1. Introduction

Matías Vernengo and Esteban Pérez Caldentey

INSTITUTIONS AND THE LIMITS OF THE CURRENT DEVELOPMENT STRATEGY

There are many explanations for why some nations grow to be rich while others are poor. And there are different views on why the great majority of economies, including the Latin American ones, remain stuck in between both poles without being able to compete with poorer economies or catch up to the rich ones.[1] The traditional mainstream explanation for the differences in economic development and growth across nations has relied on the neoclassical production function. The production function permits the decomposition of the rate of growth of an economy into the respective rates of growth of factor inputs (i.e., labor and capital) and a residual, total factor productivity, which represents the different forms of technological change.

Since growing by accumulating successive units of capital and labor is confronted with diminishing returns, a sustainable growth path can only be achieved through innovation and technological progress. This placed the focus of the analysis of growth—and of catch-up between countries—on technology, even when considering increasing returns to scale in capital and labor. However, besides insurmountable inconsistencies characterizing the specification of a production function (such as the fact that capital cannot be measured independently of prices and distribution, as pointed out in the Cambridge capital controversies), a large part of growth rates and differences in growth rates among nations cannot be explained by either factor accumulation, innovation, research and development, or technological progress (Helpman, 2004).[2] This key failure of mainstream growth theory opened the route to consider alternative explanatory variables and, in particular, sociopolitical factors including geography, culture, and institutions.

Jared Diamond, author of the best seller *Guns, Germs, and Steel,* is correct to point out that, in part, technology is geographically determined; for him, geography plays a central role. Culture has fewer defenders; most prominently among modern economists is probably McCloskey (2010). But the obstacles to that argument are even more difficult to overcome, not the least because in modern times, countries with diverse cultures have become developed, like Japan and South Korea (Acemoglu and Robinson, 2012). The Weberian Protestant work ethic would not help, in this case, to explain relative development. It is important to note that culture does matter, even if it is not determinant, since different cultures produce different types of capitalism, some more benign than others (Hall and Soskice, 2001).

The explanations of growth differences based on cultural and geographic patterns lack the generality and universality required by neoclassical theory to argue that societies placed in different contexts and historical periods respond, at the general level, to one and the same principle: utility maximization. This limitation has significantly contributed to consolidating the institutional factor as the most promising mainstream line of research to explain the central divide between the levels of development across different nations and historical periods.

According to this line of research, institutions are generally defined as "the informal norms and formal laws of societies that constrain and shape decision making" (Alston, 2008, 2). "Informal norms" are standard rules of behavior that are unwritten but understood within a group or a community; more specifically, the term refers to sanctions, taboos, customs, traditions, and codes of conduct. By contrast, formal rules "are consciously designed by humans and often codified in written form—examples are constitutions, laws and regulations as well as property rights" (North, 1990, 97).

Within this view, the focus is placed on property rights as the crucial "institution" that affects and enhances economic growth and development. This responds to an issue of theoretical consistency: the definition and specification of property rights are required for the determination of an optimal allocation of resources. Also, the "one concrete institutional element on which all authors agree as a major determinant of economic development is the existence of secure property rights" (Angeles, 2011). One of the most recent statements of the view that institutions (and private property rights) are essential for development and growth is Acemoglu and Robinson's (2012) *Why Nations Fail.*

In the case of Latin America, the institutional approach to growth has a long history, dating back to the failure of mainstream empirical studies based on trade and protectionism to prove and illustrate the distortive and inefficient nature of the state-led growth policies advocated by different governments in the region in the 1960s and '70s—which, by the way, resulted in the highest growth rates recorded in over four decades. The weakness of this economic argument led to a body of research and thinking termed the "new political economy," which emphasizes, in a way that is very similar to Acemoglu and Robinson's distinction between inclusive and extractive institutions, the rent-seeking character of government and government officials. Rent-seeking is portrayed as a wasteful, inefficient, and costly activity inherent to any regime based on strong intervention of the state in the economy. According to this line of thinking, government intervention transformed the main agents of production and growth, namely firms and entrepreneurs, into rent-seeking entities.

More recently, Engerman and Sokoloff (2000) have provided a variation on Acemoglu and Robinson's view of the role of institutions and property rights to analyze Latin American growth performance. For them, the point is that countries in the region with a high proportion of people in relation to available land would have, according to neoclassical theory, low wages—that is, low prices for the abundant factor (labor) and high prices for the scarce factor (land). In their view, then, societies with high population-to-land ratios developed institutions that protected the white elites and were, in general, less egalitarian. Property rights tended to be more insecure, and hence innovation and growth faltered. Institutions (property rights, essentially) were central, but so too was the geographic "good luck" of abundant land.

In this book, we argue that there are several key problems associated with "new institutionalist" arguments and, in particular, with the way they are applied to viewing and understanding Latin American development. For one thing, they provide a limited view of comparative historical analysis, failing to read and understand history on its own terms. An illustrative example is Acemoglu and Robinson's (2012) characterization of the Spanish and English colonizations as being extractive and inclusive, respectively, when in fact the historical record shows that both types of colonization were at times extractive and inclusive. Also, while examples of extractive institutions and poor growth performance would obviously come up in a study that covers such an enormous territory in terms of countries and time periods as *Why Nations Fail,* there are also major counterexamples that disprove their main arguments—for example, the contribution of property rights to the industrial revolution.

There is solid historical evidence showing that the usefulness of patents, copyright, and other forms of property protection for explaining growth is limited at best (Moser, 2013). Hoppit (2011) argues that in the case of England,

> property was often heavily taxed, frequently expropriated and, exceptionally, eradicated through redefinition. Such vulnerabilities did not diminish after the Glorious Revolution, they increased. . . . The scale of that expropriation was such, and the consequences so profound, as to undermine an important thesis that property rights became more secure after the Glorious Revolution, developed in a notable essay by Douglass North and Barry Weingast and now conventional amongst some 'new institutional economists'.

In other words, the Industrial Revolution can hardly be attributed to strong property rights in England. If one thinks of modern developing countries, it is hard to be sanguine about the notion that Western-style property rights in developing countries would be a sufficient condition for catching up.

Turning to more recent historical examples, the economic success of South Korea and some other Asian nations such as Singapore can hardly be said to be based on inclusive institutions. As is well documented, South Korea (as well as Japan), in an earlier period in history, used protectionism, exchange rate control and management, credit controls, and a mix of public and private initiatives to boost its real gross domestic product (GDP) per capita from U.S. $1,127 in 1961 to $28,875 in 2013, thereby changing from a middle-income to a high-income country (Chang, 2007).

Finally, the institutions emphasized by the new institutionalism and in *Why Nations Fail,* fundamentally property rights, are uniquely concentrated on the supply side of the economy, along with the generation of incentives for productive investment (to buy machines and equipment).

A different story about relative development could be advanced. Adam Smith, in *The Wealth of Nations,* argued that the division of labor, which was the basis of technological progress, was limited by the extent of the market—that is, by demand. According to Landes (1969),

> it was in large measure the pressure of demand on the mode of production that called forth new techniques in Britain, and the abundant, responsive supply of factors that made possible their rapid exploitation and diffusion. The point will bear stressing, the more so as economists, particularly theorists, are inclined to concentrate almost exclusively on the supply side.

In other words, institutions might be relevant—though not, primarily, the ones associated with the supply side, but rather those linked to the demand side, in Keynesian fashion.

Neoclassical economists, when discussing growth, always downplay the importance of demand. Structuralist authors with Keynesian tendencies, on the other hand, emphasize the role of demand-led growth. The dominance and persistence of Say's law, the notion that demand adjusts to supply, is behind the limits of the neoclassical account of the wealth of nations. Note that a demand-based argument for the wealth and poverty of nations implies that there are other institutions that matter for development. Poor countries that arrive late to the process of capitalist development cannot expand demand without limits, since the imports of intermediary and capital goods cause balance-of-payments crises. The institutions that allow for the expansion of demand, including those that allow higher wages to expand consumption and to avoid external constraints, are and have been central to growth and development. The role of the state in creating and promoting the expansion of domestic markets, in the funding of research and development, and in reducing the barriers to balance-of-payments constraints, both by guaranteeing access to external markets and by reducing foreign access to domestic ones, was crucial in the process of capitalist development.

In this view, for example, what England had and China did not was a rising bourgeoisie (capitalists) that had to compete to provide for a growing domestic market that had acquired a new taste (and hence expanding demand) for a set of new oriental goods, like cotton goods from India or porcelain from China, as emphasized by Berg (2004) among others. In the same vein, Latin American economies lacked an expanding market that would have forced domestic capitalists to produce and innovate in order to keep up with the competition. Latin American economies entered the world economy to produce silver (mining economy, Amerindian population), sugar (plantation economy, African American population), and other commodities for external markets. These were exploitation economies, less reliant on the development of domestic markets, typical of settlement colonies in the northeast United States or of the central countries in Western Europe.

CONTEXT, OBJECTIVES, AND OUTLINE OF THIS BOOK

Latin American economic development strategies have gone through significant changes over the past three decades, following the debt crisis and the "lost decade" of the 1980s. And yet, from the '80s to the present, Latin America as a whole has registered mediocre growth trend levels. The average rate of per capita GDP growth for the period 1980–2014 is 2 percent. This performance responds not only to the medium- and long-term effects of successive crisis episodes within the region—starting with Mexico's "tequila crisis" in late 1994 and culminating with Argentina's default in early 2002—many of which were the product of unsustainable balance-of-payments difficulties, but also to expansions that are, in comparison with other developing economies, short lived and less intense.

In the most recent period of expansion (2003–08), in spite of improved international conditions associated with higher commodity prices, greater access to liquidity, and external demand that allowed for higher growth rates (Pérez Caldentey and Vernengo, 2010), Latin America reached only a 3 percent rate of growth of GDP per capita, which is below that of all other developing regions (9.3, 7.0, 3.6, 6.6, and 3.8 percent for East Asia and the Pacific, Europe and Central Asia, the Middle East and North Africa, South Asia, and Sub-Saharan Africa, respectively). This expansion period did little to change the growth trend.

Currently the region faces more stringent external conditions. The slowdown in the external demand of developed economies and also of China, which had become a major trade partner for some of the economies in the region, coupled with the ongoing crash in commodity prices, has affected those economies whose production structure and exports are resource based. The transmission channels include not only the balance-of-payments difficulties, but also lower fiscal revenues (which, in some cases, far surpass those of other sources of public income), lower rates of growth, and even contractions in domestic investment (which is based on natural resources in many economies of the region). But the concomitant reductions in foreign financial inflows and higher risk perceptions have also affected countries that are not specialized in commodities. Far from being temporary, the current slowdown seems to embody a perception of protracted economic stagnation.

At the same time that Latin America faces a more restrictive external environment, other long-standing problems of the region—such as persistant poverty rates affecting some parts and some income strata of the region, high inequality (Latin America is the most unequal region in the world after Sub-Saharan Africa),[3] deficient education standards, and low productivity, among others—have become more visible and appear to be, if only at the discursive-rhetoric level, a more urgent priority for policy makers. This is not to deny that significant progress has been made in many different economic and social areas. However, these efforts—and, more importantly, their accompanying successes—have remained confined in scope and overall impact. They have not been able to generate the broad-based upgrade in capabilities needed for development (Paus, 2013).

Furthermore, the political shift toward democracy and the increasing importance of the rule of law as a guiding principle in civilian life that took hold of Latin American societies since the '80s, and more strongly in the '90s, has been tainted as a result of the more recent corruption scandals that affect many governments in the region. That is true even though corruption is certainly a structural problem that precedes the recent events.[4] Also, the rule of law and democratic principles have been undermined by the persistence of political instability and, in some cases, the sudden and illegal takeover of elected governments by judicial and mediatic processes.

As can be ascertained from the analysis above, institutions are an essential component of Latin America's development problem. We think that the new institutionalist view and the focus on property rights is part of the lack of success of mainstream policies that have dominated development economics in theory and practice in the past decades. We also think that given their importance, institutions deserve a broad, critical, and multidisciplinary approach, beyond the property rights approach, that could provide a basis for alternative policy recommendations. This, in essence, is the objective of this book.

The book comprises eight chapters, divided in two sections. The chapters in the first section highlight several key problems associated with new institutionalist arguments and, in particular, how the latter are applied to viewing and understanding Latin American development. In chapter 2, Carlos Medeiros contrasts the mainstream or neoclassical and the "new developmentalist" explanations for the successful development strategy in East Asia and the failure of Latin America, at least since the 1980s, with alternative heterodox views broadly defined as structuralist and connected with the Economic Commission for Latin America and the Caribbean and heterodox Keynesian perspectives. The author argues that both the neoclassical and the new developmentalist views have a tendency to de-emphasize the role of demand-side factors in the process of development and suggest solutions that require getting the prices right. Medeiros is also particularly critical of the so-called new developmentalist view according to which the main reason for Latin American underperformance was the macroeconomic policy adopted and the resulting real exchange rate appreciation, considered the main lever of manufacture exports, and economic growth. In his view, demand and the institutions associated with demand management are central for economic development, but multiple instruments, not just the exchange rate, must be used to promote growth, and the role of industrial policy has been neglected in Latin America.

In the same vein, chapter 3, written by the editors of this book, suggests not only that demand and the institutions that allow for its expansion are also relevant for the process of development, but also that the emphasis on private property as the main, if not almost the exclusive, role of the state in the process of development can only be inferred by distorting the historical record. The authors suggest that it is not the historical evidence, which would imply that there is significant space for a developmental state to promote technological innovation, but the preoccupations and requirements of neoclassical economics that have led to the institutional turn in development economics. The dismal productivity performance in the region is then tied to the current development strategy, which is still heavily influenced by the collapse of the state-led industrialization strategy in the early '80s, and the adoption of Washington Consensus policies subsequently.

Miguel Centeno and Agustín Ferraro suggest, in chapter 4, that two kinds of developmental failure are relevant for understanding Latin America's relative backwardness. They suggest that presidential interference tended to derail development programs, designed by career experts, that had run successfully. They exemplify their arguments with the Brazilian computer industry and the Chilean experience with a national developmental institution dedicated to industrial promotion. The authors suggest that autonomous bureaucratic institutions are central for development, but in Latin America the principle of supreme administrative authority of the president, established in several constitutions in the region, has had a negative impact on development institutions. In their view, if one contrasts the design of developmental institutions in East Asian and Latin American cases, the main lesson is that in the latter cases there is more interference from politicians.

In chapter 5, Alejandro Portes and Jean Nava review the theoretical and empirical literature leading to the institutional turn in the economics of development. They argue that sociologists have welcomed this turn as a vindication of their own ideas but have neglected two major shortcomings in the economics literature, namely (1) a failure to define institutions rigorously and to distinguish them from the real-life organizations that they underlie; and (2) a tendency to use nations as units of analysis in cross-national studies, neglecting intranational differences. They tackle these limitations through a comparative study of institutions in Latin America and one Southern European country with similar historical and cultural background. In total, twenty-nine institutions were subjected to one-year studies in six countries. Using Qualitative Comparative Analysis (QCA), the authors examine the combination of criteria leading to institutionally adequate and developmental organizations. Differences across countries and among institutions are systematically highlighted and discussed. Implications of the winning combination of determinants for a competent development institution, as uncovered by QCA, are examined. Multiple intranational differences show the inadequacy of treating countries as internally homogeneous as in past cross-national studies.

The theoretical and institutional discourse of mainstream economics analyzed in the first section of the book has, to a large extent, guided the policy prescriptions followed by Latin American governments over the past three decades since the debt crisis and lost decade.[5] Using empirically based analyses and specific source-case examples, the second section (chapters 6–9) provides critical assessments of this development strategy, identifies the future challenges, and presents alternative policy proposals to the ones that are currently being followed and implemented. While the initial chapters can be seen as discussing the deep causes of relative backwardness in the region, and engaging the new institutionalist literature that has dominated economics, the subsequent chapters deal explicitly with the limits of the current Latin American development strategy. The role of the cycles in commodity prices, the persistence of the balance-of-payments constraint, the possibility of the Dutch disease, and the role of the increasing integration with China, in particular the environmental consequences of Chinese investments in the region, are tackled in these chapters.

José Antonio Ocampo argues in chapter 6 that the decade 2003–13 was an exceptional one for Latin America in social terms and also, though less clearly, in economic terms. Growth slowed down significantly after the exceptional external factors that fed the 2003–07 boom came to an end. The unwinding of the period of high commodity prices and, to a lesser extent, of the expansionary monetary policy of the United States, has added new challenges. The major issue is the need to overcome the poor long-term economic performance that has characterized the region in the post-market reform period, particularly by adopting active production-sector development strategies.

In chapter 7, Juan Carlos Moreno-Brid and Stefanie Garry examine Latin America's economic performance in the past three decades with the objective of assessing whether it entered a new phase of strong and persistent growth with stabilization in the 2000s. Their analysis pays special attention to the changing roles of exports and investment as drivers of growth and to the region's performance in the fiscal area, the composition and dynamics of foreign trade, investment, and labor productivity. Their results indicate that, in general, the region has achieved important progress in macroeconomic matters, but it has failed to overcome major structural, long-term constraints linked to its balance of payments and, to a lesser extent, its fiscal performance. Unless these challenges are resolved, the region's long-term growth will hardly be favorable.

In a similar vein to the two previous chapters, Martín Abeles and Sebastián Valdecantos discuss in chapter 8 the return of the external constraint in South America. They suggest that South American countries transitioned from export-led growth before the subprime crisis to debt-led growth afterward. This, in turn, implies that the capacity of governments in the region to implement countercyclical polices to promote growth and social policies to reduce inequality depends fundamentally on the vision held by the international investor community.

Finally, Rebecca Ray and Kevin Gallagher look in chapter 9 at the sharp increase in social conflict and environmental degradation brought about by the recent commodity boom. The boom, driven by trade and investment with China, was concentrated in petroleum, mining, and agricultural sectors—sectors historically linked to environmental and social conflict. With some notable exceptions, Latin American governments have fallen short of mitigating these risks. Moreover, as the boom cools and Latin American economies slow, regional governments face pressure to "streamline" approvals for new export and investment projects, stymieing civil society's work of holding governments and foreign firms accountable.

INSTITUTIONS AND ECONOMIC POLICIES

Notwithstanding the combination of theoretical and empirical analyses with different emphases and approaches, this book provides a solid basis for the formulation of a coherent set of policy recommendations. First, the book argues that development policy cannot rely solely on purely economic factors such as growth and capital accumulation, or on social protection objectives. Development policies must also focus on improving the character and quality of national institutions. The most suitable definition of the term *institutions* as used in the different chapters is "blueprints specifying relations among role occupants in social organizations" (Portes and Smith, 2012, 4).

Second, this view does not imply that the main prerequisite for developmental take-offs is the establishment of set rules, such as property rights, to delimit the behavior and responsibilities of different economic agents and the spheres of action of the private and public sectors, so that market forces can optimally allocate scarce resources among alternative ends, as seems to be the case in new institutional economics. Contrarily, the institutional turn considered in this book advocates that the most important condition to promote development is strong, but flexible and dynamic, government involvement across a wide variety of areas—including investment, industrial policies and innovation, and education and other social policies—in addition to those that traditionally fall under the scope of public policies.

Third, this means that states and governments, rather than limiting their functions to those of mere "referees," regulators, or market plumbers, must assume the role of architects and market makers in the design and establishment of institutions.

Fourth, institutions, rather than focusing solely on the supply side (e.g., by changing incentives), must allow the expansion of demand to promote growth and development. In fact, the most relevant institutions to development are demand oriented. These encompass policies that include active production-sector strategies, the funding of research and development, ensuring the existence of markets for innovations and newly developed products, or overcoming external constraints by ensuring that the responses of international goods and financial markets permit the growth of domestic economies according to their potential. Demand-oriented policy means placing the focus on income and not on substitution effects.

Fifth, government involvement is not tantamount to centralized government. In fact, this book argues that developmental institutions and demand-oriented policies cannot work properly without bureaucratic autonomy. Bureaucratic autonomy means the establishment of a professional bureaucracy and public administration. Bureaucratic autonomy is counterposed to the belief that organizations are most effective, as a whole, if there is a clear and final authority for all important decisions.

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Matías Vernengo is a professor at Bucknell University. Esteban Pérez Caldentey is senior economic affairs officer at the Economic Commission for Latin America and the Caribbean in Santiago, Chile. The opinions expressed are the authors' own and may not coincide with those of the institutions with which they are affiliated.

NOTES

1. According to World Bank data from 2016, countries that had a gross national income (GNI) per capita of U.S. $1,045 or less in 2014 are considered low-income countries. Countries (such as the majority of Latin American economies) with a GNI per capita of more than $1,045 but less than $12,736 are considered middle-income countries. Countries with an income per capita above $12,736 are considered high-income economies. Low- and middle-income countries are considered "developing countries."

2. There are also measurement problems, as suggested by Felipe and McCombie (2015), since total factor productivity is not really a measure of productivity and essentially indicates the weighted average of the rate of growth of wages and profits.

3. Comparable Gini coefficient estimates are available for 2010. In descending order, the Gini coefficients are 44.4 for Sub-Saharan Africa, 43.8 for Latin America and the Caribbean, 38.1 for East Asia and the Pacific, 36.0 for the Middle East and North Africa, 35.0 for South Asia, and 33.6 for Europe and Central Asia. See Alvaredo and Gasparini (2013).

4. It is also worth noticing that the more recent literature on the effects of corruption on economic development tends to emphasize its negative impact, while the older literature suggested that a certain degree of corruption greased the wheels of business and helped promote growth. Samuel Huntington (1968, 368) famously argued that "in terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized and honest bureaucracy." From our perspective, the main problem with this literature is that it mostly deals with subjective perceptions of corruption, which may deviate from actual corruption, and that it does not address the issue of causality, that is, whether corruption causes lack of growth (or growth) or vice versa.

5. The causality between ideas and policies in Latin America is also the subject of *Ideas, Policies and Economic Development in the Americas* (Pérez Caldentey and Vernengo, 2008).

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