

ON THE SURVIVAL OF IMPERFECT INSTITUTIONS

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Abstract

When social structures are stable and social systems yield expected and desirable results, there is relatively less demand for institutional economics than during times of change. Surge of interest in institutional analysis usually comes during times when countries contemplate basic reform. The 1980s and early 1990s were such a period. NIE offered a fresh way of thinking about economic organization and its broader social context and immediately caught the attention of reformers. Yet the original contributions rarely dealt explicitly with institutional policy. This paper is concerned with the lessons of NIE for major reform or institutional policy. I particularly emphasize opportunities and limits for reform that reflect the knowledge problem as well as political and social responses to reform. Social science has not developed a comprehensive theory of social systems; rather we have accumulated bits of useful insights, often without explicitly knowing in what circumstances the insights apply. The main purpose of this paper is to discuss the lessons of modern institutional theory for institutional reform.

Keywords: *Institutional Reform, Social Technologies, Knowledge Problem, Political and Social Reaction.*

JEL Classification: *D23, H1.*

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I. Introduction

The new institutional economics, which came of age in the late 1980s, offers a fresh way of thinking about economic organization and its broader social context. Facing profound problems of economic transition in the former soviet economies, in the Third World, and in many industrial economies it is not surprising that the new field immediately caught the attention of reformers. Yet paradoxically the original contributions of the new institutional economics, NIE, rarely dealt explicitly with institutional policy. This paper is concerned with the lessons of NIE for major reform or institutional policy, in particular with limits to structural reform. These limits or constraints reflect what I refer to as the *knowledge problem*, as well as political and social barriers. Social and political forces usually limit the scope of feasible reform measures, and incomplete knowledge implies that the eventual impact of institutional policy on social organizations and outcomes is often unanticipated. For analyzing these issues, I rely on basic theoretical tools of the new institutional economics but with some adjustments with an eye on policy questions (North, 1990; Williamson, 1985; Eggertsson, 1990; Furubotn and Richter, 1997; Libecap, 1989). In particular I emphasize the concept of “social technologies” (Eggertsson, 2005). Production technologies and social technologies are necessary complements in economic activity: technological changes and economic growth depend on both types of technologies. Social technologies describe how social institutions create particular social environments and outcomes. Countries often attempt to import social technologies through institutional transplants but such attempts frequently fail because of imperfect knowledge about the properties of bundles of institutions.

For analyzing economic growth neoclassical economics has (at least until recently) ignored social and political forces, taken social technologies, as well as many formal and informal institutions of market economies, as given, and focused on production technologies and capital (including human capital) accumulation. Attempts to explain changes in production technologies (endogenous growth theory) have had limited success (Eggertsson, 2005, Chapter 1). Political economy has introduced political forces, and many recent NIE studies recognize the role of social norms (Sturzenegger and Tommasi, 1998; Hechter and Opp, 2001). My main point here is that new technologies of production, even when freely available (which they often are, being a public good), are ineffective unless backed by appropriate social technologies and corresponding institutional environments. A country with technologically backward industries promotes economic growth by importing (or inventing) new production technologies and by introducing complimentary and compatible social technologies, which involves creating new institutions or remedying existing ones. To conduct institutional policy the authorities rely on various policy instruments (Eggertsson, 2005, Chapter 8). The most common of these instruments are laws, regulations and formal enforcement mechanisms although the authorities also attempt to influence social beliefs and values (social models). Institutional policy, except for marginal adjustments, is a knowledge-intensive activity compared with policy aimed at *operating* established social systems.¹

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II. Social Equilibrium, History, and Limits to Reform

When politicians, their advisers and others conclude that particular social institutions are ‘imperfect’ and advocate reform, it often turns out that they have few degrees of freedom. Tight limits to reform follow directly from the modern interpretation of social institutions as equilibrium outcomes in games involving decision makers who maximize their utility functions and have economic, political and social interests. In other words, if we extend the assumption of rational, goal-oriented behavior beyond the market arena to all social spheres, the structure of the social and economic system becomes endogenous. When a social system is in equilibrium, the usual assumption of the rational-choice political economy literature leaves zero degrees of freedom for institutional reform. This notion is sometimes referred to as the *Determinacy or Bhagwati Paradox* (Bhagwati, 1978).

The view presented above is too pessimistic. It is inappropriate fully to endorse the Determinacy Paradox, for reasons that I will discuss. We must reject, however, the common argument that economists have a duty to make ‘sound’ economic judgments and leave political considerations to others. Dixit (1996, p. 150) correctly points out that the argument “...appears to assume that economic and political aspects are additively separable in their effects –that one can analyze each separately and then find the total effect by adding together the two calculations”.

Usually the formulation and implementation of institutional policy is in the hands of government leaders and their agents. Political leaders have various reasons to avoid institutional reform and tolerate institutions that produce poor economic results. Poor economics make good politics when one or more of the following conditions are present:

- (1) the political leaders (and their supporters) fear that reforms will undermine their personal wealth or power;
- (2) the leaders lack authority to introduce the necessary measures;
- (3) the executive does not possess necessary policy instruments (e.g. to disseminate efficient social norms) and are technically unable to create appropriate institutions;
- (4) the leaders follow theories and beliefs that misrepresent the links between institutions and economic outcomes.

Various forces that upset prevailing social equilibria can open windows for reform. These forces may change the political power balance or involve external developments that make the *status quo* untenable. Cognitive developments can also create openings for reform. Influential actors sometimes revise their previous beliefs about the nature of social technologies and about appropriate policy instruments, even without changing their long-term goals. The willingness to test new ideas about social structures is often found in uncertain times when the old system appears (rightly or wrongly) to be failing. Below I focus on the role of cognitive developments in institutional reform, particularly changing beliefs about social technologies.

The discovery of new social technologies or better understanding of social organization can have a similar role for economic progress as scientific discoveries have. New social technology has a role in economic progress similar to discoveries in the natural sciences. New technology is sometimes deliberately sought, developed, and purposely implemented, which, for instance, has been the case of *individual transferable quotas* that several countries now use for minimizing the cost of reducing air pollution or managing ocean fisheries (Eggertsson, 2005, pp. 191-202). The fine details of such systems, however, usually emerge via learning from feed-backs when the systems are implemented. In other instances, new social technologies spontaneously emerge rather and are not deliberately invented by actors aiming for specific goals.

Weingast (1995) argues that during the last 300 years 'market-preserving federalism' has characterized the growth leader in each period: the Dutch Republic, England, and the United States. Furthermore, Weingast has made the case that impure initial versions of market-preserving federalism probably are on the verge of turning China, India and Mexico into emerging economic giants.

The theory of market-preserving federalism is a good example of what I refer to as a 'social technology'. The social technology in question involves a grand (subjective) image of the links between social institutions and economic development. The theory builds on Tiebout's (1956) well-known model whereby dissatisfied actors "vote with their feet" and leave their local communities. Weingast's (1995) market-preserving constitution combines an unrestricted federal market for inputs and outputs; local self-financing and local control of economic organization; effective local financial responsibility (no bailouts by the national government); and credible commitment by all units of the federation to preserving the system and its constitutional arrangements. In such a setting, competition among lower governments for inputs and tax revenues compels the authorities in each unit to provide a growth-friendly environment for producers.

Weingast's market-preserving federalism is a (subjective) social theory or model, a vision of a specific social technology: a view of the relationship between particular social institutions and economic outcomes. As far as I know, in many or most cases market-preserving federalism emerged without the key players being fully aware of the economic properties of this social technology—they did not purposefully plan a new economic system with the aid of clear-cut policy models.² Consider England during the Industrial Revolution. At the time, England *de jure* was not a federal state; *de facto*, however, it met the conditions of market-preserving federalism. Entrepreneurs of the Industrial Revolution in England did not find a friendly home in London and the southern regions but had the choice of starting up in Northern England (Weingast, 1995). Once people believe, however, that they have discovered a new social technology they may attempt to implement it.

In sum, contrary to the *Determinacy Paradox* opportunities to reform *do* arise, usually in response to changes in the environment, new political balance, and cognitive developments. But the window of opportunity seldom is wide open and the future is uncertain. New social structures sometimes evolve in an unplanned manner, going through either vicious or virtuous cycles, and 'history matters'. Because

social systems have evolved along different paths, outwardly similar systems may respond differently to comparable stimuli. Social scientists have tried to formalize such path dependence using game-theoretic models that show how pre-existing structures constrain choice and narrow possible outcomes down to one. The heterogeneity of the past makes it difficult for social scientists to formulate a general theory of institutional change, although they often are able to explain specific situations, especially *ex post*. Winiecki (1990), for instance, provides a convincing hypothesis why for some 35 years repeated attempts by soviet leaders to reform the economies of the Soviet Union and its European satellites did failed. Winiecki claims that success in reforming soviet-type economies crucially depended on how the proposed measures affected the fortunes of mid-level government agents, who actually would carry out the reforms. He shows that the measures typically involved using decentralized mechanisms, such as prices, to relieve mid-level managers of their duties and permanently lower their socio-economic status, which gave the managers powerful incentives to sabotage the reforms. The reform experience of China is another story. Although modern China had also built a centrally managed economy, its institutional structure differed in various crucial ways from that of the former Soviet Union. Qian (2002) explains how Chinese institutions and historical developments had created incentives among mid-level and local government agents to *press for reform*, demanding decentralization of economic authority to the lower levels. Qian (2002) shows how in China the various reform measures did not create critically placed losers at any level in the system, which enabled the authorities to reform their centrally managed system and prevent its collapse.

Recently the economic performance in most countries of sub-Saharan Africa has been tragically poor. The region's political history is often used to explain economic stagnation and decline in the area. National borders, usually artificially drawn in the 19th century by European colonial powers, typically engulf an arbitrary collection of ethno-linguistic groups that previously had not formed an organized political entity (Easterly and Levine, 1997). In Africa, reform attempts often challenge the wealth and status of sub-national groups, who then oppose the measures. The colonial rulers usually gave special authority to traditional leaders, such as the paramount chiefs, who represented the foreign authority under colonial 'indirect rule'. In the years following independence, these traditional centers of power have often opposed modernization. Moreover, the experience with colonialism created in many newly independent African countries mistrust of the West and its ways, usually making them reluctant to borrow western knowledge and use western advisers. Finally, the farm sector in these primarily agricultural countries often became the target of destructive exploitation by the state, creating powerful disincentives for producers in the key sector of the economy (Bates, 1990).

Thanks to a chain of historical coincidences none of the usual explanations of Africa's growth tragedy applies to Botswana. In Botswana traditional leaders were relatively weak when Britain left; the country is relatively homogenous ethnically and linguistically; the traditional rural-urban split was absent, and agricultural interests were a dominant force in the winning coalition; and the rulers had no hesitation using

European advisers and western forms of organization. All these factors, with their historical roots, created a relatively frictionless environment for growth in Botswana. In the last third of the 20th century, the country enjoyed the world's highest per-capita growth rate (over 7 percent real growth per annum), which is yet another demonstration of the long shadow of history.

III. The Problem with Transplants

The diffusion of modern production methods from one country to another is a well-known phenomenon but a comparable spreading of legal rules has also taken place but with less success. In our vocabulary, the transfer of legal rules (usually) is an effort by some party to copy and paste social technologies and corresponding patterns of behavior between countries. There are several reasons why legal transplants are attempted. Sometimes new laws are introduced in a country through military conquest or colonialism; in other instances a government imports a new legal code to meet genuine demands for a new social technology. Governments also introduce new legal systems believing that new legal rules will create demand for change. New laws create new patterns of behavior only if relevant actors respond by changing their strategies. The actors change their strategies only if it is worth their while: if they are better off following the new rules. In part, the decision to recognize a new legal system depends on whether the government has invested sufficient economic resources in the new system. In other words, the effectiveness of a legal system depends on both cognitive and material factors, the latter involving education of judges and lawyers, recording systems, courts and enforcement organizations. We can say, therefore, that "the production of legality" requires not only sufficient demand for the product but also the product must be acceptable quality, which requires satisfactory inputs, plant, equipment, and marketing services. To conclude the paper, I discuss the difficulties involved in using legal transplants as policy instruments for improving economic performance.

Private citizens oppose new laws (at least) for three reasons. The new rules may adversely affect their material interests or conflict with valued cultural rules. Thirdly people may refuse to believe that the rules are likely to have the effect intended or claimed by the authorities. In many cases the response reflects all three modes. Even when purposeful opposition is weak, problems may arise because the transition to a new equilibrium for a whole nation involves learning and complex coordination of changing individual expectations. The adjustment of a whole community to a new social equilibrium is comparable to interactive adjustments in a complex game with multiple potential equilibria, whereas the adaptation by a single individual to a new community is similar to adjustments by households and firms to fixed parameters in a competitive market—where the task of coordination is relatively simple. Moreover, an individual who moves to a new society and brings with her a set of valued norms that are unknown and *highly dysfunctional* in the new setting probably will gradually come to ignore the old norms if the cost of compliance is transparently high.

Thorough understanding of successes and failures of legal transplants, which are prime instances of international diffusion of social technologies, would greatly aid our understanding of social and cognitive barriers to economic progress. The literature is in fair agreement that we still lack a robust theory for explaining why legal transplants succeed or fail. The law and economics literature, for instance, provides valuable insights into the economic effects of modifying various aspects of modern legal systems, but the analysis usually refers to marginal adjustments within a stable system. Less is known about conditions for success when foreign legal systems, or major parts thereof, are planted in countries with traditional or dysfunctional systems.

Consider attempts at judicial reform – measures to strengthen the judicial branch of government and such related entities as the public prosecutor and public defender’s offices, bar associations and law schools. Messick (1999) identifies several unresolved puzzles, including the following: Is a fair judicial (and legal) system a cause of good economic performance, or is there some third factor (beliefs, social capital) that affects both the quality of the legal system and economic performance? Does the success of judicial (and other legal) reform depend on the order in which the various elements are introduced? Is it vital for success to integrate judicial reform in developing countries with informal enforcement mechanisms, and how should that be done?

Legal history provides many examples of successful legal transplants (including transfers of entire legal codes), partially successful transplants, as well as failed ones. Berkowitz, Pistor and Richard (2000) provide statistical evidence showing that success is correlated with the transplant method: Transplant failure is associated with what the authors call *unreceptive transplants*. The authors find that involuntary transplant can *succeed* if the inhabitants in the target country are familiar, for cultural and historical reasons, with the new legal tradition, and voluntary transplants *fail* if there is neither significant local adaptation nor prior familiarity. The basic assumption here is that local demand for the new social technology, which is potentially embodied in transplanted laws, is a necessary condition for successful transfer of *legality*. Legal intermediaries in the receiving country must also be responsive to this demand, and the government has to provide necessary infrastructure for the transplant to succeed.

A contending hypothesis claims that governments can use imported legal codes and regulations to establish reasonable degree of control over their territories and harmonize or contain deeply conflicting social interests. According to this view, governments can employ new laws as instruments for shaping social norms, harmonizing material interests, consolidating a weak and fragmented state or taming a predatory one, and for launching economic growth. The empirical evidence suggests that *per se* the introduction of new laws cannot accomplish such changes. In addition to the Berkowitz *et al.* (2000) study, we have, for instance, the lessons from the failed *Law and Development Movement* of the 1960s, when the United States made a concerted effort to provide legal assistance to countries in Asia, Africa, and Latin America to promote economic growth. Much has been written about the failure of the movement to reach its goals (Messick, 1999).

A traditional society is often divided in its response to a modern legal code. A small modern sector may demand Western commercial law whereas other elements

of a transplanted legal code, for instance modern family law, may conflict severely with traditional values. *Selective* introduction of modern law is a time-honored strategy for minimizing disruption and social resistance to the transplant. In Africa and elsewhere, the European colonial powers recognized that their laws did conflict with the material interests and values of traditional society, which made the colonialists, in some instances, apply their laws only to European settlers. In other situations the imperialists avoided implementing legal categories that were particularly likely to clash with traditional values but were of limited economic interest to the rulers (Stephenson, 2000). The colonial powers could accomplish this, for instance, by introducing a western commercial code, while leaving traditional family law alone.

If the state does not provide a supportive institutional framework for economic activity, the question arises whether state-sponsored reform is absolutely necessary or whether private actors and their organizations are able to provide minimal property rights necessary for promoting economic growth. Both in modern and historical times, relatively complex systems of production and trade have survived in countries with dysfunctional or virtually non-existing official legal systems that rely instead on private order. Private order property rights are even found in specific sectors in countries, such as the United States, that have highly developed systems of public order.

In advanced market economies, reliance on private order is most common in groups with restricted membership, because for such groups the transaction cost of securing complex exchange is sometimes lower under private arrangements than public ones. In those cases, however, private order is nested in an effective public legal system. In the developing world there is evidence to suggest that certain countries, such as China, have been able to move through the early stage of modernization and industrialization without the support of modern law, relying instead on private and local order. These countries do not have outright predatory governments but their legal systems are antiquated or dysfunctional by Western standards.

Transaction costs economics (Williamson, 1985) helps us to understand the limits of private order and private enforcement. Self-enforcement of contracts is effective when two parties are locked into a long-term exchange relationship –locked in because switching to other trades involves net cost. Self-enforcement can also emerge in personalized multi-lateral exchanges within closely-knit groups where information flows freely. Reputation and social norms protect the integrity of exchange in these environments. In groups based on ethnicity and religion, disapproval and expulsion usually carries greater weight than do sanctions in groups based entirely on commercial relationships (Landa, 1994). With greater specialization, expanding markets, and growing need for impersonal transactions, rising information costs block trade. Informal trading networks are not practical in such circumstances. In reputation-based trade, new firms find it difficult to enter the market, and traders, fearing high enforcement risks, often turn down offers of low price and high quality when actors outside the network offer these bargains (McMillan and Woodruff, 2000). Moreover, enforcement through private business organizations has an important disadvantage: the organizations have a common propensity to monopolize the market and even block technological change, especially when the organizations represent only one side of the market, particularly the sellers (Mokyr, 1990).

The purely economic choice between public and private order ultimately depends on the relative cost of each system. To function properly, private order requires rather strenuous collection of information, which the alternative of having recourse to an efficient judicial system will modify. McMillan and Woodruff (2000) find in their study of transition firms in Eastern Europe and the former Soviet Union that public order and private order complement each other. When the two are complements, the value of a marginal unit of private order institutions increases with the development of a formal legal system, and efficiency requires that the two forms grow together. McMillan and Woodruff (2000) also find that informal networks and formal legal systems are substitutes, which means that the importance of enforcement through informal networks should fade as the legal system matures.

IV. Conclusion

Until recently the policy literature in economics typically ignored the role of basic social institutions as well as problems related to transaction costs and scarce information and knowledge. The new institutional economics, which emerged in the 1980s, put social institutions and transaction costs on the map by explaining their role in creating secure property rights and lowering the cost of exchange. Yet, initially the new institutional analysis was not oriented toward policy. NIE paid little attention to the limits and opportunities for reforming institutions that depend on social factors (norms) and political interests. In fact, the new political economy literature, which partly overlaps with NIE and assumes that people always act rationally, suggests implicitly that all possible and desired reform measures will be carried out. When institutional change that potentially would lower cost and increase productivity is not undertaken, it is because unidentified constraints block the move, and the costs of overcoming the constraints exceed the benefits.

In this paper I argue that the theory of institutional policy must go beyond formal political constraints. When governments consider legal reforms, they have to recognize that members of the general public are able to undermine reforms by not cooperating with new rules and not offering a measure of voluntary support, which in most cases is required for institutions to function properly. The success of new institutions, therefore, depends in part on public demand for a new institutional environment. The demand for institutions reflects practical or economic considerations but it also often depends on valued social norms. Conflict between new institutions and old and valued social norms often undermines reforms. I have also emphasized the knowledge problem. For institutional policy the knowledge problem is a greater challenge than issues raised by scarce information and high transaction costs. The *knowledge problem* arises because of our limited understanding of how to build social institutions: our knowledge of social technologies is incomplete. Incomplete knowledge also restricts our understanding of the long-term dynamics of social institutions and social systems, such as financial markets and labor markets under various regulatory regimes.

The knowledge problem has important implications for institutional policy. Historical studies tell us that social systems often evolved in an unplanned manner,

creating effects and results that are not immediately understood. Policymakers frequently introduce reforms that have unintended consequences; the public often resists the introduction of new institutions because of misperceptions about their nature and consequences; uncertainty about the properties of alternative social institutions—limited knowledge of social technologies—gives persuasive reformers the opportunity to convince political rulers that they should use new methods for reaching their desired goals. In particular, unexpected malfunctioning of social systems often creates opportunities for specialists and reformers to push for acceptance of alternative institutional arrangements.

When governments are unwilling or unable to introduce new institutions that are demanded by important social groups, non-governmental organizations such as industry groups could possibly provide the required institutions. Research shows that private institutions play an important role even in modern economies but that they function in the shadow of the law—laws and private institutions complement and strengthen each other. Private rules, however, are not good *substitutes* for a formal legal system, and their ability to substitute for law becomes less as the economy becomes more advanced and complex.

The final word is that the limits for reforming institutions are not as great as rational choice political economy (the Determinacy Paradox) suggests whereas the opportunities for reforming institutions are smaller than the standard dialogue in mainstream economics indicates. In order to succeed, reforms must be selective and rely on measures that are not blocked by prevailing social and political constraints. The knowledge problem calls for a flexible process of institutional reform that allows for interactive learning by the policy authority and marginal corrective adjustments.

Notes

- ¹ My chapter in Toboso and Arias (2006) extends the discussion of failed reforms. Reformers often have wrong ideas about the nature of social technologies both at the macro- and micro-levels. Over time there are also coordinated shifts in people's ideas about the workings of social mechanisms. In refer to these issues as micro- and macro-level incompatibilities and ideological drift.
- ² If the social technology of market-preserving federalism, as Weingast and others describe it, had been well understood for 300 years, Weingast and his colleagues would not have attracted considerable attention in the 1990s by explaining the arrangement in scholarly journals.

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