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ON GROWTH AND DEVELOPMENT

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On Growth and Development

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Abstract.

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

From a methodological standpoint it is then argued that the common attempts to measure growth provide at best crude evaluations of the efforts to acquire purchasing power, but hardly measure well-being. From a normative perspective, the role of growth-enhancing government intervention is thus questioned. Doubts are also raised with respect to the recent and increasing literature on institutional design, which seems to ignore much of the lessons taught by the institutional schools - both old and new. And which tends to describe the past, rather than providing explanations that might help us understand the future.

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On Growth and Development

1. Questions on terminology

Although the debate about the real purpose of economics (or political economy)¹ remains open, the literature generally agrees on the notions of growth and development which should be the object of economic investigation. It refers to growth when dealing with proportional changes in GDP or – more frequently – in GDP per capita; and to development when analysing living standards – including features that do not necessarily form the object of monetary measurement. In this paper, however, a different view is suggested. Growth is meant to concern changes in the consumers' surplus, rather than in purchasing power; and development regards changes of the institutional context. This distinction is helpful in two respects. It provides a clear separation between subjectivist and institutional issues – growth and development, respectively². And it also helps the reader to perceive and possibly disentangle a number of areas of potential confusion.

Hence, the next paragraphs of this section are devoted to discussing a number of implications derived from the terminological approach proposed in these pages, which

¹ See Buchanan (1979). Economic jargon makes use of the expression 'political economy' with two different connotations. According to the classical view economics and political economy are synonymous. If anything, the term 'political' emphasises the fact that economists are supposed to analyse social contexts characterised by political organisations (institutions) and that the results of their studies should provide guidelines to policymakers. The modern meaning refers to a branch of the so-called 'public-choice school', whereby economists study policy measures under different constitutional arrangements. Put differently, in the former case political economy regards individual behaviour and thus remains close to a strictly subjectivist straitjacket. In the latter it leads to a holistic approach, whereby the human being is replaced either by the 'representative individual' or by macro-aggregates; and a-priori theorising gives in to empirical investigation. This work accepts the first interpretation and drops the second.

² The subjectivist nature of the growth question comes from the definition of growth as "an increase in well-being", which is necessarily an individual matter. There is no such thing as collective well-being, since tastes cannot be measured, let alone compared or added across individuals. As regards the institutional nature of development, more will be said later.

is then compared with the traditional view, both from a methodological and a normative standpoint. Section 2. is devoted to the discussion of growth, growth policies, and government intervention; whereas the following paragraphs discuss the notion of development, with emphasis on the institutional side and the avenues of investigation it offers (section 3.); the role of politics (section 4.). Section 5. concludes.

On the notions of growth ...

Economics studies the voluntary interaction among human beings, who enhance their condition by trading goods with other human beings, often times characterized by different preferences and/or skills (Mises 1949 [1996], part I). In order to expand trade in goods and services, agents also exchange information and strive to acquire knowledge. By doing so, they find better ways to allocate available inputs among competing production lines; and discover their (latent) tastes through a trial and error process, which benefits from previous mistakes and follows the evolution of preferences and habits through time.

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

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

These are nonsensical exercises in many respects. Inter-personal comparisons of satisfaction and preferences are impossible. And quantitative measures of growth – GDP or consumption per capita - do not really measure satisfaction. Rather, they provide a gross assessment of the efforts made in order to acquire purchasing power, and of the monetary rewards generated by such efforts. Little is really known about the amount of happiness that purchasing power delivers, let alone about the changes in the amount of satisfaction that individuals obtain without having to use monetary means of payment³.

In short, if economic activities are defined in terms of interactions among individuals, then the notion of economic growth can only be grasped from a subjectivist standpoint and measurement remains elusive.

... and development

On the other hand, development is here conceived to be a problem of institutional evolution; where the term ‘institutional’ refers to the rules of the game within which individuals operate. These rules may be formal and informal norms enforced by means of violence and credible sanctions (as in the case of laws). Or rules of conduct derived from traditions, habits, shared ideologies, the enforcement of which rests on moral suasion and social praise or scolding, rather than on codified forms of punishment⁴. Contrary to the notion of growth, the concept of development may thus apply to a fairly well defined geographic area, which can be identified by the rules of the game prevailing there at a given time.

It follows that the difference between development and underdevelopment is described by the outcomes the context generates – both from a static viewpoint (e.g.

³ This approach does not rule out quantitative evaluation altogether. Rather, it suggests approximating the dynamics of well-being by referring to the dynamics of productivity or technology, which better describe the dynamics of consumers’ surplus. Of course, in order to have a satisfactory measure of productivity growth, data on GDP per capita should be replaced by data on GDP per hour of work. Furthermore, one should also take into account that in today’s advanced economies an increasingly large share of output – public consumption – actually reflects inputs, and that its dynamics has very little to do with changes in productivity.

⁴ In some texts institutions are also defined as agencies or bodies designed to perform given tasks of collective interests. In this light, political parties, universities and sport clubs could all be defined as ‘institutions’. Still, for the sake of clarity, we shall here confine the term institutions to the rules of the game affecting human interaction; and we shall call ‘organizations’ all collective actors designed to perform specific functions or striving to attain defined goals.

income levels, income distribution, welfare) and from a dynamic perspective (e.g. GDP growth rates)⁵. A ‘developed country’ is one where the institutional framework has respected economic freedom for a long enough period of time. A ‘developing country’ is one where economic liberty is on the rise, thereby enhancing higher productivity⁶, whereas undeveloped countries are those where economic liberty is modest.

This view of development is of course also consistent with the subjectivist approach typical of the growth question, since both ideas revolve around the notion of economic liberty, which is typical of a regime where individuals enjoy freedom from coercion in their economic activities and is not compatible with most ‘social’ views of development, this expression being correlated with the attainment of given standards in some key areas defined by the policy-maker, such as average education, average life expectancy, average caloric intake, average health conditions, etc.. Put differently, and contrary to the mainstream tradition, the quality of the institutional framework does not coincide with the production of given goods and services of public interest, nor with the proximity to an allegedly shared goal (e.g. agricultural self-sufficiency or income equality). Instead the focus is on the definition and protection of property rights, the size of government interference in individual decision-making, the discretionary nature of such interference.

What kind of growth theory is actually conceivable?

Most classical economists - Smith was an exception - did not devote much attention to growth and development because they had overlooked the foremost variable driving growth processes – entrepreneurship. In their view, growth was made possible mainly by investment, which in turn was motivated by expected (diminishing) returns to capital. In a world without entrepreneurship (and thus with limited technological

⁵ Along similar lines, Rodrik (2003) makes a distinction between reforms (policies) and institutional change. In his view the former may enhance short-term growth episodes, while the latter is necessary for sustained growth to take place. Still, this may be confusing. As the author himself concedes, growth episodes may also be considered a matter of exogenous shocks, i.e. sheer luck (Hausmann, Pritchett, Rodrik 2004).

⁶ The causality link between economic liberty and the dynamics of output per-capita is documented by Gwartney, Lawson, Holcombe (1999). See however our remarks on the inadequacies of per capita GDP (in the text) and also Karlsson (2005) for a persuasive criticism of the Economic Freedom Index with reference to which empirical work in this area is usually carried out.

change), demography and the need to replace the decaying stock of capital would then define the long-run rate of accumulation. In fact, the classical school had a theory of accumulation, rather than a theory of growth.

Economists eventually started to consider growth matters during the Great Depression, while observing the rise in unemployment that accompanied it. Partly because of this reason, during the first half of the XXth century growth tended to be perceived more as a political issue (the solution to unemployment), rather than a topic worthy of economic analysis *per se*. Indeed, most of the profession neglected to reflect on when and why people forego today's consumption or leisure in order to enhance their present and future well-being; or how the meaning of the term well-being changes across cultures and through time. Instead, efforts to understand individual behavior were replaced by attempts to pursue the common good, whatever that could mean. Politicians were *de facto* legitimized to identify the interest of society; and technocrats were endorsed with the task of conceiving suitable recipes to attain such common goal⁷. Since such recipes were applied on a large scale and affected a large number of people, it became hard to resist the temptation to study aggregate magnitudes, possibly pursuing methodological avenues borrowed from historicism. This still holds true today.

Mainstream economics has done little to conceive a more realistic theory of economic growth, the main reason being that the orthodox view also lacks a theory of entrepreneurship. As will be clarified shortly, the most popular views on growth - the so-called exogenous and endogenous approaches - do attempt to elucidate how a growth process spreads out its effects within an aggregate economic system. But they fail to explain why productivity increases (other than arguing that it follows from the fact that more and more resources are invested), why the real world does not reproduce the regular and smooth processes predicted by the theory and why different areas of the world display so many different growth patterns and irregularities⁸. In the end, the

⁷ Before World War I it was felt that public intervention was legitimized by the need to protect fundamental individual rights: in short, freedom from coercion and property rights. This does not mean that government intervention always confined its activity within those boundaries. In fact most of the time it didn't and the ruler or the ruling class tended to take advantage of the monopoly of violence in order to enrich themselves or acquire more discretionary power.

⁸ Neo-Schumpeterian and structural approaches provide a more convincing framework within which long-run growth phenomena can be understood (Gaffard and Saviotti 2004). But their focus is different. They observe when growth opportunities arise, and explain under which conditions and how they spread.

results generated by at least five decades of scholarly work on growth are rather disappointing. Modeling growth has produced poor explanations and unconvincing descriptions.

Much has to do with the failure to incorporate time into economic reasoning. As long as economics continues to be conceived as a social science devoted to studying the behavior of macroaggregates and/or the allocation of scarce resources among competing uses, one must necessarily assume that technologies, the stock of available inputs and preferences are all known and constant; or evolve following known rules. Hence, tomorrow necessarily becomes the replication of today, or tomorrow's information is already included in today's body of knowledge (the rule of change already identified).

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

As a matter of fact, the presence of time makes it virtually impossible to conceive a theory of growth⁹. Surely, this impossibility can be circumvented by defining growth in terms of inputs (as opposed to individual well-being), in turn measured by some kind of physical standard, rather than by prices originating from voluntary transactions (exchange) and based on different subjective values; and by engaging in extrapolation exercises. But such exercises hardly deserve to be called a theory¹⁰.

⁹ But it does not rule out a theory of development, as explained later on.

¹⁰ These remarks tie in with the previous reference to historicism. Surely, time is not altogether absent from the historicist context. Still, it merely serves the purpose of providing a criterion to list or extrapolate events. There is no allusion to the fact that individual action takes place through time, so that individual decisions are affected by uncertainty, by the returns to knowledge, by the distribution of preferences over different time periods.

One should thus conclude that a realistic theory of economic growth actually boils down to a theory of choice (how people's preferences are formed) and of entrepreneurship. Since the former is much closer to psychology than to praxeology, the study of economic growth is largely a matter of entrepreneurship. In other words, it becomes the economics of the acquisition of knowledge, of the returns to knowledge, of disequilibrium and competition (Holcombe 1998). Clearly, all this can hardly form the object of quantitative assessment, other than some rough measurement concerning labor productivity.

It is here maintained that freedom to choose and to develop entrepreneurial spirits are the true engine of growth¹¹. Nevertheless, the economic profession has also discussed the role of other candidates, such as trade, trade policies and government action. The following section tries to address the theoretical underpinnings of these rival approaches.

¹¹As summarised by Holcombe (1998), Adam Smith explained growth through specialisation and innovation. Specialisation was to be the result of exchange, while innovation was spurred by entrepreneurship.

2. Trade, government intervention and growth

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

The Smithian view on trade: exchange

According to the so-called 'Smithian' approach, exchange is the key engine for growth. The underlying reasoning is straightforward, persuasive and may still be regarded today as the crucial variable (along with entrepreneurship). Adam Smith was aware that resources are limited and, consistent with the historical evidence of his time, observed that technological progress played a modest role. But he also perceived that agents could enhance their welfare by exchanging goods and services in a free-market context. In particular, individuals with different preferences and/or endowments might still improve their conditions by selling and buying goods to/from people with different tastes and skills. In other words, trade was and is beneficial in that it expanded the opportunities to choose and thus increased individual welfare within a competitive framework¹². If so the problem of growth becomes one of reducing transaction costs (transportation, information and contracting), of transforming local into long-distance

¹² See also Bauer (1998). Of course, the difference between domestic and international exchange is meaningless in a free world. Almost by definition, the theory of international trade makes sense only in a world without freedom – i.e. one where agents' behavior is restricted by different bodies of legislation, which affect people's otherwise spontaneous behavior. That explains the current distinction between national and international trade, which refers to different institutional systems regarding traders, rather than distance or other variables. The one exception to this institutional vision is of course trade in natural resources, whereby the theory of comparative advantage boils down to claiming that resources are exported from endowed areas to non-endowed areas.

exchange¹³; and also one of income distribution.

The reduction of transaction costs is by and large a matter of technological progress (and ultimately entrepreneurship) and institutional change. To these issues is devoted section 3. As regards income distribution, it is fairly clear that an economy characterized by trade is no worse for everybody than one featuring pure autarky. Indeed, it is almost always better and therefore generally preferred. The picture changes, however, when one compares different trade regimes - say, moderately open trade vs. free trade. If one rules out the extreme situation where imports are invariably concentrated in industries with no home producers, free trade in a dynamic world definitely benefits all consumers; but some producers will gain and some lose or, more accurately, some owners of production factors will gain and some will lose as the competitive process unfolds. And since individuals are at the same time consumers and owners of production factors, the sign of the net effect is not necessarily positive for everybody. There is indeed widespread agreement that in an ideal world free trade is the best possible regime. In fact, this statement meets no resistance only in a static world. That is, in a situation where the structure of production is constant and all home producers keep producing and possibly exporting the same goods in the same quantities for ever. But when competitive pressure is at work and agents are forced to adjust, the attitude towards free trade becomes less enthusiastic. And the arguments in favor of policies to reduce adjustment costs become rather attractive. Hence the ongoing success of proposals ranging from free trade with countervailing measures (for instance industrial policies, regulation, tax breaks) to sheer 'fair trade' (moderate protectionism). Although the technical facets of the various policies may change, their scope and alleged legitimacy share the same foundation.

Therefore, if one excludes violence, the choice of the most desirable regime necessarily becomes a question of collective decision-making. And of course, the extent to which the preferences of some individuals can be overruled by those of others ends up by being an ethical question. Different possibilities are in order. One consists of

¹³ It is undeniable that agents are in a better position to perceive the needs of those they know better, or with whom they share a common culture. Moreover, monitoring and contract enforcement tends to be easier within fairly closed communities, among parties that know one another relatively well (reputation matters); rather than with unknown, far away agents, characterized by different behavioral patterns and traditions.

more or less sophisticated versions of utilitarianism, whereby decisions are taken by means of majority (or qualified majority) voting¹⁴. Another comes from neo-classical quarters and opts for unqualified free trade for questionable reasons (it makes the representative individual better off¹⁵). Another perspective is based on the principle of human dignity (freedom from coercion) and on property rights acquired according to the principle of the first occupant and transferred through voluntary exchange. In this case, any departure from free trade would be unacceptable for it would involve a limitation of the individual's freedom to choose among competing suppliers. Of course, the fact that such a choice reduces the income of those who are involved in the production of similar or different goods makes no difference at all.

Specialization and knowledge today

A society where trade plays a significant role tends to enhance growth on a second account in addition to extended choice. That is specialization. If an individual believes that his needs can also be satisfied through exchange, and that his ability to take advantage of trade opportunities depends on his terms of trade, then each agent will concentrate his efforts on what he can do best and is most appreciated by other agents.

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

Today the picture has changed. And the Smithian notion of specialization needs to be adjusted. Specialization is less a question of being knowledgeable about specific issues, than of being able, ready and motivated to acquire new knowledge. In the past labor productivity (and welfare) depended on the workers' skills when entering the

¹⁴ These decision procedures are studied by the so-called 'social choice theory', which has however suffered severe attack. See for instance Riker (1982).

¹⁵ Once again, by making use of the representative individual one implicitly has to make use of a cardinal measure of happiness to apply across many individuals. It must also admit coercion in order to enforce compensation and make everybody better off as the competitive process unfolds. Versions of this position currently find support within the no-global movement, as well as among the advocates of regulated capitalism.

labor market and their suitability to be part of a known production process which was supposed to undergo limited change over the years. Instead, today workers must be ready to adapt rapidly to relatively new production processes and circumstances (new companies, new industries, sometimes even new countries). Trade and globalization have magnified this need. In short, flexibility has become more important than specialization or – more appropriately – the notion of flexible specialization has replaced that of specialization.

As a result, trade offers almost unlimited rewards to those who are quick to acquire new information¹⁶, develop new knowledge and - more important - transform it into entrepreneurial endeavors, which ultimately produce growth. The key concept, clearly, is no longer related to the Smithian benefit generated by production structures dictated by comparative advantage on a global scale, but to the incentives to acquire knowledge and risk new entrepreneurial endeavors. When this happens intensive growth is under way.

Trade and trade policies

One can thus conclude that the well-known debate on the role of trade policies with respect to growth begs the wrong question (Kravis 1970; Haggard 1970). The argument whereby trade *per se* leads to growth is probably beyond dispute for relatively small areas or when it comes to countries poorly endowed with raw materials that can hardly be replaced by manufactured goods. But it has relatively little explanatory power in a context where the idea of comparative advantage appears to be less and less realistic¹⁷. Put differently, trade is a necessary condition for growth; but it is not sufficient¹⁸. And

¹⁶ The cost of these activities does not change with the extent of trade, but the rewards do.

¹⁷ It may be useful to recall that the notion of comparative advantage implies differences in the production-possibility frontiers across countries, and that for such differences to occur, at least one of the following three conditions must be met. The frontier must reflect individuals' specialization in different countries: at the beginning individuals specialize randomly, but the initial differences deepen as a result of a learning process. This is the Smithian explanation. Second, technologies are not transferable across countries. Therefore, trade cannot reduce differences in the marginal rates of transformation. This is the Ricardian view. Finally, there exist differences in factor endowments (especially raw materials), which are not subject to international trade. This is the Heckscher-Ohlin explanation.

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

¹⁸ See for instance Jansen and Kyvik Nordås (2004), who show that the effects of trade opening become substantial only if adequate institutions are in place, let alone the infrastructure required to reduce the cost of trading.

when it comes to international trade for relatively large countries, often times (international) trade is not even necessary.

This puts the well-known export-promotion, import substitution dispute into perspective¹⁹. If one follows the line of reasoning drafted earlier on, it is easy to conclude that both policies tend to distort the relative price structure that would have emerged from the unfettered interplay of economic agents. In addition, they are likely to favor and legitimize the introduction of a significant regulatory apparatus, which offers considerable discretionary power to the bureaucracy, establishes rents, strengthens interest groups, creates uncertainty and weakens property rights, the key to human action and entrepreneurship. Surely, these trade policies may well achieve some short-run goals if they succeed in mobilizing resources that in earlier times could not be exploited because of other sources of distortions, e.g. currency controls and/or regulated capital markets. In particular, export-promotion policies can be relatively effective if they encourage producers to face competition on outside markets, acquire information about new products and technologies, attract foreign investment leading to better production capacity - and thus higher productivity - thanks to the privileges offered by the local government. Whereas import-substitution policies will generate growth if the alternative is some form of central planning. Still, although export-promotion policies exhibit a better record (Greenaway and Nam 1988), both strategies are bound to fail beyond the short run²⁰. As mentioned earlier, from the static viewpoint, they both alter relative prices and thus lead to a distorted structure of consumption and production. Whereas from a dynamic perspective they discourage risk-taking attitudes - investment

¹⁹ Export promotion refers to commercial policies aimed at stimulating exporters, possibly with tax incentives, cheap foreign currency, easy credit and other kinds of favorable legislation. It does not necessarily coincide with free trade, which is not discriminatory and thus rules out preferential treatment to exporting companies. In fact, the traditional version of export promotion is closer to mercantilism. The rationale for import substitution also follows a mercantilist footpath, in that it advocates trade barriers in order to favor domestic demand for domestic products, and thus enhance domestic output.

²⁰ Liang (1992) has pointed out that these two policies are not incompatible, as shown by the S. Korean experience during the 'miracle' performed during the 1980s. During that period the government took care of selecting both the alleged winning industries worth to be protected and the most promising foreign market where efforts were to be concentrated. See also Chenery, Robinson and Syrquin (1986) for extensive documentation on the traditional trade-policy attitudes of mainstream economics (and endorsed by international agencies such as the World Bank).

Other authors have also proposed a distinction between outward orientation, characterized by selective protection; and inward orientation, characterized by generalized trade barriers. See for instance Westphal (1982).

and entrepreneurship – to the benefit of rent-seeking. Corruption and bad capital allocation are generally the most visible consequences.

Extensive growth and government intervention

The extensive approach to growth originated from Ricardo and maintained that aggregate output per capita can expand as long as additional production factors are employed. Before the industrial revolution this meant that higher living standards depended on the capacity to find new and possibly better land so as to increase agricultural production. Indeed, pessimism about growth was justified by reference to the fact that both land and capital presented diminishing returns, so that the incentives to expand would be stifled.

This view generated the socialist and neoclassical approaches, which dominated post-WWII growth economics (Arndt 1987). The former identified capital-intensive policies (including forced investment and industrialisation) as the only means to enhance better living standards²¹. Whereas the neoclassical view ultimately emphasised the role of research, development, human capital. As a result, in the socialist case government intervention turned out to be justified by the need to speed up industrialization and fixed investment, especially in those situations where private individuals were inclined to employ resources otherwise. Whereas in the neoclassical case the role of the state was related to the positive externalities generated by having

²¹ The socialist view differs from the classical one in that the latter does not consider coercive government intervention legitimate, not even for the sake of promoting higher living standards in the future (at the expense of the current generation).

When applied to undeveloped countries, the socialist view also encouraged aid policies. The key notion was that since most people in the developing world can hardly survive, savings are modest and the only way to finance capital accumulation is generous aid, part of which should be devoted to sustain consumption. As we know, this conclusion is flawed on two accounts. First, it neglects the fact that investments could be financed by foreign capital. If that does not happen, one should then wonder why foreign capitalists do not exploit allegedly great opportunities to earn substantial returns. The answer may be barriers to entry to foreign capital, or lack of opportunities, or lack of adequate protection to property rights. Modest and/or inefficient accumulation is thus a description (at best), rather than an explanation. Second, it neglects the fact that despite poverty, in most undeveloped countries individuals can mobilize substantial amounts of capital (De Soto 2000). Besides, the mercantile and industrial revolutions in Western Europe were not financed by aliens.

additional resources mobilised towards R&D and/or human capital, that is more inputs entering the production function of the national economy²².

As mentioned earlier, the extensive approach to growth has played a key role in justifying government intervention. And for good cause. One can always figure out imperfections that omniscient bureaucrats can redress by replacing individual agents in the decision-making process. In addition the extensive view does not necessarily require having entrepreneurial bureaucrats, but only technicians with some expertise in input-output analysis.

The extensive approach to growth gradually lost its appeal as from the late 1970s²³, when its failure gradually became apparent. And although its influence remains very strong even today, perhaps in different and somewhat subtler forms²⁴, its theoretical foundations continue to be rather fragile. Unless in extreme cases, it is of course plausible to assume that the marginal productivity of capital is greater than zero and decreasing²⁵, so that assessing the long-run rate of accumulation per capita (and thus growth) boils down to a matter of empirical investigation concerning three variables. One is demography. The other is the rate of time preference, which affects

²² Nobody ever cared to clarify why such externalities should take place at a national level (so that the best policies are national policies), rather than on a regional or on a world scale.

²³ One could actually argue that much of the trade-for-growth literature derives from an extensive viewpoint, whereby trade would allow a better exploitation of the existing capital stock as a consequence of a more efficient allocation of resources; and would also justify higher expenditure on equipment so as to satisfy greater demand.

If true, this reading of the trade-for-growth literature may explain why free trade tends to enjoy public support on a regional basis, but less so on a world scale. Since trade is perceived to benefit producers first and the economy overall only at a later stage, thanks to the expansion of the production capacity, the marginal benefits of free trade are significant only when producers face a free trade area that includes countries where they stand a chance to export and excludes countries with respect to which the domestic economy is expected to run substantial bilateral trade deficits. In other words, trade-for-growth eventually takes on a mercantilist shade, and tends to be identified with a job-creation vs. job-loss problem. Within this framework consumers' choice and competitive pressure seem to play a minor role or remain out of the picture altogether.

²⁴ Caselli (2004), for instance, suggests that the main failure of this category of models is due to bad functional specification, and that better results could be obtained by spelling out the elasticities of substitution between the various production factors.

²⁵ It is decreasing because operators generally prefer high-yield projects to low-yield projects. This notion is of course of little interest from an economic viewpoint, both because it is almost a truism, and because the notion of return *per se* offers poor guidance to understand human decisions. For the real problem about investment strategies concerns the time structure of individual investment plans and includes comparisons across uncertainty profiles, expected returns, cost-revenue structure over time.

savings and thus investment. And the third one is the output gap, i.e. the distance which separates an economy from its supposedly constant production-possibility frontier.

Unfortunately, since the economic literature does not say much on these variables, extensive growth theories do serve the interest of the policy-maker, but hardly face up to methodological challenges. Demography is beyond the scope of economic investigation *stricto sensu*, apart from entering the picture in order to explain (1) why accumulation may take place in equilibrium, i.e. when capital per head is constant; or (2) the size of externalities to be socialized through government intervention. As regards the rate of time preference, economists tend to remove the whole issue by assuming it is constant, by referring once again to the representative individual, and quantifying it by observing the yield on low-risk assets. At best, this amounts to a rather unrefined exercise in extrapolation, rather than an explanation. Indeed, other disciplines – say, psychology – are probably more qualified to provide useful insights in that direction. Similarly, output-gap studies do not explain why some countries lag behind and produce less than what one may expect. Instead, they describe the distance among countries in terms of GDP per capita and simulate how long it would take for a catch-up process to develop its effects. Therefore, it is hardly surprising that the standard theory of extensive growth - better known as “exogenous growth” since the mid-1950s - is in fact more likely a “what if” exercise than a theory of the gap or the frontier.

3. Development policies

If one excludes the radical-liberal standpoint, which sees little or no purpose for collective policies, the debate on state intervention to promote growth and development remains inconclusive²⁶. Nobody questions that if a country displayed the textbook features of a perfectly functioning market economy, where transaction costs are zero and individuals made the best possible use of the existing technology in order to meet known and constant needs, income would be satisfactory and reflect the best possible use of the existing technology. Still, no matter how beautiful the Nirvana world described by neo-classical scholars and experts is, the very problem of growth and development revolves about how to obtain a suitable environment where individuals can strive to enhance their well-being, make use of the technology available, acquire new knowledge. Put differently, the real question concerns not only the definition of the best policies and organisations, but rather the creation of institutions which are effective in reducing transaction costs and preventing coalitions from distorting incentives and giving origin to - and maintaining - rents.

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

Lesson from the Old Institutional School.

As mentioned several times in previous sections, today the role of institutions is hardly questioned. The Old Institutional School²⁷ defines them as habits and routines that are

²⁶ See for instance Ranis (2004) for a mainstream survey of post-war development approaches and policies.

²⁷ The birth of the Old Institutional School dates back to the end of the XIX century, with Carl Menger and Thorstein Veblen. But it is still well represented today, as witnessed by the work of - say - Geoffrey Hodgson and Douglass North (from the early Nineties).

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

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

interact on a reduced scale, and that since the rate of time preference rises, the time horizon shortens significantly and opportunities for growth are missed.

When applied to today's development economics the 'old' path-dependence view has further important implications. Although inertia does not contain much explanatory power, its very notion explains why development policies *per se* are questionable. For either the decision-maker decides to alter and 'improve' the institutional context, which is the dream of any social engineer but often ends up in disaster, since cultures cannot be changed by decree. Or one has to restrain from action and accept that agents do not necessarily share the same culture and do not develop the same routines: contrary to the mainstream assumption, there is no such thing as the 'typical' individual. And there is no 'typical culture', either.

In addition, the concept of inertia sheds light on the nature of the problems that come to the surface when inertia itself breaks down, which is indeed what has been happening more and more frequently in the last couple of decades. If anything, this is the truly new trait of development economics. Quite reasonably, the Old Institutional story claims that institutions are a self-reinforcing mechanism that breaks down occasionally as a consequence of some external shock. For example, an invasion, a major change in the charismatic élites, dramatic changes in relative prices that in a few months or years could provoke the introduction of new routines and shared patterns of behaviour and interaction. If so, there is not much to explain; and the history of economic development becomes an evolutionary journey through institutional patterns (histories of civilization), the features of the potential shocks and ultimately ideologies, which can be entirely new or inherited from other cultures. The latter is of course the case in recent years, as access to the media on a worldwide scale has become relatively cheap and easy²⁸.

To sum up, an economist inclined to policy-making cannot be very happy with the Old Institutional School, unless he has a chance to break away from path dependence or to intervene when settled cultural patterns become increasingly

²⁸ Of course, the media operate both passively and actively. They allow individuals to compare their own patterns with those of other cultures and possibly change. But they also influence the agents, so as to induce them to accept new routines and almost bypass the traditional filters provided by experience, trial-and-error processes, repeated interactions.

vulnerable, possibly to outside influence. The New Institutionalists have offered an alternative.

The New Institutional School

According to the New School economic performance takes place following given sets of rules²⁹, which in their terminology are known as institutions. The social scientist – and the economist in particular – is then supposed to study both the nature of the rules of the game and way they come to life. By and large, two possible functional dynamics are identified. One is the result of pressure exercised by interest groups aiming at creating or protecting rents to exploit³⁰. Trade or industrial policies fall into this category. On the other hand, institutions may also be the result of a competitive process, whereby rules end up by being created and selected so as to enhance interaction among individuals. Under some circumstances the former dynamics prevails and a society decays as individuals concentrate on rent-seeking activities, rather than on efficient production and growth. When the competitive process prevails, it originates an effective and possibly self-sustaining framework where economic activities prosper.

Of course, there have been attempts to find ways to make sure that the ‘good’ rules could be preserved and the ‘bad’ discarded. That has actually been the core of the research programme developed by the so-called Constitutional economists³¹, who believe that a constitution based on the notion of rule of law and protected by suitably selected political philosophers would have kept rent-seeking groups at bay, allowed market forces to expand and pave the way to growth within an appropriate environment.

²⁹ The New School is not that new, though. The debate on the dynamics of the rules of the game had already been made explicit some 150 years ago by Francesco Ferrara and Frédéric Bastiat. Today the New Institutional approach includes much of the public choice tradition, as well as the Chicago law and economics tradition and authors like Gary Becker, Douglass North, and Oliver Williamson.

³⁰ A more elaborate version is offered by Acemoglu, Johnson and Robinson (2004), who argue that selected groups get hold of political power only at the end of social conflict. By means of such power these groups shape the economic rules of the game. It is however left unexplained why interest groups must wait for social conflict to take place and why such a conflict is a necessary condition. See also Voigt (1999).

³¹ The most important among them has probably been Friedrich A. von Hayek. See Voigt (1993), Hoppe (1994) and De Jasay (1996) for an exposure of the intrinsic contradictions of the constitutional view.

Today the New Institutional view forms the backbone of the renovated neoclassical guidelines for development. On the one hand it preserves the optimizing approach that has characterised the last decades of mainstream economic theorising. On the other it is of course appealing from a normative viewpoint. By claiming that institutions are the result of human choice, rather than of a cultural heritage, it actually encourages a wide range of experiments in institutional engineering³².

Old and New: what does the loop show?

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

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

On the other hand, the loop also reveals two decisive shortcomings of the institutional vision. First, the loop does not explain why some countries manage to

³² In this respect, one cannot help observing that when it comes to choosing among different institutional solutions, the neoclassical, apparently *wertfrei* efficiency criterion come out as the most attractive. And rightly so, since it offers logical consistency instead of loose opinions.

break away from the stagnation trap and some don't; nor does it explain why some countries end up into a stagnation trap after enduring periods of successful economic performance. One can surely refer to the dynamics of the rent-seeking coalitions, but an established institutional theory of coalition dynamics is not available³³. Put differently, the loop offers a good description, but a less than adequate explanation.

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

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

³³ See Quigley (1961 [1979]) and Olson (1982).

Unfortunately, this remains an open and important question, to which the loop does not seem to offer any reply.

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

4. Development economics and active policy-making

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

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

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

In the end, the success stories are those where government action succeeds in guaranteeing enough economic freedom, and the elites are legitimised by a shared goal which secures the ‘social’ contract between the political elites, the rent-seeking coalitions and the population at large. Indeed, in the case of the various Asian Tigers in

the 1990s - and possibly China today - such a goal was higher living standards for most layers of the population.

Of course, this does not mean that failure to grow is due to lack of ambition for a better living, so that in the end poverty hits people who do not want to get richer and are unwilling to enforce a social contract based on growth or – better – to force the coalitions to sign an institutional contract designed to produce growth. But it does imply that when the residents' main concern is the improvement of their living conditions, the ruling coalitions feel vulnerable, and refrain from excessive rent-seeking. Put differently, the credibility of a development process and the sustainability (length) of a growth episode depend on whether the opposing coalitions are effectively neutralised, on whether the new rules of the game create enough economic freedom to promote private investment³⁴ and on whether government policies reproduce the outcome otherwise generated by the market process without too many inefficiencies. As recent history shows, these conditions are difficult to meet in many parts of the developed and undeveloped world.

³⁴ Deregulation is of course the key element in this domain.

5. Concluding remarks

Facts and theoretical schemes reassessed

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

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

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

Any acceptable growth theory must produce a persuasive explanation of the phenomena that characterise the three periods briefly described above. They must explain the logical connections between the various events, why they occurred at a

given time in history, why they took place in some countries, but not in others. In this paper the overall problem has been split into two broad sections. One has dealt with the logic of growth, i.e. with the mechanisms that explain growth in a context where acquiring greater purchasing power is indeed the main purpose of human action. Another one has dealt with the set of constraints or conditions that may prevent growth, even when the requirements for growth to occur are there or can be introduced with relative ease by means of sheer imitation.

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

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

As regards the logic of growth, these pages rely heavily on what could be defined as an augmented version of Galor's theory of unified growth, where the cost of exchange (trade) provides the initial spark and entrepreneurship keeps it going³⁵. By and large, its building blocs are the following. It is a fact that the Malthusian period was

³⁵ See Pomeranz (2000), where the role of trade as the engine of the Industrial revolution is duly emphasised.

characterised by modest trade opportunities and low life expectancy. As a consequence, restricted markets reduced the returns to entrepreneurial abilities. For the same reason technological progress was also limited and more inclined to satisfy scientific curiosity, than to meet economic needs³⁶. All resources were absorbed by the need to survive. Hence, income per capita stagnated³⁷. The First Phase of the Industrial Revolution took off because transportation became cheaper and safer, also thanks to *Pax Britannica*. Low trading costs enlarged the size of the potential markets and created new stimuli for entrepreneurial activities. In turn, these justified applied technological progress and greater fixed-capital accumulation. New machines called for new organisational formats and a more skilled labour force. At the same time, medical improvements extended the horizon for investment in human capital and contributed to enhancing the rewards to education. Therefore, it paid for parents to concentrate their scarce resources on a limited number of better educated children, rather than on a large quantity of illiterate offspring, some of whom would probably never reach adulthood (Galor and Weil 1999, 2000). This explains the Second Phase of the Industrial Revolution.

Will there be a Third Phase? As argued above, it seems that the economic dynamics of the world economy has been deeply affected by the dynamics of exchange and thus trading costs. These have spurred investment of various kinds whenever the institutional framework allowed individuals to take decisions and be responsible for them. Put differently, local technical change created opportunities to be exploited by relatively free societies. As pointed out in earlier sections, extrapolation is tempting, but often tricky. Still, one can hardly help observing two relatively recent phenomena, often lumped together under the term ‘globalization’. One is enhanced trade in ideas and scientific knowledge. The other is enhanced mobility. If these trends were to shape economic history for some more years to come, one could perhaps conceive new categories of interaction between growth and development. In particular, and consistent

³⁶ Economic growth does not depend on the rate of scientific innovation, but on the ability to transform technological advances into productive undertakings addressed to satisfy demand.

³⁷ This view assumes that parents intend to have a given amount of children, which until well into the 19th century was above what the means of survival would allow. According to Malthus, this amount was determined by sexual impulse. According to the view presented here, parents’ decisions depend on the resources they can spend on their children and on the expected returns on their education. The latter variable is to be assessed with respect to expected growth, rather than to current income levels. The assessment on how much parents are willing to spend remains to be answered, though.

with the line of argument developed in these pages, growth would no longer be the result of favourable institutional environments where chances are exploited, independent of where they have been created. Instead, one could have situations where economic freedom becomes a prerequisite to create chances. Put differently, technological breakthroughs and entrepreneurial challenges leading to higher productivity would become the joint product of successful (institutional) development. And institutional decline would no longer lead to stagnation, but to impoverishment.

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