*Forum Series on the Role of Institutions in Promoting Economic Growth*

# Islam, Development, and the Middle East: A Comment on Timur Kuran's Analysis

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June 24, 2003

**Forum 7**
*Institutional Barriers to Economic Change: Cases Considered*

24 June, 2003
Washington D.C.


MERCATUS CENTER
GEORGE MASON UNIVERSITY


***Forum Series on the Role of Institutions in Promoting Economic Growth***
Directed by the Mercatus Center at George Mason University and The IRIS Center
Sponsored by USAID's EGAT EG SEGIR/LIR PCE-I-00-97-00042-00, TO 07

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The objectives of the Forum Series are to help USAID make its donor assistance more effective and sustainable by incorporating insights from the New Institutional Economics into USAID's programming and delivery of development assistance. Services for Forums 6,7, and 8 are provided by the Mercatus Center at George Mason University and its consultants and the Center for Institutional Reform and the Informal Sector (IRIS). Editor for Forums 6, 7, and 8 is Peter Boettke, the project director for this portion of the Series with support from the overall project director, Clifford Zinnes, and the Forums Steering Committee (Ed Connerley, Jim Elliott, Jonathan Sleeper, and Mark Gellerson), chaired by the activity's COTR, Fred Witthans. Funding for the Series is provided by USAID's Bureau for Economic Growth, Agriculture, and Trade, Office of Economic Growth through SEGIR/LIR contract PCE-00-97-00042-00, Task Order 07. 

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## Executive Summary

Professor Kuran argues that poor economic performance in Middle Eastern economies is rooted in institutions and legal conditions that hindered the accumulation and efficient investment of private capital. He further argues that these institutions and legal conditions were specific historical developments in the Middle East, and not inherent features of Islamic societies. Thus Thus Islamic societies have the potential for better performance, provided those historical obstacles can be diminished. This much is clear from the examples of Malaysia and Indonesia, and earlier of Lebanon, all of which showed fairly rapid modernization and economic growth for substantial periods.

However, Kuran's view is incomplete. He overlooks problems specific to the Middle East that are not part of Islam, but part of the Ottoman legacy or accidents of geography. These include (1) the system of absolute central authority in politics; (2) tribalism and guilds; (3) disincentives to investment in human capital; and (4) disinclination to seek innovations. It may take revolutions – not of the Islamic variety, nor the military or one-party variety, but truly democratic revolutions – to unleash the economic potential of Middle Eastern societies.

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## Accumulation or Innovation?

Professor Kuran has given us a learned and exacting analysis of the institutional obstacles to economic growth that have left most Middle Eastern countries at levels of economic development well below that of Europe or the more advanced parts of Asia. Not that most such countries are truly impoverished; they are considerably richer and more developed than most nations of sub-Saharan Africa, Central and Andean Latin America, and southern and southeast Asia. Yet compared to their historical legacy as leading centers of trade, learning, and wealth from the tenth to fifteenth centuries, the current income and development levels of Islamic countries from Morocco to Bangladesh is disappointing, and markedly behind that of Western Europe, North America, and the leading regions of East Asia.

Kuran suggests that the reasons for this disappointing performance are long-standing institutions and legal provisions that hindered the formation of large and lasting economic organizations and that blocked the accumulation of capital across generations. In particular, the Islamic *wakf*, a charitable endowment, locked up large amounts of capital in relatively stagnant

forms, while Islamic law failed to recognize other corporate entities. Personal responsibility and divisible inheritance further fostered a parceling out of economic activity into small units. Thus, while Western countries were developing legal corporations and large privatized firms, banks and capital markets, and deploying their capital productively, Islamic countries remained bound by archaic legal and institutional systems that diverted capital into far less productive paths.

All of this is sound. Yet I find it still incomplete. Nothing is said of the technology of the West, its research universities and innovative firms. Nothing is said of how technical superiority underlay the military and economic dominance of Western nations in the 19th century world. Rather, Kuran stresses *commercial* superiority, as if having larger and more competitive trading enterprises was sufficient to tilt the balance of world power.

Yet in fact, commercial superiority did not truly arise until Western nations had superior goods to trade. Although the Venetians, Genoese, French, and British traded with the Levant from the 13th century onward, it was not until machine-made goods began to undo the Bursa silk and Ottoman cotton industries in the late 18th and early 19th centuries, and steamships and railways revolutionized military and commercial transport, that Western commercial advantages became dominant. Prior to the 18th century, it was the Ottomans who had valuable goods that Westerners wanted, and thus the Ottomans who set the terms of trade. After the mid-18th century, it was Europeans who had technically superior and cheaper goods – both military and utilitarian – and it was the Europeans who set the terms of trade. Naturally wanting to set terms that would be enforced by their own laws and courts, they sought to deal with those Ottoman groups who could be held accountable in those courts, namely non-Muslims.

The key to gaining *modern* wealth, as opposed to traditional wealth, is creating new products or using new processes so that a firm (or country) can offer the world products of a

kind, or at a price, unmatched by any competitors. By contrast, *traditional* wealth is created by canny trading of commodity goods, taking advantage of locational advantages or efficiencies (e.g. good land for grain, good climate for fruit trees, mineral riches, or particular traditional skills in textiles or metalwork). The institutions of the Ottoman empire were fine for producing traditional wealth; and indeed the countries of the Middle East still rely primarily on traditional wealth creation for economic growth. Where they have failed is in matching the ongoing technological innovation of Western countries, which has fueled the dramatic and exceptional modern wealth creation of the last two hundred and fifty years. In short, I do not believe Western advances relative to Islamic countries are due to the West having larger and better organized firms for trading coffee, carpets, silks, or other commodities than could arise in Islamic societies. Rather, it was in being able to produce technically superior products (superior in uniformity, quality, and/or price), and enforcing such market advantages with technically superior arms, that the West rose to dominate other regions. Moreover, I believe this statement remains as true in the twenty-first century as in the eighteenth. Thus the question of why the Islamic Middle East failed to keep pace with the rise of the West, and the question of why it still lags behind, boils down to identifying the obstacles to technical advance and innovation in Middle Eastern societies.

Opportunities and Obstacles to Innovation

I must differ from Professor Kuran's presentation in one regard – the role of large and complex corporations in Western economic development. In my view, the large and complex corporation is more a system for *preserving* wealth than for creating it. I say this for several reasons. First, large corporations start from small successful partnerships or corporations. It is only when the

success of the enterprise leads to growth that the problems of large-scale organization need to be managed effectively. Large scale itself is not often the driver of success. Rather, large firms tend to fall prey to conservatism, and often fail. Second, larger firms tend to exercise their market power to hinder free competition; where they succeed, innovation again is reduced. Finally and most important, it is well known that most innovation and job creation comes from small companies, not large ones. It was Apple who launched the personal computer, and Microsoft –then a small start-up – that developed the operating system that made it possible for IBM and others to create the personal computer market. Indeed the dominant player in that market now is Dell – another firm that started as a small garage-start up, and grew to a multi-billion corporation in a few decades. There is no reason that an entire economy of small, family-based firms – for example, Taiwan – cannot enjoy rapid economic growth and modern development if it makes products the world wants. Thus we want to look more closely at obstacles and opportunities for innovation in manufacturing.

The Middle East *did* have large-scale organizations that controlled manufacturing practices – they were known as guilds. Although not centrally controlled, hierarchical organizations like modern firms, these organizations did exercise considerable control over contracts and practices in manufacturing. However, their interests and goals were to preserve current practices and the wealth of their members. They had no interest in creating modern wealth through innovating new products and processes; rather their interest was in preserving traditional wealth by limiting access to markets and competition. It was not until the power of guilds was dramatically reduced – in Europe as well as Asia – that independent manufacturing and innovation in manufacturing products and processes became a regular feature of production.

While guilds played a similar role in both East and West, Kuran is quite right to point to the *wakf* as an institution inimical to economic development. Large tracts of productive assets, mainly land, were tied up in perpetuity. Moreover, they were exempted from taxation and thus no share of the product could be put to social benefit, except for the specific purposes laid out in the endowment. However, this institution too had its counterpart in the West, in the vast accumulation of tax-exempt lands held by churches. At various points in the history of European countries, the Church held anywhere from one-tenth to one-fifth of productive land, and collected tithes on much of the rest. While, as with the *wakf*, much of this wealth was put to charitable causes – hospitals, orphanages, schools, support for the needy – this wealth was similarly tax-exempt and held back from profit-seeking enterprises.

If both West and East had similar institutions in regards to guilds, and *wakf* or church properties, what then lifted the obstacles to manufacturing innovation in the West? What changes created different climates in regard to corruption, authority, and innovation?

First, it must be recalled that corruption was seriously widespread even in England, as late as the early 19th century. Large landlords who controlled Parliament through "rotten boroughs" (tiny electoral units based on a few old villages) relied on pay-offs for votes to get elected; once in office the King and ministers paid for their votes. It was precisely opposition to such corruption that produced the Reform bills of the early 19th century. Kuran states that in the Middle East "there existed few wealthy merchants with enough of a personal stake in democratization or the strengthening of property rights to lead and finance political struggles toward these goals." In this he is quite correct, since the wealthy merchants of the Islamic lands, in cooperation with Islamic courts, guilds, and the state, could rely on having their current practices protected and their estates (as *wakfs*) preserved. There were no modern manufacturing

centers – such as Birmingham and Manchester – with hundreds of thousands of industrial workers and thousands of small family-based manufacturing concerns creating new products using new processes – who needed to break down the corrupt control of government and the economy by landlords and privileged elites.

But from whence came these new manufacturing processes and products, which – reinforced by a technically superior military and navy – helped Britain become the "workshop of the world?" They arose from changes in schooling, science, and technology that had no counterpart in the Middle East (or for that matter anywhere outside western Europe.)

In the tenth through fifteenth centuries, the Islamic lands were not only in the forefront of economic development, they were also in the forefront of scientific study and discovery. In experimental optics, in anatomy, physiology and medicine, and in astronomy it was Muslim scientists who built upon and extended the legacy of the ancient Greeks, and who laid the foundations for the later development of Western medicine and science. Yet it is remarkable that this later development occurred not in Islam, but in the West.

The turning point appears to have been in the sixteenth and seventeenth centuries. During these centuries, fiscal and political problems led to wars and rebellions throughout Europe, the Middle East, and Asia. In most regions of the world, the result was a conservative backlash, an insistence on order, and a re-examination of classic texts and scripture to search for ways to restore and maintain social stability. In China, the Manchu dynasty drew intellectuals into a restudy of classic Confucian texts. In the Ottoman empire, scholars revived the authority of the hadiths and Quran as a guide to law and the state, ending the period of free exploration, western borrowing, and institutional innovation characteristic of the first two centuries of Ottoman rule. Although there were recurrent episodes of Western-inspired reforms in the 18$^{th}$

and 19th centuries in the Ottoman lands, these were repeatedly quashed by conservative counter-reactions. Even in Europe, wherever the Counter-Reformation took hold – as in Spain and Italy – a revived church/aristocratic state alliance combined to suppress independent thought, to maintain aristocratic claims to power, and to hold off democracy and modern economic development for centuries.

Yet while all these negative trends were progressing across most of Eurasia, Britain found a different path. In the wake of religious discord, instead of a throttling conservative embrace, a *modus vivendi* of partial pluralism developed. In addition, in the shelter of this modest pluralism, independent networks of mechanics, experimenters, and natural philosophers undertook an experimental and mathematical investigation of nature that had no parallel. Even in other parts of Europe, the more abstract and mathematical approach of the Cartesians held off the experimental/theoretical advances of Boyle and Newton, while the English continued to push experimental chemistry and magnetism/electricity studies forward. In the process, the English developed a cadre of engineers, entrepreneurs, and mechanics capable of truly innovating in manufacturing processes and products.

The linch-pin of this system was the development of the first practical atmospheric engines in the early 18th century, later succeeded by true steam-engines in the early 19th century. Using steam condensation to create a vacuum, and then using atmospheric pressure to drive a piston into the evacuated chamber, England created practical engines for large-scale pumping at a time when most of the rest of world did not even believe in or know of the very phenomena of vacuums and atmospheric pressure. Holding a monopoly of the engineering skills and mechanical training necessary to design steam engines, improve them, and adapt them to a

variety of transport and production processes, England became the locale for every significant advance in steam power for almost 150 years.

Steam engines were first used to pump out mines for tin, copper, and most importantly, for coal. The early atmospheric engines were so inefficient they were only practical to use with the scrap from coal mines, which came virtually free. But they allowed deeper and deeper shafts, and thus an expansion of coal output at constant marginal costs, something not achieved anywhere else. This enabled England to continue to expand its coal output, and apply coal to heating, metallurgy, brick-making, and any other processes needing heat. Further improvements led to steam engines being used to drive bellows and textile machinery, and eventually to power ships and railways, the latter providing critical military advantages. By the mid-19$^{th}$ century, machine manufacture and steam-transported military might and supplies were able to support an economic and military empire stretching across the globe.

Further progress came with the appreciation of the value of sustained experiment and technical innovation, and the creation of another institution lacking elsewhere in the world – the modern research university. Born in Germany, but widely imitated, these institutions fostered the study of materials, chemistry, biology, botany, and medicine on the basis of the new experimental science and methods, and fueled dramatic advances in dyeing, fertilizer, and other valuable processes and materials.

## Modern Obstacles to Modern Wealth Creation in the Middle East

To a remarkable degree, the products of Middle Eastern countries remain largely those rooted in the creation of traditional wealth – from caviar to carpets, and oil to agricultural products. Modern banking, transport, refining, and retailing enterprises have been created, from the brief

success of Lebanon as the financial center of the Middle East to the hub functions of Dubai. Yet there are no major chemical firms, world-class manufacturing facilities, or centers of product and process innovation in the Middle East such as those that characterize Europe, Japan, the East Asian NICs, or North America or for that matter, Israel; the one truly modernized Middle Eastern economy.

This is not simply because of the dominance of Islam, but is related to it. As in Confucian China (or Jesuit-dominated Europe in the counter-reformation), much of the Middle Eastern educational establishment is provided and controlled by religious authorities, and focuses on religious, philosophical, and legal study, rather than experimental science and engineering. Those trained in engineering and science generally emigrate to Western countries where they have greater scope to apply their education.

The state – which should have an interest in providing a secular and more practical education to its people – too often has no strong incentives to do so. Military regimes and traditional monarchies have been able to live off of control of oil or foreign aid resources, or through close alliance with the clerical authorities and merchant guilds, and thus have no need to raise the productivity of their people as a whole. Indeed, the system of authority in the Middle East has rested not on popular choice, but on individual authority and conformity to religious principles. Thus Ottoman sultans and traditional kings enjoyed near absolute personal authority, justified in part by their role as "defenders of the faith." In addition, tribal chiefs often enjoyed considerable personal authority at the local level. What Westerners see as "corruption" is often simply seen in the Middle East as the normal prerogatives of personal authority at many levels.

The main alternative to this system in the Middle East was, for several decades after World War II, scientific socialism, of the type advocated by Nasser in Egypt and the Baathist

parties in Syria and Iraq. These countries did advocate modernizing and secular education and economic organization. But in following the socialist model, as opposed to the western liberal model they associated with their colonial oppressors, they followed the Soviet Union and other socialist states into the trap of grossly inefficient allocation of resources and disincentives to innovation and private enterprise. This path, in other words, proved as fruitless as traditional Islam.

Today, Middle Eastern countries are stranded between a failed socialist past, and a legacy of hostility to Western imperialism. Many have thus turned to a revived Islamic movement, hoping to find a way out of this dilemma. Yet of course this neither lifts the weight of unhindered personal authority in state and local government, nor encourages the practical education and investment in modern engineering and production to become more competitive in world markets. The result is that Middle Eastern economies remain dominated by traditional enterprise.

There are two paths to change this. One is for government in the Middle East to promote private enterprise that is innovative, independent, and globally competitive (much as Korea did with its *chaebol*, and India is now doing with software and services). Yet this will, in time, inevitably reduce the sphere of pre-eminence of religious authorities to family and private matters, as in the West, and reduce the unbounded authority of traditional states. As with Korea or Taiwan, autocratic regimes can coexist with rapid modernizing growth for a while, but not indefinitely. Another is for conflicts within Middle Eastern countries to overturn the authority of absolute states and religious leaders, creating an opening for secular entrepreneurs to play a leading role in Middle Eastern societies. Unfortunately, given the current state of international affairs, any "space" opened up in authoritarian states is most likely to be filled by Islamic

radicals, rather than pro-western reformers. The best prospects for economic modernization thus seem to lie with those authoritarian or traditional leaders who are willing to promote economic advance even at the cost of eventual reductions in their own unbridled authority.