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Wider Perspectives on Global Development

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Studies in Development Economics and Policy

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UNU-WIDER

Anthony B. Atkinson
Kaushik Basu
Jagdish N. Bhagwati
Douglass C. North
Dani Rodrik
Frances Stewart
Joseph E. Stiglitz
Jeffrey G. Williamson

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World Institute for Development Economics Research of the United Nations University (UNU-WIDER)

Katajanokanlaituri 6B, FIN-00160 Helsinki, Finland
www.wider.unu.edu

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List of Abbreviations

AFL–CIO	American Federation of Labor–Congress of Industrial Organizations
CAP	Common Agricultural Policy
CEA	Council of Economic Advisers
CEPR	Center for Economic Policy Research
CPI	Consumer Price Index
CRISE	Centre for Research on Inequality, Human Security and Ethnicity
CUTS	Consumer Unity and Trust Society
DFI	direct foreign investment
DFID	Department for International Development
EC	European Community
EMU	European Monetary Union
EPA	Environmental Protection Agency
EPZ	export processing zone
EU	European Union
EZ	Euro zone
EZLN	*Ejército Zapatisto de Liberación Nacional* (Zapatista Army of National Liberation)
FDI	foreign direct investment
Fed	Federal Reserve Bank (US)
FES	Family Expenditure Survey
FSU	former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GERC	general-equilibrium reversal claim
GNP	gross national product
HDI	Human Development Index
HI	horizontal inequality
ICC	International Criminal Court
ICFTU	International Confederation of Free Trade Unions
IFI	international financial institution
ILO	International Labour Organization
IMF	International Monetary Fund
INTRAC	International NGO Training and Research Centre
IP	intellectual property
IT	information technology
LO	trade union federation (Norway)

LSE	London School of Economics and Political Science
MDG	Millennium Development Goal
MNC	multinational corporation
NAFTA	North American Free Trade Agreement
NBER	National Bureau of Economic Research
NEP	New Economic Policy (Malaysia)
NGO	non-governmental organization
NHO	employers' organization (Norway)
NIC	newly industrializing country
NIEO	New International Economic Order
NRM/NRA	National Resistance Movement/National Resistance Army (Uganda)
NTB	non-tariff barriers
OECD	Organisation for Economic Cooperation and Development
PPF	production possibility frontier
PPP	purchasing power parity
PRSPs	poverty reduction and growth strategies
QR	quantitative restriction
R&D	research and development
RUC	Royal Ulster Constabulary
SEZ	special economic zone (China)
SOE	state-owned enterprise
SSA	sub-Saharan Africa
TFP	total factor productivity
TVEs	township and village enterprises
UNIFEM	United Nations Development Fund for Women
UNRISD	United Nations Research Institute for Social Development
UNU	United Nations University
USSR	Union of Soviet Socialist Republics
WIDER	World Institute for Development Economics Research, UNU
WTO	World Trade Organization

Notes on the Contributors

Sir Anthony B. Atkinson is Warden of Nuffield College, Oxford. He was previously Professor of Political Economy at the University of Cambridge, Tooke Professor of Economic Science and Statistics, LSE, Professor of Political Economy and Head of Department, University College, London, Visiting Professor of Economics at MIT and Professor of Economics, University of Essex. He is a Fellow of the British Academy and an Honorary Member of the American Economic Association. He is past President of the Royal Economic Society, the Econometric Society, the European Economic Association and the International Economic Association, and has served on the Royal Commission on the Distribution of Income and Wealth, the Pension Law Review Committee and the Commission on Social Justice.

Kaushik Basu is the C. Marks Professor of International Studies in the Economics Department of Cornell University. Previously he taught at Princeton, MIT and the LSE, and founded the Centre for Development Economics in Delhi. A Fellow of the Econometric Society and a recipient of the Mahalanobis Memorial Award, he is editor of *Social Choice and Welfare*, and has served on the editorial boards of the *Journal of Development Economics* and the *World Bank Economic Review*.

Jagdish N. Bhagwati is University Professor, Columbia University and Senior Fellow in International Economics at the Council on Foreign Relations, New York. He is an External Adviser to the WTO and a member of UN Secretary General Kofi Annan's High-Level Advisory Group on the NEPAD process in Africa. He is also a Director of the National Bureau of Economic Research, on the Academic Advisory Board of Human Rights Watch (Asia) and was a member of the Advisory Board of the Council on Economic Priorities Accreditation Agency. Professor Bhagwati has been Arthur Lehman Professor of Economics and Professor of Political Science at Columbia, Ford International Professor of Economics at MIT and Professor of International Trade at the Delhi School of Economics.

Douglass C. North is Spencer T. Olin Professor in Arts and Sciences, Washington University in St Louis, having been the Henry R. Luce Professor of Law and Liberty in the Department of Economics in Arts and Sciences and serving as director of the Center in Political Economy. In 1992 he became the first economic historian to win one of the economics profession's most prestigious honours, the John R. Commons Award. A fellow of the British Academy he was also elected to the American Academy of Arts and Sciences.

He has been editor of the *Journal of Economic History*, is past President of the Economic History Association and a twenty-five-year member of the Board of Directors of the National Bureau of Economic Research. The Nobel Memorial Prize in Economics in 1993 was awarded jointly to Professor North and Professor Robert W. Fogel of the University of Chicago, 'for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change'.

Dani Rodrik is Professor of International Political Economy at the John F. Kennedy School of Government, Harvard University. He is affiliated with the National Bureau of Economic Research, the Centre for Economic Policy Research (London), the Center for Global Development, the Institute for International Economics and the Council on Foreign Relations. Among other honours, in 2002 he was presented the Leontief Award for Advancing the Frontiers of Economic Thought. He has published widely in the areas of international economics, economic development and political economy, and is an editor of the *Review of Economics and Statistics* and an associate editor of the *Journal of Economic Literature*.

Frances Stewart is Professor of Development Economics and Director of the Centre for Research on Inequality, Human Security and Ethnicity (CRISE), Queen Elizabeth House, University of Oxford. She is a Fellow of Somerville College. A former Council member of the United Nations University, she is currently a Board Member of the International Food Policy Research Institute and an Overseer of the Thomas Watson Institute for International Studies, Brown University. Formerly Director of the International Development Centre, Queen Elizabeth House, she has also been special adviser to UNICEF on Adjustment (1985–86) and has been one of the chief consultants for the Human Development Report since its inception.

Joseph E. Stiglitz is University Professor at Columbia University. He has taught at Princeton, Stanford, Yale and MIT and was the Drummond Professor at All Souls College, Oxford. In 1979 he was awarded the John Bates Clark Award, given biennially by the American Economic Association to the economist under forty who has made the most significant contribution to the field. In 2001 he was awarded the Nobel Prize in Economics. He was a member of the Council of Economic Advisors from 1993 to 1995, during the Clinton Administration, and served as CEA chairman from 1995 to 1997. He then became Chief Economist and Senior Vice-President of the World Bank from 1997 to 2000.

Jeffrey G. Williamson is the Laird Bell Professor of Economics, Center for International Development at Harvard University where he was Chair of the Economics Department. He is also Research Associate at the National Bureau of Economic Research. He taught at the University of Wisconsin for twenty years before joining the Harvard faculty in 1983. Professor Williamson has served as President of the Economic History Association and is the author of more than twenty scholarly books and almost 200 articles on economic history, international economics and economic development.

Introduction: Wider Perspectives on Global Development

Giovanni Andrea Cornia, Matti Pohjola and Anthony Shorrocks

UNU-WIDER is one of the world's leading research institutes on development economics. It strives to provide original analysis of important global issues and to offer policy advice aimed at the sustainable economic and social development of the poorest nations. Established in 1984 in Helsinki, Finland, as the first research and training centre of the United Nations University, UNU-WIDER is part of an international academic community which promotes the United Nations' aims of peace and progress. One aspect of this role is to provide a forum for bringing together leading scholars from around the world to address urgent global problems.

The WIDER Annual Lecture was inaugurated in 1997 to allow a distinguished scholar to offer his or her analysis and views on a topic relevant to the work of UNU-WIDER. This volume reproduces the first eight Annual Lectures. The authors are universally recognized as among the most prominent contributors in their fields, and the range of themes captures the vitality, breadth, detail and quality associated with the research of UNU-WIDER on international development. Most of the core issues in the field of development are included among the topics: governance and institutions, trade and globalization, inequality and conflict, growth and employment. The individual contributions offer great insights into the role of economic, political and social factors in global development, and into the way that effective structures and institutions can be designed in order to improve the well-being of the poor.

Institutions are the formal and informal rules that structure human interaction. The way that they evolve shapes economic development via the costs of transactions and production. In Chapter 1, Douglass North develops a theory of institutions which is then used to examine organizational problems in the modern world and to look at the challenges that these problems pose for low-income countries. He goes on to show how the theory of institutions can be used to improve economic performance in transitional economies. By focusing on deep-rooted institutional obstacles and their evolution, rather than on macroeconomic issues, North provides a more realistic and original assessment of the momentous changes faced by nations in transition and of the sources of the difficulties encountered. This chapter is also a key contribution to the analysis of the appropriate way to proceed with policy reforms and policy implementation in transitional and developing economies.

Chapter 2, by Joseph Stiglitz, provides a thorough critique of the 'Washington Consensus'. His analysis shows that while certain elements of the Washington Consensus – for example, low inflation and low budget deficits – might have been relevant for addressing the economic crises of Latin America in the 1980s, they are not sufficient for achieving long-term growth, or even macroeconomic stability, under different circumstances. Stiglitz emphasizes the lack of attention of the Washington Consensus to developing sound financial markets (as opposed to mere financial liberalization), a neglect evident in the problems in the financial sector across much of East Asia in the late 1990s.

It is now widely accepted that governments complement markets. A market economy cannot thrive, and the majority of people cannot benefit, without wise government and effective state institutions. Stiglitz stresses that developing and transition economies need to do more that just liberalize in order to build markets: they need to build regulatory capacity and to establish truly competitive markets in order to overcome asymmetric information and market imperfections, especially in sectors which have undertaken large-scale privatization of state enterprises. Otherwise, the new market economies will be inefficient, and will not yield the broad-based growth which is so essential to raising living standards. In addition to these tasks, state action is required to support public investment in human capital – which raises living standards and growth – and to assist countries in adopting new technologies.

Income inequality has been a core interest of UNU-WIDER over the years. In Chapter 3, Anthony Atkinson examines the rise in income inequality in a large number of industrialized countries since the late 1970s. This phenomenon, which first became apparent in the United States and the United Kingdom, has subsequently become evident across much of the developing and developed world. However, the experience is not uniform across countries. This suggests that rising inequality is not inevitable, a conclusion that contrasts with the widely held belief that it is an unavoidable consequence of the present revolution in information technology, and/or the globalization of trade and finance.

Atkinson's analysis suggests that the world is working in more complex ways than those described in simple technological and trade explanations of the level and trend of inequality. The latter theories see wage differentials as nothing more than the outcome of supply and demand, thereby ignoring the role of conventions and social norms. More recent economic theories show that supply and demand only places limits on possible wage differentials, while social forces determine where wages actually lie between those limits. These newer models also indicate that shifts in pay norms can result in widening wage differentials, and thus higher income inequality. Moreover, Chapter 3 reminds us that progressive income taxation and social transfers can substantially reduce the income inequalities that may arise in the market place. Thus national governments do have room for manoeuvre, especially in influencing the social norms which are as important – perhaps even more important – in determining the distribution of income as the much-cited trends in trade and technology.

Jagdish Bhagwati, in Chapter 4, presents us with a quite different perspective on globalization than we typically get in the polarized debates in the media between its proponents and opponents. He first points out that the different dimensions of globalization may have different impacts; therefore, to analyse the debate, globalization needs to be disaggregated instead of being treated as a gigantic whole. Concentrating on international trade and direct foreign investment (DFI), Bhagwati shows that these two dimensions of globalization are economically benign. He then argues that they can also be socially benign – that is, they can produce beneficial consequences for a variety of social objectives. However, this holds only as a general tendency, so undesirable outcomes can occur. Consequently, appropriate governance is needed at both national and international levels to manage globalization.

In Chapter 5, Frances Stewart expands on some of the central themes of her studies for UNU-WIDER: the causes of humanitarian emergencies, and institutions and group behaviour. Stewart documents the ways in which political power, social demarcations and economic differences combine to produce horizontal inequalities between population subgroups within countries, and the impact of these horizontal inequalities on social cohesion. The case studies leave no doubt that inequitable treatment of groups – either real or perceived – can be a major source of social instability and hence a major obstacle to improvements in well-being. Yet, as emphasized in the title of the chapter, these phenomena are routinely neglected in the design of development policies, which tend to focus on outcomes for individuals rather than groups.

The evidence indicates that historical patterns of privilege can be redressed, particularly if the privileged groups are a minority. In other circumstances, however, the interplay of political and economic forces may exacerbate the underlying problems. In strongly divided countries, Stewart suggests that donor countries and international organizations must ensure that their policies take account of horizontal inequity, recognizing that this stance may conflict with narrowly defined efficiency objectives.

Jeffrey Williamson's research covers a wide range of historical and contemporary topics, including growth, trade, migration, living standards and inequality. All these themes are evident in Chapter 6, which offers a broad perspective on the global impact of trade and factor flows over many centuries. Noting that while world inequality has been trending upwards for most of the past 500 years, 'globalization' – defined in terms of commodity price convergence across regions of the world – began only around 1820. During the 'first global century' up to 1913, lower transport costs and tariffs stimulated trade which, together with relatively free factor mobility, created powerful egalitarian forces on a world scale. However, as Williamson stresses, not everyone stood to benefit from a continuation of these policies, and the period from 1913 to 1950 was characterized by an anti-globalization backlash under which restrictions on migration and rising tariffs resulted in price divergence across countries.

The period from 1950 until the present day constitutes the second globalization era. It differs, however, from the first global century in one important respect – the mass labour migrations that were the main globalization force in the nineteenth century have been replaced by immigration controls, leaving trade (aided by tariff reductions) as the principal source of international price convergence. Weaving together the economic, political and demographic factors, which help to explain the pattern of living standards across countries and over time, Williamson offers a vision of the way in which the world is likely to develop over the next half-century.

Kaushik Basu is known for the creative way in which he brings the tools of economic and philosophical analysis to bear on current development issues. In recent years his interests have included questions concerned with international labour standards and worker rights, particularly those related to the use of child labour in developing countries. Chapter 7 begins by noting that one of the consequences of globalization is an erosion of democracy, with the lives of individuals in developing nations becoming increasingly dependent on decisions taken in other countries over which they have no influence. The imposition of global labour standards – however well-meaning the motivation of the proponents – risks adding to this disenfranchisement as well as hurting the intended beneficiaries. Hence the need for a thorough assessment of the rationale for international intervention.

Respect for personal liberty leads Basu to argue that individuals should be allowed to enter into a labour contract that would be outlawed in the developed world, provided that the contract does not involve coercion and provided that the parties concerned fully comprehend the implications of their agreement. Those who favour imposing external constraints on such free market activities must offer convincing counterarguments. Individual ignorance or irrationality is one possible route, along with explicit or implicit coercion. Another possible justification rests on the existence of multiple equilibria, when an external 'benign intervention' might result in a switch to a stable and mutually preferred equilibrium. A third, more subtle, line of reasoning is that while individual free market transactions may be justifiable, certain *classes* of contracts can have such severe repercussions that these undermine the case for respecting individual freedom. Basu expands on these ideas and examines their implications for global labour standards in the context of such issues as child labour, hazardous working conditions and workplace harassment. The attention to the detail of the argument is a welcome contrast to what Basu refers to as the 'muscular desire' of international bureaucrats to get on with the business of crafting legislation.

In Chapter 8, Dani Rodrik addresses one of the core issues in development: how can low-income countries achieve faster rates of economic growth? Reviewing the lessons to be drawn from recent history, particularly with regard to Latin America and Asia, Rodrik concludes that successful policies are invariably built on sensible general principles such as a desire to interact more closely with the global economy, to maintain fiscal discipline and to establish a strong and supportive institutional environment. However, attempts to translate these general principles into a collection of orthodox liberal policies have a patchy record of success, at best. This conclusion is reinforced by the fact that the vast majority of significant growth accelerations over the past fifty years fail to reveal any clear link with economic liberalization.

The alternative framework proposed by Rodrik involves a move away from a blanket prescription and towards a more nuanced strategy, which focuses on the particular constraints that prevent a given country from growing faster. The consequent policy recommendations may be quite different for countries that appear superficially to share similar problems, or for the same country at different points of time. Rodrik makes a persuasive case for an alternative strategy which has profound implications for the construction of economic policy in developing countries.

Overall, the contributions in this volume address many of the core issues in the field of global development. It is hoped that the lessons drawn, and the policy advice offered, will contribute significantly to the efforts of UNU-WIDER to promote the sustainable economic and social development of the poorest nations and to assist in the eradication of the blight of poverty from the world.

Giovanni Andrea Cornia
University of Florence
(Director of UNU-WIDER, 1996–99)

Matti Pohjola
Helsinki School of Economics
(Director i. a. of UNU-WIDER, 2000)

Anthony Shorrocks
Director of UNU-WIDER

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The Contribution of the New Institutional Economics to an Understanding of the Transition Problem

Douglass C. North

Introduction

Institutions and the way they evolve shape economic performance. Institutions affect economic performance by determining (together with the technology employed) the cost of transacting and producing. They are composed of formal rules, of informal constraints and of their enforcement characteristics; while formal rules can be changed overnight by the polity, informal constraints change very slowly. Both are ultimately shaped by the subjective perceptions people possess to explain the world around them which in turn determine explicit choices of formal rules and evolving informal constraints. Institutions differ from organizations. The former are the rules of the game; the latter are groups of individuals bound together by a common objective function (economic organizations are firms, trade unions, cooperatives; political organizations are political parties, legislative bodies, etc.).

This chapter develops this analytical framework which is then applied to explore the underlying organizational problems of economies in the modern world. We then analyse the problems these changes pose for Third World and transition economies, and go on to apply the analysis in order to improve our understanding of transition economies.

Institutions and efficient markets

Institutions are the rules of the game in a society; more formally, they are the humanly devised constraints that shape human interaction. In consequence they structure incentives in exchange, whether political, social or economic.

That institutions affect economic performance is hardly controversial. That the differential performance of economies over time is fundamentally influenced by the way institutions evolve is also not controversial. But because Western neoclassical economic theory is devoid of institutions, it is of little help in analysing the underlying sources of economic performance. It would be little exaggeration to say that, while neoclassical theory is focused on the operation of efficient markets, few Western economists understand the institutional requirements essential to the creation of such markets, since they simply take them for granted. A set of political and economic institutions that provides low-cost transacting and credible commitment makes possible the efficient factor and product markets underlying economic growth.

Four major variables determine the costliness of transacting in exchange. The first is the *cost of measuring the valuable attributes* of the goods and services or the performance of agents in exchange. Property rights consist of a bundle of rights and, to the degree that we cannot measure precisely the valuable attributes of the separable rights being exchanged, then the costs of transacting and the uncertainties associated with transacting rise dramatically. Measurement consists of defining the physical dimensions of the rights exchanged (colour, size, weight, number, etc.), but also the property rights dimensions of the exchange (rights defining uses, income to be derived and alienation). When such costs are high or unforeseeable, the rights are imperfectly and incompletely specified. In consequence, the other variables in the cost of transacting become important.

The second variable in the costliness of the exchange process is the *size of the market*, which determines whether personal or impersonal exchange occurs. In personal exchange, kinship ties, friendship, personal loyalty and repeat dealings all play a part in constraining the behaviour of participants and reduce the need for costly specification and enforcement. In contrast, in impersonal exchange there is nothing to constrain the parties from taking advantage of each other. Accordingly the cost of contracting rises with the need for more elaborate specification of the rights exchanged. Effective competition acts as an essential constraint in efficient impersonal markets.

The third variable is *enforcement*. In a world of perfect enforcement, there would be, ideally, a third party impartially (and costlessly) evaluating disputes and awarding compensation to the injured party when contracts are violated. In such a world opportunism, shirking and cheating would never pay. But such a world does not exist. Indeed, the problems of creating a relatively impartial judicial system that enforces agreements have been a critical stumbling block in the path of economic development. In the Western world the evolution of courts, legal systems and a relatively impartial body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over time and space, an essential requirement for a world of specialization.

If we retain the neoclassical behavioural assumption of wealth maximization, then these three variables alone determine the cost of exchange; that is, individuals would maximize at every margin (if cheating pays, one cheats; if loafing on the job is possible, one loafs; if one could with impunity burn down a competitor, one would do so). But it is hard to imagine that complex exchange and organization would be possible if this assumption accurately described human behaviour; the costliness of measuring performance, of contract fulfilment and of enforcing agreements would foreclose a world of specialization (and division of labour). *Ideological attitudes and perceptions*, the fourth variable, matter.

Ideology – consisting of the subjective 'models' individuals possess to explain and evaluate the world around them – not only plays an essential role in political choices, but also is a key to the individual choices that affect economic performance. Individual perceptions about the fairness and justice of the rules of the game obviously affect performance; otherwise we would be at a loss to explain a good deal of schooling, as well as the immense investment made by politicians, employers, labour leaders and others in trying to convince participants of the fairness or unfairness of contractual arrangements. The importance of ideology is a direct function of the degree to which the measurement and enforcement of contracts are costly. If the measurement and enforcement of contract performance can be done at low cost, then it makes very little difference whether people believe that the rules of the game are fair or unfair. But because measurement and enforcement are costly, ideology matters.

Efficient markets are a consequence of institutions that provide the low-cost measurement and enforcement of contracts at a moment of time, but we are interested in markets with such characteristics over time. Essential to efficiency over time are institutions that provide economic and political flexibility to adapt to new opportunities. Such adaptively efficient institutions must provide incentives for the acquisition of knowledge and learning, induce innovation and encourage risk taking and creative activity. In a world of uncertainty, no one knows the correct solution to the problems we confront, as Hayek has persuasively argued. Institutions should therefore encourage trials and eliminate errors. A logical corollary is decentralized decision making that will allow a society to explore many alternative ways to solve problems. It is equally important to learn from and eliminate failures. The institutions therefore must not only provide low-cost measurement of property rights and bankruptcy laws, but also provide incentives to encourage decentralized decision making and effective competitive markets.

The composition of institutions

Formal rules include political (and judicial) rules, economic rules and contracts. *Political rules* broadly define the hierarchy of the polity, its basic decision structure and the explicit characteristics of agenda control. *Economic rules* define property rights. *Contracts* contain the provisions specific to a particular agreement in exchange. Given the initial bargaining strength of the decision making parties, the function of rules is to facilitate exchange, political or economic.

Informal constraints cannot be as precisely defined as formal rules. They are extensions, elaborations and qualifications of rules that 'solve' innumerable exchange problems not completely covered by formal rules and that in consequence have tenacious survival ability. They allow people to go about the everyday process of making exchanges without the necessity of thinking out exactly at each point and in each instance the terms of exchange. 'Routines', 'customs', 'traditions' and 'culture' are words we use to denote the persistence of informal constraints. They include conventions that evolve as solutions to coordination problems and that all parties are interested in having maintained (such as, for example, the rules of the road), norms of behaviour that are recognized standards of conduct (such as codes of conduct that define interpersonal relationships in the family, business, school, etc.) and self-imposed codes of conduct (such as standards of honesty or integrity). Conventions are self-enforcing. Norms of behaviour are enforced by the second party (retaliation) or by a third party (societal sanctions or coercive authority), and their effectiveness will depend on the effectiveness of enforcement.

Self-imposed codes of conduct, unlike conventions and norms of behaviour, do not obviously entail wealth maximizing behaviour, but rather entail the sacrifice of wealth or income for other values. Their importance in constraining choices is the subject of substantial controversy, for example, in modelling voting behaviour in the US Congress (see Kalt and Zupan, 1984). Most of the controversy has missed the crucial reason why such behaviour can be and is important. That is that formal institutions (rules) frequently deliberately, sometimes accidentally, lower the costs to individuals of such behaviour and can make their normative standards embodied in self-imposed codes of conduct matter a great deal. Individual votes do not (usually) matter, but in the aggregate they shape the political world of democratic polities and they cost the voter very little; legislators commonly find ways by strategic voting to vote for their personal preferences rather than those of the electorate (Denzau, Riker and Shepsle, 1985), and judges with lifetime tenure are deliberately shielded from interest group pressures so that they can make decisions on the basis of their interpretation (subjective models) of the law. In each case, the choices that are made may be different from what they would be if the individual bore the full cost that resulted from these actions. It is the institutions that deliberately or accidentally create the externalities that alter choices. The lower the cost we incur for our convictions (ideas, dogmas, prejudices), the more they contribute to outcomes (see Nelson and Silberberg, 1987, for empirical evidence).

Agreements may be enforced by a third party (societal sanctions or the coercive force of the state), by the other party to the agreement (retaliation), or by self-imposed standards of conduct. How effectively agreements are enforced is the single most important determinant of economic performance. The ability to enforce agreements across time and space is the central underpinning of efficient markets. On the surface it would appear to be an easy requirement to fulfil. All one needs is an effective, impartial system of laws and courts for the enforcement of formal rules, the 'correct' societal sanctions to enforce norms of behaviour and strong normative personal standards of honesty and integrity to underpin self-imposed standards of behaviour.

The creation and enforcement of efficient property rights depend on the polity, but it is difficult, if not impossible, to derive a model of a polity that produces such results with a strictly wealth maximizing behavioural assumption employing the time horizons that characterize political decisions. It is equally difficult to create normative standards of behaviour that will reinforce formal rules and make them effective. Yet when economists talk about 'efficient markets', they have implicitly assumed that all of the above conditions exist.

The historical evidence upon which to build generalizations about the evolution of efficient markets is slim indeed. We cannot explain the ascendancy of the Western world in the past six centuries purely in terms of the simple restructuring of property rights and the evolution of more efficient political markets. We must invoke the cultural and specifically ideological constraints that altered attitudes and made such property rights effective. While the Weberian heritage of the role of the Protestant ethic in the rise of capitalism has been discredited in its crude form, cultural beliefs were an important (and at least partially independent) source of the successful development of the Western world. Nor has the issue been resolved with respect to Japan and the newly industrializing economies in Asia. We know all too little about the role of cultural beliefs in shaping economic performance.

Institutional change

Understanding institutional change entails an understanding of:

(1) the stability characteristics of institutions
(2) the sources of change
(3) the agent of change, and
(4) the direction of change and path dependence.

A basic function of institutions is to provide stability and continuity by dampening the effects of relative price changes. It is institutional stability that makes possible complex exchange across space and time. A necessary condition for efficient markets is channels of exchange, both political and economic, which make possible credible agreements. This condition is accomplished by the complexity of the set of constraints that constitute institutions – by rules nested in a hierarchy, each level more costly to change than the previous one. In the United States, the hierarchy moves from constitutional rules to statute law and common law to individual contracts. Political rules are nested in a hierarchy even at the level of specific bills before Congress. The structure of committees and agenda control assures that the status quo is favoured over change.

Informal constraints are even more important anchors of stability. However, it is important to stress that these stability features in no way guarantee that the institutions are *efficient* (in the sense of producing economic growth). Stability is a necessary condition for complex human interaction, but it is not a sufficient condition for efficiency.

The sources of institutional change are changing perceptions, sometimes reflecting changes in relative prices and/or changes in preferences. Historically, fundamental changes in relative prices – such as changes in land/labour ratios as a consequence of population growth or decline – have been a key source of change. Thus, the decline of manorialism is linked to the population decline in the era that followed the fourteenth-century plague. But the associated decline of feudalism was also linked to another fundamental relative price change – alterations in military technology (the pike, cross-bow, long-bow and, of course, gunpowder) which altered the viable size and fiscal needs of polities. Changes in the relative stock of capital (both physical and human) are key sources of the institutional change of the past 200 years and will be discussed in more detail below.

But preferences change as well. For example, there may be no way to explain the demise of slavery that does not take into account the growing abhorrence on the part of civilized human beings of ownership of one person by another. Slavery was both profitable and viable in many parts of the New World in the nineteenth century. Moreover, slavery had persisted for millennia without incurring the opprobrium that began to crystallize in the Western world in the late eighteenth and early nineteenth centuries and led to the demise of slavery in the British West Indies, the US abolitionist movement and finally the end of New World slavery in Brazil in the 1880s. Ideas matter, and as they evolve they do alter preferences and hence choices.

The agent of change is the entrepreneur – political or economic. So far, we have left organizations and their entrepreneurs out of the analysis, and the definition of institutions has focused on the rules of the game rather than the players. Left out was the purposive activity of human beings to achieve objectives which in turn result in altering constraints. Organizations consist of firms, trade unions, political parties, regulatory bodies, churches and so forth. Organizations and learning alter outcomes, but how?

The institutional constraints, together with the traditional constraints of economic theory, define the potential wealth maximizing opportunities of entrepreneurs (political and economic). If the constraints result in the highest payoffs in the economy being criminal activity, or the payoff to the firm being highest from sabotaging or burning down a competitor, or to a union from engaging in slowdown and make-work, then we can expect that the organization will be shaped to maximize at those margins. On the other hand, if the payoffs come from productivity enhancing activities, then economic growth will result. In either case, the entrepreneur and his/her organization will invest in acquiring knowledge, coordination and 'learning by doing' skills in order to enhance the profitable potential. As the organization evolves to capture the potential returns, it will gradually alter the institutional constraints. It will do so either indirectly, via interaction between maximizing behaviour and its effect on gradually eroding or modifying informal constraints; or directly via investing in altering the formal rules. The relative rate of return on investing within the formal constraints or devoting resources to altering constraints will depend on the structure of the polity, the payoffs to altering the rules and the costs of political investment.

But it is not just the efforts of organizations to alter the rules that shape long-run economic performance. It is also the kind of skills and knowledge that they will induce the society to invest in. Investment in formal education, new technologies and pure science have been a derived demand from the perceived payoffs to such investment.

Institutional change, then, is an incremental process in which the short-run profitable opportunities cumulatively create the long-run path of change. The long-run consequences are often unintended for two reasons. First, the entrepreneurs are seldom interested in the larger (external to them) consequences, but the direction of their investment influences the extent to which there is investment in adding to or disseminating the stock of knowledge, encouraging or discouraging factor mobility, etc. Second, there is frequently a significant difference between intended outcomes and actual outcomes. Outcomes frequently diverge from intentions because of the limited capabilities of the individuals and the complexity of the problems to be solved.

The second economic revolution

Let us now turn to applying the foregoing analytical framework to the problems of modern economies. A little history is a prerequisite.

The tension between population and resources first popularized by Malthus has fundamentally shaped the long-run pattern of economic change. The potential economic well-being of human beings has been limited by the productivity of the technology human beings have developed. That has imposed an upper bound on their possible well-being. The lower bound has been imposed by the degree of success of human beings in exploiting that technology.

There have been two basic breakthroughs in economic history which have altered the ratio of population to resources. The first economic revolution was the creation of agriculture, which permitted an expansion of population for 10 millennia (albeit with widely varying success at solving problems and