The Review of Austrian Economics, 18:3/4, 235–240, 2005.

Introduction—Forum Series on the Role of Institutions in Promoting Economic Growth

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By the end of the 20th century it was obvious that earlier public policy models of economic development and poverty reduction were less effective than desired. As a consequence international institutions, devoted to promoting development throughout the world, began a reassessment of their aid programs and the general mode of thinking about the problem of underdevelopment. Along these lines, the United States Agency for International Development (USAID) tapped the Institute for Research on the Informal Sector (IRIS) at the University of Maryland to administer a Forum Series on the Role of Institutions in Promoting Economic Growth.

The aim of the Series was to improve both the self-understanding of the task of effectively aiding economic growth and development, and the effectiveness in the delivery of economic growth and development. The Swedish International Development Agency at roughly the same time commissioned a study from the researchers associated with The Workshop in Political Theory and Policy Analysis headed by Elinor and Vincent Ostrom. Again the focus was an intellectual reassessment of the role that institutions play in promoting or hindering economic growth and development (see Ostrom et al. 2002).

Ever since moving to GMU from NYU in 1998, I have been interested in creating a research niche in our graduate program devoted to international political economy and transition studies. Soon after my arrival, I taught a course on the Rule of Law and Economic Development sponsored by the Templeton Foundation in the GMU School of Law with Todd Zywicki. Several individuals who were involved with the Forums Series participated in the course and in the related conference.[1] I was also part of the team working with IRIS during the initial stage of the Forum Series, under the direction of IRIS research director Clifford Zinnes.

We organized our research effort at the Mercatus Center at George Mason University under the name "Global Prosperity Initiative" and I began working closely with several advanced graduate students interested in questions associated with Austrian economics, self-governance, institutions and economic development.[2] At first our efforts were limited to reading groups and internal working paper discussions. But soon our efforts branched out to engage with other scholars and centers of activity. We began organizing sessions at conferences and publishing working papers in professional journals.[3] Brian Hooks worked as both the manager of this project and our organizational entrepreneur as we started to expand.

The intellectual synergies between what we were doing at GMU, what was going on at IRIS and the intellectual reassessment at USAID and in the development community in general were real and obvious. Several parties sought to build on those synergies in order to further develop the network of scholars that were working on questions of institutional analysis and social change.

Instrumental among them was Fred Witthans, who was in charge of the Forum Series at USAID and suggested we approach Chas Cadwell at the IRIS Center to explore the possibility of bringing the Mercatus perspective into the Forums Series. This created the opportunity to more fully integrate efforts of the Social Change Project (already up and running at Mercatus) with the Global Prosperity Initiative and we signed on to organize the final three forums in the Series. We were charged with both continuing the theoretical agenda of exploring how institutions impact economic growth and development, and assessing the effectiveness of USAID policies with regard to small and medium size enterprises in light of institutional analysis.[4]

The papers in this issue of the *Review of Austrian Economics* are a sampling of the output of this effort and were chosen to reflect the Cognition, Economy and Society aspects of the new institutional revolution of development economics. All two are surveys of an existing literature and thus steer the reader to a literature that, if followed up, would open up new areas of research. Kevin McCabe examines the research in neuroeconomics and what we have learned from this line of research for our understanding of cooperation and trading behavior. Boettke, Coyne, Leeson and Sautet summarizes the arguments in Austrian Economics, Public Choice and New Institutional Economics and attempts to forge a new framework of analysis in the field of comparative political economy. The papers are brought together in the hope that researchers will learn more about the interaction between economic/financial, political/legal and social/cultural institutions and how that interaction impacts on the wealth and poverty of nations.

In addition to the Forum Series papers, this special issue contains two other related papers. One of our main goals of the programs at the Mercatus Center is encouraging and supporting graduate student research. Both Ben Powell and Chris Coyne participated in the USAID Forums and the activities associated with the Series that took place at the Mercatus Center and George Mason University—weekly workshops, research papers, and field research. The product of these activities was a series of studies on development planning and postwar reconstruction.

What Have We Learned About Social Change and Economic Development in the Process?

After decades of flirtation with pure formalism, economics over the past few decades has brought institutions back into the center of economic analysis. Legal, political and even social institutions are now focal points of economic analysis. This transformation of economics has been acknowledged by the Nobel Prize committee with awards going to Hayek (1974) in part for his work on the comparative economic systems; to Buchanan (1986) for the development of the economic analysis of politics; to Coase (1990) for the development of the law and economics; to North (1993) for the development of the new economic history; and to Smith (2002) in part for his analysis of the institutional framing question as explored through experimental economics.

In the work of these scholars, and those pursuing the implications of their research program, there is evidence of two approaches to Institutional Economics:

1. The use of economic tools to examine the efficiency of different institutional arrangements, and
2. The use of basic economic reasoning to aid in assessing how alternative institutional arrangements impact economic performance through time.

For the field of development economics, and in particular the analysis of the impact of foreign assistance and public policy on economic outcomes in underdeveloped nations, it is our contention that it is the second approach that is most relevant.

Scientific thinking is, to a significant degree, the ability to systematically examine a phenomenon with methods that are replicable by peers and subject to peer review. Beyond that basic demand for intersubjective assessment, the most important thing is to choose methods that are appropriate for the task at hand. Once we settle on the second approach—the use of basic economic reasoning to aid in assessing how alternative institutional arrangements impact economic performance through time—then we must choose tools and methods of analysis that are suited to that task rather than try to force fit methods that may be appropriate for the first task, to this new task.

The institutional revolution in economics cannot just be limited to adding new variables into standard analysis. Instead, as the path breaking theorists mentioned above, all recognized, the institutional revolution transforms the methods and methodology of economic analysis. The models and tools of measurement utilized in the field of economic development and the policy advice provided in that area by governments were intellectually wedded to the Keynesian system of economics and political economy. With the breakdown of the Keynesian system, an analytical and empirical transformation of economics must follow. A major problem, as we see it, is that the analytical transformation has been ongoing for decades, but the empirical transformation has been much slower. In fact, with the lowering of computing costs and the development of finer estimation techniques the incentive compatible behavior for economists is to continue to employ measurement tools that were developed for the earlier analytical approach while attempting to force fit them to the tasks that emerge from the new analytical approach. It is in our opinion a mistaken scholarly and policy tactic, not because we don't learn anything from the endeavor but because the endeavor omits, and in fact, crowds out alternative empirical approaches that may be more appropriate to comparative institutional analysis.[5]

Following North we define institutions as the *de facto* (unofficial) and *de jure* (official) rules which govern the economic game and their *enforcement*. A key issue is in fact the relationship between the official and unofficial rules: the closer the tie between them, the lower the enforcement costs. The looser the relationship, the higher the enforcement costs.

It is our contention that perhaps the best way to discover this relationship is through on-the-ground research. There are no easily identifiable proxy variables that can be measured. A certain "dwelling within" the environment is required to pick up on the subtle social bonds and networks that reveal the political economy of everyday life. In addition, the opening up of economic analysis to ideology and the study of belief systems as the main carrier of the unofficial norms and social sanctions for violating those norms must be permitted. And the reason for this permission is rather pragmatic—economic performance through time is a function of the incentive structures that economic actors face and the quality of the information these actors receive and can process, so as to respond effectively to these incentive structures.

In other words, without a study of the underling public ideology and belief systems in a country, the economist cannot come to know the relationship between the *de facto* and the *de jure*. Without understanding that relationship, the economist cannot come to know the veracity of the rules and their enforcement. Without understanding the rules and their enforcement, the economists will not understand the incentives that economic actors face in making decisions. Finally, without understanding the incentives that actors face, there is no hope for understanding economic performance through time.

The work of the Global Prosperity Initiative at the Mercatus Center at George Mason University tends to focus on 3 major factors in economic development that follow from this line of reasoning:[6]

(1) The property rights structure in a society;
(2) The entrepreneurial environment in a society;
(3) The alignment of interest groups in favor or resistant to economic reform, and their capacity to achieve their goals.

There can be no sustainable economic development without clearly defined and enforced property rights established. In the standard Washington Consensus policy prescription of macroeconomic stabilization, deregulation and privatization the emphasis on the establishment of clearly defined and enforced property rights is often glossed over. But none of these policies will work to generate sustainable development without first establishing private property rights.

We know from macroeconomic analysis that policies of economic freedom (low inflation, low level of taxation and regulation, open international trade, the establishment of a private property market economy, etc.) and per capita income (both the level and rate of growth) are positively correlated. What these studies fail to establish is why this is so.

Our work looks at the entrepreneurial environment as the reason why. It is through entrepreneurial activity (both in its arbitrage and its innovative forms) that greater wealth is created in society. And entrepreneurial activity is either encouraged or retarded by the basic institutions in a society, reinforced by its public policies.

Even with full knowledge of the relationship between economic freedom, entrepreneurial activity and economic growth and development, we still have the task of examining the viability of forming winning coalitions around economic reform in this direction. In most societies throughout the world, the logic of collective action prevents the forming of such winning coalitions and thus these societies languish in poverty.

Too often bureaucratic inertia or interest-group barriers imbedded in the institutions of policymaking overwhelm any attempt at reform. Would-be reformers face an uphill battle with little promise of reward for success, or worse, sure punishment by those bureaucrats and special interests that have captured the system. These types of barriers can be identified as political economy or "public choice" problems and they point to the very important notion of "policy ownership" as a solution. The domestic actors within recipient countries need to internalize the reforms in order to overcome the interest groups and institutional inertia supporting the *status quo*. This local institutional capacity is crucial for sustainable development.

The Global Prosperity Initiative recognizes that economic development is not a function of natural resources, or of geographic advantage. It is, however, a function of establishing rules of the game which empower individuals to bet on ideas and to find the financing to bring those bets to life, and to reap the rewards, whether positive or negative.

The New Institutional Economic perspective, which informs this approach and inspired the Forums Series to which these papers contributed, holds the promise to reinvigorate local development efforts to the mutual benefit of both the developed and the developing worlds, and we contend that through the application of the innovative methods it presupposes, that promise can be realized.

Acknowledgments

We gratefully acknowledge the Mercatus Center for providing the intellectual and financial support necessary for this project, and in particular Brian Hooks for his leadership throughout the project. I also want to acknowledge Clifford Zinnes and the staff at IRIS for the intellectual stimulus and opportunity they provided us to learn and grow in our understanding of the difficulties encountered in moving from theory to application in the area of development economics. Several individuals at USAID were important in pushing us to test our ideas against policy realities and for this opportunity we thank Fred Witthans, Ed Connerley, Jim Elliott, Jonathan Sleeper, Tham Truong, Jolyne Sanjak, and Mark Gellerson. I would also like to acknowledge the role of USAID in providing the financing for the Forum Series. The usual caveat applies.

Notes

1. The conference was organized by Todd Zywicki and led to a special issue of *The Supreme Court Economic Review* on "The Rule of Law, Freedom and Prosperity." See Zywicki (2002).
2. Edward Stringham, now at San Jose State University, was a key contributor to these early efforts and took the lead in coordinating the activities of his fellow students. The work that began in those discussions is now being published in a two volume edited collection of Stringham's exploring the public choice view of the state and the provision of market-based law (see Stringham 2005a, 2005b).
3. To get a sampling of the type of work and the level of productivity of this group of researchers examine the CVs of Edward Stringham (http://www2.sjsu.edu/stringham/), Ben Powell (http://www2.sjsu.edu/depts/economics/faculty/powell/index.html), Scott Beaulier (www.scottbeaulier.com), Chris Coyne (www.ccoyne.com) and Peter Leeson (www.peterleeson.com).
4. The full Forum Series can be found at: http://www.usaid.gov/our_work/economic_growth_ and_trade/eg/forum_series/index.html
5. Examples of work that pursues the institutional analytics within the empirical project of macroeconomics that has proven very useful would include the work by Glaeser and Shleifer (2001) on legal origins and economic development and growth, as well as the work by Acemoglu, Johnson and Robinson (2001, 2002) on colonial

origins, and more recently the debate among these economists on the precise role of institutions in determining country level economic performance.

6. A list of publications and activities sponsored by the Global Prosperity Initiative can be found at: http://www.mercatus.org/globalprosperity/.

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