

The Importance of Expectations in Economic Development

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1. Introduction

What factors and processes influence the wealth of nations? This is the central question addressed by Professor North and his colleagues John Wallis and Barry Weingast (NWW) (2009) in their framework for “interpreting recorded human history.” In attempting to address this question, NWW develop a conceptual framework for understanding how institutions shape the organizations necessary for cooperation and economic development. While a small number of countries have been able to develop the institutions necessary for sustainable economic development, in most countries this outcome has been elusive. Moreover, our understanding of the process of institutional change and development is still in its early stages. From this standpoint, the NWW framework is a welcome and important contribution. It provides clarity to our understanding of different types of social orders and offers insights into the requirements for movement between different orders.

NWW differentiate between three distinct social orders. The first type of order, the “primitive social order,” is a hunter-gather society. The second type of order is a “limited access order” or what the authors call the “natural state.” The natural state is an order where political institutions restrict entry to the economic system to create rents. These rents in turn are used by those in the political system to maintain order. The natural state has been the dominant form of

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social order for much of recorded human history. The third type of order is the “open access order.” Open access orders, which are relatively new in terms of human history—approximately 300 years old—are able to sustain order through open political and economic competition. In contrast to limited access orders, open access orders are fluid in that citizens are allowed to form contractual organizations—organizations where arrangements are enforced by third parties—which contribute to sustained openness and economic development. Indeed, open access orders characterize the handful of developed countries that exist today.

In addition to identifying the different types of social orders, NWW also provide the “doorstep conditions” necessary for the transition out of the natural state into an open access system. The doorstep conditions include: (1) Rule of law for elites, (2) Perpetual forms of organizations for elites, and (3) Political control of the military. In short, elites must be constrained by the law, just like citizens. This includes mechanisms for enforcing these constraints. Further, organizations must be perpetual meaning their sustainability is not directly dependent on the current members of the elite. Finally, control of the military must be consolidated. When control is dispersed, as in many natural states, conflict between groups is the norm.

At first glance, the policy implications of the NWW framework may appear sobering—the toolkit of mainstream development economists will fail to assist limited access orders make the transition to open access orders. According to the NWW, instead of measuring development through standard metrics—e.g., per capita income, physical and human capital investment, and infrastructure investments, etc.—focus should be placed on the process of development which entails the shift from the natural state to an open access system. Positive changes in development metrics can indicate the movement of a limited access order closer to the doorstep

conditions, but these changes, by themselves, do not constitute the process of development. Another important implication of the NWW analysis is that natural states are just that—natural. They are not ‘weak,’ ‘failed’ or ‘dysfunctional.’ As a result, policy aimed at ‘fixing’ these orders will fail because they are not broken in the first place.

When it comes to natural states, one might conclude that NWW are ‘panglossian pessimists.’ Natural states are natural states and open access systems cannot be imposed from outside. Further, the current policies of the development community will be largely ineffective in the NWW view of the development process. It would seem that natural states are stuck being natural states with little that can be done to change the situation.

In contrast to this pessimistic interpretation, this essay emphasizes that the implications of NWW’s analysis provide the foundations for a realistic reassessment of the constraints facing the development community in their efforts to assist natural states. Ultimate success requires understanding what can and cannot be achieved in efforts to assist natural states. From this standpoint, it is my contention that the implications of NWW’s analysis should be read with optimism. In putting forth bold implications, NWW afford us the opportunity to critically reconsider the current policies and strategies employed by the development community, as well as potential alternatives to the status quo. The purpose of this essay is to take advantage of this opportunity.

The central theme of this paper is the role that expectations play in development. In the broadest sense, ‘expectations’ refer to the views held by decision makers regarding the future state of key variables. Expectations play a key role in development efforts because they frame the activities of the development community, as well as the perceptions of indigenous politicians and citizens living in the natural state. A central issue highlighted by NWW’s analysis is that the

development community tries to impose the conditions of existing open access systems on limited access orders. Since the two do not mesh, given the absence of the doorstep conditions, failure is typically the outcome. This paper will argue that a failure to appreciate the role of incentives is an important contributor to these failures.

The expectations of the development community are naively optimistic because they fundamentally assume that the conditions of existing open access systems can be imposed or established in a natural state. These expectations result in specific policies toward natural states which assume the existence of the doorstep conditions. These policies, in turn, influence the expectations of politicians and citizens living within those states. The disconnect between what can actually be achieved in the natural state, and the expectations created by the development community, often leads to perverse outcomes and the failure of development efforts.

It is my contention that a central lesson from NWW's analysis is that movements within the natural state, as well as the establishment of the doorstep conditions necessary for development, are directly dependent on the existence of certain expectations. Many development problems involve a 'collective action problem' which requires the coordination of many people. The solution to this problem requires that individuals are confident in their expectations about what others are going to do so that they can respond accordingly. Appropriate expectations are necessary to facilitate the widespread coordination required to overcome collective action problems.

Creating appropriate expectations ultimately requires understanding what is feasible within different social systems. NWW's framework provides a means for understanding what is feasible under different systems. For example, a transition from a limited access system to an open access system cannot take place absent the existence of the aforementioned doorstep

conditions. In general, the relevant comparison is not the natural state to some ideal open access system, but rather one natural state to another natural state. The central issue is understanding the realistic alternatives relative to the current natural state.

Discussions of development assistance often focus on the problems of the quantity of resources (Sachs 2005), incentives (Easterly 2001) or information (Easterly 2005). The recognition of the importance of expectations adds an additional wrinkle to these discussions. Development is not simply a matter of the quantity of the resources invested, as this assumes that the recipients have the incentive and information to use the resources effectively. Moreover, in addition to the incentive and information issues regarding the use of resources, the various parties involved in development efforts must hold certain expectations in order for the effort to be successful. Absent appropriate expectations, citizens and policymakers will fail to make the necessary commitment and investment required for success.

This paper proceeds as follows. The next section provides a brief history of modern development economics. It is important to understand how the subfield of development economics has evolved over time in order to understand how expectations regarding current development efforts get established. In the context of NWW's analysis, it will be argued that at the core of modern development economics is the assumption that the doorstep conditions allowing for an open access system have either already been established or can be established by exogenous forces. These expectations drive the type of development policies that are adopted. Section 3 explores the role of expectations in the process of economic development and discusses the factors influencing expectation formulation. Particular emphasis is placed on the ability of the development community to effectively shape expectations. Section 4 concludes.

2. The Evolution of Development Economics and the Expectations of Development

In order to understand the expectations that have emerged regarding economic development initiatives, it is important to understand the evolution of development economics as a field of study. In the broadest sense, development economics focuses on understanding the causes for the economic progress or stagnation of societies.² Issues of economic development can be traced back to the earliest writings in economics as indicated by the title of Adam Smith's (1776) classic, *An Inquiry into the Nature and Causes of the Wealth of Nations*. However, the 'modern' development economics subfield that exists today did not emerge until the 1930s (see Arndt 1981 and Bell 1987). The rise of modern development economics was due to several factors and events.³

The increased availability of statistics and data, which allowed for cross-country comparisons of standards of living, was a major factor in the rise of modern development economics. For example, Clark (1939) collected detailed data on the income accounts for the United Kingdom and is widely known for his contributions for his work on national income estimation. The use of this aggregate data provided a means of comparing the wealth of nations and economic development. Comparisons of income and other measures of progress made differences in development clear and highlighted the failure of certain societies to develop and progress. As such, these data were used to identify the counties in need of assistance and aid.

Another important influence on the evolution of modern development economics were the global economic events starting in the late 1920s. The Great Depression in the United States led to questions regarding the stability of capitalism. These questions were further fueled by the

² For a detailed survey of the field see Stern 1989.

³ For a discussion of some of the important early literature in development economics, see Bardhan 1993.

industrialization of the Soviet Union through forced investment and saving. This supported the belief at the time that state planning was a critical element of the development process (see Myrdal 1956). In reviewing the early writing in development economics, Bell (1987) emphasizes that “if they shared anything in common, it is a distrust of the proposition that matters [of development] can be left to the market” (825). At the same time, the independence of former colonies led to numerous countries and societies with varying levels of development and institutional quality. These events led economists to focus on issues surrounding comparative economic systems and to further understand the factors contributing to development across societies.

A final influence was the rise of what today is known as the ‘international development community’ in the 1940s. The development community includes international organizations which attempt to facilitate economic, legal, political and social stability and development around the world. This includes the United Nations (UN) which was founded in 1945 to uphold international law, to facilitate international peace and security, and to promote economic and social development. The World Bank and the International Monetary Fund (IMF) also emerged from the Bretton Woods Agreement in 1944 as agencies of the UN and continue to play a critical role in international development efforts.

Several organizations within the World Bank are focused on economic development issues while the IMF is closely involved in the global financial system and the global macro economy.⁴ The creation of these organizations provided a centralized apparatus to carry out

⁴ The World Bank Group consists of five international organizations: International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA), International Centre for Settlement of Investment Disputes (ICSID). Although the World Bank Group was created as part of the United Nations system, each of the above agencies is governed by its member countries. Discussion of the World Bank and economic development typically focus on the IBRD and the IDA, since those agencies focus on issues of economic development.

research regarding economic development across countries and to implement global programs and projects aimed at fostering economic development. Since the creation of its various elements in the 1940s, the development community has been a driving force behind international development efforts.

Several distinct trends have dominated modern development economics. In the 1940s, the ‘investment gap’ and ‘big push’ theories emerged and became the centerpiece of development efforts. These theories were grounded in macroeconomic models which emphasized the importance of capital and savings for growth. For example, the Harrod-Domar model, which has long been used by those in the development community, assumed that growth in output is driven by investment in capital which is a function of savings. Given this assumption, the model explains growth through levels of savings and the productivity of capital. The central prediction of the model is that growth is the result of increased savings and productive investments. This model is attractive from the standpoint that an analyst can make predications of growth and calculate the savings needed to yield a certain level of growth.

The Harrod-Domar model was the impetus for both the investment gap theory and the big push theory. As per the Harrod-Domar model, it was believed that the lack of growth in underdeveloped countries was due to a lack of saving and a lack of productive capital investments—i.e., an ‘investment gap.’ Governments and the international development community were seen as the remedy to both of these problems. Development analysts used the Harrod-Domar model to calculate the level of savings needed to achieve certain rates of growth in underdeveloped countries. This investment gap could then be filled by wealthy countries and the development community who would provide aid to the governments of underdeveloped countries.

It was also believed that the problem of a lack of productive capital investments could be solved by a ‘big push’ through government coordinated investments of foreign aid in a number of sectors and industries.⁵ This big push style industrialization was often combined with mercantilist policies such as ‘import-substitution’ whereby underdeveloped countries would rely on domestic substitutes for goods they would usually import. The idea was that developing countries should promote the development of domestic industries which are typically underdeveloped or in their infancy.

The use of the Harrod-Domar model, and the associated investment gap and big push policies, continue to be mainstays in the development community (see Easterly 1997, 2001: 35–37). Advocates of increased aid rely on the investment gap logic as evidenced by Sachs (2005) who attributes ongoing underdevelopment in the poorest countries in the world to the poverty trap (56-7). The central idea is that the income of citizens in these countries is so low that it barely covers the basic necessities required for survival. As such, they are unable to save for investment. The overall impact is that these societies are unable to accumulate the savings necessary to make capital investments to break out of the poverty trap. As a result, Sachs and others who rely on the poverty trap logic call for increased foreign aid from developed countries to fill the investment gap and assist poor countries in breaking out of the poverty trap.⁶

A second trend in modern development economics started in the 1960s. During this time, the development community began to expand its focus regarding the investment gap in developing countries. Prior to this broadening, the focus was on the lack of investment in physical capital. However, with the limited success of such investments, the development community began initiatives for increased investment in human capital as well as in physical

⁵ The “big push” theory of development was put forth by Rosenstein Rodan (1943) in one of the most influential papers in development economics.

⁶ For critiques of the poverty trap argument, see Bauer 2000 and Easterly 2006.

capital. The underlying idea was that an educated populace was required to increase productivity and hence growth.

However, as Easterly (2001: 71-84) has documented, the massive investments in education over the past several decades have largely failed to achieve the desired outcomes. The reason is twofold. The first is that dysfunctional institutions in many of the world’s poorest countries fail to generate an environment where citizens can utilize their education in a productive manner. With a low return on human capital investment, citizens responded by either not taking full advantage of educational opportunities or by leaving their home country after obtaining an education. In short, human capital matters, but only when there is a relatively high return on the initial investment. Second, efforts to centrally plan education investments, like all other aid efforts, neglect the difficulties associated with allocating aid to achieve the desired ends.

While investments in physical and human capital continue, the development community has coordinated around several core development principles known as the “Washington Consensus.” The Washington Consensus is a list of ten policies first presented by John Williamson (1990) which were meant to represent the consensus among the development community regarding reform in developing countries. Williamson’s original list was expanded over the course of the 1990s to address issues associated with governance and institutional reform. The original and augmented Washington Consensus is summarized in Table 1:

Original Washington Consensus	Augmented Washington Consensus
1. Fiscal discipline	11. Corporate governance
2. Reorientation of public expenditures	12. Anticorruption
3. Tax reform	13. Flexible labor markets
4. Interest rate liberalization	14. Adherence to WTO disciplines
5. Unified and competitive exchange rates	15. Adherence to international financial codes and standards
6. Trade liberalization	16. “Prudent” capital-account opening
7. Openness to foreign direct	17. Non-intermediate exchange rate regimes

investment	18. Independent central banks/inflation targeting
8. Privatization	19. Social safety nets
9. Deregulation	20. Target poverty reduction
10. Secure property rights	

Table 1: The Original and Augmented Washington Consensus⁷

The augmentation of the Washington Consensus reflected a broader trend in development economics—the emphasis on the importance of institutions. On the academic front, the renewed focus on institutions was driven by the work of Douglas North (1990, 1991, 2005) who reminded the economics profession that ‘institutions matter’ for economic outcomes. Within the development community, the focus on institutions emerged from the realization that in many cases the implementation of the policies associated with the original Washington consensus required fundamental institutional changes. The new Washington Consensus aims to prescribe best practice guidelines for institutional changes required for the effective functioning of the policies listed under the original Washington Consensus. The guidelines are typically used by the development community to develop a plan for carrying out the desired change and reforms in policies and institutions.

The evolution of modern development economics has created certain expectations within the development community regarding the process of development and what is required for development to occur. These expectations in turn influence policies and the expectations of leaders and average citizens operating within developing countries. Two challenges related to the expectations created by the tools used by modern development economists present themselves.

⁷ Source: Rodrik 2007: 17.

First, as NWW indicate, the formulation of development policies is based on the characteristics of existing open access societies. In other words, the policies designed to assist limited access societies are based on what has already been achieved in open access societies. Policies based on the characteristics of existing open access societies assume that developing countries either have already achieved the doorstep conditions—the rule of law, control over violence through political control of the military, and perpetual political institutions—or that they can obtain these conditions in a relatively low cost manner. This leads to an inaccurate comparison between open access and limited access orders. The relevant point of comparison for limited access orders is not what exists in open access orders; rather, the relevant comparison is what is feasible given the existing constraints in limited access orders. As both North and Weingast describe in earlier essays in this volume, when policies grounded in the characteristics of existing open access orders are implemented in limited access orders they are bound to fail because the complementary conditions are absent.

Success in development efforts requires understanding what is feasible in natural states, including the real existing constraints. As NWW make clear, the movement to an open access society is often not feasible for limited access societies, at least not in the short run. What is more important is the movement toward the doorstep conditions which are necessary for the movement from limited access to open access.

This leads to a second issue with modern development economics and resulting development efforts. In addition to assuming that the characteristics of established open access systems can be achieved in limited access orders, it also assumes that the development community can centrally plan the implementation of these conditions. This neglects the process through which plans for development are transformed into actual outcomes. Easterly (2001,

2005) emphasizes the incentive and information issues involved in the process. In the realm of development, the best laid plans often fail because of perverse incentives and the absence of important information and feedback mechanisms.

A related, and often underappreciated, issue in the development process is the role of expectations in achieving buy-in from the relevant parties involved in development efforts—the development community, indigenous political leaders and citizens. Absent appropriate expectations, those involved in development efforts will fail to coordinate their actions in a manner which contributes to ultimate success. Given this, understanding the role that expectations play in the development process is critical for understanding the ability of the development community to assist limited access societies. The next section provides further insight into the role of expectations, as well as the factors contributing to the formation of expectations.

3. Expectations and Development

3.1 The role of expectations

Expectations refer to the views held by individuals regarding the future state of key variables. Expectations play an important role in the process of development because many development issues involve a ‘collective action problem,’ the solution to which requires widespread coordination among a large number of people. In order to overcome this problem, individuals must be confident with what others are going to do so that they can respond accordingly. For example, in the case of property reform individuals must expect that their rights will be enforced and respected by others. Absent this expectation, the reforms will fail to get off the ground or sustain over time.

In general, the absence of appropriate expectations regarding the actions of others makes it extremely difficult for individuals to effectively coordinate their actions. While the specifics of each development situation will differ, in each case if the expectations of the relevant players are aligned, at least to some degree, with the aims of the development effort, there will tend to be a greater degree of coordination and cooperation. In contrast, where expectations fail to align with broader goals of development efforts, those efforts are more likely to fail.

By helping us understand how expectations are formed, work in the area of behavioral economics can provide insight into how expectations matter for development. Behavioral economics attempts to combine insights from psychology with economics to better understand economic behavior. Recent work in behavioral research illustrates that a critical element of expectation management is how outcomes relate to expectations. For instance, Diener (1984) and Frank (1989, 1997) conclude from their work that individuals assess their current state of affairs relative to their expectations.

For example, a millionaire who loses \$100,000 in the stock market in a single day may, at least for a while, be less happy than a middle class individual who finds a \$100 dollar bill on the street. The central issue is the ‘frame of reference,’ the benchmark against which an individual compares his or her current situation, which is a critical determinant of ultimate satisfaction or disappointment. Even though the millionaire is wealthier than the middle class individual in absolute terms, he is worse off relative to his initial position. His loss, relative to his frame of reference, is greater than the gain realized by the middle class individual relative to his frame of reference.

A related literature emphasizes the importance of ‘anchoring’ (see Tversky and Kahneman 1974). Anchoring is the tendency for people to establish one piece of information—

the anchor—as a baseline when making a decision. Given limited brain processing capability, people cannot compare all relevant alternatives. As such, they pick an anchor to serve as a benchmark for comparison. The anchor, in turn, is based on past experiences and the context within which the chooser acts. Schmid (2004: 39) notes that “The value of a product is evaluated on its own relative to some limited set of alternatives that are evoked in the context and framed by the environment of the particular case.” This logic can be extended beyond the value of a product and applied to outcomes of various policies, including development efforts.

A central conclusion of the behavioral literature is that individuals experience improvements by doing well or improving relative to local norms, such as consuming more than in the past or relative to other individuals. What matters are outcomes relative to the ‘frame of reference’ or ‘anchor.’ This realization can be applied to efforts to assist limited access orders. A disjuncture between expectations and outcomes is an important reason why development efforts may fail. When individuals are forced to participate in development activities that provide an outcome that is worse than they anticipated, they may very well refuse to act in a cooperative manner. The result is a failure to solve the collective action problem required for sustainable change. For example, citizens may refuse to accept or engage in reformed political institutions because the reforms fail to meet their expectations. If a large number of citizens hold this view, the widespread coordination necessary for sustainable change will not be obtained. Given this, understanding the importance of the frame of reference or anchor is critical for those in the development community in understanding and establishing expectations and carrying out development efforts.

3.2 Setting expectations

In general, the expectations conducive to successful development will vary with the situation. In some cases, it may be better if individuals expect very little. For instance, if expectations in the country in question are modest, coordination around development initiatives will often be easier to achieve. If the populace does not expect significant development in a short amount of time, obstacles that arise may be overlooked with less resentment. If, on the other hand, citizens expect immediate development, it may be harder for the development community to achieve the desired outcome. In such instances, citizens may quickly lose patience with and refuse to support development initiatives which means they will ultimately fail to sustain.

Where citizens' expectations are at odds with what is feasible, they will feel cheated relative to their initial expectations—i.e., their 'anchor'. The result may be a lack of cooperation and investment on the part of citizens. The main implication is that efforts aimed at pushing limited access orders toward the doorstep conditions requires establishing realistic expectations to ensure that citizens have the proper frame of reference.

Where development efforts require a significant commitment on the part of citizens, success requires creating high expectations which provide an incentive for citizens to make the necessary investment. For example, in order for impersonal social and economic interaction to take place, individuals must have an expectation that their property rights will be respected. Likewise, in order for citizens to participate in the political process, they must have an expectation that their political and civil rights will be protected. This indicates that a mix of both high and low expectations is needed, depending on the nature of the activity in question.

Along these lines, one can envision the following decision rule: low expectations are best concerning cases of 'goodwill' and high expectations are best concerning the provision of basic necessities and the respect of basic rights. Low expectations are best when the central

question for success is whether the populace will blame those carrying out the development effort for every mishap. Large and grandiose plans of ‘goodwill’ would fall into this category. For example, in the poorest of countries, promising local and rudimentary solutions to health and education issues is more realistic compared to some kind of large-scale and well-functioning education or health care system. In these cases, low expectations are important because there is the real possibility that the failure of development efforts will result in resentment and non-cooperation in future periods.

In some cases, however, higher expectations will assist the development process. For example, in the case of security and protection from violence individuals will tend to expect immediate protection. In the absence of security, the basic cooperation necessary to achieve the broader development goals will be less likely. In such instances, high expectations are preferable so that people are willing to make the investments necessary for success in the development effort.

Past experiences with both formal and informal institutions are a critical factor in how indigenous people establish expectations. This finds support in the notion of ‘availability heuristics,’ which emphasizes how people tend to evaluate perceived possibilities relative to past experiences. As Rabin (1998: 30) notes, “A pervasive fact about human judgment is that people disproportionately weight salient, memorable, or vivid evidence even when they have better sources of information.” On a daily basis individuals rely on guideposts to coordinate their actions. These guideposts are often based on past experiences or interactions with others. Driving on a specific side of the road is one example of widespread coordination grounded in past experiences. Similarly, meeting a friend or family member in a certain location based on past meetings is another example of this logic. In general, past experiences influence the current

frame of reference utilized by individuals to make current decisions. The central point is that there is an epistemic aspect to the process of expectation formation in which past experience shapes expectations about the future by providing the raw materials necessary to frame the universe of imagined outcomes. The development community can attempt to create certain expectations, but the actual process of expectation formulation on the part of indigenous people is at least partially based on past experiences that are outside the control of exogenous policymakers.

The use of an availability heuristic can influence development efforts in a number of ways. For example, if citizens have had negative experiences with past development efforts, this will impact their frame of reference toward future development efforts. Likewise, if citizens have had negative experiences with their own domestic government, this will adversely impact expectations regarding development programs carried out through that government. Coyne and Boettke (2009) discuss the problem of credible commitment in reconstruction efforts. They emphasize that, based on historical interactions, citizens often do not trust their own governments, let alone foreign occupiers. This can slow or completely impeded efforts to reconstruct conflict-torn countries. A similar logic can be extended to all development efforts.

In sum, the problem with establishing appropriate expectations is twofold. The first is determining what the ideal frame of reference should be so that citizens have an incentive to invest in a manner which contributes to the development effort. The second is the epistemic aspect of expectation formulation. The fact that development efforts involve exogenous forces raises an additional issue. In addition to ensuring that the proper incentives are in place, the development community must deal with the fact that the process of expectation formulation is embedded within an existing cultural context. The adaptive efficiency of a social system is a

function of the epistemic properties of its political, legal, economic, and customary traditions and institutions (see North 2005; Boettke, Coyne and Leeson 2008). As such, reforms must be grounded in customary practices, institutions and expectations. Because those in the development community are outside the indigenous context where development efforts are taking place, they will often perceive and interpret the frame of reference of indigenous citizens in a manner that is different from how the actual citizens perceive their situations. Ultimate success in development efforts requires finding adequate solutions to both aspects of the expectations problem.

3.3 Implications

Expectations are important for development outcomes. But in setting expectations, the development community is constrained because of the epistemic aspects involved in the process of expectation formulation. The members of the development community cannot fully comprehend the past experiences of indigenous citizens which are a critical aspect of the process of formulating the appropriate anchor. What does this imply for development efforts?

The decision rule put forth in the previous sub-section can offer some guidance in answering this question. Recall that the proposed decision rule called for high expectations regarding basic ‘necessities,’ but low expectations regarding ‘goodwill.’ Creating high expectations around the delivery of basic necessities provides some certainty to guide the actions of citizens. With increased certainty, citizens can be confident in the basic rules of the game. This allows citizens to pursue and discover what they view as valuable within those general rules, resulting in the emergence of subsequent indigenous expectations. In other words, what is needed are simple and stable rules that provide a broad and predictable environment for

indigenous people to engage in discovery. Because the proposed institutional environment is open ended, indigenous actors can discover the appropriate expectations regarding future developments.

For example, consider a situation where a development effort is aimed at reforming property rights. The best that the development community can do is to recognize the *de facto* property rights as quickly as possible and then enforce those rights once established. If property rights are well defined, and if citizens are confident that their property rights will be respected and enforced, they will then make the investment in utilizing that property in a manner which yields immediate and future benefits. We cannot know how they will use their property *ex ante*, but we can allow citizens to discover various alternative uses by providing broad and general rules which encourages discovery.

Bauer (2000) emphasizes the importance of “trader-entrepreneurs” in poor countries. These individuals are alert to small-scale trading opportunities that contribute to the movement from subsistence to exchange. He emphasizes that trader-entrepreneurs “are productive in both static and dynamic senses” (2000: 6). Not only do they serve an economic function through executing mutually beneficial exchanges, but they also habituate outward looking norms and ideas which facilitate subsequent growth and development in a variety of markets. Along similar lines, Easterly (2005) emphasizes the importance of ‘searchers’ in the development process. ‘Searchers’ are individuals who explore solutions to problems through a trial and error process and who are subject to feedback mechanisms. In contrast to ‘planners,’ who rely on top-down plans to address problems, searchers rely on bottom-up solutions. An underappreciated benefit of searchers is that they play a key role in the endogenous formulation of expectations. Given a basic and predictable environment that encourages such behavior, searchers will discover the

opportunities and expectations that foster subsequent development. Returning to Bauer's insight, they will take advantage of existing opportunities, but also create new opportunities as well.

As another example of the importance of broad and stable rules, consider the work of Chamlee-Wright and Storr (2008) regarding the rebuilding of communities in New Orleans after Hurricane Katrina. They find that public policy designed to help Katrina victims often created uncertainty regarding whether citizens would return in large numbers. This uncertainty prevented private citizens from functioning as active stakeholders in their neighborhoods and slowed the overall recovery effort. In other words, the proper anchor was not established at the outset which reinforced pessimism on the part of citizens regarding rebuilding. Given these low expectations, private citizens lacked the incentive to invest in the rebuilding process. Chamlee-Wright and Storr argue that what public policy should have done is establish general and stable rules which served as a guidepost to citizens. This would have contributed to a set of expectations encouraging citizens to act entrepreneurially while discovering what works and what does not work in the rebuilding process.

The argument being put forth here is similar to that developed by Hayek (1960) in *The Constitution of Liberty*. Hayek argued for general and stable rules so that individuals can discover what they do not already know. Civilization progresses by discovering new knowledge and by sharing that knowledge with others. Simple and open ended rules are necessary precisely because we cannot know everything and we cannot know what will be learned in the future. Detailed rules and regulations, or unstable and unpredictable rules distort or altogether stifle this learning process and therefore limits the progress of society.

The argument being put forth here differs from Hayek's in that he was mainly focused on the meta-rules governing an entire society. The argument being made here—the need for

general, simple and predictable rules—is that Hayek’s logic needs to be applied to even the smallest development efforts in natural state orders. The claim is not that these small-scale efforts will contribute to the wholesale movement from the limited access systems to open access systems, but instead that these efforts can contribute to marginal improvements within a given natural state.

It should be noted that creating broad and stable rules is by no means a panacea. Even establishing simple rules is not always an easy task. In many cases citizens may be reluctant to commit to basic reforms, even if they involve ‘necessities’ such as basic rights. A variety of factors such as war and conflict, or past experiences between different groups within a society may contribute to the failure to coordinate on basic reforms. In such cases, the set of realistic actions available to the development community is severely constrained.

Where feasible, however, the best course of action for the development community is the creation of simple and stable rules that can be quickly established and enforced. For example, efforts to protect very basic property rights and to protect citizens from exploitation by members of the political elite are likely to generate desirable outcomes as compared to more grandiose development plans. Under such a scenario, indigenous citizens have the opportunity to engage in the discovery of what works and what fails to work. The creation of such rules should be viewed as a genuine ‘citizen-based approach’ to development because it allows indigenous actors to discover, establish and adjust their own expectations regarding future development.

4. Concluding Remarks

NWW’s analysis forces us to reconsider what the process of development entails and what the development community can accomplish. The focus of this paper has been on the role that

expectations play in economic development. Modern development economics establishes unrealistic expectations regarding what can be achieved in limited access orders. Specifically, the assumption that the conditions of existing open access systems can be imposed or established in a natural state neglects the real constraints that exist in these societies. This in turn leads to policies which create perverse expectations on the part of indigenous people living in limited access orders. This essay has three main implications.

The first is that expectations matter for development efforts. Without the proper expectations, indigenous citizens will fail to make the necessary investment for successful development. The result will be that the collective action problems preventing reform and change will persist.

Second, the process of setting expectations requires establishing the proper ‘frame of reference’ or ‘anchor.’ This, in turn, involves two issues. The first is determining what the proper benchmark should be. The second is understanding how past experiences and the indigenous context influence the formation of expectations. For obvious reasons, finding a solution to both issues can be difficult, which leads to the third implication.

The best strategy for the development community is to set high expectations regarding basic necessities. Specifically, high expectations should be established around the delivery of simple and predictable rules which will allow the citizens to engage in discovery. The more detailed and complicated the rules or the plan associated with development efforts, the more likely they are to fail. Focus should be placed on making promises that can be delivered on in a relatively short period of time and which allow citizens to discover that which they do not already know. Simple rules such as enforcing fundamental property rights, delivering essential

services and providing basic protection against violence provide the best hope for assisting natural states in the complex process of economic development.

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