

## Symposium

# The Political, Economic, and Social Aspects of Katrina

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In this paper, we examine the resiliency of community recovery after a natural disaster. We argue that a resilient recovery requires robust economic/financial institutions, political/legal institutions, and social/cultural institutions. We explore how politically and privately created disaster preconditions and responses have contributed to or undermined institutional robustness in the context of the Gulf Coast's recovery after Hurricane Katrina. We find that where postdisaster resiliency has been observed, private-sector responses contributing to the health of these institutional arenas are largely responsible. Where postdisaster fragility and slowness has been observed, public-sector responses contributing to the frailty of these institutional arenas are largely the cause. In other words, we engage in a comparative institutional analysis of civil society, entrepreneurial commercial society, and government agencies and political actors in the wake of a natural disaster.

**JEL Classification:** P16, P17, H11

## 1. Introduction

Disasters, whether man-made or natural, represent a “natural experiment” for social scientists. As one business leader put it to us on one of our first research trips in February 2006 to New Orleans after the storm, “Heck, I understand it is not every day that you can flood a city of half a million people and see what happens.” The tragic dimensions of the event in terms of lives lost and lives disrupted must never be forgotten, but the opportunity to learn about the resiliency of social systems also must not be lost.<sup>1</sup> Natural disasters are the social scientist's

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Daniel Rothschild at the Mercatus Center has been an invaluable project manager and partner in the coordination of research since the inception of our five-year project.

<sup>1</sup> Robustness and resiliency as welfare criterion in assessing political-economic systems moves the discussion from ideal allocative efficiency within a clearly defined institutional structure to a focus on the character of the institutional structure itself. For a discussion of the implications for political economy of moving the analytical focus from ideal efficiency to the robustness of institutions and the strategy for doing so, see Levy (2002) and Boettke and Leeson (2004).

equivalent to tests done by engineers to learn about the strength of materials and machines. Much can be learned about the political economy of everyday life when we examine behavior under conditions of great stress.

John Stuart Mill, in fact, argued in his *Principles of Political Economy* that it is a surprising fact of life how robust free economies are in the wake of devastation.

This perpetual consumption and reproduction of capital affords the explanation of what has so often excited wonder, the great rapidity with which countries recover from a state of devastation; the disappearance, in a short time, of all traces of the mischiefs done by earthquakes, floods, hurricanes, and the ravages of war. An enemy lays waste a country by fire and sword, and destroys or carries away nearly all the moveable wealth existing in it; all the inhabitants are ruined, and yet, in a few years after, everything is much as it was before (Mill 1848, pp. 74–5).

Mill argued that the possibility of rapid recovery mainly depends on whether or not the country has suffered massive depopulation or not. But there are other issues involved as well as the human capital embodied in the population. The free flow of labor and capital seems to be an important aspect, as well. In addition, the ability to quickly reestablish clearly defined and enforced property rights seems to be a characteristic in common with rapid recoveries from disaster. Jack Hirshleifer (2002) in his essay “Disaster and Recovery” states clearly that: “Historical experience suggests that recovery will hinge upon the ability of government to maintain and restore property rights together with a market system that will support the economic division of labor.”

Hurricane Katrina offers us some unique challenges. First is the magnitude of the storm. Katrina was estimated early on to have caused between \$100 billion and \$125 billion worth of damage (more than half of that attributed to the New Orleans flood), whereas the costliest hurricane to that date in U.S. history was Hurricane Andrew (1993), which cost roughly \$44 billion. The massive amount of debris generated by the storm—some 100 million cubic yards, or 35 times the rubble generated by the September 11 attacks in Manhattan—made simply cleaning up the Gulf Coast a uniquely Herculean task.

Second, problems associated with the state of affairs before the storm could contribute to nonresiliency. New Orleans, for example, was not a particularly good environment for business before Katrina.<sup>2</sup> In fact, it ranked at the bottom on various measures of economic freedom and the costs of doing business. As a result, few major businesses were located in the city. Only one Fortune 500 company, Entegry, is headquartered in the city. Taxes and regulations did not attract businesses. New Orleans was instead an economy dominated by politics and political connections. There is a reason why New Orleans was often portrayed as the stereotypical corrupt southern city. Historically, New Orleans and Louisiana were in fact extremely politicized environments with numerous high-profile examples of graft and corruption.<sup>3</sup>

In addition, the population in Orleans Parish was poor and undereducated compared with national averages (e.g., median household income was roughly \$27,000, whereas the national

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<sup>2</sup> In the Pacific Research Institute’s Economic Freedom of the States Index, Louisiana ranks 40th out of 50 states in terms of economic freedom (see Huang, McCormick, and McQuillan 2004).

<sup>3</sup> According to one study published in 2004 ranking U.S. states by measures of corruption, Louisiana was ranked the third most corrupt. Mississippi was ranked the most corrupt (Corporate Crime Reporter 2004).

average was \$42,000, and roughly 28% of families in New Orleans were living below the poverty line, whereas the national rate was 12.4%). The population was particularly vulnerable to the effect of the storm because, in some areas of the parish, vehicle ownership was very low and the population was old and ill.

Finally, factors involved in the devastation of Katrina highlight how the folly of man compounds the fury of nature. Government-subsidized flood insurance led to excessive construction in areas most vulnerable to flooding. This was not just limited to the low-income areas, but also occurred in some of the higher income areas that were also devastated by the storm and do not get discussed as much in the national press. Also, government responses to the storms (and previous ones) might have impeded the commercial sector response that is necessary to reconnect the social-economic networks that are characteristic of a vibrant social system of exchange and production.

In the aftermath of Katrina, a research team was assembled by the Mercatus Center at George Mason University to study the political, economic, and social aspects of Katrina and to test Mill's hypothesis about "rapid recovery." The basic idea behind the project is that a social system of exchange and production is analogous to a three-legged barstool. The first leg represents the economic/financial institutions in place, the second leg represents the political/legal institutions in place, and the third leg represents the social/cultural institutions in place. The idea is that unless all three legs are strong and sturdy, when weight is put on the seat the stool will tumble. The system, in other words, will not be "robust" and nonrobust systems are almost by definition not particularly resilient; thus, Mill's hypothesis of speedy recovery in the wake of a crisis must be qualified.

We learned this lesson during our examinations of the difficult post-Communist transitions during the 1990s and our studies of developing economies in the early 2000s.<sup>4</sup> In short, politics, economics, and society are embedded, and social scientists studying transition and development problems are mistaken to focus on only one of the factors to the exclusion of others if they hope to provide a full understanding of the problems under investigation.<sup>5</sup> Post-Communist transition was not as simple as just getting the prices right, and solving the problem of underdevelopment is not just about getting the right institutions. Of course, getting the right market prices and establishing a rule of law are essential components to addressing these problems, but simply stating that is not the same thing as addressing that topic.<sup>6</sup> It is our conjecture that tackling the problems of transition and development cannot proceed as if the economy, polity, and society are disembodied from one another and thus that the problems are technical in nature (analogous to engineering problems). Instead, in dealing with social systems, the technical problems of economic life find

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<sup>4</sup> The Mercatus Center's "Global Prosperity Initiative" conducted a series of U.S. Agency for International Development-sponsored forums on the role of institutions in economic development analysis and sponsored field research in political economy in countries such as Romania, the Czech Republic, Botswana, China, Costa Rica, the Dominican Republic, and the Philippines. In addition, the Mercatus Center has for the past three years been leading a research project titled "Enterprise Africa," which examines private sector initiatives at poverty alleviation. See [www.mercatus.org](http://www.mercatus.org) for a discussion of these various projects as well as the work on Katrina.

<sup>5</sup> Boettke and Storr (2002) developed this thesis of the "triple embeddedness" of economy, society, and polity and demonstrated its intellectual roots in 19th and early 20th century writers (see also Boettke et al. 2005).

<sup>6</sup> See Boettke (1993, 2001) for an examination of the political economy of post-communism. Boettke (1994) provides a critique of development planning.

their solution within political and social “ecology” that cannot be ignored if progress in the behavioral and social sciences is going to be made on the questions of social change.<sup>7</sup>

The circumstances in a postdisaster situation, we conjecture, are similar to those of the problems of transition and underdevelopment. As Hirshleifer (2002) argues, “the subject of disaster and recovery can be regarded as a special case within the general problem of economic development.” We follow him in that regard, and our research project was designed to reflect that.

In what follows, we report some of our preliminary findings from the project. In section 2 we look at the political/legal dimensions of Katrina and its aftermath, with a particular focus on the Federal Emergency Management Agency (FEMA) and the difficulties of government planning for disaster recovery and rebuilding. In section 3 we discuss the social/cultural dimensions and focus on the social networks and the signals that are required for these social networks to reform after devastation. In section 4 we discuss the economic/financial dimensions and focus on how cities rebound (or not) in the wake of crises. Finally, we conclude with a discussion of what we have learned so far and where we are going with future research on this topic.

## 2. The Political/Legal Dimension

As the events of August and September 2005 unfolded along the Gulf Coast, it became evident that government failures at the local, state, and national level were compounding the situation. In the aftermath of the storm, the extent of government failures became a topic of newspapers and talk shows. The confusion of relief efforts was soon followed by reports of misappropriated funds; the Government Accountability Office now reports that the cost of fraud and abuse in rebuilding could top \$2 billion. With the Hurricane Katrina debacle raising questions about public corruption’s effect on disaster relief, corruption has once again become an important issue in American politics.<sup>8</sup> In our work, we attempt to address this issue not by analyzing the effect of corruption on disaster relief, but rather by analyzing the effect of natural disaster relief on public sector corruption (see Leeson and Sobel 2007). Consider Figure 1, which plots the raw relationship between natural disasters and public sector corruption in the United States

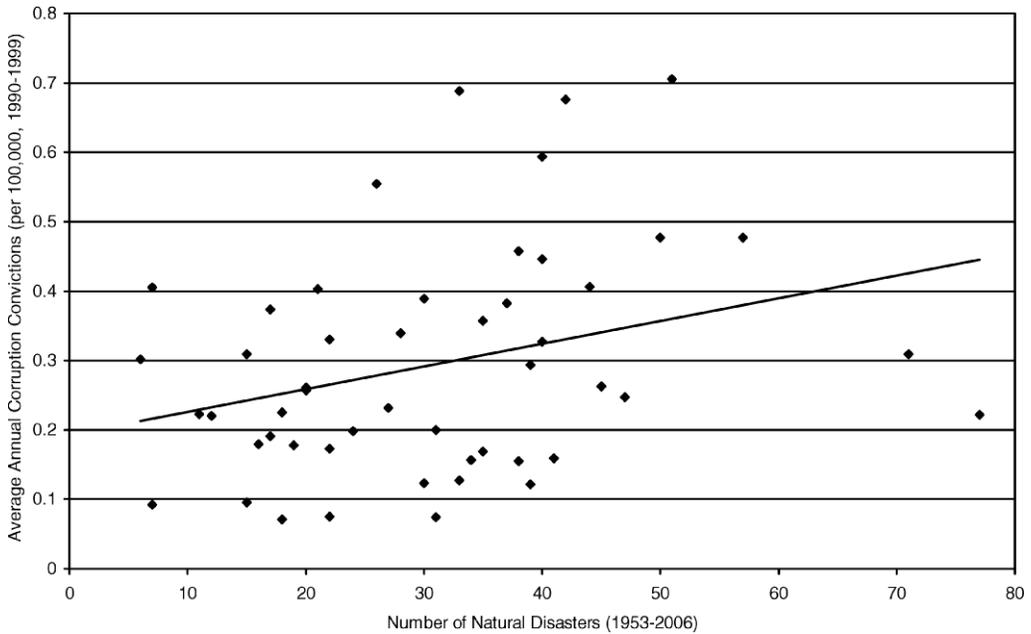
On the vertical axis, we measure average annual federal corruption convictions per 100,000 residents (1990–1999) in each of the U.S. states. On the horizontal axis, we measure the total number of natural disasters that have struck each state (1953–2006). The relationship is clearly positive. States that have been hit by more natural disasters are more corrupt.

This relationship points to an important potential connection between natural disasters and public sector corruption. Although it does not seem likely that natural disasters per se

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<sup>7</sup> This was the theme of Vernon Smith’s Nobel address titled, “Constructivist and Ecological Rationality” (see Smith 2003). As Smith argues, even with respect to the theory of choice in economics, mistakes in analysis are inevitable when the choice analysis fails to specify the context of choice and instead attempts to analyze decisions against some abstract standard of efficiency and rationality. Also see Jones (2006), where he argues that culture matters to economic outcomes, but that culture also never stops responding to market forces and is thus constantly evolving—even if stubbornly. Pejovich (2003) refers to this as the “interaction thesis” and challenges economists to deal with cultural constraints if they want to understand the transaction costs of transition.

<sup>8</sup> For a thorough understanding of corruption and its effect on political and economic life, see Wallis (2004). In this paper, Wallis examines the concept of “systemic corruption,” by which he means the political manipulation of the economy by political actors in order to secure “economic rents” that they can use to gain control of the government.



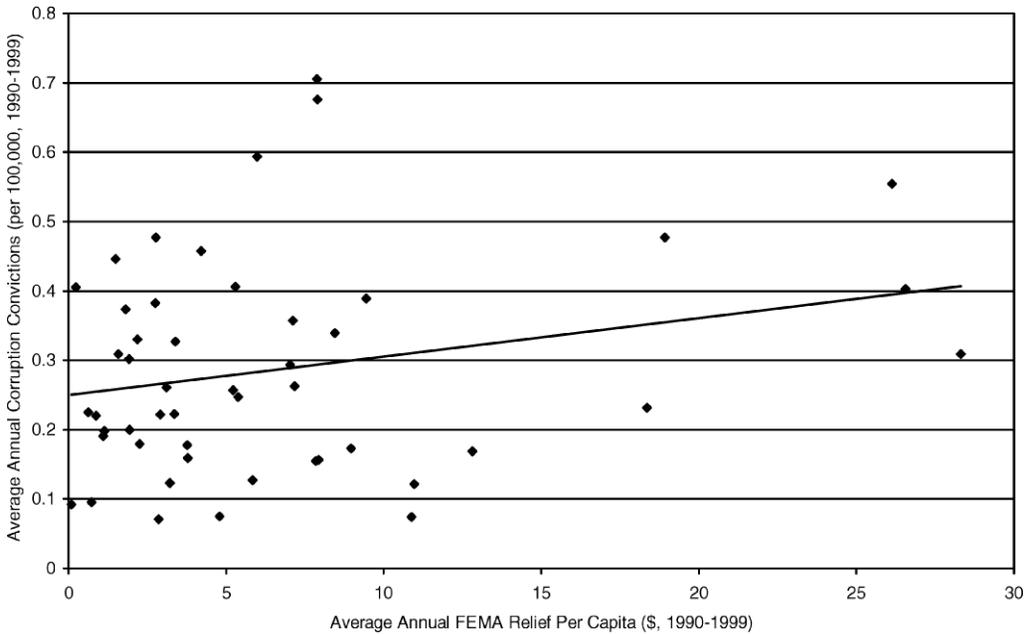
**Figure 1.** Natural Disasters and Corruption

could affect corruption, it is not unreasonable to think that the FEMA-provided relief funds that attend natural disaster could. The economic intuition here is straightforward and parallels the reasoning in the economic development literature, which suggests that rich natural resources (the “natural resource curse”) and foreign aid could appreciably increase public sector corruption in resource-rich and aid-recipient countries.

Recent research by Djankov, Montalvo, and Reynal-Querol (2005); Leite and Weidmann (1999); and Svensson (2000) demonstrates that resource windfalls generated by natural resources and foreign aid set in motion rent-seeking activities that can lead to poor economic performance and increased concentration of political power. Ades and Di Tella (1999) and Leite and Weidmann (1999) show that resource windfalls from natural resources or aid also tend to increase public corruption. Resource windfalls increase rents to those in charge of the new resources. This raises the value of controlling windfall resources, which in turn leads to a flurry of rent-seeking activities that are partly manifested in the form of greater corruption.

Natural disaster relief creates resource windfalls in essentially the same way that natural resources and foreign aid do. The president declares a natural disaster and FEMA relief flows to the affected area to aid those in need and reconstruct what the disaster destroyed, creating a windfall. This windfall creates new opportunities for political corruption.

FEMA relief is especially corrosive in terms of corruption because of the chaotic atmosphere in which it is unavoidably deployed. In the case of a major disaster, the combination of billions of dollars of relief being dumped onto one location in only a short period of time, along with the confused and difficult-to-monitor environment in which these windfalls are dispensed, create incredible temptation for public officials to abuse their positions of power by corruptly appropriating relief funds. Disaster-created conditions also make it exceedingly difficult for government, preoccupied with the havoc of the disaster itself, to effectively oversee into whose hands relief is going and whether these hands are legitimate or



**Figure 2.** FEMA Relief and Corruption

not. These factors make disaster-related windfalls especially damaging to public sector corruption.

Consider Figure 2, which explores our core hypothesis in the raw data.<sup>9</sup> The vertical axis in this figure measures average annual corruption-related convictions per 100,000 residents in the states between 1990 and 1999. The horizontal axis measures average annual FEMA-provided disaster relief in the states over the same period. As in Figure 1, the relationship here is strong and positive. States that receive more FEMA-provided disaster relief are more corrupt.

This relationship withstands the test of econometric interrogation. After controlling for the standard determinants of public corruption used in other studies, such as Glaeser and Saks (2006), as well as a number of other potentially important variables that might influence the level of corruption across the United States, including geography, political institutions, and political history, FEMA-provided disaster relief continues to produce a statistically and economically significant increase in corruption in America.

Importantly, the effect of FEMA relief on corruption, we find, is not due to reverse causality. One could imagine, for example, that more corrupt states are capable of attracting more federal (disaster-related and otherwise) funding in the first place, creating a positive relationship between corruption and FEMA relief, but one that has nothing to do with the latter leading to the former. To address this econometrically, we instrument FEMA relief with private insurance claims for natural disasters, which are the subject of political manipulation, and find FEMA relief continues to be positively linked to increased corruption.

<sup>9</sup> North Dakota did not fit on the scale and is therefore excluded from Figure 2.

Corruption not only hinders the effective management of disaster relief; it also has long-term consequences for economic prosperity. More corruption is associated with lower growth and investment, and states that receive disaster relief often suffer from these effects.

When determining the best course of action, policymakers must remember that increased corruption is an unintended consequence of disaster relief. Increased oversight is unlikely to solve the problem of corruption because of the circumstances surrounding disaster. The time-sensitive nature of the disaster relief means that protocol will take a backseat when disasters actually strike.

Policies that assume the federal government plays the primary role in disaster response are the most susceptible to corruption. Total elimination of public corruption generated by disaster relief will not be possible so long as FEMA relief exists. Any plan to reform disaster relief that intends to minimize corruption should recognize the role of local actors, such as charities and businesses, and create space for them to react in times of crisis. Policymakers should recognize the consequences of disaster relief when dealing with urgent crises to make sure that they do not hinder the long-term prosperity of a community.

The problem with disaster relief efforts is not just the incentive that public officials face in the political game (see Sobel and Leeson 2006, 2007). Even if incentives were appropriately aligned so that public officials wanted to allocate funds in the most effective way possible, they would still need to know what the most effective way to solve the problem at hand would be.

In other words, to successfully coordinate natural disaster relief, the social system must solve Hayek's "knowledge problem" at three critical information nodes: (i) identification of disaster, (ii) determination of what relief is needed and who needs which relief resources, and (iii) evaluation of ongoing relief efforts. We need to know more about the comparative ability of government and the private sector to do this. The market economy, with the incentives and information generated by private property, relative prices, and profit and loss accounting, tends to coordinate the actions of economic decision makers in a manner in which the gains from trade are realized and resources are allocated to their highest valued use. The information used in the market economy is always contextual or, as Hayek (1945, p. 521) stressed, "knowledge of particular time and place." The political process does not have access to that contextual knowledge, and actors within the political context face different incentives than those in the market. As a consequence, it should not be surprising that when relief resources are allocated politically, the resulting allocation, while "politically efficient" in the sense of maximizing the political goals of government actors, is economically inefficient. Thus, information problems are as severe for the public sector's response to natural disaster as the incentive problems discussed above. These dual obstacles, which political agents unavoidably confront when attempting to manage natural disaster relief, should give pause to arguments that would give government greater power to address the crisis of natural disaster.

### **3. The Social/Cultural Dimensions**

Since Katrina, federal, state, and local government officials have debated what form government rebuilding assistance should take. Meanwhile, private citizens in some communities have been successfully executing their own redevelopment plans without the assistance of an overarching government program. Church leaders, family members, neighbors,

nonprofit activists, and business owners have been deploying the resources found within civil and commercial society to address the devastation of the storm. We have examined the role social capital has played in the post-Katrina recovery process and, in particular, how social capital resources are being deployed to overcome the collective action problem associated with postdisaster recovery (see Chamlee-Wright 2006a). The usual assumption is that large-scale government response offers the only viable path toward successful recovery. In fact, luminaries such as Thomas Schelling have argued that Katrina proves this point. Schelling has said,

There is no market solution to New Orleans. It is essentially a problem of coordinating expectations. If we all expect each other to come back, we will. If we don't, we won't. But achieving this coordination in the circumstances of New Orleans seems impossible.... There are classes of problems that free markets simply do not deal with well. If ever there was an example, the rebuilding of New Orleans is it (Gosselin 2005).

And yet, communities such as those that surround the Mary Queen of Vietnam (MQV) Catholic Church in New Orleans East make problematic the bleak logic of the collective action problem as set out by Schelling. Despite being told by city officials that his community would not be allowed to rebuild, within weeks of the storm, Father Vien Nguyen of MQV helped to organize crews of returning residents to assist one another, particularly the elderly, in gutting and repairing homes. The early return of large numbers of residents and the quick progress they made in repairing their homes played a pivotal role in securing the return of services from the power company Entergy. Father Vien:

[I]n order to justify [and] divert power out here, we must justify that there are people here planning to receive it.... [Entergy] needed paying customers.... I gave [them] pictures that we took of our people in Mass, first Mass. First Mass was 300, second Mass was 800; third Mass we invited all the people from New Orleans, and we had more than 2000. So I had those pictures to show him. He said, 'Those I get. But now we need a list [of people who have returned].' And so we went and got what he asked. We called our people to put their names down and their addresses.... So within one week, I went back to Lafayette, we went back to his office; I said, 'Well, the city has 500 petitioners.' So, the first week of November, we had power. And we were the only people with power (pers. comm.).

The successful return of the Vietnamese-American community in New Orleans East, which represented much of the local business community, enabled the return of non-Vietnamese residents as well. Thus, the signaling effect generated by patterns of mutual assistance can help to coordinate not only the expectations among people directly involved in the exchange of services, but among unknown others as well.

Working from an extensive set of on-the-ground interviews, our research team engaged in the qualitative analysis needed to understand *how* some communities are successfully executing strategies for community rebound, even in the absence of a large-scale government redevelopment plan. We have identified four patterns by which residents and business owners are creating and leveraging social capital assets in their interactions with each other and other elements within civil society. Our analysis concludes that government disaster response and redevelopment policy should be crafted and executed in such a way that it does not unduly inhibit civil society's ability to respond.

Although the signals emanating from civil and commercial society are crucial to the recovery effort, these signals can be drowned out if public policy distorts markets and the basic rules of the social order. In another study, our social capital research team documents how government assistance and development planning efforts can unintentionally impede long-term

recovery by retarding the swift return of the social and economic systems that coordinate daily life (see Chamlee-Wright 2006b). Government provision of goods and services long after immediate needs have passed creates what one New Orleanian referred to as a “FEMA economy,” by which she means the expansive and distortion effects of federal disaster relief on the local economy, including its effects on local labor and housing markets.

Many businesses trying to reopen have found it difficult to attract employees. Certainly this is in part because many people simply haven’t returned to the affected region. But the repeated extension of unemployment benefits has exacerbated this problem. Furthermore, the premium wages government relief agencies pay low-skilled workers crowds out private employers from the labor market, stunting the speed of recovery. For service-based companies, the labor shortages are particularly daunting as they attempt to bring operations back on line. As one business owner noted, “You’re competing with FEMA, you’re competing with everybody. The contractors that are doing debris pick up and stuff, they are paying big bucks. They are paying \$12 [to \$15] an hour to stand behind a truck with a little [‘stop’] sign.”

Redevelopment planning efforts are another source of signal distortion as the basic rules of the game continue to shift under the feet of residents and business owners hoping to return. To take but one example, New Orleans is currently in its third discrete rebuilding planning process since the storm. As each new planning process and the commensurate rebuilding plan appear, residents are forced to change their decisions about how and whether to rebuild. When a previously announced plan is scrapped in favor of a new plan with different rules for rebuilding, time is lost, progress made under the now-obsolete plan is rendered useless, and residents are left wondering whether the next plan will be “the one”—or just another aberration. These multiple and varied signals that the city has sent to its residents have left people making decisions about rebuilding without any consistent knowledge of what and when policymakers will allow them to rebuild. This in turn slows the rebuilding process and delays the recovery of key commercial and civil society organizations and institutions. When governments fail to establish the rules of the game for rebuilding, or worse yet change the rules in mid-course, it becomes difficult for victims to make vital decisions and get on with their lives.

Long-term relief efforts and large-scale recovery plans tend to ignore the innate abilities of individuals, communities, and businesses to use a variety of resources and sources of information to guide their decisions about whether and how to rebuild. These decisions are not made in isolation but, rather, depend substantially on the signals sent by similarly situated people.

Recovery efforts guided by the signals that emerge from action on the ground produce faster, more robust, and more sustainable redevelopment than efforts stemming from a politically produced and centrally executed recovery plan. Moreover, large-scale redevelopment programs can overwhelm and obfuscate the signals created locally, stalling and distorting the organic recovery that is crucial to long-term sustainable development. The focus on the problem of signal noise in the postcrisis situation that emerged in our work on the social and cultural dimensions of recovery dovetails nicely with the work in our political and legal research on the “knowledge problem” that is confronted at each decision node in the public sector response to crisis.

We argue that instead of top-down procedures of planning the recovery, public policy can foster an environment that encourages sustainable, organic recovery by

- providing quick, clear, and credible commitments about what goods and services governments will provide and when;
- creating in advance alternative regulatory regimes specific to postdisaster environments; and
- avoiding policies that distort local economies and hamper civil society rebuilding.

Because policy mistakes can have serious retarding effects on postdisaster rebuilding efforts, policymakers must understand the systemic reasons why government help so often goes awry, why private citizens with a stake in the outcome are best situated to lead their own recovery, and how to craft policy responses in a way that keeps “signal noise” to a minimum.

#### 4. The Economic/Financial Dimensions

“Living cities” play a crucial role in the positive link between economic freedom and prosperity. The first work we have engaged in on the economic and financial dimensions address how commercial life can lead a devastated city back to vibrancy (Ikeda and Gordon 2006). There is no upper bound on the size of living cities, and they appear to recover effectively from disasters. Cities and their suburban hinterlands form in ways that accommodate entrepreneurial activities.<sup>10</sup> At the other end of the spectrum there are declining cities that are less likely to recover. We follow Glaeser and Gyourko (2005) in arguing that government programs that help to sustain poverty can establish a lower bound by transforming a declining city into what could be termed a “welfare city.” New Orleans has, in fact, experienced this fate and consequently was ill-prepared to recover quickly from a large-scale natural disaster.

Louisiana presents an “underperformance puzzle” because its actual economic performance ranks below what is predicted (via cross-sectional statistical models) by its low ranking on popular indices of economic freedom (e.g., Huang, McCormick, and McQuillan 2004) and the even lower ranking of the state’s actual entrepreneurial performance (Garrett and Wall 2006). In other words, although the economic policy rankings already predict a low performance, the actual economic performance is worse. We contend that this is because the statistical methodology used in the creation of the indices does not capture all of the relevant variables and does not pay sufficient attention to the central role that cities play in this nexus, both as the principal hosts of economic freedom and as engines of economic growth. The explanation of the underperformance lies in the character of Louisiana’s primary economic engine, New Orleans, as a welfare city instead of a modern living city. It does not incite innovation and growth. Rather, it persists in a declining state, mostly propped up by government programs, and it holds much of the rest of the region down with it.

For instance, a common index of economic development is the historical trend in population growth. Although we observe that at the Metropolitan Statistical Area level (New Orleans–Metairie–Bogalusa) population growth slowed dramatically between 1980 and 2000, averaging 1.5% per decade compared with an average growth rate per decade of 18.8% between 1900 and 1960 and 14.5% between 1960 and 1980, these data and rankings are revealing when placed in the context of relevant comparative trends. The U.S. Commerce Department’s

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<sup>10</sup> On the relationship between the vibrancy of cities and the wealth of nations, see Jacobs (1985).

Regional Economic Information System includes the most detailed county-level employment and population files for the United States. The South outperforms the rest of the U.S., but the Orleans Parish and the surrounding metro area perform worse. Although other areas of the South are thriving, the New Orleans area has been declining as an economic force.

However, our research team argues that with time and the right institutions in place, New Orleans can re-emerge as a living, entrepreneurial city. As a way forward, we have examined the concept of “private neighborhoods,” which enables local communities to choose the thickness of their own rules, as one such enabling institution.<sup>11</sup> At first the idea of entrusting local neighborhoods with governance powers might sound radical and unrealistic. But as Nelson (2005) points out, roughly half of all new housing built in the U.S. in the 1980s and 1990s is governed by private neighborhood associations (PNAs). He estimates that 52 million Americans live in such housing arrangements. Moreover, with respect to the New Orleans case, we have to recognize that the argument that large urban governments possess economies of scale in providing public goods is unconvincing when we consider the evidence on schooling and policing in the area before Katrina.<sup>12</sup> The *status quo* is not working on a variety of measures of economic performance and governance capabilities. Something has to change.<sup>13</sup> Not only would the establishment of PNAs devolve governance to the very local level, taking collective decision making out of the hands of a notoriously corrupt political culture, but by establishing stronger links within, and among, various surviving and newly established neighborhoods, a network of PNAs would tend to promote the emergence of networks of commercial and civic relationships that could serve as the social infrastructure that would serve New Orleans, with or without future natural disasters.

Our working hypothesis is that the region does not lack entrepreneurial spirit; what is lacking is the directing of that entrepreneurial spirit into wealth-creating activities.<sup>14</sup> That is a function of the rules in which individuals find themselves playing the economic game. Currently, the rules of the economic game are not conducive to wealth creation; rather than a living and vibrant entrepreneurial city, New Orleans is a declining city because of the regulations and taxation that raise the costs of doing business and the policies that subsidize counterproductive behaviors. Change the rules of the game and with that the structure of payoffs for different behaviors; if the rewards are greater for productive entrepreneurship than either unproductive or destructive entrepreneurship, then New Orleans can be transformed into a living city in which the commercial life is as vibrant as the cultural life we associate with the city.

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<sup>11</sup> The concept of “private neighborhoods” and how they have the power to transform local government is developed by Nelson (2005).

<sup>12</sup> In 2003, for example, the murder rate in New Orleans was eight times the national average.

<sup>13</sup> During one of our first field trips (February 2006), we spoke with a youth minister who said that before Katrina, any discussion of redevelopment would have led him to organize his youth groups to protest the unwarranted intrusion of capitalism into his community. But after Katrina, the initial reaction that New Orleans must be rebuilt to be exactly where it was before the storm caused him and his colleagues to question their previous position. To rebuild New Orleans as it was (especially the center city where he worked) would entail accepting substandard schooling, violent gangs, and drug addiction that destroyed lives. No, he argued, New Orleans needs a fresh start to give the families and youth in the city the opportunity to construct a meaningful future. He argued that “redevelopment with justice” was what was needed. It is not quite clear what all that would entail, but PNAs might be a decentralized vehicle for the needed experimentation.

<sup>14</sup> Baumol (1993) argues that entrepreneurship can be directed in productive, unproductive, and destructive directions because of different rules of the game that determine the relative payoffs of types of entrepreneurial behavior (see also Boettke and Coyne 2003).

## 5. Conclusion

The Mercatus Center project on “Crisis and Response in the Wake of Hurricane Katrina” is a five-year study that addresses the political, economic, and social aspects of the storm and its aftermath. We are exploring Mill’s hypothesis about the rapidity with which regions can come back from devastation. In so doing, we are hoping to make progress in political economy on the issues of “robustness” and “resiliency.”

The evidence to date is mixed. On one hand, we have seen the vibrancy of civil society in the wake of the crisis, the clumsiness of governmental decision making, and the great initiative of both private sector and public sector actors to get around the system to get things done during the initial period of rescue and recovery, as well as during the rebuilding phase. In his *Memoirs of an Unregulated Economist*, George Stigler (1985, p. 61) recounts a story about how he as a young man working during WWII was accused of holding the outrageous position that the price system would be the best way to allocate resources during an evacuation of New York City. As Stigler tells the story, he first clarified that he had never advocated the use of the price system to the U.S. government, but on second thought he should have. As he says, in the wake of a bombing of New York City, any system of resource allocation will be imperfect. But in the case of repeated bombings, the price system will prove to be more resilient and guide the adjustments quicker than any other system of resource allocation.

Crises of the magnitude of a bombing of New York City that require evacuation will inevitably lead to grotesquely confused situations, but “the market system’s flexibility, adaptability and resourcefulness in finding new ways to make money” will ensure that the confused situation is as orderly as it could be.

This is what underlies Mill’s hypothesis on the great rapidity of recovery after devastation. The free flow of labor and capital and the lure of profit guide this process of recovery. But if labor and capital flows are restricted or profits are outlawed, the recovery process will lag behind, and the affected area will linger in its misery. The voluntary sector, as reflected in both the market economy and civil society, possesses great resiliency, but not unlimited resiliency. Adam Smith (1776, book V, chapter 5, pp. 49–50) pointed out that,

... the natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations; though the effect of these obstructions is always more or less either to encroach upon its freedom, or to diminish its security.

As our work to date suggests, unfortunately, many of the governmental policies adopted to deal with the crisis and that guide the rebuilding effort along the Gulf Coast have had the unintended and undesirable consequence of slowing the process of recovery. It is not just a matter of “a hundred impertinent obstructions,” but an intricate network of regulations and restrictions on economic life. A behemoth bureaucracy has proven to be ineffective, whereas the pockets of nimble entrepreneurial responses by actors across the region have often been more effective in rebuilding lives, neighborhoods, and communities. Rather than creating bureaucracies to deal with crises, as a matter of public policy, there is a need for enabling entrepreneurship in the economic and social dimensions.

Our research recognizes the interaction thesis that Pejovich (2003) has argued explains the transaction costs of transitions. The economy, polity, and society are interwoven with one

another. We do not deny that for many questions we can isolate and address technical issues in economics, politics, and sociology. But when dealing with questions of social change, we contend that a thorough understanding will only come from examining the interaction and nested nature of the economy, polity, and society in addition to the technical issues. Political and legal structures determine relative payoffs for entrepreneurial behavior, and a vibrant civil society enables individuals to realize gains from trade from extended networks by allowing them to benefit from the strength of weak ties, instead of relying exclusively on the strong ties of family and friends. Social cooperation consistent with an ever-expanding division of labor requires not only a legal system that clearly defines and enforces property rights, and a political system that constrains predation, but a set of cultural beliefs and attitudes that legitimate the contractual society as opposed to the connection-based society. The ability to realize the gains from trade among strangers has been a major puzzle in political economy from the time of Adam Smith to today and is at the core of our understanding of the developmental process in economics.<sup>15</sup>

An intricate matrix of political, legal, economic, and social institutions are required for individuals to realize the full extent of the gains from trade in an economy. Olson (1996) argued that the existence or absence of this matrix explained why some nations were rich and others poor and why it was so difficult to transition from poor to rich. As we have argued, our approach to the problem of the recovery of a region in the wake of a natural disaster is to treat the problem as a subset of the broader question of underdevelopment. Mill's hypothesis about the speedy recovery of regions in the aftermath of war, famine, hurricane, fire, etc., was predicated on the existence of institutions that did not hinder the entrepreneurial spirit of enterprise and the free flow of labor and capital into the affected regions. Moreover, unproductive and destructive entrepreneurial behaviors were discouraged and not rewarded. If not, Mill's hypothesis about the rapid recovery in the wake of a crisis would be hard, if not impossible, to maintain.

Present and future research in the Mercatus project is focusing on the responses of civil society among immigrant populations in New Orleans; comparative historical research on cases in the United States and abroad on recovery after floods, earthquakes, fires, war, etc.; detailed microeconomic analysis of insurance policy and its effect on construction along the flood plain; electoral politics in the aftermath of crises; and the nature of entrepreneurial development of cities, just to name a few, are already scheduled and under way. Our goal is to learn from the natural experiment of Hurricane Katrina and specifically to learn about what constitutes a robust political economy and help to solve the problems of economic development.

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<sup>15</sup> As Smith (1776, p. 18) put it: “In civilized society he stands at all times in need of the cooperation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons.” For a modern attempt to grapple with this central mystery of modern economic life, see Seabright (2004).

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