

# **The Law and Economics of Foreign Intervention and Rule Reform**

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## **1. Introduction**

Foreign intervention refers to the use of the discretionary power of a government in one society to address perceived problems in foreign societies. In addressing these problems, foreign interventions aim to construct a preferable state of affairs in these societies from the standpoint of those intervening. This may or may not align with what those in the foreign society view as a preferred state of affairs.

There are many different types of foreign interventions which can be understood in the context of Nye's (2004) distinction between 'soft power' and 'hard power.' Soft power refers to the use of persuasion to achieve the desired ends, while hard power refers to the use of force or coercion. Examples of soft power include the dissemination of certain information, or cultural products, as well as monetary aid. Examples of hard power include military occupation and the removal of government regimes through force.

Given these categories, one can envision a continuum of foreign interventions with soft power on one end and hard power on the other. As one moves away from the 'soft' end of the continuum interventions become 'harder' and may involve such things as mediation, the seizure of assets, embargos, sanctions, and a range of military activities. Thinking of foreign interventions in this manner highlights that whether an intervention is 'soft' or 'hard' is a matter of relative degree. It also highlights that not all foreign interventions are coercive in nature. For example, many countries welcome foreign aid and the associated advice of development experts which is clearly less coercive as compared to say military occupation.

The purpose of this chapter is to highlight how a mix of concepts from law and economics and Austrian economics is crucial to understanding the success and failure of foreign

interventions. In order to gain analytical tractability, I limit my focus to foreign interventions intended to foster the conditions necessary for economic prosperity. These conditions are well-known to economists and consist of some mix of property rights, constraints on government, sound policy, and sound money. Law and economics informs us that in order for these conditions to be achieved, foreign interventions must focus on changing the array of rules in the societies in which interventions take place. If rules can be changed appropriately, the conditions for development and growth can be established.

Rules find their reason in the need to create parameters on both private and public activity to establish and maintain social harmony and peace (Brennan and Buchanan 1985: ix). Rules can be formal—e.g., constitutions, legislation, etc.—or informal—e.g., norms, beliefs, etc.—in nature. At its core, law and economics is focused on how rules are formed and structured, as well as how different rules affect economic, political, and social outcomes. From the perspective of law and economics, rules serve as prices which influence the net benefit of engaging in certain behaviors. Changes to rules will change the incentive structure facing individuals, ultimately resulting in changes in outcomes.

The law and economics of foreign intervention implies that success requires changing existing rules to achieve the desired ends. This, in turn, requires working within the relevant player's goals to find incentives such that the pursuit of those goals will produce behaviors that align with the desired ends of the foreign interveners. For example, if the goal of foreign intervention is to establish self-sustaining, liberal economic institutions, success requires establishing a set of incentives such that the relevant players prefer those institutions relative to the other alternatives. If such rules can be established, market institutions will be self-sustaining

and self-extending over time precisely because they yield a high net benefit relative to other alternatives.

While establishing the appropriate rules are necessary for success in foreign interventions, they have often proven elusive. For example, empirical evidence regarding foreign interventions to ‘export’ democracy through military occupation (Bueno de Mesquita and Downs 2006; Pickering and Peceny 2006; Coyne 2007), spur economic growth through foreign aid (Easterly 2001, 2006), and influence economic, political, and social change through sanctions (Pape 1997, 1998) indicates more failures than successes.

While there is an array of potential issues contributing to these failures, one major factor highlighted by those writing in the Austrian tradition is the knowledge constraint facing the designers of planners designing interventions and reforms (see Mises, 1920; Hayek 1945; Sowell 1980; Lavoie 1985a,b, Boettke 1993, 2002; Ikeda 1997; Coyne 2007). In its broadest form, the ‘knowledge problem’ emphasizes that planners lack the context specific knowledge to effectively achieve their ends through rational planning. This epistemic problem manifests itself in numerous ways in foreign interventions. For example, in the context of exporting democracy the knowledge problem manifests itself through the limited knowledge of outside planners to design effective meta-rules which constrain government (Coyne 2007). The epistemic constraint in the context of foreign intervention can be understood as one specific case of the problem facing people in all complex interactions—the problem of discovering and using the relevant knowledge that is dispersed throughout society.

In the following sections I consider how appreciating both the incentive issues (the law and economic focus) and the epistemic issues (the Austrian focus) facing foreign interveners can offer insight into the limits of what foreign interventions to reform rules can accomplish in

practice. I apply this logic to understanding the conditions under which reformed rules will ‘stick’ in the desired manner (Section 2), as well as incentive and epistemic issue of reforming rules due to issues of credible commitment (Section 3). Establishing incentives is crucial, but determining the appropriate incentives is a difficult task given that the perceptions of citizens in other societies are grounded in a cultural context that often cannot be understood by outsiders in a manner that can be effectively incorporated into policies. Appreciating both the incentive and epistemic aspects of rule reform allows us to gain a better understanding of the limits of foreign intervention (Section 4).

## **2. Rules and Enforcement Costs**

### **2.1 Rules**

Economic, political, and social outcomes are a function of formal and informal rules (North 1990). The ‘rules of the game’ provide incentives which guide behaviors for better or worse. Foreign intervention seeks to change existing rules or establish new rules in other societies. Therefore, a central issue is understanding how rules emerge and sustain over time. This, in turn, requires an understanding of the relationship between informal and formal rules.

Informal rules refer to the underlying norms, beliefs and attitudes held by people. According to North (2005: 23), “...the beliefs that humans hold determine the choices they make that, in turn, structure the changes in the human landscape.” When individuals share a similar set of beliefs, or common heritage, it “...provides them with a means of reducing divergent mental models...and constitutes the means for the intergenerational transfer of unifying perceptions (2005: 27). Formal rules, in contrast, are codified and therefore constitute written rules.

Prior to North's emphasis on informal rules, Hayek (1988) argued that the "extended order" of human society was largely a spontaneous order which was the result of purposeful human action, but not human design. Specifically, Hayek (1960: 62) emphasized that:

We understand one another and get along with one another, are able to act successfully on our plans, because, most of the time, members of our civilization conform to unconscious patterns of conduct, show a regularity in their actions that is not the result of commands or coercion, often not even of any adherence to known rules, but of firmly established habits and traditions. The general observance of these conventions is a necessary condition of orderliness of the world in which we live, of our being able to find our way in it, though we do not know their significance and may not even be consciously aware of their existence.

Elsewhere Hayek (1979: 107-8) again emphasized the importance of past experiences and traditions, including the underlying beliefs and dispositions, "which in more fortunate countries have made constitutions work which did not explicitly state all that they presupposed, or which did not even exist in written form." Hayek's point is that a constitution is a codification of the underlying beliefs and traditions of a society which have existed and evolved for long periods of time prior to codifying formal rules. Further, Hayek is highlighting that in order for formal rules to operate as desired, they must be supported by certain belief systems which reduce the enforcement costs of the formal rules. These informal rules are the result of a historical evolutionary process that cannot be grasped even by those who currently follow those rules.

More recently, the recognition of the importance of past experiences manifests itself in the concept of institutional 'path dependency,' which highlights that the way in which rules and beliefs developed in past periods constrain choices in the present. As a key contributor to the path dependency literature, North (1990, 2005) has emphasized that formal rules are indeed important but must be complemented and reinforced by informal rules in order to operate in the

desired manner. Together, the formal and informal rules will operate effectively, but any disjuncture between the two will result in dysfunction.

As noted at the outset of this subsection, North argues that informal rules are the product of the “mental models” of the individuals involved. As such, existing informal rules constrain the feasible set of feasible rules, and thus, political, economic and social rules that function in one society may not be feasible in other societies at some specific point in time. North (2005) also emphasizes that social scientists lack a firm understanding of how informal norms evolve and develop, including how to influence the direction of mental models, and the resulting informal rules, necessary to supplement and reinforce the desired formal rules.

Taken together, the insights of Hayek and North highlight the epistemic aspect of the problem of designing preferable rules through foreign intervention. Rules create incentives which guide human behavior, but in order for rules to be effective they must be grounded in informal rules which have emerged as a result of a long and varied process which cannot be fully grasped or comprehended by those involved in that process, let alone by those outside that process. Boettke, Coyne and Leeson (2008) emphasize that the ‘stickiness’ of rule changes is a function of the distance between rule design and the location of the desired institutional take-hold. In this context ‘distance’ refers to the knowledge-distance between the local knowledge and the knowledge possessed by those designing rules. As this distance increases, so too does the likelihood that the designed rules will fail to stick in the desired manner because of the gap between the local knowledge and the knowledge possessed by the rule planner.

The key observation in this discussion is that societies have a preexisting endowment of informal rules which serves as a constraint on what can be achieved via foreign intervention. Interventions which attempt to transplant formal rules are not the same thing as transplanting the

entire social system that generated that institution in the first place. Absent the complementary informal rules to serve as a foundation, formal rules will be dysfunctional. As Boettke (2001a: 262-3) writes, “When culture and economic logic coincide, commercial experimentation flourishes and material progress lifts the masses of people from subsistence. Absent this coincidence...behavior is diverted either into a *sub rosa* existence or manifests itself in counterproductive ‘rent seeking’ games.” This dysfunction will be evident in the enforcement costs associated with formal rules.

## **2.2 Enforcement Costs**

There are two ways that rules can be enforced—self-enforcement and external enforcement. While both means can be effective in enforcing rules, they differ dramatically in the associated costs of enforcement. To understand the differences in these costs, first consider a scenario of ‘perfect alignment’ where people’s beliefs perfectly align with the formal rules in a society. In such an instance, enforcement costs will be zero and formal rules would be largely irrelevant since people will voluntarily follow what the formal rules dictate given that they map perfectly to their underlying beliefs and attitudes. In contrast, consider the other extreme scenario of ‘perfect opposition’ where people’s underlying beliefs and attitudes are completely at odds with the formal rules. In such a case, enforcing formal rules will be extremely costly. This relatively high cost will manifest itself both in terms of the resources necessary to maintain order, as well as the level of coercion required to force people to acquiesce to the dictates specified by the formal rules.

Rarely does a society map to one of these extreme categories, but instead operates based on some mix of informal beliefs and formal enforcement to ensure compliance with formal rules. Nonetheless, considering these two conceptual categories highlights the relative costs of enforcement. Where a society is closer to the ‘perfect alignment’ end of the rule-enforcement spectrum enforcement costs will be relatively low as compared to societies closer to the ‘perfect opposition’ end. In such an instance, it is not that deviations from the formal rules never occur, but rather that they are the exception as compared to the norm. In contrast, where a society is closer to the ‘perfect opposition’ end of the rule-enforcement spectrum deviations from the formal rules are likely to be the norm, hence the need for the constant threat of coercion to induce coordination and cooperation around formal rules.

From the perspective of foreign intervention this matters for at least two related reasons. First, it is not simply a matter of outsiders designing what they perceive to be the appropriate formal rules for prosperity.<sup>1</sup> In order to be effective formal rules must align, to some degree, with underlying beliefs and attitudes. Absent the appropriate beliefs held by citizens to support formal rules, continued coercion will be necessary in the absence of voluntary compliance.

Second, recognizing the importance of enforcement costs highlights the trade-off associated with formal rules that deviate with underlying belief systems. This trade-off is captured by the inverse relationship between the alignment of formal rules with underlying informal rules and the enforcement costs of formal rules. This is relevant because at some point establishing formal rules becomes too costly relative to the perceived benefits of those rules. Further, this implies that the costs of rule reform are not simply the effort to design and implement rules, but also the cost of enforcing those rules after they have been implemented.

The main implication is that formal rules which effectively support growth and development cannot be established at will. To understand this point, consider the implications of imposing a certain property rights scheme designed by outsiders on a society where informal rules clash with that scheme. The enforcement costs would be extremely high and people would need to be continually prodded and coerced to follow the formal rules. In addition to being costly in terms of resources, this type of coercion is fundamentally at odds with economic liberalism and will fail to be conducive to development.

### **3. Credible Commitment and Rule Reform<sup>2</sup>**

A major issue in changing existing rules, or establishing new rules, is the problem of establishing a credible commitment to change behavior in the future. In general, commitment problems are present in all areas of life where there is a temporal dimension. Wherever a time dimension is present in interactions, those involved must be confident that agreements made in the present will be binding in future periods.

As a simple illustration, consider a credit exchange where the creditor delivers a good in the present period with payment due by the borrower at an agreed upon time in the future. Absent some kind of enforcement mechanism, the issue is that when the payment date arrives it may not be in borrower's interest to make payment. If default is anticipated by the creditor at the time of the initial interaction, the agreement will break down. In order to ensure that the initial agreement and transaction take place, the borrower must send a credible signal that they are committed to delivering on their part of the agreement. Similar logic can be applied to a wide array of interactions and in many cases mechanisms emerge to signal credibility (e.g.,

enforceable contracts, reputation, warranties, external agencies, etc.). However, where mechanisms of credibility are absent, potentially beneficial agreements may not take place.

The credible commitment problem associated with reforming rules is well known among social scientists. Boettke (1993, 2001b) notes how the absence of credible commitments contributed to the failure of reforms in the former Soviet Union. Persson and Tabellini (2000) conclude that the effects of institutional changes vary depending on the ability to make credible promises prior to elections. Kydd and Walter (2002) conclude that extremists are successful in sabotaging the process of peace negotiations when they are able to foster mistrust and uncertainty regarding the credibility of those involved in negotiating and implementing the peace deal. Keefer and Vlaciuc (2005) explore how different policy choices across democracies can be explained by the ability of political competitors to make credible commitments to voters prior to elections. In their economic analysis of dictatorship and democracy, Acemoglu and Robinson (2006: 133-172) provide an analysis of the origins of democracy and dictatorship and highlight the importance of credible commitment in the distribution of political power. Keefer (2008) notes that where political leaders lack credibility, they are less able to prevent rebellion because they cannot make binding promises to potential insurgents. Similarly, Flores and Nooruddin (2009) contend that the key to economic recovery in post-conflict societies is a credible commitment to peace because in the absence of such a commitment citizens will fail to make the investments necessary for recovery. Nooruddin and Flores (forthcoming) evaluate World Bank assistance programs to post-conflict societies and conclude that the central obstacle to achieving peace among combatants is securing credible commitments. Gehlbach and Keefer (2009) explore how autocracies and weak democracies use institutionalized ruling parties to signal credibility to potential investors. They argue that absent the protections offered to investors under a mature

democracy, members of the political elite may invest in sending a credible signal that they will not expropriate the property of investors. Coyne (2007), Coyne and Boettke (2009), and Coyne and Pellillo (forthcoming) all highlight the role that credible commitment problems play in reconstruction and rebuilding efforts during ongoing conflict, as well as when conflict ends.

As this literature illustrates, appreciating the issues of credibility and commitment in the context of rule reform illustrates a central problem facing foreign interventions. The success of foreign interventions involving rule reforms ultimately requires mechanisms that signal a binding commitment on the part of the political elite to abide by the announced rule reforms in future periods. That is, success requires that people have the incentive not only to coordinate around rule reforms, but also to deliver on the promised reforms in future periods. Changes in rules can be understood as agreements to change behaviors in future periods so the parties involved must have the appropriate incentives to deliver on their promises. The failure to appreciate incentives for reforming rules is likely to lead to failure because of a neglect of the importance of signaling a credible commitment.

To further understand why signaling a credible commitment is important in the context of foreign intervention, consider the strategic interaction between ‘rule reformers’ and ‘citizens.’ From the perspective of rule reformers, a reform that seemed optimal when initially introduced may appear suboptimal in future periods. Without a credible commitment that is binding, rule reformers often have an incentive to renege on the initial agreement.

To provide a basic example, consider a foreign intervention intended to promote constraints on an existing government. The credible commitment problem in this hypothetical scenario is as follows. Citizens would benefit from these reforms, but members of the existing

political elite incur the costs because their power is constrained. Because of the loss of this power, it may be in the interest of the political elite, who initially agreed to the rule reforms, to renege in future periods so they can maintain their hold on power. If citizens anticipate this response on the part of elected officials, they will not buy into the initial rule change and efforts at reform will fail.

This hypothetical scenario highlights the importance of signaling credibility in rule reforms. The problem surrounding the sustainability of changes to rules emerges because citizens realize the incentives facing rule reformers. In other words, citizens are able to anticipate that rule reformers will have the incentive to shift their behavior in future periods and renege on agreements made in the present period. Kydland and Prescott (1977) highlighted that current decisions by actors depend critically on expectations regarding future policy and those expectations are influenced by current and past policies chosen. Expectations guide the actions of citizens and absent a credible and binding constraint on the past promises of rule reformers there is a likelihood that those reform agreements will be broken in the future. Given this likelihood, citizens may fail to adopt and invest in the rule reform meaning that it will not take hold in the first place.

The rule reform dilemma described above can be illustrated as follows. Consider a game of complete and perfect information, as illustrated in Figure 1, where Player 1 is the 'rule reformer' and Player 2 is a representative 'citizen.' The rule reformer may refer to anyone involved in changing existing rules or establishing new rules. This might include external technocrats, military officials, or diplomats, as well as internal political elites. Citizens refer to anyone who is not a rule reformer.

The first step of the game is that rule reformer announces a change to the rules. The citizen, who chooses second, must decide whether to buy into the rule reform or reject the rule reform meaning they will not follow the announced change. Assuming the citizen does buy into the announced reform, the rule reformer must then decide whether to deliver on the promised change or renege. Given that the citizens knows that the rational move is for the rule reformer to renege on the announced change in future periods, their best move is to reject the announced reform after the change is initially announced. What this basic game illustrates is the fact that absent a credible commitment which binds rule reformers, the change in rules will fail to stick.

### **INSERT FIGURE 1 HERE**

The unique Nash equilibrium in Figure 1 is for the rule reformer to renege on the announced change to the rules and for the citizen to reject the rule reform (Renege, Reject). Because of this, the rule reform fails to ‘stick’ as the citizen knows that the rule reformer will not deliver on their initial promise in future periods.

While Figure 1 illustrates the basic commitment problem, in reality the situation is even more complex because in many instances citizens cannot be completely sure if the rule reformer is actually credible and sincere in their claim to not only adopt changes to rules, but to follow them in the future. In other words, it is more realistic to ease the assumption of complete and perfect information. Other than easing this assumption, the logic of the game is largely the same as illustrated in Figure 2.

## INSERT FIGURE 2 HERE

Rule reformers (Player 1), announce a rule change which can be either ‘sincere’ or ‘insincere.’ Sincerity implies that the rule reformer actually intends to deliver on the promised reform in future periods. The citizen (Player 2) must then decide whether to accept (“Buy In”) or reject (“Reject”) the announced rule reform. The central issue facing the citizen is that, in the face of imperfect information, they cannot know whether the rule reformer is actually sincere or insincere. The only available information is the rule reformer’s past behaviors. The rule reformer is intended to create a break from the past, but the citizen must base their expectation of future behavior on past behaviors. If the citizen does decide to “Buy In” to the rule change then the rule reformer must decide whether to deliver on the rule reform or renege on the promised change.

If the rule reformer is ‘sincere,’ then the best course of action is for the citizen to buy into the reform. In such an instance both parties will be committed to the rule reform and the change will be self-sustaining over time. Further, note that if the rule reformer is sincere and the citizen buys in, the rule reform will yield a higher payoff for both parties as compared to a scenario where the citizen rejects the reform or where the rule reformer reneged on the promised reform. However, if the policymaker is ‘insincere’ then the best strategy for the citizen is to reject the announced rule reform. This is because in such an instance the citizens would commit to announced reform only to have the rule reformer renege at some point in the future.

In the face of imperfect information regarding the rule reformer’s true type, as well as past experience where rule reformers may have reneged, it may be rational for the citizen to assume that the rule reformer will be insincere in their announced commitment to rule reform.

Consider that the reason for a foreign intervention to reform rules is that there is a perceived problem with the status quo. In order to improve rules they must be perceived as being ‘broken,’ or at least not as good as they could be in the wake of reform. This means that there is a high probability that citizens have had a bad experience with the rules or rule enforcers in the past, hence the need for reform. The problem is that citizens base their expectations about the future on past experiences, good or bad, making it difficult for rule reforms to take hold.

The only way out of this conundrum is to establish a binding and credible commitment. In other words, rule changes must somehow signal credibility regarding the rhetoric of rule reformers regarding their sincerity in future periods. To be clear, the issue is not just a matter of establishing constraints on the future activities of elites. To initiate successful rule changes, rule reformers must establish constraints while simultaneously sending a signal to citizens that the rule reforms are credible.

It is important to note that actual foreign interventions are even more complex than what is captured in games presented above. In reality rule reforms are more complex because the relevant ‘rule reformer’ is typically some mix of existing, indigenous political elites and ‘outsiders’ (e.g., development experts, foreign advisors, military occupiers, national leaders, etc.) who oversee the design and implementation of reforms. The reason that this adds complexity to the situation is that citizens must not only judge the credibility of a single rule reformer, but rather an array of rule reformers. The presence of numerous layers of overlapping reformers makes the credible commitment problem that much greater.

Recognizing the complexity of the credible commitment problem highlights the epistemic aspect of the issue. The previous discussion focused on the incentive aspects of the problem.

Incentives (i.e., constraints) must be established such that elites follow reforms once established. Further, a signal regarding the credibility of those incentives must be established so that citizens have an incentive to 'buy in.' However, in addition to these incentive issues there is also an epistemic aspect to the problem of credible commitment. The epistemic aspect of the commitment problem arises because in the context of foreign intervention, credible commitment games are embedded within a cultural context. This means that different players will interpret the issue of credibility in different ways which makes finding a solution that much more difficult. What indigenous citizens view as a signal of credibility may be fundamentally different from what outsiders view as legitimate and binding. The relationship between the incentive issue and the epistemic issue can be summarized as follows. While the issue of incentives deals with the structure of the credible commitment game, the epistemic aspect deals with how different players interpret the game.

This implies that getting rule reforms right is not simply a matter of better or more effective planning. In order to establish the appropriate incentives and signal, rule reformers have to know what the appropriate incentives and signals are which will be context specific. As noted in Section 2.1, the further removed rule reformers are from the target of their reform, the less likely it is that rule changes will 'stick' over time because they will lack the context-specific knowledge necessary to align formal rules with informal rules. Outsiders will often interpret and understand the credible commitment problem in a different manner than insiders. Differences in interpretation can occur through several channels including a misunderstanding of the fundamental commitment problem or a misunderstanding of the overtures necessary to signal credibility. Where such misinterpretations occur, it can result in the failure to signal credibility

leading to either higher enforcement costs for rules as discussed in Section 2, or the ultimate failure of rule reforms.

#### **4. Foreign Intervention and the Limits of Romantic Rule Reform**

From the foregoing analysis, one might conclude that we are largely helpless to improve the world around us. If rule reform is constrained by informal rules, how can improvements to the status quo ever be made? The beginnings of the answer to this question can be found by appreciating Buchanan's (2004: 133) point that all social analysis must "start from the here and now." We are not helpless to improve the status quo, but we are constrained in what can be accomplished. Buchanan's point is that in order to understand what rule reforms are possible, we must start by appreciating the rules that currently exists. Appreciating the status quo forces one to recognize the existing institutional constraints, and hence the feasible alternatives for changes.

Buchanan (1986) further develops this point in attempting to reconcile a tension that he sees in the writings of F.A. Hayek. Buchanan points out that Hayek is simultaneously a harsh critic of 'rational constructivism'—the idea that the world can be constructed as desired according to human reason—while simultaneously endorsing major reforms to improve the world, such as the denationalization of money, which are both constructivist and based on reason. Buchanan (1986: 323) notes that it is not so much 'rational constructivism' that Hayek is warning against, but instead 'romantic constructivism' which attempts to design rules while ignoring "...culturally evolved rules for human behavior that constrain the set of institutional alternatives..." (Buchanan 1986: 319; see also Vanberg 1983). These insights allow us to establish the existing state quo as the 'outer bound' for the reform of rules. Rules reforms that

fail to appreciate this outer bound will be more likely to fail in their desired end as compared to those that appreciate existing constraints.

Within the constraints of the status quo, rule reforms must appreciate the importance of belief systems and informal rules as discussed in Section 2. Foreign interventions to implement rules, which appear preferable from the standpoint of the designer, will fail to operate in the desired manner the further removed they are from underlying beliefs and informal rules. Even if these interventions are motivated by the best of intentions, they will fail if designed rules are at odds with the underlying realities of the society in which they are imposed.

The recognition of the limits of what can be rationally designed is recognized by Fukuyama (2004: 31-2), who focuses on the “components of institutional capacity” and the transferability of knowledge associated with each component as illustrated in Table 1.

**INSERT TABLE 1 HERE**

One could disagree with the transferability which Fukuyama assigns to each institutional component. However, the power of his schemata is that it emphasizes that the transferability of institutional capacity is a function of the ability to formalize the knowledge associated with the institutional component. The formalization of knowledge is important for its communication in different contexts. Where knowledge cannot be formalized, it becomes difficult, if not impossible, to transfer. The extreme case of this is Hayek’s (1945) notion of context specific knowledge of “time and place” which cannot be formalized let alone transferred to different

contexts. Given this, the knowledge associated with the first component, organizational theory, is typically the most easy to formalize and, hence, the most transferable across societies. As one moves down the list of institutional components, it becomes increasingly difficult to transfer knowledge because the nuances of the component are more difficult to formalize in any meaningful way.

The implications are as follows. Foreign interventions which aim to influence the organizational design and management of rules are the most likely, although by no means guaranteed, to succeed because they require the least amount of context specific knowledge. In contrast, interventions aimed at influencing embedded social and cultural factors—i.e., informal rules—are the least likely to succeed because they tend to require knowledge which cannot be easily understood, let alone formalized. In general, while determining the transferability of different rules and ‘institutional components’ is not always easy, thinking about rule reforms in these terms provides a starting point which appreciates the limits of what can be constructed through human reason.

In sum, a basic appreciation for the status quo places limits on utopias by shifting focus from what ‘ought’ to be done in an ideal world to what ‘can’ be accomplished in actuality. This is crucial for adopting rule reforms that have a realistic chance of working. More importantly, recognizing constraints on what can be designed is central to ensuring that interventions undertaken to improve the lives of people in other societies don’t have the opposite effect by causing significant harms.

## 5. Concluding Remarks

Traditional law and economics focuses on rules as prices which influence the net benefit of engaging in certain behaviors. While fully appreciating the importance of incentives, those writing in the Austrian tradition also emphasize the knowledge constraint facing those who seek to improve the world through rationally designed interventions. While the issue of incentives deals with how rules influence behaviors, the epistemic aspect focuses on how people interpret those rules. This chapter has attempted to combine these insights to understand some of the limits of foreign interventions aimed at establishing the conditions for economic growth and development.

The overarching implication is that there are significant constraints on what foreign interventions can accomplish. In focusing on the constraints of what can be designed through human reason, the analysis developed in this chapter indicates that first-best, and often the second- and third-best policies, will not be realistic given the incentives and knowledge limitations. This implication may appear obvious, but as the numerous examples of failed foreign interventions indicates, these lessons have yet to be sufficiently internalized. The failure or success of future interventions will depend on the appreciation of basic incentives and constraints including the status quo. This is important precisely because failed foreign interventions are not simply a matter of wasted resources and efforts, but instead can impose significant costs on ordinary citizens around the world. Some of these harms could be avoided with a simple shift in primary focus from designing reforms to improve the world, to a deeper appreciation of the limits of what can be designed through human reason.

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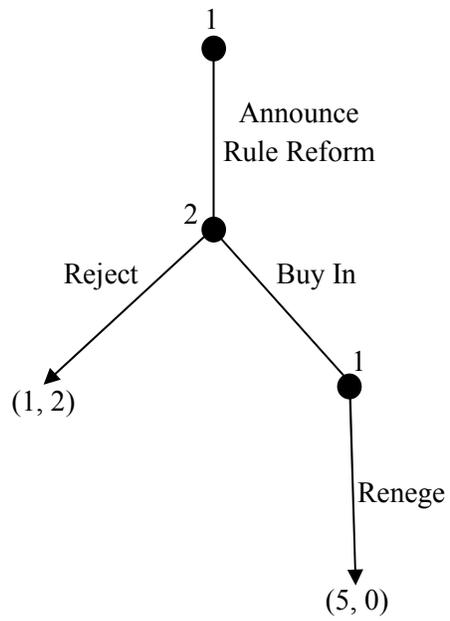
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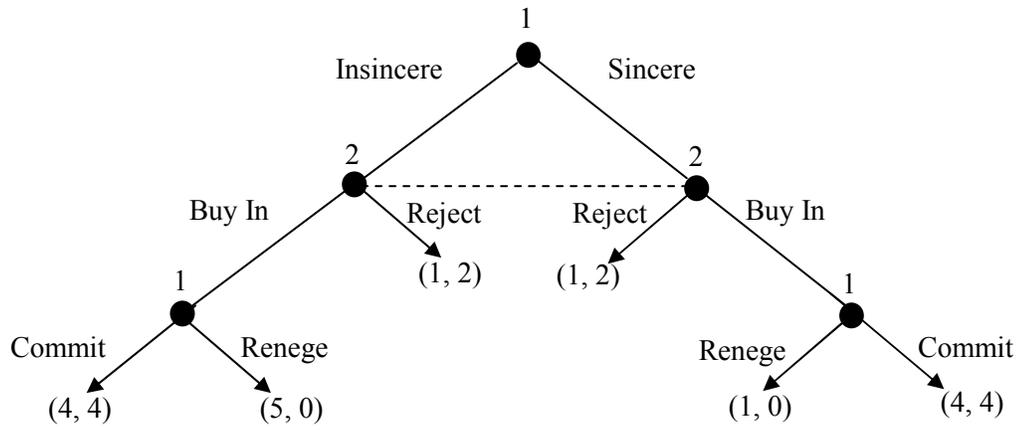
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**Figure 1: The Commitment Problem with Complete and Perfect Information**



**Figure 2: The Commitment Problem with Imperfect Information**

Component	Transferability
Organizational design and management	High
Institutional design	Medium
Basis of legitimization	Medium to low
Social and cultural factors	Low

**Table 1: Example of Transferability of Components and Institutional Capacity<sup>3</sup>**

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<sup>1</sup> ‘Outsiders’ should be understood broadly to include not just those physically outside the society, but those outside the relevant context. For example, a foreign intervention may involve international development advisors working with national leaders to design and implement rule reforms at the local level. Even though the national leaders are citizens, they may still be ‘outsiders’ in regards to the possessing the relevant knowledge of the local level. This is precisely why Boettke, Coyne, and Leeson (2008) emphasize that the relevant issue is the knowledge distance between the planner and the context in which the reform is being implemented.

<sup>2</sup> This section draws on Coyne and Boettke (2009).

<sup>3</sup> Source: Fukuyama 2004: 31.