A CRITICAL VIEW OF THE INSTITUTIONAL SOLUTION IN ECONOMICS

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Abstract

Institutionalism is the solution at hand when the expected correlations fail to work. The analytical framework is henceforth enriched with institutional pillars such as stable political structures, lack of corrupt practices, well-specified property rights, low-cost enforcement of contracts, etc. This paper's thesis is that institutionalism has its own limits circumscribed by the original view of the logic of economic inquiry based on causation. Ignoring the external circumstances of the social whole by virtue of ceteris paribus postulation creates an epistemic vacuum as regards the most part of our understanding of economic evolutions. In guise of a practical corollary, the paper ends with a casuistic illustration from Eastern European transition economies and concludes that the uncertainties of transition, neither more obscured, nor more difficult than of any other historical system, are left as much puzzling in orthodox as in institutional recipes.

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JEL Classification: B15, B52, P48, P51

Introduction

Economic methodology probably goes through one of its most fertile periods, when intakes from virtually the whole spectrum of science nourish its development. The tumultuous debate on method is indicative of a manifest dissatisfaction with the neoclassical thought, itself an import from physics at origin, as dominant epistemological platform in economics. Its major *theoretical* corollary, namely that free market functioning through voluntary transactions is conducive to a social optimum, has been constantly questioned on such grounds as contradictory results of modelling approaches or lack of relevance of policy initiatives in diverse socio-economic contexts.

Institutional economics has received so much credit among the proposed alternatives to the extent of even being commended as the exclusive solution to development (e.g. North, 1990; Easterly and Levine, 2002; Clark, 2007; Pejovich, 2008). Having gained the recognition of two Nobel prizes, to Ronald Coase and to Douglass North, the neoclassical pair has accordingly raised to the stature of introducing itself as *the method* of economic study.

This paper’s thesis is that institutionalism reaches its own limits circumscribed by the original view of the logic of economic inquiry based on causation. Ignoring the external circumstances of the social whole by virtue of ceteris paribus postulation creates an epistemic vacuum as regards the most part of our understanding of economic evolutions. A social phenomenon, to which economic causation is only a part, requires an analytical framework embedded in historical specificity (historicity). A rival epistemology of that contour is not within the scope of this paper. I nevertheless attempt to scrutinize two major claims of the institutional literature that serve as organizing themes of the next section. First is the issue of validity of the institutional solution as an explanatory companion of neoclassical economics, which increasingly devolved into a methodological platform of its own. Second is the issue of relevance of comparability of economic performance based on institutional change over long periods of time. Failure to appear so would represent “a challenge to the fundamental logic of our approach” say Acemoglu and Robinson (2002).

In guise of a practical corollary, the paper ends with a casuistic illustration from Eastern European transition economies and concludes that the uncertainties of transition, neither more obscured, nor more difficult than of any other historical system, are left as much puzzling in orthodox as in institutional recipes.

Institutionalism: the unfinished query for a reformed economics

Blaug bestowed upon the work of the American institutionalists—Thorstein Veblen, Wesley Mitchell and John Commons being the most prominent among them—the accolade of representing the only worthy alternative critic of orthodox analysis, along with Marxist critics (1978, p. 710). At the beginning of the 20th century, they produced an original if disparate body of thinking, which, whatever the reason, failed to dent into the increasing acceptance of neoclassicism as standard methodology and was pronounced death by the establishment: „institutionalism is a historical interlude which ended for all practical purposes in the thirties" (Kenneth Boulding, quoted in Blaug, 1978, p. 713).

The spirit of "*Le Roi est mort, vive le Roi!*" seemingly reigns the intellectual realm as well, and so "blackboard economics" emerged as a discipline in need of continuously redefining *the rules* of market functioning in order to gain any relevance for the practitioner. The bounded rationality of *homo oeconomicus* was first configured by the Coasean definition of *transaction costs* in 1937 and since evolved into the paradigm of *institutionalism*. The import of this intellectual lineage had been anticipated by Adam Smith's explicit recourse to a set of laws and institutions in the form of an "equal and impartial administration of justice which…by securing to every man the fruits of his own industry gives the greatest and most effectual encouragement to every sort of industry." (Smith, 1776, Book IV, ch. VII, Part 3) More specifically, Hayek enlisted "individual property, contract, trade, honesty, law, peaceful striving and saving" (*The Fatal Conceit*, 1988) as building blocks of his concept of 'extended market order'.

The institutional thought has so become associated with the neoclassical school in a purposeful query to defend the intellectual basis of *capitalism*, an economic system interchangeably referred to as "institutionalized classical liberalism", "free enterprise", “private-property”, or “free-market economy” (Pejovich, 2008, pp. 37, 38, 55). Nevertheless, the post-war lessons with development prove astonishingly deprived of relevant cases and suggest that an economy of private property does not of necessity lay the foundations of economic performance. Whereas the rise of capitalism is continuously praised for having “produced economic results that no other institutions and systems have been able to duplicate” (Pejovich, p. 96), some economists cannot help arguing that “the fact that the world’s *most* successful economies during the last four decades prospered doing things that are more commonly associated with failure is something that cannot be easily dismissed.” (Hausmann and Rodrik, 2002)

There is little doubt that the neoclassical manifesto has been considerably strengthened by the Friedmanian philosophical position that a theory is valid as long as it yields “better predictions for as wide a range of phenomena” (Friedman, 1953), irrespective of the realism of its assumptions. This is a perfect match with the natural scientist’s view of the world in which inquiry rests on reasoning from hypothesis to result, which is fundamental to thinking about causality and hence about the predictive purpose of scientific inquiry.

In the physicist’s world, two bodies of equal mass, say one kilo of plumage and one of lead, are supposed to reach the ground after travelling the same distance exactly in the same time *in the absence of counteracting causes*. The observed causation from gravitational force to free fall is deemed to remain a statement of tendency and not a law-like regularity unless amended by subsequent experiments capable of measuring other interfering forces, like, in this case, frictions. Now, the scientist’s theoretical set goes more realistically with the observed world and, indeed, one kilo of lead is expected to bite the dust quicker than the plume counterpart.

This epistemological pedestal is only possible by employing the qualification *ceteris paribus*. It is only by ruling out the effect of all other independent variables except the one under consideration that the scientist is able to arrive at specific causal relationship. The economist's view likewise embrace the Aristotelian nature of science that proclaims, "We have knowledge of a thing only when we have grasped its cause" (Falcon, 2008) to depict a similar law-like regularity, from 'self-interest' to 'efficiency' *via* 'specialization'. In no way one can detect a non-algorithmical path of reasoning to account for certain behaviour, because, it is assumed, "economics is not concerned with the idiosyncrasies of particular cases" (Schlicht, 1985, p. 1).

Institutionalism immerses itself into this paradigm in varying degrees (cf. Dugger, 1979). The strongest link lies in the embrace of the foundational neoclassical postulates of rational behaviour and equilibrium. The institutionalist camp appended to this fictional behaviour of *homo oeconomicus* formal and informal constraints enabling self-regulating markets to function. Instead of constant, recurrent, familiar images of economic evolutions, the knowledgeable world is configured within an indefinitely expanding institutional context without giving up the pretence of predictability though. Let's discuss in turn two of the most valuable innovations it brings about, theoretical and methodological.

On the theoretical side, the social fabric of market transactions is delineated by ever larger boundary conditions in an attempt to keep the predictive power into the plausible realm at the same time with providing a more realistic facet of the economy. The rigid limits of allocation of scarce means between alternative uses, an issue of "applied mathematics or engineering" in the words of Buchanan (quoted in Pejovich, 2008, p. 124), is opposed the choice between alternative social arrangements.

The *firm* that uses the resources of an entrepreneur is such an arrangement, says Coase (1937). His approach is at once path-breaking and mainstream. By bringing into attention "the cost of using the price mechanism", the *market* suddenly becomes enlivened by the work of rational participants—principals and agents—who measure, specify, and enforce costly contracts. Crucial decisions may refer to definitions of property rights over economic resources or to calculations of costs when harm is inflicted on other people's economic activity. Were these to be ignored by entrepreneurs, the market transactions would reach sub-optimal levels as long as the value of neglected resources is not object of their choice.

This thicker description of reality nevertheless preserves the individual's role as wealth maximizer. Coase acknowledges that his analysis "is tractable by two of the most powerful instruments of economic analysis…the idea of the margin and that of substitution" and so, after a detour through more personal forms of economic behaviour, the analyst returns to the familiar framework of causation. The informed, unconstrained choice of available alternatives directly leads to efficient workings of the economic system, and performance becomes associated with "institutions that provide low-cost measurement and enforcement of contracts" (North, 1998a).

On the methodological side, the institutional solution proves remarkably versatile, being nurtured from quite a large number of sources (see Kaufman, 2007). Institutionalism arrives at a more nuanced methodological view, ready to accept intakes which were once anathema to orthodoxy. What seemed a firm belief in successful market outcomes might be typically explained now as "an admixture of luck plus shrewd judgments and unanticipated outcomes" (North, 1998b).

The analytical results do not come any more in clear-cut models of behaviour. The study of institutions, by virtue of their social nature, admits causal explanation of human intentionality leading to softer variants of determinism and equilibrium conditions (Dugger, 1979; North, 1998a; Hodgson, 2007). Maximizing behaviour can be modified in innumerable ways, from psychological motives—e.g. individual perceptions about 'the social cost'—to political competition—e.g. ideology and accountability—to historical and social contexts—e.g. path dependence and the emergence of tacit knowledge.

The resulting wide variety of patterns of development is however reducible to a very clearly determined causal mechanism: the institutional framework of a society provides the incentive structure underlying its aggregate choice of institutions that may or may not result in increasing efficiency.

Innovative and convincing though it may be, the interplay of the ‘game’—the competitive market environment of voluntary interactions between maximizing individuals—and the ‘rules of the game’—the norms and institutions enabling their exchange—is founded, let us not forget, on the initial presumption of *causality*. Institutionalism is the solution at hand when mainstream economics fails to provide a consistent view of the real-world. When the expected correlations fail to work, say, between liberalization and welfare, or between free trade and economic growth, the analytical framework is enriched with institutional pillars such as stable political structures, lack of corrupt practices, well-specified property rights, low-cost enforcement of contracts, etc. The logic behind *ceteris paribus* stays intact, in the sense that we of necessity are capable to infer the consequence if the status of the world resembles our institutionally-enriched analytical framework.

In other words, the institutionalism retains the flawed reasoning on *causality* in spite of its effectual methodological program to offer a broader, “’socialized’ view of economic behaviour” (Kaufman, 2007). In this view, the critique of standard reasoning in economics becomes more compelling the more so is centred on one of the most promising, praised solutions to overcome its deterministic character. It is chiefly in this last variant that institutional economics seeks to differentiate itself as “a fast-growing method for the analysis of economic and social issues…[able to explain]…the economic performance of countries having different institutional arrangements” (Pejovich, 2008, p. 117).

Economists are again tempted to provide recipes of ‘good’ or ‘bad’ institutions which accordingly translate into superior/inferior performance. Nowhere is this allegation more evident than the persistent claim about the alleged superiority of capitalism not only over socialism, but also over any other system of economic organization. The task ahead so advances the twin issues of *epistemology* and of *policy recipe* within the analytical framework of institutionalist construction in South Eastern Europe (SEE), for which, “institution building is at the heart of the transition process” (Raiser et al., 2001).

The South Eastern Europe (SEE) or Balkan region [2] lends itself to institutional analysis for obvious reasons. The area processes of nation building inherit a subverting legacy of hundreds of years of Ottoman invasions, of competing great power interests, and fifty years of communism that left the region in a continued state of conflict. The multifarious tensions which surfaced in the aftermath of the fall of communism have given analysts reason for considerate concern in sombre terms like, “South-East Europe is now a vast political laboratory on top of a mass grave” (Krustev, 1999). In general, the confidence in a clear-cut analytical framework to deal with the problems of development is considerably moderate. Referring to this region’s evolutions, Malek (2006) observes that “they are much more difficult to be operationalized and assessed.”

The presentation of Pejovich (2008) attempts to produce a regional-based ranking of countries’ affinity with the Western system of governance. I reproduce his results in Table 1 with a modification: his second group (of ‘lesser influence’) is further divided in more homogeneous groupings, of SEE countries and of former Soviet republics.

Magnifying the economic tableau merely results in no “striking evidence”, but contradictory as compared to the basic hypothesis. The SEE group does not perform more badly in terms of ‘economic freedom’, as originally supported, nor does the group of Western influence succeed in surpassing its counterparts relative to ‘business’ and ‘labour’ indices. Moreover, the observer may wonder how countries like Moldova and Belarus are capable to establish more performing ‘labour markets’ than the more advanced economies of Hungary, Poland, Estonia, and Croatia.

Concluding remarks

The rise of institutionalism as a companion pair within the neoclassical paradigm leaves its mark on the economic thought with one clear lesson: the free functioning of market can not be properly defined on the outside of a particular institutional setting. On the other hand, a limited understanding of the amalgam of formal and informal rules, as well as contradictory empirical evidence with respect to countries’ capability to enforce ‘good’ institutions signal an unfinished task in search for a new paradigmatic approach.

A social phenomenon, to which economic causation is only a part, requires an analytical framework embedded in historical specificity (historicity). How to make sense of historical specificity is indeed one provocative question, to which institutionalism provides partial answers only. What is questionable consists of the assertion that the object of our knowledge is subject to a *unique logical structure*. The nuance is worthy of repeated emphasis: the classic logic is not becoming invalid in understanding the social context, but puts its explanatory power at use only in contexts dominated by the natural specificity of human-independently recurrent events.

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Endnotes

[1] In this representation, the Balkan area is used interchangeably with 'South Eastern Europe' and includes the following countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia, and Montenegro.

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Table 1 Market freedom in formerly communist European countries (2006/2007)[2]

Greater Western influence				Lesser Western Influence (I)				Lesser Western Influence (II)			
Countries	Economic freedom	Business freedom	Labour freedom	Countries	Economic freedom	Business freedom	Labour freedom	Countries	Economic freedom	Business freedom	Labour freedom
Estonia Lithuania Latvia Czech R. Slovakia Hungary Slovenia Poland Croatia	1.75 2.14 2.43 2.10 2.35 2.44 2.41 2.49 2.78	80.00 86.40 76.80 61.20 71.10 71.20 74.20 65.10 53.80	51.20 60.10 64.10 77.20 62.50 66.10 48.70 56.20 52.00	Bulgaria Albania Romania Macedonia Bosnia & Herzegovina	2.88 2.75 3.19 2.80 3.01	66.90 56.10 70.90 60.90 53.80	71.50 60.60 61.40 58.10 57.30	Belarus Moldova Russia Ukraine	4.11 3.10 3.50 3.24	54.50 70.00 66.60 54.00	64.70 61.20 66.20 51.80
	Average: 2.32	*Average*: 71.09	*Average*: 59.70		*Average*: 2.93	*Average*: 61.72	*Average*: 61.78		*Average*: 3.49	*Average*: 61.28	*Average*: 60.98

[2] Adapted from Pejovich (2008), Table 11.1, p. 126, Table 12.3, p. 133; Original sources: Kane, T.K. Holmes and M.A. O'Grady (eds.) *Index of Economic Freedom*, Washington D.C., Heritage Foundation and *Wall Street Journal*, (annual publication)

The scale should be read as follows:

Economic freedom (a measure of institutional change, 2006): free (1-1.99), mostly free (2.00-2.99), mostly unfree (3.00-3.99), repressed (4.00 or higher)

Business freedom (a measure of how entrepreneurs are to start businesses, 2007)/Labour freedom (a measure of the ease of hiring and firing employees, 2007): free (80-100), mostly free (70-79.9), moderately free (60-69.9), mostly unfree (50-59.9), repressed (0-49.9)