The Role of the Economist in Economic Development

Christopher J. Coyne and Peter J. Boettke

The issue of economic development has been at the center of economics from its beginnings. Adam Smith, writing in 1776, attempted to determine the factors that led to the wealth of nations. He concluded that low taxes, peace and a workable system of justice would lead to economic growth (Smith 1776, p. xliii). Robert Lucas, discussing the economic development of India more than two centuries later wrote: "The consequences for human welfare involved in questions like these are simply staggering: Once one starts to think about them, it is hard to think about anything else" (Lucas 1988, p. 5). Clearly, economic development is still a central issue in modern economics.[1] However, the economic development establishment has changed greatly since the time of Smith.

As this field has evolved, one critical question has been overlooked: where is the economist in all this? In other words, what role is the economist to play in understanding and contributing to economic development? This question is rarely, if ever, considered. Is it the job of the economist to research and discuss historical successes and failures? Must he go further and make policy recommendations based on the results? If so, what does economic science offer him in terms of fulfilling his duties? The mainstream literature on the topic would lead one to think that not only is the economist in a position to analyze past occurrences, but also that he has access to an economic oracle allowing him to predict future developments and provide invaluable advice to

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[1]To understand the continuing relevance of this issue, see Sachs (2005).

reach these goals (Anderson and Boettke 2004). This contention is evident when one looks at Joseph Stiglitz's best selling book, *Globalization and Its Discontents* (2002).

Stiglitz's book is a good representation of the current mindset in much of the development literature and has been popular among both academics and nonacademics alike. Stiglitz's book also provides key insights into how those in the development establishment view the role of the economist given that the author was both chairman of the Council of Economic Advisers and chief economist at the World Bank. After discussing the failures of various attempts at generating economic growth in developing countries, Stiglitz concludes with recommendations of how to "correct" these failures.

Included in his list of recommendations are: the creation of international public institutions (p. 222), a change in the governance and "mind set" of the WTO and IMF (pp. 224–27), acceptance of the dangers of capital markets, bankruptcy reforms and standstills, less reliance on bailouts, improved banking regulations, improved risk management, improved safety nets, improved responses to crises (pp. 236–40), and refining conditionality of assistance and debt forgiveness (pp. 242–43). Underlying these recommendations is the assumption that policymakers and economists can design effective policies and interventions to generate the desired outcomes.

It is the failure, by both Stiglitz and the development community in general, to consider the role of the economist that serves as the foundation of this paper. It is our contention that the true role of the economist in economic development has been obscured.[2] The development community has misused the science of economics as the basis for piecemeal planning. This paper reconsiders both the field of economic development and the economist's role within that field.

We begin, in Section 1, with a brief history of development economics. The purpose is to understand how we arrived at the current state of affairs. In Section 2, we argue that indigenous institutions, a critical component for understanding any economic order, have been overlooked by those in the development community. We seek to address this oversight by providing an analysis of the role that informal, indigenous institutions play in social change and economic development. Section 3 provides a reconsideration of the nature of economics and a framework for understanding why the current view of the role of the economist in development economics persists. Section 4 concludes.

[2]We are not the first to recognize this. In fact, Peter Bauer dedicated most of his career to consistently criticizing the development establishment (see Bauer 1963, 1972, 1981, 1991 and Bauer and Yamay 1957). Given the intellectual climate in the 1950s, which emphasized central planning, the development community did not accept Bauer's critique. The emphasis on central planning persisted through the collapse of communism. While most would now recognize that central planning cannot work, most still call for an active role for government in economic development.

The Rise and Failure of Development Economics: A Brief History

As mentioned above, the issue of the wealth of nations can be traced back to Adam Smith (1991). However, it was only after World War II that economists began to pay particular attention to the needs of poor countries. Prior to World War II, economists studying growth theory focused mainly on wealthy countries (Arndt 1997). These economists, influenced by the Great Depression in the United States and the industrialization of the Soviet Union through forced investment and saving, focused on a labor surplus which they concluded had to be absorbed.[3] The result was what became known as the investment gap theory. According to this view, capital accumulation was critical because growth was proportional to investment. How was this gap to be filled?

Development economists at the time postulated that poor countries would be unable to save enough to grow. Foreign aid and investment from wealthy countries were needed to fill the gap. This aid would, in theory, increase investment in capital in the poor countries and lead to greater output and growth. Because foreign aid would flow from the governments of wealthy countries to the governments of poor countries, the state was placed at the center of all efforts at economic development. Indeed, the intellectual climate in the 1950s was grounded in the belief that state planning within both developed and developing countries was critical for economic success.[4]

The investment gap theory took firm hold in the United States. At the time, the Soviet Union was viewed as an economic power. The U.S. wanted to demonstrate an alternative to growth via forced savings and investment.

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[3]A major driver of the focus on development economics was aggregate techniques developed in the Keynesian revolution. These techniques provided economists with a way to easily measure economic development through per capita income.

[4]On the topic of economic development, Nobel Laureate Gunnar Myrdal wrote:

> The special advisers to underdeveloped countries who have taken the time and trouble to acquaint themselves with the problem, no matter who they are . . . all recommend central planning as the first condition of progress. (1956, p. 201)

Bauer, in his review of Mydral's three books on development economics wrote:

> The main instruments of development policy envisaged by the author are clear. He considers comprehensive development planning, in the sense of government determination and control of economic activity . . . as indispensable and presumably sufficient for that increase in output which is the essence of economic improvement for the masses. (Bauer 1972, p. 467)

Bauer put forth an analysis and criticism of foreign aid as the key to economic development (pp. 95–135).

Under the Kennedy administration (1961–1963), foreign aid reached its historical maximum at $17.3 billion. After this peak, the U.S. slightly decreased aid under Johnson (1963–1969) with a high of $17.2 billion in 1966 and a low of $11.8 billion in 1969 (Shapiro and Birdsall).

Amidst the widespread acceptance of the investment gap theory, Robert Solow published his famous growth model in 1957. The underlying argument was that investment cannot sustain growth due to diminishing returns. Simply put, the incentive to invest falls as an individual invests more. For Solow, long-term growth could only be sustained with technological change, not investment. Solow's model was fiercely debated in the literature and while it had a large impact, development economists were hesitant to accept that investment was not the dominant cause of long-term growth.

With the advent of the computer in the 1970s, economists attempted to calculate the exact amount of foreign aid necessary to fill the investment gap. The revised standard minimum model was developed with the growth part of the model known as Harrod-Domar. The Harrod-Domar model postulated that the growth rate of GDP was proportional to last year's investment level (Easterly 2001, p. 35). It is interesting to note that the Harrod-Domar model was directly influenced by the debates of the Soviet economists in the 1920s (Boettke 1994b, p. 93). Domar even remarked that the Soviet journal, *The Planned Economy*, was "a valuable source of ideas" for the development of his own approach (Domar 1957, p. 10).

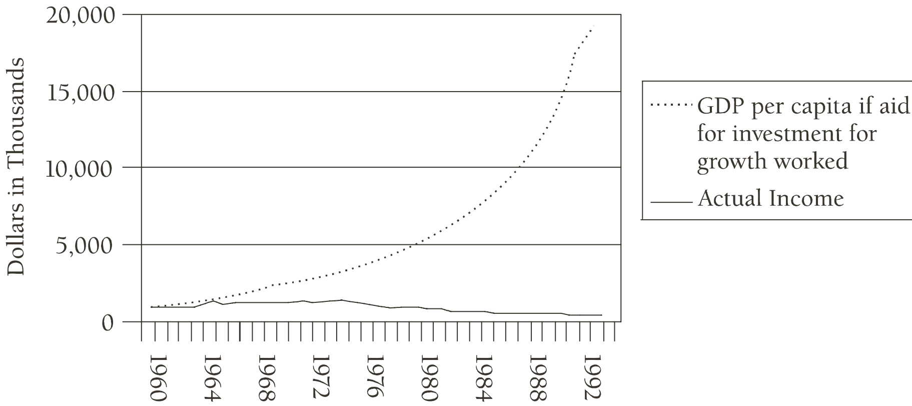
However, it was realized over time that investment was not the key to sustained growth. The assumptions of the aforementioned models were simply unrealistic. For instance, it was assumed that aid would correlate with investment one-to-one. It was also assumed that the country receiving aid would increase its level of national saving. Finally, a linear relationship between investment and GDP growth was assumed.

The major issue was that there was no incentive for individuals in the country receiving aid to increase their own level of savings. There were incentive issues in terms of the government as well. Most importantly, government officials, when operating under the investment gap theory, have the incentive to maintain or increase budget deficits since doing so widens the gap leading to more aid. Although the investment gap theory eventually fell out of favor in the academic literature, Easterly (2001, pp. 35–37) notes that it is still widely used in the many international financial institutions who make decisions regarding aid, investment and growth.

Figure 1 illustrates Zambia, one of the many failures stemming from the mainstream view of foreign aid. The graph shows the theoretically predicted outcome of per capita GDP had aid been effective versus the actual outcome in Zambia.

If the $2 billion of aid had worked as the investment gap theory predicted, Zambia would have a $20,000 per capita income as compared to the actual per capita income of $600. Further, as Easterly (2001, p. 42) points

Figure 1
Foreign Aid to Zambia



Source: William Easterly, "The Five Myths of Third World Development," available at http://www.worldbank.org/researc/growth/present.htm.

out, Zambia had a high level of investment prior to receiving aid and investment moved inversely to the level of aid.

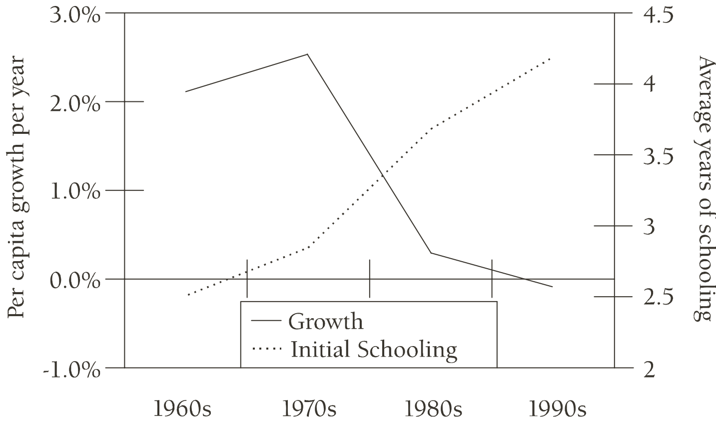
A shift in the trend of economic development occurred in the 1980s and 90s. It was argued that investment in physical capital was not the only factor of production. Also important was investment in human capital. Given this, the Solow growth model was augmented to control for the education of workers. The fashionable trend in development economics became pushing an agenda of government sponsored education. Adriaan Verspoor of the World Bank perhaps summarizes this position best: "The education and training of man–and although often neglected–of woman contributes to the economic growth through its effects on productivity, earnings, job mobility, entrepreneurial skills, and technological innovation" (1990, pp. 20–21).

With the human capital model gaining momentum, there was an explosion in education spending. As of 1960, only 28 percent of countries worldwide had 100 percent primary enrollment. The worldwide median primary school enrollment increased to 99 percent in 1990, up from 80 percent in 1960. Further, between 1960 and 1990, the median college enrollment rate of countries worldwide increased from 1 percent to 7.5 percent (Easterly 2001, p. 73). Despite the growth in education, it is widely agreed that the actual correlation between growth and schooling is highly disappointing.[5] Figure 2

[5]Barro (1991) and Barro and Sali-i-Martin (1995) have found that growth is related to initial schooling although this is usually assumed to be temporary.

illustrates this disappointment—highlighting the trend of increasing schooling but decreasing growth:

Figure 2
Average Years of Schooling and Yearly Growth



Source: William Easterly, "The Five Myths of Third World Development." Available at http://worldbank.org/research/growth/present.htm.

To understand why the investment in education failed, consider that education and skills provide a benefit in an uninhibited marketplace where labor resources are free to move and where institutions create a relatively high payoff to an ethic of workmanship and entrepreneurship. If these conditions do not exist, the incentive to take full advantage of educational opportunities remains small. With little incentive to develop one's skills, few individuals become educated and the circle of poverty continues. Simply forcing education has little or no effect without the other contributing factors. Transferring resources to build schools and provide teachers does not lead to growth. Instead, a country's environment must provide a set of incentives that creates a high payoff to investing in one's future.

The emphasis on human capital and education, while failing to produce results in terms of sustained growth, has remained one of the key focuses of both development economists and international organizations involved with development. It is true that no unskilled country has become rich. But then why have efforts to invest in education failed? There must be something else that the development community is overlooking.

While the emphasis on human capital is still a major component of development economics, the latest trend can be simply summed up as "institutions matter." This trend is in response to the work of Nobel Laureate Douglass North (1994), who emphasized the importance of institutions and institutional change. However, this realization leads to the question: which institutions matter? Currently, the literature focuses on the role of exogenous

institutions, oftentimes international agencies, in "promoting" economic growth in underdeveloped countries.[6]

Within this context, the focus has become finding the right policy mix for growth. For instance, emphasis is often placed on attempting to determine the extent of government involvement and intervention in the economy. Interestingly, one can also see that the past trends discussed above are still very present. There is still an emphasis on investment, foreign aid and education, but now under the guise of "institutions." Given the failure of past attempts to impose institutions resulting in economic development, why should we assume that current recommendations to do more of the same would lead to better results?

The critical oversight of the development community is that it is *both* indigenous and exogenous institutions that matter.[7] While focusing on exogenously imposed institutions (i.e., government agencies, educational systems, infrastructure, etc.), the discipline of economics has invested few resources in understanding indigenous institutions. Much of this results from confusion over the role of the economist and the demands of the state on economists which we will discuss later in the section "The Nature and Use of Economics." In the next section, we focus on why indigenous institutions are important and provide a framework for understanding them.

What is Missing?
Understanding the Role of Indigenous Institutions

What exactly is our goal when undertaking issues of economic development? Presumably, it is to understand why certain economies progress while others are stagnant or regress. As discussed above, it is widely agreed that the institutional framework of any economy will influence its progress or lack thereof

[6]Anderson and Boettke (2004) analyze the 2002 issues of the *Journal of Development Economics*. They conclude,

> while some of the institutional issues are getting play, the field has not thrown off its "Development Set" character. Instead of getting a field that varies methodological approaches and formulations on a case-by-case basis, we observe conventional methods addressing traditional development economics ideas, notably the *dirigisme* of diligent public servants, but in a more tentative and watered-down form. (p. 315)

Klein and DiCola (2004) analyze the ties of 2002 authors and editorial officers of the *Journal of Development Economics* to major international development organizations. Of the 124 authors, they find that 75 percent have ties to the "Big 8" development institutions. Further, of the 26 editorial officers, the authors find that all have ties to the Big 8. The work of North (1994, 2005) which focuses on the role of formal and informal institutions is one notable exception to this general trend.

[7]When using the term "institutions," we follow the New Institutionalist literature to indicate both formal and informal rules which serve to govern human behavior and the enforcement of those rules.

(Kasper and Streit 1999; North 1994; Platteau 2000; and Scully 1992). Most agree that the capitalist institutions of private property, rule of law, and some degree of stability are necessary for progress to occur. However, there is still much debate regarding the extent of government involvement in these institutions.[8]

This of course leads to a critical question. Given that we know what it takes for an economy to develop and become prosperous, are these institutions transportable? Can institutions that are successful in one country be exported and imposed in other countries in the hopes that the results will be the same? This is the question that underlies the entire endeavor of economic development. Economic theory provides the means to analyze the consequences of differing rule regimes. But what can it offer in terms of helping the economist understand why some rules sustain while others fail to do so?

As discussed above, the development community currently emphasizes the role of exogenous institutions while overlooking the critical role played by indigenous institutions. Achieving an understanding of indigenous institutions not only requires a comprehension of institutional change, but also a theory of why certain institutions are accepted or rejected. The anthropologist, James Scott (1998, pp. 6–7), has revived the Greek word *mētis* which will serve as the foundation for our understanding of indigenous institutions.

Mētis includes skills, culture, norms and conventions that are shaped by the experiences of the individual. This concept applies to both interactions between people (i.e., interpreting the gestures and actions of others) and between people and the physical environment (i.e., learning to ride a bike). The notion of *mētis* is not one that can be written down neatly as a systematic set of instructions, but rather evolves through experience and practice.[9]

In terms of a concrete example, think of *mētis* as the set of informal practices and expectations that allow ethnic groups to construct successful trade networks. For instance, orthodox Jews dominate the diamond trade in New York City (and many other locales), using a complex set of signals, cues, and bonding mechanisms to lower the cost of trading (Bernstein 1992). The trade would not function nearly as well if we simply dropped random traders into the same setting; that difference can be ascribed to *mētis*. The informal institutions

[8]We now have significant empirical evidence that the socialist model of planned industrialization doesn't hold the answer to economic development (see Boettke, 1990, 1993, 1994a, 1994b, 1994c). It is also known that an institutional environment that fosters the rule of law and protects private property and freedom of contract also demonstrates economic progress (see, for example, Berger, 1986; Boettke 1996; Gwartney, Lawson, and Block 1996; 1998, 1999; Scully, 1992). See Boettke and Coyne (2003) for a discussion regarding the importance of certain institutions as preconditions to entrepreneurship and economic progress. Boettke and Coyne (2003) and Coyne and Leeson (2004) discuss how the institutional environment directs entrepreneurial activities toward productive, positive-sum, or unproductive, negative or zero-sum ends.

[9]One can see a connection between *mētis* and the work of Hayek, especially the role of prices in economizing on tacit knowledge of time and place. See Hayek (1948).

of the current traders allow potential situations of conflict to be transformed to situations of coordination, where an overwhelming majority of traders are better off by sticking to the established rules.

Mētis is not static in nature. Obtaining and acting on knowledge should be viewed as a changing process over time. As knowledge travels between groups and international borders, new *mētis* is created and old *mētis* fades away and loses relevance. Therefore, a key problem in economic development is whether *mētis* has adapted to the new and changing circumstances. As we will see, if the underlying *mētis* does not align with reforms and formal institutions, these institutions will fail to sustain and be effective even if they are growth-inducing institutions.[10] It should also be noted that all societies have *mētis* of some nature and its mere existence does not guarantee successful economic development. If *mētis* aligns with institutions that are growth retarding, economic development will not be achieved.

The solution commonly offered by development economists is that we must impose the correct formal structure (i.e., a constitution, property rights, etc.) in developing countries. However, the realization of the role of *mētis* illustrates why this reasoning is wrong. Consider the causal connection between *mētis*, institutions and outcomes as depicted in Figure 3.

Figure 3
The Relationship Between *Mētis*, Institutions, and Outcomes

This relationship can only move from left to right—formal institutions must be based on the *mētis* of the people acting within them. If *mētis* fails to align with the formal institutions, then they will fail to sustain and be effective. For example, if the populace fails to have any notion of property rights, attempting to impose such a system will ultimately fail as individuals will not respect or utilize the system as it was intended. This serves to explain why institutions that are effective in one context cannot simply be transported and imposed in other contexts. There is no guarantee that the transported institutions will yield the desired result because the underlying *mētis* differs across societies.

Mētis provides the knowledge necessary for individuals to coordinate around mutually beneficial ends. If the *mētis* aligns with the institutional

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

structure, individuals will coordinate around the institutions and they will sustain with little or no external involvement. If, however, *mētis* fails to align with the institutions, they will fail to stick and operate in the desired manner. The formal institutions will either unravel or will require continual external support.

It is critical to remember that *mētis* is not static. We are not proposing that social change can never take place. Further, activities taken by exogenous actors can influence the nature of *mētis*. Our contention is that if the underlying *mētis* fails to align with institutional changes, they will fail to be effective. As such, one must either introduce institutional changes which align with the underlying *mētis* or the *mētis* must change such that the desired institutional changes can be effectively made.[11] If at some point in time, *mētis* fails to align with growth-enhancing institutions, it does not mean that the society is doomed. It does mean, however, that a shift in *mētis* is necessary before the growth-enhancing institutions can become fully effective.

This contention is supported by the work of Boettke and Leeson (2003) who describe the repeated failures of attempted market reforms in Russia as a result of planning and imposing instead of recognizing the social processes necessary for the acceptance of such institutions. The failure of attempts at imposing institutions is not limited to market reforms. Other examples include government interventions in forestry and agriculture, urban planning, and language (Scott 1998). How then are we to understand and analyze this connection between *mētis*, institutions and outcomes in the context of economic theory?

The recognition of the role of *mētis* indicates that context matters. In other words, certain institutions cannot be planned by some central organization and imposed upon the populace. Applying this realization to institutional change, Boettke writes:

> It is not due to an intellectual argument against "Western imperialism" that we must recognize that development is not an issue of simply either writing down the constitutional rules of a Western-style democracy or copying the economic institutions of capitalism, but rather an *epistemological argument* about rules. . . . Economics may establish the properties of alternative rules, but culture and the imprint of history determine which rules can stick in certain environments. The problem is not one of private property and freedom of contract generating perverse consequences, but the fact that some social conventions and customary practices simply do not legitimate these institutions. (1996, pp. 257–58; italics in original)

[11]As Bauer and Yamay write, "it is clear that economic progress requires and causes significant changes in social institutions and in the people who are served by them" (1957, pp. 68–69).

This has broad and significant implications for development economics as it is widely accepted today. One cannot step out of the historical context of a country and design and impose the "appropriate" institutional structure in the hopes that it will be accepted. Despite the fact that we know what institutions are necessary for growth (i.e., capitalist institutions), we are still unable to impose them because they may not be supported by the underlying *mētis* enabling their widespread acceptance.[12]

A connection exists between our framework and the work of Mises on the issue of postwar reconstruction. Mises, writing on the economic reconstruction of Europe, argued: "This reconstruction cannot be undertaken from without, it must come from within. It is not simply a matter of economic technique, still less of engineering; it is a matter of social morale and of social ideologies" (2000, p. 29). Mises clearly recognized that social change was not merely a matter of central planning and engineering, but rather had a substantial indigenous element.

Along similar lines, Mises focuses on public opinion and ideology as the foundation of social change, when he writes:[13] "What determines the course of a nation's economic policies is always the economic ideas held by public opinion. No government, whether democratic or dictatorial, can free itself from the sway of the generally accepted ideology" (1996, p. 850). And later, "The supremacy of public opinion determines not only the singular role that economics occupies in the complex of thought and knowledge. It determines the whole process of human history" (p. 863). The notion of *mētis* is broader than the notion of public opinion. Nonetheless, public opinion and ideology can be seen as one critical element of *mētis*. Indeed, as we will discuss below, changes in public opinion, and hence *mētis*, are critical to social change.[14]

This framework is also consistent with the work of Hernando de Soto (1989, 2000). The motivation that underlies *The Other Path* (1989) is de Soto's desire to understand the plight of Peru. In his study of the country, he found a flourishing informal economy that was operating outside the formal political, legal and economic system. The cost of engaging in the formal system had become so high that economic actors had set up an informal institutional setting in which to undertake their activities.

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[12]As North writes: "The perceptions of the actors play a . . . central role in institutional . . . change because ideological beliefs influence the subjective construction of the models that determine choices" (1994, p. 103). See also, North (2005, pp. 23–37). Pejovich (2003) provides a cultural explanation for the failure of transition efforts in Central and Eastern Europe.

[13]For Mises's complete discussion of this topic, see *Human Action* (1996, pp. 177–91 and 886–88). For more on Mises's view of society, see Salerno (1990, esp. pp. 31–36), which discuss Mises's treatment of the evolution of social institutions.

[14]For an analysis of Mises's view of the role of public opinion and the implications for democratic outcomes see Caplan and Stringham (2005).

De Soto followed this initial analysis with *The Mystery of Capital* (2000), in which he sought to understand why the West was rich relative to the rest of the world. It is not enough for the informal sector to be successful, de Soto argues, but it must be codified or recognized as formal in order for the full potential of capital to be unlocked. In other words, the *mētis* did not align with the formal institutions in Peru and therefore the formal institutions failed to be effective. Instead, the *mētis* aligned with the informal institutions that emerged and, as de Soto pointed out, the informal network flourished. De Soto argues that in order for growth to be achieved the *mētis* underlying the informal institutions must be recognized by the formal institutions.

The above realizations significantly limit the procedures followed by the World Bank, IMF, and World Trade Organization among others. Currently, these organizations require "conditionality" which involves forcing countries to commit to imposing certain institutions in order to secure and maintain funding. These institutions are imposed without any shift, let alone consideration, of the underlying *mētis*, and as such tend to fail in achieving the desired the ends.

As our discussion of *mētis* demonstrates, indigenous institutions are the product of social processes. In order for indigenous institutional change to take place, a change in the *mētis* must precede it. Institutional imposition from above cannot work. Under such circumstances, whether the imposed institutions are growth-inducing or not, they will fail to be effective. Institutional effectiveness is a function of endogenous, not exogenous, social processes.

Why has the development community overlooked this dichotomy of formal and informal institutions and chosen to focus on the former while discarding the latter? An answer can be found when we consider the role of the economist. It is our contention that the true role of the economist in economic development has been obscured.

The Nature and Use of Economics: Why Does the Conventional Role Persist?

The Persistence of the Conventional Role

The science of economics provides us with true laws of the world. The role of the economic theorist is: (1) to identify and elaborate on these laws and (2) to use them to explain complex economic facts. When attempting to predict future events, the economist is no longer a theorist or historian, but rather assumes the role of forecaster. This forecasting can take two forms–qualitative or quantitative. A qualitative forecast relies on economic laws to explain a causal relationship while a quantitative forecast places a numerical value on some future occurrence. It is often forgotten that economic laws, by their very nature, are qualitative rather then quantitative. When the forecaster engages in quantitative predictions, he has gone beyond the knowledge that the science of economics is able to provide.

To illustrate, the laws provided by the science of economics tell us that *ceteris paribus* when price increases, quantity demanded decreases (a qualitative forecast). It fails to tell us that an $X increase in price leads to a Y percent decrease in demand (a quantitative forecast). This is a critical realization because all of the development organizations—the World Bank, IMF, WTO, etc.—rely heavily on quantitative forecasts for their various programs as well as their analysis of economic development in general.[15] In short, the economist's comparative advantage is not in forecasting but in understanding economic laws and the specific situations where they are applicable.

The active role of the development agencies provides insight into why the conventional role of the economist persists. This persistence is grounded in a fundamental misunderstanding of the nature of economics and, hence, the role of the economist. It is our contention that the emphasis on government intervention and scientific management has led economists to seek to accomplish tasks which they cannot possibly achieve.

In *Reaching for Heaven on Earth* (1991), Robert Nelson argues that modern economics has taken on a theological significance that was denied other social sciences. It is Nelson's contention that since economic progress was seen as the solution to social ills, the discipline of economics was given a special status as the harbinger of economic progress. Economists have been elevated to the level of "priests" who utilize economic science to transform the liberal state to the administrative state with the goal of eradicating social ills. This special status given to economists includes privileged positions in advising policymakers as to the social and economic programs that should be undertaken.

What then does this mean for the economist, specifically in the realm of economic development? The following dichotomy serves to explain the role of the economist and highlight the point made by Nelson. In the first instance,

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[15]As Rothbard writes:

> The pretensions of econometricians and other "model-builders" that they can precisely forecast the economy will always flounder on the simple but devastating query: "If you can forecast so well, why are you not doing so on the stock market, where accurate forecasting reaps such rich rewards?" It is beside the point to dismiss such a query . . . by calling it "antiintellectual"; for this is precisely the acid test of the would-be economic oracle. (1970, p. 257)

This is not to discount the role of model building and econometrics as an economic tool for use in analyzing historical events. It is only to highlight the point that using such tools to forecast future occurrences is outside the realm of the science of economics. See Rizzo (1978).

For an example of the IMF's use of forecasts and projections, see the "World Economic Outlook, September 2002 — Statistical Appendix" available at: http://www.imf.org/external/pubs/ft/weo/2002/02/pdf/appendix.pdf.

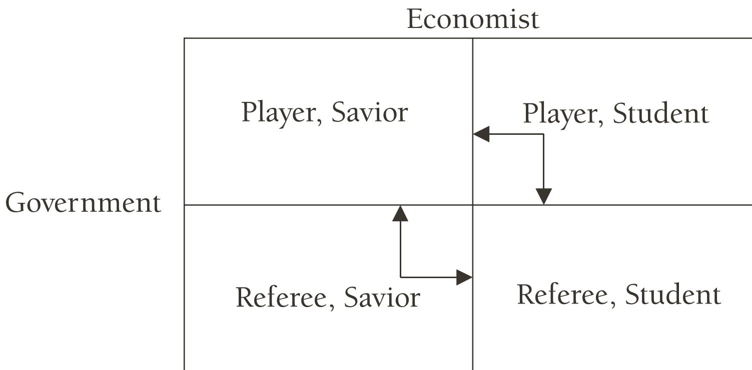
when analyzing the pure market in which the government plays a passive role, the economist is left only to understand and explain the workings of the economy. In other words, the economist is a "Student" of the economy. The economist is able to explain the consequential chain for some occurrence—if X occurs, then Y, then Z, etc. In the context of development economics, the economist as a "Student" is primarily concerned with understanding how the indigenous institutions of a particular country evolved to meet certain social needs and how they function within the unique cultural context of the country in question to coordinate economic activity.

However, the role of the economist changes drastically when we introduce development agencies (the World Bank, IMF, etc.) whose goal is to influence the operation of the market. Given that their aim is to actively intervene in the economy, the consequences of these acts are far more widespread and intricate than a simple causal connection (if X, then Y, etc.). Given the longer chains of reasoning needed to determine the impacts of various policies, the economist becomes even more important to the decision makers who take on an active role in intervening in the economic order.

In this context, the economist becomes a "Savior." As a "Savior," the economist is guided more by his, and his employer's, desire to effect successful change than his ability to actually do so. The economist as "Savior" is overly ambitious regarding the effectiveness of his policy recommendations. These recommendations are not only limited to how government may be able to better enforce existing rules, but also are primarily concerned with what new institutional arrangements should be imposed to replace "inefficient" indigenous ones. What this means is that as government becomes increasingly interventionist, it requires economists to act as "Saviors" in order to provide recommendations as to how the government should intervene.

The following matrix (Figure 4) serves to illustrate the interaction between the various roles of the government and the economist.

Figure 4
The Development Dilemma



The government can act either as a "*Referee*" or a "*Player*." As "Referee," the state is limited to enforcing indigenously emergent institutional rules. Its capacity as "institutional builder" is restricted to the mechanisms of enforcement and its presence in the social order is passive. As a "Player," the state not only enforces endogenously emergent rules of the game, but also actively creates these rules and the institutional composition of society itself. In this capacity, government exogenously imposes institutional order from above instead of merely recognizing and providing a network of enforcement for indigenous institutional arrangements that evolve spontaneously from below. As discussed above, the economist can either take on the role of a "Student" or of a "Savior."

When presented in this fashion, it is clear that some of the pairs form a stable equilibrium (on-diagonals) while others do not. This instability is due to the incentive incompatibility of the roles represented by the off-diagonals. When government assumes the role of a "Player" and the economist as "Student," or when government acts as "Referee" and the economist as "Savior," the situation is unstable. Without active policy recommendations from savior-minded economists, the government cannot effectively act as "Player." In other words, when the government assumes the role of "Player," there is a strong incentive to employ economists as "Saviors." These savior-oriented economists provide recommendations for social and economic intervention and control to correct social ills.

Given this, envision a situation where the government is a "Player" and actively seeks to intervene in the economic and social order. In such a situation, the upper right quadrant is unstable. When the government wishes to intervene in the economy, there is little role for the economist as a "Student." In stark contrast, the government as a "Player" requires the employment of "Savior" economists who provide policy advice in terms of what social and economic interventions and controls should be undertaken.[16]

Similarly, if government is restricted to the passive role of "Referee," simply enforcing indigenous rules, the "Savior" economist's overly ambitious policy recommendations concerning how to create institutional order anew have no impact. In other words, when the government is a "Referee" there is no incentive to employee savior-oriented economists. With no role for "Savior" economists, the situation will move from the unstable lower left quadrant to the lower right quadrant. In the absence of government support, savior-oriented thinking is unsustainable. In the event of either of these disequilibria pairings, the system tends to move to one or the other of the equilibrium pairings (in bold) indicated by the arrows in Figure 4.

In the equilibrium depicted in the upper left box of the matrix, government is a "Player" and the economist is a "Savior." This equilibrium represents

[16]This does not mean that there is a complete absence of economists as "Students," but rather that the government as a "Player" requires the employment of "Savior" economists. In such a situation, "Student" economists are marginalized.

the current situation in development economics as well as reform attempts by the development community over the past half a century. Mises recognized this pairing of a player-oriented government and a savior-oriented economics profession when he noted that,

> The development of a profession of economics is an offshoot of interventionism. . . . He [the professional economist] is an expert in the field of economic legislation. . . . They [professional economists] rival the legal profession in the supreme conduct of political affairs. The eminent role they play is one of the most characteristic features of our age of interventionism. (1949, p. 869)

In this equilibrium, the economist designs a new institutional order ignorant of existing indigenous, endogenously emerged arrangements and the government imposes this order. As long as the state is a "Player" in the economic game, savior-oriented economists will be required to formulate its various interventions and to provide credibility for these interventions to the populace.

Section 2 provided an overview of the failure of this approach, which emphasizes only the "right" exogenous institutional mix to be imposed on underdeveloped economies. Despite these continued failures, it is important to note that the equilibrium depicted in the upper left hand box has persisted. There are at least two reasons why this has been the case.

The first relates to the discussion in this section regarding the perversion of what the discipline of economics can realistically accomplish. Clearly, a misunderstanding of the nature of the discipline is part of the reason that the role of the economist has become distorted in the context of economic development. Not only have economists been called on to provide recommendations for initial interventions, but they have also been called on to continue to provide advice as those initial interventions produce unintended consequences and fail to achieve the desired results.[17]

The second reason for the persistence of the conventional role of the economist is the perverse incentives faced by both those both in the development community and those in government positions in developing countries. Although the stated goal of the development community is to eradicate poverty and social ills, there is a strong incentive for those involved to fail in achieving this goal. Indeed, if the ultimate goal were in fact accomplished, those in the international development community would eradicate their own source of employment. As such, there is a strong incentive for those involved in development agencies to continually identify ills that must be corrected by government interventions. Moreover, those in government positions in developing countries face strong incentives to ensure that their country remains in

[17]This, of course, is the dynamics of interventionism as developed by Mises (1977, pp. 37–39) and discussed by Rothbard (1970, pp. 264–66).

a state of underdevelopment in order to continue to receive aid from the development community.[18]

The other equilibrium is depicted in the lower right box of the matrix—government as "Referee" and the economist as "Student." Here the economist primarily seeks to understand indigenous institutional history and function and the state's activity is limited to refining the means by which indigenous institutional arrangements are enforced.[19] This approach takes full account of *mētis* and its connection to the effectiveness of indigenous institutions.[20] Until movement toward this quadrant takes place, we should expect development efforts to continue to fail. By neglecting the role of informal institutions and *mētis*, the "Player, Savior" equilibrium will continue to yield results that fail to achieve the stated ends. Changing this equilibrium will require a major shift in thinking regarding both the role of government in the area of development and also what the discipline of economics, and economists working within that discipline, can realistically achieve.

What is the Proper Role of the Economist?

Given our framework for understanding indigenous institutions and our reconsideration of the nature of economics, what does this mean for the role of the economist in economic development? Given the nature of the science of economics, there is clearly a role for the economist both in situations where he must explain the causal chain—the pure market—and where he is called upon to analyze actions that influence market activity—the results of policy. The economist is first and foremost a student of the economic order. He not only needs to understand economic theory, but must also study both formal and informal institutions to understand their economic implications. Part of the study of the economic order involves understanding the *mētis* that enables individual economic agents to coordinate their activities.

A full understanding of *mētis* involves moving beyond the standard methods of looking at aggregate data and instead engaging in on-the-ground fieldwork to construct an analytical narrative (Boettke et al. 2005). This fieldwork entails detailed case studies and ethnographic data intertwined in a narrative to understand the everyday life of those in developing and transition countries. Through the use of surveys, directed interviews and participant-observer

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[18]Placing strict conditions (i.e., "conditionality") to foreign aid was meant to remedy this incentive problem. However to date conditionality has been a failure mainly because lending countries and agencies have failed to carry out threats of cutting off aid when developing countries fail to meet conditions.

[19]This equilibrium does not preclude the presence of economists who support government intervention. However because government activity is limited, there is little role for savior-oriented economists in the public space.

[20]As noted in Section 3, a society's *mētis* will limit the effectiveness of policies. This limitation works in both directions. Government interventions will fail to operate effectively in the absence of *mētis* to support those policies. Likewise, in the absence of a *mētis* conducive to liberal orders, free-market policies will fail to operate as desired.

behavior, one can offer key insights into how individuals within a specific setting "get things done."[21] Given that policies and exogenous institutions that fail to align with the underlying *mētis* will fail to be effective, this type of research is critical.[22]

In addition to being a student, the economist can also engage in the role of educator in which he explains the workings of the market to the general public as well as those involved in policy. In this role, the economist plays a critical role in shaping public opinion and ideology which, as indicated by Mises, are critical for social change to take place.

In the context of public policy, there have been various views on the role of the economist. In 1953, Milton Friedman stated the following: "The role of the economist in discussions of public policy seems to me to be to prescribe what should be done in the light of what can be done, politics aside, and not to predict what is 'politically feasible' and then recommend it" (p. 264).

In other words, Friedman suggests that the economist should focus on the best realistic alternative rather than the politically expedient course of action. In contrast, W.H. Hutt (1971) described a dual role for the economist. In addition to suggesting the best alternative, Hutt contended that the economist should suggest the politically feasible course of action as well. In other words, Hutt argued that the economist's policy advice should be along the following lines:

> In our judgment, the best you will be able to get away with is programme A along the following lines; but if you could find a convincing way of really explaining the issue to the electorate, our advice would have to be quite different. We should have to recommend programme B, along the following lines. (1971, p. 23)

Hutt's dual role for the economist seems to be plausible. In the absence of political constraints it would be feasible for the economist to prescribe the best possible alternative action. However, if the economist knows that there are certain political constraints on what can and cannot be achieved, his advice may change to achieve the desired ends given those constraints.

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[21]This is in line with P.T. Bauer who called for interdisciplinary cooperation especially between anthropologists, economists and historians in understanding the plight of underdeveloped countries and, more specifically, to understand "the extremely important and interesting range of issues in the transmission of knowledge, skills, attitudes and inducements between countries and groups" (1972, p. 304). Among the benefits of this interdisciplinary approach, "It may help to convey the value of direct observation and of unprocessed material, and conversely, the pitfalls of reliance on second-hand and third-hand material, including reliance on statistics without examination of their sources and background" (1972, p. 305). Boettke et al. (2005) survey the new learning in comparative political economy and suggest how this learning should redirect our attention in economic development.

[22]For readily apparent examples of this type of fieldwork, see de Soto (1989, 2000) and Chamlee-Wright (1997).

The critical point that must be emphasized is that the discipline of economics limits utopias. It informs individuals as to what they cannot achieve (for example, a post-scarcity world). The economist can engage in a study of the economic system as well as the indigenous and formal institutions which influence economic activity. He is also able to communicate economic laws and the suitability of various means in achieving stated ends. The most important realization is that the economist is not a savior. He cannot recommend a formula that can be simply imposed via government intervention that guarantees economic growth.

Conclusion

We have provided a reconsideration of the role of the economist in economic development. In doing so, we first considered the evolution of development economics to understand how the role of the economist has become what it is today. We argued that economists and policy makers alike overlook the role that indigenous institutions play in economic development. We concluded that the informal institutions, which underlie formal institutions, cannot be imposed from above but must develop from the ground up. Imposing formal institutions that do not align with the underlying *mētis* will not be effective. We also provided a framework for understanding why the conventional view of the economist in economic development persists.

Our reconsideration of the role of the economist in economic development concluded that there is a significant role for the economist to play in this area. The discipline of economics provides the economist with the tools to be a student of the economic system. He is suited to understand the interplay of both formal and informal institutions and their impact on economic activity. In addition to his role as a student, the economist can serve a critical function as an educator and adviser to both the general public and policy makers. In this capacity, the economist plays an important role in shaping public opinion and ideology which is critical in achieving long-lasting institutional and social change.

The framework developed here has widespread applications for understanding underdeveloped countries or countries currently in the process of transition. It can be applied to cases of both success and failure to aid in understanding the current institutions of these countries. Often, studies of these countries focus on the speed of reform and policy changes. The debate on "shock therapy" versus "gradualism" is one clear example of this. The analysis presented here sheds new light on these studies because it highlights that it is not simply the speed that matters, but whether changes in the formal institutions are aligned with the underlying *mētis*.

Truly understanding the plight of underdeveloped nations requires a complete comprehension of both formal *and* informal institutions. Grasping what economists can do to remedy the situation of these underdeveloped nations requires a complete understanding of the role of the economist and what the

discipline of economics enables him to achieve. This paper has provided key insights into achieving success in both of these areas.

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