Dignity and Development

Claudia R. Williamson*

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Abstract

This paper explores how expanding the notion of informal institutions in the broader institutional framework provides a more complete explanation for development. Specifically, I incorporate McCloskey's notion of 'dignity and liberty' as part of the institutional nexus. By doing so, a richer explanation and understanding of the importance of institutions in explaining different economic outcomes is offered. Focusing on bourgeois dignity offers a precise mechanism to explain how institutions matter to support economic growth. In addition, analyzing the changing attitudes towards the bourgeoisie provides a specific example of mechanisms that can lead to institutional change.

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*Claudia R. Williamson (Claudia.williamson@nyu.edu) is a post-doctoral fellow at the Development Research Institute, Department of Economics, New York University, 19 W. 4th St, NY, NY 10012. I would like to thank Deirdre McCloskey, Christopher Coyne, Peter Leeson, Adam Martin, Carrie Kerekes, Benjamin Powell and the 2011 Association for Private Enterprise Education conference participants for valuable feedback and comments.

1. Introduction

Understanding the causes of economic growth and development remains a central task of economics. Adam Smith (1776) highlighted the importance of such causes to the wealth of nations as secure property rights, rule of law, specialization under the division of labor and the extent of the market. These explanations are incorporated and expanded in modern economic analysis; however, many other 'possibilities' are proffered as the main causes that are out of line from a Smithian understanding. These explanations range from savings and investment, physical and human capital accumulation, geography, natural resources, domestic and foreign trade, the slave trade and colonialism, a protestant work ethic, and exploitation. The problem with such explanations is not that they are unimportant or do not affect economic outcomes. Instead, these theories miss the underlying incentives for why capital or technology, for example, is adopted and productive in certain societies and not in others. Proximate causes are confused with *fundamental* reasons for economic growth and development.

North and Thomas (1973, p. 2) capture this confusion when stating: "the factors we have listed (innovation, economies of scale, education, capital accumulation, etc.) are not causes of growth; they *are* growth" (italics in original). Factor accumulation, whether physical or human, is only a proximate cause of growth and cannot explain cross-country differences (Olson 1996). Instead, the fundamental explanation of differences in growth is differences in institutions. North (1991, p. 97) defines institutions as "the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)." In short, institutions determine the incentives to engage in productive versus unproductive activities ranging from economic exchange to rent seeking to respecting another person's rights.

New Institutional Economics (NIE) attempts to understand the wealth of nations by studying a country's formal and informal economic, political, social and legal institutions. Emerging from this literature is the conclusion that institutions matter a great deal - in particular, secure property rights institutions. Understanding how specific institutions structure and alter economic, political and social outcomes is somewhat more difficult to decipher. In addition, understanding the origins of institutions and mechanisms for institutional change remains elusive. An emerging consensus is that institutions are endogenous, suggesting that there are feedback mechanisms in play (for example, see Acemoglu, Johnson, and Robinson 2005). Supporting this view is the idea that history and geography indirectly affect economic outcomes through lasting effects on current institutional structures (see Nunn 2009 for a review of this literature).

Deirdre McCloskey (2006, 2010) in her works on 'The Bourgeois Era' provides a unique and comprehensive view of the modern world. In *The Bourgeois Virtues: Ethics for an Age of Commerce*, she presents, convincingly, that not only do virtues support the market but also that capitalism nourishes the soul. Specifically, she explores how a bourgeois, capitalist, commercial society supports seven Western virtues (courage, temperance, justice, prudence, faith, hope, and love). Building from this story, in *Bourgeois Dignity: Why Economics Can't Explain the Modern World,* McCloskey undertakes a daunting challenge: to explain the sustained economic take-off beginning with the Industrial Revolution. Her strategy is to show that none of the material explanations (exploitation, foreign trade, investment, to name a few) can work alone, or in combination, to fully explain the factor by which income per capita has increased since 1700. What can explain it is that the bourgeoisie became free and dignified – channeling entrepreneurship into wealth creating innovation. Uniquely hers, she argues that why the change occurred is due to a change in the way people *talked* about markets and innovation – what she refers to as 'sweet talk.'

The first goal of the paper is to create a general framework for understanding competing explanations for development. Secondly, I incorporate McCloskey's 'dignity and liberty' into this broader institutional framework. McCloskey's view on explaining the modern world offers a precise mechanism to explain *how* institutions matter to support economic growth. In addition, her work provides a specific example of feedback mechanisms that exist leading to institutional change.[1] Therefore, in my view, McCloskey is providing a specification of the 'Institutions Rule' hypothesis.

Liberty is closely related to the work on economic institutions, specifically, economic freedom; therefore, liberty is already assumed under the umbrella of 'institutions' and, for the most part, already incorporated in the institutional paradigm. Dignity, I argue, can also be considered as part of the institutional nexus – as another form of informal institutions, related but not identical to culture. Therefore, focusing on the role of informal institutions provides a bridge between McCloskey and the NIE. In addition, I suggest, as a way of illustrating one potential feedback mechanism for institutional change, that the change in 'sweet talk,' and thus, dignity, came about through the exchange of ideas that occurred with the rise in economic exchange. This

[1] It should be noted that McCloskey is attempting to explain the take-off and sustained economic growth that occurred around 1700-1800 that is associated with the Industrial Revolution. Therefore, parts of her argument may not directly apply to current reasons for poverty in some countries.

section relies, in part, on the notion that the way in which individuals interact and integrate can lead to institutional change. It also highlights the feedback relationship between liberty and dignity.

The analysis can be viewed as twofold: first, it can be thought of as broadening our understanding of how *all* institutions shape subjective costs, thus providing the relative alternatives available for individuals to base their chosen means to purse their chosen ends. And secondly, I am reinterpreting McCloskey's work as an institutional explanation for economic growth and development. However, this should not be viewed as squeezing McCloskey's original contribution into a narrowly defined, preexisting institutional framework. Instead, it should be viewed as expanding our definition of institutions and using McCloskey's work to support the claim that institutions do cause growth. By doing so, we arrive at a much richer explanation and understanding offered by either McCloskey or the NIE literature in explaining different economic development outcomes.

2. Institutions as Fundamental

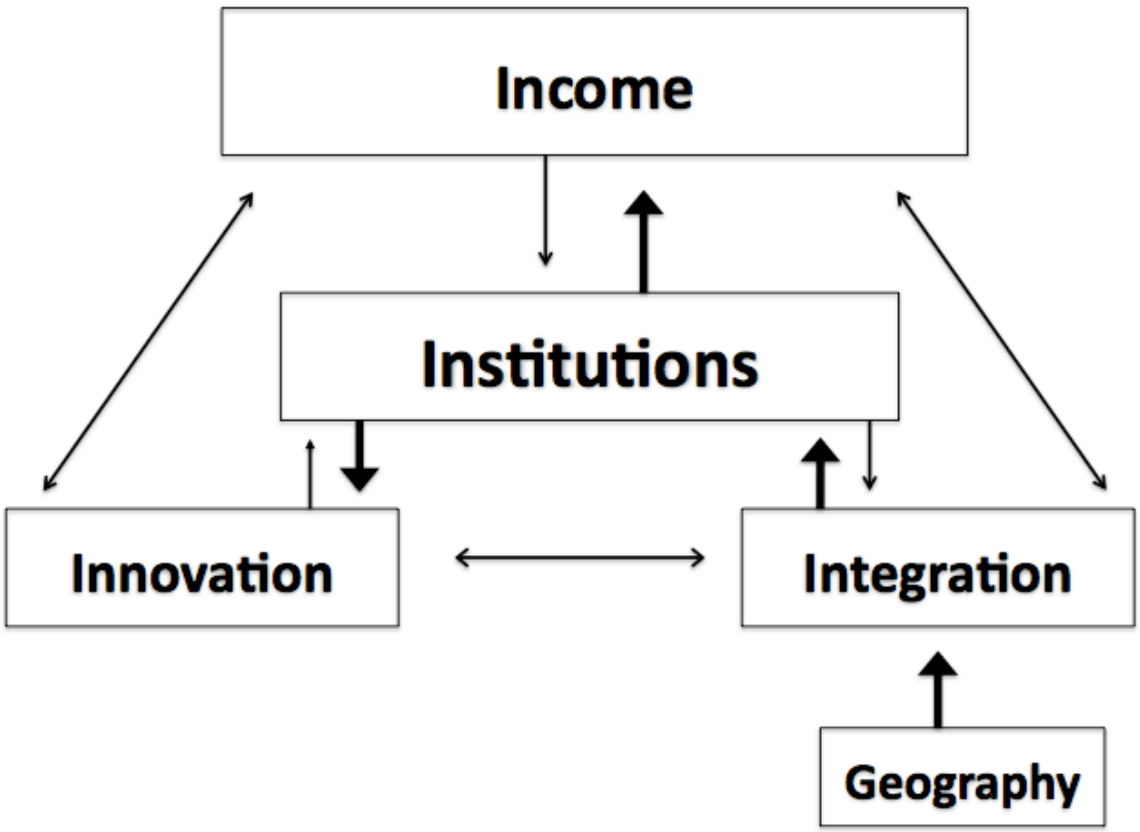
Before incorporating McCloskey's 'dignity and liberty,' we need to create a general framework that provides an understanding of how the main 'proximate' explanations as well as the fundamental institutional causes of economic development fit together.[2] Figure 1 below is provided as a visual summary of what the literature classifies as 'deep determinants' of economic development. This includes how geography, institutions,

[2] The point of this section is not to provide a survey of the literature; therefore, many important articles related to specific topics may be omitted.

innovation and integration fit together to explain income.[3] This is by no means a comprehensive framework or covers all aspects of economic determinants; however, I focus on what has emerged as the leading explanations. The bolder arrows of the figure are the areas that this paper will cover as a means of incorporating McCloskey's insights into the New Institutional perspective, although some of the other connections will be briefly discussed. To include all possible effects would be too much for one paper. Therefore, the main parts to be discussed are how institutions (which includes bourgeois dignity and liberty) determine income and innovation, and how integration (partly determined by geography) is a possible force for institutional change. This second part is only briefly covered, as a full analysis would require more space than allotted; however, it is mentioned as it helps to illustrate how McCloskey's insights fit into our current explanations and also push us beyond our typical way of thinking.

[3] This figure is adaption from Rodrik et al. (2004).

Figure 1:



2.1 Institutions → Income

"The continued existence of society depends upon private property."

Mises (1978: 87)

Institutions are the formal and informal rules governing human action. This includes not only defining such rules but also the enforcement of these rules. Enforcement can occur through internalizing norms of behavior, by social pressure exerted on the individual, or through the power of external enforcers. Institutions are fundamental because they structure and determine the way in which all other activities, including political, economic, and social, take place (or do not take place) within society. Institutions provide the context for individuals to act. They alter the relative costs or payoffs to engage in activities, including exchange or entrepreneurship to innovate. People innovate, or invest in human or physical capital, or trade, when they have an incentive to do so. What shapes incentives is the institutional structure individuals face.

'Good' institutions are therefore defined as institutions that align individual incentives to maximize social cooperation and prosperity. The social benefits derived from Adam Smith's invisible hand phenomenon occur within the context of good institutions, namely a system of private property. The institutional make-up leads individual self-interest down the socially beneficial path by guiding and constraining relative alternative choices (Smith 1776).

Mises (1920, 1949) supported this idea in claiming that a market economy, and the continued existence of society, is founded upon the institution of private ownership of the factors of production. He illustrates that private property leads to incentives for economic exchange, which leads to a price mechanism that makes possible a system of profits and losses, i.e. economic calculation. Hayek (1945, 1960) examines the price mechanism as a coordinating device conveying dispersed knowledge and information. Both Mises and Hayek are highlighting not only the incentive mechanisms that stem from secure property rights institutions but also an informational aspect that emerges from such a system.

Douglass North (1981, 1990) resurrected the institutional perspective after an ideological shift among the profession (as a result of the Great Depression and rise of socialism) led many economists to focus on material explanations (Easterly 2002). North argues that institutions are the "underlying determinant" of economic performance. To North, institutions are created as constraints to reduce uncertainty in exchange and stabilize expectations by structuring political, economic, and social interaction. Property rights institutions internalize externalities by guiding incentives and arise when the gains outweigh the costs of internalization (Demsetz 1967). Property rights institutions provide the incentives facilitating production and exchange, investment, technological innovation, and entrepreneurship (Scully 1988; de Soto 1989, 2000; Boettke 1994; Leblang 1996; Kerekes and Williamson 2006, 2008).

Rodrik, Subramanian, and Trebbi (2004: 131) present empirical evidence supporting the claim that 'Institutions Rule:'

> We estimate the respective contributions of institutions, geography, and trade in determining income levels around the world…Our results indicate that the quality of institutions ``trumps'' everything else. Once institutions are controlled for, conventional measures of geography have at best weak direct effects on incomes, although they have a strong indirect effect by influencing the quality of institutions. Similarly, once institutions are controlled for, trade is almost always insignificant, and often enters the income equation with the 'wrong' (i.e., negative) sign.

The empirical literature supports this associated between institutions and a country's level of investment and economic growth (Besley 1995; Knack and Keefer 1995; Mauro 1995; Hall and Jones 1999). Acemoglu, Johnson, and Robinson (2001) find large *causal* effects of property rights institutions on per capita income in former colonies. They also attribute the reversal in relative incomes from 1500 to today across countries to variations in institutions (Acemoglu, Johnson, and Robinson 2002).[4]

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[4] More recently, Acemoglu and Johnson (2005) find evidence of a positive correlation between property rights institutions and economic growth, investment, and financial development.

Institutions also affect investment and economic development by encouraging, or discouraging, entrepreneurship, as we will discuss more in a later section (Johnson, McMillan, and Woodruff 2002; Boettke and Coyne 2003; Sobel 2008).

Most development economists today emphasize the role of institutions in the development process. Two emerging results in the institutional literature are 1) Institutions are fundamental, as cited above, and 2) Institutions are endogenous. Many studies recognize that institutions are themselves endogenous and at least partially determined by the development process itself—including the role of integration and innovation. However, this is usually discussed in the context of overcoming reverse causality and endogeineity in an empirical exercise (Acemoglu, Johnson, and Robinson 2001, 2002; Rodrik et al. 2004, for example). In a following section, I offer a slightly different interpretation on how integration can be endogenized leading to informal institutional changes that often go undetected. Building from McCloskey, institutional change can be a function of ideas and the spread of ideas is a function of integration.

2.2 Institutions → Integration AND Geography → Integration → Institutions

> "Cultures in prolonged contact with one another usually influence one another, whether that contact is due to conquest, migration, or commerce…Geography alone presents highly disparate opportunities for cultural diffusion in different parts of the world."
>
> (Sowell 1998: 7, 375).

Integration not only includes exchange through trade, but also any way individuals may interact with each other including conquests, colonization, and migration. I summarize the two areas that have received the most attention in the literature, economic exchange and colonization, to show how integration and institutions interact.

An individual's 'natural propensity to truck, barter, and exchange,' is noted by Smith (1776). One of the most agreed upon positions among economists is the benefit of complete international free trade. The strong empirical association between free trade and growth is also extensively documented in the literature (Frankel and Romer 1999, Sachs and Warner 1995, and Dollar and Kray 2004). The light version, or proximate view, supports the hypothesis that trade is an underlying source of growth given certain institutional parameters. However, others argue that trade is a fundamental cause or an 'engine of growth.' According to this view, market integration determines directly if poor countries will converge to rich countries.

After much discussion, trade falls on the proximate side of the debate, not as a fundamental cause of growth (for example, see Rodríguez and Rodrik 2000; Mokyr 2010). Specialization and the extent of the market is a function of the institutional environment. Therefore, institutions determine the degree to which individuals will engage in productive economic exchange (related to section 2.3 below). McCloskey also agrees that trade alone can't explain economic growth when she says, "Trade explains some of the patterns of production, but not the size of production." Trade promotes domestic efficiency explaining why there is a strong positive correlation with free trade and economic growth. However, trade does not directly lead to dynamic economic growth, which is why it is not a fundamental reason for development. It should be emphasized that this is NOT an argument against free trade. Poor countries today can benefit tremendously by freeing trade (mainly because of domestic massive inefficiencies). In addition, economic exchange, and integration, in general, may have a dynamic effect, and may, therefore, be fundamental, if it can serve as a mechanism for institutional change.[5] This will be part of the argument later applied to McCloskey's bourgeoisie becoming dignified.

In fact, the 'Why History Matters' literature argues precisely that colonization, a form of integration, indirectly affects economic outcomes through its effect on institutional development. The three seminal contributions to this literature are La Porta et al. (1997, 1998, 2008), Engerman and Sokoloff (1997, 2002), and Acemoglu , Johnson, and Robinson (2001, 2002). Theses studies document the lasting impact of colonization by showing that colonial rule strongly impacted domestic institutions and these effects persist today. For La Porta et al., the type of legal system transplanted, either common law or civil law, was determined by the identity of the colonizer. Among the colonies, common law countries are among the more prosperous as the legal institutions could adapt to local conditions. The effect of this transplantation persists today affecting financial markets, political institutions, and property rights.

Engerman and Sokoloff and Acemoglu , Johnson, and Robinson argue that it was not so much who colonized you but how. The 'how' was determined by characteristics of the region, including income levels, the disease environment, and cultivation abilities. Engerman and Sokoloff state that geography determined the ability for cash crops to be cultivated with large-scale plantations and slave labor. As a result, certain factor endowments permit extreme inequalities and the dominance of a small group of elites. These differences in endowments have since stunted institutional development to promote long-term economic growth. For Acemoglu et al., the initial disease environment

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[5] Sobel and Leeson (2007) find empirical support for this dynamic effect of trade affecting institutions. Their results suggest that when a country increases its volume of international that country has a tendency to become more economically free.

shaped the extent to which secure property rights were established. If colonizers did not view the region as hospitable, they had a 'get in, get out' mentality, setting up extractive institutions. However, if they viewed the environment as a place of long-term settlement, colonizers had an incentive to establish secure property rights. In addition, the authors argue that an 'institutional reversal' in countries that were relatively rich in 1500 explains the reversal of income that we see today. This reversal, caused by colonizers, was partly determined by the preexisting institutional structure. Due to path dependency, past institutions persist shaping current institutional quality.

This leads to a second critical point: geography (and to a lesser extent, natural resources) only matters in the way it has shaped integration. Geography—navigable waterways, distance to coastline, mountains, climate and disease conditions, terrain conditions—all determine the ease of interacting with others. This integration, or lack of, affects institutional quality. In addition to the above literature, Hall and Jones (1999), Sala-i-Martin and Subramanian (2003), Easterly and Levine (2003), Rodrik, Subramanian, and Trebbi (2004), and Nunn (2009) show that geography only exhibits an indirect effect on development by impacting the quality of current institutions, including informal institutions such as trust. This indirect effect explains why, at first blush, many studies find a significant association between geography and economic outcomes; however, once institutions are controlled for, any significance (usually) disappears.[6]

Sowell (1998, 2008) offers a slightly different theoretical explanation for how geography influences institutions. He argues that integration shapes and determines

[6] Others (Diamond 1997; Gallup, Sachs, and Mellinger 1999; and Sachs 2001, 2003) argue that geography directly impacts economic development due to endowment of resources and transactions costs associated with unfavorable conditions.

culture—an informal institution.[7] The cultural progress of any society depends largely on the ability to interact and learn of advances made by others. This includes peaceful, voluntary interactions such as economic exchange and involuntary exchanges through conquests and colonization. Geography can impede or facilitate these interactions between groups. Hence, geography plays a critical role in determining, at any given time, cross-cultural exchange of ideas and knowledge. From Sowell:

> …the influence of geography…has not been simply in its effects primarily on things—natural resources or economic prosperity—but on people...[T]he effect of geography in making cultural interactions more difficult has been particularly striking…(1998: 99).

Groups that live in isolation due to geographic conditions do not advance as much culturally relative to other societies where the costs of interacting are much lower.

Following Sowell, Coyne and Williamson (2010, 2011) hypothesize that trade serves as a mechanism of cultural exposure by raising people's awareness of alternative ideas, beliefs, and values, inducing a 'creative destructive' aspect to cultural evolution (Cowen 2002). In addition to economic benefits, a society's openness to international trade can generate, on net, positive cultural effects. This argument will be extended below to understand McCloskey's change in rhetoric, illustrating the feedback between liberties to engage in economic exchange and the rise of a dignified bourgeois society.

2.3 Innovation → Income (obviously) BUT Institutions → Innovation

"Simply put, economic growth, driven by entrepreneurship, cannot be explained without reference to institutions."

[7] For our purposes, one can think of culture as a subset of "beliefs, attitudes, and values that bear on economic activities of individuals, organizations, and other institutions" (Porter 2000: 14).

Boettke and Coyne (2003: 3)

It is widely accepted that entrepreneurship and innovation are catalysts of economic progress. Entrepreneurship is omnipresent and can best be described as a discovery process where entrepreneurs are alert to profit opportunities (Mises1949; Kirzner 1973). Entrepreneurs innovate (Schumpeter 1934) and drive the equilibrating force of the market process (Kirzner 1973). Individual economic actors simply do not take information and scarce resources as given to realize their goals. Instead, the entrepreneurial aspect in all human action seeks new information and new ends to be pursued. However, if entrepreneurs are present in all societies, how can entrepreneurship *cause* development?

The answer to this dilemma is that entrepreneurship and innovation are determined by a society's institutional structure. As stated in Boettke and Coyne (2003), "entrepreneurship cannot be the cause of development, but rather, that the type of entrepreneurship associated with economic development is a consequence of it" (p. 3). They go on to show that development is caused by the adoption of certain institutions, which in turn channel and encourage the entrepreneurial aspect of human action in a direction that spurs economic growth. When development is absent, it is due to the absence of institutions that encourages entrepreneurship that generate innovation and a greater extent of the market.

This is similar to Baumol's seminal work on entrepreneurial activity (1990). Baumol also noted that entrepreneurs are present in all societies. The reason economic differences exist across different settings is that profit opportunities vary according to the specific institutional setting. These institutional structures, which direct entrepreneurial alertness, differ across societies. Baumol distinguished between productive, positive-sum activities and unproductive, zero or negative-sum activities. The relative payoff to engaging in any activity is directly determined by the formal and informal institutional structure. Some institutions, such as private property and a general legal framework, encourage and reward wealth creation. In those societies, more individuals will be lead down the socially beneficial avenue. In societies where the relative payoff is higher for lobbying and rent seeking, individuals will devote time and resources to those activities. The institutional structure in this example produces unproductive, socially costly, entrepreneurship. The relative decisions are shaped by differing political, economic, and social institutions that structure corresponding rates of returns to various activities.[8]

In sum, this section has developed what can be called the 'Institutional Hypothesis' where the fundamental leading cause of growth is institutions. The next section incorporates McCloskey's 'dignity and liberty' into the institutional paradigm. In addition, I link the above hypothesis that integration can alter an institutional structure by relating changes in economic exchange to changes in dignity.

3. McCloskey's Dignity as Institutions

> "Good policies are boringly similar: rule of law, property rights, and above all, dignity and liberty for the bourgeoisie."
>
> McCloskey (2010: 122)

Following the above language, McCloskey's hypothesis can be summarized as follows:

[8] Sobel (2008) tests and confirms Baumol's theory by examining how differing institutional qualities affect differing types of entrepreneurship.

Dignity (and Liberty) → Innovation → Economic Growth.[9] This implies that dignity is a direct cause of growth, not a proximate cause. Specifically, a *change* in the way people talked about markets, ideas, prudence, entrepreneurs, and innovation lead to the *change* in economic progress. The change occurred in a way such that individuals became more approving of activities such as competition, markets, and economic exchange. Entrepreneurship became more dignified in social terms than it ever had before. This change in social status (coupled with some minimum level of liberty, as discussed below) led to a rise in productive entrepreneurship and thus innovation.

McCloskey is not alone in arguing that social approval matters for entrepreneurship. Baumol argues that individuals living in Ancient Rome had profit opportunities available in both the political and economic spheres; however, a social stigma surrounded commercial activities. As Baumol states, "The bottom line, for our purposes, is that the Roman reward system, although it offered wealth to those who engaged in commerce and industry, offset this gain through the attendant loss in prestige" (p. 901). In addition, Moykr (1996) also argues that social status of entrepreneurs was critical in shaping the Industrial Revolution. Both the formal and informal rules structure the relative payoff to engaging in entrepreneurial and commercial activities. A mix of the formal and informal provides economic profits, while the informal drives psychic profit.

In addition to how informal rules structure entrepreneurial incentives, McCloskey's hypothesis also supports the work showing that informal norms affect formal institutions. For example, her ideas support the public opinion literature arguing that policies, for the most part, are shaped by ideas (for example see Mises 1998, Bastiat

[9] Powell and Rodet (2011) empirically support the idea that both dignity and liberty lead to more entrepreneurship

1964; Hayek 1944; Caplan 2000, 2001, 2002). Hayek argues in *The Road to Serfdom* that socialism was a consequence of ideas. Caplan and Stringham (2005) summarize Mises' and Bastiat's position on public opinion and the role that it plays in shaping economic outcomes. Quoting Mises, '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" (Mises 1998: 863). This strand of research argues that ideologies and opinions matter a great deal for both political and economic outcomes. If the public does not want innovation it does not offer political or social support to encourage entrepreneurship.

In summary, informal institutions effect development through two channels: by directly impacting entrepreneurial dignity, and indirectly by impacting the formal institutions, which dictate other entrepreneurial incentives.

3.1 Redefining Institutions

"Ideas provide a social infrastructure within which individuals pursue their own interests"

Boettke, Coyne, Leeson (2008: 7).

Instead of viewing institutions as reducing transactions costs (North-Demestz), which institutions do, or focusing solely on the formal economic and political institutions, as is often the case (Acemoglu Johnson, Robinson 2005; Glaesar et al. 2004), we should consider institutions as broad rules that guide individual choices and social interaction. This includes a range of institutions from sociological considerations such as public opinion, culture, ideology, values and preferences to economic, political, and legal structures. Once we define institutions in this manner, adding in McCloskey's 'dignity and liberty' is relatively simple. Liberty is freedom – economic, political and social freedoms.[10] Therefore, liberty is already included in our common understanding of institutions. Incorporating dignity may require a bit more work. However, if we accept the broader institutional definition outlined above, then dignity is just an extension of the sociological aspects of institutions. Therefore, McCloskey's change in conversation regarding commerce, or the rise in dignifying the merchant class, or social support of entrepreneurs, *is* an institutional change. It is an informal, ideological shift that lowers the relative costs and increases the individual, and thus, social benefit of engaging in productive, wealth creating activities.

The idea that institutions are fundamental should not be viewed as squeezing McCloskey into a narrowly defined, preexisting framework.[11] Instead, it should be viewed as a broadening of our understanding of how all institutions and rules governing societies determine economic outcomes. McCloskey's notion of 'dignity and liberty' naturally fit into this broader institutional paradigm, and, in fact, provides a much deeper and complete explanation for how institutions determine economic, political, and social outcomes. Institutions are not just about transactions costs or externalities – they capture *all* subjective costs that structure the relative alternatives available for individuals to base their chosen means to purse their chosen ends. As McCloskey (2010: 254) says:

> The desire to make deals did not change…What changed was the ease of making the deals…What changed were the 'transactions costs'…that is the costs of getting together to made a deal—transportation costs, the costs of robbers on the highway or in the market, the costs of trusts, the costs of insurance, the costs of using credit, the costs of getting coins and bills, the

[10] McCloskey does not specifically define liberty; therefore, this definition is my interpretation of liberty.
[11] It is possible that there are fundamental and proximate institutions; however, that is beyond the scope of this analysis.

> costs of negotiaiton, the costs of taboo, the costs of sneering at the bourgeoisie…When such costs fall, 'commercialization' takes places.

For example, a socially enforced norm against owning your own business is possibly just as powerful as a government-enforced law against private ownership of a business. In fact, the first scenario may be worse than the second because informal cultural rules are sometimes more difficult or slow to change. Also, it may be easier to avoid government regulations through informal markets but much more difficult to avoid community based enforcement of such views. In addition, even if government repeals its law, individuals may still feel socially constrained and not engage in entrepreneurial activities. This example provides a case where underlying informal norms need to align with formal in order to achieve maximum benefit – an idea fleshed out in more detail below.[12]

3.2 Relating 'Dignity and Liberty' to Other Works

> "Give people liberty to work and to invent and to invest, and treat them with dignity, and you get fast catching up."
>
> McCloskey (2010: 122)

In order to arrive at a full institutional explanation, it will be useful to relate McCloskey's work on liberty and dignity to two strands of literature that are closely related to each idea: the economic freedom literature and the literature on culture and development.

A very large and conclusive literature supports the claim that capitalism leads to economic growth and development. Economic freedom, in its most compact definition,

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[12] The idea that institutions are often difficult to unbundle and separate is related to McCloskey's (2006) argument that virtues should be viewed as an alloy of metals—difficult to separate but together combine for an overall effect.

refers to the protection of private property rights and the freedom of voluntary transactions (Gwartney et al. 1996). A government that does not enforce contracts, usurps property from its citizens without due compensation, and puts limits on voluntary transactions, violates the tenets of economic freedom. In so doing, such a government provides a disincentive for entrepreneurship and productivity, given that individuals are skeptical about realizing the gains of their productive efforts. It is the lure of the individual's potential gain from productive activities and new ideas that makes entrepreneurship, and thus growth. Noting that protection of private property and freedom of choice and exchange are the key elements of economic freedom, De Haan et al. (2006) conclude that a vast majority of studies support the positive link between economic freedom and growth.

The literature on culture and development is not as extensive as the economic freedom literature; however, the studies that do exist support the notion that 'culture matters' (Fernandez 2010). Such studies include Grier (1997) and Barro and McCleary (2003) where the authors examine the impact of religion on economic development. This can be thought of as recent attempts to estimate the effects of cultural ethics discussed in the work of Weber and others.[13] Several studies investigate how informal institutions, such as trust, individual autonomy, and respect, are important for economic outcomes (Guiso et al. 2006; Tabellini 2008a, b, 2009). Tabellini (2009) finds a strong causal and direct relationship between culture and economic development across different European countries. In addition, Licht et al. (2007) and Williamson and Kerekes (2010)

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[13] Weber's thesis described the Protestant ethic, or culture, as one important determinant in the emergence of capitalism in northern Europe. Likewise, Tocqueville (1835) described a culture in America with attributes similar to some of those later associated with Weber's Protestant ethic.

empirically show that culture indirectly promotes economic prosperity by underpinning both political and economic institutions.

These findings also support the emerging literature on self-governance where public production of law and formal legal systems are not necessary to establish and enforce property rights and contracts (Benson 1989a, 1989b; Greif 1993; Greif, Milgrom, and Weingast 1994; Nenova and Hartford 2004; Leeson 2007a, b, 2009). In fact, as argued in some articles (for example, Leeson 2007c, d), relying on informal institutions alone can provide better outcomes than those achieved with a corrupt government. This suggests that culture is capable of substituting for and providing functions traditionally attributed to formal institutions.[14]

Following from this line of reasoning, Mathers and Williamson (2011) argue that certain cultural attributes can either encourage or discourage institutions associated with economic freedom. This is similar to Boettke, Coyne, and Leeson's (2008) argument suggesting that in order for formal institutions to 'stick' and, thus, promote economic growth and development, formal institutions must map onto the informal rules. This implies that informal and formal institutions should complement one another in order to be self-enforcing and support economic growth. Therefore, the success or failure of formal economic institutions depends on the preexisting informal rules; thus, certain cultural attributes may complement economic freedom, or capitalism, and enhance its subsequent effect on growth.[15] The authors confirm this hypothesis by showing that

[14] See Boettke and Leeson (2009) for a theoretical explanation of the endogenous emergence of informal, private institutions.
[15] This is similar to an argument by North (2005) where formal and informal institutions contribute to economic growth through a feedback process.

cultural traits such as trust and tolerance and respect for others enhance economic institutions' effect on growth.

This hypothesis links back to the feedback between formal and informal institutions as suggested above. Williamson (2009) finds that informal and formal institutions do not necessarily act as substitutes or complements. In some countries, they can substitute for each other, and, at other times, they do complement each other. Countries with both informal and formal institutions of higher quality support economic development; however, countries that exhibit strong informal institutions with weak formal institutions are among the richest countries today, suggesting that what is driving development are the informal institutions. Also, of interest is that the substitute/complements relationship is asymmetric. Countries with strong formal, but weak informal are the poorest countries, suggesting that formal cannot substitute for informal.

Following the arguments outlined above regarding complementarity between formal and informal rules, McCloskey's 'sweet talk,' which gave way to dignifying the bourgeoisie, may only be sweet because of some minimum, pre-existing liberty that allowed the change in ideas to actually have an effect. It was the match between the informal and formal institutions, or cultural values coupled with economic freedom, or dignity *and* liberty, that sparked the industrial revolution.[16] As she states:

> The rhetorical change, after all, was itself in part a feedback from dignity and liberty. Dignity and liberty were in turn the result in part…of the long perfected property rights of Europe, the medieval liberties of the towns, the competition among states…(2010: 448).

[16] McCloskey views the change in conversation as different from a cultural change as culture is often slow changing. However, as North (1994) argues with institutional change, some aspects will be slow changing while other aspects will be more adaptive and change quickly. Therefore, we can still view the change in conversation and dignity as an institutional shift.

Thus, dignity cannot substitute for a lack of liberty in order to ignite and sustain growth. Dignity needs to be grounded in liberty, which depends on secure property rights. This is an important distinction in moving forward and applying McCloskey's insights to today's poor countries, which, for the most part, lack liberty.

It should be noted that McCloskey rejects the North-Thomas-Weingast's argument that it was a *change* in property rights institutions that sparked the Industrial Revolution. Instead, she argues that property rights were already present for quite a long time. Therefore, it was a rise in dignity supported by already existing liberty that sparked and sustained the economic change. My argument suggests that the rise in dignity is still a change in institutions that lead to the change in growth – perhaps previously incorrectly attributed to the wrong change in institutions.

3.3 Getting to 'Sweet Talk'

> "Competition is essentially a process of the formation of opinion: by spreading information, it creates that unity and coherence of the economic system…"
>
> Hayek (1980[1948]: 106)

In addition to providing a specific example of how institutions matter for development, McCloskey's insights also illustrate one specific mechanism for institutional change. This mechanism can be summarized as follows: Economic exchange → Exchange in Ideas → Sweet Talk → Dignity. It should be noted that McCloskey's third book in the 'Bourgeois Era,' *The Bourgeois Revaluation: How Innovation Became Virtuous 1600-1848* explains how the rise in dignity came about. I take the most liberties in this section in order to illustrate one possible explanation for how talk sweetened. This section builds from many of the arguments presented above where institutions, including liberty, encourage economic exchange, which leads to an exchange in ideas giving rise to dignity.[17]

The basis for such a claim stems from the argument where geography affects institutional arrangements by shaping the way in which individuals' interact across societies. One main mechanism for interacting across different groups is through trade, or economic exchange. Specifically for McCloskey, geographic constraints influenced the Atlantic Trade during the 17th and 18th centuries leading to distinct patterns of economic exchange around the North Sea:

> What made such talk conceivable was the "rise" of the bourgeoisie in northwestern Europe…It was a rise in dignity, accompanied by public opinion, and of liberty, accompanied by revolution. The rise happened in the Netherlands especially, and the Netherlands was the irritating model for the rest…What made the project of ethics in commerce conceivable was the economic and political rise of the middle class around the North Sea, merchant communities hurrying about their busy-ness…(2011: 56).

The underlying logic is that trade not only results in the exchange of goods and services, but also in exposure to different attitudes, beliefs, ideas, and values. Trade serves as a mechanism of cultural exposure by raising people's awareness of alternative ideas, beliefs, and values (see Cowen 2002 and Jones 2006). According to Coyne and Williamson (2010), similar to the creative destructive process of economic exchange for goods and services that creates economic benefits, trade may also generate positive cultural effects through a similar creative destructive process among beliefs, values, and ideas. The same competitive pressures that lead to the adoption of technological innovations can serve to promote the adoption of norms, beliefs, and attitudes that further

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[17] Acemoglu, Johnson, and Robinson (2005) present evidence that exchange can lead to formal political institutional change. They argue that the major changes in political institutions during the 1600s is a result of the Atlantic trade where commercial interests used their newly acquired economic power to gain more political power.

promote exchange and prosperity. As McCloskey states, "trade is surely a conduit of ideas and competitive pressures" (2010: 226).

The progression through which economic exchange can lead to cultural change implies that initial exposure to alternative norms, views, and attitudes will create subsequent opportunities for future market interactions. This sets in motion a cyclical, reinforcing mechanism for change. Individuals find it beneficial to adopt cultural traits that serve commercial interests. According to Jones (2006), the merging of cultures creates commonalities reducing the costs associated with interaction and exchange. These reduced transaction costs lead to increased interactions fostering trust and contributing to the growth of social networks. Thus, exchange can foster an informal institutional change.[18]

This process of cultural exposure may best be thought of as an indirect, unintended consequence of entrepreneurial activities. It is possible that entrepreneurs responding to profit opportunities from economic exchange also carry cultural influence, even though this is not the primary goal. Thus, McCloskey's change in conversation, and thus a rise in dignity, can be viewed as an unintended indirect effect of a rise in economic exchange, grounded in newly granted liberties. It is through exchange where individuals learn from each other the 'good habits of wealth producing behavior.' As she states:

> The change was not genetic (as Clark argues) or psychological (as Weber argued) or economic (as Marx argued) or legal (as North argues) but sociological and political. Literacy, printing, a free press, and free

[18] Instead of viewing culture as a fixed stock, it is more suitable to view it as an ongoing process of transformation. Cowen (2002) contends that trade openness promotes views of individual autonomy, increases the likelihood of risk taking, provides people with an increased number of opportunities for interaction and exchange, and generates trust through the cultivation of social relationships. Coyne and Williamson (2010) provide empirical support for this hypothesis.

conversation make technology available (2010: 293).

Trading activities and markets are a venue for free conversation. Markets should be understood as a “social space” where both economic and non-economic, including sociological, relationships emerge and develop (Storr 2008).[19] Therefore, economic exchange can be an avenue for non-economic exchange. Through this exchange process is how a change in ideas and rhetoric can emerge. Economic exchange, as a result of secure property rights and other institutions, led to a cultural exchange that eventually dignified the merchant class.[20]

4. Conclusion

This paper has two main contributions. First, I outline a general framework for understanding economic development by summarizing the main determinants of economic growth. The paper is by no means comprehensive but outlines the leading explanations for development. The emerging consensus from this framework is that ‘Institutions Rule.’ Second, I incorporate McCloskey’s ‘dignity and liberty’ into the ‘Institutions Rule’ framework by expanding the notion of institutions. Therefore, McCloskey’s change in conversation regarding commerce *is* an institutional change. Her work offers a precise mechanism to explain *how* institutions matter to support economic growth. In addition, the feedback between dignity and liberty provides a specific example

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[19] The free press idea is supported by the media freedom literature where media can serve as a mechanism for institutional change (see, for example, Leeson and Coyne 2010).
[20] This argument does not contradict the above section where trade is only a proximate cause of economic growth. The proximate view of trade takes place within a fixed institutional structure. The argument in this section is that trade can *change* the institutional structure. If true, then trade have a dynamic, indirect effect on growth due to its effect on institutions.

of mechanisms that exists leading to institutional change. As such, we arrive at two main conclusions: 1) dignity must be grounded in liberty, and 2) economic exchange as a result of underlying liberties leads to dignifying the bourgeoisie. This suggests that by moving towards freer trade, poor countries today will reap the traditional benefits of free trade, but it might also set in motion a cycle for more liberties and institutional change.

In terms of applying McCloskey's work to future research, the possibilities are practically endless. Her work touches on all aspects of economics including trade theory, political economy, entrepreneurship, the importance of public opinion, and, naturally, development economics. Specific to development, McCloskey's arguments complement the works of Bauer (2000) and Easterly (2006) in providing yet another explanation for why foreign aid will not achieve it aims and may in fact undermine its stated goals.

As this paper argues, the institutional literature will benefit tremendously by incorporating McCloskey's work. However, I also believe that reading McCloskey's research through an institutional lens provides a deeper understanding of her insights. For example, McCloskey does not specifically define dignity and liberty, although we understand what is meant by these terms. Although related, she does imply something more than property rights and rule of law. Therefore, by relying on the institutional literature, we can fill in any gaps that may exist in her analysis. By doing so, we can go beyond her insights and offer other specific channels in which dignity and liberty might matter for sustained economic growth; for example, by reducing transactions costs, acting as a coordinating device, and serving to overcome credible commitment and collective action problems. From this perspective, there are more similarities between McCloskey and the NIE literature than disagreements.

So, in summary, what can be done to end world poverty? McCloskey (2010: 449) offers a concise answer:

> …give a man and a woman the liberty to innovate, and persuade them to admire enterprise and to cultivate the bourgeois virtues, and you save them both for a long life of wide scope, and for successively wider lives for their children and grandchildren, too. That's the Bourgeois Deal, which paid off in the Age of Innovation."

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