CHAPTER ONE

Risk, Uncertainty, and Social Progress

The future is, by definition, uncertain. But the developed world has many tools to quantify uncertainty and turn it into measured risk: that is, to calculate the probability of many types of events with some certainty. In fact, whole industries have come into existence to calculate risk and help people hedge against it. Reliable information about risk is so pervasive that individuals informally allow with virtually no reflection a whole range of indispensable household decisions to depend on cooperation with complete strangers. Developed countries can also count on social institutions, from private financial and insurance firms, to government welfare programs, to help manage risks, which are beyond the resources of a single household. As a result, people in the developed world respond actively to risk by marketing, developing, and financing new companies and products.

But similar ambitions fail in developing countries. Experts frequently explain this contrast by citing a shortage of capital—the developing world simply cannot generate the funds to break out of its cycle of poverty. The conventional wisdom is that an absence of capital throttles the ingenuity of people in developing countries and prevents them from undertaking ventures that would improve their own welfare. Sophisticated economic theorizing equates development with capital accumulation and argues that the difference between the capital required by the country for investment and the capital available to it constitutes a financing gap.

To remedy the shortage, a wide range of multilateral and bilateral institutions—including the International Monetary Fund (IMF), the World Bank, the U.S. Agency for International Development (USAID), and the United Nations Development Programme (UNDP)—dispense aid to the world’s deeply troubled and impoverished regions. Nevertheless, the very people targeted to benefit from these organizations’ generosity often mistrust their interventions, breeding cynicism instead of hope. Nor have disbursements of a trillion dollars over the past fifty years to needy regions successfully breached the disparity between rich and poor either within one country or among nations. Instead, gaps in wealth between the richest and poorest nations are at historic heights.

But the absence of capital is itself a reflection of other factors. This book attributes the wealth gap between developing and developed countries to
the divergence between uncertainty and risk. Uncertainty refers to events about which knowledge is imprecise, whereas risk relates to events that can be assessed with some degree of certainty. Transforming uncertainty into risk is how countries grow rich. Lack of institutions that make managing risk possible is the root cause of the disparity in economic performance between developed and developing countries. Uncertainties grounded in the social and political systems of sovereign states, such as rampant public-sector mismanagement (which people living in developed countries no longer have to face), discourage households from engaging in activities that would harness their skills and capital.

Economic development begins with innovation that produces technological progress; that progress depends on an innovator’s willingness to take a journey into the unknown. There is no question of such journeys for people living in developing societies; uncertainty over reaping the benefits of discovery makes such journeys unlikely and thereby keeps the pace of innovation low. Such journeys could only become routine in developing countries as in the developed world if developing-country innovators could assess the risk involved and therefore hedge against it. Without the tools to assess, for instance, the reliability of trading partners and the legal frameworks to form social institutions to cope with market risk, innovation and invention are unlikely.¹

Measuring the social costs of these impediments to innovation is difficult; underestimating them, easy. When faced with such impediments, most sensible people simply forgo measuring risk and taking calculated chances. They withdraw into the arena where they can avoid uncertainty. Not surprisingly, this means fewer business ventures and also fewer basic risks taken by average households. This inherent conservatism means that both businesses and households only take those risks against which they can self-insure.

Developing-country households need better information about the risks they face and better tools for managing risks. Institutions that make market risk tractable expand the time horizons of economic actors. Developing countries rarely have private or social insurance for unemployment, retirement, workers compensation, intergenerational care, and disaster relief, so that people depend entirely on household savings, whereas either market or social insurance options exist in developed economies for all. If they are secure against basic market risks, households will learn to expand their frame of reference beyond their own endeavors. Once able to calculate the return on investments, they will pool their exposure to market risk by investing in the projects of other households. This is the essential step toward economic growth that people in developing countries are barred from taking. And if households cannot measure larger risks, they cannot take these steps.
Even as most households struggle, uncertainty does not prevent all members of a society from prospering. Many regimes have an interest in promoting uncertainty because it compels people to accept outcomes that allow only the ruler and a small band of cronies to prosper through secrecy, endogamy, and violence—defeating open, mutual endeavors by unrelated stakeholders. When households face the prospect that autocrats and their cronies will appropriate any gains they might make, the rationality of self-insurance is reinforced: be conservative; trust only those you know—and not all of them. For instance, households may invest in more children instead of in physical or human capital, but faster population growth slows the growth of per capita income.4

The disparities in risk management between developed and developing regions place a high cost on international investment and growth and result in the systematic undervaluation of assets in developing countries. It is the mandate of international organizations like the IMF and the World Bank to eliminate global gaps by imparting an anatomy of capital formation during the early stages of economic growth. Their charters permit capital to be lent but prohibit ventures into the politics of member states that are the very source of their capital inadequacy.5

By disregarding the political and social roots of poverty, organizations mandated to remedy global poverty may actually perpetuate uncertainty and contribute to the longevity of the governments that violate the rights and ignore the welfare of the people they govern. For example, an autocratic regime may agree to policies it will not enforce to guarantee the infusion of donor funds needed to reward its followers. Regime officials may agree to create institutions the donors advocate but ensure those institutions are diverted from their agreed-upon function once they are created. Since the government’s books are rarely open to an independent external audit, donors are unable to track the deployment of donor assistance to monitor compliance.6 Weak enforcement makes agreements with donors easy to game. In the future, donors, who have pre-announced aid targets, will be back to loan even more money to the same regimes—even if their policy objectives have not been met. After all, donors still have to justify the next year’s aid budget.

So here is the conundrum of growth in the developing world: the very people who are in a position to transform uncertainty into risk are those who benefit from the current regime, and the organizations responsible for implementing schemes to foster growth are unable to address the root problem.

It is easy to blame reform failures on a lack of capital accumulation or an absence of domestic institutional capability. But to understand why capability is wanting in one region and not in another, we must examine the incentives of key social actors. Why do coalitions and leaders in one
environment govern for prosperity, while in another they secure their own well-being at the expense of the people they lead? Leaders of East Asia’s “tiger” economies, for example, built regime legitimacy by creating institutions that upheld their promise to share growth, which helped woo big business with assurances of social cohesion. Such innovations in governance, which implemented broad-based access to the benefits of development, helped East Asia to experience sustained economic growth.\(^7\) In Latin America, by contrast, despite progress in democratization, substantive reduction of poverty and of inequality has not occurred. Leaders and regional elites secure their own welfare with shortsighted policies that undermine domestic economic sustainability. The roads, schools, health care, electricity, and property rights needed to give impoverished citizens control over their own lives are denied as threats to political stability.

This book begins where international organizations’ missions end and explores the political arrangements that create incentives for political leaders either to foster growth or to steal their nation’s wealth. It postulates that variations in economic performance among nations frequently stem from reversible institutional failures that encourage leaders to ignore the basic needs of all citizens. And it offers a way to break the poverty trap caused by perverse political incentives. *Capital and Collusion* contrasts the experiences of various regions and nations to ascertain the coalition foundations of divergent strategies in economic development. It seeks both the causes of and the solutions to the problems of underdevelopment in the politics and social structures of sovereign states. Exploring the frontier between risk and uncertainty, it aims to offer readers a new perspective on the forces driving development in some of the world’s fastest-growing regions.

Economic progress in developing nations requires significant and complementary innovations in social and political structures. Creating a political and social framework favorable to economic growth is often the greatest challenge these nations face. Yet developing countries are frequently advised to adopt models of economic institutions that can only succeed once appropriate social institutions exist. Enforceable property rights, for instance, often enjoy the status of being a necessary condition for economic development. The sustainability of the property rights requires social coherence and political accountability, since property rights can be overturned by the forces of social upheaval or confiscated by unchecked political discretion. The influence of the rich can compromise the property rights of the poor. The security of property rights in highly unequal societies is often enforced by military might rather than the rule of law. The property-rights regime is only as stable as the social and political foundations on which it rests.
When Risk Is Opportunity

Modern market economies provide many opportunities for the evaluation and measurement of risk, especially financial risk. If not for assumptions about the effectiveness of social and political institutions, many options for managing risk would be unavailable. Standard economic theory assumes that markets spread, pool, or assign a price to risk and can, over the long term, reduce, manage and reward it. This is a highly unrealistic expectation in most developing countries given that inadequate information obscures estimates of the economic value of private assets.\(^8\) Whereas developed market economies possess many tools to pool, quantify, measure, and price risk, making it possible for them to reduce risk by reallocating it to those most capable and willing to bear it, the contracting parties in developing societies are prevented by asymmetric information from using the tools common to mature market societies.\(^9\)

Individuals in developing countries do not have the option of taking remedial actions such as checking individual or commercial credit reports to overcome market imperfections and eliminate search costs or alleviate information asymmetries. As a result, they cannot trade many claims or risks. When these inefficiencies are paired with inadequate common knowledge and an absence of shared beliefs about valuation, market participants are rarely able to agree on an optimal contract for risk management. Rather than diversifying their portfolios at market prices, individuals choose to self-insure. As a result, household strategies for managing risk in developing countries vary significantly from those practiced in developed countries.\(^10\)

A framework for capital markets in developing regions must go beyond the emphasis on market risk in financial theory to address the sources of uncertainty embedded in the political and social order. Unlike risk, uncertainty cannot be priced, and it therefore prevents many trades from occurring and may reduce or destroy the value of economic assets.\(^11\) Uncertainty within an economic system is a market breaker; when two parties have widely divergent valuations of outcomes, they will be unable to agree on the terms of trade. Developing nations frequently avoid investments requiring sunk costs in favor of low-value short-term exchanges that discount an uncertain future.\(^12\) Three sources of uncertainty—market, social, and political—prevent the economic calculation of risk and wreck the coordination of market activity.

The Trinity of Uncertainty in Economic Development

Noncompliance with contractual obligations—from private basic business contracts to tax collection by the government—is the most common
source of uncertainty within the market system. Calculating returns on investments becomes difficult when individuals are uncertain about contract compliance. Institutions can mitigate uncertainty by monitoring the reputations of individual market participants and using the courts to make opportunistic behavior costly for perpetrators. In developed economies, institutions also provide innovators with capital from sources beyond their families by making it easier to know the probability of default of an individual loan. Applying the law of large numbers, institutions can facilitate the pooling of risk by providing information about the aggregate percentage of all loans that will default. Institutions, routine in well-functioning market economies, strengthen access to credit and shape risks into catalysts for development, yet they are in short supply in developing countries.

Avoidance and aversion, both a means of survival in the face of uncertainty, are the other side of risk and opportunity. When contract enforcement is weak, people respond by avoiding situations that require trusting a third party as well as the risk of investing in the projects of other households. Unfortunately, both of these actions are at the heart of economic growth. Households that avoid them violate the golden rule of investing, putting all their eggs in the same basket instead of diversifying in favor of a balanced and less volatile outcome. All of us self-insure, but in the face of this uncertainty and immeasurable risk, developing-country households invest their resources in excessive self-insurance. To insure against accidents or economic downturns, households rely entirely on their own resources and on informal networks of interpersonal obligations with neighbors and family members, constraining enterprise growth and avoiding business opportunities that might otherwise produce greater gains to society.

When households diversify their portfolios by investing in the projects of other households, the eventual result is the allocation of resources to the most effective or optimal manager. Public markets for stocks and bonds eventually allow the Microsofts or General Electrics to emerge, buoyed by the investments of thousands if not millions of diverse households. When contract enforcement is undependable, however, firms reliant on the pooled capital of many separate agents cannot emerge. Moreover, overall risk in the economy will increase because those who invest only in their own efforts face the risk of losing everything if they fail. Diversification protects such households from the risk of losing everything when faced by a downturn in a particular sector of the economy. Contingencies that are small on the scale of the economy cannot be managed in the absence of insurance markets, and individual households forgo many socially advantageous transactions as a result of their risk-averting behavior. An absence of insurance markets or mechanisms for
hedging risk is one of the great barriers to growth and prosperity in developing nations.

A second source of uncertainty in developing societies is policy discontinuity and social disorder that result from disparities in income distribution or from ethnic divisions. Uncertainty arises because predictions of social instability exhibit extreme variance. Experts frequently hold radically divergent views about the probability of social disorder and, depending on their background and training, view the same data through radically different lenses. Thus, estimates of the frequency or intensity of social disorder are highly unreliable. Like estimates of climatic change, estimates of social volatility fluctuate radically; no agreed-upon basis exists to measure their probability. Uncertainty over the exact timing or intensity of disorder dramatically constrains investment decisions in suspect countries. The emphasis on short-term gain stunts the growth of productive enterprises or organizations and prompts the development of such organizations as mafias or private armies that arise to take advantage of the high returns resulting from an extremely unstable environment.

A developed economy depends on organizations that enable individuals to undertake activities they cannot accomplish on their own by voluntarily placing their private resources into a common pool governed by an agent or representative body. Without effective social institutions, most households will choose to hold on to their capital. Pooling works best when members surrender personal rights to terminate or liquidate the collective entity. No one wants to invest in an entity that can be abused by high-handed insiders. When individuals drop their liquidation option and submit to the will of the institution’s governing body, they enable the formation of a self-determining entity. They also enhance the validity of contracts with an external third party, making the enforcement of judgments against the collective entity more credible. For example, a legally chartered corporation that can only be liquidated after a majority decision of the shareholders can transact with other entities in the name of its membership.

In developing societies, by contrast, where recourse against the inefficient management of common resources is weak, individuals are reluctant to join an entity governed by unrelated parties and will not consent to surrender their rights to liquidate the organization. If such an agreement is unenforceable, then the parties to it are right to suspect that they could lose all of their investment. Long-lasting enterprises will not exist without trust over how they will be governed. Thus, uncertainty interferes with the formation of many joint endeavors, leaving many common goals unattainable.

A society without the capacity for independent institutions is left with a state that often uses its coercive organs of power to form a dictatorship. When only a few actors can hold the sovereign accountable, minority
rights protection is weak. If the state fails to create a framework for cooperation, then only organizations exercising violence can secure obedience from large groups of people. In this regard, uncertainty is conducive to autocratic rule.

Polarized societies are unable to agree on sharing the fiscal burden to support optimal social investments—roads, schools, police, defense, or courts of law, for instance. Social development stagnates if societies are unable to agree on the amount of these nontradable social goods that are necessary but are not provided through the market system. If a society creates insufficient quantities of social resources, it will produce fewer traded market goods, which then increases the likelihood of civil unrest. A society unable to divide up today’s fiscal burden will lack the social resources necessary to cope with future needs. This risk is particularly prevalent in societies where a wealthy elite exists with little interest in paying taxes it might have to pay to provide public services it will never use.

Social polarization stemming from inequality or ethnic fragmentation also accounts for failure at economic policy reform. Populist efforts to reduce inequities result in frequent ruptures of policy continuity and in a lack of follow-through on policy initiatives designed to stabilize the macroeconomy. For example, no fewer than twelve elected presidents in Latin America who promised market reforms in the 1990s were unable to finish their constitutional terms; the resulting policy reversals undermined the credibility of market reforms. In effect, these policy reversals occurred because sociopolitical stalemates prevented the Latin American societies from resolving debates about the level and distribution of taxes. Unable to tax, the governments borrowed from international capital markets with devastating results for sound public finance. By contrast, the dramatic opening of China’s economy to market forces occurred with limited disruption because the benefactors of reform represented all strata of society. Hence, the expectation exists that the opening process will be stable and continuous, and those market reforms not already implemented will eventually be undertaken.

Consensus-building machinery allows governments to make bets on the future backed by their citizens. Social fragmentation that prevents consensual revenue collection and expenditure management is likely to leave the state with an inelastic revenue base. When new funding can only be raised through arbitrary levies enforced by coercion, governments face an uncertain future. Executable contracts or effective institutions for risk sharing in the marketplace will not be feasible until underlying social and political uncertainties are resolved.

A consensual budget mechanism is the best long-term social risk insurance. The proposition that the legitimacy of collection has an important
bearing on the effectiveness of collection enjoys strong confirmation by economic history. Consensus about fiscal priorities among taxpayers lowers the cost to government of revenue collection. If this is so, then development policy must concentrate on establishing links between public credit and institutionally grounded consensus on national priorities. Making the government dependent on revenue from the entire citizenry is also the most certain way to encourage risk markets in developing countries. A government that depends on a broad-based revenue system will have strong incentives to avoid the economic logic of autocracy. Social disaffection, social strife, and social divides simply prevent the collective action necessary to transform household capital into the working capital of development in both the private and public sectors.

A third source of uncertainty arises when political agents use their discretion to pursue goals inconsistent with the needs of the social collectives they represent—when they represent themselves instead of their nominal constituents. To understand the consequences of discretion to potential investors in a developing country economy, consider a simple coin toss. In this scenario, the probability of either outcome is 50 percent. But if political discretion enables one party to mint the coin according to its own specifications, the outcome to the other participant becomes uncertain, dependent wholly on the party in control. In this way, the exercise of discretion allows rulers to narrow their support base to a few key supporters, including ethnic and religious leaders, the military, secret police, technical experts, or a few wealthy business groups. With a narrow support base, leaders can hoard resources to purchase the maximum amount of loyalty. The politics of exclusion gives leaders latitude to put resources to discretionary use, creating risk for nonsupporters and privilege for those whose goodwill is needed. Institutions that make holding office dependent on winning broad coalitions are the most credible way to constrain the excesses of executive discretion. To court large coalitions, leaders must have as one of their gifts a capacity for economic policy. An irony of political development is that by creating a healthy economic environment in which private citizens can manage household risk with little direct assistance from government, the leadership makes itself dispensable and more susceptible to challenge. Leaders of small winning coalitions are simply unwilling to do so.

Autocracy and Underdevelopment

Autocracies litter the underdeveloped world. This is not coincidence. Insufficient public goods usually prevent autocracies from attaining their economic potential. In fact, an autocrat stays in power longer if there is
less economic development. Autocrats build support by providing special advantages to politically loyal firms even if that means channeling investment into projects that are not necessarily efficient via firms whose performance is not competitive. Attempting to improve policies and institutions that affect general market conditions does not provide a loyalty premium. For example, a leader does not create a special group of loyalists by stabilizing the currency; all citizens benefit. The social benefits of an information-efficient market clash with an autocrat’s desire to maximize loyalty by rewarding followers with access to information, privilege, and justice.  

Typically, autocratic regimes only enforce the contract or property rights of regime insiders, which cause the investment risks of insiders and outsiders to vary so extensively that only friends of the regime can take advantage of economic opportunity. At-large investors will avoid investments requiring political access or subsidies to be profitable.  

Firms that must operate without recourse to reliable contract enforcement demand protection from uncertainty in the form of rents from the government—such as monopolies, price-fixing, or subsidies—before investing. When government is besieged with efforts by firms trying to obtain such protection, a political marketplace that puts politicians in the driver’s seat of the economy emerges, effacing the boundary between business and government. Politicization of access to market opportunities ensures a suboptimal level of investment, sealing the trap of underdevelopment.  

In an ideal society, everyone in effect insures everyone else. Households do not invest their entire savings in their own business; they pool their risks by owning shares in the businesses of other households. The resources of the entire society can thus ensure the mutual survival of the group. Autocracies, by contrast, are unlikely to provide a well-hedged variety of framework to anticipate crisis because the only crises that matter are those that threaten the regime’s narrow political base. Thus, autocracies face uncertain futures because the rulers are unlikely to have access to adequate information to effectively allocate social resources. Only in the very long run when the ruling junta is faced with a catastrophe that threatens all of society does it address general issues of social welfare to prevent a political crisis from endangering its own survival.

**The Postindustrial Productivity Gap**

In a market economy, mechanisms such as bond-rating agencies, real estate appraisers, and insurance companies exist to price economic risk. If general economic conditions are the same for all firms, these mechanisms allow risk to be shifted to the most capable manager and each individual company can be evaluated according to its particular market perfor-
mance. To establish specific knowledge about a company’s state of health, an investor must be able to distinguish what part of company performance is due to management and what part is due to general economy-wide conditions.³⁵

Market-based insurance cannot flourish in developing economies because risk bearing is thwarted by information asymmetry from both private and public sources.³⁶ To avoid government interventions, firms restrict information and underreport revenues, leaving insurance providers without tools for accurate assessments. Although these methods of opaque accounting may protect a company from governmental malfeasance, they prevent the valuation of a firm’s potential. A second source of asymmetric information stems from corrupt governments that inaccurately provide information about the general state of the economy to the public in order to supply information for a particular group of cronies. When accurate information about individual market participants is restricted, the overall market is unable to price risk effectively, preventing the shifting of risk to those most willing and able to bear it.³⁷

Risk coverage toils under an additional handicap in developing countries. Since no private party will insure against risks derived from the actions of government agents, and no market exists for risks due to government malfeasance, insurance contracts do not exist to protect against government favoritism.³⁸ Only in the political realm can insurance contracts between a government and the governed be written.³⁹ Constitutions and political institutions alone hold leaders accountable for the consequences of their policies.⁴⁰

Regardless of culture, religion, or nationality, people are willing to take controllable risks. Without institutions to mitigate individual, social, and political sources of uncertainty, though, the market for goods and services lacks depth, scope, and liquidity. People view themselves as independent foragers, forgoing many possible gains from cooperation. Unable to manage ordinary risk, they are discouraged from seeking opportunity, thus they ensure that the future will be no different than the present. Instead of building, collaborating, or innovating for tomorrow, individuals plunder one another’s current endowments.⁴¹

By contrast, efficient risk management allows an economy to exploit the full potential of gains from knowledge and innovation. The smooth-functioning machinery that spreads risk will encourage individuals to start new companies and to use knowledge-intensive resources to build products requiring prolonged incubation by innovators. Without effective risk allocation, technological innovation is suspended. Technological exploration inevitably creates a productivity gap between the societies that approach the technological frontier and those that fall behind. A postindustrial social order is emerging in developing countries in which access
to information reduces market risks and allows individuals to undertake activities that once were the exclusive domain of a privileged few. Marx and Engels predicted that the struggle between the bourgeoisie and the proletariat—between the owners of capital and those who had only their labor—would one day produce a classless society. The access to information that has resulted from information technology has ended the dichotomy between labor and capital that characterized the first Industrial Revolution. In advanced industrialized societies, information technology and information access has become the great leveler, allowing workers to claim the residual profits of their own human capital. Now, a postindustrial productivity gap increasingly separates developing countries, where social relations are based on tradition and hierarchy that restrict equal access to information about economic opportunity, from developed countries. The gap grows where new technologies cannot find sources of private investment capital because the relevant social institutions to support the contractual arrangements to manage and quantify risks are absent.

No matter how sophisticated an economy may be, no one can be adequately protected from the next natural catastrophe, the next outbreak of war, or the next jump in the price of some basic commodity such as oil or water. Although households in both developing and developed countries face these same unavoidable macrouncertainties, people living in developed countries enjoy some insurance from everyday risks to household income. For example, households in developed countries receive some relief from inevitabilities such as retirement, unemployment, and disability. Such insurance encourages acceptance of market outcomes. With foreseeable improvements in financial technology and new techniques in risk management, the gap in risk mitigation between developing and developed economies will widen.

In developing countries, poor financial information foments volatility and uncertainty that make it difficult to assess assets and claims to future streams of income. The subsequent undervaluation of shares hinders investment and growth in enterprises. Insiders’ practice of hiding information and assets from outside scrutiny makes attracting capital difficult. Insider manipulation of financial information fosters asymmetries of information between contracting parties, thinning the volume of trade and inviting opportunism. If not for the poor quality of information that frustrates the assessment of risk, market participants would take more risks to enrich themselves and their societies. When the market cannot distinguish between efficient and inefficient firms, the result is a so-called lemons discount, adversely impacting well-managed firms and increasing their cost of capital. Owners end up seeking refuge in government patronage from an adverse business environment.
One result of the lemons discount is overburdened state systems result that lack the legal and institutional capacity needed to resolve conflicts ignited by growth. These overburdened states are unable to stimulate the institutional change needed to meet the demands that investors and citizens place on them. For example, when the private market provides no insurance against household risk, individuals end up depending on state-owned industries for jobs. People cannot risk losing the job they receive from the government because they cannot get insurance, education, or health care from the market.

The unequal distribution of financial assets across countries is one of the great disparities in world development. High-income countries with less than one-fifth of the world’s population, account for more than 90 percent of world financial assets.\textsuperscript{45} Low-income countries with at least one third of the world’s population account for less than 1 percent of global financial assets. These cross-country differences in financial assets as a percentage of gross domestic product (GDP) contribute significantly to global insecurity. Thirty countries with a combined population exceeding 400 million have not received any private, long-term, nonguaranteed external credit since 1970.\textsuperscript{46} Surprisingly, even the most impoverished of these countries rarely have a shortage of capital, yet capital is not available for growth because private savings rarely correlate with financial deepening.\textsuperscript{47} Money not channeled into the financial system hides under mattresses and in teapots, creating a gap between a poor nation’s savings and its investment.\textsuperscript{48} Even in the best-performing emerging nations such as India and China, the financial system is weak, powerless to channel money to small, innovative firms. Emerging nations are better at duplicating the technology of developed economies than at duplicating their financial institutions.

Many policy makers ask if it is only rich countries that can support strong and healthy financial systems. It seems excessively idealistic to talk about the development of capital markets in inhospitable environments where people barely eke out a living, but the alternative, an ineffective financial system, is also very high in opportunity costs and futures lost. Without effective financial markets, economies are locked into a cycle of low expectations and low performance. One way to break this cycle is to actively initiate reforms to stabilize financial market activities and to encourage people to engage in them. This means tackling the failures in domestic governance and transparency that prevent emerging economies from effectively harnessing the resources of their own citizens.\textsuperscript{49} Market economies without capital markets engage both wishful thinking and broken promises, creating grievances instead of opportunities.
Poverty and Uncertainty

A sharper awareness of why markets in developing countries do not respond to the standard expectations of capital theory can improve both long-term economic policy analysis and global stability. Economic models generally assume institutions already exist that provide regulation, oversight, and incentives driven by competition. But the emergence of such institutions is the very essence of development.

Mastering uncertainty through the provision of basic services such as health care, public roads, education, law enforcement, and property rights is critical to economic development; it makes people adaptive rather than opportunistic. Health care that leads to longer lives and reduced infant mortality rates decreases social uncertainty. Numeracy supports activities such as accounting that in turn build confidence in the manageability of the future. Although independence of the courts builds confidence in the legal system, impartiality is a consequence as much as a cause of development. Property rights give people confidence about the future use of the wealth they create today and are essential to risk management, for without their enforcement, any investment is a gamble.

Poverty reflects deep uncertainty about the future. The poor, whether they are Christian, Muslim, or Hindu, will tend to view their fate as being in the hands of God. The well-to-do rarely entertain equally passive views of the future. They are more likely to view their economic success as a result of will and ability, whereas the not-so-well-off consider almost every event in life a matter of luck. Imelda Marcos of the Philippines, one of history’s most colorful kleptocrats, was fond of attributing her great fortune to her superior intelligence, just as the power elite do in other societies.

All developing countries share the same central weakness. Living under deep uncertainty, people in developing societies cannot frame the most basic decisions about investment or consumption in relation to how the future will unfold. They cannot make decisions based on reasonable probabilities about the results of their actions, nor can they identify a feasible range of alternatives needed to plan and organize a better future. They can expect a shortsighted response from the people with whom they must interact: people who, like them, prioritize near-term goals rather than long-term ones. Poverty deprives households of the ability to take actions that have a long-term impact on the key variables in their lives. Faced with deep uncertainty about the future, they do not accumulate capital. The remainder of this book addresses how the world’s most promising emerging nations transform uncertainty into risk to create opportunities that help their citizenry escape from poverty.