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Luke M. Jackson  
University of Denver

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Institutions, the State, and Economic Development:

An Analysis and Evaluation of Ha-Joon Chang's Critique of the Dominant Discourse and  
His Thoughts on State-Led Development Theory

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A Thesis

Presented to

the Faculty of Arts and Humanities

University of Denver

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In Partial Fulfillment

of the Requirements for the Degree

Master of Arts

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by

Luke M. Jackson

March 2013

Advisor: Dr. Peter Ho

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Author: Luke M. Jackson

Title: Institutions, the State, and Economic Development: An Analysis and Evaluation of Ha-Joon Chang's Critique of the Dominant Discourse and His Thoughts on State-Led Development Theory

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## ABSTRACT

This paper examines two distinct schools of thought on how to best spur economic activity in developing economies. Mainstream economists, like Hernando De Soto and Douglass North, argue private property rights and free markets, and the institutions which nourish and protect them, are the primary driver of economic growth. Heterodox economists, led by prominent author and economist Ha-Joon Chang, acknowledge institutions play an important role in inducing economic activity but challenge the notion institutions are the *primary* driver of development. They argue targeted state-led investment and regulation are as important, if not more important, than protecting market freedom and private property rights in spurring economic growth in developing economies. Specifically, this paper provides a dispassionate global presentation/analysis of the mainstream/dominant discourse, Chang's critique of the mainstream discourse, as well as a thorough presentation of Chang's thoughts on state-led development theory. By analyzing the works of a broad cross-section of prominent mainstream and heterodox development economists in the context of Chang's challenge to mainstream thought, this paper sought to come to a better understanding of the significance of Chang's contribution to the literature on institutions and development.

This paper concludes that while Chang succeeds at exposing flaws in the mainstream's arguments, and while he presents a plausible case for state intervention, he is not one-pointedly hostile to the mainstream's view that property rights and institutions are primary drivers of growth. Indeed, the literature survey summarized above suggests Chang recognizes the importance of property rights but seeks to prod the mainstream into broadening the discussion to include the role of the state, thereby challenging the mainstream's *emphasis* on the importance of institutions, specifically private property rights.

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## **INTRODUCTION**

There are two distinct schools of thought on how best to spur economic activity in developing economies. Mainstream economists, like Hernando De Soto and Douglass North, argue private property rights and free markets, and the institutions which nourish and protect them, are the primary driver of economic growth. Heterodox economists, like prominent author and economist Ha-Joon Chang, acknowledge institutions play an important role in inducing economic activity but challenge the notion institutions are the primary driver of development. They argue targeted state-led investment and regulation are as important, if not more important, than protecting market freedom and private property rights in spurring economic growth in developing economies. This paper summarizes the large volume of research on this topic by examining both points of view. At its core, this paper seeks to determine if Chang and other heterodox economists make a compelling challenge to the mainstream narrative that institutions are the most important factor underpinning economic growth. It also evaluates whether Chang and heterodox economists themselves make a compelling case for state-led intervention as a stimulus for growth.

In summary, this paper provides a dispassionate global presentation/analysis of the mainstream/dominant discourse, Chang's critique of the dominant discourse, as well

as Chang's thoughts on state-led development theory. The survey of literature on these topics reveals a substantial yet disjointed collection of viewpoints yet lacks a comprehensive analysis of all parts combined. Because of this, we have a very fragmented view of Chang and, by extension, an unclear picture of the relevance of his challenge to the dominant discourse. By putting all of the pieces together, this paper hopes to come to a better understanding of the significance of Chang's contribution to the literature on institutions and development.

### **Institutions Defined**

First, it is important to understand what is meant by “institutions” since the term “institutions” is defined differently by different economists.

Mainstream economist Douglass North provides a broad definition. He defines institutions as the “humanly devised constraints that structure political, economic, and social interaction” (North, 1991, p. 97). Simply, institutions create order and reduce uncertainty in exchange. For example, North says our constitutions, laws and property rights are some of the *formal* rules that guide exchange. North says there are also *informal* constraints guiding our political, social and economic interactions including customs, traditions, codes of conduct, and taboos (North, 1991, p. 97).

Ha-Joon Chang distinguishes between institutions and policies. He considers institutions more permanent arrangements, while he views policies as more easily changeable. He gives the example of a tariff, noting how raising tariffs on certain industries would be a policy, but the tariff itself would be considered an institution



(Chang, 2003, p. 9). On the whole, Chang's definition of institutions, like North's, is very broad, and focuses on the following: democracy, an efficient bureaucracy and judiciary, property rights, intellectual property rights, corporate governance institutions, bankruptcy law, limited liability, a good public finance system (banking, central banking, securities regulation, social welfare, and labor institutions that provide safety nets and protect workers' rights (Chang, 2003, p. 10).

This paper will focus on a small subset of institutions. Specifically, this thesis will center on the institution of private property rights (as well as the rule of law protecting these rights). Emphasis is placed on the institution of private property rights because many mainstream development economists highlight the importance of private property rights as a primary driver of economic development. Some of those authors include Hernando De Soto, Douglass North, Tom Bethell and Peter Bauer.

## **THE MAINSTREAM VIEW ON INSTITUTIONS**

Broadly speaking, the mainstream/dominant discourse argues that institutions, specifically private property rights and liberalized markets, are the primary driver of economic growth in developing economies. This by no means reflects the true extent of mainstream development theory and, in fact, represents a narrow subsection of it. However, for the purposes of this paper, attention will be given to the importance of property rights (and associated institutions) given the critical role those rights play in the mainstream discourse. In the brief literature survey that follows, the works of prominent mainstream authors are examined. The representative samples from the survey presented below are just that ... samples. They do not cover the entire spectrum of research on institutions and development as presented by the mainstream but do provide a general overview of the literature as depicted by prominent mainstream, development economists.

Hernando De Soto, author of [The Mystery of Capital](#) and [The Other Path](#), is a strong advocate for property rights and a rule of law. He believes that these institutions underpin economic growth. In [The Mystery of Capital](#), De Soto maintains Third World nations are poor because they lack the legal institutions to secure property and obtain greater value in the expanded market. He says that poverty in these nations is not due to

a lack of assets, noting that the poor in Third World and former communist nations have accumulated \$9.3 trillion in real estate over the past 40 years (De Soto, 2000, p. 35). Put in perspective, that is more than 46 times as much as all the World Bank loans of the past three decades and 93 times as much as all development assistance from all advanced countries to the Third World in the same time period (35). De Soto argues that the primary problem is a lack of legal access to their assets that would allow them to secure value in the market. “What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market” (48). De Soto further says in the West (i.e., the United States and other developed nations) every asset, piece of land, office and house is formally fixed in updated records that are governed by rules of the property system. In other words, every asset is someone’s formal property. With formal property, the economic potential of assets becomes fixed and surplus value can be produced (48). For example, under a formal property system, a house ceases to be just a physical object that provides shelter. It also takes on economically and socially meaningful qualities as well. The house can be used as collateral for a loan, equity exchanged for investment and as an address for collecting debts and taxes. By showing ownership of an asset as a title, security, or contract, capital is born. De Soto says formal property is the tool that allowed the West to produce surplus value over and above its physical assets and thereby create economic growth and development.

In The Mystery of Capital, De Soto also explores the importance of a rule of law. He says it is vital to integrate assets into one formal representational system. In the West,

where property is universalized and standardized, it is easier to evaluate an asset's potential and exchange assets because information about an asset's quality and economic potential is accessible to all (De Soto, 2000, p. 54). A property system allows individuals to obtain information about assets without having to see the property itself in person. This increases exchange and enhances the production of capital (54). However, in developing nations, there are hundreds of legal and extralegal systems and organizations (53). As such, what can be done with their property is limited to the individual and his/her close acquaintances, not a broader network of people. This reduced transparency of assets also reduces exchange potential. De Soto points out that incorporation of property rights under one legal system facilitates accountability (55). When government protects legal property and enforces contracts, people that do not pay for goods and services can be charged penalties, fined, have their credit ratings downgraded, and lose some or all of the privileges of private property. The protection of property rights and the enforcement of contracts create accountability which builds trust in transactions so there is an environment conducive for the production of capital (62). In developing countries, this security of transactions is missing which makes it difficult to create surplus value (62).

The Other Path, like The Mystery of Capital, highlights the importance of property rights and the need for a system which incorporates legal and extralegal property arrangements under one legal system. Using Lima, Peru, as a case study, De Soto discusses the extralegal and black markets within Lima. He shows how a lack of property rights, a corrupt legal system, and an inability of many of its citizens to enter the

formal economy decreases productivity and investment and stunts technological progress. To illustrate his point, De Soto gives the example of two informal housing settlements in Lima, Mariscal Castilla and Daniel Alcides Carrion. The two settlements were built adjacent to one another during the same time period and inhabited by people with the same socioeconomic characteristics. The only difference between them is legal security... Mariscal was classified as a “permanent,” legal settlement while Daniel was classified as a “removable,” informal settlement. De Soto argues that levels of investment in housing and other buildings are determined by the measure of legal security provided by the state (the greater the security, the greater the investment). In Mariscal, where there was legal title to land, the value of a typical dwelling in the settlement was 41 times greater than in the informal Daniel settlement. The land itself was also 12 times greater. When De Soto examined a larger sample of thirty-seven settlements across Lima, he found that the value of buildings whose owners had received legal title was nine times that of buildings whose owners had not received title (De Soto, 1989, p. 24).

De Soto concludes when property rights are enforced and the legal system brings all people under the formal economy, economic growth ensues. “If a government cannot give its citizens secure property rights and efficient means of organizing and transferring them – namely contracts – it is denying them one of the main incentives for modernizing and developing their operations” (De Soto, 1989, p. 179). Property rights and a strong legal system reduce uncertainty, provide security, and allow one to reap the benefits of a

fixed location. In doing so, economic activity can be pursued efficiently, thereby stimulating investment and production.

Douglass North, an American economist, author and recipient of the Nobel Memorial Prize in Economic Sciences, sees institutions as providing “rules of the game.” These rules (institutions) shape the behavior of the players (economic agents) in the game and provide the incentive structure of an economy. This incentive structure determines whether an economy grows, stagnates, or declines (North, 1991, p. 97).

In The Rise of the Western World, North reasons that economic growth will only occur when the existing economic organization is *efficient*. North says the most efficient and socially desirable economic activity is where individuals and society mutually benefit from economic transactions. Institutions, he says, create an economic environment where this kind of win-win environment blossoms (North and Thomas, 1973, p. 2).

Take the modern-day example of the iPhone and Apple. Apple spent large sums of money, manpower and time to research and develop the iPhone, the iPad and the iPod. Had there been no laws assigning exclusive rights to Apple’s new ideas and inventions that enabled it to reap the rewards of the company’s initial up-front investment, it is likely Apple would not have such an investment in financial and human capital in the first place. The private costs (time, research, money, etc.) would have outweighed any benefits. However, the presence of private property rights prompted Apple to engage in economic activity (the production of the iPhone) because the company reaped the returns on its labor. The private benefits (profit) exceeded the costs (time, labor, and money).

But the benefits of Apple's invention extend to society as well, as owners of iPhones, iPads and iPods will attest. Hence, the private rate of return was brought into parity with the social rate of return. Economic efficiency was achieved. North might argue this illustrates the importance of institutions as a way to induce socially desirable behavior. Because of laws assigning exclusive rights to inventions, Apple had an incentive to risk private resources for both private and social gains. Without property rights, few risk their personal resources for the good of society.

In The Noblest Triumph, author Tom Bethell argues that economic development is achieved through the adoption of legal regimes that give security to private property. In Bethell's view, when property is privatized and a rule of law is established in such a way that subjects all people, including rulers, to the same law, "economies will prosper and civilization will blossom" (Bethell, 1998, p. 2). Bethell makes the case for the importance of institutions, like private property, by citing historical instances in which the presence of private property brought about economic growth and a lack thereof stunted growth.

Bethell illustrates the importance of private property by contrasting the decline of the Ottoman Empire, starting in 1863, with the rise of the West throughout the 19<sup>th</sup> and 20<sup>th</sup> centuries. While a number of factors have been attributed to the decline of the Ottoman Empire and the change in the balance of power, Bethell argues that the shift in power was a result of institutional change in the West and a lack thereof in the Ottoman Empire. Such changes in the West included the incorporation of individual rights into law and practice, the emergence of property rights, the development of constitutional

government, the security of property, and the enforcement of contracts (Bethell, 1998, p. 231). Bethell says the Ottoman Empire made no such changes. He cites J.R.

McCulloch's Principles of Political Economy published in 1825, in which he notes that the finest brains cannot create wealth if the government "does not respect and maintain the right of property," adding that this was the "principal cause of the present wretched state of the Ottoman dominions" (Bethell, 1998, p. 233). McCulloch further says that the English, French, and Hollanders, know that once they have paid taxes to the government, they are...

"... permitted to enjoy or accumulate the residue of their wealth, whereas the subjects of Eastern despotisms have, generally speaking, no security that the moment they have paid the stated contributions, the pasha, or one of his satellites, may not strip them of every remaining farthing" (Bethell, 1998, p. 233).

Karl Marx, writing to Freidrich Engels in 1853, even recognized the importance of private property. While discussing the "East" (Turkey, Persia, and India), Marx notes that they have a common basis, "namely the absence of private landed property" which he says "is the real *clef* (key), even to the eastern heaven" (Bethell, 1998, p. 234-235). Bethell concludes that the "widespread and secure ownership of property is the sine qua non of prosperity" (Bethell, 1998, p. 341).

De Soto, North, and Bethell provide a representative sample of the dominant discourse on institutions and development. Many other authors offer similar insights and also stress the importance of institutions. These include, but are not limited to, Ronald Coase, Nathan Rosenberg and Peter Bauer. While their works are not discussed here, all made significant contributions to the dominant discourse. In addition, there are a number



of empirical studies that illustrate the importance of institutions, property rights, and a stable rule of law [(see Acemoglu, Johnson, and Robinson (2001), Hall and Jones (1998), and Roll and Talbott (2001)]. In summary, within the mainstream, there exists an extensive collection of prominent economists and authors, as well as a large body of research, advancing the idea that institutions, specifically private property rights, are the primary drivers of economic development.

## **CHALLENGING THE MAINSTREAM NARRATIVE**

Ha-Joon Chang is an ardent critic of the dominant discourse on institutions and development. He believes there are significant empirical and theoretical flaws in the mainstream discourse, about which Chang provides an extensive critique. But Chang goes further. In Kicking Away the Ladder, Chang lays out his case that it is state-led initiatives, like tariff protection and export subsidies, which underpin economic activity. Following is a summary of Chang's critique of the mainstream discourse which is followed by an explanation and evaluation of Chang's view that the state is the driver of development.

### **Empirical Critique**

A number of empirical studies emerged over the last decade that lend strong empirical evidence to the mainstream idea that institutions, specifically property rights, play an essential role in bringing about economic growth (see Hall and Jones (1999), Acemoglu, Johnson, and Robinson (2001) and Talbott and Roll (2001)). Each report indicates that institutions have a strong determining effect on aggregate incomes. While a number of other variables (latitude, climate, disease environment, natural resources, soil quality, etc.) have some impact on economic output and incomes, the correlation between institutions and aggregate incomes is robust. Put simply, these studies suggest that

institutions are the primary factor explaining differences in levels of economic activity in developing nations.

However, Chang says many of these studies fail to look at the relationship between institutions and growth *in a particular country... over time*. He says existing mainstream studies are cross-sectional and, therefore, simply contain a snapshot of economic activity for an entire population *at a specific point in time*. For example, rather than measuring the economic output of multiple countries at a certain point in time, and then attempt to correlate each country's output – or lack thereof – with the existence or non-existence of institutions, Chang says country-specific studies showing the effect of various institutions (and other factors) on a particular country over a long period of time would better inform the discussion. Such “time-series” studies would allow researchers to account for the unique attributes and needs of each country and their effect on economic output. The institutions conducive for growth in one nation may not be as effective in another country. Thus, studies that look at data *over time in the same country* can better assess a country's specific institutional prescriptions and how the introduction of those prescriptions affects economic growth (Chang, 2010, p. 483).

Chang argues time-series studies should not be of a strictly econometric nature because econometric studies are unable to capture complexities that characterize the domain of institutions. Chang maintains that historical narratives and comparative historical studies should be incorporated. Only then will studies offer better insights into the relationship between institutions and economic growth (Chang, 2010, p. 483).

Chang notes that it is difficult to measure the quality of institutions and it is nearly impossible to quantify them. For example, since a property rights system is made up of a vast, complex set of institutions consisting of land law, urban planning law, tax law, inheritance law, contract law, bankruptcy law and intellectual property rights law, Chang says it is almost impossible to aggregate all these separate components into a single property rights system (Chang, 2007, p. 22). Given the difficulties associated with measuring and quantifying the property rights system, Chang says empirical studies thus tend to rely on subjective measures of the overall quality of institutions. In other words, these indexes measure the quality of institutions through the use of *qualitative* judgments... which are inherent with biases. Chang says many indexes which measure institutional quality are constructed by organizations that have biases towards free market policies and Anglo-American institutions (Chang, 2010, p. 484). He claims such biases result in inclinations to identify and measure institutions that fit into the mainstream narrative while ignoring institutions, like the welfare state, that might potentially help growth (484). Chang further adds that many indexes are based on surveys of businessmen who are educated and trained in the United States; thus, they have biases towards free market policies (484).

Parts of Chang's review of the empirical evidence have been accepted by some mainstream economists, including Jeffrey Nugent (a Professor of Economics at USC), Philip Keefer (a Lead Research Economist at the World Bank), and Young Back Choi (a Professor of Economics at St. Johns University). For instance, Choi says that Chang's critique on the problems associated with indexation of the quality of institutions is "well-

taken” (Choi, 2011, p. 512). Nugent and Keefer both recognize that much of the evidence in support of the dominant discourse is based on cross-sectional studies. Indeed, efforts are being made to eliminate these shortfalls. For instance, Nugent notes that new institutions and development studies are making efforts to use micro-level data as well as appropriate case studies to help relax the simplifying assumptions criticized by Chang. He cites a few case studies, including one by Gaspart and Seki (2001), which explains why fishermen in Toyoma Bay fish cooperatively by sharing all costs and revenues in an otherwise capitalistic society (Nugent, 2011, p. 564).

Dani Rodrik, a professor at Harvard University, shares Chang’s critique of the indices used by the mainstream, most notably those which measure institutional quality. Rodrik says many indices ask respondents (foreign and domestic investors) if they consider their investments safe and how they would rate the rule of law (Rodrik, 2004, p. 6). As such, Rodrik says these indices only capture investors’ *perceptions* of the institutional setting, not the *official* aspects of it (6). Take the example of property rights. While surveys might measure how well property rights are *perceived* to be protected, the same surveys do not indicate what those rules actually are, thereby making it difficult to accurately measure institutional quality. Rodrik points out that these perceptions of institutional quality might further be skewed by other aspects of the economic environment. For instance, when the economy is doing well, respondents will likely rate institutional quality higher than when the economy is doing poorly. Rodrik’s overarching objection with the surveys is...

“... the results do not indicate what specific rules, legislation, or institutional design is actually responsible for the institutional outcome being measured... all that we can infer is that performance is superior when investors feel property rights are protected (or the rule of law upheld)... the results are silent on what it is that makes investors feel that way” (7).

Rodrik uses the experience of Russia and China to illustrate. Russia has, in principle, full protection of private property rights by an independent judiciary. China, on the other hand, has neither an independent judiciary nor, until recently, protection of private property. However, Rodrik points out during the mid-to late-1990's, investors felt better protected in China than Russia, scoring China higher than its neighbor on security of property and rule of law. Rodrik says the disconnect between the perception of rules and actual rules shows it does not matter how safety is achieved as long as investors feel safe. Rodrik notes that empirical studies that stress the importance of institutions fail to illustrate how safety is achieved. Rather, they only indicate that it is critical to investors (Rodrik, 2004, p. 7).

Chang's criticism of cross-sectional studies and Rodrik's analysis of investors' perceptions of institutional quality appear to have merit. Mainstream economists agree Chang/Rodrik's concepts would improve existing empirical research. Indeed, an analysis of their empirical critiques suggests that avoiding “property rights reductionism” is more important to Chang and Rodrik than trying to counter the mainstream narrative (Rodrik, 2004, p. 1). In other words, with respect to empirical research, the intent is not so much to deny the crucial role of institutions in driving economic development as it is to elevate the debate (and research) beyond what Chang and Rodrik feel is an oversimplified view of institutions as the “be-all, end-all” of development policy. As Rodrik noted, effective

institutional outcomes do not necessarily translate into a set institutional design. While empirical studies suggest a property rights system protected by the rule of law may provide the foundation on which economic growth can occur, those same cross-sectional studies are silent on how the institutional design should be set up. Likewise, while Chang suggests empirical studies on institutions have pointed economists in the right direction, more work still needs to be done before studies can be put to good use. He advocates approaching the issue of development on a country-by-country basis, applying institutional prescriptions that are compatible with the local economy rather than taking the results of empirical studies and applying general institutional remedies across the board for all nations (Chang, 2010). Long story short, Chang and Rodrik argue, persuasively, the relationship between institutions and growth is more complex than the dominant discourse may suggest.

### **Theoretical Critiques**

Chang further challenges the dominant discourse by pointing out theoretical flaws in its arguments. The article, “Institutions and economic development: theory, policy and history,” highlights three of those flaws: (1) its neglect of causality running from development to institutions, (2) its inability to see the impossibility of a free market and (3) its view that the freest market and strongest protection of property rights are best for economic development (Chang, 2010, p. 473).

## Reverse Causality

The mainstream believes causality runs from institutions to economic development (see Acemoglu, Johnson, and Robinson 2001 and 2005). In other words, they posit that once the appropriate institutions are in place, economic growth ensues. Chang disagrees and points out that causality can run the other way... from economic development to institutions. He says increases in wealth can prompt greater demand for institutions. As nations and its citizens accumulate wealth, there is a greater demand for political institutions that are more transparent and accountable. Chang also notes that greater wealth makes institutions more affordable. Because institutions are costly to set up and operate, increases in wealth will allow nations to afford these institutions (Chang, 2010, p. 476). Hence, as a result of increases in wealth, causality can run from economic development to institutions, not just the other way around.

This argument attracts support from some mainstream thinkers. Young Back Choi says Chang rightly criticizes institutional economists' "over-simplified and mechanistic view of institutions in which causality flows from certain desirable institutions to the economic outcome" (Choi, 2011, p. 512). Jeffrey Nugent also adds that "causality could in principle be two-way," adding that "the importance of reverse causation has long been recognized" (Nugent, 2011, p. 564).

Peter Boettke (a Professor of Economics and Philosophy at George Mason University) and Alexander Fink (an Assistant Professor at the University of Leipzig in Germany) say the debate over reverse causality is much more nuanced than Chang suggests. They say Chang conflates *institutions* (the rules of governance) with *policies*



(the actions taken within the rule of governance). Citing economist James Buchanan, Boettke and Fink contend the foundational rules of governance, which determine how well property and persons are protected, have first-order effects on development, meaning these rules determine the long-term prosperity and development of a society. On the other hand, they note that the policies pursued within the existing rules of governance have a lesser effect on development (Boettke and Fink, 2011, p. 501).

Boettke and Fink argue that, by grouping policies (i.e., modern bureaucracy, limited liability, bankruptcy law, securities regulation, and a central bank) under the umbrella of “institutions,” Chang is able to validate his reverse causality argument by demonstrating how today’s developed nations did not acquire “institutions” until after their economic development. Boettke and Fink contend this line of reasoning is flawed because Chang is actually referencing policies, not institutions. They concede Chang is correct to say these policies arose after initial development, but contend it was institutions, like the protection of property rights, that laid the foundation for initial growth. Since institutions have first-order effects on development, only a change in the institutions that provides security to private property will yield economic development... not a change in policies called for by Chang (Boettke and Fink, 2011, p. 501).

As Arielle John and Virgil Storr of George Mason University point out, supporters of the dominant discourse do not consider “institutions” described by Chang (bankruptcy law, securities regulations, modern bureaucracy) as institutions essential for creating economic growth (John and Storr, 2011, p. 584). The dominant discourse stresses the importance of the protection of property rights. In this context, they agree

with Chang that there is a (reverse) causal link between “policy institutions” and economic development, but reject that such “institutions” (policies) can be equated to the causal link between property rights as a prerequisite to economic growth advanced by mainstream economists.

John and Storr add if wealth is a prerequisite for the adoption of higher-quality institutions, then it would follow that massive aid transfers to developing countries would be beneficial and put these nations on a path towards good institutions. However, they point out that Western countries have given trillions of dollars in foreign aid to African, Latin American and Asian countries, with few instances of countries actually creating growth-enhancing institutions. Further, they add the more important question is if wealth does precede the development of quality institutions, how is it that development is achieved in the first place? (John and Storr, 2011, p. 585).

To be fair, both the mainstream (Boettke and Fink) and Chang seem to confuse the issue of causality. In this author’s view, the debate should be viewed in terms of primary versus secondary institutions. While the mainstream is correct to point out certain “primary” institutions (i.e., a system of private property rights and a rule of law that protects those rights) do need to be in place before initial development can be conceived, Chang is also right to point out many “secondary” institutions (i.e., bankruptcy law, limited liability and securities regulation) arise after initial growth has been attained. Hence, it seems clear, as argued by Chang, that causality can run both directions.

It should be noted, however, Chang might disagree with the assessment that “primary” or “secondary” institutions” are indeed, primary or secondary. For example, in Kicking Away the Ladder, he argues not all “global standard institutions (those institutions advocated by developed countries which include strongly protected property rights and liberalized markets) are beneficial or necessary for all developing countries” (Chang, 2003, p. 11). He gives the example of stringent intellectual property rights and notes how such rights can actually stunt growth in developing economies. Thus, Chang may not consider a system of strongly protected property rights as a “primary” institution. Likewise, mainstream economists might dispute Chang’s view that bankruptcy law and securities regulation, for example, rise to the level of property rights as an institution. Nonetheless, as it relates to causality, it is this writer’s view that defining institutions as either primary (must be in place before development) or secondary (may or may not be in place before development) clarifies the confusing semantics that surround the issue of causation.

There appears some consensus, even in the mainstream, around Chang’s belief that economic growth can lead to higher-quality institutions, thus confirming Chang’s view that causality flows two directions, not one. As Choi points out, the mainstream may have an over-simplified view of causality running from institutions to economic development (Choi, 2011, p. 512). However, demonstrating causality can run from economic development to institutions does not, by itself, significantly alter the dominant discourse that certain fundamental institutions (property rights, rule of law, contracts) are fundamental drivers of economic growth. Robbert Maseland, professor at the University

of Groningen in Netherlands, sums up that view when he notes “it is not at all evident that taking reverse causality into account would somehow change or invalidate the insights gained so far from focusing on one side of the relation” (Maseland, 2011, p. 556). As such, while this line of argument by Chang adds flavor to the mainstream narrative, it does not significantly change its underlying contents.

### **Impossibility of Free Markets**

Mainstream economists generally agree that more liberalized markets best promote economic growth. Chang disagrees. In his second theoretical critique, he criticizes the mainstream for its inability to see the impossibility of a free market and for its assumption that markets which maximize market freedom are best for economic growth.

Chang says regulation of free markets is commonplace (e.g., child labor laws, minimum wage and legal limits to working hours). Therefore, even if there is consensus freer markets are better for economic development, it is not possible to have a totally free market and, therefore, impossible to measure the “freest” market. Chang makes the case that because it is impossible to define the boundary of a free market, it is therefore impossible to know which institutional arrangements maximize economic freedom (Chang, 2010, p. 478-479).

Chang further argues a market that maximizes market freedom is not necessarily best for development. He says some degree of regulation restricting business freedom can even be good for long-term economic growth, such as child labor laws. These laws

may hurt individual firms in the short run because firms cannot benefit from the use of child labor. But in the long-run, children are healthier and educated, thus benefitting the quality of the future labor force (Chang, 2010, p. 479).

Again, on this point, Chang attracts qualified support from even free market economists. Mark Pennington, a professor at the University of London, points out that notable free market economists (i.e. Friedrich Hayek, Ronald Coase, James Buchanan) realize institutions and rules are an important part of the marketplace. In fact, as Pennington points out, Hayek in The Constitution of Liberty, makes the case for a number of government actions including social security measures, educational provisions, and environmental regulations, which he views as consistent with a free market economy. Pennington says free market economists seek to create rules that are compatible with a social order that increases the scope of voluntary exchange and encourages positive sum interactions among people (Pennington, 2011). While Pennington recognizes there is room for disagreement about the appropriate extent of the market, this does not undermine the role of free markets. In Pennington's words...

“... to suggest there is no such thing as a ‘free market’ because there is no strictly objective way to define the boundaries of such a market is equivalent to saying that democracy is meaningless because no ‘pure’ form of democratic organization has ever existed” (2011).

Robbert Maseland says Chang presents “a very welcome review of critiques of the dominant institutional discourse in economics” but criticizes Chang for oversimplifying the debate (Maseland, 2011, p. 555). Maseland says Chang critiques a vague, subjective topic, like economic freedom, centering his discussion on low-level

generalizations ... like defining “freest” markets (556). Maseland questions whether this invalidates the mainstream’s arguments, and ultimately, he argues Chang does not translate his criticism into a cogent argument that attacks central themes in the mainstream narrative. Maseland says Chang “fails in his attempt to reveal fundamental problems with the theoretical and empirical aspects of the (dominant) discourse” (555).

Again, there appears agreement among many mainstream economists that there is no such thing as a totally free market (nor should there be) as well as general acceptance of Chang’s view that it is impossible to objectively define the “freest” market. So, in this sense, Chang’s admonishments to the dominant discourse to avoid the over-generalizations commonly used by the mainstream are well-founded. As Chang notes, it is impossible to know what “maximizing economic freedom” means when there is no logical way to define the boundaries of a free market. And clearly, many rules and institutions commonplace in markets (which reduce market freedom) are actually beneficial for economic growth. Mainstream economists agree that completely unfettered markets create social costs which can hurt development. However, as noted by Pennington and Maseland, establishing the impossibility of a purely free market does not undermine the mainstream’s primary theoretical insights.

### **Strongest Protection of Private Property Rights**

Chang argues against the notion that the strongest protection of private property rights best promotes development. In the dominant discourse, it is assumed that a stronger protection of property rights is always best for economic growth. Chang

disagrees. While he acknowledges some protection of property rights is good, he feels more protection is not always better. He says overly strong protection of private property can limit investment and growth, noting that this can be the case with some protection of intellectual property rights. “While some protection of IPRs (intellectual property rights) may be necessary to motivate firms to invest in knowledge generation, at least in certain industries (chemicals, pharmaceuticals, software), too much protection of IPRs may be bad for the society” (Chang, 2010, p. 481). According to Chang, too much protection can lead to monopoly. The monopoly can impose costs that could potentially offset the benefits resulting from greater innovation (481). Chang adds that too much protection of property rights can hinder innovation by making technological diffusion very costly (481).

Chang further argues the security of a property right cannot be considered something good in itself. He notes that what is important for economic development is the ability to decide what property rights to protect and under what circumstances to protect them (Chang, 2007, p. 25). He says that a particular property right may become good or bad for society depending on changes to technology, population, political balance of power and ideology (24). He points out that there are many historical examples where the violation of existing property rights was beneficial for development. Chang gives the example of the Enclosure in Britain. During the 18<sup>th</sup> and 19<sup>th</sup> centuries, England passed a number of enclosure acts that enclosed previously open pastures available as common land for grazing livestock. While these acts violated existing communal property rights, Chang notes the enclosure contributed to the development of the woolen manufacturing

industry by promoting sheep farming on the confiscated land (24). He also gives the example of the granting of squatter rights in the United States during the 19<sup>th</sup> century and land reform in nations, like Japan and Taiwan, after World War II, noting that these violations of existing property rights helped contribute to the growth of these respective nations. Thus, Chang argues what is important for economic development is “*not* the protection of all existing property rights at all costs, but the ability to decide which property rights to protect to what extent under which conditions” (25).

The literature survey reveals Chang’s property rights argument prompted robust debate.

The works of Brent Allred and Walter Clark of the College of William and Mary and American University, respectively, tends to support Chang. They say patent rights can negatively impact innovation in developed countries, especially when they are used to block rivals from accessing certain technologies. Stronger protection of patent rights can also hinder innovation by reducing the incentives of the actual patent holders to innovate if they face little competition. In addition, Allred and Clark say the barriers created by patent rights prevent others from learning by imitation, thereby hampering innovation. They cite The Commission on Intellectual Property Rights (2002) which states developing countries need to start with some technological base or skill set in order to become world-class innovators. If property rights are too strong, individuals cannot attain the basic, necessary skill set to eventually become topnotch innovators (Allred and Clark, 2007).



In a study of the impact of patent rights on innovative activity and technological diffusion, Allred and Clark found that while patent reforms in *developed* countries have positive effects on innovation and diffusion up to a certain point, patent reforms in *developing* countries do not appear to have any significant, positive influence on innovative activities in developing countries. This suggests that innovative activity will not respond *primarily* to changes in the legal environment, including the strengthening of property rights, at least without a lengthy time lag. Allred and Clark claim that high patent protection standards for developing countries, therefore, may not be conducive to innovation due to these nations' incremental and imitative approach to novelty (Allred and Clark, 2007).

Jeffrey Nugent, like Chang, recognizes the complexities and dangers of generalizations in regards to institutions and development. For instance, Nugent agrees with Chang that the protection of existing property rights under all circumstances is not always best for development. He gives the example of intellectual property rights, noting that the strength of these rights should take into account the nation's level of development, the ability of its citizens and firms to carry out research and development, the sector composition of output, and the ability of the legal system to enforce these rights. He further adds that the protection of existing private property rights can be harmful when these rights are concentrated in the hands of a few, large politically powerful landowners, potentially leading to the undersupply of important public goods (Nugent, 2011, p. 562-563).

The survey also reveals a number of economic historians, like Hernando De Soto, who argue the technological boom and massive investment that began at the end of the 18<sup>th</sup> century were made possible only after property rights were protected and made independent of politics. A number of major inventions in Europe were a result of a system of patents that protected intellectual property rights. De Soto says the importance of these patents “resides in the fact that, with the exception of a handful of discoveries, most innovation entails expensive research and education, costs which are worth assuming only if they can later be recouped” (De Soto, 1989, p. 177). It is patent rights, according to De Soto, that gave people a powerful incentive for increased investment in education and research to find innovative solutions to technological problems. De Soto says it is not just the patent holder that reaps the benefits of intellectual property rights.

“The economic importance of property rights is *not* that they provide assets which benefit their holders *exclusively*, but that they give their owners sufficient incentive to add value to their resources by investing, innovating or pooling them productively *for the prosperity and progress of the entire community*” (De Soto, 1989, p. 178).

Like De Soto, Douglass North and Robert Thomas imply strong protection of property rights are critical, regardless of a nation’s current level of development. North and Thomas sum up their point in the following passage from their novel, The Rise of the Western World:

“It is important to understand the difference between the rate of innovative activity which will occur in the absence of the ability to capture externalities and the rate that will occur if these externalities can be internalized. Innovation could and did occur historically, as we have seen, in a world when no property rights protected the innovator. However, only that kind of innovation occurred in which the costs (or risk of losses) were so small that the private rate of return exceeded them. Any innovation involving substantial costs (or the possibilities of large

losses) would not occur until the private rate of return could be increased sufficiently to make the venture worthwhile” (North and Thomas, 1973, p. 154).

They give the example of an improvement in a manufacturing process. While such an improvement might occur by accident or through trial and error, no research would be undertaken as long as the benefits were immediately available to other manufacturers and the costs of research were greater than the manufacturer’s private gains from it.

Conversely, if the manufacturer can keep the improvement secret, maintain a monopoly and/or patent the innovation for a period of time, this would increase the manufacturer’s potential private profits so that much higher research costs could be undertaken and the improvement could then occur at an earlier time. North and Thomas argue that “innovation involving significant research costs would seldom, if ever, be worth the risk without some form of protection to internalize a significant share of its gains” (North and Thomas, 1973, p. 155).

Chang provides a useful critique of the mainstream view that private property rights which are most strongly protected are always best for development. Consideration must be given to striking a balance between encouraging and protecting investment (for those willing to accept the increased risk of investing in a developing country) and insuring against the proposition that less competition will result (monopolies). Allred and Clark, along with De Soto, North and Thomas, make compelling arguments on both sides.

While it seems clear that a strict enforcement of private property rights may not always be the best solution for development, as some mainstream economists suggest,

most mainstream economists hold firm to the notion that protection of private property is needed to stimulate economic growth. How much protection? For who? That is a topic warranting further study, but Chang's critique has introduced the idea that the establishment of the strongest possible property rights does not, per se, ensure economic success. At a minimum, Chang's theoretical critique has broadened the discussion about fundamental principles held dear by the mainstream discourse.

## **THE STATE AND ECONOMIC DEVELOPMENT**

Chang feels state-led interventionist measures like export subsidies, tariff protection and infant industry promotion play an important role in bringing about economic growth in developing economies. In Kicking Away the Ladder, Chang suggests these factors were instrumental in creating economic growth for now-developed countries (NDCs), including Great Britain, the United States, Germany, France, Netherlands, and East Asian powers, like Japan. The following section evaluates Chang's discussion of the role played by the state in creating economic development in the United States and contrasts that narrative with that of mainstream economists, including Douglas Irwin, Hernando De Soto and Nathan Rosenberg.

Chang looks at the historical experiences of a number of NDCs during their development phase (primarily between 1815 and 1914), citing their use of restrictive and protective measures that resulted in increased output and growth. In Kicking Away the Ladder, he claims these NDCs did not develop through the use of "good" institutions prescribed by the mainstream (e.g., strongly protected property rights including intellectual property rights, liberalization of trade and investment, and democracy). Rather, he argues that these nations used what the mainstream deems "bad" institutions, including infant industry promotion, tariff protection and export subsidies.

“How did the rich countries *really* become rich? The short answer to this question is that the developed countries did *not* (my emphasis) get where they are now through the policies and the institutions that they recommend to developing countries today (‘good’ institutions). Most of them actively used ‘bad’ trade and industrial policies, such as infant industry protection and export subsidies” (Chang, 2003, p. 2).

In arguing most nations used interventionist measures during their development phase, Chang claims the state, and not the institutions referenced by the mainstream, is the primary driver of economic growth.

“Infant industry promotion (but not just tariff protection) has been the *key* (my emphasis) to the development of most nations, and the exceptions have been limited to small countries on, or very close to, the world’s technological frontiers... preventing the developing countries from adopting these policies constitutes a serious constraint on their capacity to generate economic development” (Chang, 2003, p. 10).

It is important to note Chang still views institutions, like private property rights, democracy, a central bank, limited liability and bankruptcy law, as critical to the growth-creating process. In “Institutions and Economic Development,” Chang describes markets and private property as “essential institutions for economic prosperity” (475).

Additionally, in Kicking Away the Ladder, Chang points out the importance of providing security to private property, noting that “it may be reasonable to argue that persistent uncertainty about the security of property rights is harmful for long-term investment and growth” (82). Similarly, in Rethinking Development Economics, Chang says there can be “disruptive effects” when there is a “very high degree of contestation of the rights-obligation structure underlying existing markets” (56).

## **Chang on the United States**

Contrary to common belief, Chang argues the United States used extensive infant industry protection and state intervention when it was developing. Chang notes that the first tariffs were passed by Congress in 1789, a five percent flat rate tariff on all imports. By 1792, the rate had jumped to 12.5 percent. It then doubled in 1812, during the war with Britain, to meet wartime expenditures. Upon conclusion of the war, tariffs were maintained at their wartime levels because of the “infant industries that had grown up under the ‘natural’ protection accorded by the war with Britain” (Chang, 2003, p. 26). In 1816, tariffs on most textile goods were around 25 percent while tariff rates on manufactured goods were as high as 30 percent (Bartlett, 1998). By 1820, tariffs on manufactured goods had reached 40 percent (Chang, 2003, p. 26).

However, it is worth noting that while the southern states initially welcomed the tariffs as a way to promote its infant industries, they eventually turned against the tariffs because infant industry promotion was not working. The southern states wanted to import superior British manufactured goods (Chang, 2003, p. 26). Despite the South’s demands to lower tariffs, protectionism peaked in 1828 with the Tariff of Abominations. At this time, average tariff rates rose to 49 percent (Bartlett, 1998). Another tariff law passed in 1832 which placed an average 40 percent rate on manufactured goods and a 40-50 percent rate on iron and textile goods. Then, for a short period in the mid-19<sup>th</sup> century, tariffs fell. Beginning in 1846, tariffs started moving downward and by 1857, averaged 20 percent (Bartlett, 1998). However, by 1864, tariffs again reached their

highest levels, due in large part to the wartime expenditure necessitated by the Civil War (Chang, 2003, p. 28). In fact, by 1875, Chang points out the United States had average tariff rates ranging between 40-50 percent on manufactured products, the highest rates seen among all NDCs during that time (Chang, 2003, p. 44).

Paul Bairoch, author of Economics and World History, points out that the two best 20-year GDP per capita growth performances for the United States were during the periods between 1870-1890 (2.1 percent) and 1890-1910 (2.0 percent). Bairoch says both of these periods saw a high degree of protectionism, suggesting that protectionist measures were the cause of higher growth rates (Bairoch, 1993, p. 51-53).

Without infant industry protection, Chang feels the U.S. economy would not have industrialized and developed as fast as it did. Coupled with agricultural research and expanded public investments in education and transportation in the mid-19<sup>th</sup> century, these interventionist measures assisted the U.S. on their path to development. Chang notes it was only after the Second World War that the U.S. finally started lowering tariff rates. By then, according to Chang, it had already attained industrial supremacy. Chang says “it is clear that the U.S. economy would not have got where it is today without strong tariff protection” (Chang, 2003, p. 29-30).

### **Irwin Response**

Douglas Irwin, a prominent author, economist, and free trade activist, provides perhaps the most comprehensive critique of Kicking Away the Ladder. Irwin takes issue with Chang’s sample-selection bias. Irwin notes that Chang only looks at countries that



developed during the 19<sup>th</sup> century but does not analyze the countries that *failed to develop* in the 19<sup>th</sup> century to determine if they pursued the same protectionist policies only more intensively. Irwin says Chang's discussion would be the equivalent of a doctor studying people that live long lives and finding that some smoked tobacco... then attributing their longevity to the fact that they smoked while completely disregarding the people that lived shorter lives to see if smoking was even more prevalent. At best, Irwin says, attributing economic development of NDCs to their use of protectionist policies, while ignoring other factors such as institutions that could have contributed to economic growth, paints an incomplete picture (Irwin, 2004).

Irwin also says Chang disregards the works of previous economic historians on the subject of development, including The Rise of the Western World by Douglass North and Robert Thomas, and Nathan Rosenberg's, How the West Grew Rich. Irwin says both offer insights into the economic rise of NDCs, emphasizing the importance of political systems that provide security to economic transactions and economic systems that allow for competition. Instead of engaging these works and explaining why their lessons are or are not relevant, Chang chooses to ignore them altogether (Irwin, 2004).

Additionally, Irwin challenges Chang's "correlation therefore attribution" approach to explaining the development of NDCs, including Chang's approach to explaining growth in the United States. Irwin says that just because certain trade and industrial policies were pursued by NDCs and the resulting economic outcome was a positive one does not mean that the economic outcome was a *result* of those specific policies. He notes that the economic success of developed countries could have been

produced despite the inefficiencies and distortions created by the protectionist policies “because the broader institutional context was conducive to growth” (Irwin, 2004). He gives the example of the United States which started as a wealthy nation with a high literacy rate, widely distributed land ownership, a stable government, political institutions that protected property, and a large internal market that permitted the free trade of goods and mobility of labor. Irwin argues with such favorable conditions, “even very inefficient trade policies could not have prevented economic advances from taking place” (Irwin, 2004). But, in 23 Things They Don’t Tell You About Capitalism, Chang says the “special conditions” response from Irwin fails to acknowledge that countries like Finland, Denmark, Korea and Switzerland grew despite a lack of similar advantages (e.g., large domestic market and an abundance of natural resources) and with significant state intervention (Chang, 2010, p. 69).

Regardless, Irwin says Chang ignores these factors in Kicking Away the Ladder and is particularly critical of what he considers unsupportable statements:

“Although some commentators doubt whether the overall national welfare effect of protectionism was positive, the U.S. growth record during the protectionist period makes this skepticism look overly cautious, if not downright biased” (Chang, 2003, p. 29-30).

“It is clear that the U.S. economy would not have got where it is today without strong tariff protection at least in some key infant industries” (Chang, 2003, p. 61).

In summary, Douglass Irwin clearly takes issue with Chang. Irwin stresses correlation is not causation. He says Chang provides no evidence protectionism causes growth and fails to conduct comparisons that look at the various ways in which trade policy affects growth and compare them to other factors that lead to economic expansion.

Irwin would like to see an analysis that looks at the costs and benefits of infant industry policies and an examination of alternative explanations for why America grew, including the possibility infant industry promotion and tariff protection inhibited growth and were simply overcome by the advantages of other aspects of the U.S. economy (Irwin, 2004).

Discussions surrounding early development of the United States beg for a comparative, empirical analysis ... like that called for by Irwin. Such an analysis could serve to highlight factors most central to the development of the United States. However, as Chang points out in his criticism of mainstream empirical studies, measuring the quality of institutions will be no easy task as such measurements are often replete with qualitative judgments. So, although Irwin's suggestion is worthy of consideration, it would be important to guard against the same empirical flaws Chang highlighted in his critique of the dominant discourse.

### **Hamilton, Block and Keller on the United States**

Chang is not alone in highlighting the state's role as a driver of economic development in the United States. Alexander Hamilton, one of Americas' Founding Fathers and a prominent economist of his time, presented "The Report on Manufactures" in 1791 to Congress, which outlined his vision of an active federal government that would promote the United States' manufacturing industry. In that report, Hamilton called for the federal government to implement a number of industrial, trade and technology policies. For one, Hamilton advocated emigration-inducing policies that would entice skilled workers from abroad to come work in the United States. Those policies included

travel subsidies, customs exemptions, and most importantly, an inventor monopoly, which allowed the original inventors of imported technologies to receive monopoly privileges. In Hamilton's view, the implementation of such policies could not be left to the individual entrepreneurs because "the capitals employed here are not equal to the purposes of bringing from abroad workmen of a superior kind" (Ben-Atar, 1995, p. 402). In other words, Hamilton believed that the private sector did not have sufficient resources (capital, higher wages, etc.) to entice foreign workers to come to the United States. In his eyes, only the federal government had such resources.

Hamilton was not only a proponent of the state subsidizing workmen interested in emigrating to the United States, but was also in favor of importing foreign machines that would improve and grow the country's manufacturing industry. He argued the United States could not wait for private entrepreneurs to undertake these costly improvements. Rather, he believed that the "public purse must supply the deficiency of private resources" (Ben-Atar, 1995, p. 406).

Authors Fred Block and Matthew Keller build on Hamilton's report. In The State of Innovation: The U.S. Government's Role in Technology Development, Block and Keller note while Hamilton's ideas were never fully implemented, they helped fuel state-led initiatives that drove U.S. industrialization in the nineteenth century. Hamiltonian ideas prompted state-led efforts to build railroads and canals. These projects were financed by state funds, and/or newly created private entities subsidized by the state would be hired to do the work. Block and Keller argue these "transportation innovations played an important role in driving economic growth in the antebellum period" (5).

These transportation innovations, as well as the creation of the Department of Agriculture in the 1860s (which was conceived to modernize America's dominant economic sector -- farming) and the National Academy of Sciences (a non-profit organization providing scientific knowledge and advice to the federal government), helped "lay the foundation for rapid economic growth in the last three decades of the nineteenth century" (5).

### **De Soto and Rosenberg Response**

Like Irwin, economists Hernando De Soto and Nathan Rosenberg offer contrasting narratives to Chang as well as Hamilton, Block and Keller. De Soto provides a chronological history of the birth and growth of property rights in the United States in his novel the Mystery of Capital and argues that *this development* was the key to our nation's early economic growth.

Early American colonists unsuccessfully sought to apply English property law in the states. New forms of property access, dubious title cases, the lack of a uniform surveying system, an abundance of land and a general disregard by many colonists of English law made it difficult to follow British property law (De Soto, 2000, p. 112). Land squatting was thus commonplace because it faced little resistance from government and opportunities to do so were so vast. Squatters invented their own form of extralegal property rights known as "tomahawk rights," "cabin rights," and "corn rights." Like legal titles, these rights could be bought, sold, and transferred. De Soto notes that these extralegal rights were widely accepted in America's frontier communities and became the source of legal title years later (117).

In 1642, a statute was passed in Virginia that formalized the squatter's cause and further advanced the concept of property rights. The statute said "if any person or persons whatsoever have sett downe upon any plantation or ground which did properly belong to any other man," a "valuable consideration is to be allowed by judgment of twelve men" (119). In other words, if a settler made an improvement to a piece of land, he could buy and own the land. According to De Soto, this principle, known as preemption, laid the foundation for the integration of extralegal property arrangements into American law over the next two hundred years (120).

Eighty years later, in *Green vs. Biddle*, the U.S. Supreme Court strengthened those rights when it declared unconstitutional a Kentucky law which gave occupants legal title to their land if they paid taxes on it and occupied the land for seven years. A political and judicial backlash followed, prompting 11 states to pass squatter-friendly laws between 1834 and 1856 based on the Kentucky model. Then, between 1830 and 1840, Congress passed a law strengthening settlers' rights and in 1841 extended property protection to "every person... who shall hereafter make a settlement on the public lands" (135).

De Soto argues that recognition and incorporation of extralegal property rights under one legal system was the *key factor* that allowed the United States to become "the most important market economy and producer of capital in the world" (148). He argues that the United States' formal integration of property into one legal system resulted in "expanded markets and capital needed to fuel explosive economic growth" and served as the "momentous change that still drives U.S. economic growth" (149-150).

Nathan Rosenberg also feels a system of property rights is essential to stimulating innovation as well as improvements in production and manufacturing. In his view, the American Industrial Revolution was built on and driven by markets, private property and other institutional foundations (Rosenberg, 1986, p. 165).

Rosenberg argues improvements in production, agriculture, manufacturing and transportation were instrumental in creating growth, all of which blossomed because of institutions. The “West’s system of innovation is interwoven probably beyond separation with its system of private property rights... it can be reasonably argued that the West’s success in technological innovation is attributable to its success in organizational innovation” (Rosenberg, 1986, p. 30-31). These organizational changes include not only a system of private property rights and contracts, but also a stable legal structure that is predictable and reduces risks associated with trade (115-119).

It should be noted Rosenberg agrees with Chang that the state played a role in creating growth, most notably the partnerships which existed between private businesses and governments. The idea behind the partnerships was to generate the highest possible revenue from the export a particular good. To do so, governments granted monopolies so that competition from other companies would not bid the price of a product down. Likewise, monopoly privileges on certain imported goods ensured that domestic buyers would not bid the price of the product up. Rosenberg also notes that the granting of monopolies was designed to encourage the introduction of new industries... a point ardently defended by Chang (Rosenberg, 1986, p. 135-136).

But while Rosenberg acknowledges contributions of the state, technological advances and new innovations as factors driving growth, he makes his view that institutions are the primary driver of growth and the primary force behind the Industrial Revolutions in the United States and England.

“In short, the Industrial Revolution was a period in which technological and organizational advances played a more conspicuous role in bringing about growth. These advances were built on, and indeed depended on, trading, market, property relations, and other institutional foundations that were laid before that time” (Rosenberg, 1986, p. 165).

He further adds the following:

“There is a fascination in the physical apparatus of giant factories, smokestacks, whirring machinery, and well-drilled workers. We need to keep reminding ourselves that *what matters to economic expansion is the institutional system that made the apparatus*” (Rosenberg, 1986, p. 145).

### **Lamoreaux and Friedman Response to De Soto and Rosenberg**

Naomi Lamoreaux, author of the article “The Mystery of Property Rights: A U.S. Perspective,” provides a counter to De Soto and Rosenberg’s narrative in support of property rights. Lamoreaux argues the United States, despite being held up around the world as a nation with exemplary protection of private property, has continually reallocated existing property rights to promote development or further other goals. Lamoreaux points out under some circumstances, secure property rights can in fact be “inconsistent with economic development” (276). She provides a number of examples to make her case, including examples of water rights disputes, the abrogation of land from Native Americans, and the emancipation of enslaved African-Americans, noting how in



each instance, reallocations of existing property rights were designed to “promote economic development” and be “welfare enhancing” (277-279).

Gerald Friedman, author of the article “The Sanctity of Property Rights in American History,” corroborates Lamoreaux. Throughout the colonial and antebellum period, Friedman says state and local governments “regularly interfered with private property, reflecting a widespread belief in government’s moral obligation to promote a healthy economy and to sustain troubled citizens” (5). He notes how local governments set food and transportation prices, regulated wages and employed powers of eminent domain to “advance social ends at the expense of private property holders” (5).

However, Lamoreaux makes it very clear that the United States’ tampering with property rights had little disruptive consequences and did not “undermine Americans’ basic faith that they were secure in the enjoyment of their property” (Lamoreaux, 2011, p. 277). She points out property rights would not be considered secure if there was repeated reallocation of existing rights conducted in the name of economic development. So, while Lamoreaux does illuminate flaws in the mainstream’s oversimplified assumption that the strongest protection of existing property rights best promotes development, she also reinforces the arguments of De Soto and Rosenberg who emphasize the need for security of property to generate growth.

### **United States Final Thoughts**

The analyses above suggest the United States’ growth during the 18<sup>th</sup> and 19<sup>th</sup> centuries was more complicated than some in the mainstream and some in the heterodox

theory may suggest. Economic development was not solely driven by the implementation of a system of private property rights nor was it exclusively driven by state-led investment and protectionist policies. Rather, economic development appears to have been a combination of both factors.

It is important to note while each of the authors discussed above tends to fall on one side of the debate, neither author disregards the importance of other factors in the growth-generating process. For instance, while the works of Chang (and others) do place greater emphasis on the state's role engendering economic development in the United States, they acknowledge the importance of other factors, like the institution of private property rights, in creating economic growth. As noted at the outset of this section, Chang realizes "persistent uncertainty about the security of property rights is harmful for long-term investment and growth" (Chang, 2003, p. 82). Thus, Chang appears to be suggesting that the institution of private property needs to be coupled with state-led measures to engender economic development. This idea is reinforced in Rethinking Development Economics where Chang says "markets are fundamentally political constructs and therefore it is not possible, or even desirable, to try to completely rid markets of politics" (56). In other words, markets and the state are intertwined and ultimately both are needed on some level to cause development.

Similarly, while mainstream economists, like De Soto and Rosenberg, place primary emphasis on the institution of private property rights in the growth process, they also acknowledge the state has an active role to play driving development. Nathan Rosenberg notes in How the West Grew Rich that western governments were very active

facilitating manufacturing and trade. He says states “subsidized railways, canals, and turnpikes” and “protected domestic enterprise with tariffs and quotas against competition from foreign imports” (Rosenberg, 1986, p. VII). Hernando De Soto, though silent on the use of infant industry protection and tariffs in the Mystery of Capital, does recognize the importance of the state when he points out modern property systems “are only successful because they were supported by well-thought-out political strategies” (De Soto, 2000, p. 187). De Soto firmly believes that a strong state and legal system reduce uncertainty in exchange, provide security to property and ultimately allow one to reap the benefits that come with ownership of private property.

In summary, markets, private property and the state all played a role in the economic development of the United States. It seems clear that future discussions regarding economic growth in developing countries must start with the premise that both private property rights and the state are needed on some level to bring about economic activity in developing nations.

## FINAL THOUGHTS

So, let's revisit the questions asked in the introduction. Does Ha-Joon Chang provide a compelling challenge to the mainstream view that institutions, in particular property rights, are a primary driver for economic growth in developing economies? And do Chang and fellow heterodox economists themselves make a compelling case that the state has a critical role in creating economic growth?

Interestingly, while Chang succeeds at exposing flaws in the mainstream's arguments, and while he presents a plausible case for state intervention, the literature survey does not show Chang to be one-pointedly hostile to the mainstream's view that property rights and institutions are primary drivers of growth. Indeed, the literature survey summarized above seems to suggest Chang recognizes the importance of property rights but wants to broaden the discussion to include the role of the state, thereby challenging the mainstream's *emphasis* on the importance of institutions, specifically private property rights.

For example, Chang correctly argues causality can run from economic development to institutions, that the "freest" market cannot be defined and that strong protection of private property rights has the potential to hinder development. He also rightly critiques mainstream empirical studies for their simplistic assumptions, their

failure to incorporate time-series data and case studies, and their often skewed indexes. But these arguments by themselves do not undermine the importance of the security of private property and free markets. For instance, demonstrating reverse causality does not invalidate the significant body of causal evidence, even if imperfect, that property rights and the institutions that support them underpin growth. Likewise, making the case that a freest market cannot objectively be defined fails to weaken the mainstream's view liberalized markets are critical to economic growth. And similarly, noting that the strongest protection of property rights is not always best for development in no way minimizes the fact that the protection of these rights still remains a fundamental ingredient for growth. In summary, much of Chang's critique involves the *process* by which the mainstream discourse has been established (e.g., the kind and quality of mainstream studies, the oversimplification of economic assumptions and the herd mentality that freer-always-equals-better). While these add a layer of nuance and complexity to the mainstream argument, they do not undermine them. Some, like Maseland, are more blunt in concluding Chang ultimately "fails in his attempt to reveal fundamental problems with the theoretical and empirical aspects of the (dominant) discourse" (Maseland, 2011, p. 555). Even if that is the case, Chang's critiques add a needed dimension to the dominant discourse. By highlighting the mainstream's use of overgeneralizations, such as "freer is always better" and "stronger protection of property best promotes development," Chang has successfully revealed flaws in the mainstream's oversimplified discussion of property rights and free markets.

Additionally, Chang's presentation of the importance of state intervention as an essential factor in the growth-generating process deserves merit. Chang successfully demonstrates state intervention *existed* as the United States developed. The use of infant industry promotion and other state-led measures to promote economic development in the 18<sup>th</sup> and 19<sup>th</sup> centuries was widespread as Hamilton, Block and Keller also attest. While Irwin correctly notes Chang provides no causal link between state intervention and growth, similar criticism could be directed towards mainstream economists, like De Soto, for suggesting but not documenting causality in his U.S. property rights-led development example. Ultimately, what is needed is a more comprehensive analysis of the various ways in which state policies affected growth in NDCs and a comparison and analysis of other factors, like institutions, that may have contributed, if not driven, economic expansion. Such an analysis should strive to establish causal links either to institutions, the state or both.

So, in the end, what can we make of Chang's overall contribution to the literature on institutions and development? In his empirical critique, Chang strongly resists "property rights reductionism," the idea that property rights are the be-all, end-all of development policy. In Kicking Away the Ladder, Chang suggests state-led policies are the key to developing nations, but he also is conscious of the importance of institutions, like private property, in the growth-generating process. These arguments seem to suggest Chang clearly wants to elbow some heterodox views into the mainstream discussion. Through his works, he seeks to establish the importance of the role of the state, even during the early phases of a country's development. At a minimum, that is a point on

which many mainstream and heterodox economists would likely agree. As we saw in the United States, even property rights were conferred by the state. In the final analysis, Chang wants to make the case that there is no one-size-fits-all approach to development. There is no set formula for engendering economic growth. It varies across nations. Chang wants us to recognize the complexities of cultures and institutions. He wants us to realize that what works for each nation is contingent upon local constraints and opportunities as well as the specific institutional prescriptions that are compatible with the local economy.

In summary, private property rights and the state play a critical role generating economic growth. In this author's view, the mainstream and heterodox camps should not be viewed as opposites, but rather as partners working toward the same end, even if by different approaches. Going forward, both sides should work to blend their ideas in the development arena and should base future discussions surrounding economic development on the notion that institutions and the state are needed (in some varying degree) to launch and sustain economic activity.

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