Look at the case of imperial China. A brilliant young man would devote all of his energies to studying law in preparation for the exams that gave entrance into the upper echelons of the ruling bureaucracy. That same young man today may study electrical engineering with the dream of one day opening his own firm because now Chinese businessmen can earn greater prestige and profits than they could in the past. In which society should we expect greater economic growth?

In recent years the economics profession and policy world have begun to pay more attention to the institutional environment necessary for economic growth. Geography and other explanations for success have begun to be pushed aside as institutions have become increasingly recognized as the main driver of economic success (Rodrik, Subramanian, and Trebbi 2004). Some in the profession have moved toward detailed analytical narratives to explain individual cases in economic development. There has also been a virtual explosion in research measuring economic freedom and using it to explain economic performance. In Washington, DC, people in policy circles now generally, though incompletely, acknowledge the need for private property rights and the rule of law for economic development.

Making Poor Nations Rich seeks to push the current debate further in the direction of an appreciation for the critical role that entrepreneurs and the institutional environment of private property rights and economic freedom play in economic development. The book begins by collecting the key essays that explain how entrepreneurs create economic growth and why some particular institutional environments encourage more productive entrepreneurship than do others. Part 1 ends with a chapter explaining the overall empirical findings on the importance of economic freedom for prosperity. With the theoretic underpinning and overall empirical results in place, the final two parts of the book provide detailed case studies of individual countries and regions by examining the institutional environment that entrepreneurs operate in and the effect this environment has on economic prosperity. Part 2 focuses on countries and regions that have failed to develop because of barriers to produc-

tive entrepreneurship. Part 3 contains case studies of countries that have developed by reforming their institutional environment to better protect private property rights and grant greater levels of economic freedom.

This book is similar to Rodrik's edited volume *In Search of Prosperity*. Both books employ an analytical narrative approach using case studies. Both find that institutions are important for development. This book differs from Rodrik's by emphasizing the primary importance of entrepreneurship and what specific type of institutional environment is necessary for encouraging the productive entrepreneurship that promotes growth. This is most evident in our three country studies, Botswana, China, and India, which overlap with Rodrik's volume. In each case, the authors in this book illustrate more forcefully the primacy of reforms that promoted property rights and enhanced economic freedom in creating growth in these countries.

This book begins by examining alternative explanations for the vast differences in wealth around the world. In Chapter 2 Mancur Olson begins with the standard economic assumption that any economic gains that can be had are exploited. He pushes the argument to its logical conclusion that "what is, is efficient." However, when one looks around the world and sees the dramatically differing standards of living between countries it seems unlikely that the most efficient policies are in place everywhere. Olson identifies two possible explanations for the differing economic performance of countries. The first is that national borders may mark areas of differing resource endowments. Poor countries are poor because they lack land and natural resources, physical and human capital, or access to the latest technology. If differences in these endowments explain the differing performances, then poor countries are, in fact, doing as well as they can given their endowment. The second possible explanation is that national boundaries mark the borders of public policies and different institutional environments. Some of these policies and institutions are better than others. In those that are better, more profit opportunities are seized, whereas those with poor institutions leave potential gains from trade unexploited—big bills are left on the sidewalk.

Olson first deals with the possibility of each of the differing resource endowments as the explanation for differing economic performance. He finds that differing access to knowledge is not an adequate explanation. In Korea royalties and other payments for disembodied technology were

minuscule—less than one-thousandth of GDP. If knowledge can be had so cheaply it is not likely to be holding countries back from developing. The standard assumption that knowledge is equally available to all countries is well founded.

Olson finds that overpopulation and diminishing returns to labor do not cause differences in performance. If they did, we should find countries with net out-migration converging in incomes with countries with in-migration. We do not. Furthermore, population density does not explain differing performance. Many of the most densely settled countries in the world have high per capita incomes.

What about differences in capital? With diminishing returns to capital we should see capital flow from capital-rich countries to capital-poor countries. As Olson puts it, "Capital should be struggling at least as hard to get into the third world as labor is struggling to migrate into the high-wage countries" (p. 38). Instead, we see the lion's share of capital in a few wealthy nations, and we see capital continue to flow to these countries. Labor and capital often migrate in the same direction, but if all countries had the most efficient policies they should move in opposite directions due to diminishing returns. Olson drives home the point that something else, namely institutions, is driving the flow of capital, so a country's capital stock cannot be taken as exogenous in explaining economic performance. Other research, such as Hall and Jones (1999), has followed up on this point by creating measures of institutional quality and finding that institutions do, as Olson predicts, play a major role in the accumulation of capital and achievement of growth.

Next he looks at human capital and divides it into two parts: "marketable human capital" and "public good human capital." Marketable human capital reflects the skills, propensities, or cultural traits that affect the quantity and quality of productive inputs that an individual can sell in the market. Public good human capital is knowledge about what types of public policies are good. Migration allows us examine each of these separately and see which is more important for explaining differing economic performances between countries. When people migrate, they take both forms of human capital with them. However, only the marketable human capital impacts performance in the new country. Because even large migrations do not dramatically alter the public policy outcomes in the new country, we can isolate the effects of each type of human capital.

What do we find? New immigrants earn about 55 percent of the income of an American of the same age, sex, and years of schooling, whereas many come from countries whose incomes per capita are only one-tenth or one-fifth as large as America's. Cut a different way, we can look at two immigrant groups in America—one from a rich country and one from a poor country—and see what the gap between their incomes is. Germany is much richer than Haiti. If this difference existed because Germans are better educated or smarter than Haitians, then we would expect German immigrants in the United States to also be much richer than Haitian immigrants. But Haitians and Germans in the United States have much closer income levels than do Haitians and Germans in their home countries. It's not the people that differ; it's the institutions.

Olson's overall finding is that "the large differences in per capita income across countries cannot be explained by differences in access to the world's stock of productive knowledge or to its capital markets, by differences in the quality of marketable human capital or personal culture." The only plausible explanation left is that differing performances are caused by differences in the quality of countries' institutions and policies. There are big bills left on the sidewalk. If a country improves its institutions, it can pick up these bills.

In Chapter 3, "Entrepreneurship and Economic Growth," Randall Holcombe describes the process that creates profit opportunities that lead to economic growth. He provides the theoretic underpinning of a central theme in this book: the importance of entrepreneurs for economic growth. Instead of viewing growth merely as a function of inputs, Holcombe argues that "Smithian growth," in which the division of labor is limited by the extent of the market, is a better description of real-world development. As markets grow, this growth leads to continual innovation and specialization in the division of labor. Growth is essentially unlimited. What is the mechanism that causes more innovation to occur? Holcombe introduces the Kirznerian (1973) entrepreneur for this purpose.

The Kirznerian entrepreneur seizes profit opportunities that had previously gone unnoticed. Although Kirzner used the entrepreneur to explain how the market process attains a particular equilibrium, Holcombe connects the entrepreneur to economic growth. The profit opportunities that the entrepreneur seizes must come from somewhere. As Olson pointed out, profit opportunities do not last very long before they are

grasped in a market economy. Most profit opportunities that are acted on must be new. Where do they come from? Holcombe argues that the profit opportunities that entrepreneurs seize come mainly from the actions of other entrepreneurs. Individual acts of entrepreneurship create new profit opportunities for other entrepreneurs to act on.

Holcombe argues that entrepreneurial opportunities emerge from the actions of other entrepreneurs for at least three reasons. One reason is that even in a general equilibrium setting, any change made by one entrepreneur necessarily alters the economic environment and will require additional adjustments by other entrepreneurs to attain a new equilibrium. A second source of opportunities comes from the fact that entrepreneurial activity generates wealth and increases the extent of the market. The third source of opportunities comes through the creation of market niches that did not previously exist. New entrepreneurs enter and expand a market niche after it is created. All of these entrepreneurial opportunities come into being because of prior acts of entrepreneurship. As Holcombe puts it in one example, "Bill Gates could not have made his fortune had not Steve Jobs seen the opportunity to build and sell personal computers, and Steve Jobs could not have built a personal computer had not Gordon Moore invented the microprocessor" (p. 61).

What are the implications of Holcombe's model of entrepreneurial growth? Maybe most important, the implication is that growth is not limited. As long as entrepreneurs make innovations, there will be new opportunities for others. Another implication is that just forcing education, investment, or research and development into a production function will not necessarily improve growth. Instead, these things occur in response to entrepreneurial opportunities. The more opportunities there are, the greater incentive there is to search for them by engaging in these activities. How can we explain differing economic performances of countries? The differences must lie in the entrepreneurial opportunities that are available and hence the new ones that will be created. Holcombe links Kirzner's entrepreneur with Friedrich Hayek's (1945) emphasis on the particular knowledge of time and place. Because opportunities arise in this context, people must be free to act on them and seize the profits when they see them. So a decentralized free economy will likely lead to more entrepreneurial opportunities. After they are seized entrepreneurship builds on itself and acts as an endogenous engine of economic growth. Holcombe

does not elaborate very much on the institutional structure that is necessary for entrepreneurial development. For that we turn to Chapters 4 and 5.

Chapter 4 builds on Holcombe's and Olson's insights by examining how the cultural and policy environment impacts the allocation of entrepreneurial activity. William Baumol begins with Schumpeter's five types of entrepreneurial acts—introducing a new good; introducing a new method of production; opening a new market; discovering a new source of supply of raw material or intermediate good; and carrying out the new organization of an industry—and then adds rent seeking as a sixth type of entrepreneurial activity. The rent seeking may take the form of lobbying regulators or legislators for favors, suing in the courts to harm competitors, or conducting military activity. Baumol observes that, unlike the other forms of entrepreneurship, rent-seeking activity is not socially beneficial. He argues that differing economic performances of countries can be explained in part not by the total supply of entrepreneurial activity but rather by the allocation of entrepreneurial efforts among these activities. He further argues that the allocation of entrepreneurship is influenced by the institutions in society. Countries with cultures and economic policies that reward unproductive entrepreneurship will channel more of their entrepreneurial effort to those activities, and consequently the economies will perform poorly. He neatly summarizes his main argument in three propositions.

1. The rules of the game that determine the relative payoffs to different entrepreneurial activities do change dramatically from one time and place to another.
2. Entrepreneurial behavior changes direction from one economy to another in a manner that corresponds to the variations in the rules of the game.
3. The allocation of entrepreneurship between productive and unproductive activities, though by no means the only pertinent influence, can have a profound effect on the innovativeness of the economy and the degree of dissemination of its technological discoveries.

Baumol illustrates the importance of these propositions by briefly surveying a variety of historic episodes. He shows that in ancient Rome

persons of honorable status could accumulate wealth through land holding, usury, and political payments but not through industry or commerce. Though productive entrepreneurship was rewarded with financial gains, those gains were partially offset by the loss of prestige. Baumol argues that this situation made the Romans divert more entrepreneurial effort to unproductive political entrepreneurship. The result was that although the Romans had a great deal of technical knowledge, such as many forms of machine gearing still used today and the steam engine, this knowledge was not translated into commercial gain and instead often amounted to "elaborate toys." A similar claim is made for medieval China. Prestige and wealth came with attaining a high rank in the bureaucracy, whereas high social standing was denied to people engaged in commerce. Instead of efforts being focused on serving consumers, efforts were focused on scoring well on the exams that were used to allocate bureaucratic positions. The result, much like the Romans, was a squandered chance at an industrial revolution.

As was done for Rome and China, many periods of history in Europe from the Middle Ages through the Industrial Revolution are examined to see how the changing rules of the game and cultural norms impacted the allocation of entrepreneurial activity. The historical episodes considered lend support to Baumol's three main propositions.

The chapter's main contribution—that entrepreneurs respond to incentives and that rules of the game that reward unproductive entrepreneurship will harm economic performance—seems intuitive and obvious. Yet this contribution has strong policy implications. Countries performing poorly may have cultural attitudes that punish some forms of productive entrepreneurship, but they also likely have poor economic institutions that bias entrepreneurial innovation toward unproductive activities. To improve economic performance all they need to do is change the rules of the game that govern economic activity. As Chapter 5 will show, the rules of the game that promote productive entrepreneurship are rules that protect private property and promote economic freedom.

Chapter 5, "Economic Freedom and Property Rights: The Institutional Environment of Productive Entrepreneurship," provides the bridge between our more theoretical chapters and the case studies that follow. The central message of Chapters 2 through 4 is that a country's institutional environment is an important determinant of its economic

performance. This chapter, by Robert Lawson, describes the environment necessary for economic growth—economic freedom and property rights—and then systematically examines the evidence and literature to support his claim.

Although we understand intuitively what economic freedom entails—namely, private ownership, personal choice, voluntary exchange, and free entry into markets—it is not easily objectively quantifiable. The *Economic Freedom of the World* report, published annually by the Fraser Institute (and co-authored by Lawson), is the most widely used scholarly index that attempts to measure economic freedom. In this chapter the index and the scholarly literature based on it are used to show that economic freedom is correlated with prosperity.

Some of the chapter's main findings are that higher levels of economic freedom are associated with

- Higher levels of per capita income
- Higher rates of economic growth
- Higher levels of entrepreneurial activity
- Higher rates of domestic investment
- Larger amounts of foreign investment attracted
- Longer life expectancies
- Better access to safe water

One finding in particular fits very well with Olson's message from Chapter 2. Not only do levels of economic freedom matter, but also changes in freedom matter. Countries that improve in economic freedom, regardless of their initial position, tend to grow faster than other countries. This fact is consistent with Olson's description of how big bills that are left on the sidewalk are quickly picked up. Countries initially well inside their production possibilities frontier enact policies that move them closer to the frontier. In the process, a number of profit opportunities that were previously just sitting ungrasped on the sidewalk because of institutional barriers now become available, and economic growth increases while they are acted on. Although this chapter reviews the overall empirical relationship, it also identifies some of the countries that have improved the most in recent years. A number of them—Botswana, China, India, Ireland, and New Zealand—are the subjects of later chapters in this book.

The overall message of this chapter is quite clear. "After over a decade of research, the empirical evidence is overwhelmingly clear: Societies that organize themselves with private property, rule of law, and free markets outperform, on almost every measurable margin, societies that are less economically free" (p. 131).

It is with this message in mind that we turn to the case studies presented in this book. In each case study a particular country or region of the world is examined in detail. Looking at each on an individual basis allows us to examine the precise policy changes that have occurred in each area and how they have impacted economic performance. We first look at countries and regions where a poor institutional environment has prevented entrepreneurs from promoting sustained economic growth. Then we turn to success stories about countries that have improved their institutions and economic performance.

1. Failures in Entrepreneurial Development

Africa has been the biggest failure in the quest for economic development during the last fifty years. Africa is mired in poverty, famine, disease, and illiteracy. Not only are most African countries extremely poor, but also they're getting poorer. Since 1975 sub-Saharan Africa has averaged a 1 percent annual decrease in per capita GDP. In Chapter 6 George Ayittey explains the causes of Africa's problems and how development efforts could be more successful.

Under colonial rule African institutions contained elements of capitalism, but they were far from perfect. They often focused on resource extraction rather than development. After gaining independence many African countries rebelled against all things colonial—including capitalism. Africa's problems stem from embracing socialist ideologies after independence. Ayittey argues that the failure of socialist policies led to African governments transforming into what he terms "vampire states." The vampire state exists only to enrich the rulers. The general population has little or no say in state activities, finding themselves impoverished as the rulers suck the wealth from the economy. Ayittey argues that these states follow a general pattern of evolution to their own collapse. As people begin to exit and move into the informal economy, governments resort to inflation to raise revenue. As the situation of the population deteriorates,

the people eventually rise up and rebel. Then the struggle for political power eventually plunges the country into civil war.

The West has played a role in prolonging Africa's poverty through aid sent to leaders of these vampire states and through programs that have displaced indigenous institutions.

Ayittey argues that Africa needs investment in order to develop but that to get investment Africa needs an enabling economic environment. This environment includes property rights, incentives, rule of law, and freedom. How can Africa get it? We must first stop the aid/reform dance with African leaders who continually game Western donors. Instead, we must fundamentally change our view of Africa. We must distinguish between modern Africa and traditional Africa. Much of the African population works in the traditional and informal sectors. These are the sectors that had sustained Africa for centuries and that have been neglected or squashed by the modern African states that have developed in the postcolonial period. Ayittey argues that the modern sector is nonreformable. What is to be done with it? Instead of sending African governments more aid, "The rogue African state should be left to the fate it deserves—implosion and state collapse" (p. 173). Instead, development assistance should be channeled to the informal sectors where the majority of Africans live. He argues that we need to have a "bottom-up" approach to development rather than a "top-down" approach. Instead of looking to African elites, we should look to the free enterprise spirit of the general population and help them foster the institutions necessary to create the right environment for attracting investment and growth.

Much of Latin America has also experienced disappointing levels of economic growth. Much like Africa, natural resources abound, yet development lacks. It is a region characterized by state power, political instability, corruption, and poverty for the masses. In Chapter 7 Alvaro Vargas Llosa explains the region's colonial history, twentieth-century policies, and more recent attempts at reform. Overall, he summarizes the region's history as a mix of corporatism, state mercantilism, privilege, wealth transfer, and political law and argues that these have caused the region's poverty.

Although Latin American peasants had little access to landed property and trade during the colonial period, they have not fared much better since. Vargas Llosa argues that land reform after independence did not lead to full private property rights but that instead the new states

became the real owners in most cases. The dominant postindependence institutional environment could be better classified as economic nationalism than as property rights and economic freedom. Leaders believed that their countries were at a structural disadvantage because rich nations "monopolized" capital and technology and Latin American exports would not earn enough foreign exchange to pay for the capital needed to improve living standards. He argues that leaders implemented barriers to imports, subsidies, legal discrimination, and even nationalization of certain industries to "correct" for their structural disadvantage. The result was continually lagging economic performance. Overall, economic nationalism was just a new way of doing what was done before in Latin America: draining resources from ordinary people to sustain those living off government privilege.

The 1980s and 1990s promised to be a period of reform in Latin America. With the exception of Chile, Vargas Llosa maintains that there was only the mirage of reform. As state assets were sold off, the revenue was used to make unsustainable increases in government spending in many countries. Although some effort was made to reform monetary and fiscal policies, reforms were often offset with new interventions into the economy. As he puts it, "reform meant replacing inflation with new taxes, high tariffs with regional trading blocs, government monopolies with private monopolies, price controls with regulatory bodies" (p. 202). In one particularly crucial area, the judiciary, Vargas Llosa maintains that there was negligible reform. He argues that the judiciary in Latin America is just a corrupt arm of the government, not a limit on political power or a safeguard of individual rights.

Latin America experienced essentially no economic growth between 1989 and 2004 because of the various institutional impediments to development. Vargas Llosa concludes his chapter with a discussion of a few of the areas where reforms could help reverse Latin America's five hundred years of state oppression and begin to promote the growth that will lift ordinary people out of poverty.

With the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991, hopes were high that the former Communist bloc would embrace markets and converge to western Europe's standard of living. Some eastern European countries have been relatively successful at reforming their economies. Others have not. In Chapter 8 Peter Boettke,

Christopher Coyne, and Peter Leeson explain Romania's relatively unsuccessful transition to a market economy by examining the incentives facing entrepreneurs. Consistent with Baumol's (1990) theory, they show that unproductive entrepreneurship is better rewarded than productive entrepreneurship in Romania.

The chapter identifies Romania's excessive and continually changing regulatory environment as a main cause of unproductive entrepreneurship. In a World Bank survey 86 percent of respondents claimed that "constant changes in the laws and regulations are a main obstacle to doing business." The constant changes stem in part from "emergency ordinances" that are immediately active executive decrees. In some years these decrees account for more than 50 percent of all new laws. A constantly fluctuating legal and regulatory environment makes it hard for entrepreneurs to do long-term business planning in the aboveground market. The widespread corruption in government courts also raises the costs of operating in the aboveground market, as do the bribes that must be paid to regulators. Overall, Transparency International found Romania was the third most corrupt country in Europe. The extensive system of bribes and the changing regulatory framework lower the benefits of participating in aboveground productive activities and simultaneously divert entrepreneurs to unproductive activities by making it more profitable to try to become one of the system's administrators. The chapter argues that due to other factors such as financing availability, a poorly functioning land market, and distance from the political center, the entrepreneurial environment is even worse in rural areas of the country.

For Romania to develop it will need to promote an environment of more productive entrepreneurship. Enacting judicial and regulatory reforms, as well as aligning de jure and de facto property rights, is one of the most urgently needed changes. Whether the failure of past policies or membership in the European Union will be enough to induce the needed reforms is yet to be determined.

Sweden is the final case of failed economic development policy that we examine. It may at first seem strange to consider Sweden a case of development failure because it has a relatively high per capita income and is often used as an example of a successful interventionist state. However, in Chapter 9 Dan Johansson shows that most of Sweden's growth occurred before it implemented a comprehensive welfare state and that since the

rise of the welfare state rates of entrepreneurial creation and economic growth have fallen.

From 1870 to 1970 Sweden was one of the fastest-growing countries in the world. In 1970 it was the fourth-richest country in the Organisation for Economic Co-operation and Development (OECD), but three decades later it had fallen below the median country to fourteenth. This fall coincides with the creation of the Swedish welfare state. Swedish tax revenues as a percent of GDP were lower than those of both the United States and Britain until the end of the 1950s. By 1970 they had increased to 40 percent of GDP and to 50 percent by 1976. This high level of taxation has remained to the present.

Johansson argues that regulations and the financing of the Swedish welfare state put up barriers to entrepreneurship that inhibited economic growth. He finds that many industries are off-limits to entrepreneurs because they are reserved for the government. Very high real tax rates have often made entrepreneurial action unprofitable even when ventures would have been nominally profitable. The tax system is also biased against young, small, independent, and less-capital-intensive firms. Yet these are the types of firms that promote much new growth. Wealth is also taxed, and by 1990 Sweden's wealth per capita stood at about $13,000 or roughly 17 percent of the U.S. level. New firm formation has been limited because wealth per capita is important to enable start-ups. Plus, private markets play only a limited role in directing wealth flows because the bulk of Swedish savings is tied up in compulsory pension savings. Labor market rigidities also stifle the willingness of new firms to hire employees.

All of this taxation and regulation has limited new job creation. The total population has increased by about two million since 1950, but only 155,000 new jobs have been created in the private sector, while 770,000 have been created in the public sector. Not surprisingly, Johansson finds that entrepreneurial activity is lower in Sweden than in other countries. In a survey of thirty-four countries Sweden had the sixth-lowest share of its population engaged in entrepreneurial activity.

Overall, Johansson's chapter demonstrates that Sweden is not an example of high growth and a pervasive welfare state. He finds that Sweden grew before it had its welfare state and that because of interventions that harm small and fast-growing firms Swedish economic growth has slowed.