Classroom Companion: Economics

Bryan Cheang
Tom G. Palmer

# Institutions and Economic Development

## Markets, Ideas, and Bottom-Up Change

Springer

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London, UK Bryan Cheang

# Praise for *Institutions and Economic Development*

"This marvellous handbook displays an impressive grasp of the vast literature on economic development, highlighting the crucial role of liberal ideas of freedom for economic success. The handbook masterfully summarizes debates on free markets, institutions, and culture as causes of development. This is the best textbook treatment of liberalism and development that I have ever seen."

—William Easterly, *Professor of Economics at New York University (NYU) and Co-director, NYU Development Research Institute*

"Read this book and learn why countries that are rich are composed of people who are free to follow their own bottom-up rules of order in society and economy."

—Vernon Smith, *Nobel Laureate and Professor of Economics, Chapman University*

"Cheang and Palmer offer a clear, lively and engaging introduction to the liberal perspective on one of the key questions in political economy: why are some nations richer, and more highly developed, than others? Their answer, which draws on the work of authors such as Douglass North, Friedrich Hayek, and Elinor Ostrom, emphasises the importance of trade, entrepreneurship and innovation, along with the ideas and institutions that facilitate such activities. This handbook will be read with profit by students of economic development, whether they are of a liberal persuasion or not."

—Paul Lewis, *Professor of Political Economy, King's College London*

"*Handbook of Liberal Institutions and Economic Development* by Bryan Cheang and Thomas Palmer is an outstanding tool for teaching economic development and political economy at both the undergraduate and graduate level. It is written in clear and straightforward prose so widely accessible, but also carefully researched and presents the various perspectives fairly and comprehensively. This work represents a great contribution to the literature, and should be widely adopted in classrooms and beyond."

—Peter Boettke, *Professor of Economics and Philosophy, George Mason University*

"What is the nature of economic development? What are its consequences? Answering these questions poses a vital task in a modern world which has achieved immense gains in living standards over recent generations but is yet to entirely throw off the vestiges of material deprivation. In this book, Bryan Cheang and Tom Palmer present an unremittingly liberal vision of economic development. They illustrate the profound contributions of human agency and enterprise toward economic development, powerfully revealing how freedom underpins productive forces of change. Cheang and Palmer further explain how the freedom to develop is best secured within a quality institutional framework of laws and norms constraining political domination and exploitation. This *Classroom Companion* is an indispensable, state-of-the-art source outlining a humane pathway to development, one that secures a more prosperous and just world for all."

—Mikayla Novak, *Senior Fellow, Mercatus Center*

# Contents

# Development and Progress

# 1

Arguably, the most important question in Economics and probably in social science is ‘why are some nations rich, and others poor?’ Not only is this an interesting theoretical question, it has practical relevance to human living. According to the World Bank, 9.4% of the global population are still living below the poverty line of US$1.90-a-day (The World Bank, 2020). Understanding the factors that contribute to a nation’s economic development will help clarify the path forward for development policymaking.

This Companion will explore the phenomenon of economic development and review the leading theories explaining why it is present in some nations and absent in others. Such a task will necessarily require one to be selective, as development studies is a complex field involving various disciplines with no easy answers. Even today, development economists debate the causes of development and how to foster it in poor nations, if at all possible.

Before diving into development theories, however, this chapter will first define some basic concepts and establish general facts. The subsequent sections will pin down the concept of ‘economic development’ and provide factual information about changes in living standards over time. We show that a real and sustained improvement in living standards has indeed occurred—called the ‘Great Enrichment’ which started in the late eighteenth century onwards. Accordingly, we explore the deep determinants of this development and focus on the rules and values in society which have facilitated this improvement in living standards.

## Why Care About Development?

It is important to first establish why we should care about development. Some today argue that societies ought to move past an obsession with economic growth, and particularly a fixation with Gross Domestic Product (GDP). Growth is said to be unsustainable, driving environmental problems such as global warming and



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resource depletion. The Intergovernmental Panel on Climate Change (2021) estimates that a global warming level of 1.5 °C is inevitable under the current growth trajectory of a carbon-based economy. Untrammelled growth also aggravates social divide and polarisation. This is why some experts and countries are emphasising the importance of non-material aspects of well-being, beyond a narrow fixation with growth. Michael Spence, an American economist and Nobel Laureate, has called for a focus on other factors that determine the quality of life such as education, economic opportunities and access to basic services (Semuels, 2016). Others, such as ecological economist Giorgos Kallis, go further and argue for zero or even negative GDP growth to limit the environmental damage dealt to our planet (Kallis, 2017). Thus, there is a need to clarify some basic terms, especially the concepts of 'growth' and 'development'. Economic growth simply refers to the increase in a nation's gross domestic product (GDP), which is defined as the total market value of all goods and services produced within a territory in a given year. Seen this way, economic growth reflects the level of material production of a nation, i.e. how much goods and services its residents enjoy.

It is granted that growth does not guarantee development. Economic development is a more holistic concept and is generally understood to include growth, plus other aspects that define a good life. Reasonably, economic development also includes measures such as literacy rates and education standards, access to health care, quality and availability of housing, and life expectancy. Recently, aspects of social progress have also been emphasised, such as a nation's environmental quality and gender equality.

## Wealth Liberates People

We acknowledge that growth is no guarantee of development. Surely, possessing more money in and of itself does not mean one is happier. However, growth is nonetheless a necessary, though insufficient condition, for development. A high growth nation is not necessarily a developed one, but no nation can be considered developed if it is unable to facilitate growth in incomes for a broad swathe of its population. Thus, all major developed nations today are also those with high incomes, measured in terms of real GDP per capita.

What is also important is that economic growth enables people to pursue the goals that matter to them. Wealth allows one the financial empowerment to pursue non-material goals, whether those are environmental objectives, the pursuit of social justice activism or some deeper sense of meaning. In fact, available data shows that richer nations are those that fare well on a variety of non-material indicators too. Wealth liberates people to focus on higher levels of Maslow's Hierarchy of Needs. People are free to care about deeper things in life if money is no longer a pressing issue.

According to the environmental Kuznets curve, economic growth may cause a deterioration of the natural environment at early stages but will help improve it after some point (see Yandle et al., 2002 and Dasgupta et al., 2002 for evaluations). It is accepted that in the early stages of development, as industries are created and consumption increases, environmental outcomes may be worse. But after a certain point, economic growth can also benefit the environment by generating the resources necessary for transitioning to renewables and investing in green technologies, by shifting the values of people towards post-material aspects including environmental preservation and by fostering a healthy civil society that allow for environmental activism. Additionally, market-driven growth also facilitates environmental entrepreneurship (Huggins, 2013).

This does not mean that richer countries have no responsibility towards the environment or that they do not contribute to climate change, but it is to say that growth need not be seen as the enemy to environmentalism.[1] Data from the Yale Center for Environmental Law and Policy show a strong correlation between GDP per capita and a nation's performance on the Environmental Performance Index (EPI), which measures ten variables from air quality to carbon emissions (Wendling et al., 2020). This relationship is shown in Fig. 1.1. Moving away from a macro-view, which may obscure individual-level factors, it must also be pointed out that whether growth hurts or helps environmentalism depends on the institutional quality, governance and the policy design of specific nations (Sterner et al., 2019). To improve the environment, improve governance.

Richer countries also do better on various measures of social progress, the subject of growing interest in developed nations. Today, people care not just about money, but about issues of gender equality, sexual orientation, racial equality and fairness and social justice more generally. Interesting, there is strong association between economic growth and social progress. Data from the Social Progress Imperative in Fig. 1.2 show a close connection between GDP per capita and the Social Progress Index, which captures outcomes related to 17 Sustainable Development Goals, including personal rights, personal choice and inclusivity.

Admittedly, not all rich nations do well when it comes to social progress. The Social Progress Imperative has made clear, for example, that countries in the Gulf such as UAE and Saudi Arabia, for example, have high GDP but poor results in social progress, especially when it comes to inclusiveness (Kioes & Pfeiffer, 2015). There are also many countries today which enjoy high rates of income growth, but fall short when it comes to civil liberties and human rights, with China being the prime example. That being said, it is nonetheless clear that economic growth, while an insufficient condition for development, is a necessary one.

The philosopher Brian Kogelman (2022), in a recent and intriguing paper, argued that 'we must always pursue economic growth'. For poor countries, it is clear why growth is a moral imperative. A small increase in national income can mean the difference between life and death. But for richer countries where most

[1] The authors of the 2022 Environmental Progress Index for instance have usefully shown that some nations are not pulling their weight in climate action. Yale Center for Environmental Law & Policy (2022). *Environmental Performance Index 2022.* Yale University. https://epi.yale.edu/downloads/epi2022policymakerssummary.pdf.

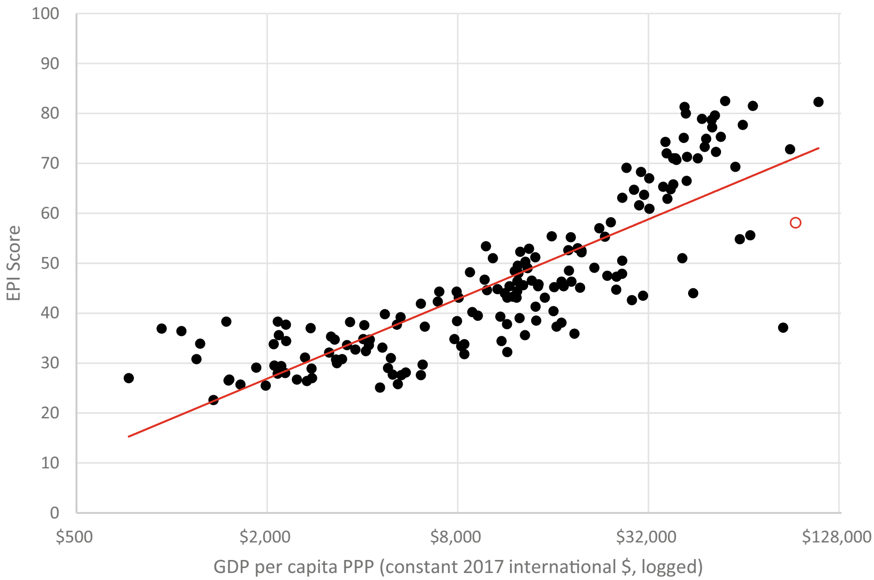


**Fig. 1.1** Environmental Performance Index against GDP per capita *Source* Yale Center for Environmental Law (Wendling et al., 2020)

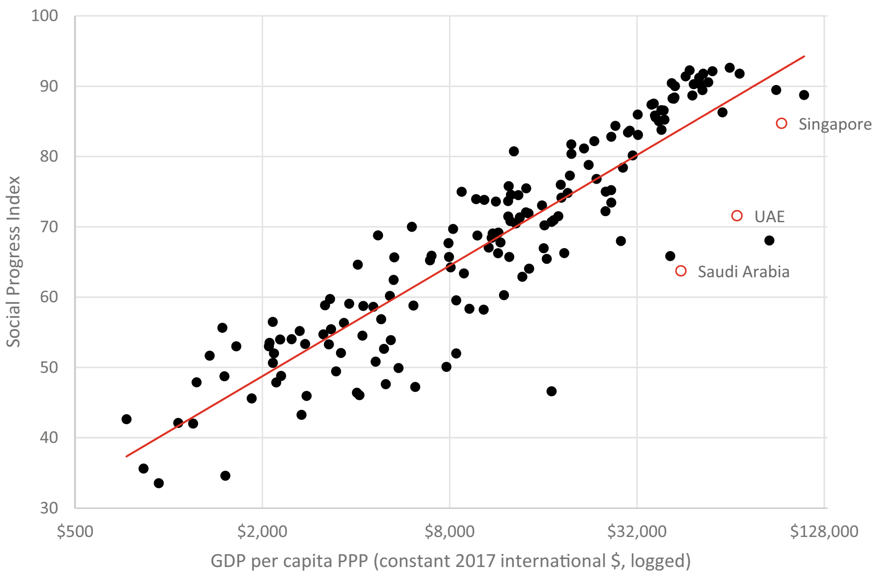


**Fig. 1.2** Social Progress Index against GDP per capita *Source* World Bank, Social Progress Imperative (2022)

material needs are satisfied, some scholars have argued against endless growth, whether due to the problems of increased acquisitiveness, social decay or being a distraction from achieving higher, post-material goods like art, culture and leisure (Keynes, 2010; Rawls, 1971, p. 290). Brian Kogelman (2022) argues against these points and explains that growth typically occurs naturally once the underlying conditions giving rise to it (which we will explore in this handbook) are in place, and that to limit this growth would involve morally objectionable actions: turning institutions extractive, reducing dignity for entrepreneurs or to censor the spread of ideas and technology.

## But Prosperity is not Inevitable

We do not of course promote a naive Pollyannaism. Economic progress may have occurred on a dramatic scale, but it has been uneven and is never guaranteed. We need to learn what contributes to economic progress and avoid that which stifles it.

The disparity in economic conditions today is clear. Certain regions of the world have not experienced the same levels of economic growth that most of the Western world now takes for granted. Average income per capita in Middle East & North Africa and sub-Saharan Africa is $6,534 and $1,501, respectively. By contrast, the income per capita of North America and Europe & Central Asia is $61,502 and $23,955, respectively, several times larger than that of Middle East and Africa. World Bank Data clearly shows the disparity in terms of 2020's GDP per capita, with the Africa being the poorest region as shown in Fig. 1.3.

A historical analysis since 1960 will also reveal uneven progress in growth rates, shown in Fig. 1.4. In this period, the dramatic rise of North America, Europe & Central Asia deserves much attention. Latin America, East Asia and the Middle East & North Africa have made modest strides but still lags far behind Western countries. Unfortunately, sub-Saharan Africa has barely budged from their income level of 1960.

Economic progress is also not guaranteed. Even though the past few centuries saw a dramatic increase in living standards, this progress was disrupted by major world events of the twentieth century. World War I saw the deaths of about 20 million military personnel and civilians (Mougel, 2011). World War II was much worse, with some estimates counting up to 60 million deaths. Between both World Wars were economic disruptions, largely arising from the Great Depression, which led to mass unemployment in numerous countries, and a decline of international trade of up to 60% (Office of the Historian, 2017).

The interwar period saw the rise of extreme political ideologies in the form of Fascism, Nazism and Communism, all of which would wreak havoc in the decades to come. While Fascism and Nazism were relatively short-lived, it did culminate in the Holocaust, which claimed the lives of 11 million people (Paul, 2020). Far

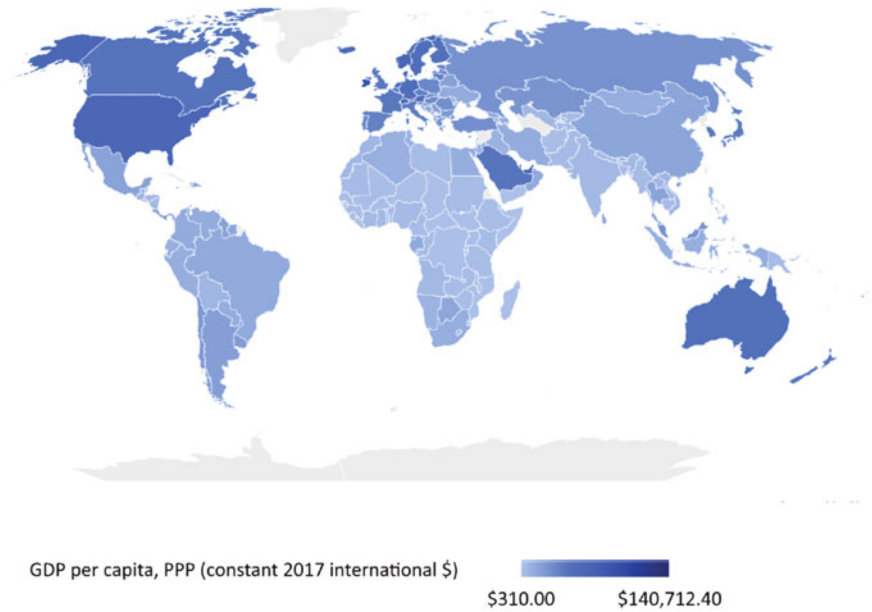


**Fig. 1.3** GDP per capita by countries, 2020 *Source* World Bank (2020)

worse, however, has been the legacy of state-sponsored communism.[2] It has been estimated that approximately 100 million people have been killed by communist regimes due to political killings and economic mismanagement, the biggest culprits being Stalin's USSR and Mao's China (Albert et al., 1999). On a larger level, it has also been found that about 262 million people were killed by authoritarian and totalitarian governments in the twentieth century (Rummel, 1997).

These tragedies, understandably, led to a slowdown in economic development and stalled human progress. They also stand as warnings against certain institutions and ideas that are inimical to development, a theme that this book will return to.

The urgency of economic development is clear today. In fact, recent developments have increased poverty. It has been reported that in 2020, global extreme poverty rose for the first time in more than 20 years, due to the disruptions brought about by COVID-19 and governmental responses to it (The World Bank, 2020). Estimates show that about 100 million more people today are living in poverty since the pandemic struck (Mahler et al., 2021).

[2] It should also be clarified though that the communist regimes mentioned are large-scale, state-sponsored attempts at socialism, and should not be conflated with a variety of Marxist or socialist positions taken today. There are indeed a number of reasonable positions in this regard, for example, analytical Marxism (see Leopold, 2022), and recent proposals of democratic socialism or liberal solidarity (Hodgson, 2021).

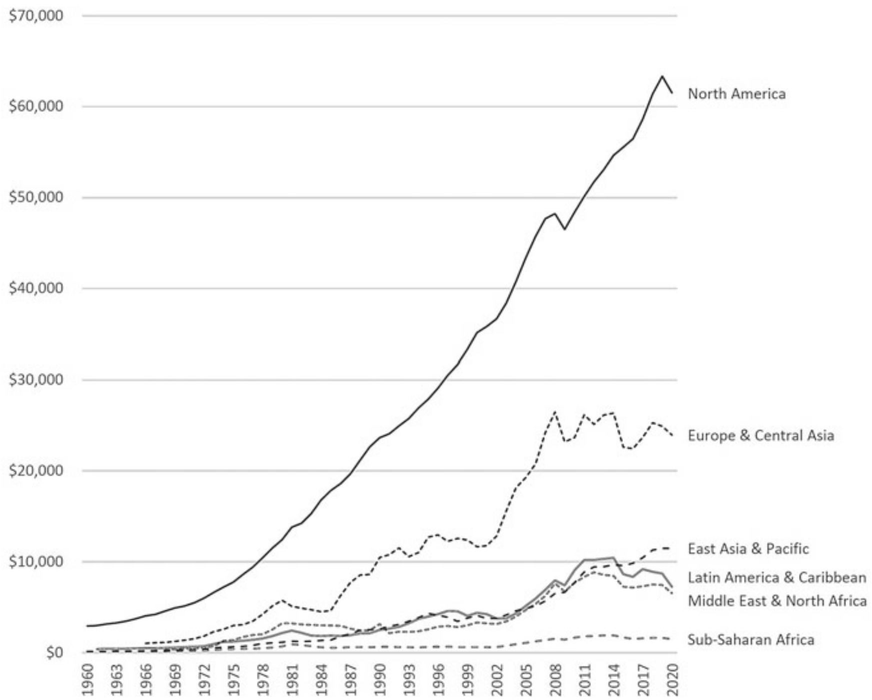


**Fig. 1.4** GDP per capita by regions, 1960–2020 *Source* World Bank (2020)

## Explaining Development

The principles of economics help us understand why some nations are rich and others poor. We need to first interrogate the simplest of questions: how is wealth created? To answer this, we have to investigate how goods and services are produced for the benefit of consumers.

The most elementary concept to understand in development economics is that of the Production Possibilities Curve (PPC), which helps distinguish a high growth society from a low-growth one.

A nation that has a larger PPC from the origin is one that is capable of producing a greater amount of goods and services, and thus able to satisfy the material wants of its citizens. Economics also teaches that an outward shift of the PPC (Fig. 1.5) is possible through an increase in the quantity and quality of factors of production. These factors of production in turn include land and natural resources, physical capital, labour, human capital as well as entrepreneurship. These are the immediate ingredients of economic growth.

The most basic resource is land, coupled with other natural resources found in the natural world. Most firms rely on physical premises (though there's the rise of online businesses today) and have to transform some natural resource when

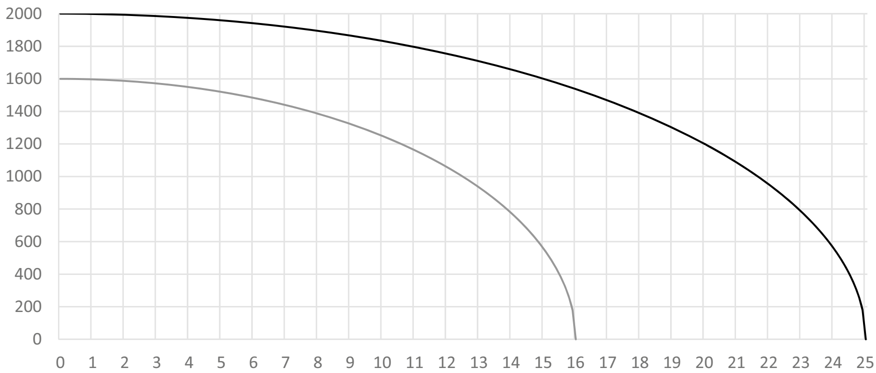


**Fig. 1.5** Shift of the PPC curve

producing goods and services. This on the surface suggests that the greater the availability of natural resources, the greater the potential for production.

Labour is important because they are productive assets used by firms. Workers are needed to serve customers, operate capital, manage business processes, etc. Therefore, population growth is generally considered a positive factor in stimulating economic growth. An important aspect to consider is not just labour, but the wider category of human capital. Labour is the physical asset of the human body, while human capital refers to the skills, knowledge and experience that labour possesses. An increase in human capital means that on net, the workforce is more productive, and hence, material production may be increased. Human capital in turn is dependent on expenditures on education, on the job training programs, medical care and more.

Physical capital is also another ingredient of an economy's productive capacity. Capital consists of physical goods that are used in the production of other goods and services for consumer benefit, i.e. machines, factories, equipment, etc. Capital is accumulated in an economy when people save and invest. Rather than enjoying present consumption, funds are directed towards investing in capital goods. Capital goods are essential for high levels of material production because without them, we would not go very far. Capital goods allow workers to be more productive than they otherwise would be. Greater investments in capital translate into greater productive capacity.

The most important aspect of production, however, is entrepreneurship, which is often neglected in most mainstream accounts of economics. Entrepreneurship involves the act of creating business ventures to achieve commercial profits but is much broader than business. Entrepreneurs, in our definition, are those who discover and seize profit opportunities. Entrepreneurship is an important driver of growth insofar as it promotes efficiency and innovation through 'creative destruction', a la Joseph Schumpeter. New businesses compete with old ones, and this incessant competition replaces long-standing practices with new and productive ones that will result in better products at lower prices (Caballero, 2010).

In sum, it is by increasing the quantity and quality of these resources will nations be able to sustain the production of material goods and services for its people. The Production Possibilities Curve will be shifted outward, illustrating the greater combinations of goods and services that can be produced.

It is important to remember, however, that the above account is incomplete. Ultimately, goods and services are produced within an economy for the benefit of consumers. We thus need to look at consumers and their pursuit of economic value. Production is intimately tied to consumption. A consideration of consumption then behooves us to reflect on specialisation and the division of labour, both of which fulfil human wants, and to which we now turn.

Imagine that you are stranded on an island with some other strangers. In order to survive, you will need to meet your basic needs of eating and drinking. If you tried to gather food and drink on your own, it may be possible, but highly inefficient. One would have to forage for food from the earth, but then will encounter the difficulty of transforming them into edible products: we need tools to cut fruit, hunt animals and prepare food. How will we make tools? Where would we look for the minerals needed to form tools? All this for a simple meal. At this point, we should be able to realise that any community that relies purely on self-sufficiency will not be capable of mass production and high standards of living.

## Gains from Trade

Consequently, one of the most basic insights of Economics is the importance of specialisation, exchange, and the division of labour. Rather than trying to do everything on your own, you may simply specialise in one activity, let's say being a farmer. You become very good at this and produce agricultural produce for society, in return for money which you then use to exchange for other goods and services you desire. If everyone in society engaged in such specialisation and exchange based on the division of labour, society will be able to produce much more than was possible under self-sufficiency. This basic insight was most popularly advanced by Adam Smith in 1776 with his *Wealth of Nations and* remains ever-important today.

Economists have an important principle called 'comparative advantage', which is when one can produce a certain good or service at a lower opportunity cost than someone else. When people specialise in what they have a comparative advantage in and trade with others, both parties can consume beyond what is possible in its absence. If we didn't trade with others, we would have to give up more resources to achieve a certain outcome, but in trade, we take advantage of someone else's relative efficiency and mutually gain in the process. What is true for an individual is true for a nation. When nations produce what they have a comparative advantage in, they manage to transcend the confines of their PPC. Thus, economies stand to gain from trade in terms of greater production and consumption possibilities. In the late twentieth century, the opening up of many developing nations like China and India to global trade was a big factor behind their rapid economic development

(Panagariya, 2019). Today, it is estimated that the total value of free trade around the world is $28.5 trillion (UNCTAD, 2022).

Trade should not just be seen in terms of goods and services. The free movement of labour around the world promises to bring about even greater prosperity. As it is today, severe restrictions on immigration mean that talent is locked up in places where little use is made of them. When we allow people to move freely, we unlock their potential. The economist Michael Clemens (2011) likens the gains from free immigration to 'trillion-dollar bills on the sidewalk'. So large is this gain that 'eliminating those (immigration) barriers amount to large fractions of world GDP—one or two orders of magnitude larger mount to large fractions of world GDP—one or two orders of magnitude larger than the gains from dropping all remaining restrictions on international trade' (Clemens, 2011, p. 84).

## Gains from Innovation

Closely accompanying gains from trade are also the gains from innovation.

Innovation is another critical key to understanding economic development. There are two components. First, 'product innovation' refers to the introduction of new types of goods and services and the improvements in quality of existing products. This is an important aspect of economic development, because material well-being does not just mean having higher incomes, but access to better quality products. Political elites throughout history, like Kings and Queens, enjoyed wealth, but never had the same access to the technologies, gadgets and appliances of today.

This is complemented with 'process innovation' which refers to the introduction of new ways of producing goods and services and the improvements in commercial practices. This may include managerial practices, organisational processes and the improved uses of various factor inputs. Process innovation results in greater productivity. Goods and services can be produced cheaper and faster, saving resources for other uses instead. It is process innovation that makes new products become widely available to the masses, even if they may be limited to the elite few in the beginning. Process innovation also helps us reimagine the possibilities of business. Today, business activities transcend physical distance and can operate remotely across continents. The extent of the market has tremendously been extended due to the discovery and use of new production techniques.

The benefits of innovation are significant. Technological progress for one has allowed us to enjoy better product quality at reduced prices. A good example is personal computing. Personal computing has not always been a luxury accessible to most people. In 1972, the most basic model, HP 3000, costs a whopping $95,000, equivalent to half a million in today's dollars. Today, the cheapest model goes for a few hundred dollars and possesses capabilities beyond the wildest dreams of computer scientists back in the 1970s. The prices of other consumables have also fallen dramatically. The decline in the price of televisions

(96%), software (67%) and toys (69%) is a testament to the immense potential of technological revolutions (see Roser & Ritchie, 2013b).

The gains from specialisation, coupled with the gains from innovation, improve material living standards, allowing the average individual to enjoy a greater range of ever-improving goods and services.

## Entrepreneurship the Driving Force

Trade and innovation, however, are not mechanical processes. They are fundamentally driven by entrepreneurs, who are central players on the economic stage. Entrepreneurs make use of the various factors of production and synthesise them into a coherent plan of action. Without them, capital, labour, land and other resources would have no economic value to consumers whatsoever.

The role of entrepreneurs, however, is often neglected in mainstream economics, including in the field of development. Early theories of growth tended to emphasise greater inputs into an economy's production function, which in turn generates outputs. Economic growth, however, is not delivered the same way a factory machine produces clothes. The economy is an organism comprising human action. When we unpack this 'black box', we observe the crucial element of entrepreneurship.

Entrepreneurship is often difficult to define. It certainly must be distinguished from business management, which is primarily centred around the smooth oversight of the firm's operations. We take entrepreneurs here to be anyone who discovers and seize profit opportunities (Holcombe, 2006). Sometimes, entrepreneurs help bring the market into equilibrium, and in other times, they disrupt the status quo. The equilibrating and disruptive functions of entrepreneurship cohere with the intellectual contributions of economists Israel Kirzner (1973) and Joseph Schumpeter (1942), respectively.

Gains from trade are tied to entrepreneurial action. Entrepreneurs, either by themselves or within firms, are alert to profit opportunities around them. They seize these opportunities by developing production plans to satisfy their consumers. Of course, some entrepreneurs are more successful than others, and they are guided in their endeavours by the feedback mechanism of profit-loss, which rewards firms that are best able to value-add to the customers they serve.

The gains from innovation also must be understood in relation to entrepreneurship. Entrepreneurs, as part of their constant process of learning, sometimes discover new goods and services, and new production techniques worth employing. They then pursue these new innovations and disrupt the status quo in the process. The disruptive actions of these entrepreneurs constitute the process of 'creative destruction' that the economist Joseph Schumpeter (1942, p. 83) described as 'the essential fact about capitalism'. This is the same process that has radically transformed our lives, especially in the past few decades which witnessed exponential technological progress. It was entrepreneurial insight that conceived Uber, the smartphone and the mRNA vaccines, and soon, spaceflights for the ordinary man. Today, many growth models in economics recognise the centrality of entrepreneurship and creative destruction (see Aghion & Howitt, 1992, 2008).

The benefits of innovation accrue to ordinary consumers and are not simply concentrated in the hands of the elites. This was the subject of empirical research by Nobel Laureate William Nordhaus (2004), who showed that from 1948 to 2001, most of the benefits of technological progress in the United States were received by consumers rather than by the producers themselves.

It should also be noted that today, there are numerous criticisms against the corporatisation of business. Arguably, large corporations dominate the economy, forming an economic oligarchy. Economic wealth may also translate into political influence, undermining the democratic process. Those who play down the severity of market dominance point to how the large firms and billionaires of the 1990s are no longer around today, a testament of creative destruction (Bourne, 2019). However, given the unprecedented nature of Big Tech and the network effects they enjoy, a new era of anti-trust regulations and corporate governance reforms may be sorely needed (Zingales, 2014; Fukuyama et al., 2021).

## Institutions and Ideas Matter

Economies become wealthy by exploiting gains from trade and gains from innovation, which are in turn made possible by entrepreneurship. Both mechanisms allow greater levels of production, and a broader range of consumer wishes to be satisfied. However, some nations have not been able to take advantage of these processes. They lack some fundamental ingredients that are needed to engage in successful economic production. We need to understand why. Increases in productive inputs and the gains from trade and innovation are all part of the explanation but remain proximate causes of growth. Hence, there is a need to turn to more fundamental explanations of growth, as opposed to proximate accounts.

There have been generally four schools of thought in the analyses of fundamental factors of growth. The first is the geography school, which holds that a nation that enjoys favourable geographical conditions is one that will ultimately thrive, or at least derive a significant headstart. The second is the cultural school, which focuses on the favourable cultural traits that predispose a nation towards economic production and progress. The third is the leadership school, which focuses on the actions of enlightened political leaders in enacting good policies. Last of all is the notion that 'institutions matter', which is the idea that the prevailing rules in any society influence economic behaviour, and hence outcomes (Fig. 1.6).

In this book, we primarily focus on the role that institutions and ideas play in generating positive economic outcomes. Institutions, i.e. the rules and norms in a society, as well as the ideas that underpin them, have a fundamental impact on a nation's growth prospects. This is not to say that they are the only factors that matter, but rather that they are most central to any understanding of long-run development.

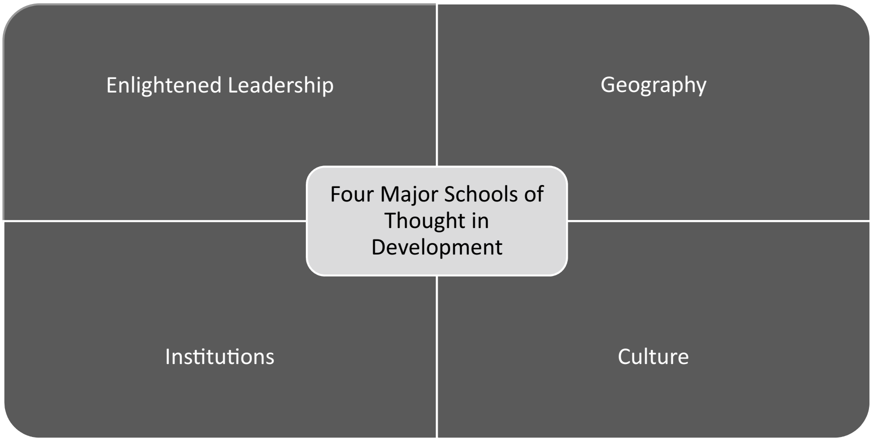


**Fig. 1.6** Four Major Schools of Thought in Development

The idea that institutions are of great importance is today taken for granted in the social sciences (Rodrik et al., 2004; Acemoglu et al., 2005; Acemoglu & Robinson, 2012, 2020). This was not previously the case. For much of the twentieth century, however, various post-war theories of development either assumed the presence of good institutions or downplayed their importance.

## Economic Theories

In the post-war period, development theory heavily emphasised the importance of capital accumulation. According to what is now known as 'capital fundamentalism', poor nations needed to mobilise domestic savings and welcome overseas investments in order to kick-start economic growth. Seen this way, the problem with poverty is a lack of capital investment, which can be solved through an injection of such funds. Closely associated with capital fundamentalism was the theory by Walt Rostow of the 'linear stages of growth', which posited that developing countries are in the backward stages of modernisation and thus may advance through the following stages: traditional society, preconditions for take-off growth, economic take-off, the drive to modernity and the age of mass consumption (Rostow, 1960). Rostow's modernisation theory also rested on the belief that developing nations sorely needed capital, without which they would not be able to bring about industrial development and catch-up growth.

The emphasis on capital accumulation thus dovetails with the emphasis in development circles on foreign aid. Poor countries should, according to this perspective, foster domestic savings for investment purposes, including initiatives such as tax incentives and government investment in domestic industries. One theory in this vein of thought is by the development economist Paul Rosenstein-Rodan who believed that there was a minimum scale for savings, investments and demand that must be reached for growth to take-off. Accordingly, the state should embark on a 'big-push', to catalyse growth through large, infrastructure and similar spending projects (Murphy et al., 1989; Rosenstein-Rodan, 1943). If domestic efforts are inadequate, then external injections of foreign aid may be necessary. If poor countries lacked capital, then it would make sense for richer nations or world organisations to inject such capital into these countries through aid programs.

While these theories correctly pointed out that capital investment is key to any nation's growth story, the heavy emphasis on capital meant that the deeper problems of governance were neglected. Poor countries may not have a functioning state bureaucracy with which to foster investments or attract them (Bardhan, 1990). In the absence of proper and functioning institutions, external foreign aid programs may in turn be mired in inefficiency and corruption at worst. As will be shown in the later chapters, such foreign aid programs sidestepped the deeper question of how to reform domestic institutions in a manner that promoted market-based development.

In the later twentieth century, two other economic theories of development came to the fore: endogenous growth theory and the neoliberal-Washington Consensus. Both theories also sidestepped institutional questions. In the 1980s onwards, as part of the rise of 'neoliberal' ideas, a set of policy reforms, known as the Washington Consensus, became part of the dominant paradigm in development. These policies emphasised macroeconomic stability, fiscal restraint and balanced budgets, as well as market policies like privatisation and liberalisation (Williamson, 2009). The Washington Consensus framework has been controversial and subject to much debate till today. One important strand of criticism is that it failed to recognise that market reforms required certain institutional pre-requisites, which many post-communist nations did not possess at the time (Rodrik, 2006).

Endogenous growth theory emerged in part to fill the gaps in neoclassical economics, emphasising the interplay of internal factors that would lead to technological and productivity improvements (Romer, 1994). An important ingredient in endogenous growth theory is investments in human capital and the knowledge spillovers that such investments will lead to. Consequently, an implication of this perspective is that the state has a role to play in promoting and creating incentives for human capital improvements and technological research, since private firms may under-invest in them (Cypher & Diaz, 2008).

While both Washington Consensus and endogenous growth theory pointed to important insights, that of the importance of markets and human capital respectively, the focus on the institutional environment was not central. Economists today generally agree that the quality of a nation's governance should be the first question of development. Poor governance, or the absence of healthy governance institutions, will mean that markets cannot function properly, or that the requisite investments in technology are not forthcoming.

## Geography and Culture

In addition to economic theories of development, there have also been other theories that place a premium on culture and geography. In these perspectives, institutions are also not the central actor. The geography school argues that development is mainly dependent on a nation's geographical location and natural conditions. Understandably, there's a wide variety of theories within the rubric of geography, with some emphasising climate (Bloom et al., 1998), the access to waterways (Sachs et al., 1995), its role in generating uneven development (Harvey, 2005), as well as the nature of the factor endowments present. A well-known, albeit very long-run theory drawing from an emphasis on factor endowments is by Jared Diamond (1997), who identified initial favourable conditions such as the East–West axis and favourable animal and plant endowments in the Eurasian landmass, all of which provided a head start in the race to develop.

The relationship between geography and institutions is complex and disputed. Some variants of geographical theories may be more deterministic, suggesting that natural conditions may pose a severe barrier to development, trapping nations in poverty (Bloom et al., 2003). A leading proponent of the geographical school, Jeffrey Sachs, has claimed explicitly that institutions are not fundamental causes of development: 'for much of the world, bad climates, poor soils and physical isolation are likely to hinder growth whatever happens to policy' (Gallup et al., 1999).

This is not to say that institutions do not matter at all; in fact, the claim is that geography may in fact have an indirect effect on the nature of institutions that are created. The leading institutional economists today, Daron Acemoglu and James Robinson, acknowledge that geographical factors have an indirect, historical influence on the type of institutions that colonies inherited during colonialism, which in turn led to path-dependent effects over the long run (Acemoglu et al., 2002). While those like Jeffrey Sachs place more weight on geography and the barriers it poses, Acemoglu and Robinson emphasise institutions.

The notion that 'institutions matter' is of course more complicated than it sounds. Institutional economics is an internally diverse school of thought, which includes an older tradition in America featuring the likes of Thorstein Veblen, John Commons, Wesley Mitchell and John Kenneth Galbraith, as well as 'New Institutional Economics', its standard bearers being Ronald Coase, Douglass North, Elinor Ostrom, among others (see Hodgson, 2004 and Menard & Shirley, 2005 for an excellent coverage of both sub-traditions). One, though by no means the only, theme that unifies all institutionalists is the belief that economics cannot be reduced to an analysis of individual utility maximisation and rational behaviour, a cornerstone of mainstream economics today. Individuals are shaped by their culture, habits-of-mind, history, politics and more. Economic behaviour is thus far more complex and is situated within socially embedded rules. The agenda of institutional economics thus broadens our field of vision, refocuses attention onto the myriad factors that influence human action, and contributes to an interdisciplinary approach to development studies. By examining insights from other disciplines beyond the narrow confines of economics, one better understands the nature and causes of the wealth of nations.

Accordingly, 'culture', something that is typically sidestepped in mainstream economics but central to sociology, is crucial for development studies. On this aspect, prominent economic historians have shown how the prosperity of the Western world is in large part a product of its values. A number of accounts emphasise the Protestant work ethic of Max Weber, whereby protestant Christianity is said to promote hard work, a sense of thrift and values conducive to capitalism. The historian David Landes (1995) is one example of such a proponent. A related argument is by Joel Mokyr (2016), who focused his argument on the culture of innovation that arose in the Western world due to intellectual figures such as Francis Bacon, all of whom disseminated an ideology of progress. What such accounts have in common are unique cultural traits that explain Western prosperity.

A question that arises from such accounts is whether then pro-development values are basically rooted in the West. Does development require Westernisation then? A useful cultural account of development is by Lawrence Harrison, who outlined some universal values that are conducive to progress. Pro-growth cultures are those that have religious beliefs that encourage rational thought, material progress, forward-thinking and practicality (Harrison, 2006). Such cultures also see in trade a positive-sum game and the possibility of mutual gain. Seen this way, poor countries require a cultural transformation in order to attain development.

In our perspective, culture is an important ingredient in development and is one that works in close tandem with institutions. Institutions, being the rules that govern human life, are connected with the prevailing cultural norms and beliefs. The beliefs we hold shape and are in turn shaped by the rules of society and the way we are collectively governed. We argue that economic progress and development require societies to have a set of rules and values that reward economic exchange, production, and innovation. In subsequent chapters, we explain why the institutions of market capitalism, as well as the liberal values that underpin them, are essential for nations to experience progress.

Institutional economists, in the tradition of Douglass North, have acknowledged that both culture *and* formal institutions influence behaviour and shape development outcomes. This is not new. Yet, ongoing questions remain as to how, when and why is it that culture influences institutions and vice versa. It has been said that culture has been treated as a black box in institutional analysis (Acemoglu & Johnson, 2005). The link between culture and institutions is complex and is the subject of ongoing research.

Another major challenge in development theory is how societies can indeed transition to and acquire the set of institutions and values that reward progress. It is one thing to know what these ingredients are and a totally different task altogether of the actual implementation. Indeed, Western nations have tried to socially engineer Western-style institutions in poor nations, with mixed success. For every South Korea, there is an Iraq that undercuts the 'Western Institutions' argument. It is also difficult to see how cultural change can take place, especially in the context of top-down development policies implemented by global organisations.

## The Great Enrichment Tells Us That Prosperity is Possible

Achieving economic development is indeed an important objective to work towards. History also shows that economic progress is possible. One of the most important facts in history is the Great Enrichment, which refers to the sudden and enormous improvements in living standards in the nineteenth century. This is best represented in Fig. 1.7, which depicts what has famously been called the 'hockey stick' graph of development.

What this graph illustrates is that first and foremost, human beings have been poor for most of history. This data, gathered from the work of British economist Angus Maddison, tells us that people from the past were much poorer than we are today. Estimates tell us that the average income per person in 1820 was around $1100 a year. People living in the decades and centuries before were no richer than this.

The amazing breakthrough occurred only very recently in human history (the blade of the hockey stick), beginning in the nineteenth century onwards and which accelerated in the 2nd half of the twentieth century. During this period, the average national income of Western Europe rose by 517% percent. In the same period, average American GDP per person rose by 581% percent and life expectancy by 28 years. In Asia, average GDP per person rose by 96% percent between 1913 and

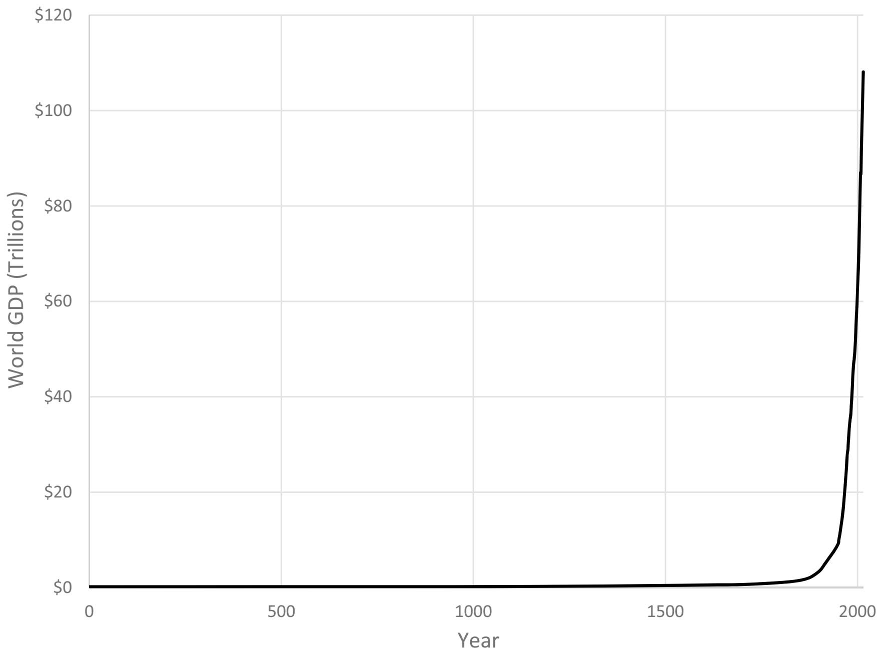


**Fig. 1.7** World GDP over the last two millennia *Source* Maddison Database (2010)

1999. Today, the average GDP per capita is approximately $15,000, more than 15 times the average of the past (Roser, 2013).

The economic historian Deirdre McCloskey, in her Bourgeois trilogy, has shown how this Great Enrichment dramatically increased incomes by a factor of 30, or in other words, 3000%. This is a significant turning point in history, one that we should appreciate, study, and seek to sustain. For the first time in recorded human history, half of the world is middle class or richer. Research by the Brookings Institution published in 2018 shows that we have reached a 'global tipping point', where some 3.8 billion people now live in households with enough discretionary expenditure to be considered 'middle class' or 'rich' (Kharas & Hamel, 2018) (Fig. 1.8).

Significantly, the middle class is fast growing and is projected to reach more than 4 billion people by the end 2020 and 5.3 billion people by 2030. Compared to today, the middle class in 2030 will have 1.7 billion more people, while the vulnerable groups will have 900 million fewer people (Fig. 1.9).

It cannot be overemphasised that economic growth has benefitted not just the 1%, but the very poor among us. Data shows that the number of people living in poverty and absolute poverty has been slashed. Since 1820, the number of people *not* living in extreme poverty has gone up to more than 7 billion (Figs. 1.10 and 1.11).

A major contributing factor to this dramatic reduction in poverty was the rise of Asia in the twentieth century, especially India and China. East Asian economies

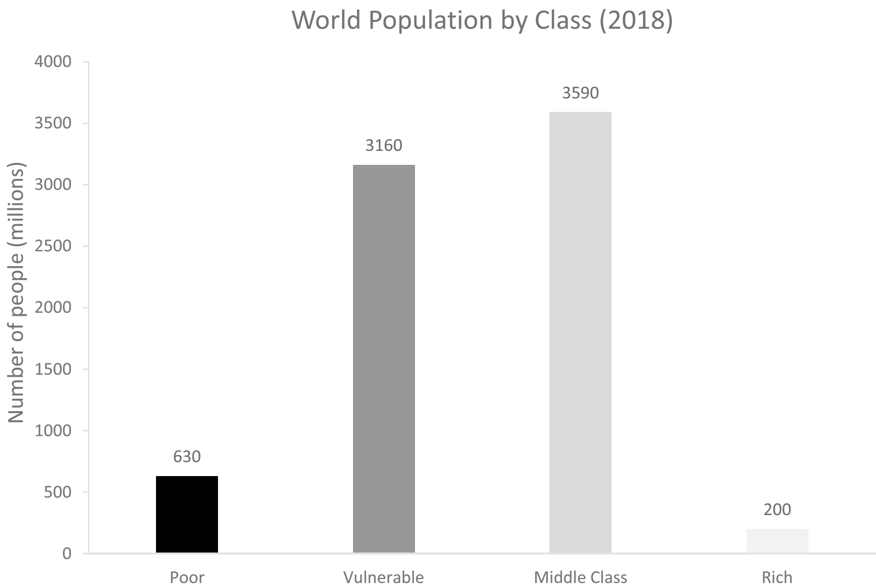


**Fig. 1.8** World Population by class in 2018 *Source* Calculations by World Data Lab as Reported by Brookings Institution (Kharas & Hamel, 2018)

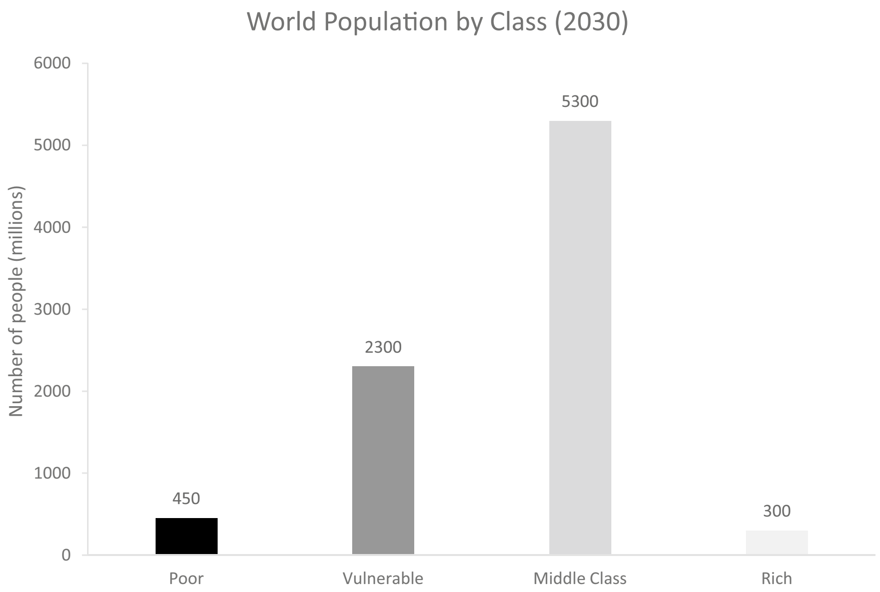


**Fig. 1.9** World Population by class in 2030 *Source* Calculations by World Data Lab as Reported by Brookings Institution (Kharas & Hamel, 2018)

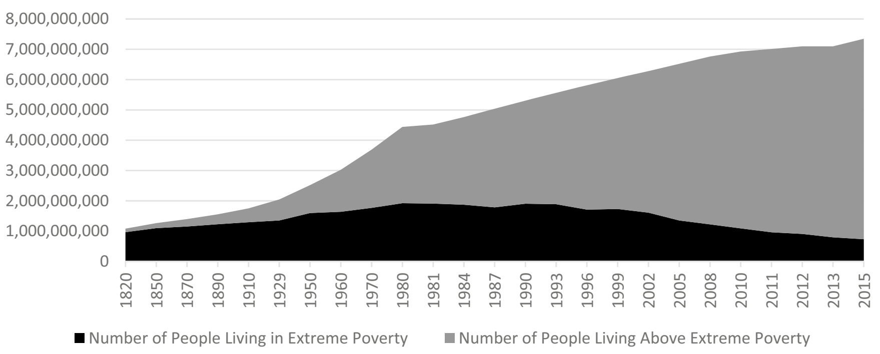


**Fig. 1.10** World population living in extreme poverty, 1910–2015 *Source* World Bank; for details see Ravallion (2015)

like Japan, South Korea, Singapore, Taiwan and Hong Kong industrialised and caught up to the West within one generation. China and India's growth have also been significant, to the point of reducing global income inequality. According to investigations by Christoph Lakner, a consultant at the World Bank, and Branko Milanovic, senior scholar at the Luxembourg Income Study Center, global income inequality fell for the first time since the Industrial Revolution, in the period from 2008 to 2014 (The World Bank, 2019).

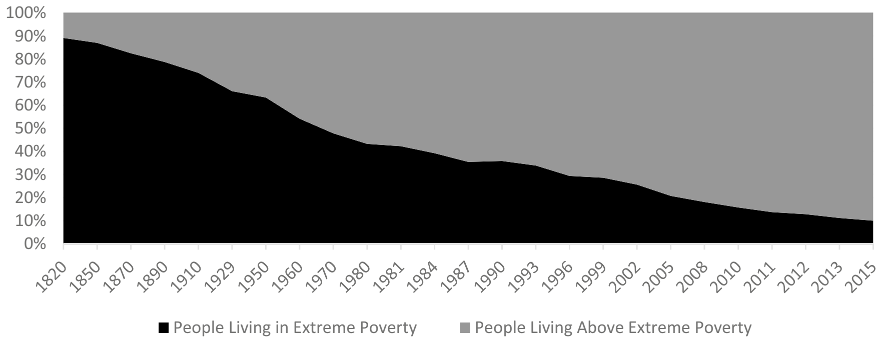


**Fig. 1.11** Proportion of world population living in extreme poverty, 1910–2015 *Source* World Bank; for details see Ravallion (2015)

## Access to Essential Goods

Of course, the high living standards that most people enjoy today are not just denoted in monetary terms. Economic prosperity has also allowed nations to provide for basic needs, namely access to food and water, health care, and education.

Access to food has seen tremendous improvements in the past 60 years. Daily caloric supply has increased 31% since 1961, according to the UN Food and Agriculture Organisation. The global per capita supply of protein has also increased similarly by about 33%, from 61 g in 1961 to 81 g in 2014. However, these trends vary tremendously across the world's regions. The daily per capita caloric supply in North America is 3,471 cal while that of Africa is only 2,311. Protein supply tells the same story. In 2014, per capita protein supply in North America is 40% higher than in Africa (Roser & Ritchie, 2013a).

Progress in the access to safe and reliable water supply is also seen. As of 2020, about three of our four people have access to safe drinking water, with an upward though slow trend of progress in the last ten years. Household sanitation levels have also improved markedly over the past two decades with more than half of the households gaining access to 'safely managed' sanitation facilities where excrements are safely disposed of (Unicef, 2020).

Access to education is also a key aspect of economic development, of which we have made great strides. In 1900, 78.6% percent of people aged 15 years and older were classified as illiterate. In 2016, that number has dropped to under 14% percent. Primary school enrolment has also increased over the past century from 72% in 1970s to 91% today (Roser & Ortiz-Ospina, 2016).

We are also living longer and healthier lives today. In 2017, the average life expectancy in the world was 71.7 years. Just around 150 years ago, it was 29.7 years (Roser et al., 2019). Notwithstanding the impact of COVID-19, there have been great improvements in the past two decades in healthcare access and quality, due to gains in low- and middle-income countries. This is according to recent data from the Global Burden of Disease study published in *The Lancet*. In 2016, the global average healthcare access and quality score was 54.4, increasing from 42.4 points in 2000 (Fullman et al., 2016).

## On Sustainability

While the core focus of this handbook is on the nature and the causes of the wealth of nations—economic development—no discussion of it would be complete without some brief mention of sustainability. Today, sustainability is a highly valued objective in business, society, and public policy. From the perspective of development, the key concept is that of 'sustainable development', which we may simply define as an approach to development that is cognisant of wider environmental impacts, and which aims to limit these harms to the natural world. This is because economic growth may proceed at too fast a pace or may be driven by environmentally unfriendly strategies. Thus, sustainable development calls for an approach to growth sensitive to these green objectives.

One initial step in the sustainability project is to better capture these objectives, which are said to be neglected in national income indicators. Gross domestic product and its variants are focused on the measurement of material income generated from the production of goods and services. So, a narrow obsession with these indicators may blind societies to the negative effects of growth. There are of course a variety of environmental indicators that one may track, but one specific indicator that synthesises both traditional growth aspects with environmental goals is that of 'Green GDP', which subtracts losses to biodiversity and climate costs (Stiglitz et al., 2009). An influential and recent indicator is the Sustainability Development Index, which modifies the HDI by also considering 'ecological overshoot', i.e. 'the extent to which consumption-based CO2 emissions and material footprint exceed per-capita shares of planetary boundaries' (Hickel, 2020).

The proper relationship between growth and environmental objectives is complex, because it is dependent on deeper normative commitments.[3] It should be pointed out that there are a variety of environmentalist positions (see Schmidtz & Shahar, 2019 for a comprehensive volume). One of which is 'deep ecology', or radical environmentalism, which holds that the natural world possesses intrinsic value in itself, and thus deeply rejects anthropocentrism in most mainstream environmentalism (Naess, 1971). Other radical positions trace environmental problems to deeper ideological roots of Western society, such as capitalism, neoliberalism, patriarchy and industrialism. If such a radical position is taken, then many contemporary environmental proposals, which operate within the framework of industrial capitalism, are rejected. This rejection may take the form of eco-socialism, the paradigm of de-growth (Jackson, 2016; Victor, 2019) or even a wholesale rejection

[3] We recommend reading Michael Hulme's (2021) latest book on climate change, which transcends the narrow scientism in mainstream discourse and shows how normative commitments, social meanings and the humanities shape climate discourse.

of the basic tenets of modern life. On another end, some extreme anthropocentric humanists reject environmentalism for being fundamentally incompatible with human flourishing (Biddle, 2011).

We obviously cannot settle this debate, which understandably features a wide range of positions beyond those just stated. The point we wish to make is that if economic growth and environmentalism are both seen as desirable—and there are good reasons to believe so—then there should be a reasonable compromise on both sides. Many mainstream environmentalists propose solutions, such as carbon taxation and investment in green energy, which are not only compatible with growth, but may even contribute to growth and its material benefits. These win–win proposals are to be encouraged. Arguably, the paradigm that most befits such a position is 'ecomodernism', which seeks to decouple growth from its environmental impacts and alleviate environmental problems through modern, smart, and technologically driven solutions (Asafu-Adjaye et al., 2015; Symons, 2019). As with all positions, ecomodernism has its share of criticisms. We, however, broadly share its basic premises: climate change is a serious problem and a consequence of modernity, but rather than dismantling the inherited institutions of modernity, lets reform them (Hulme, 2021, Chap. 3).

This handbook ultimately is not about environmentalism but endorses the basic idea that growth and environmental objectives need not be at loggerheads. Growth, especially its pace and the approach used, may have to be modified, especially in the transition to renewables. Such policies and compromises should be supported. But growth itself should not be entirely rejected. There is also a strong relationship between growth and environmentalism (see Fig. 1.1 abovementioned again), such that wealthier nations, on balance, can better afford to invest in renewables, are more climate-resilient, and tend to have more vibrant civil societies where environmental activism flourishes. In fact, many leading economists have begun to incorporate environmental concerns into growth analyses and outline their mutual compatibility—most notably William Nordhaus, whose work has 'brought us considerably closer to answering the question of how we can achieve sustained *and* sustainable global economic growth' (emphasis mine) (Royal Swedish Academy of Sciences, 2018).

In the spirit of institutionalist thinking, the task of achieving sustainable development may also be considered as a challenge of governance. What sort of institutional arrangements and what reforms to existing institutions may be achieved if green objectives are to be met? Seen this way, the constraints of political economy, such as incentive compatibility, bounded rationality, and collective action problems, need to be considered in environmental governance (Sterner et al., 2019; Fleck & Hanssen, 2016)). Accordingly, environmental governance may also benefit from the insights of polycentric, bottom-up theories of governance explored in this handbook, especially the way in which these foster experimentation in environmental adaptation strategies—an approach to climate change embraced by Nobel Laureate Elinor Ostrom herself (see Pennington, 2008; Ostrom, 2012; Kahn 2021; Turnheim et al., 2018).

## So What?

The tremendous human progress that occurred, so clearly documented above, bears several important lessons. First, it tells us that poverty, not prosperity, has been the norm in human history. Most of us are born into a developed nation, with clean water, access to food, health care, and modern amenities. We typically take these for granted as if they always were. This was never the case. One should therefore not take for granted the modern living standards that have become so common everywhere. Consequently, this means that we ought to be focused on explaining prosperity, not poverty. Poverty is obvious and common. Prosperity is the puzzle to explain. The importance of development economics, and this book, becomes clear.

Second, there is more room for optimism than we initially thought. It is easy to look around the world and be filled with pessimism. The media contributes, in no small part, to the Mean World Syndrome, a psychological phenomenon first coined by Dr George Gerbner in the 1970s to describe our impression that the world is more dangerous than it really is (Gifford, 2020). The nature of news reporting is that it will always report on events that happened, rather than those that did not. While there are both good and bad things that happen in the world, our headlines are always flooded with reports on war, epidemics, and other crises due to our natural inclination towards negative information (Pinker, 2018). This constant stream of bad news plays on our primal fears and contributes to our pessimism.

Human welfare may also be understood in subjective terms, in relation to individual happiness, rather than the attainment of goods and services related to welfare (such as income and essential goods abovementioned). Does growth necessarily lead to greater happiness? Are people happier today than they were before? The famous insights by Richard Easterlin (1974, 1995) provide a negative answer. Through time-series data that track happiness levels as incomes rise, it has been shown that in Europe, United States and even in Asia, higher levels of income do not correspond with higher levels of happiness (Easterlin, 1995). If we consider subjective happiness, we also have cause for concern about the rise of mental health problems in many countries today.

We cannot settle these disputes definitively. Some scholars have, for example, insisted that happiness has indeed increased, if happiness is understood in its cultural contexts, or if different measurement approaches are used. What is important to note for our purposes is that the timeframe of analysis matters. A longer timeframe demonstrates greater levels of progress, but a shorter timeframe will naturally give us more cause for concern. Optimists of human progress point to how we are living in the most peaceful time in human history today (Pinker, 2011). Relative to centuries ago, this may be true. However, at the time of this writing, the first major war since 1945 has broken out in Europe. This Ukraine crisis is also connected with a severe energy crisis and inflationary pressures sweeping major economies. The stagflation of the 1970s seems to be recurring at present times. The timeframe of analysis is critical.

The facts of the Great Enrichment, however, give us room to be optimistic. We are much better off than our ancestors of centuries past, at least on a good many indicators. The question is ‘why?’, and how we can sustain this.

## Liberal Political Economy and Institutional Entrepreneurs

In our book, we show that liberalism is the prime force for material development and human well-being. Liberal policies, institutions, and ideas provide a framework for individuals to enrich themselves through trade, exchange, and innovation. It is the basis for nations to achieve economic prosperity. Beyond just wealth, liberalism also accords the freedom to individuals to fulfil their wishes, and what they believe to be a good life. This freedom is not just an ingredient necessary for growth, it is also a moral end in itself worth striving for. Put this way, the purpose of development is not merely about increasing national income, reducing poverty, creating jobs—as important as these all are—but allowing people to actualise their potential as free beings.

Liberalism is of course contested on numerous levels. There are debates about what actually constitutes liberalism and also concerns about the ill-effects of liberalism in society. For us, we take liberalism in its classical sense, a rich tradition including esteemed figures like Adam Smith, David Hume, John Locke, John Stuart Mill and in the twentieth century Ludwig von Mises, Milton Friedman, Karl Popper, Friedrich Hayek, Elinor Ostrom and more (see Schmidtz & Brennan, 2010). This is the political philosophy that emphasises the importance of individual freedom, the maintenance of general rules in the social order, the rule of law, and competition as a key organising principle. It is the same set of ideas that contributed to the growth of Western society in the nineteenth century and the birth of constitutionalism in the West.

The recognition of the contribution of liberalism to material development and human welfare is by no means original to us. Adam Smith, the father of modern economics, first posited that it was liberalism that led to the wealth of nations. Some development economists in the twentieth century, against the grain of mainstream thinking, also emphasised market liberty rather than development planning, individuals such as Peter Bauer, William Easterly, Hernando de Soto, and Deepak Lal. Today, prominent figures such as Deirdre McCloskey have unveiled the humane face of liberalism and how it accords dignity, equality, and liberty to the least well-off and oppressed among us.

We present an account of market liberalism that is distinct from the confines of neoclassical economics, which lies at its heart man as a rational utility maximiser, with fixed preferences and who possesses all relevant information, and which models markets from the perspective of competitive general equilibrium. Liberalism, in our account, is presented from the perspective of institutional economics, which takes the rules and social influences of human interaction seriously.

Accordingly, the liberal institutionalism of Douglass North, F.A. Hayek and Elinor Ostrom forms the guiding thread in this handbook.[4] Importantly, these trio of scholars adopt what may be called a 'culturally-situated' form of individualism, which allows us to explore the important role of cultural values in influencing national development prospects.[5]

Our account of liberal institutions and values is heavily influenced by Douglass North, F.A. Hayek and Elinor Ostrom. The insights of Douglass North are especially crucial because of the historical institutionalism he employed, where he showed how certain ideas can stand the test of time and influence economic performance far into the future, for better or for worse (see Galiani & Sened, 2014 for a comprehensive review of his legacy). His writings, with Barry Weingast (1989) also revealed the importance of liberal institutions of property rights and limitations on power to improvements in living standards in eighteenth-century England. Similarly, Hayek is also relevant to us because of his non-neoclassical, evolutionary defence of the market order, which is the approach we take in Chapter 3. Hayek's liberalism also allows us to defend the market order on culturally agnostic grounds—one that accepts value pluralism rather than a monistic social system, thus addressing the East Asian cultural challenge that we take seriously (see Chapter 6). Elinor Ostrom has significant contributions to institutional economics that we explain in Chapter 4. Her work encourages scholars to examine the rules in use, rather than the rules in form, and this opens us up to a range of property rights institutions, from state, to private, to communal to open access. We also draw on her vision of a polycentric social order and connect this to value pluralism—which is a novel defence of liberalism we present in Chap. 6.

The 'culturally-situated' individualism of North, Hayek and Ostrom also explains our emphasis on the role that institutional entrepreneurs play in reforming governance and the intellectual climate of opinion. Institutional entrepreneurs are individuals, organisations or coalitions that seek, advocate, and enact governance reforms and ideological change. Governance reforms include new policies, the reform or abolishment of existing government policies that may be harmful, as well as larger legal, political or constitutional rules that may hinder civil freedoms. Such reforms are at times coupled with ideological change, which is also crucial, since ideas (and not just random policies) have a life of their own and a deep effect

[4] The inter-connections and overlaps between all three of them are vast and interested parties should consult other sources to understand them better. We recommend the following accounts. Boettke, P. J., & Mitchell, M. D. (2017). *Applied Mainline Economics.* Mercatus Center. Aligica, P. D., Boettke, P. J., & Tarko, V. (2019). *Public governance and the classical-liberal perspective: Political economy foundations.* Oxford University Press.

[5] Notwithstanding internal differences, all three scholars generally do not subscribe to a hard form of methodological individualism and allow for an analysis of how social structures, cultures and belief systems influence individual preferences and decision-making. For example, Hayek's defence of the liberal order rests neither on the poles of methodological individualism or methodological holism, but on a middle way: a 'holistic individualism', as explained by Paul Lewis (2014).

on the course of history. Their role is especially felt in certain critical junctures of time, when political leadership plays a big role in setting the future course of society (Beaulier & Smith, 2015).

The role of institutional entrepreneurs has often been neglected in past development studies, as many of the well-intentioned governance reforms were often imposed without an appreciation of the local context and participation. Institutions and ideas cannot be easily engineered from afar but evolve gradually as people in their own communities press for change. Throughout this book therefore, we present original interviews, case studies and stories of agents of change and how they have helped to further human development.

We acknowledge that market liberalism subject to much criticism. In the context of development, it is said that a heavy reliance on markets may be unwise. There are various voices in this regard. Many economists emphasise the pervasiveness of market failures, which is supposedly worse in developing nations, and hence a need for active government intervention. Dependency theorists and Marxist-based theorists emphasise the exploitation of poor nations by rich countries or the exploitative effects of transnational capital. Critics of Washington Consensus policies also point to evidence that 'neoliberal reforms' have failed when they were applied by transitioning economies after the Cold War. We will in this book take these criticisms seriously and discuss them in the various chapters.

## Structure of the Book

Some clarifications on our approach are in order. Our primary target audience is the intelligent lay reader, undergraduate and graduate students, and policymakers. As such, there will be little technical analysis of various growth models, which interested readers may find elsewhere. This is not to say that the quantitative analyses of growth in mainstream economics are unimportant, but that rather we choose to expand our inquiry to wider questions that are often obscured. We therefore adopt an interdisciplinary approach and focus on the 'big ideas' within development thinking, one that incorporates issues of culture, history, ethics, institutions and politics. Notably, such themes are often sidestepped in conventional mainstream economics, which is unfortunate for anyone interested in development, because these are important variables that affect a nation's progress (Boettke, 1994).

The limitation of a purely quantitative approach is that humanistic considerations that are crucial to any rich consideration of human flourishing are omitted (McCloskey, 2021; 2022; Smith & Wilson, 2019). Economics also cannot be divorced from politics, especially when we consider the intimate role that power exerts in determining economic outcomes (Ozanne, 2016). Many of these factors, culture, ethics, power and the like cannot be easily modelled within the confines of mainstream economics and requires a broader field of vision.

In this handbook, therefore, we approach development from the interdisciplinary lens of *political economy*, in terms of examining the interaction between states and markets in generating economic outcomes, and the effects of these shifting institutional boundaries. We place these issues within a wider context of *ethics*, where we consider what it means to live in a good society, one where the freedom and equality of individuals are respected. We premise our case on the belief that to live a full life requires protecting the rights of free and equal citizens under the rule of law.

We also provide a disclaimer that any handbook such as this will necessarily be incomplete, considering the voluminous literature on development, both past and present. There are understandably some concepts or ideas that will be omitted in this handbook. We provide references to both primary and secondary sources that the reader is fully encouraged to reflect on. In line with the spirit of good social science, we also encourage the reader to critically evaluate (and even disagree with) the arguments that we make.

Chapter 2 will start with a brief historical survey of key thinkers in the field of development economics. We start with the classical development economists of the twentieth century and proceed to explore the contributions of several contemporary thinkers on major development issues: Jeffrey Sachs, Amartya Sen, Robert Solow, and Paul Romer. This chapter also provides an interesting contrast between two 'anti-establishment' figures in the form of Peter Bauer and Ha-Joon Chang, who themselves occupy different ends of the debate over the merits of markets. Both individuals, despite their contrasting ideological perspectives, illustrate the importance of examining development from a perspective.

A political economy analysis will confront the central question on the proper role of state and markets in resource allocation and economic coordination. Crucially, state-market relations are also embedded within a wider web of institutional arrangements and cultural environment. The framework we adopt for the subsequent chapters is summarised by the phrases 'getting the prices right' (Ch 3), 'getting the institutions right' (Ch 4) and 'getting the culture right' (Ch 5), all of which if aligned produce positive development outcomes.[6]

We provide a liberal political economy answer to the central institutional question of 'what are the rules, norms and arrangements necessary for progress?'. To that question, we focus on the importance of markets, especially the institutions and values that sustain them. Crucially, in this handbook, we will also consider leading objections to markets in the development context, in order to provide nuance. For example, Chap. 3 will consider market failure theory and dependency theory. Chapter 6 will consider the tough challenge posed by the East Asian developmental state paradigm.

Accordingly, Chap. 3 will explore the nature of markets and its necessity in the context of development. We argue here that economic freedom is an essential requirement of any nation that wishes to achieve growth, and widely shared prosperity. We acknowledge that in the development establishment, pro-market reforms

[6] I wish to acknowledge that this helpful tri-fold classification is obtained from Peter Boettke et al. (2005).

have often been pursued by global organisations in a top-down manner without due regard for local knowledge. Through specific case studies and interviews conducted, we show how such reforms are best implemented in a bottom-up manner by local actors who provide crucial contextual knowledge. This chapter considers the criticisms of market failure theorists and dependency theorists against markets, more specifically neoclassical economics, and their relevance today. An alternative paradigm of understanding markets in the form of market process theory, best associated with the economist Israel Kirzner, is also introduced.

Chapter 4 will first provide a brief review of the field of institutional economics. It will show that there is much overlap between old and new institutional economics, and that the key distinguishing feature of this field is that it rejects the notion of the 'given individual' in mainstream economics and instead places a premium on the wider influences on human decision-making. Institutional economics is thus highly relevant to development studies in its interdisciplinary emphasis. Accordingly, the second part of the chapter focuses on the institutional regulation of markets, namely legal institutions that uphold the rule of law and property rights protections. Political economists have consistently stressed the way markets, and economic behaviour in general, are necessarily embedded in political, social and cultural institutions, which if neglected would render any analyses incomplete. We show that these legal institutions, which are the bedrock of any healthy market economy, are instrumental in facilitating productive wealth creation. We will also review past approaches to development pursued by international organisations, such as foreign aid and Washington Consensus policies, and show how a neglect of institutions hampered their effectiveness.

Chapter 5 will explore the importance of cultural values as a determinant of economic progress. Beginning with a discussion of the prominent cultural scholar Lawrence Harrison, we proceed to explore the specific cultural values that hinder or contribute to development, particularly focusing on individualism, and the extent to which commercial activities are socially honoured. The importance of culture is seen by the fact that many economic reforms of the past, while well-intentioned, did not succeed since they were foreign impositions, for example: many Washington Consensus policies failed because they were exogenously imposed (Boettke et al., 2008). Thus, a consideration on culture and values helps us understand why certain reforms succeed, and why others fail, and also helps us appreciate how local actors translate principles of development into successful and concrete programs on the ground.

We also present arguments from economic historians who documented the role that culture-as-ideas played in the historic development of Western societies, particularly how a mentality of innovation, improvement and market-tested betterment facilitated a Great Enrichment. We argue that a liberal, pro-enterprise culture is essential for economic development and helps hasten the process of building inclusive economic and political institutions. However, such a position must also be tempered, because culture-as-ideas are transmitted in specific times and places by cultural entrepreneurs, and the outcome of such transmission and cultural competition is fundamentally uncertain.

In these chapters, we also explore challenges to liberalism, such as dependency theory and market failure economics. In this post-Cold War era, the intellectual pendulum has swung back against market liberalism, especially after the Great Financial Crisis of 2008. Marxist-inspired theories of development remain popular, decades after dependency theory first came on the scene in the 1960s. The criticism against global capitalism continues to touch on the way capital exploits labour, siphons natural resources from the poor and concentrates wealth and power in economic elites (Ghosh, 2019; Patnaik & Patnaik, 2021). Recently, Western capitalism is also said to be founded on historic racism and systemic injustice. Less radical positions emphasise the imperfections of markets and thus the necessity of strong government intervention to create markets, regulate businesses or provide the basic conditions for development (Stiglitz & Greenwald, 2014).

Our general response to these criticisms is that markets are by no means perfect, especially if judged against a benchmark of efficiency as in neoclassical economics. Markets do fail and have also been rigged by political elites at the expense of others. Western history is not unblemished. We, however, argue that these imperfections notwithstanding, markets remain the best possible mode of economic organisation and is also one that is most consistent with human dignity. Our case studies will show how markets are not just Western constructions, but very much desired by local communities themselves in their search for better lives. We will show how liberal change agents in developing countries pursue market reforms and the widely shared prosperity that it fosters.

Chapter 6 will focus on the topic of state capacity and political leadership in the context of development. State capacity, understood as the existence of centralised political authority and the ability of said authority to enforce its will, levy taxes and provide public goods, is identified by many scholars to be crucial for development. Some also go one step further and insist that technocratic political leadership is also desirable. This argument says that astute and wise political leadership is sufficient for positive economic development, and how good institutions are merely secondary to and follow such leadership.

This perspective is one that resembles our belief in the importance of leadership but differs in its emphasis on state power in fostering development. In this view, it is strong, enlightened political leaders who lead their nations to prosperity, rather than those who pursue liberal ideas. The prime example often used here is that of Singapore, seen as a successful benevolent dictatorship and technocracy. We will also discuss the China model of state capitalism, which is also, notably, one that is largely inspired by the success story of Singapore (Ortmann & Thompson, 2014). These are two countries who on the surface seem to contradict our position, since they achieved economic growth while maintaining authoritarian and illiberal political institutions.

Our response is that strong, enlightened leaders can sometimes have a positive impact on society, but such power should also at the same time be constrained. State capacity is indeed an ingredient in development but must also be tempered by *state constraints*. These are constraints on the exercise of power and involve checks and balances and the rule of law. Civil society organisations and social movements therefore play an important role in acting as a bulwark against state power, through their political activism and challenges to state injustice. Additionally, state capacity itself does not exist in a vacuum, and often (as we will show through examples), the state gains such capacity through its collaborations with these civil society organisations, who provide relevant policy knowledge and advice to state officials.

Chapter 6 also seeks to address the East Asian cultural challenge, which challenges the universality of Western liberal democracy. In response, we draw insights from political philosophers who defend value pluralism and the literature on polycentric governance and show that ultimately, a liberal social order may be defended on culturally agnostic grounds. A social system that grounded on pluralism, rather than an agreement on moral truths, and one that affords a scope for decentralisation, best accommodates the great diversity of social life we see in today's world.

We conclude our book in the last chapter. This chapter will focus on the theory of institutional change, with a special emphasis on institutional evolution and how it is driven by local actors. Most institutionalists, while acknowledging that institutions matter, are at a loss of how to actually establish good institutions. The practical task of achieving good institutions is a challenge for both academic theoreticians and world organisations. Here, we suggest that community-based organisations and intellectual entrepreneurs are especially crucial in improving institutions by promoting new ideas and reforms. This book thus ends on an optimistic note by making a case that progress in institutional reform is very much alive and possible.

## Discussion Questions

1. What is the difference, if any, between economic growth and economic development?
2. How important are material wealth and prosperity in living a good and full life?
3. To what extent has human history experienced progress (or regress) in the past few centuries?
4. In what ways are we living better lives than people of the past? And in what ways have life become worse?
5. What is the relationship, if any, between material aspects of development and non-material components such as equity, sustainability and justice?
6. What is the difference between proximate and fundamental causes of growth, and how do we distinguish them?

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