



Institutions Matter, but Not for Everything

The role of geography and resource endowments in development shouldn't be underestimated

Jeffrey D. Sachs

THE DEBATE over the role of institutions in economic development has become dangerously simplified. The vague concept of “institutions” has become, almost tautologically, the intermediate target for all efforts to improve an economy. If an economy is malfunctioning, the reasoning goes, something must be wrong with its institutions. In fact, recent papers have argued that institutions explain nearly everything about a country's level of economic development and that resource constraints, physical geography, economic policies, geopolitics, and other aspects of internal social structure, such as gender roles and inequalities between ethnic groups, have little or no effect. These papers have been written by such respected economists as Daron Acemoglu, Simon Johnson, and James Robinson; Dani Rodrik, Arvind Subramanian, and Francesco Trebbi; and William Easterly and Ross Levine.

Indeed, a single-factor explanation of something as important as economic development can be alluring, and the institutions-only argument has special allure for two additional reasons. First, it attributes high income levels in the United States, Europe, and Japan to allegedly superior social institutions; it even asserts that when incomes rise in other regions, they do so mainly because of the Western messages of freedom, property rights, and markets carried there by intrepid missionaries intent on economic development. Second, according to the argument, the rich world has little, if any, financial responsibility for the poor because development failures are the result of institutional failures and not of a lack of resources.

The problem is that the evidence simply does not support those conclusions. Institutions may matter, but they don't matter exclusively. The barriers to economic development in the poorest countries today are far more complex than insti-

tutional shortcomings. Rather than focus on improving institutions in sub-Saharan Africa, it would be wise to devote more effort to fighting AIDS, tuberculosis, and malaria; addressing the depletion of soil nutrients; and building more roads to connect remote populations to regional markets and coastal ports. In other words, sub-Saharan Africa and other regions struggling today for improved economic development require much more than lectures about good governance and institutions. They require direct interventions, backed by expanded donor assistance, to address disease, geographical isolation, low technological productivity, and resource limitations that trap them in poverty. Good governance and sound institutions would, no doubt, make such interventions more effective.

When economic growth fails

When Adam Smith, our profession's original and wisest champion of sound economic institutions, turned his eye to the poorest parts of the world in 1776, he did not so much as mention institutions in explaining their woes. It is worth quoting at length from Smith's *Wealth of Nations* on the plight of sub-Saharan Africa and central Asia, which remain the world's most troubled development hot spots:

All the inland parts of Africa, and all that part of Asia which lies any considerable way north of the Euxine and Caspian seas, the ancient Scythia, the modern Tartary and Siberia, seem in all ages of the world to have been in the same barbarous and uncivilised state in which we find them at present. The Sea of Tartary is the frozen ocean which admits of no navigation, and though some of the greatest rivers in the world run through that country, they are at too great a distance from one another to carry commerce

and communication through the greater part of it. There are in Africa none of those great inlets, such as the Baltic and Adriatic seas in Europe, the Mediterranean and Euxine seas in both Europe and Asia, and the gulfs of Arabia, Persia, India, Bengal, and Siam, in Asia, to carry maritime commerce into the interior parts of that great continent: and the great rivers of Africa are at too great a distance from one another to give occasion to any considerable inland navigation. (Book I, Chapter III)

Smith's point is that Africa and central Asia could not effectively participate in international trade because transport costs were simply too high. And, without international trade, both regions were condemned to small internal markets, an inefficient division of labor, and continued poverty. These disadvantages of the hinterland exist to this day.

Smith couldn't know the half of it. The problems of African isolation went far beyond mere transport costs. Characterized by the most adverse malaria ecology in the world, Africa was as effectively cut off from global trade and investment by that killer disease. Although the disease ecology of malaria was not understood properly until two centuries after Adam Smith, what was known demonstrated that Africa's suffering was unique. It had a climate conducive to year-round transmission of malaria and was home to a species of mosquito ideally suited to transmitting malaria from person to person. When Acemoglu, Johnson, and Robinson find that the high mortality rates of British soldiers around 1820 in various parts of the world correlate well with the low levels of GNP per capita in the 1990s, they are discovering the pernicious effects of malaria in blocking long-term economic development.

The ability of a disease to cut off economic development may seem surprising to some but reflects a lack of understanding of how disease can affect economic performance. Thus, in writing that malaria has a limited impact in sub-Saharan Africa because most adults have some acquired immunity, Acemoglu, Johnson, and Robinson completely neglect the fact that the disease dramatically lowers the returns on foreign investments and raises the transaction costs of international trade, migration, and tourism in malarial regions. This is like claiming that the effects of the recent SARS (Severe Acute Respiratory Syndrome) outbreak in Hong Kong SAR can be measured by the number of deaths so far attributable to the disease rather than by the severe disruption in travel to and from Asia.

In an environment in which capital and people can move around with relative ease, the disadvantages of adverse geo-

graphy—physical isolation, endemic disease, or other local problems (such as poor soil fertility)—are magnified. It is probably true that when human capital is high enough in any location, physical capital will flow in as a complementary factor of production. Skilled workers can sell their outputs to world markets almost anywhere, over the Internet or by plane transport. Landlocked and at a high altitude, Denver can still serve as a high-tech hub of tourism, trade, and information technology. But when countries that are remote or have other problems related to their geography also have few skilled workers, these workers are much more likely to emigrate than to attract physical capital into the country. This is true even of geographically remote regions within countries. For example, China is having great difficulty attracting investments into its western provinces and is instead facing a massive shift of labor, including the west's few skilled workers, to the eastern and coastal provinces.

Recent history, then, confirms Smith's remarkable insights.

Good institutions certainly matter, and bad institutions can sound the death knell of development even in favorable environments. But poor physical endowments may also hamper development. During the globalization of the past 20 years, economic performance has diverged markedly in the developing world, with countries falling into three broadly identifiable categories. First are the countries, and regions within countries, in which institutions, policies, and geography are all reasonably favorable. The coastal regions of east Asia (coastal China and essentially all of Korea, Taiwan Province of China, Hong Kong SAR, Singapore, Thailand, Malaysia, and Indonesia) have this beneficial combination and, as a result, have all become closely integrated with global production systems and benefited from large inflows of foreign capital.

Second are the regions that are relatively well endowed geographically but, for historical reasons, have had poor governance and institutions. These include the central European states, whose proximity to Western Europe brought them little benefit during the socialist regime. For such countries, institutional reforms are paramount. And, finally, there are impoverished regions with an unfavorable geography, such as most of sub-Saharan Africa, central Asia, large parts of the Andean region, and the highlands of Central America, where globalization has not succeeded in raising living standards and may, indeed, have accelerated the brain drain and capital outflows from the region. The countries that have experienced the severest economic failures in the recent past have all been characterized by initial low levels of income and small populations (and hence small internal markets) that

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Bauxite spills from chutes into freight wagons in Ghana. Despite being well endowed with natural resources, Ghana remains heavily dependent on international financial and technical assistance.

live far from coasts and are burdened by disease, especially AIDS, tuberculosis, and malaria. These populations have essentially been trapped in poverty because of their inability to meet the market test for attracting private capital inflows.

When institutions and geography matter

It is a common mistake to believe—and a weak argument to make—that geography equals determinism. Even if good health is important to development, not all malarial regions are condemned to poverty. Rather, special investments are needed to fight malaria. Landlocked regions may be burdened by high transport costs but are not necessarily condemned to poverty. Rather, special investments in roads, communications, rail, and other transport and communications facilities are even more important in those regions than elsewhere. Such regions may also require special help from the outside world to initiate self-sustaining growth.

A poor coastal region near a natural harbor may be able to initiate long-term growth precisely because few financial resources are needed to build roads and port facilities to get started. An equally poor landlocked region, however, may be stuck in poverty in the absence of outside help. A major project to construct roads and a port would most likely exceed local financing possibilities and may well have a rate of return far below the world market cost of capital. The market may be right: it is unlikely to pay a market return to develop the hinterland without some kind of subsidy from the rest of the world. Nor will institutional reforms alone get the goods to market.

In the short term, only three alternatives may exist for an isolated region: continued impoverishment of its popula-

tion; migration of the population from the interior to the coast; or sufficient foreign assistance to build the infrastructure needed to link the region profitably with world markets. Migration would be the purest free market approach, yet the international system denies that option on a systematic basis; migration is systemically feasible only within countries. When populations do migrate from the hinterlands, the host country often experiences a political upheaval. The large migration from Burkina Faso to Côte d'Ivoire was one trigger of recent ethnic riots and civil violence.

A fourth and longer-term strategy that merits consideration is regional integration: a breaking down of artificial political barriers that limit the size of markets and condemn isolated countries to relative poverty. In this regard, the recent initiative to strengthen subregional and regional cooperation in Africa should certainly be supported. Yet, given political realities, this process will be too slow, by itself, to overcome the crisis of the poorest inland regions.

A good test of successful development strategy in these geographically disadvantaged regions is whether development efforts succeed in attracting new capital inflows. The structural adjustment era in sub-Saharan Africa, for example, was very disappointing in this dimension. Although the region focused on economic reforms for nearly two decades, it attracted very little foreign (or even domestic) investment, and what it did attract largely benefited the primary commodity sectors. Indeed, these economies remained almost completely dependent on a few primary commodity exports. The reform efforts did not solve the underlying fundamental

problems of disease, geographical isolation, and poor infrastructure. The countries, unattractive to potential investors, could not break free from the poverty trap, and market-based infrastructure projects could not make up the difference.

Helping the poorest regions

Development thinking and policy must return to the basics: both institutions and resource endowments are critical, not just one or the other. That point was clear enough to Adam Smith but has been forgotten somewhere along the way. A crucial corollary is that poverty traps are real: countries can be too poor to find their own way out of poverty. That is, some locales are not favorable enough to attract investors under current technological conditions and need international help in even greater amounts than have been made available to them in recent decades.

An appropriate starting point for the international community would be to set actual developmental goals for such regions rather than “make do” with whatever economic results emerge. The best standards, by far, would be the Millennium Development Goals, derived from the international commitments to poverty alleviation adopted by all countries of the world at the UN Millennium Assembly of September 2000. The goals call for halving the 1990 rates of poverty and hunger by the year 2015 and reducing child mortality rates by two-thirds. Dozens of the poorest countries—those trapped in poverty—are too far off track to achieve these goals. Fortunately, at last year’s UN Financing for Development Conference held in Monterrey, Mexico, and at the World Summit on Sustainable Development held in Johannesburg, South Africa, the industrial world reiterated its commitment to help those countries by increasing debt

relief and official development assistance, including concrete steps toward the international target of 0.7 percent of donor GNP. The extra \$125 billion a year that would become available if official development assistance were raised from the current 0.2 percent of GNP to 0.7 percent of GNP should easily be enough to enable all well-governed poor countries to achieve the Millennium Development Goals. Like official development assistance, debt-relief mechanisms have been wholly inadequate to date.

Armed with these goals and assurances of increased donor assistance, the international community, both donors and recipients, should be able to identify, for each country and in much greater detail than in the recent past, those obstacles—whether institutional, geographical, or other (including barriers to trade in the rich countries)—that are truly impeding economic development. For each of the Millennium Development Goals, detailed interventions—including their costs, organization, delivery mechanisms, and monitoring—can be assessed and agreed upon by stakeholders and donors. By freeing our thinking from one-factor explanations and understanding that poverty may have as much to do with malaria as with the exchange rate, we will become much more creative and expansive in our approach to the poorest countries. And, with this broader view, the international institutions can also be much more successful than past generations in helping to free these countries from their economic suffering. ■

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