

On economic growth and development

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Abstract The paper offers a subjectivist approach to economic growth and an institutional view of development. In particular, the term development regards the prevailing rules of the game and their effects on the key variables for economic activity to take off: property rights and productive entrepreneurship. And growth is deemed to be the result of favourable institutional environments where chances are exploited and individuals succeed in improving their living conditions.

Methodological and normative investigation questions the validity of the recent and increasing literature on institutional design, where institutional economics actually plays only a modest role.

Keywords Growth · Development · Institutional economics

JEL Codes B53, O10

1. Questions on terminology

Although the debate about the real purpose of economics remains open, the literature generally agrees on the notions of growth and development. It refers to growth when dealing with proportional changes in GDP or – more frequently – in GDP per capita; and to development when analysing living standards – including features that do not necessarily form the object of monetary measurement. In this paper, however, a different view is suggested. Economic growth is meant to concern changes in consumers' surplus, rather than in purchasing power; and development regards changes of the institutional context. This provides a clear separation between subjectivist and

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institutional issues – growth and development, respectively. And thus offers a key through areas of potential confusion.

In particular, this section examines a number of implications derived from this approach, which are then compared with the traditional view, from a methodological and a normative standpoint. Section 2 discusses economic growth, growth policies, and government intervention. The notion of institutional development is developed in Section 3, while the role of politics forms the object of Section 4. Section 5 concludes.

1.1. On the notions of economic growth . . .

Economics studies the voluntary interaction among human beings, who enhance their condition by trading goods with other human beings generally characterized by different preferences and/or skills (Mises, 1949 [1996], part I). Agents also exchange information, strive to find better ways to allocate available inputs among competing production lines, learn about their (latent) tastes through trial and error processes, which benefit from previous mistakes and follow the evolution of preferences and habits through time.

The same principles – subjectivism and methodological individualism – also suggest that human well-being is the difference between the amount of satisfaction (happiness) one enjoys and the sacrifices or disagreeable things one has to undergo, either because there is no choice (bad luck, violence), or because such undesirable actions are nevertheless necessary in order to attain desired goals, including sheer survival. As a result, growth is necessarily an individual matter and originates either from changes in satisfaction and/or in labor. This is indeed what has been occurring since the end of the XIX century (if not earlier), when productivity growth has affected both sides of the coin: individual consumption has increased, working conditions have improved, working hours per worker per week have generally diminished.

There is not much more one can say, though. For in order to make any quantitative assessment about overall growth, one should be in a position (1) to argue that the well-being of one individual living at time t_0 can be measured and compared with that of another individual living at time t_i , (2) to sum or average out the results of such a comparison across all individuals, (3) to interpret and evaluate the result thus obtained according to *wertfrei* criteria.

These are nonsensical exercises in many respects. Inter-personal comparisons of satisfaction and preferences are impossible. In addition, GDP or consumption per capita do not really measure satisfaction. Rather, they provide a gross assessment of the efforts made in order to acquire purchasing power, and of the monetary rewards generated by such efforts.¹ Unfortunately, little is known about the amount of

¹Indeed, the inadequacy of GDP-like measures to evaluate welfare had also been acknowledged by eminent mainstream authors, such as Pigou and Hicks. Rather unfortunately, however, their objections led to Sen's formulation of the so-called capability theory, whereby growth should be measured according to the change in the individuals' abilities to perform certain functions or attain given goals (Sen, 1984). This research avenue does not seem to be very useful in the context of the present paper. On the one hand, the definition of capabilities – which include self-respect, lack of shame and community life – is *de facto* left to the policy-maker and ignores that *some importance may be attached to the power a person has over his or her own life – that a person is not forced by circumstances to lead a specific type of life and has a genuine freedom to choose what he wants*, as Sen himself acknowledges (1984, p. 86), but quickly forgets. Furthermore,

happiness that purchasing power delivers, let alone about the changes in the amount of satisfaction that individuals obtain without having to use monetary means of payment. The only attempts to assess happiness come from qualitative surveys, where individuals are asked to say how happy they feel. Although these data provide interesting information about the components of a happy condition, they don't say much about the cost individuals are willing to suffer to reach their goal. One might also doubt whether happiness is a good proxy for consumer surplus. Satisfaction is a relative emotion, which is heavily influenced by comparisons with other peoples' conditions (hence envy and the struggle for power and prestige). It follows a process of adaptation, so that satisfaction increases when future improvements seem within reach and declines when consumption fails to improve. These phenomena explain why *per capita income in western countries [. . .] has risen sharply in recent decades, whereas average happiness has stayed "virtually constant" or has even declined* (Frey and Stutzer, 2002, p. 413). Or why *across nations income and happiness are correlated but that the effects are small and diminishing* (Frey and Stutzer, 2002, p. 418). In short, there seem to be good reasons to neglect happiness when discussing economic growth and policies.

1.2. . . . and development

On the other hand, development is here conceived to be a problem of institutional evolution; where the term 'institutional' refers to the rules of the game within which individuals operate. These rules may be norms enforced through violence and credible sanctions (as in the case of laws). Or behavioral patterns derived from traditions, habits, shared ideologies, the enforcement of which rests on moral suasion and social praise or scolding, rather than on codified forms of punishment. Ideally, in a classical-liberal world the institutional framework guarantees economic liberty, that is negative freedom (freedom from coercion), protection of private property rights, freedom of contract.² In fact, it often legitimizes interference in individual decision-making, even when the rule of law applies.³

Institutions have been classified in different ways according to the degree of economic, political and personal freedom they generate. For the purpose of this paper institutions will be referred to in order to elaborate a new version of development, which applies to a fairly well defined geographic area identified by the rules of the game prevailing there at a given time. In particular, a 'developed country' is one where

capabilities are ill-suited to describe individual well-being. Instead, they are a rather ambiguous yardstick to assess whether an individual is able to conform to what Sen calls 'living standards.' The operational problems raised by such a notion are thus considerable. The very fact that Sen (1998) eventually suggests to adopt life expectancy as a measure of capability is telling.

²A free person is here defined as *one who faces no man-made obstacles to choosing according to his preferences, provided only that his doing so does not cause a tort to another person* (De Jasay, 1995 [2002], p. 282).

³Montesquieu is probably responsible for identifying a state of freedom with the rule of law, where the latter expression, *means that government must never coerce an individual except in the enforcement of a known rule [. . .] and requires that all laws conform to certain principles* (Hayek, 1960 [1978], p. 205). Although attractive at first sight, this notion of the rule still allows for coercion, violation of private property, extensive regulation, as long as these measures are carried out within a constitutional framework that defines the domain of government action. See also Hoppe (1994) and De Jasay (1996).

the institutional framework has respected economic freedom for a long enough period of time. Instead, in a ‘developing country’ economic liberty is on the rise, thereby enhancing higher productivity.⁴ Finally, undeveloped countries are defined as those where economic liberty is modest.

Therefore, development no longer depends on the proximity to an allegedly shared goal (e.g. agricultural self-sufficiency or income equality). And it is therefore incompatible with most ‘social’ notions of development, which refer instead to standards or capabilities established by the policy-maker by considering education, life expectancy, caloric intake, health conditions, etc..

1.3. What kind of growth theory is actually conceivable?

Most classical economists – Smith was an exception – did not devote much attention to growth and development because they had overlooked the foremost variable driving growth processes – productive entrepreneurship.⁵ In their view, growth was made possible mainly by investment, which in turn was motivated by expected (diminishing) returns to capital. In a world without much productive entrepreneurship (and thus with limited transfers from technological advance to innovative economic activity), demography and the need to replace the decaying stock of capital would then define the long-run rate of accumulation. In fact, the classical school had a theory of accumulation, rather than of economic growth.

Economists eventually started to consider how economic growth matters during the Great Depression, while observing the rise in unemployment that accompanied it. Partly because of this reason, during the first half of the XXth century growth tended to be perceived more as a political issue (the solution to unemployment), rather than a topic worthy of economic analysis *per se*. Indeed, most of the profession neglected to reflect on when and why people forego today’s consumption or leisure in order to enhance their present and future well being; or how the meaning of the term well-being changes across cultures and through time. Instead, efforts to understand individual behavior were replaced by attempts to pursue the common good, whatever that meant. Politicians were *de facto* legitimized to identify the interest of society; and technocrats were endorsed with the task of conceiving suitable recipes to attain such common goal.

Surely, the lack of a theory of entrepreneurship – productive and unproductive – made it difficult to conceive economic growth disconnected from *ad hoc* policies.

⁴See also Boettke and Coyne (2003). The causality link between economic liberty and the dynamics of output per-capita is documented by Gwartney, Lawson, Holcombe (1999). See however the previous remarks on the inadequacies of per capita GDP and also Karlsson (2005) for a persuasive criticism of the Economic Freedom Index with reference to which empirical work in this area is usually carried out.

⁵Following the Austrian tradition broadly understood, an entrepreneur is an individual who perceives profit opportunities and consequently takes action in order to improve his own well-being. The emphasis here is of course on productive entrepreneurship, i.e. on *those activities that benefit both the entrepreneur and society at large*. It differs both from unproductive activities, which *benefit the entrepreneur but harm society in general*; and also from evasive activities, which *include the expenditure of resources and efforts in evading the legal system or in avoiding the unproductive activities of other agents*. See in particular Coyne and Leeson (2004, p. 237), who document how different incentive systems lead to different kinds of entrepreneurship and from whom the definitions above have been borrowed.

The dynamics of productivity remained a mystery (other than being described as a consequence of more resources being invested), and one had to refer to exogenous shocks in order to elucidate why different areas of the world display so many different growth patterns and irregularities. In the end, decades of growth modeling still leave us with poor explanations and unconvincing descriptions (Boettke and Coyne, 2003).

Despite mainstream economics, however, change does take place in the real world. Even if its direction may sometimes be predicted, its features and intensity remain uncertain, to say the least. For they are the outcome of a trial and error process, where individuals experiment, take risks and revise their choices through repeated selection procedures. This is what happens when agents choose among different suppliers of goods and services and modify their choices according to their past experiences, their new tastes, the new opportunities available. Or when they take chances and strive to acquire temporary market power in their endeavors to see their entrepreneurial efforts rewarded by consumers. And also when they choose how to employ their time and talent – say leisure, work, investment in human capital.

As a matter of fact, the very presence of time makes sure that technologies, the stock of available inputs and preferences are not always constant or known in advance. Otherwise tomorrow would be the mere implementation of today's body of knowledge. This accounts to claiming that it is impossible to conceive a theory of growth, other than in terms of productive and unproductive entrepreneurship, as originally proposed in Baumol (1990). Surely, this impossibility can be circumvented by defining growth in terms of inputs (as opposed to individual well-being), in turn measured by some kind of physical standard, rather than subjective values; and by engaging in extrapolation efforts. Still, such exercises seem to be closer to accounting and statistics, than to economics.⁶

To conclude, the economics of growth is the economics of the acquisition of knowledge, of the returns to knowledge, of disequilibrium and competition (Holcombe, 1998). As mentioned earlier on, these phenomena unfold following the prevailing institutional context. That is, the stage in development attained by a given country. What about the traditional engines of growth – trade, trade policies and government action? The following section tries to formulate an answer.

2. Trade, government intervention and growth

The traditional debate about the rules of the game enhancing growth has addressed different mechanisms. Two broad categories stand out. One emphasizes the role of exchange and specialization. The other puts forward an extensive view, whereby the key to higher income and wealth is the ability to mobilize and invest larger amounts of inputs. Thus, government intervention comes into the picture either to design and manage optimal trade regimes and policies, or to mobilize resources that otherwise would remain underemployed, because of the actors' ignorance or because of alleged 'market failures.'

⁶In these cases time merely serves the purpose of providing a criterion to list or extrapolate events. There is no allusion to the fact that individual decisions are affected by uncertainty, by the returns to knowledge, by the distribution of preferences over different time periods.

2.1. The Smithian view on trade: extended choice

According to the so-called ‘Smithian’ approach, exchange is the key engine for growth. The underlying reasoning is straightforward, persuasive and may still be regarded today as quite relevant (along with entrepreneurship). Adam Smith was aware that resources are limited and, consistent with the historical evidence of his time, observed that technological progress played a modest role. But he also perceived that agents could enhance their welfare by exchanging goods and services. In particular, individuals with different preferences and/or endowments might still improve their conditions by selling and buying goods to/from people with different tastes and skills. In other words, trade is beneficial in that it expands the opportunities to choose and thus increases individual welfare within a competitive framework (see also Bauer, 1998). In this light, the problem of growth clearly becomes one of reducing transaction costs (transportation, information and contracting), of transforming local into long-distance exchange.⁷

As for trade regimes, it is accepted that consumers always benefit from free trade. However, since some owners of production factors will gain and some will lose as the competitive process unfolds; and since individuals are at the same time consumers and owners of production factors, the sign of the net effect is not necessarily positive for everybody. This explains why when competitive pressure is fierce and agents are expected or forced to adjust, the attitude towards free trade becomes less enthusiastic. Ultimately, the choice of the most desirable trade regime becomes a question of collective decision-making. Different possibilities are in order. One consists of more or less sophisticated versions of utilitarianism, whereby decisions are taken by means of majority (or qualified majority) voting. Another comes from neo-classical quarters and opts for unqualified free trade by referring to the so-called representative individual.⁸ A third perspective is based on the principle of human dignity (freedom from coercion) and on property rights acquired by the first occupant and transferred through voluntary exchange. The consequence would be free trade once again, but for a different reason: i.e. any departure from unrestricted exchange would involve a limitation of the individual’s freedom to choose among competing suppliers and thus be unacceptable.

2.2. Specialization and knowledge today

A society where trade plays a significant role tends to enhance growth on a second account – specialization. If an individual believes that his needs can also be satisfied through exchange, and that his ability to take advantage of trade opportunities depends

⁷Local exchange is based on personal contacts. Long-distance exchange is often impersonal and involves higher monitoring and contracting costs.

⁸It is an example of how the right conclusion can be attained for the wrong reason. By making use of the representative individual one implicitly introduces a cardinal measure of individual happiness, which allows computing averages and enforcing ‘fair’ compensation to make everybody better off as the competitive process unfolds. Versions of this position currently find support within the no-global movement, as well as among the advocates of regulated capitalism.

on his terms of trade, then each agent will concentrate his efforts on what he can do best and is most appreciated by other agents.

In the past the notion of specialization was fairly straightforward. Individuals were supposed to improve their skills through a learning-by-doing process or by taking advantage of economies of scale. As a result, productivity would increase, even in the absence of technological change.

Today the picture has changed. And the Smithian notion of specialization needs to be adjusted. Specialization is less a question of being knowledgeable about specific issues, than of being able, ready and motivated to acquire new knowledge. In the past labor productivity (and welfare) depended on the workers' skills when entering the labor market and their suitability to be part of a known production process which was supposed to undergo limited change over the years. Instead, today workers must be ready to adapt rapidly to relatively new production processes and circumstances (new companies, new industries, sometimes even new countries). Flexibility has become more important than specialization or – more appropriately – the notion of flexible specialization has replaced that of specialization.

Surely, trade offers almost unlimited rewards to those who are quick to acquire new information, develop new knowledge and – more important – transform it into entrepreneurial endeavors, which ultimately produce growth. When this happens, intensive growth is under way.

2.3. Trade and trade policies

One can thus conclude that the well-known debate on the role of trade policies with respect to growth begs the wrong question (Kravis, 1970; Haggard, 1970). The argument whereby trade *per se* leads to growth is probably beyond dispute for relatively small areas or when it comes to countries poorly endowed with raw materials that can hardly be replaced by manufactured goods. But it has relatively little explanatory power in contexts where the theory of comparative advantage does not apply.⁹ In these cases, trade remains a necessary condition for growth; but is not sufficient.¹⁰ Indeed, when large countries are involved, (international) trade might even be unnecessary.

This puts the well-known export-promotion, import substitution dispute into perspective. Surely, these policies may well achieve some short-run goals if succeed in mobilizing resources that in earlier times could not be exploited because of other sources of distortions, e.g. currency controls and/or regulated capital markets. In par-

⁹It may be useful to recall that the notion of comparative advantage implies differences in the production-possibility frontiers across countries, and that for such differences to occur, at least one of the following three conditions must be met. The frontier must reflect individuals' specialization in different countries: at the beginning individuals specialize randomly, but the initial differences deepen as a result of a learning process. This is the Smithian explanation. Second, technologies are not transferable across countries. Therefore, trade cannot reduce differences in the marginal rates of transformation. This is the Ricardian view. Finally, there exist differences in factor endowments (especially raw materials), which are not subject to international trade. This is the Heckscher-Ohlin explanation.

None of these requirements seems to be an adequate description of the world as it stands today.

¹⁰See for instance Jansen and Kyvik Nordås (2004), who show that the effects of trade opening become substantial only if adequate institutions are in place, let alone the infrastructure required to reduce the cost of trading.

ticular, export-promotion can be relatively effective if they encourage producers to face competition on outside markets, acquire information about new products and technologies, attract foreign investment leading to better production capacity – and thus higher productivity – thanks to the privileges offered by the local government. Whereas import-substitution policies will generate growth if the alternative is some form of central planning. Nevertheless, both strategies are bound to fail beyond the short run. From the static viewpoint, they both alter relative prices and thus lead to distorted structures of consumption and production. Whereas from a dynamic perspective they discourage risk-taking attitudes – investment and entrepreneurship – to the benefit of rent-seeking. Corruption and bad capital allocation are generally the most visible consequences.

2.4. Extensive growth and government intervention

As aired earlier, the current mainstream approach to growth is by and large ‘extensive’. That is, it is believed that aggregate output per capita can expand as long as additional production factors are employed. Before the industrial revolution this meant that higher living standards depended on the capacity to find new and possibly better land so as to increase agricultural production. Indeed, pessimism about growth was justified by reference to the fact that both land and capital presented diminishing returns, so that the incentives to expand would be stifled.

In more recent times, the classical view gave way to the socialist and neoclassical approaches (Arndt, 1987). The former identified capital-intensive policies (including forced investment and industrialisation) as the only means to enhance better living standards. Whereas the neoclassical view ultimately emphasised the role of research, development, human capital. As a result, in the socialist case government intervention was justified by the need to speed up industrialization and fixed investment, especially in those situations where private individuals were inclined to employ resources otherwise. Whereas in the neoclassical case the role of the state was related to the alleged positive externalities generated by having additional resources mobilised towards R&D and/or human capital, that is more inputs entering the production function of the national economy.¹¹

The extensive approach to growth gradually lost its appeal as from the late 1970s, when its failure gradually became apparent. And although its influence remains very strong even today (see for instance Caselli, 2004), its theoretical foundations continue to be rather fragile. Unless in extreme cases, it is of course plausible to assume that the marginal productivity of capital is greater than zero and decreasing,¹² so that assessing the long-run rate of accumulation per capita (and thus growth) boils down to a matter of empirical investigation concerning demography, the rate of time preference (which affects savings and thus investment), the output gap (i.e. the distance which separates an economy from its supposedly constant production-possibility frontier).

¹¹Nobody ever cared to clarify why such externalities should take place at a national level (so that the best policies are national policies), rather than on a regional or on a world scale.

¹²If anything, because operators generally prefer high-yield projects to low-yield projects. This notion is almost a truism, and thus of little interest from an economic viewpoint.

Unfortunately, the economic literature does not say much on these variables. Demography is beyond the scope of economic investigation *stricto sensu*, apart from entering the picture in order to explain (1) why accumulation may still take place in equilibrium; or (2) the size of externalities to be socialized through government intervention. The rate of time preference tends to be ignored by assuming that it is constant, that it applies only to the representative individual, and that it equals the yield on low-risk assets. Similarly, output-gap studies describe the distance among countries in terms of GDP per capita and simulate how long it would take for a catch-up process to develop its effects. But do not explain why some countries lag behind and produce less than what one may expect.

In a word, it is hardly surprising that the standard theory of extensive growth - better known as “exogenous growth” since the mid-1950s - looks more like a “what if” exercise than a proper theory. It serves the interest of the policy-maker, but hardly faces up to methodological challenges.

3. Development policies

If one excludes the radical-liberal standpoint, which sees little or no purpose for collective policies, the debate on state intervention to promote growth and development remains inconclusive.¹³ Nobody questions that if a country displayed the textbook features of a perfectly functioning market economy, where transaction costs are zero and individuals made the best possible use of the existing technology in order to meet known and constant needs, income would be satisfactory and reflect the best possible use of the existing technology. Still, no matter how beautiful the Nirvana world described by neo-classical scholars and experts is, the very problem of growth and development revolves about how to obtain a suitable environment where individuals can strive to enhance their well-being, make use of the technology available, acquire new knowledge. Put differently, the real question concerns not only the definition of the best policies and organisations, but rather the creation of institutions which are effective in reducing transaction costs and preventing coalitions from distorting incentives and giving origin to - and maintaining - rents.

All this has been finally more or less accepted by the economic profession. In particular, it is now believed that every country must find its own way, while efforts to replicate textbook blueprints - such as the Washington Consensus - are most likely to fail. At the same time, although nobody denies that institutions are essential, it is also generally maintained that adequate policies aimed at institution building would be highly desirable. So far the results have been rather disappointing, though. And the rationale for attributing a crucial role to government intervention to this purpose is not so obvious, either (see for instance Rodrik, 2003 and Ranis, 2004).

¹³See for instance Ranis (2004) for a mainstream survey of post-war development approaches and policies.

3.1. Lesson from the Old Institutional School

As already mentioned earlier on, today the role of institutions is hardly questioned. The Old Institutional School¹⁴ defines them as habits and routines that are shared and commonly accepted within a community. Favourable institutions are thus those cultural elements that encourage the development of the key-variables for economic growth: trade, productive entrepreneurship, individual responsibility, individual preferences, risk taking, competition. If accepted, such a cultural framework clearly bars those versions of the social contract or of social justice that justify violations of property rights, and thus coerced redistribution or constraints upon the freedom to exchange. When it comes to growth and development, the Old Institutionalists do emphasise that economics should be concerned with the analysis of different economic systems, the performance of which is explained by the logical connections among phenomena that can only be grasped by means of an interdisciplinary approach. But they have not succeeded in developing a full evolutionary theory of culture, informal rules, behavioural patterns (Hodgson, 1998). As we know, inertia (path dependence) is the only relevant dynamics that the Old Institutional School has effectively proposed. Regrettably, this remains a long shot from a satisfactory explanation of institutional evolution.

Still, the Old Institutionalists have made two important points that might open the way to stimulating insights for future work. First, it is now apparent that when an area displays unsatisfactory living standards – whatever that may mean, as discussed earlier on – three possibilities apply. Maybe the institutional framework is indeed conducive to growth, but a different set of formal rules prevails and thwarts the critical variables that would otherwise foster growth. A second possibility is related to those cases where the dominant culture (embedded and shared routines) favours a moral system that is not conducive to growth. Societies where religion plays an important role and cohesion is strengthened around an established elite that renovates itself through co-opting procedures usually discourage self-responsibility and productive entrepreneurship. Similar remarks also apply to societies where ethnic or tribal tensions are present, so that individuals more or less deliberately accept to set aside liberty and opt for a fairly static rent-seeking system that reduces tensions and the risk of conflict (but also of growth chances). A final picture refers to situations where path-dependence has broken down, but no new institutional pattern has come to the surface. That does not necessarily imply that agents operate in a vacuum. It does mean, however, that routines are fragile, people interact on a reduced scale, and that since the rate of time preference rises, the time horizon shortens significantly and opportunities for growth are missed.

When applied to today's development economics the 'old' path-dependence view has further important implications. Although inertia does not contain much explanatory power, its very notion explains why development policies *per se* are questionable. For either the decision-maker decides to alter and 'improve' the institutional context, which is the dream of any well-meaning social engineer but often ends up in disaster,

¹⁴The birth of the Old Institutional School dates back to the end of the XIX century, with Carl Menger and Thorstein Veblen. But it is still well represented today, as witnessed by the work of – say – Geoffrey Hodgson and Douglass North (from the early Nineties).

since cultures cannot be changed by decree. Or one has to restrain from action and accept that agents do not necessarily share the same culture and do not develop the same routines: contrary to the mainstream assumption, there is no such thing as the ‘typical’ individual. And there is no ‘typical culture,’ either.

In addition, the concept of inertia sheds light on the nature of the problems that come to the surface when inertia itself breaks down, which is indeed what has been happening more and more frequently in the last couple of decades. If anything, this is the truly new trait of development economics. Quite reasonably, the Old Institutional story claims that institutions are a self-reinforcing mechanism that breaks down occasionally as a consequence of some external shock. For example, an invasion, a major change in the charismatic élites, dramatic changes in relative prices that in a few months or years could provoke the introduction of new routines and shared patterns of behaviour and interaction. If so, there is not much to explain; and the history of economic development becomes an evolutionary journey through institutional patterns (histories of civilization), the features of the potential shocks and ultimately ideologies, which can be entirely new or inherited from other cultures. The latter is of course the case in recent years, as access to the media on a worldwide scale has become relatively cheap and easy.

To sum up, an economist inclined to policy-making cannot be very happy with the Old Institutional School, unless he has a chance to break away from path dependence or to intervene when settled cultural patterns become increasingly vulnerable, possibly to outside influence. The New Institutionalists have offered an alternative.

3.2. The New Institutional School

According to the New School economic performance takes place following given sets of rules,¹⁵ which in its terminology are known as institutions. The social scientist – and the economist in particular – is then supposed to study both the nature of the rules of the game and way they come to life. By and large, two possible functional dynamics are identified. One is the result of pressure exercised by interest groups aiming at creating or protecting rents to exploit.¹⁶ Trade or industrial policies fall into this category. On the other hand, institutions may also be the result of a competitive process, whereby rules end up by being created and selected so as to enhance interaction among individuals. Under some circumstances the former dynamics prevails and a society decays as individuals concentrate on rent-seeking activities, rather than on efficient production and growth. When the competitive process prevails, it originates an effective and possibly self-sustaining framework where economic activities prosper.

Of course, there have been attempts to find ways to make sure that the ‘good’ rules could be preserved and the ‘bad’ discarded. That has actually been the core

¹⁵The New School is not that new, though. The debate on the dynamics of the rules of the game had already been made explicit some 150 years ago by Francesco Ferrara and Frédéric Bastiat. Today the New Institutional approach includes much of the public choice tradition, as well as Chicago-style law and economics.

¹⁶A more elaborate version is offered by Acemoglu, Johnson and Robinson (2004), who argue that selected groups get hold of political power only at the end of social conflict. By means of such power these groups shape the economic rules of the game. It is however left unexplained why interest groups must wait for social conflict to take place and why such a conflict is a necessary condition. See also Voigt (1999).

of the research programme developed by the so-called Constitutional economists, who believe that a constitution designed to restrict government abuse and enforced by suitably selected political philosophers would keep rent-seeking groups at bay, allow market forces to expand and pave the way to growth within an appropriate environment.

Today the New Institutional view forms the backbone of the renovated neoclassical guidelines for development. On the one hand it preserves the optimizing approach that has characterised the last decades of mainstream economic theorising. On the other it is appealing from a normative viewpoint. By claiming that institutions are the result of human choice, rather than of a cultural heritage, it actually encourages a wide range of experiments in institutional engineering.

3.3. Old and new: what does the loop show?

As is often the case with views sharing a common focus but distinct axiomatic foundations, it is difficult to resist the temptation to offer a unified theory based on encompassing assumptions. Institutional economics has been no exception. Although several synthetic versions can be identified, they all revolve around the proposition whereby individuals do operate within a general framework of habits and practices, but may also play an active role, as they try to change the existing routines in order to suit their needs and ambitions. Or as they take into account new environmental conditions and adjust their behaviour to information or technological progress. In the former case preferences are exogenous. In the latter case they are endogenous. Under both frameworks, however, such efforts could lead to new routines, which then become part of the institutional setting.

This is what Hodgson (1998) calls the ‘Action-Information Loop,’ where preferences can be both exogenous and endogenous, according to the circumstances. This key mechanism brings the Old and the New approaches together. When it comes to development the loop may offer a description of why growth frequently fails to take off, or of why it does indeed taper off and some countries end up in some kind of a trap. This is actually the case when some coalitions succeed in introducing new routines that enhance rent-seeking and remove or weaken key elements for growth. Once these routines become part of the shared behavioural pattern, economic stagnation results. Western Europe in the last two decades could be an interesting case study along these lines.

On the other hand, the loop also reveals two decisive shortcomings of the institutional vision. First, the loop does not explain why some countries manage to break away from the stagnation trap and some don’t; nor does it explain why some countries end up into a stagnation trap after enduring periods of successful economic performance. One can surely refer to the dynamics of the rent-seeking coalitions, but that requires an established institutional theory of coalition dynamics, which in fact is not available.¹⁷ Put differently, the loop offers a good description, but a less than adequate explanation.

¹⁷See Quigley (1961 [1979]) and Olson (1982) for some early and only partially successful attempts.

In addition, it remains unclear what happens when the features and/or the legitimacy of the incumbent institutional framework (culture, habits, routines) become uncertain. As aired at the end of the section devoted to the Old Institutional School, this becomes increasingly frequent and may well be identified as the core of the transition problem. Indeed, during the last decades the very notion of a clearly identifiable culture has changed and possibly weakened. Cultural systems have become more open, as more and more people can now see and evaluate how others live and behave in the rest of the world, what kind of ethical system they share and what outcomes they generate. Individuals have been stimulated to question behavioural patterns that decades earlier would have been accepted as a matter of course. Education has emphasised hard science, technology and reduced the importance of moral disciplines. Last, but not least, family links have been softened and mobility has reduced the importance of developing long-lasting personal relations as a way to insure against undesirable events or carry out social interaction based on trust, not only from the economic viewpoint.

As a result, increasingly large numbers of individuals – especially young people – do not take habits and routines for granted any more, let alone understand or be aware of their cultural background or heritage. And when inertia weakens, the moral constraints embedded in the institutional context are gradually replaced either by targets borrowed from other contexts (e.g. through the media) or by new rent-seeking behavioural patterns, whereby the new organisational rules of the rent-seeking coalitions supplant the previous institutional constraints. The recent and different experiences in Central and Eastern Europe, in several Asian countries (including Japan and China) suggest plenty of examples. Therefore, and contrary to the (old) institutional tenet, routines do not necessarily break down only when a shock takes place. Unfortunately, this remains an open and important question.

A similar critique can of course also be addressed when considering the rules of the game, which are supposed to change when new coalitions overthrow the incumbent pressure groups, or when the interests of the incumbent groups evolve and encourage their members to change the rules of the game. Instead, it is a fact that routines also break down when a significant part of the community does not accept them any more, either because of changes in the moral codes they are based upon, or because of the results they yield. In the first case the break is triggered by ideological change (exogenous preferences); in the latter by sheer disappointment (endogenous preferences). Such a break opens a wide range of possibilities, depending upon its nature and the reaction of the outside environment. The success of development and/or transition follows the combination of such features. But once again it is imperfectly described the new-institutional framework on which part of the loop relies.

4. Development economics and active policy-making

It has been maintained that development takes place when the elements that discourage entrepreneurship and individual responsibility are removed, opportunities for exchange are expanded and property rights secured. Does that conflict with active policy-making? As a matter of fact, several success stories in Southeast Asia demonstrate that ‘miracles’ were also accompanied by substantial government intervention, which distorted the domestic price structure, carried out substantial redistribution; and

at the same time secured property rights and enhanced trade through outward-oriented policies.

These ‘miracles’ are useful in that they draw attention towards two phenomena. The first is rather obvious: The positive effects that one could loosely call the establishment of the rule of law (predictable law-making and reduced discretionary power) sometimes prevail upon the negative consequences of government interference. The second relates to the rules of the political game, whereby under given circumstances a government that stands a chance to introduce and/or strengthen some elements of economic freedom can stay in power only if it meets the demands of the dominant interest groups, which are not strong enough to form a cartel to stop potential competitors, but are strong enough to topple the incumbent political leaders.

If so, one must accept that if the incumbent leaders want to make an impact in terms of development, they are obliged to provide rents to key actors, which in turn allow them to create an institutional environment suitable for growth. Thus, the ruling élites face the double task of carrying out policies consistent with their legitimacy-to-be, and buying out the incumbent rent-seekers. It is often an elusive game, played by a political class that is relatively fragmented or at least conditioned by small but relatively influential groups, and/or by coalitions (which can also include politicians and bureaucrats) that stand to lose from the introduction of the new rules of the game (which may or may not reflect new cultural patterns). The features and the outcome of this process are then crucial to assess the chances of development, which may result in short-term growth episodes, or sustained periods of growth.

In the end, the success stories are those where government action succeeds in guaranteeing enough economic freedom, and the elites are legitimised by a shared goal which secures the ‘social’ contract between the political elites, the rent-seeking coalitions and the population at large. Indeed, in the case of the various Asian Tigers in the 1990s – and possibly China today – such a goal was higher living standards for most layers of the population.

Of course, this does not mean that failure to grow is due to lack of ambition for a better living, so that in the end poverty hits people who do not want to get richer and are unwilling to enforce a social contract based on economic growth or – better – to force the coalitions to sign an institutional contract designed to produce growth. But it does imply that when the residents’ main concern is the improvement of their living conditions, the ruling coalitions feel vulnerable, and refrain from excessive rent-seeking. Put differently, the credibility of a development process and the sustainability (length) of a growth episode depend on whether the opposing coalitions are effectively neutralised, on whether the new rules of the game create enough economic freedom to promote private investment and on whether government policies reproduce the outcome otherwise generated by the market process without too many inefficiencies. As recent history shows, these conditions are difficult to meet in many parts of the developed and undeveloped world.

5. Concluding remarks

Explaining growth is the ultimate purpose of economic investigation. Indeed, understanding how and under which circumstances individuals and communities succeed

in enhancing their well being is the very purpose of economic analysis. It is not an accident that this discipline became a social science, and aspired to explain social phenomena by using a scientific method of enquiry with Adam Smith's *Wealth of Nations*, when growth began to matter and in some areas of the world income per capita started to grow significantly.

As clearly put by Galor (2004), from the standpoint of growth the history of mankind can be divided into three broad periods. The first goes until the early 19th century and features an extremely low rise in income per capita throughout the world. When adopted, technological improvement did allow increases in overall production. Greater output was however devoted to feeding larger populations, which would expand along Malthusian principles until the survival limit set by output was reached. As a result, income per capita stayed more or less constant.

Advanced countries experienced the First Phase of the Industrial Revolution as from the end of Napoleon's wars. This period was characterised by greater technological innovation and substantial investment in non-human capital. As a result output accelerated, outpaced population growth and thus allowed an increase in income per capita. The Second Phase of the Industrial Revolution took place as from the end of the 19th century and is not yet over. During this period fixed-capital accumulation stabilised in terms of GDP, but ceased to be the only engine for growth. The rate of technological progress gathered speed and investment in human capital took off, encouraged by manufacturers who needed more skills to operate the equipment, and by the evolution of life expectancy, which increased the present value of investment in technical education. As time went by, population growth rates began to decline, thereby allowing income per capita to rise even faster.

Any acceptable growth theory must produce a persuasive explanation of the phenomena that characterise the three periods briefly described above. They must explain the logical connections between the various events, why they occurred at a given time in history, why they took place in some countries, but not in others. In this paper the overall problem has been split into two broad sections. One has dealt with the logic of growth, i.e. with the mechanisms that explain economic growth in a context where acquiring greater purchasing power is indeed the main purpose of human action. Another one has dealt with the set of constraints or conditions that may prevent growth, even when the requirements for growth to occur are there or can be introduced with relative ease by means of sheer imitation.

It has also been argued that today's most fashionable growth theories are disappointing, to varying degrees. The neoclassical school is lacking both from a logical and factual standpoint. The exogenous view suggests that growth is a function of accumulation, but does not explain why agents invest different amounts in different countries and in different historical periods. In the same way, it does not explain why the frontrunners have frequently outpaced those behind and have experienced different growth rates over time. The endogenous view presents similar shortcomings, except for the fact that it replaces the emphasis on fixed capital by highlighting the role of supposedly increasing returns to investments in technology or human capital. Once again, the empirical evidence is weak: It does not explain the dynamics of growth over long historical periods, nor does it account for manifest miracles (Japan, China, Singapore after WWII) or miracles gone astray (Argentina during the 20th century, China or Islam at the beginning of the second Millennium of the Christian Era).

The institutional view is indeed more satisfactory, but only marginally. As a matter of fact, the old institutional school does describe why some cultures may enhance growth and others don't. But it fails to explain what happens when cultural backgrounds become fragile and the very notion of shared values becomes questionable; or why certain cultures started to generate growth only during the last two centuries of the history of mankind.

As regards the logic of growth, these pages rely heavily on what could be defined as an augmented version of Galor's theory of unified growth, where the cost of exchange (trade) provides the initial spark and productive entrepreneurship keeps it going.¹⁸ By and large, its building blocs are the following. It is a fact that the Malthusian period was characterised by modest trade opportunities and low life expectancy. As a consequence, restricted markets reduced the returns to productive entrepreneurial abilities. For the same reason technological progress was also limited and more inclined to satisfy scientific curiosity, than to meet economic needs.¹⁹ All resources were absorbed by the need to survive. Hence, income per capita stagnated. The First Phase of the Industrial Revolution took off because transportation became cheaper and safer, also thanks to *Pax Britannica*. Low trading costs enlarged the size of the potential markets and created new stimuli for entrepreneurial activities. In turn, these justified applied technological progress and greater fixed-capital accumulation. New machines called for new organisational formats and a more skilled labour force. At the same time, medical improvements extended the horizon for investment in human capital and contributed to enhancing the rewards to education. Therefore, it paid for parents to concentrate their scarce resources on a limited number of better educated children, rather than on a large quantity of illiterate offspring, some of whom would probably never reach adulthood (Galor and Weil, 1999, 2000). This explains the Second Phase of the Industrial Revolution.

Will there be a Third Phase? As argued above, it seems that the economic dynamics of the world economy has been deeply affected by the dynamics of exchange and thus trading costs. These have spurred investment of various kinds whenever the institutional framework allowed individuals to take decisions and be responsible for them. Put differently, local technical change created opportunities to be exploited by relatively free societies. As pointed out in earlier sections, extrapolation is tempting, but often tricky. Still, one can hardly help observing two relatively recent phenomena, often lumped together under the term 'globalization.' One is enhanced trade in ideas and scientific knowledge. The other is enhanced mobility. If these trends were to shape economic history for some years to come, one could perhaps conceive new categories of interaction between growth and development. In particular, and consistent with the line of argument developed in these pages, growth would no longer be the result of favourable institutional environments where chances are exploited, independent of where they have been created. Instead, one could have situations where economic freedom becomes a prerequisite to create chances. Put differently, technological breakthroughs and entrepreneurial challenges leading to higher productivity would become

¹⁸See Pomeranz (2000), where the role of trade as the engine of the Industrial revolution is duly emphasised.

¹⁹Economic growth does not depend on the rate of scientific innovation, but on the ability to transform technological advances into productive undertakings addressed to satisfy demand.

the joint product of successful (institutional) development. And institutional decline would no longer lead to stagnation, but to impoverishment.

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