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INSTITUTIONS AND INSTITUTIONAL CHANGE IN NATIONAL ECONOMIC DEVELOPMENT

von

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It seems only mildly ironic for an American economist to address his German colleagues on institutions and institutional change in national economic development. After all, American institutionalism is a direct descendant -- through Richard T. ELY and John R. COMMONS -- of the German Historical School. As a professor at the University of Wisconsin (where both ELY and COMMONS did their most famous work), as the editor of the journal which ELY established (now entitled Land Economics), and as an economist whose conceptual approach draws much from COMMONS, I speak to you with more than casual interest in the irony. Of course I am aware that economists such as Karl KNIES, Wilhelm Georg FRIEDRICH ROSCHER, Bruno HILDEBRAND, Gustav VON SCHMOLLER, and Werner SOMBART are not much admired these days, particularly in Germany. But I am also aware that there exists an abiding interest among German economists in Volkswirtschaftslehre. This is sufficient common ground for us to explore the topic of national economic development, and to think about the role of institutions and institutional change in that process. First I must say a few words about the scope of economics.

The Scope of Economic Science

I start with the obvious need to focus on first principles, for it is precisely here that differences between "orthodox" economists and institutional economists emerge. Following Lionel ROBBINS, it would seem that most orthodox economists regard the subject as being concerned with constrained choice. Individuals and firms, facing myriad wants and limited means, allocate scarce resources so as to maximize an objective function. Most contemporary economists believe, as did Robbins, that economics is "neutral between ends." With the incorporation of mathematics and statistics into the mainstream of economic theory, formal models and hypothesis testing became the hallmark of real "science." This formalism helped contribute to the conviction that contemporary economics was more objective, more value free, and hence more "scientific" than that of early practitioners -- including, certainly, the German historicists. Finally, orthodox economists believe that efficiency is the truth rule by which all decisions should be evaluated. I have written extensively on the claimed objectivity of efficiency as a "truth rule" (BROMLEY, 1989a, 1989b, 1990).

With an emphasis on allocation and allocative efficiency, orthodox economics is at its most powerful when a number of other conditions can be regarded as exogenous. Tastes and preferences are best regarded as both exogenous and stable. The endowments that each market participant brings to the process of exchange are usually regarded as fixed. And, of course, the institutional setup of the economy is beyond "scientific" analysis. Given stable tastes and preferences, given endowments, and given

fixed institutional arrangements, maximization algorithms can be employed to great benefit. The insights derived from constrained maximization exercises are legendary and are not at issue here.

But an economist interested in larger questions, in Volkswirtschaftslehre, would find these constrained maximization exercises unduly sterile. Indeed, to me it is more interesting to consider economics as the study of how individuals and groups organize themselves for their provisioning. Resource allocation is certainly important on this broader conception of our subject. But on this more expansive notion there is seen to be more to economics than mere maximization given a number of constraints. A meaningful economics cannot limit itself to deriving the first- and second-order conditions for all manner of choice problems. Indeed, there is general agreement that the maximization algorithms of such power for the narrow Robbins-inspired concept of economics are not at all pertinent to the broader notion of economics advocated here (FIELD, 1979).

Under my broader notion of economics one is invited to undertake a study of the nature of the institutional arrangements in an economy, as well as the allocation of scarce resources within those institutional arrangements. Those institutional arrangements of interest to the economist include the conventions, rules, and entitlements that define domains of choice for economic agents. As I have argued previously:

> ... there are two levels of transactions in a society. The first is concerned with negotiations and bargains over the structure of choice sets. It is here that transactions (Ordnungspolitik) take place over the "rules of the game." The second level of transactions, more familiar, concerns market transactions from within choice sets (BROMLEY, 1989a, p. 237).

I refer to the first kind of decisions as institutional transactions, and to the second kind of decisions as commodity transactions. The institutional transactions can be over rules, or they can be over entitlements such as property rights. DAHLMAN observes:

> In the process of defining property rights, the economic system must make two interrelated decisions ... The first is to decide on the distribution of wealth; who shall have the rights to ownership of the scarce economic resources even before, as it were, trading and contracting begin. The second refers to the allocative function of property rights; they confer incentives on the decision makers within the economic system ... one set of decisions must be treated as endogenous for the system, and constitute the exogenous conditions for each trading agent in the resulting set of trades; the second set of decisions is made in the context of the making of these trades (DAHLMAN, 1980, p. 85).

So we are concerned, in institutional economics, with the transactions that are endogenous to the economic system, yet exogenous to any economic agent within that system. Those enamored with constrained maximization algorithms, or those who believe that efficiency analysis is both necessary and sufficient to insure objectivity in science, will avoid analysis of the endogenous dimension. They will, instead, show much more interest in maximizing models which take institutions, preferences, and endowments as exogenous.

This partial approach to economics is clearly inappropriate when the subject of interest is one of national economic development. On the contrary, my conception of economics -- how individuals and groups choose to organize themselves for their provisioning -- is precisely concerned with national economic development. Imagine, if you can, a serious discussion about national economic development in which the economist must avoid consideration of: (1) changing tastes and preferences; (2) changing endowments; and (3) changing institutional arrangements. Indeed, national economic development in the absence of change in tastes and preferences, in the ab-

sence of change in endowments, and in the absence of changes in institutional arrangements is a logical contradiction. To a certain extent then, orthodox economics, by virtue of its methodological preoccupation with constrained choice, is badly suited to a serious discussion of national economic development.

We see this reflected in the fact that most economists address economic development through growth models. There, in the neo-classical version, factor and product prices respond to scarcity so that the economy tends toward full employment equilibrium. In the Keynesian variant, prices are less flexible and hence equilibria are possible in which unemployment persists, and all markets do not clear.

However, national economic development is a process in which institutional arrangements -- the rules of the economy -- are the conscious variables of choice. Choices with respect to rules are driven by a collective determination of the performance indicators deemed appropriate for the society under study. For instance, performance indicators may include such issues as: (1) relative income shares among various sectors of the population; (2) the sources of income arising from different property rights arrangements over different natural resources such as land and water; (3) the rate of growth of per capita income; and (4) various "quality of life" indicators of special importance.

While it is difficult for economists to admit any special competence in advising on the choice of institutional arrangements, the institutional setup is the very foundation of an economy and so it follows that economists -- if they wish to say anything meaningful about economic development -- cannot fail to address this important issue.

Economic Science and Economic Development

I have suggested that conventional economics has a tendency to model economic development as if fully articulated markets already exist. Under this assumption, the problem is taken to be one of simply reallocating factors of production to their most advantageous use. Here, the economist is, in fact, modeling economic growth, with development being regarded as some unspecified result of prior "growth." For instance, as incomes rise, as primary schooling rates increase, as infant mortality falls, and as diets improve, the economist would conclude that "development" has occurred.

By way of contrast, I regard economic development to be a far more comprehensive undertaking -- one in which a wide range of structural aspect of the economy are purposefully modified at the outset. In my approach, one starts out with explicit institutional change -- getting the rules right. Here, development is a conscious act that causes economic growth as well as future economic development. Notice that development is a causal factor rather than being a final product of a process of economic growth. I referred above to getting the rules right. The rules are institutional arrangements, and institutions are:

> ... sets of rights and obligations affecting people in their economic lives. Some of these rights and obligations are unconditional and do not depend on any contract (other than the fictitious 'social contract').... Others are acquired voluntarily, by entering into contracts. Some contracts are explicit, others are implicit in conventions recognized by both parties. Contracts may relate to the exchange of goods or services or money or authority in varying proportions. A system of institutions can thus be described more or less equivalently ... as the set of rights and obligations in force; or in the parlance of sociology and social anthropology, as a role-system or status-system; or in the parlance of economics as defining: (i) what markets exist, taking market in the broad-

> est sense, to include all voluntary exchange; and (ii) how economic relations are regulated in areas where markets do not exist (Matthews 1986, p. 905).

The concept of an institution encompasses two related dimensions. The first of these reflects a regularity in human behavior based on shared preferences and shared expectations of the actions of others, while the second is based on a socially sanctioned and enforced set of expectations of the actions of others. That is, institutions are capable of being demarcated into two classes: (1) conventions; and (2) entitlements. A convention is a regularity in human behavior that brings order and predictability to human relationships. An entitlement is a socially recognized and sanctioned set of expectations in a society with regard to de jure or de facto legal relations that define the opportunity sets of individuals with respect to the opportunity sets of others (BROMLEY, 1989a). Institutions permit us to carry on our daily lives with a minimum of repetitive and costly negotiation. Institutions reduce transaction costs.

John R. COMMONS defined an institution as: "... collective action in restraint, liberation, and expansion of individual action (Commons, 1990, p. 73)." To Commons, institutions were the "working rules of going concerns." Such working rules indicate what:

> ... individuals must or must not do (a duty), what they may do without interference from other individuals (privilege), what they can do with the aid of collective power (right), and what they cannot expect the collective power to do in their behalf (incapacity or exposure). (COMMONS, 1968, p. 6).

It is through the establishment of institutions that societies create markets. Indeed, markets can only exist within a legal system that has consciously set out to create ordered domains of exchange. A market is a process whereby control over future income streams is transferred among participants. Markets are concerned with changes in ownership and control of future streams of benefits and costs. The essence of a market is the exchange of both information and ownership with an eye to the future. Markets are arenas of information about the terms of trade, about future expectations, and about future control over income streams. A market without rules about transactions is a contradiction in terms.

Realistic notions of markets, therefore, require that we imagine the existence of a large number of buyers and sellers separated across time and space, all acting to exchange items which, upon completion, will leave both parties better off. Such notions of exchange require a legal environment in which willing buyers and sellers can negotiate trades. The requirements of any market are therefore, at minimum, ownership of the things to be exchanged, and information about exchange opportunities. The essence of the legal foundations of an economy is to provide a predictable structure within which exchange activity can flourish. This legal foundation is required whether the economy is organized along lines that give the government a dominant role, or whether it is organized so that the private sector is the dominant active agent.

The difficulty comes when we realize that no economic system, whether market oriented or command oriented, can thrive if locked into an inflexible structure that does not recognize the exigencies of new technology, new scarcities, or new preferences on the part of buyers. Indeed, this flexibility is said to represent one of the main benefits of market processes as opposed to command processes. It is, however, a fallacy to attribute this flexibility to the existence of markets rather than to the real cause, which is a legal environment that recognizes new opportunities, and that functions to capitalize on those opportunities. Markets do not cause adaptation to new conditions but rather allow responses to those situations as permitted by the legal foundations of the economy.

The social problem is, therefore, to craft a legal structure that offers both predictability yet flexibility; a structure that establishes order, yet allows for change. We are concerned, therefore, with rules about transaction as well as with rules for changing rules

about transactions. It is important to understand that predictability of institutional arrangements is not the same thing as inflexibility.

In the transactions that are here referred to as institutional transactions we encounter the domain in which the institutional preconditions of the market are determined. That is, we encounter the domain in which the institutional preconditions of exchange are determined -- with markets being but one special arena of exchange. The obvious interest here in institutional transactions is found in the fact that institutional change to encourage greater market activity in the developing countries will occur at the level of conventions and entitlements. That is, the status quo structure of rights and duties which defines current economic (commodity) transactions will be modified through institutional transactions to bring about a different structure of entitlements. This brings us, then, to a need to explore the role of the state in national economic development.

The Role of the State

In summarizing his long experiences in economic development work, Peter BAUER that:

> This historical experience ... was not the result of conscription of people or the forced mobilization of their resources ... Nor was it the result of forced modernization of attitudes and behavior, of large-scale state-sponsored industrialization ... it was not brought about by the achievement of political independence, by the inculcation in the minds of the local people of the notion of national identity, by the stirring-up of mass enthusiasm for the abstract notion of economic development, or by any other form of political or cultural revolution. It was not the result of conscious efforts at nation building ... or of the adoption by governments of economic development as a formal policy goal or commitment. What happened was in very large measure the result of the individual voluntary responses of millions of people to emerging or expanding opportunities created largely by external contacts and brought to their notice in a variety of ways, primarily through the operation of the market. These developments were made possible by firm but limited government, without large expenditures of public funds and without the receipt of large external subventions (BAUER, 1991, pp. 190-91).

BAUER's observations on development experiences in the tropics raise a fundamental question about the role of the state. I suggest that the function of the state is: (1) to establish an institutional structure (a collective good) that will encourage industry on the part of atomistic economic agents; and (2) to create the means and opportunities for that institutional structure to be modified through time as social and economic conditions warrant. Social efficiency is determined by the extent to which institutional arrangements can be fashioned to preclude equilibria at inefficient outcomes. We know from game theory that the isolation problem (the classic prisoner's dilemma) results in stable outcomes at Pareto inefficient points. What is missing in the isolation problem is the institutional structure external to the group that creates the conditions whereby binding agreements might be established and enforced. It is these binding agreements that convert an isolation problem into a coordination game that we know as an assurance problem. In coordination games the equilibrium point (or points) are Pareto efficient (BROMLEY, 1989a).

Agricultural development and economic change is promoted to the extent that the state can foster institutional arrangements that will establish a coordination problem among its separate citizens acting as independent economic agents. We know that rural or urban elites can have an inordinate influence on the design of both the particu-

lar institutional structure chosen, but also on the transfer mechanisms that give rise to information, as well as to benefits and costs.

To think of the state as an authority system may serve to remind us that there must be a coercive force in any social setting. By "coercive force" I do not mean this in a political sense of repression or totalitarianism. I mean that entitlements -- rights and duties -- cannot exist, indeed they have no meaning, in the absence of an enforcement structure to which one can turn to have their claim given protection. We must recognize that the nation-state is an authority system whose purpose is to give meaning to all transactions. When one has rights it means that the state will come to your defense in a dispute with others. To have clear contractual rights in exchange means that the state stands ready to enforce agreements surrounding that exchange. In this way the state is a party to every transaction.

Getting Prices Right Through Getting Rules Right

> Exchange, the most obvious manifestation of the network of relationships, reflects the internal organization of society, but it is the result of the organization of production rather than its cause (COQUERY-VIDROVITCH, 1985, p. 99).

Interestingly enough, the development community has discovered the legal foundations of exchange through an interest in structural adjustment policies. The preoccupation with "getting prices right" leads, logically, to the problem of "getting the rules right." There are two aspects to the problem of getting the rules right. One dimension of rules in a market economy is that concerned with the agency problem. Agency problems are concerned with incentive alignment within firms (between owners and employees) in order that the firm may reach its objective(s) efficiently. Agency problems are concerned, as well, with incentive alignment between policy decisions at the national level and the behavior of atomistic agents within the national economy -- whether those agents are firms or consumers. In this domain, the "right" rules insure that firms are efficient, and that the total economy is also efficient in attaining the policy objectives. Welfare economics is concerned, to a certain degree, with these two agency problems when it addresses productive efficiency, and when it addresses what we call top-level efficiency.

There is, however, another critical aspect to getting the rules right of greater interest to me here. The straightforward analytics of welfare economics assume that all transactions are (nearly) costless. In fact, we know that certain transactions in a market economy are very costly in terms of: (1) the costs of gaining information about transacting opportunities; (2) the costs of formalizing contracts; and (3) the costs of enforcing contracts that have been struck. Viable market economies require rules in this second domain as well, for it is these rules that hold down the transaction costs of market processes. An economy with vague and misunderstood property rights, with no contract law, and with no uniform commercial code, is an economy with very high transaction costs. It is not enough to get one set of rules "right" if the absence of the second set of rules keep transaction costs high.

We might think of rules in the first domain as rules of transactions which provide "correct" incentives. In the second domain we might regard these as rules about transactions which allow the "correct" incentives to provide decisive signals to atomistic agents. Inadequate rules about transactions result in very high transaction costs. Eliminating the explicit role of government as a producer, as a buyer, and/or as a seller will have minimal impact on overall economic performance in the developing world as long as high transaction costs prevent independent entrepreneurs from stepping in to replace the state. Additionally, improved technical inputs in the absence of

an improved contractual infrastructure will mean that the new income streams derived from these inputs will be concentrated in the hands of a few. In the absence of accompanying institutional arrangements necessary to economic development these new income streams will not work their way through the economy to induce other changes and improvements (BROMLEY and CHAVAS, 1989).

The allocation of economic resources, and the exchange of goods among individuals, can take place within an informal framework (e.g. family and friends), or within a more formal framework (the "market") (BEN-PORATH, 1980). In either case it is necessary that implicit or explicit contracts exist: these contracts are the rules about transactions. Rules about transactions comprise what I call the legal foundations of exchange. Exchange in any economy is the essence of a contractual arrangement, and it is contracting over the future that gives vibrance to an economy. Both parties to a transaction exchange ownership of a future stream of benefits promised by the respective objects of exchange -- money and the commodity in question. This is a contract precisely because specific performance is implied.

The legal foundations of exchange concern the fundamental problem of securing contractual behavior such that individual transactors need not undertake the task of enforcing their own exchange -- enforcing their own contracts. This is what we mean by private ordering. Private ordering becomes necessary when the legal foundations of exchange are absent. When the legal foundations of exchange are missing or underdeveloped, the rules about transactions are deficient. In an economy without the necessary legal foundations, where private resources are necessarily devoted to the task of collecting information about contracting possibilities, to the task of arranging specific contracts, and to the task of enforcing contracts, market opportunities are artificially attenuated. When market opportunities are attenuated, economic development is inhibited (BROMLEY and CHAVAS, 1989).

Markets function not because of the absence of law, but only with the explicit presence of law. Markets are "efficient" only when the legal foundations exist to hold down the costs of transacting across time and space. The lessons of eastern Europe and the Soviet Union -- indeed the experience in your own country over the past year -- are instructive in this regard. To those who imagine that markets will automatically appear if only government would get out of the way, recent difficulties must come as a surprise.

The lessons of American economic growth are dominated by the instrumental use of the law to encourage enterprise -- whether the land acts, the creation of new mining law, or the writing of a new water law to fit new ecological and economic conditions in the arid western part of the nation (HORWITZ, 1977; HURST, 1956, 1982). Economic development requires the instrumental use of the law -- contract law, property law, bankruptcy law, administrative law, and tort law. The disappointing results we observe in eastern Europe -- and in much of the tropics -- are the logical outcome of societies that lack the legal foundations of exchange. It is not enough to legitimize private property rights. The economy must possess a meaningful set of institutions about transactions, as well as a coherent set of institutions of transactions.

Conclusions

I have made several points here. First, the economy is a set of ordered relations that indicate arenas of choice for atomistic economic agents. Second, the arenas of choice given by the set of ordered relations are defined by -- determined by -- convention, habit, and by rules and entitlements represented by the legal system. Exchange cannot exist without a structure of elaborate rules about transactions. Third, rules in the absence of an authority system to give meaning to those rules are not rules at all but

mere suggestions. Many developing nations have yet to constitute themselves as meaningful authority systems with respect to the economy as a set of ordered relations. They may be "authority systems" in one unhappy sense of that word, but the coercive powers of the state are not yet constructively applied to the economy as a going concern. My fourth point was that a viable economy is one in which the set of ordered relations provide predictability without rigidity, and flexibility without chaos. To say that the economy is a set of ordered relations is not to imply a dirigiste approach at all. But economics and the economy are about futurity, and a system in which the future is not only unknown but unpredictable is an economy with no hope. When I say "unpredictable" I do not mean that one can predict with perfection. I have rather more modest ideas in mind about prediction. But the essential problem in any economy is to provide a climate for independent actions with intertemporal implications. Chaos is the antithesis of this condition.

The final point to be established here is that the problem of development economics is not one of getting prices rights. Rather, the problem is to get the rules right. Prices are mere artifacts of the momentary convergence of technology, ecology, human needs or wants, disposable income, and the institutional arrangements -- the rules -- that indicate who can exchange what with whom, and how much it will cost.

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