INSTITUTIONAL COMPETITION

My assignment for this conference is to explore the relevance of "institutional competition" as a deliberate strategy in improving the competitiveness of economies. The historical record gives us a very mixed response with respect to the success of economies in deliberately altering the institutional framework and thereby improving performance. In what follows I shall first describe the nature of institutional change (I); briefly explore the historical record (II); then derive some lessons from that history that may have present day relevance (III).

I

Let me begin by stating five propositions about institutional change:

1. The continuous interaction between institutions and organizations in the economic setting of scarcity and hence competition is the key to institutional change.

2. Competition forces organizations to continually invest in skills and knowledge to survive. The kinds of skills and knowledge individuals and their organizations acquire will shape evolving perceptions about opportunities and hence choices that will incrementally alter institutions.

3. The institutional framework provides the incentives that dictate the kinds of skills and knowledge perceived to have the maximum pay-off.

4. Perceptions are derived from the mental constructs of the players.

5. The economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent.

Let me expand on each of these propsitions.

1. The study of institutions and institutional change necessitates as a first requirement the conceptual separation of institutions from organizations. Institutions are the rules of the game and organizations are the players The interaction between the two shapes institutional change.

Institutions are the constraints that human beings impose on human interaction. They consist of formal rules (constitutions, statute law, common law, regulations) and informal constraints (conventions, norms and self enforced codes of conduct) and their enforcement characteristics. Those constraints define (together with the standard constraints of economics) the opportunity set in the economy.

Organizations consist of groups of individuals bound together by some common objectives. Firms, trade unions, central banks, cooperatives are examples of economic organizations; political parties, legislatures, regulatory agencies illustrate political organizations; religious bodies, clubs are examples of social organizations. The opportunities provided by the institutional matrix determine the kinds of organizations that will come into existence; the entrepreneurs of organizations induce institutional change as they perceive new or altered opportunities. They induce it by altering the rules (directly in the case of political bodies; indirectly by economic or social organizations pressuring political organizations); or by altering, deliberately and sometimes accidentally, the kinds and effectiveness of enforcement of rules or the effectivess of sanctions and other means of informal constraint enforcement.

Informal constraints will be altered as organizations, in the course of interaction, evolve new informal means of exchange and hence develop new social norms, conventions and codes of conduct. In this process "obsolete" informal constraints will gradually wither away to be replaced by the new ones.

2. New or altered opportunities may be perceived to be a result of exogenous changes in the external environment which alter relative prices to organizations or a consequence of endogenous competition among the organizations of the polity and the economy. In either case the ubiquity of competition in the overall economic setting of scarcity induces entrepreneurs and the members of their organizations to invest in skills and knowledge. Whether it is learning by doing on the job or the acquisition of formal knowledge, the key to survival is improving the efficiency of the organization relative to that of rivals.

While idle curiosity surely is an innate source of acquiring knowledge among human beings, the rate of accumulating knowledge is clearly tied to the pay-offs. Secure monopolies, be they organizations in the polity or in the economy, simply do not have to improve to survive. But firms, political parties or even institutions of higher learning faced with rival organizations must strive to improve their efficiency. When competition is "muted" (for whatever reasons) organizations will have less incentive to invest in new knowledge and in consequence will not induce rapid institutional change. Stable institutional structures will be the result. Vigorous organizational competition will accelerate the process of institutional change.

3. There is <u>no implication</u> in proposition 2 of evolutionary progress or economic growth--only of change. The institutional matrix defines the opportunity set, be it one that makes the highest pay-offs in an economy income redistribution or one that provides the highest pay-offs to productive activity. While every economy provides a mixed set of incentives for both types of activity, the relative weights (as between redistributive and productive incentives) are crucial factors in the performance of economies. The organizations that come into existence will reflect the pay-off structure. More than that, the direction of their investment in skills and knowledge will equally reflect the underlying incentive structure. If the highest rate of return in an economy comes from piracy we can expect that the organizations will invest in skills and knowledge that will make them better pirates. Similarly if there are high returns to productive activities we will expect organizations to devote resources to investing in skill and knowledge that will increase productivity.

The immediate investment of economic organizations in vocational and on the job training will obviously depend on the perceived benefits; but an even more fundamental influence on the future of the economy is the extent to which societies will invest in formal education, schooling, the dissemination of knowledge, and both applied and pure research which will mirror the perceptions of the entrepreneurs of political and economic organizations.

4. The key to the choices that individuals make is their perceptions, which are a function of the way the mind interprets the information it receives. The mental constructs

individuals form to explain and interpret the world around them are partly a result of their cultural heritage, partly a result of the "local" everyday problems they confront and must solve, and partly a result of non-local learning. The mix among these sources in interpreting one's environment obviously varies as between for example a Papuan tribesman on the one hand and an economist in the United States on the other (although there is no implication that the latter's perceptions are independent of his or her cultural heritage).

The implication of the foregoing paragraph is that individuals from different backgrounds will interpret the same evidence differently; They may, in consequence, make different choices. If the information feedback of the consequences of choices were "complete" then individuals with the same utility function would gradually correct their perceptions and over time converge to a common equilibrium; but as Frank Hahn has succinctly put it, "There is a continuum of theories that agents can hold and act upon without ever encountering events which lead them to change their theories." (Hahn, 1987, p. 324) The result is that multiple equilibria are possible due to different choices by agents with identical tastes.

5. The viability, profitability, and indeed survival of the organizations of a society typically depend on the existing institutional matrix. That institutional structure has brought them into existence; and their complex web of interdependent contracts and other relationships have been constructed on it. Two implications follow. Institutional change is typically incremental and is path dependent.

It is incremental because large scale change would harm existing organizations and therefore is stoutly opposed by them. Revolutionary change will only occur in the case of "gridlock" among competing organizations, which thwarts their ability to capture gains from trade.

Why can't economies reverse their direction overnight? This is surely a puzzle in a world that operated as neo-classical theory would have us believe. That is, in a neo classical world abrupt, radical change should immediately result from a radical change in relative prices or performance. Now it is true that on occasion accumulated pressures do produce an abrupt change in institutions akin to the punctuated equilibrium models in evolutionary theory. But it is simply a fact that the overwhelming majority of change is incremental and gradual. We take it for granted but why do we take for granted something that is inconsistant with the theory we employ. Revolutions are extraordinary and even when they occur turn out over time to be far less revolutionary than their initial rhetoric would suggest.

Path dependence could mean nothing more than that yesterday's choices are the initial starting point for today's. But path dependence appears to be a much more fundamental determinant of long run change than that. The difficulty of fundamentally altering paths is evident and suggests that the learning process by which we arrive at today's institutions constrains future choices. The institutional structure builds in a set of constraints with respect to downstream changes that biases choices.

II

It is understanding the nature of path dependence that is the key to understanding the success or failure of economies in altering their competitive positions and there is still a great deal about path dependence that we do not understand. But it is a fact of history; one of the most enduring and significant lessons to be derived from the past. It is not that economies in the past have not been aware of their inferior or declining competitive positions. They have. But perceptions about the reasons are something else again. Spain's long decline in the seventeenth century from the most powerful nation in the western world since the Roman empire to a second rate power was a consequence of recurrent war and fiscal crises. The policies that were considered feasible in the context of the institutional constraints and perceptions of the actors were price controls, tax increases and repeated confiscations. As for the perceptions of the actors here is Jan De Vries description of the effort to reverse the decline:

> But this was not a society unaware of what was happening. A whole school of economic reformers ...wrote mountains of tracts pleading for new measures. ... Indeed in 1623 a Junta de Reformacion recommended to the new king. Philip IV, a series of measures including taxes to ecourage early marriage (and hence population growth), limitations on the number of servants, the establishment of a bank, prohibitions on the import of luxuries, the closing of brothels, and the prohibition of the teaching of Latin in small towns (to reduce the flight from agriculture of peaants who had acquired a smattering of education). But no willpower could be found to follow through on these recommendations. It is said that the only accomplishment of the reform movement was the abolition of the ruff collar, a fashion that had imposed ruinous laundry bills on the aristocracy. (De Vries, 1976, p. 28)

As the foregoing quotation makes clear there is no guarantee that economic decline will induce perceptions on the part of the actors that will lead to reversal of that decline and improving performance. We have only to look today at the evolving perceptions of those in the Russian Republic as evidenced by the recent election for a modern illustration.

What constrains the choices of the players is a belief system reflecting the past--the cultural heritage of a society--and its gradual alteration reflecting the current experiences as filtered (and therefore interpreted) by that belief system. That is, in essence, why path dependence exists.

Historical success stories of institutional adaptation can only be understood in these terms. They reflected conditions where the belief sytem underlying an institutional matrix filtered the information players got from current experiences and interpreted that information in ways that induced choices that led to the modification, alteration, or adoption of institutions that resolved existing problems or led to improvements in competitive performance.

Take the successful development of the Netherlands and England in early modern Europe. It was the lack of large scale political and economic order that created the essential environment hospitable to political/economic development. In that competitive, decentralized environment lots of alternatives were pursued as each society confronted its own unique external environment. Some worked, as in the cases of the Netherlands and England; some failed, as in the cases of Spain and Portugal; and some, such as France, fell in between these two extremes. But the key to the story is the variety of options pursued and the likelihood (as compared to a single unified policy) that some would turn out to produce political/economic development. Even the relative failures in Western Europe played an essential role in European development and were more successful than other parts of the world because of competitive pressures.

The last point deserves special emphasis. It was the dynamic consequences of the competition amongst fragmented political bodies that resulted in an especially creative environment. Europe was politically fragmented; but it was integrated in having both a common belief structure derived from Christendom, and information and transportation connections that resulted in scientific, technological, and artistic developments in one part spreading rapidly throughout Europe. To treat the Netherlands and England as success stories in isolation from the stimulus received from the rest of Europe (and to a lesser degree Islam and China) is to miss a vital part of the explanation. Italian city states, Portugal, and Germanic states all fell behind the Netherlands and England; but banking, artistic develoment, improvements in navigation, and printing were just a few of the obvious contributions that the former states made to European advancement.

The Netherlands and England pursued different paths to political/economic success but in each case the external environment was conducive to the evolution of a belief structure that induced political and economic institutions that lowered transaction costs.

In both polities competition among the evolving nation states was a deep underlying source of change and equally a constraint on the options available to rulers within states. It was competition that forced the crown to trade rights and privileges for revenue including most fundamentally the granting to representative bodies--variously Parliament, States General, Cortes--control over tax rates and/or certain privileges in return for revenue. But it was the evolving bargaining strenth of rulers vis-a-vis constituents that was the decisive feature of their subsequent development. Three considerations were at stake: 1) the size of the potential gains the constituents could realize by the state taking over protection of property; 2) the closeness of substitutes for the existing ruler--that is the ability of rivals (both within and outside the political unit) to the existing ruler to take over and provide the same, or more, services; 3) the structure of the economy which determined the benefits and costs to the ruler of various sources of revenue.

Let me briefly describe the background conditions of the two polities that led up to the contrasting external environments that shaped the belief systems.

To understand the success of the Netherlands one must cast a backward glance at the evolution of the prosperous towns of the Low Countries such as Bruges, Ghent, and Liege; their internal conflicts; and their relationship to Burgundian and Habsburg rule. The prosperity of the towns, whether based on the wool cloth trade or metals trade, early on made for an urban centered, market oriented area unique at a time of overwhelmingly rural societies. Their internal conflicts reflected ongoing tensions between patrician and crafts and persistent conflicts over ongoing efforts to create local monopolies which, when successful, led to a drying up of the very sources of productivity which had been the mainspring of their growth. Burgundian (and later Habsburg) rule discouraged restrictive practices such as those that developed in the cloth towns of Bruges and Ghent and encouraged the growth of new centers of industry that sprang up in response to the favorable incentives embodied in the rules and property rights. In 1463 Philip the Good created a representative body, the States General, which enacted laws and had the authority to vote taxes for the ruler. The Burgundians and Habsburgs were rewarded by a level of prosperity that generated tax revenues that made the low countries the jewel in the Habsburg Empire.

England evolved along a route different from that of continental polities. Being an island made it less vulnerable to conquest and eliminated the need for a standing army (and undoubtedly contributed to the different initial belief structure that Macfarlane describes). The Norman conquest, the exception to British invulnerability to external conquest, produced a more centralized feudal structure than on the continent. The political institutions,in consequence, differed in several important respects from those of the continent. There was a single parliament for the entire country; no regional estates as in France, Spain, and the Netherlands. There was also no divisions into towns, clergy, and nobility. But the more centralized feudal structure did not gainsay that the crown could not overstep the traditional liberties of the barons as the Magna Carta attests.

We can now turn to examining the evolving bargaining strength (and the three underlying determinants) of ruler versus constituent that shaped the belief structure and the path of each polity. Take the Netherlands. The productive town economies stood to gain sustantially by the political order and protection of property rights provided by the Burgundians and then by Charles V. The structure of the economy built around export trades provided the means for easy-to-collect taxes on trade but not at a level to adversely affect the comparative advantage of those export trades. The liberty to come and go, buy and sell as they saw fit led to the evolution of efficient economic markets. But when Philip II altered the "contractual agreement" the Seven Provinces became convinced that they could only prosper with independence. The resistance was initiated by the States General which in 1581 issued the Act of Abjuration of allegiance to Philip II and claimed sovereignty for the Provinces themselves. The powers of the newly independent country resided with each province (which voted as a unit) and a unanimity rule meant that the States General could only act with the unanimous approval of the Seven Provinces. Cumbersome as that process was, this political structure survived. The polity not only evolved the elements of political representation and democratic decision rules but equally supported religious toleration. The belief structure that had evolved to shape the independent polity was more pragmatic than "intellectual," a consequence of the incremental evolution of the bargaining strength of constituents and rulers.

As with the Netherlands it was England's external trade that provided an increasing share of crown revenue with taxes on wine, general merchandise and wool cloth; but it was the wool export trade that was the backbone of augmented crown revenue. Eileen Power's classic story of the wool trade (1941) describes the exchange between the three groups involved in that trade: the wool growers as represented in Parliament, the merchants of the staple, and the Crown. The merchants achieved a monopoly of the export trade and a depot in Calais, Parliament received the right to set the tax, and the crown received the revenue. Stubbs (1896, 3:599) summarized the exchange as follows: "The admission of the right of parliament to legislate, to enquire into abuses, and to share in the guidance of national policy, was practically purchased by the money granted to Edward I and Edward III..."

With the Tudors the English crown was at the zenith of its power but it never achieved the unilateral control over taxing power that the crowns of France and Spain achieved. The confiscation of monastery lands and possessions by Henry VIII alienated many peers and much of the clergy and as a consequence "Henry had need of the House of Commons and he cultivated it with sedulous care" (Elton, 1953, 4). The Stuarts inherited what the Tudors had sown and the evolving controversy between the Crown and Parliament is a well known tale. Two aspects of this controversy are noteworthy for this analysis. One was the evolving perception of the common law as the supreme law of the land--a position notably championed by Sir Edward Coke--and the other was the connection made between monopoly and a denial of liberty as embodied in the Crown grants of monopoly privileges.

England and the Netherlands represent historical success stories in which an evolving belief systems shaped by external events induced institutional evolution to provide the initial beginning of modern economic growth. But the stories do not end there. The Netherlands became an also ran in European development, England stagnated after World War II. And elsewhere Argentina, for example, one of the 10 highest income countries in the world in the early 20th century declined to third world status between 1940 and 1990. Thus while path dependence does tend to perpetuate a given direction of an economy paths do get reversed.

III

Let me draw some specific implications for institutional change from the previous two sections.

We can briefly deal with economies that have failed to develop. These are cases in which the belief system, reflecting the historical experiences of that economy, has created an institutional matrix that induces the development of organizations whose profitable opportunities predominantly favor redistributive activities. Political organizations in such cases will appear similar to those of the classic "Virginia school" of political economy in which the state is little more than a theft machine. We do not have to look very far to see instances of such polities in sub-saharan Africa or with some modification in Latin America.

The obverse, the success stories, have been briefly described in the outlines above of the Netherlands and Britain--instances where external experiences reinforced evolving belief systems in the direction of productive activities by the economic organizations. Political organizations in these cases have evolved strong informal constraints--norms of behavior--that have constrained the behavior of the political actors.

It is the two remaining cases I wish to briefly explore which are of most interest to us at this conference; the case of the NIC's and the cases of high income countries that, as in the brief conclusion on the Netherlands and Britian, loose their comeptitive edge. In both cases it is the polity and political organizations that play a decisive role.

In order to deal with these cases it is necessary to disabuse ourselves of an empty argument that reflects the ahistorical understanding of economists. The argument concerns the positive role of government in establishing the rules of the game. Did the NICs succeed in spite of governement "meddling" with the economy or was in fact government involvement crucial to development. The argument is empty because there is an implicit assumption that the rules of a "laissez faire" economy are a natural result that occured without the active participation of government and will fall into place by themselves. Not so. In the western world the evolution of the legal framework underlying efficient market economies was a long incremental process stretching from the medieval law merchant to the gradual integration of those rules into common and roman law. If the legal framework doesn't already exist or only partially exists it must be created. Moreover there is not just one set of rules that will provide the proper incentives for productive activity and finally the rules themselves must continually change to adapt to new technologies and opportunities. Rules that will provide low transaction and transformation costs in one context will be obsolete in another. Hayek's notion of collective learning is a powerful insight into the critical role of our cultural heritage embodying past "successes". It is the basis of path dependence. But collective learning embodying the wisdom derived from past experiences does not always equip us to solve future problems and indeed may prevent us from reaching solutions.

The interesting issue about the NICs is not whether they made mistakes or not--they did. Rather it is 1) what set of conditions will give the political organizations of a society the degrees of freedom to pursue radically different policies? How did they come to enjoy the relative freedom from economic interest group pressures? and 2) How can we account for the behavior of the governemnt officials whose objective function appears (largely) to have been maximizing the economy's growth rather than their own wealth? The usual answer to the first question is that the existance of an external threat (North Korea in the case of South Korea and mainland China in the case of Taiwan) was the critical factor. The usual answer to the second question is culturally derived social norms. Neither answer is completely satisfactory.

The beginning of an answer to the second case can be derived from Mancur Olson's <u>The Rise and Decline of Nations</u> (1982) but it is incomplete at best since it fails to focus on the interplay between economic and political organizations. In fact Olson fails to model the polity at all. But his emphasis on the growth of redistributive coalitions as an economy evolves is a significant contribution. But it needs to be put in the context of political economy not only to see how such coalitions will affect productivity but also to explore the prospects of altering institutions to increase competitiveness.

Successful economic growth will reflect, as described in the brief historical sketches of the Netherlands and England, productive economic organizations shaped by an institutional matrix that provides incentives to increase productivity. Political organizations will have evolved to further the goals of the economic organizations and a symbiotic relationship between the economic and political organizations will evolve. Whether or not this combination will produce the redistributive coalitions of Olson's that strangles productivity growth is much more complicated than simply a question of the stability of the society or the lack of changing boundaries or the comprehensiveness of the interest group.

A more useful starting point is the path dependent pattern that emerges from this successful evolution of political/economic organization. Path dependence in such instances has evolved a degree of mutual interdependence that is has both formal ties and informal interdependence. The question is, I believe, the following: with changes in external competititive conditions or technology which adversely affext the productivity of the economy how flexible is the political organizational structure to changing the institutional framework to improve the competitive position of the economy. To the extent that the successful evolution has bound the key political organizations to the economic organizations that must bear the brunt of the changing institutional rules the alteration is more difficult and will only occur when the costs of competitive failure reach such proportions that they weaken the influence of the econonomic organizations.

To the extent that political organizations have greater degrees of freedom from the affected economic organizations institutional reform is easier. A multiplicity of economic organizations with diverse interests for example can lead to a polity with some degrees of freedom of action.