Forum Series on the Role of Institutions in Promoting Economic Growth

The New Comparative Political Economy

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Forum 6

The Interaction Thesis: Alternative NIE Perspectives on Development Economics and the Dilemmas of Foreign Aid Policy

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Forum 6: Session on Comparative Political Economy

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Executive Summary

The Nobel Prize winning economists Robert Lucas has remarked that once you study the problem as to why some nations are rich and others are poor it is difficult to think seriously about any other issue in economics. With the collapse of communism in the late 1980s the field of comparative political economy has undergone a major revision. Socialism is no longer the viable alternative system it once was perceived to be. Now we recognize that the choice is one between alternative institutional arrangements of capitalism*s*. Progress in the field of comparative political economy is made by an examination of how alternative legal, political and social institutions shape economic behavior and impact on overall economic performance.

In this paper I survey the new learning in comparative political economy, and then suggest how this new learning should redirect our attention on the impediments to entrepreneurship in the societies in transition and undergoing development.

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Introduction

With the collapse of the communist bloc in 1989 and the fall of the Soviet Union in 1991, the specialized field of comparative *economic* systems has faded into history. During the 1940s and 1950s a 'Grand Debate' over the merits of capitalism and socialism took place between economists. On a theoretical level, the debate was settled at the time with a compromise position somewhere between the two poles of laissez faire capitalism and comprehensive central planning. Perhaps full-blown planning would confront problems of overadministration, but pure laissez faire would lead to suboptimal results due to market failures, macroeconomic instability, and social inequities in terms of income distribution. The positive role of government in the economy was to manage the system to steer clear of the failings of laissez faire while avoiding the problems that an overly bureaucratic system would have to confront. Bumbling bureaucrats and erring entrepreneurs are both to be avoided, and in the 1950s and 1960s it was the professional consensus that sound economic policy would do so. On an empirical level, the main questions turned to the ability of the economic system to generate sustained economic growth and avoid significant deviations against the economic growth trend. Markets without monopoly, innovation without income inequality, growth without business cycles became the mantra of the day for public policy from a Neo-Keynesian perspective.

Because the field of comparative economic systems tended to emphasize the polar positions of capitalism and socialism, while the mainstream of the profession emphasized the compromise position of government management of the economy through taxes and regulation (micro) and monetary and fiscal policy (macro), the field was actually a low prestige field by the 1960s. The theory of laissez faire capitalism was held in far more disdain than the theory of workable market socialism. In the 1950s and 1960s, the theory of market failure discredited the argument for laissez faire, and the theory of government failure was only in its infancy within contemporary economics. The rise of foreign aid programs after WWII reinforced the mainstream position of the desire of government management of the economy. Even though entangled in Cold War rhetoric, the foreign policy of the US and UK with regard to aiding developing economies was not one exporting laissez faire capitalism, but rather one of exporting government schemes for development planning.[1] The USSR was deemed a threat precisely because its economic system was perceived to have accomplished the amazing task of industrializing a largely peasant country in less than a generation. Development assistance from the West was to promote democracy and economic growth and the means chosen for this task was government management of the economy. The 1950s-1970s saw a frantic race between the West and the USSR to export government planning to the underdeveloped world.

[1] See Boettke, ed., *The Collapse of Development Planning* (1994).

It is not for lack of trying that this approach to development assistance through government management of the economy has failed. While foreign aid is but a small fraction of the annual US government budget (less than 1%), the absolute dollar figures are not trivial ($11 billion for foreign aid in 2001). Moreover, the commitment has been consistent over time. In short, billions of dollars have been spent in Africa, Latin America, and East and Central Europe and the former Soviet Union to ease the transition from underdevelopment. The dollars spent must largely be written off as wasted.[2] The policies to promote economic development have failed in their primary purpose. This is most evident in the African situation, but the experience in Latin America and Eastern Europe questions the efficacy of foreign aid programs as well. At a time when the US government is poised to commit several billions of dollars over the next decade or more at state-building throughout the Middle East, it is crucial that we understand the reason for this systematic waste of dollars in the name of development assistance.

The older comparative economic systems literature tended to discard market led economic development due to the then consensus among economists that rational public policy would lie between the extremes of capitalism and socialism. That mainstream intellectual consensus fractured in the 1990s due to the failure of socialism in practice and the frustration with attempts by government to engineer economic growth throughout the less developed world. Filling the intellectual void is the New Comparative Political Economy. Work in this emerging literature looks at how alternative political, legal and cultural arrangements impact on economic performance. In terms of research this approach follows on the heels of the comparative institutional analysis championed by

[2] This, of course, is the stunning conclusion one must draw after an examination of the evidence as presented in William Easterly, *The Elusive Quest for Growth* (2001).

New Institutional Economists. However, the implications for public policy have not been fully worked out as of yet, or more accurately, where worked out have not been incorporated into the policy consensus because of the radical challenge they represent to the development policy community.

In this paper I will attempt to provide an overview of this new field of study and articulate the implications for development aid policy. Section 1 will discuss literature in comparative economics and the development aid project, Section 2 will discuss what we have learned in little more than a decade of transition experience in Eastern Europe and the former Soviet Union, Section 3 will discuss the direction of empirical work, and Section 4 will address the question of assessment and public policy in light of the New Comparative Political Economy.

I. LITERATURE REVIEW

In the late 19th century one of the central questions in the social sciences was "Why No Capitalism in China?" Max Weber's question made sense because from what historians could glean from the record, if an alien visitor had landed on Earth in 1200, there would be little doubt that China would be the leading civilization, and Western Europe would have been viewed as barbaric. But if that alien visitor were to land in 1890, China would be backward and Western Europe would be the developed civilization. What happened?

Many alternative explanations have been offered to explain the great divergence between Europe and China during the period from 1200 to 1900. The Chinese leadership for fear of barbaric influence closed their society off to trade with outsiders. But there are other factors working against the rise of capitalism in China. Max Weber is often associated with a mono-causal explanation of the growth of capitalism in Western Europe – namely, the Protestant Work Ethic. But the narrative Weber constructs to explain the European miracle is more complicated than that.[3] Law, politics, geography are blended together with culture and economic policy to provide the answer.

In the late 19th century the development landscape was characterized as the capitalist developed world, and the non-capitalist under-developed world.[4] But as the idea of a socialist system that would supplement capitalism grew in popularity and moved from dissident intellectuals to revolutionary movements to actual governments in power, the older distinctions between countries would fade with the Bolshevik revolution. And with the perceived success of the Bolsheviks to rationalize the Russian economy (electrification, collectivization and industrialization) in the 1920s and 1930s when the Western world was suffering through the Great Depression provided additional justification for the distinction. The world was now divided into the capitalist developed world, the socialist developed world, and the underdeveloped world. The scientific mind was seemingly confronted with the following choice for development assistance --- either rely on the protracted and painful evolutionary process of market-led development that Europe went through from 1200 to 1900, or pursue the more rational process of government-led development that the Soviet Union did in 1920 and 1930. In addition, the Soviet path enabled the allies to defeat the Nazi threat in WWII.

In the early decades of the 20th century, the literature on socialism tended to focus on a critique of capitalism (exploitation, monopoly and business cycles) and said little about the operation of socialism. In fact, because socialism was expected to rationalize

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[3] On Weber's system in general see Swedberg (1998). Also see Boettke (1998) and Boettke and Storr (2002).
[4] I do not have the space to discuss the very important issue of colonialism here.

production and lead to a burst of productivity that would generate a post-scarcity situation, the application of *economic logic* to the problems of socialism was assumed to be obsolete. This all changed with Ludwig von Mises's famous challenge to socialists in 1920 when he said: "Economics, as such, figures all too sparsely in the glamorous pictures painted by the Utopians. They invariably explain how, in the cloud-cuckoo lands of their fancy, roast pigeons will in some way fly into the mouths of the comrades, but they omit to show how this miracle is to take place." (1920, 88). The Marxian prohibition against explicit discussions of the future organization of socialism also resulted in the ignoring of the economic considerations. After Mises's challenge this was no longer acceptable. Whatever one's view of socialism, the examination of the organizational logic of socialism was recognized to be a vital exercise.[5]

The problem, according to Mises, was that socialists did not "realize that the bases of economic calculation are removed by the exclusions of exchange and the pricing mechanism, and that something must be substituted in its place, if all economy is not to be abolished and a hopeless chaos is not to result." (1920, 124). Socialists demanded the abolition of private ownership in the means of production, and Mises's response was to point out that this abolition of private property would eliminate the intricate web of institutions that underpin the capitalist order. Without private property in the means of the production, there would no market for the means of the production, and without a market in the means of production there would be no prices established on the market for the means of production, and without prices of the means of production there will be no way for economic actors to rationally calculate the alternative uses of these means of

[5] See Boettke, ed. *Socialism and the Market: The Socialist Calculation Debate Revisited*, 9 volumes (2000) for a collection of the relevant literature through the 20th century on this debate.

production. Absent the ability to engage in rational economic calculation, "we have the spectacle of a socialist economic order floundering in the ocean of possible and conceivable economic combinations without the compass of economic calculation. Thus in the socialist commonwealth every economic change becomes an undertaking whose success can be neither appraised in advance nor later retrospectively determined. There is only groping in the dark. Socialism is the abolition of rational economy." (1920, 110).

Mises's "impossibility of rational economic calculation under socialism" argument invoked attempts by economists throughout the world to devise workable answers. The most 'successful' of these attempts was Oskar Lange and Abba Lerner's model of market socialism. In the Lange-Lerner model, the optimality conditions worked out in the Walrasian system were transported into the model of market socialism. The Central Planning Board would decree that state enterprises should produce output at the level that would minimize average costs and price final products equal to marginal cost. By doing so, the Central Planning Board would ensure that microeconomic efficiency would be approximated by the state enterprises. In combination with the fact that socialism would abolish business cycles through rationalizing production, and income would be distributed on explicitly egalitarian grounds, Lange argued that he had demonstrated that not only the theoretical possibility of socialist economy, but also its practical superiority.

Mises and F. A. Hayek (1948) countered these arguments. Lange and Lerner had diverted the debate into the realm of statics where the debate did not belong. In the real world, the key theoretical problem of socialism is one of obtaining the knowledge that must be included in the economic calculation of alternative uses of these scarce factors of production. The most cost efficient use of resources is discovered within the competitive market process as entrepreneurs attempt to realize profits. As Hayek argued, stating that the formal rules of optimality worked out in the Walrasian model will be followed is not a solution at all. "The fact is that it has never been denied by anybody, except socialists, that these formal principles *ought* to apply to a socialist society, and the question raised by Mises and others was not whether they ought to apply but whether they could in practice be applied in the absence of a market." (Hayek 1948, 183). The principles of optimality within a market economy are the outcome of a competitive process, not merely a formal mathematical rule that is an assumption going into that process. Firms seek to maximize profits, and in competition with other firms, stumble to marginal cost pricing and producing at the level which minimizes average costs. Pricing equal to marginal cost does mean that the full opportunity cost of resource use is being taken into account, and minimizing average costs does translates into the deployment of all least cost technologies, but the important point Mises and Hayek were attempting to make is that these optimality conditions emerge out of the competitive market process. At the time they wrote this, most economists were so wedded to the Walrasian project (where plans are reconciled prior to exchange) that the Austrian focus on entrepreneurial discovery and the adjustment of plans through the process of exchange simply failed to be understood.[6]

The planning debate was diverted into the mathematical theory of optimal planning on a theoretical level in the wake of this misunderstanding. Mises and Hayek were defeated by hypothesis. There was, of course, no logical impossibility of comprehensive central planning if it was to be done by an omnipresent, omniscient and

[6] See Don Lavoie, *Rivalry and Central Planning* (1985) for an examination on how the failure to understand the Austrian entrepreneurial perspective led to confusion in the debate of socialist planning.

omnipotent entity.[7] On an empirical level, the debate over socialism and capitalism focused on the assessment of growth rates. In the 1950s, Soviet growth rates were estimated to have far surpassed those generated by governments in the capitalist world. Unfortunately, it was rare that an economist in the era of aggregate economics (1950-1975) stopped to think about the composition of the "growth" experienced. As Murray Rothbard put it: "Curiously, one finds that the 'growth' seems to be taking place almost exclusively in capital goods, such as iron and steel, hydroelectric dams, etc., whereas little or none of this growth ever seems to filter down to the standard of living of the average Soviet consumer. The consumer's standard of living, however, is the be-all and end-all of the entire production process. *Production* makes no sense whatever except as a means to *consumption*. Investment in capital goods means nothing except as a *necessary way station to increased consumption*." (1962, 835-36) The Soviet system could be characterized as one of 'conspicuous production' where government investment rather than producing tangible benefits to consumers becomes the *raison d'etre* of the economic system, and this "turns out to be a peculiar form of wasteful 'consumption' by government officials." (1962, 836)

These criticisms of Soviet economic growth were at least a decade ahead of the time where they would be able to have an impact. In the 1950s and 1960s, the literature in comparative systems was divided into either theoretical models of optimal planning (including material balance approaches, linear programming, mechanism design theory, and input/output analysis) or macroeconomic growth estimates. Important for our discussion is the fact that in the 1950s-1970s, the hegemony of the mathematical models

[7] On the impact of the assumptions of benevolence and omniscience in the political economy of socialism see Mises (1949, 692) and Hayek (1948, 187).

of planning or statistical analysis of growth in comparative systems prevented any significant discussion of the alternative institutional arrangements that constituted the different economies under examination.

We have seen that the Austrians sought to address the issue of institutions from the beginning of the debate. But institutional arguments tended to be dismissed by the proponents of socialism.[8] A misleading picture emerged that there were theoretical proofs of the optimality of planning, and empirical examples of successful social engineering of growth. These two literatures intersected with long range growth planning. Under the influence of this sort of neo-Keynesian market socialist consensus, development planning focused on the investment gap, the lack of human capital investment, and the question of population control. All the Western economies in the 1950-1980 era adopted Keynesian policy and an increased role of government regulation of industry. And this mix of government policies to manage the economic system is what was exported to less developed economies by the IMF, World Bank and foreign aid programs in general.

Only in the 1970s when the Bretton Woods agreement broke down and the Keynesian policy consensus fractured due to stagflation and then a deregulation movement started in the UK and then the US, did the bias in public policy toward government management of the economy in the developed world start to fade. Timing is everything, and by the 1970s the Soviet system under Brezhnev had become visibly corrupt politically and fallen behind technologically, so that the Soviet model no longer

[8] Lange, for example, accused Mises in an ironic twist of being an 'institutionalists' because of his emphasis on the tight connection between private property, pricing and economic calculation. Lange also argued that questions of motivation of the actors within the economic bureaucracy were outside the realm of economic theory and more properly belong "to the field of sociology" during the debate. See Lange (1936-37a, 55, 55 fn. 2, and 1936-37b, 127).

held the idealistic appeal it once did. So starting in the 1960s and continuing into the 1970s, a new strain of microeconomic research that emphasized the institutional context of decision-making started to emerge in the economics literature and was embodied in the fields of law and economics, public choice, and the New economic history.

Mises and Hayek had opened the door for this analysis with their challenge to the assumptions of omniscience in political economy. The Austrians tended to assume benevolence on the part of economic planners because of value freedom issues.[9] In their understanding of value free analysis, the ends being pursued are treated as given, and the means chosen to satisfy ends are the exclusive domain for economic analysis. It is the effectiveness of chosen means in obtaining given ends that is to be assessed.

Assuming benevolence on the part of government planners ensured that the economic critique of planning policy could not be just dismissed as ideological nonsense. The means of government planning were demonstrated to be ineffective with regard to the ends sought of increased human well-being. If government policy were intended to decrease human well-being, then there would be no strictly speaking economic criticism to be offered. But it precisely because government economic planning is to increase economic well-being, that the demonstration via economic reasoning of the inefficiency of government planning is powerful. Even assuming the best of intentions, and only the best of intentions, on the part of economic planners, the ineffectiveness of the means chosen would undermine those best laid plans.

Adam Smith's discussion of the operation of the invisible hand in a market society invoked unintended consequences to explain how individuals pursuing their self-

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9 For example, see Mises (1949, 692). On the Austrian argument for value-freedom in general see Boettke (2001)

interest could generate public benefits. The flip-side of that argument is found in the Mises/Hayek critique of government planning --- individuals pursuing the public interest generate social ills that nobody intended. The reason for the disconnect between intentions and results is that the economic knowledge required for actors to coordinate their activities and realize the mutual gains from exchange. In short, while the Austrians left the assumption of benevolence in tact, they questioned the assumption of omniscience. This line of research resulted in developments in information economics in general and mechanism design theory in particular.[10] But while these lines of research took off from the Austrian perspective, they deviated significantly from the main points raised by Mises and Hayek and thus tended to miss the entrepreneurial element in that Austrian theoretical discussion of the competitive market process.

Public choice theory pursued the opposite argumentative strategy.[11] Here the assumption of omniscience was left in tact, but the assumption of benevolence was called into question. Modern political economy advances by challenging both assumptions for a variety of reasons.[12] By challenging behavioral perfections in man, the Austrian and public choice writers opened the door for an institutional analysis. If men were both benevolent and brilliant, then institutional differences would fade into the background. Good men in full knowledge of alternatives would chose the 'right thing' to better their brethren. No disconnect between intentions and results would emerge. By allowing

[10] On the influence of Mises and Hayek's criticism of socialism and subsequent developments in formal economic theory see Mirowski (2002).

[11] On the relationship between Austrian economics and public choice see Boettke and Lopez (2002) and the references cited therein. Also see Boettke and Leeson (forthcoming).

[12] Hayek recognized the importance for political economy of relaxing both assumptions and in fact claimed that as the basic research agenda of Adam Smith and his contemporaries. (1948, 11) Hayek, however, was discussing Smith's advocacy of economic liberalism (system of natural liberty) which did not require for its operation either benevolence or brilliance on the part of man. Instead, liberalism represented a *robust* set of institutions.

slight deviations from the benevolence and brilliance assumptions, economists showed that the disconnect between intentions and results emerged in a variety of situations. In short, economic outcomes were a function of the institutional situation within which imperfect individual interacted.

Socialism would run into problems because the alternative institutional arrangement it demanded *by definition* impacted economic decision making by structuring incentives and influencing the flow and quality of information.[13] New Institutional economics emerged in the attempt to explain how alternative institutional arrangements in general impacted on economic decision making in terms of incentives and information. Property rights, for example, could be distinguished in terms of control rights and cash flow rights. Complete private property right systems would ensure that economic decision makers had both rights and thus would generate incentives that would lead individuals to husband resources efficiently. Attenuation of these rights through taxation, regulation, or confused property law would result in alternative rational behavior --- such as a short term time horizon in investment.

In the context of comparative economic systems this focus on how alternative institutional arrangements impact decision making through structuring incentives and affecting the flow and quality of information eventually led to the work of Janos Kornai (1992). Kornai discussed the implications of overadministration, soft budgets and the shortage economy. The property rights analysis of Steve Pejovich also pointed the way

[13] If you think of the problem of economic coordination as a problem of *learning*, then you can think of the problem with real-existing socialism as analogous to the general problem of learning environments. In a classroom that is lit too dimly and the instructor presents notes on a black-board written with black ink it would difficult for students to *learn* the appropriate information. On the other hand, a well lit room with a white-board with black ink might provide a better learning environment. Socialism was an economic learning environment similar to the dimly lit and black-boards with black ink. Even if 'students' wanted to learn it was hard for them to decipher what they were supposed to learn from the signals being sent in that environment.

to the important difference between the *de facto* and *de jure* in discussing property rights in practice.[14] Gregory Grossman's (1977a and 1977b) work on the extent of the black market in Soviet Russia, and the work of David Levy (1990), and Andrei Shleifer (1992) on the rent-seeking nature of the Soviet system follow from opening economic theory up to institutions driving the analysis rather than behavioral and cognitive assumptions of perfection.[15]

The older comparative systems focus on optimal planning models gave way to the newer comparative political economy with its focus on the ubiquity of 'markets', the incentives of bureaucracy, the selection criteria generated by the institutional arrangement, and the impact of these various factors on economic performance. This impact was larger felt at the microeconomic level. In the 1970s and 1980s, economists still attempted to estimate Soviet growth rates (e.g., Offer 1987) and determine the impact of collectivization and industrialization on the Soviet people using growth figures (e.g., Ellman 1975[16]). As the Soviet system crumbled, the comparative macroeconomic analysis began to crumble as well.[17] The consensus models in the field had failed to capture the bankruptcy of the Soviet system, and thus correctly fell into disrepute.

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[14] Following Mises, Rothbard argued prior to the property rights school that "the important feature of ownership is not legal formality but actual rule, and under government ownership it is the government officialdom that controls and directs, and therefore 'owns,' the property." (1962, 828). Compare that with Yoram Barzel's statement 27 years later "The claim that private property has been abolished in communist states and that all property there belongs to the state seems to me to be an attempt to divert attention from who the true owners of the property are. It seems that these owners also own the rights to terminology" (1989, p. 104, fn. 8).

[15] Also see the papers by Anderson and Boettke (1993 and 1997).

[16] Ellman concludes his analysis stating that "in this period collectivization appears as a process which enabled the state to increase its inflow of grain, potatoes and vegetables and its stock of urban labor, at the expense of livestock and the rural and urban populations." (Ellman 1975, 858-859). However, see Gisser and Jonas (1974) who argue counterfactually that Soviet growth without industrialization would have achieved at least the same growth rates. If we include in our analysis not only the distortions in terms of the capital structure that Soviet industrialization wrought, but the cost in terms of human life, then one would be hard pressed to see how Soviet growth rates could be invoked to justify anything.

[17] On the debate over Soviet growth figures see Ericison …

The second world model of development planning was no longer a realistic option and thus the development project had to be transformed. Frustration with a generation of Keynesian-Market Socialist inspired policy attempts to lift the underdeveloped world out of poverty and into modernity had become evident within the development aid community. Keynesian economics was wrong, market socialism was wrong, and thus billions of dollars spent on the basis of these wrong ideas had produced little positive results. Instead, these dollars fueled corruption, and white elephant investments throughout Africa and Latin America.[18]

In the 1980s, the policy toward the poor nations shifted from Keynesian investment gap and demand management, and/or market socialist regulation and nationalization of industry, to a more market-oriented path which came to be known as the "Washington Consensus." Critics often referred to this policy advise as "market fundamentalism", but that is just hyperbola. The basic policy advise is privatization, deregulation, fiscal balance, low inflation, and open trade. A lot of focus has been on the question of conditionality --- loans are conditional on adopting certain policies and will be withdrawn if certain policy targets on deficits, inflation or trade liberalization are not met. What the new comparative political economy has to say about this is subtle and was only brought out fully in the context of the transition experience in East and Central Europe and the former Soviet Union.

[18] Stiglitz's *Globalization and Its Discontents* (2002) can be read as an attempt to resurrect the Keynesian/market socialist development agenda, provided the right people are in charge.

II. TRANSITION EXPERIENCE

The collapse of communism in the late 1980s and early 1990s led to an intellectual stocktaking in the field of comparative political economy and development economics. The older models and empirical estimates seemed to have missed the mark wildly. Economists trained in the traditional manner in these fields saw their human capital investment decline in value more rapidly than they could ever have imagined. After an initial blip of interest during the perestroika days, the traditional field of comparative systems collapsed. Accomplished researchers retired, young scholars making their way were denied tenure, and departments did not hire in the field. Traditionally trained comparativists were not called upon to pro-offer policy advice. Instead, those jobs went first to established names in macroeconomic policy and then to established names in microeconomics.

The first line of business was to get the macroeconomic situation in balance. The former communist countries suffered from fiscal imbalances and repressed inflation. This initial condition ensured that as reforms began the previously hidden inflation would be revealed and threaten the macroeconomic stability of the countries. One of the main problems with the socialist system was that the microeconomic inefficiencies of the state enterprises fueled the macroeconomic imbalances of the country through the subsidization they required. The link between the state enterprises and government subsidies had to be severed, but in so doing one would introduce bankruptcy and unemployment in countries that previously did not permit this. The technical task of macroeconomic policy in this situation was complicated enough, but soon enough it was also recognized that there was a network of policies that would need to be introduced simultaneously in order to avoid undermining the positive impact of one another. If sequentially timed, rather than simultaneous, the policies would have fought against each other.[19] Privatization without price liberalization, or price liberalization without tight monetary policy, or deregulation without fiscal restraint, all would result in producing results that would be even less desirable than the current system.

Transition studies has produced three distinct moments:

(1) Getting the Prices Right

(2) Getting the Institutions Right

(3) Getting the Culture Right

Each moment emerges out of the increased recognition of the full extent of the intellectual detour that the Keynesian-Market Socialist approach forced upon us from 1950-2000.

Obviously, I understand that not everyone agrees with my assessment of the evolution of contemporary history of political economy. But in the spirit of conjectures and refutations, let me state the position as forcefully as possible to invite refutation. It is not only the policy advice, but the entire intellectual tool-kit that was developed to fit the Keynesian-Market socialist approach that must be jettisoned from the development aid agenda. The "Washington Consensus" was still too derivative of the previous command and control paradigm. In the transition experience, as we attempted to achieve macroeconomic stabilization and getting the prices right, we learned that this task

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[19] This was the original justification for 'shock therapy' --- the simultaneity argument. See Boettke (1993 and 2001) for a slightly different argument for 'shock therapy' based on signaling credible commitment to reform. The 'shock' therapy versus 'gradualism' debate never successfully negotiated the two main points of each side – the question of simultaneity on the one hand, and the question of path dependency on the other.

requires first that we establish the right set of institutions within which the right prices will naturally emerge as individuals realize the mutual benefits from exchange. But in moving to the institutional level of analysis, we also learned that you cannot simply construct and impose whatever institutional design our theory suggests wherever we want it. In the public finance literature there is a warning against ‘flypaper’ theories of taxation --- taxes do not just stick wherever we impose them. Similarly, institutions do not just stick wherever we hope they may. So we are drawn into the intellectual flame of focusing on the elusive concept of getting the culture right. If a culture accommodates the right institutions, the right prices will emerge and macroeconomic stabilization will be achieved. Not by policy design through managing the levers of monetary and fiscal policy, but naturally as individuals realize the mutual gains from exchange within an institutional environment that gives these individuals wide-scope to bet on ideas and find the financing to bring those bets to life.

Few economists have ventured a theory of cultural and institutional change. Our most sophisticated intellectual tool-kit is best designed for the analysis of situations in which change is absent. And most attempts to discuss change within that framework simply eliminate the discussion of change by way of construction. The tool kit of comparative statics does not permit a discussion of change *per se*, but an analysis of the situation prior to the intervening change and the situation after the change has had its effect. Nowhere in the analysis is an examination of how the change in fact took place. But that is precisely what is required.

The notion of multiple equilibria, as developed in modern game theory and models of increasing returns, also omits the process of change and instead focuses our attention on moments when the results of an intervening changed have already been worked out. In the contemporary history of economic thought the Walrasian notion of pre-reconciliation of all plans has permeated formal techniques. The process by which plans come to be reconciled through time has defied formalization. Due to the biases of 20th century economics, the discussions of change by less formal economists were dismissed as either critics of economic science (e.g., the theories of change as developed by old institutional economists) or intellectually fuzzy and ideologically motivated (e.g., Austrians and even the early work of public choice and property rights economists). But the bias in 20th century economics are the reason why economists were so ill-equipped to understand both the frustration with development planning and the collapse of communism.[20]

Economics gives us an argumentative structure. The formal tractability from the logic of human choice to social intercourse required a trivialization of the situational logic the actors had to confront. This was done in traditional models by assuming cognitive perfection on the part of the agents. But when that was done institutions were not an important determinant in outcomes. Conformity with cognitive perfection will yield optimality, deviations from cognitive perfection would result in sub-optimal results. Once we eschew the behavioral assumptions of benevolence and omniscience we are forced to introduce the institutional environment of choice into the analysis in order to understand economic performance.

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[20] See Boettke (1997) for a discussion of how these biases have derailed progress in economic science. I would characterize that bias in a two-fold way. First, formalism – which attempted to dictate the way an argument could be stated if it was going to be assessed. Second, positivism – which attempted to dictate the form evidence had to take in order to be considered in weighing alternative arguments. Model and measure were the scientific mantra of the era. On the relationship between Austrians and older institutionalists and the pivotal moment in 20th century economic thought see Boettke (1989), Samuels (1989) and Rutherford (1994).

One way to capture how institutions impact on economic performance is to model them as the constraint against which economic actors attempt to realize their desires. As institutions shift, the relative price of different behaviors change and economic theory can predict the direction of change in behavior. As it becomes relatively more costly to engage in criminal behavior due to a change in the institutions of enforcement and/or punishment, individuals will engage in less criminal behavior. As the transaction costs associated with trade are reduced due to an increased clarity in the property rights arrangement, more trading opportunities will be pursued and mutual gains from trade will be realized.[21] In short, individuals will respond rationally to the incentives they face and these incentives are a function of the institutions that are effectively operating in that context.

But as Douglass North, a pioneer in the sort of analysis I just laid out, has emphasized in is recent writings, claiming that individuals respond rationally to incentives it to say nothing at all unless you can explain how individuals represent those incentives. In other words, questions of social meaning and interpretation of social signs must move to the forefront of any analysis of how alternative institutional arrangements impact on economic decision making. Beliefs and other carriers of social meaning flood back into the analysis and we are confronted in the 21st century with the basic social science dilemma which 19th century thinkers such as Max Weber had to grapple with --- namely the interaction of political/legal, economic/financial, and social/cultural variables to explain the performance of a social system.

[21] In essence, this is the theoretical argument underlying Douglass North's discussion of how institutional structures and institutional change influence the course of economic history. See North (1981).

It is my contention that progress will made in terms our understanding the underlying causes of the wealth and poverty of nations when the New Comparative Political Economy engage in the sort of comparative historical analysis that characterized Weber's work. At the same time that we take off from Weber's analysis of modernity, the analysis must be informed by subsequent developments since Weber in the general science of human action. Rational choice theory as if the actors were humans is one way to describe what I am suggesting as the theoretical framework for conducting the comparative historical examination required to improve our understanding.

Andrei Shleifer is arguably the leading social scientist examining the questions of transition and development more generally.[22] His work has examined legal origins, political regimes, regulatory enforcement mechanisms and entrepreneurship. He has sought to integrate the results from these different research projects into a framework for the "New Comparative Economics". Our projects overlap considerably, in fact, outside of Mises and Hayek, the project I am sketching out is most influenced by Buchanan, Coase, Olson, North and Shleifer.

The great strength of Shleifer's approach is that it focuses our analytical attention on, given institutional possibilities, the trade-offs that exist in policing predation at the public and private level.[23] By pointing out the enforcement costs associated with given institutional capabilities, Shleifer is able to predict the sort of governance regime that will emerge. His research program demands that scholars pay attention to historical details

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[22] See Shleifer (1998 and 2000) as representatives of his work in this field in general. However, I will mainly be commenting on Shleifer (2003).

[23] Following joint work done with Ed Glaeser (Glaeser and Shleifer 2003), four alternative enforcement mechanisms of law and order are explored: (1) private self-governance; (2) judicial enforcement; (3) government regulation; (4) socialism. Private self-governance minimize the costs associated with public predation, but increase the possibilities for loss due to private predation. Socialism, on the other hand, minimizes the social losses due to private predation, but increases the possibilities of loss due to public predation.

and institutional factors is devising schemes of governance. His work follows naturally from applying the economic way of thinking to the realm of institutions and the choice between enforcement mechanisms.

Shleifer's (2003) analysis, however, forces us to limit our analysis to *within* institutional choice, rather than *between* institutional choice.[24] The reason for this is rather simple --- shifts in the institutional frontier, like shifts in the production possibility frontier, are often beyond our command and control.[25] But long term growth results from shifting out the production possibility frontier and long term improvements in the quality of institutions results from shifts of the institutional frontier ---- *in fact, it is the precisely the interaction of both frontiers that we must understand to get a handle on the problems of transition and development*. Is there a possibility for "catch-up" along the institutional frontier dimension along similar lines to the one that many economists assert exists for the production possibility frontier? One would hope so, otherwise the lesson to be learned is that the process of development is completely beyond our ability to aid.

I disagree that the task of development assistance is hopeless, but I am arguing that the project of development aid has to be completely rethought in light of the intellectual failure of the Keynesian/market socialist paradigm, and the policy failure of development assistance in the 3rd world and transition assistance to the 2nd world. We began the 20th century with the distinction between the developed capitalist world, and the underdeveloped non-capitalist world, and we being the 21st century with these

[24] Other conceptual problems with the Shleifer analysis would be the way private markets are supposed to maximize the opportunities for social loss due to private predation, and also the lack of a relative price mechanism between enforcement alternatives. Nevertheless, the thought experiment inspired by Shleifer's analysis is a significant break through in the field of comparative analysis as it focuses our attention on alternative governance structures in terms of minimizing the social loss due to predation.

[25] Williamson (2001) actually has argued that such questions of changing institutional possibilities (realm of culture) are so slow that they can be represented by 10^3.

distinctions once again firmly in tact. The 2nd world divergence is now behind us, and the problems of development and transition merge into one.

The problem is less complicated in the sense that certain policy options should be eliminated as programs for progress. We know in a fundamental sense that there is no path to prosperity outside of a private property market economy. Nationalization, regulation, closed borders are not paths to development. Adam Smith once remarked that "Little else is requisite to carry a state to the highest degree of opulence from the lowest form of barbarism, but peace, easy taxes and a tolerable administration of justice; all the rest being bought about by the natural course of things." (1776, xliii). We can do little better than Smith in terms of general sentiment. But unpacking all that is packed into this program for successful development has proven more difficult.

Markets, in the sense of individuals trading goods and services, are ubiquitous. But, a market economy does not exist in a vacuum, it is embedded within a broader set of institutions. Large differences in economic performance must be explained in terms of the differences in institutional environment. As Mancur Olson has put the problem:

> Though low-income societies obtain most of the gains from self-enforcing trades, they do not realize many of the largest gains from specialization and trade. They do not have the institutions that enforce contracts impartially, and so they lose most of the gains from those transactions (like those in the capital market) that require impartial third-party enforcement. They do not have the institutions that make property rights secure over the long-run, so they lose most of the gains from capital-intensive production. Production and trade in these societies is further handicapped by misguided economic policies and by private and public predation. The intricate social cooperation that emerges when there is a sophisticated array of markets requires far better institutions and economic policies than most countries have. (Olson 1996, 22)

We know what institutions are in existence in societies that have the intricate social cooperation that a sophisticated array of markets produces, but do we know how to transport these institutions to societies where they are lacking?

III. EMPIRICS AND ASSESSMENT

There are two reasons I want to highlight for why traditional statistical measurement techniques are ineffective in our attempt to answer the question of the transportation of the required institutions. First, the crucial distinction between *de facto* and *de jure* in the rules that govern economic life introduces hidden economic activities that must be accounted for if we are to glean an accurate picture of a social system of exchange and production. For many of the poorest societies, the unofficial economy is where the vibrancy of economic life is to be found. These societies are poor precisely because the free exchange of good and services is prohibited by government. The former socialist economies, for example, were dominated by unofficial markets both internal and external to the official planned economy. The rules that governed social intercourse were not limited to the official rules of a centrally planned economy dominated by the communist bureaucracy, but included the implicit rules that governed black market dealings, intra-plan negotiations by tolkachi, back-room deals among bureaucrats, and corrupt dealings with party officials. The problem I am pointing to is not just that the existence of a black market means that there is unrecorded activity. That is a problem, but there are ways to overcome that problem to some extent through estimation techniques. No, the problem I am pointing to runs deeper. The way of everyday life is being dismissed from analysis by focusing on the official economy. The Sovietologist Alain Besançon describes the contrast between macroeconomic accounts and more narrative empirical accounts of the Soviet economy as follows:

> The Soviet economy is the subject of a considerable volume of scholarly work which occupies numerous study centers in Europe and the United States and which provides material for a vast literature and various academic journals. But those born in the Soviet Union or those who approach Soviet society through history, literature, travel or through listening to what the émigrés have to say, find that they cannot recognize what the economists describe. There seems to be an unbridgeable gap between this system, conceived through measurements and figures, and the other system, without measurements or figures, which they have come to know through intuition and their own actual experience. It is an astonishing feature of the world of Soviet affairs that a certain kind of economic approach to Soviet reality, no matter how well-informed, honest and sophisticated, is met with such absolute skepticism and total disbelief by those who have a different approach that they do not even want to offer any criticism – it being impossible to know where to begin. (1980, 143)

This is not just a problem of perspective and historical accuracy. When it comes time for society to go through the process of transition this distinction has a practical importance because the *de facto* system is what is being reformed, not just the *de jure* system. It is the political economy of everyday life that is found in need of transition. The fantasy political economy of what officials said was found wanting years ago when the people found it not in their interest to follow the letter of the law. Of course, one of the first steps any transition must take is to repeal the official rules that in fact proved to be unworkable. But after this first step, the hard work of confronting the *de facto* principles governing real life must begin in earnest --- including addressing among others, the control rights, the norms of dispute resolution, and the habits of thought.

It is here that the demand for an empirically grounded approach to the question leads to a recognition that one must push to get beyond the numbers and to the *meanings* embedded in social relations. But the argument for the narrative turn need not just rest on the positive assessment that we need to look at data which is not amenable to standard statistical data analysis, we can also look at the shortcomings of standard data analysis on its own terms for the question we have put before ourselves. As Gregory Mankiw (1995) has pointed out, all models of economic growth run into three problems with the econometrics: simultaneity, multicollinearity, and degrees of freedom. These problems question the ability of the "data" to adjudicate between the different hypotheses concerning the wealth and poverty of nations. The upshot of this problem with the empirical literature on economic growth, Mankiw argues is: "It is not that we have to stop asking so many questions about economic growth. We just have to stop expecting the international data to give us all the answers." (1995, 307)

Some economists will try harder to work with the aggregate data. But we can also recognize that aggregate macroeconomic data is not the only sort of data we can analyze. Detailed case studies and ethnographic data can be deployed to construct a narrative of the political economy of everyday life that is operation in poor nations.[26] We can conceive of an economic ethnographic narrative as being constructed out of 3 sources of information from the field:

(1) Personal Interviews with participants and officials in the particular sector under examination[27]

(2) Surveys given to a wide variety of participants[28]

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[26] There has, of course, been a literature that has developed in the late 1990s that attempts to analyze norms and trust via econometric techniques. I will not comment on this literature here except to point out that it should not crowd out attempts to incorporate ethnographic techniques into the economic analysis of transition and development.

[27] Edward Stringham and I have done a study of the Czech Stock Exchange that emerged in the 1990s utilizing the personal interviews ethnographic techniques combined with more traditional historical data analysis, see Stringham and Boettke (2003).

[28] See Dan Klein and Alex Tabarrok for an example of the use of questionnaire/survey data to address a problem in political economy --- in this instance the issue of off-label drug practices.

(3) Participant observer observation[29]

By opening the economic analysis of transition and development to this information, we broaden our understanding of the development process, get a sense of the challenges that economic actors face, and the impediments that actors face in trying to realize the mutual gains from exchange.

In de Soto's *The Other Path*, for example, he printed a picture of researchers from his Instituto Libertad y Democracia with a printout 30 meters long of the procedures an entrepreneur would need to set up a small industry (1989). Milton Friedman has argued that a simple examination of the shelf space of federal government regulations of business would suffice to provide you with a first approximation of how onerous the government burden was on the economy. In Lima, Peru during the 1980s, de Soto estimated that the informal sector comprised 60 percent of the economy. This channeling of economic activity into the black market was a function of hundreds of regulations that made it next to impossible for an entrepreneur to negotiate the bureaucracy and start of new business.

One of de Soto's favorite quips is to point out that in his youth while it was common for everyone to assert that property was held in common, when he and his friends would wander to near a home the dog on that land would growl and bark to keep them away. The dog knew, de Soto points out, that the home belonged to his owner. The punchline to de Soto's story is that he predicts that the countries that will succeed in the 21st century will be those that formally recognize what the dogs already knew. In short,

[29] Here we could site classic journalist forays into understanding a foreign land, such as Hedrik Smith's *The Russians* or works from the 'natives point of view' such as de Soto's work on Peru.

make *de jure* what is already *de facto* and you will unleash the ultimate resource --- the human imagination.

In *The Mystery of Capital* de Soto (2000) modifies this conclusion slightly to warn that the act of unleashing the productive capacity of capitalism requires more than government curtailing its onerous regulations. The fundamental problem that countries face is turning "dead capital" into "live capital." In de Soto's narrative, this is a function of formal property holdings. The *de facto* owners of *The Other Path* can realize the gains from exchange, but they cannot realize the full benefits of specialization and exchange that a more secure property system would enable. The formality of property holdings is required for individuals to be able to use their property to raise live capital that can generate new wealth creating activities.[30]

The importance of saved capital and the existence of financial institutions that enable individual savings to be channeled into investment funds for economic development is recognized by a variety of economists. Murray Rothbard, for example, argued that technological change was actually accorded to much attention in the economic theory of development. Technology does not work itself, but must always works through an investment of capital. As Rothbard put it: "The African peasant will gain little from looking at pictures of American tractors; what he lacks is the saved capital needed to purchase them. That is the important limit on his investment and on his production." (1962, 491)

Government attempts to coerce savings to promote growth, however, are ineffective. Capital built out of coerced savings, Rothbard argued, for a variety of

[30] It is not my purpose here to assess the truth of de Soto's perspective that formal titling of land by the state is a prerequisite for realizing the gains from social cooperation under the division of labor.

reasons is wasted and dissipated. The investments undertaken that are not based on consumer demand and profit and loss signals on the market will result in malinvestment. (1962, 835) Keynesian and socialist attempts at government planned investment result not in economic growth, but economic waste. As Rothbard argued:

> Capital is an intricate, delicate, interweaving *structure* of capital goods. All of the delicate strands of this structure have to fit, and fit precisely, or else malinvestment occurs. The free market is almost an automatic mechanism for such fitting; and we have seen throughout this volume how the free market, with its price system and profit-and-loss criteria, adjusts the output and variety of the different strands of production, preventing any one from getting long out of alignment. But under socialism or with massive government investment, there is no such mechanism for fitting and harmonizing. Deprived of a free price system and profit-and-loss criteria, the government can only blunder along, blindly 'investing' without being able to invest properly in the right fields, the right products, or the right places. A beautiful subway will be built, but no wheels will be available for the trains; a giant dam, but no copper for transmission lines, etc. These sudden surpluses and shortages, so characteristic of government planning, are the result of massive malinvestment by the government. (1962, 836-837)

Thus, assessment of economic activities within an economy focuses not on the macroeconomic data, but on the microeconomic structure of investment and enterprise. The preoccupation with aggregate growth rates belies the composition of the capital structure, and the subjective assessment of trade-offs that individuals make in the process of constructing that composition.[31]

Poor countries can improve their economic situation only in the same way that richer countries did – namely increased capital investment. Unfortunately, poor countries are particularly "prone to the wasteful, dramatic, prestigious government 'investment' in

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[31] I have used the example in my writings of two 300lbs men to convey the problem with being content with aggregate economics – one who obtains his weight through hard physical training, while the other obtains his weight through no training and eating. If we look at the aggregate weight, the individuals are equal. But in order to assess their health, we need to look beyond their aggregate weight and study the composition of their weight. See Boettke (1993).

such projects as steel mills or dams, as contrasted with economics, but undramatic, private investment in improved agricultural tools." (Rothbard 1962, 838)

The visible manifestation of underdevelopment is poverty, and its immediate cause is lack of saved capital. The underlying cause, however, is the lack of credible institutions in the realms of politics, law, economics, finance, and society. This lack of credible institutions manifests itself in the inability to ward off predation by either private or public actors. Perhaps one of the most important empirical lessons we have learned from the transition from socialism, and the problem of development assistance more generally, is that efforts to supply the saved capital in terms of loans are counter productive except in areas where credible institutions which constrain predation are already in place.[32]

Development assistance will not be effective if it crowds out indigenous efforts to provide social services, nor will it be effective if it attempts to fill an investment gap. Schooling is not the answer any more than technology transfer *unless* the indigenous population are secure in their knowledge that if they place a bet on an economic idea that will be able to reap the rewards should that bet pay off. They also must be responsible for any losses that they incur in placing their bet if one is going to have prudence in their decisions about when and on what to gamble. The question for the development aid project becomes one of building an institutional infrastructure. Only within a set of institutions that constrain predation and permit the human imagination to wonder to think of new ways to satisfy the desires of their fellow men will the problem of

[32] The Keynesian inspired investment gap theory also started from the recognition that the problem was lack of saved capital, but the argument was that the tight link between savings and investment was severed. Only the government can be relied upon to provide the necessary investment funds. Alternatively, the problem isn't that savings and investment aren't linked it is that the economic environment does not encourage savings and the financial institutions are either lacking or underdeveloped in terms of their financial intermedidation role.

underdevelopment be conquered and the material means be available for human beings to flourish.

To put this in less poetic language, poverty is overcome not through money, but by increasing real output in a society. Increases in real output, however, are generated only by increases in real productivity. Increases in real productivity are a result of three things: (1) improvements in labor skill, (2) improvements in technology available to labor, and (3) improvements in economic organization. These three improvements follow from investors being secure that they will be able to reap the rewards from their efforts through time. In short, the improvements result in the natural course of things provided that individuals are free to pursue mutually beneficial exchanges that they perceive in any given society. If the range of mutually beneficial exchanges is truncated through threat of predation and/or government prohibitions, then increases in productivity will be curtailed and wealth creation will be stunted.

The most important thing for the world's poor is to free their economies. Trade, not necessarily aid as it has traditionally been delivered, is the mechanism through which the world's poor will be lifted from beyond the struggle for subsistence. But as we have stressed the expansion of trading opportunities, both domestically and abroad, is a function of the institutions in a society, and the most important of these institutions are the political, legal, economic, financial, and social institutions that protect against predation by private and public actors.[33] Within the appropriate institutional environment, not all countries will necessarily converge on growth rates for the simple reason that not all communities of individuals would freely choose to occupy themselves

[33] I am not listing geography for two reasons: (1) I am not persuaded that either natural resources or geography provide much in the way of an explanation of differences in per capita income growth, and (2) geography is a parameter and not a variable in public policy.

with maximizing economic returns. If the bulk of people in a community do not want to work hard, it would be foolish for a government to coerce them into working and saving. Of course, given the tight connection between material progress and human capabilities I doubt that a free people would choose to live in the conditions of the poorest regions of Africa of their own accord.[34] No, the poor of this world are not poor out of free choice, but because of lack of quality institutions and bad public policy.

IV. PUBLIC POLICY IMPLICATIONS

How do we correct the problem of low quality institutions and bad public policy? Bad public policy is relatively easy --- education and research in the principles of political economy. To a significant extent this is what the Ronald Coase Institute is attempting to do with scholars throughout East and Central Europe. By developing a network of scholars throughout the region who are knowledgeable of how to construct an institutionally rich economic analysis, they hope to be able to influence public policy in the long-run by changing the intellectual climate of opinion. This is an important strategy on a least two counts: first, it seeks to create an indigenous movement, rather than imposing something from without, and second, it recognizes the importance of the underlying intellectual climate of opinion for public policy. The first builds on a recognition that top-down constructivism runs into real constraints. The second builds on a recognition that in the world of affairs pure self-interest explanations only go so far. Ideas and interests interact with one another to produce the policy space in any society

[34] On the tight connection between material progress and human capabilities see Boettke (2001) and also Boettke and Subrick (2003).

ultimately. This is most evident in democratic societies, but I would contend that it is in operation in dictatorships as well (though the disciplinary mechanisms are dampened).

The policy implications of the narrative I have constructed concerning the contemporary history of thought in comparative political economy is that the focus of our efforts in development assistance should be at the level of the institutional infrastructure. It is widely agreed that the underlying institutional framework of any economy will influence its progress or lack thereof.[35] Despite this recognition, little attention has been paid to the informal, indigenous institutions (culture, values, religions, etc.) that form the underlying framework of the social order. More specifically, little has been said about how these institutions can be understood and also how they can be changed. Most agree that the capitalist institutions of private property, rule of law and some degree of stability are necessary for progress to occur.[36] But this adds little insight for it begs the question – are these institutions transportable? Can institutions that are successful in one country be exported and imposed in other countries in the hopes that the results will be the same? This is the question that underlies the entire endeavor of economic development. Economic theory is able to provide the means to analyze the consequences of the actions of differing regimes of rules. But what can it offer in terms of helping the economist to understand why some rules stick while others fail to do so?

Achieving such an understanding not only requires a comprehension of institutional change but also a theory of why there is acceptance or rejection of certain

[35] See for example, Kasper and Streit (1994), North (1994), Platteau (2000), Scully (1992) among others.
[36] This is certainly not an exhaustive list of the institutions necessary for economic growth. It is simply meant to highlight that there is some agreement on the underlying institutions that are necessary for economic progress to occur. For example, we now have significant empirical evidence that that the socialist model of planned industrialization doesn't hold the answer to economic development (see Boettke, 1990, 1993, 1994). We do know that market economies grounded within the context of a rule of law which protects private property and freedom of contract demonstrate robust progress (see for example, Berger, 1986; Boettke 1996; Gwartney et al 1996, 1998, 1999; Scully, 1992).

institutions. The importance of "stickiness" is often realized by developmental economists, but the solution offered is often that we must achieve and impose the correct incentive structure in order for institutions to be accepted.[37] The problem is deeper than aligning incentives, however important incentive alignment may in fact be. It is a cultural problem. One cannot step out of the historical context of a country and design and impose the appropriate institutional structure in the hopes that it will be accepted (i.e., stick). Despite the fact that we may know what institutions are necessary for growth (i.e., capitalist institutions), we are still unable to impose them due to the fact that they will not be supported by the underlying "ideas" and values that allow for the widespread acceptance of institutions.[38] Economists may very well know what it takes to create an economic success but they do not necessarily know how to do so given the underlying culture.

The engineering mentality has to be abandoned completely in the development aid project. The older development economics sought to engineer the economy, the newer development economics often attempts to engineer the institutions governing the economy when in fact caution is required on the part of external actors. This implies that economists should dispose of any plans of imposing institutions on countries, including notions that we must find the correct mix of incentives to promote economic progress. Doing so begs the question of how the incentives will be implemented and accepted or rejected by the populace given that their "ideas" will not necessarily support them. Focus must be placed on policies that will result in changing the underlying cultural norms and

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[37] Stiglitz realizes that part of the problem with the current globalization is that it "undermines traditional values" (2002, 247). Unfortunately he fails to make the connection that acceptance of institutional change requires a shift in these underlying values. Instead, he calls for the gradual implementation of reforms so that the populace can adjust slowly.

[38] As North writes: "The perceptions of the actors plays a…central role in institutional…change because ideological beliefs influence the subjective construction of the models that determine choices" (1994, 103).

conventions with respect to markets and the institutional infrastructure required to promote the vast network of markets which characterize a vibrant and progressive society. Only then will institutions that are placed over this indigenous framework stick resulting in economic development. Simply put, the only path is an indigenous one. It is best then, for governments to leave as much room as possible for the cultural order to take its course. Until culture, which cannot be imposed, and economic logic dovetail, societies will fail to meet their full potential.

Once the general institutional framework appropriately moves to the center of the intellectual agenda of development economics, there are two other sets of policy questions that arise. First, there is the general public policy recipe that countries need to be encouraged to pursue if the goal is long term economic growth. As we have stressed before, increases in real output result only because of increases in real productivity. Privatization, price liberalization, low inflation, fiscal responsibility, low levels of taxation and regulations, and open international trade constitute the general policy recommendation. The more regulatory policy recommendations of economists such as Joseph Stiglitz (2002) or Robert Wade (1990) represent the last vestiges of the previous command and control mentality of the Keynesian/market socialist era of economic thought. Advocates of this older model are innocent of modern research in political economy that emphasizes institutions, public choice, and entrepreneurial discovery within a dynamic market process.

The second set of policy questions is associated with the details influencing the entrepreneurial process in a society. While legal and political institutions, and even social capital, have been subjected to empirical examination in the economic growth literature, entrepreneurship remains an elusive variable. The elusiveness is to a considerable extent self-imposed by economists because of the methodological straight-jacket they wear. Entrepreneurship, almost by definition, is an aspect of human decision making that defies point prediction. Moreover, aggregate economics is a poor measure of the role of entrepreneurship in society. Instead, the entrepreneurial perspective pushes the analyst to focus on the details of the microeconomic environment and how that environment impacts on economic decision making. David Harper (1996 and 2003), for example, emphasizes the psychological as well as general institutional, policy and cultural factors that impact the vibrancy of the entrepreneurial environment in any society.

An empirical examination of the entrepreneurial space may attempt to score these different elements impacting the entrepreneurial process. See Figure 1. In addition to transaction-cost studies of entrepreneurship (e.g., USAID's Investor Road Map studies) and the study of "informals" undertaken by de Soto, this scoring of the different elements has the potential of identifying the relative weights of different impediments to individuals betting on ideas and finding the financing to bring those ideas to life.

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The New Comparative Political Economy is an emerging literature that refocuses scholarly attention on the political/legal, economic/financial, and social/cultural institutions that govern economic life. We have argued that not only does this research program require a reorientation of theory to be institutionally informed, but also a rethinking of the nature of the empirical element in political economy. An ethnographic turn in empirical work is required for political economists to understand the social meanings that economic actors work within as they attempt to realize the mutually beneficial gains from exchange. At a policy level, the new comparative political economy literature warns of errors committed when ideal efficiency rather than *robustness* serves as the welfare standard against which public policies are to be judged. Finally, the new comparative political economy demands that the policy advisors mentality be reoriented from that of the engineer to that of the gardener. The task is not to construct a vibrant economic order, but to *cultivate* economic development by aiding the establishment of the institutional conditions that enable economic actors to pursue their plans freely, to place their bets on economic ideas, and find the financing to bring those bets to life in the marketplace.

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Variables Impacting Each Stage

International - Free Trade Agreements/ Trading Blocs - Customs - Tariffs					
National & Local - Tariffs - Customs Corruption - Taxation - Rule of Law - Regulations					
Industry - Local & Nat. Governance - Associations - Competitive Environment - Ind. Specific Regulations - Sources of Finance - Social Network - Social Culture					
Individual - Social Network - Social Culture - Local Admin/Governance - Ethnic Background - Education - Age					
	Existence of Entrepreneurial Situation & Identification	Planning and Decision	Resource Mobilization/ Assessment & Project Launch	Organization & Consolidation	Reassessment of Plan

Stages in the Entrepreneurial Process

Figure 1: The Entrepreneurial Space (developed by Aligica, Coyne and Leeson)