

Economic Capital and Creative Empowerment

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We often hear the basic question: “Why some countries are rich and others are poor”. This has been one of the major questions of political economy (and even long before) its more formal or scientific formulation in the late 18th century. Most prominently and especially England, at a time when Western Europe, was experiencing an economic upheaval, disruptions that would totally transform the lives of its inhabitants. Over the last two hundred years, economic development has been rather uneven¹. Some countries have witnessed steady growth, year after year, while others stagnated. Some have become rich and then declined. After WWII, the world became divided into three areas: Western countries, the Eastern block, and the South. The first two fought a battle of ideas over a most fundamental question — that of the nature of human societies and the role of freedom. They also fought to impose their respective model over the South — the developing world — and to control its natural resources. After more than half a century of a destructive approach to development, things are now changing and we may have reasons to be optimistic for the next twenty years.

¹ In modern economics, the notion of economic development generally encompasses the emergence of norms, rules, and institutions that enable economic growth to occur. In other words, growth takes place within a given framework, while development is also about changes and improvements in the framework itself. Note that nowhere in the works of 19th century classical economists is “economic development” separated from the general understanding of wealth creation within the marketplace. Economic development was simply the process of trade and capital accumulation at works in markets.

In the last quarter of the 19th century, Europeans and Americans were five times more productive than somebody living in Asia or Africa. This gap didn’t worry Economists who thought poor countries would eventually catch up with rich ones. But the great convergence didn’t materialize. Hundred years later, at the end of the 20th century, the income disparity between the richest countries and the poorest ones had risen to 19 times. Over the past four decades, poverty as a percentage of total population of the poorest area of the world — i.e. sub-Saharan Africa (SSA) — has remained high; roughly 70 percent of its population lived on US\$2 a day adjusted for purchasing power parity. Over the same period, GDP per capita for the region has also been flat between \$500 and \$600 per annum in 2000 US dollars.

In the 1950s most economists in the West believed in the virtues of government-led development planning. The idea was that the poorest countries were stuck in a Poverty Trap from which they could not emerge without an aid-financed Big Push. Peter Bauer ominously criticized the idea at the time, but to no avail. Recent studies have, however, confirmed his views [W. Easterly 2002]. Poverty can persist in some cases for some period of time, but the stagnation of the poorest countries in the world, especially in SSA, has a lot to do with bad government rather than fate. In other words, there is strong evidence that differences in levels of poverty around the world and their variations have to do with differences in the quality of institutions [W. Easterly 2006].

A similar conclusion was reached in the study of the impact of development aid. Aid has played the role of a Big Push in many cases, and while it accelerated, growth in SSA

declined — from around 2 percent per annum until the early 1970s down to zero after that. Whether aid caused the fall in growth or low growth prompted aid has been, and still is, a hotly debated subject. Unfortunately for those who see aid as a cornerstone of development, there are only a few cases of countries that received aid and subsequently experienced a take off, while many other countries received aid and did not take off. It is difficult to establish theoretically and empirically a positive effect of aid on development and growth. As yet, the Big Push (i.e. aid) has not had the effects that many expected.

Accordingly, the last ten years have witnessed more and more skepticism among economists and others regarding the effects of development aid. Until the 1990s the appeal of development plans was very strong². Even the use of the term “aid,” as Bauer brilliantly noted, benefited those who supported it, as it promoted an unquestioning attitude³. Yet, after decades of aid, it has become more accepted that aid has not created sustained development because the process of development is a complex one and artificially engineering it has remained beyond the pale of policymakers. While economists may know the “what” of development, they don’t know the “how.” Bauer’s view — that development cannot be engineered — has now gained greater acceptance. Economists understand better the real process of aid itself, and by contrast, the nature of economic development.

Aid is rarely delivered according to plan and the aid process is fraught with difficulties of all kinds. It is better to think of it as a bargaining game played by numerous players who all have different intentions. Because it reduces the cost of public spending (in terms of tax-

² A contemporary defender of the development plan view is Jeffrey Sachs (2005).

³ As Peter Bauer (1993, page 2) explained, the term aid “disarms criticism, obscures realities, and pre-judges results. Who could be against aid to the less fortunate? The term has enabled aid supporters to claim a monopoly of compassion and to dismiss critics as lacking in understanding and sympathy.”

tion to be levied), aid transfers have enabled rulers to pursue policies favoring themselves and their supporters, thereby providing resources to those who are well organized and leaving the others in a situation of growing dependency. Those who benefit from the status quo have no interest in changing the situation. Not only aid cannot generate growth, it actually participates in the deterioration of the institutions the recipient countries may have [S. Djankow et al. 2008]. The deterioration of institutions weakens the long-term growth prospects of recipient countries. As institutions become weaker, the rule of law disappears, corruption increases, and rent seeking becomes widespread. Because aid can be seen as a windfall, it has a similar effect on beneficiaries as natural resources can have — it creates an “aid curse.” Until the 1990s, aid was the mantra of the economics of development. While Peter Bauer saw no reason why the fundamental concepts of economic theory — incentives, supply and demand, and entrepreneurship — should not apply to developing countries, the profession instead placed the emphasis on structural economic conditions. The causality was wrong; policy makers sought macroeconomics outcomes rather than establishing the institutional underpinnings of individual choice and trade.

Somewhere along the way in the 20th century, economics lost all reference to the framework in which human action takes place, and which gives action its social dimension. Where Adam Smith’s *The Wealth of Nations* had emphasized the role of the basic institutions of the English Common Law — the laws of property, contract, and tort —, economists of the modern sort abandoned the idea of the primacy of institutions and focused on solving problems of constrained maximization. The classical emphasis on institutions stemmed from the Smithian view of the human propensity to truck, barter, and exchange, and the institutional arrangements that promote this propensity. Some 20th century economists, such as Peter Bauer, James Buchanan, Fried-

rich Hayek, and Ludwig von Mises remained focused on the importance of institutions in the understanding of economic phenomena. For Mises, individual property rights and their transfer enable social cooperation under the division of labor. Because individual owners are residual claimants, they allocate resources to their highest value and, doing so, they promote the interest of others.

The other key mechanism that disappeared in 20th century economics was the entrepreneurial function. With a few exceptions such as Joseph Schumpeter, most authors, “whether explicitly or simply by virtue of omission, consider entrepreneurial supply to have played a passive part in the drama whose major themes were invention, changing factor prices, and new market opportunities” [P. Kilby 1971, p. 3]. Gains in productivity are necessary for per capita income growth to occur, and these gains are only possible if shifts from less productive to more productive techniques take place through the creation of new commodities, new material, new organizational forms, and new knowledge. The entrepreneur is the discoverer of hitherto unknown gains from trade. He is the driving force behind productivity gains that are crucial to the processes of economic development and growth [I. Kirzner, F. Sautet 2006]. These processes do not simply consist of physical and human capital accumulation. If this were the case, they would simply be the result of greater savings. More than just physical and human capital accumulation is required to obtain development and growth; the introduction of sheer (socially useful) novelty is also necessary (i.e. innovation). In this sense, the entrepreneur, as the agent of creation, is the source of actual change.

As William Baumol pointed out, the social effect of entrepreneurial activity is determined by the quality of the formal and informal institutional make up of a society [W. Baumol 1990]. This is where the role of institutions intersects with that of the entrepreneurial function. Entrepreneurs may discover socially productive or unproductive activities depend-

ing on the relative payoffs society offers. When property rights are well defined and enforced, entrepreneurial activity is socially productive. But when individuals know that they can lobby governments for their own benefit, entrepreneurs will divert their gaze towards socially unproductive activities. Institutions form the basis of the economic capital of society, which, depending on its nature, may empower individuals to become creative — i.e. to be entrepreneurs.

Many rules in society evolve without centralization. This is because entrepreneurs not only discover gains from trade in the economy; they also discover ways of improving the framework within which they operate. This can be at the public level with institutional entrepreneurs who change laws and legislation, but also at the private level where entrepreneurs devise new contracting technologies. In developing countries entrepreneurs are behind the development of methods used to create and enforce property rights and the emergence of private market governance [Boettke and Leeson 2009]. They create the institutional framework in which trade takes place; a framework that government and reformers often ignore at their peril. Because of its effects on the evolution of rules and norms, entrepreneurship is not only the engine of economic growth; it is also the driving force of development.

Today, institutions have taken a more important place in theory and in policy [D. Acemoglu et al. 2005]. Even if pundits such as Joseph Stiglitz have criticized it, what became known as the “Washington Consensus” (which emphasizes sound microeconomic policy, macroeconomic stability, and robust institutions), has had a profound impact on policymakers. The tales of the two Germanys and the two Koreas show how dramatic the role of institutions can be in economic performance [M. Olson 1996]. But policy choices (in terms of fiscal, monetary, and exchange rate for instance), when they deeply affect the decisions entrepreneurs can make, can also influence long-term growth [P.B. Henry, C.

Miller 2009]. It is now well recognized that (a) well-defined, enforced, divisible, and transferable property rights (available to a very broad cross-section of society), (b) low taxation, and (c) open trade, constitute the core of a good institutional and policy framework. To this core, one can add the notion of rule of law, limited public spending, a light-handed regulatory framework (including the ease of doing business), and transparent and responsible public governance⁴. These institutions and policy form the basic economic capital that can promote a creative and prosperous society.

These items can be considered as causal factors in the process of development, but they often emerge in the process itself. The problem is that though institutions are crucial to entrepreneurship and development, building them is a very difficult issue. The experience with the transposition of Western institutions in developing economies has been poor. Transferred institutions are not often well adopted, which shows how endogenous the development of institutions can be. It is difficult for outsiders to understand why particular institutional arrangements work in certain circumstances and not in others. Local knowledge is crucial to policymaking, but is often hard to obtain. Moreover, the issue is not only which institutional difference may explain why some countries are rich and others are poor (although this is important), it is also understanding why each country follows a specific path of institutional development. Some see institutional paths as the results of pure luck; for instance the luck of an elite group of country blessed by

⁴ Other issues such as a good physical infrastructure should be considered as consequences rather than preconditions of development. Clearly better roads and cell phones are creating virtuous cycles of growth in many African countries such as Kenya. But these are the results, not the cause, of development. Also, access to capital and equality of opportunity should not be considered as part of the institutional framework favorable to growth, as they can promote policies that generate socially unproductive entrepreneurship.

culture and history — the “happy chance” of Western Europe.

The world is perhaps at the dawn of the new era, as the long expected convergence may be around the corner. Today there are more and more people living in countries with growth rates higher than that of the G7 average. If this trend continues, global growth in the next twenty years could be the highest recorded in human history. Until recently, the only missing element was SSA, which had experienced no growth between 1970 and the 2000s. This is changing, however, with a greater awareness of the importance of local solutions to institutional deficiencies (thanks to social entrepreneurship) and a better appreciation of aid’s lethal effects. “Trade rather than aid” has become a new mantra. Hence, this new century is witnessing a dramatic turnaround in Africa’s fortunes, with six of the world’s ten fastest-growing economies today in SSA, which is experiencing a surge in foreign direct investment [E. Miguel 2009]. This evolution is one of the most unexpected developments in the last decade; a major “discontinuity” that policymakers had not seen coming.

Success in development is a reflection of the fact that more and more resources are discovered and allocated through market mechanisms. In spite of what its critics say, globalization pushes countries in a cycle of virtuous change. Witness the success on the Doing Business index of countries such as Georgia, Thailand, Mauritius, and Malaysia, which rank above many E.U. countries. And as far as SSA is concerned, Rwanda and Zambia have dramatically progressed in recent times⁵. Clearly, the Doing Business index only measures a small aspect of what makes a good framework for growth and development; but it is an important one nonetheless.

The current evolution is often local — such as the implementation of community-based natural resource management in Namibia — and for that reason more sustainable. It even-

⁵ Rwanda is ranked 58 in 2011, up from 70 in 2010. Zambia is 76, up from 84.

tually translates into better governance of local firms and public organizations. The world is becoming more global and yet more local. The Apple iPod is designed in the US and built in China with components coming from Japan and other Asian economies. But if the importance of local knowledge continues to grow, especially in emerging markets, multinationals may be limited in their growth. Wal-Mart is a big US company and yet it cannot penetrate certain markets.

Under current trends, the Hopeless Continent (as Africa was called not long ago) may show, one more time, that development can occur anywhere. The G7 economies will account for a constantly diminishing share of the world GDP as the Asian, BRIC (Brazil, Russia, India, and China), and some African economies continue to develop. Four major downside risks should be accounted for, however.

First, the geopolitics of aid is likely to continue in the years to come and this may dampen the dynamism of economies that could otherwise move up faster. Policy experts and other organized groups should continue to favor trade, not aid. Yet, aid could also subside in the next twenty years if the fiscal situation of Western countries were to worsen. Such a situation would be another “discontinuity;” an unexpected, but clearly possible, event. In other words, there could be a silver lining to a disastrous situation: the developing world could benefit from the West’s fiscal chaos. Even if development aid only represents a small portion of OECD countries’ budgets, when urgency requires cutting spending, aid could be amongst the first items to be sacrificed.

Second, Western countries may continue to engage in protectionism and subsidies, and increase their reluctance to trade with their poorer neighbors, as western populations fear

competition from low-income economies. For instance, the US government subsidizes cotton, which has depreciated world prices for many years and has had lethal effects on developing economies. The developed world may also impose its own standards on its poor counterpart (especially in terms of environmental policy) as a precondition to trade. Protectionism is a serious risk for the developing world. More policies, such as the 2000 African Growth and Opportunity Act in the US (which reduced tariff rates on African textiles) should be enacted in Western countries.

Third, part of the growth in African countries in the last decade has been fuelled by high prices in mineral and oil resources. Another part has been heavy foreign investments, especially from China. Armed conflicts may still represent a danger if resource prices were to fall. These conflicts have been widespread in African countries in the last three decades, as 70 percent of them have been at war for at least one year.

Finally, as poor economies create more and more wealth, the demand for more democratic institutions may rise. But with more democracy may also come the risks associated with politics and the dynamic of special interests. This could squander the newly created wealth before it generates a real takeoff [F. Zakaria 2007]. Various election crises in the last decade (such as in Kenya or in the Ivory Coast) have shown the limits of democratic reforms and the latent social divisions that still exist in many countries. In their transition towards democracy, developing countries should continue to pay attention to political competition and constitutional constraints, and their role in limiting socially unproductive entrepreneurship.

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