INSTITUTIONS MATTER (revision 3/28/94)

I

Successful development policy entails an understanding of the dynamics of economic change if the policies pursued are to have the desired consequences. And a dynamic model of economic change entails as an integral part of that model analysis of the polity since it is the polity that specifies and enforces the formal rules.

While we are still some distance from having such a model the structure that is evolving in the new institutional economics, even though incomplete, suggests radically different development policies than those of either traditional development economists or orthodox neo-classical economists. Development economists have typically treated the state as either exogenous or as a benign actor in the development process. Neo-classical economists have implicitly assumed that institutions (economic as well as political) don't matter and that the static analysis embodied in allocative-efficiency models should be the guide to policy; that is "getting the prices right" by eliminating exchange and price controls. In fact the state can never be treated as an exogenous actor in development policy and getting the prices right only has the desired consequences when you already have in place a set of property rights and enforcement that will then produce the competitive conditions that will result in efficient markets.

The key to efficient markets are low costs of transacting. Transaction costs are the costs involved in measuring what is being exchanged and in enforcing agreements. Goods and services or the performance of agents have multiple valuable attributes and the ability to measure those attributes at low cost is a necessary condition for capturing the gains from trade that were the keys to Adam Smith's Wealth of Nations. But a sufficient condition requires in addition that the contracts embodying the exchange process can be enforced at low cost. Those conditions are not met in third world countries and in consequence markets either do not exist or are beset by very high costs of transacting. Because transaction costs will influence the technology employed both transaction and transformation costs will be higher in the factor and product markets of such economies.

The inability to have low cost specification of the attributes being exchanged and enforcement of agreements in economic markets is ultimately a function of the political markets of such economies because it is the polity that specifies the property rights and provides the instruments and resources to enforce constracts.

II

It is one thing to define the characteristics of efficient markets at a moment of time it is quite another to model the way markets evolve through time. To do so we must explore the interaction between institutions and organizations over time. Before going further it is essential to distinguish clearly institutions from organizations. Institutions are the rules of the game of a society or more formally are the humanly-devised constraints that structure human interaction. They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both.

Organizations, too, specify the constraints that structure human interaction inside the organization but in addition they are action groups. They are composed of groups of individuals bound by a common purpose to achieve objectives. They include political bodies (political parties, the senate, a city council, a regulatory agency); economic bodies (firms, trade unions, family farms, cooperatives); social bodies (churches, clubs, athletic associations); and educational bodies (schools, colleges, vocational training centers). Organizations in pursuit of their objectives are the primary source of institutional change. These definitions undergird five propositions that define the essential characteristics of institutional change:

1. The continuous interaction of 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 dictates 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 elaborate on these propositions. Economic change is a ubiquitous, ongoing, incremental process that is a consequence of the choices individuals and entrepreneurs of organizations are making every day. While the vast majority of these decisions are routine (Nelson and Winter, 1982) some involve altering existing "contracts" between individuals and organizations. Sometimes that recontracting can be accomplished within the existing structure of property rights and political rules; but sometimes new contracting forms require an alteration in the rules. Usually existing informal norms of behavior will guide exchanges, but sometime such norms will gradually be modified or wither away. In both instances institutions are gradually being modified. Modifications occur because individuals perceive that they could do better by restructuring exchanges (political or economic). The source of the changed perceptions may be exogenous to the economy--for instance a change in the price or quality of a competitive product in another economy that alters the perceptions of entrepreneurs in the given economy about profitable opportunities. But the fundamental source of change is learning by entrepreneurs of organizations.

While some learning is a result of idle curiosity, the rate of learning will reflect the intensity of competition amongst organizations. Competition is a ubiquitous consequence of scarcity and hence organizations in an economy will engage in learning to survive. But the degree can and does vary. If competition is muted as a result of monopoly power the incentive to learn will be reduced.

The rate of learning determines the speed of economic change, the kind of learning determines the direction of economic change. The kind of learning is a function of the expected pay-offs of different kinds of knowledge and therefore will reflect the mental models of the players and most immediately at the margin, the incentive structure embodied in the institutional matrix (which consists of the framework of interconnected institutions that together makeup the formal rules of an economy) If the institutional matrix rewards piracy (or more generally redistributive activities) more than productive activity then learning will take the form of learning to be better pirates.

Change is typically incremental, reflecting ongoing ubiquitous evolving perceptions of the entrepreneurs of organizations in the context of an institutional matrix that is characterized by network externalities, complementarities and economies of scope among the existing organizations. Moreover since the organizations owe their existence to the institutional matrix, they will be an ongoing interest group to assure the perpetuation of that institutional structure-- thus assuring path dependence. Revolutions do occur, however, when organizations with different interests emerge (typically as a result of dissatisfaction with the performance of existing organizations) and the fundamental conflict between organizations over institutional change cannot be mediated within the existing institutional framework.

III

It is one thing to describe the characteristics of economic change; it is something else to prescribe the correct medicine to improve the performance of economies. We simply don't know how to transform ailing economies into successful ones but some fundamental characteristics of institutions suggest some clues.

1. Institutions are made up of formal rules, informal norms and the enforcement characteristics of both and it is the admixture of rules, norms, and enforcement characteristics that determines economic performance. While the formal rules can be changed overnight, the informal norms change only gradually. Since it is the norms that provide the essential "legitimacy" to any set of formal rules, revolutionary change is never as revolutionary as its supporters desire and performance will be different than anticipated. More than that societies that adopt the formal rules of another society (such as Latin American countries' adoption of constitutions like that of the United States) will have very different performance characteristics than the original country because both the informal norms and the enforcement characteristics will be different. The implication is that transferring the formal political and economic rules of successful western market economies to third world and eastern European economies is not a sufficient condition for good economic performance. Privatization is not a panacea for solving poor economic performance.

2. It is polities that shape economic performance because they define and enforce the economic rules of the game. Therefore the heart of development policy must be the creation of polities that will create and enforce efficient property rights. Unfortunately, however, research in the new political economy (the new institutional economics applied to polities) has been largely focused on the United States and other developed countries. While we know a lot about the characteristics of the polities of third world countries we have very little theory about such polities. We know even less about the consequences of radically altering the institutional framework of central and eastern European societies. However, the characteristics of institutions described in the foregoing sections of this paper suggest some implications:

a. Political institutions (rules that specify the structure and decision making framework of the polity) will be stable only if they are supported by organizations with an interest in their perpetuation. Therefore an essential part of political/economic reform is the creation of such organizations. Such political organizations will have the coercive power to specify and enforce the economic rules.

b. It is essential to change both the institutions and the belief systems for successful reform since it is the mental models of the actors that will shape choices. Therefore belief systems and the way they evolve will be the ultimate determinants of the institutional matrix.

c. Evolving norms of behavior that will support and legitimize new rules is a lengthy process and in the absence of such reinforcing norms polities will tend to be unstable.

d. While economic growth can occur in the short run with autocratic regimes, long run economic growth entails the development of the rule of law and (probably) the protection of civil and political freedoms.

e. Informal constraints--norms of behavior, conventions, and codes of conduct--are a necessary (but not sufficient) condition for good economic performance. Societies with norms favorable to economic growth can sometimes prosper even with unstable or adverse political rules. The key is the degree to which there is enforcement of the adverse political rules. We know very little about the evolution of belief systems and consequent informal constraints although religions have clearly been a basic component of belief systems.

3. Understanding the interaction between changing institutions, the consequences for the welfare of the diverse groups of participants in a society, the resultant perceptions of the diverse groups, the degree of access of diverse groups to political expression, and in consequence the political repercussions of the changed institutions which will lead to subsequent institutional change requires a dynamic modeling of these changes through time. It is thinking in these dynamic terms rather than static "one shot analysis" that is essential for good policy. Until we explicitly evolve such models in the context of intimate knowledge of the (path dependent) characteristics of individual economies we will fail to achieve the desired results.

4. Path dependence means that the degrees of freedom that policy makers possess to alter the direction of economies is constrained by the institutional matrix and the belief systems of the players. Of all the implications of institutional analysis for policy this is the most important. It is essential to have an intimate knowledge of the institutional structure and the way it is evolving to understand what is possible. The implict assumption of neo-classical theory that institutions don't matter and can be ignored in policy prescription is itself a prescription for disaster.

5. It is adaptive rather than allocative efficiency which should be the guide to policy. Allocative efficiency is a static concept with a given set of institutions; the key to continuing good economic performance is a flexible institutional matrix that will adjust in the context of evolving technological and demographic changes as well as shocks to the system. It is the creation of a stable polity with complementary norms that is the essential characteristic. Successful political/economic systems have evolved such characteristics over long periods of time. The western world, for example, evolved stable political and economic institutions over hundreds of years. We know very little about how to create such systems in the short run or indeed, whether it is even possible to create them in short

periods of time. However it is doubtful if the policies that will produce allocative efficiency are always the proper medicine for ailing economies. Efficient policies that are perceived to be inequitable will engender political reactions which can stall or reverse effective reforms.