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INSTITUTIONS AND THEIR CHANGES

Significant and long-term diversification of economic performance results mainly from respectively significant changes between institutional systems. This paper aims at defining conceptual relations between institutions and economic policy. Institutional changes in the contemporary world are presented, and an analytical framework to explain them is proposed. Using this framework, the three cases of changes as defined by an initial institutional system are discussed: 1) free market system and rule of law, 2) extreme statism and its breakdown, 3) reforms after the breakdown of such a system.
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1. THREE LEVELS OF EXPLANATION

A brief look at modern and contemporary history proves that countries differ very much with respect to their economic performance. The long-term growth trend exhibits significant diversification. In 1950, per capita incomes in North Korea and South Korea were comparable, whereas in 2004, the per capita income in the former was merely approx. 8 per cent of that in the latter. In Poland and Spain at the beginning of the 1950s, also, the per capita income levels were equivalent, and in 1990, Poland's per capita income was just 42% of that in Spain.

Countries also differ with respect to the frequency and scale of economic downturns, which have an effect on their long-term average growth rates. Mexico and Spain, for example, experienced comparable levels of per capita income in 1960, but in 2003, Spain's income was greater than that in Mexico by 70 per cent. For the most part, this was due to the three great economic crises suffered by Mexico in 1982-83, in 1986-87, and in 1995, whereas Spain's economy grew relatively uniformly.

The OECD countries also reveal considerable differences in the long-term unemployment rate over the last 20 years, as it is much higher in Germany, France and Italy than, for example, in Great Britain, the United States or in Denmark. The above mentioned and other differences in

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economic performance are typically explained by means of the first-level variables. Thus, it is easy to prove, using the so-called growth accounting, that a large differentiation of the economic growth rate is related to considerable discrepancies in the growth rate of productivity and sometimes – additionally – in the investment rate. The differences in the frequency and the depth of economic breakdowns are explained by the differentiation of external shocks and domestic economic policy. The differences in long-term unemployment rates are similarly explained.

It is straightforward that such explanations require subsequent explanations of the second degree. What are the reasons for a persistent differentiation in the growth rate of productivity and of investment rate? What explains the differentiation of economic policies leading towards differences in the frequency and the depth of economic breakdowns and the long-term unemployment rates?

While seeking for the answers to such questions and to many similar ones, one inevitably comes across the explanatory variables called institutions (or institutional factors). This is not a new event. Quite the contrary, it was Adam Smith – the founder of modern economics – who focused on those factors in his pursuit after the causes of "the wealth of nations". The evolution of economic thought, however, has gone in the non-institutional direction, except for several scholars (e.g., L. von Mises, F. A. Hayek). The research focused only either on the first-level variables, without considering their institutional environment (e.g., the so-called growth theory) or on economic processes, under – mostly hidden – assumption that the institutional system is given (typically private market or capitalistic economy).

However, for some 30 years now, the situation in the economic sciences has been noticeably changing. There are new, usually interrelated currents of institutional thought, such as the property rights theory, public choice theory, law and economics, new institutional economics etc. Those currents permeate throughout mainstream economics, thus enhancing the position of institutional factors in the explanation of the major types of economic performance: the long-term growth rate, the long-term unemployment rate, the level of inflation.

Measures of institutional variables have emerged: the degree of economic freedom, the extent of the rule of law, the underlying limitations of political authority, etc. Hence, with those measures, empirical research is possible to identify the relationships between institutional factors and economic performance (for the discussion of the results see, e.g., the World Bank publication *Building Institutions for Markets*, 2002). The research has been carried out very extensively. However, it is still much left to do, for example, as regards concretization and operationalization of institutional factors. The main concepts need to be revised and standardized; we shall refer to it in the remainder. It is worth studying which institutional solutions – at the level of legal or informal definitions – are functionally equivalent, i.e., stimulating diverse behaviours (working, saving, innovating, learning) with equal force, and which are functionally different. An important question is which institutional solutions can coexist with each other in diverse fields of social life (e.g., in politics and in the economy), i.e., produce a system, and which cannot.

The up-to-date development of institutional research has generated very important results. It is unquestionable that the considerable differentiation of the long-term growth rate in many countries is mainly attributable to significant differences in the respective domestic institutional systems. Empirical research has corroborated intuition and commonplace opinion that a large extent of economic freedom (rooted in the private property rights) and the related scope of the legal market are significant and irreplaceable for long-term economic development. The research also proves that high levels of long-term unemployment do not result from the free market, but, quite the contrary, from its specific restrictions: the big tax wedge, restrictive regulations of labour and product markets, etc.

Once a significant impact of institutional variables on economic performance has been demonstrated, another question arises: what are the factors affecting the stability or change of institutional factors? Why are institutional systems persistent which generate poor performance, and why do dysfunctional solutions emerge within good systems? How to explain reforms or institutional reforms aiming at the improvement of economic performance? These issues are situated at the third level of explanation – i.e., explanation of an institution's dynamics. This is a vast research area where interests of historians, sociologists, political scientists and economists meet.

I believe that there are much more open questions at this level than at level two, with respect to interdependencies between various institutions and their impact on people's action, and consequently, on economic (and non-economic) performance.

Before proceeding to the remarks on the dynamics of institutions I shall make an attempt to be more specific about the definition of the concept.

2. INSTITUTIONS VS. ECONOMIC POLICY

According to Douglass C. North who is a classic of institutional research, "institutions are the rules of the game in a society; more formally, they are humanly devised constraints that shape human interaction. Thus, they structure incentives in exchange, whether political, social, or economic" (North, 1998, p. 95). This definition may serve as a useful starting point, however, more precision is needed before we may classify more or less roughly some determinants of human behaviours as "institutions".

Here, it will suffice to aim at defining precisely the relations between institutions and economic policy (or in a broader sense, policies). The more factors that are ranked in this policy, the less will be included in the institution, and, respectively, the less impact on economic performance they will have. For example, if a type of monetary and foreign exchange system will be considered as a part of economic policy, it will not be included in the institution.

Economic policy is typically understood as certain actions of governments. They can be divided into: 1) reform policy ("reforms" are sometimes called "structural"), and 2) macroeconomic policy (monetary, fiscal policies). Reforms, once introduced, change to some extent and scope a domestic institutional system which consists of all institutions affecting human actions in a given country. The exemplified monetary and foreign exchange system is an institutional variable because its diverse alternatives signify various game rules in a society. Thus, the effects of reform policy are reached through the changes in institutions. The question why state "actors" perform such changes belongs to the area of institutional dynamics.

One should mention that not all the changes in the domestic institutional system result from the top reforms. The bottom-up changes resulting from the action by non-state actors are also possible. The proportions between those changes depend on the fundamental variable feature of domestic institutional systems, specifically, on the centralization degree of decisions shaping the "rules of game" in society, or rather, in a state which is society's main nationwide organization as regards the range of activities. Conceptually, the centralization degree of those decisions is inverse in respect to the range of freedom while choosing types of contracts (freedom of contracts), and types of organizations (freedom of assembly, freedom of entrepreneurship). In a highly centralized system, any deeper, spontaneous, adaptive changes are excluded, as well as the requirements to preserve the essential identity – i.e., extreme centralization, indeed – also exclude any deeper top changes. Therefore, it is an inflexible system. In a system with a considerable range of freedom of interactions, spontaneous evolution is feasible without a loss of the system's fundamental identity, i.e., the wide range of this freedom. In fact, modern capitalism differs significantly from what it used to be two or three hundred years ago with respect to its organizational forms or types of contracts.

A macroeconomic policy – by definition – does not encompass changes in institutions, but it takes effect by means of some macroeconomic variables, e.g., interest rate or current decisions on budgetary expenditure. The content (quality) of this policy depends however on institutional factors; in the former example of the modern monetary system, whether monetary policy contributes to targeting and keeping low inflation depends on the degree of the actual independence of the central bank. Therefore, any deeper changes in macroeconomic policy may require accordingly profound institutional changes.

Hence, economic policy which uses reforms takes effect through changes in institutions, and deeper changes in macroeconomic policy depend on transformations of institutions.

3. INSTITUTIONAL CHANGES IN A BROADER PERSPECTIVE

A glimpse at the past two hundred years allows for the following remarks:

- The countries of the West have changed their institutional systems towards a free market (liberal) system in the 19th century, while no other countries have done so, except for Japan.
- A wave of statism has begun in the West since the beginning of the 20th century, particularly since the Great Depression (protectionism, increased legal-administrative regulation of the economy, strong build-up of the state's fiscal position). At the turn of the 1970s and 1980s, the Western countries have seen a wave of free-market reforms. The particular countries differ by the distribution of reforms over time and by the scale of changes.
- During the 20th century, the majority of less-developed countries experienced some changes within the circle of statism (e.g., transitions from colonial systems statism to postcolonial systems statism). In some countries, statism has increased significantly, especially in Latin America after World War Two. In other countries, the increase of statism was extremely dramatic, e.g., in Bolshevik Russia after 1917, and in Mao's China after 1949.
- While the majority of Third World countries opted for statism, a small group of so-called Asian tigers pursued a market-driven model, focusing on

exports. Since the end of the 1970s, China, and later on, India, some Latin American and African countries joined them. Radical market reforms have been introduced in some countries from the former Soviet block after the collapse of communism. However, countries with statism (or the so-called failed states) still exist in the Near East, in a large part of Africa, not to mention Cuba and North Korea, whereas some countries (Venezuela under the rule of Chavez and Argentina under the rule of Kirchner) experience an increase of statism.

• The particular cases differ by their dynamics. Some transformations consisted just in gradual accumulation, while others embraced radical changes. This refers both to transformations towards statism as well as the market. For example, gradual changes toward statism have been taking place in the West after the World War Two, whereas dramatic shifts – in Russia and China in the 20^{th} century. Ongoing market reforms have dominated the West and India over the past thirty years, while some ex-socialist countries have seen radical liberal breakthroughs.

• Finally, some market reforms began along with the democratization of the political system (Central-Eastern Europe) while others have been pursued within the inherited democracy (the West, India), and still others – under non-democratic regimes (Asian Tigers during the period 1950-1980, China since the end of the 1970s).

How to explain those institutional changes?

I do not believe that a theory is possible to precisely explain those (and other) cases of institutional transformations, not to mention its ability to accurately predict such changes. The course of history is largely unpredictable due to the non-stochastic uncertainty resulting, among other things, from strategic behaviour of people, from an inability to precisely define triggers of changed social behaviours (e.g., riots) or places, timing and consequences of conflicts, including wars, etc.

However, it is possible (and needed) to set up analytical frameworks to define the main variables (mechanisms) which affect institutions. A task to be accomplished by various empirical research consists in filling those changes with actual contents and thus, in allowing for generalizations on dynamics of institutions.

The simplest framework should contain – in may opinion – the following categories of variables:

1. Initial conditions, including an initial institutional system whose existence or transformation is to be explained.

2. Two opposite forces acting in the period under study:

2.1. Collectivist forces (acting towards statism – when we analyse a system embracing a state)
2.2. Liberal forces (anti-collectivist, acting against statism).

The specification of initial conditions is an indispensable element of any explanation of dynamics in respective events. In addition to the institutional system – an explanatory object – the initial conditions may include:

- natural and geographical factors, and
- social structure in its diverse dimensions, the country's location, etc.

The collectivist forces act in favour of the preservation of inherited collectivist aspects or elements of the institutional system, thus defying any liberal changes. Liberal forces act in favour of the preservation of inherited freedom aspects or elements of the institutional system, thus exerting pressure for liberal reforms. Both types of forces include internal and external factors interacting among themselves and with initial conditions.

I shall now attempt at describing the three cases of institutional dynamics, which differ by the nature of the initial institutional system.

A free-market system and the rule of law

We deal here with the initial system under the wide range of freedom, and the state subjected to the rule of law. Such a system allows for – as previously mentioned – many bottom-up driven innovations, thus enhancing its adaptability in view of diverse threats and potentials, and consequently, improving economic conditions of life in the country. One may therefore naively expect that a positive feedback will function:

Good initial institutional system → Economic prosperity → Continuation of a good system

However the history of the West shows that while this feedback certainly functioned, it was not strong enough in order to effectively prevent various tides of statism experienced by almost all Western countries. Therefore, during some periods the forces of statism dominated the liberal forces there. How to define those collectivist forces – temporary winners?

I put forward the following useful categorization:

1. Situation events, including dramatic episodes such as the Great Depression of 1929, or more recent ones – corporate scandals in the U.S. in the early 21^{st} century.

2. Systematic forces of a psycho-social nature, acting permanently, though not necessarily with the same intensity over time (liberal forces can be categorized in a similar way).

One may distinguish the three types of systematic forces:

- **Collectivist doctrines (**Those doctrines reveal a wider issue, namely, the part of intellectualists in capitalist countries who have engaged in battle against free-market capitalism. The analysis of this problem belongs to the sociology of knowledge and was tackled among others by L. von Mises (1994) and J. Schumpeter (1962)). In the 19^{th} and 20^{th} centuries, it was Marxism with its condemnation of the free market as the main cause of the imminent crisis of capitalism. The source of collectivist messages in Western countries was the orthodox Keynesism with its emphasis on fiscal stimulation of the economy. One should also mention the old-fashioned welfare economics whose basic concepts of market failure, public goods, and externalities provided a theoretical foundation for state's interventionism. The main problem was not about those conceptual instruments as such, but about their frequent abuse. For example, there are not so many public goods in the real world, as the numerous books seem to imply.
- Propagation of **collectivist myths**. They come partly from the collectivist doctrines, but there are also many "autonomous" myths. Some have been described by Frederic Bastiat in the 19^{th} century. The series of collectivist myths is long, and I shall mention here just a few. There is a widespread belief in a "free lunch", e.g., among those voters who are in favour of increased budgetary expenditure, and at the same time, they criticize excessive taxes. The free labour market is often perceived as the exploitation instrument of the weak (employees) by the strong (employers). It is believed that the amount of labour in the society is constant, therefore an easy way to increase the number of employed persons is shorter working hours. "Strategic" sectors (usually not defined) should be controlled by the state, etc.
- **Statist interests**, i.e., those which support the state's expansion because of the expected individual or group benefits: there are many politicians who derive significant psychological gratification from a broad or increased range of authority. Therefore, they will be forcing the increased interventionism of state. There are many entrepreneurs keen to seek shelter from competition by means of the state's protectionism – that is why free trade has always been under attack. A perspective of rights from the state will always be favoured by a part of society, etc.

Various groups of statist interests usually calculate coldly, and make use of the widespread collectivist myths. It may also happen that at first, those interests which succeed later legitimize the statism in new collectivist myths and finally accept them as true. In such a way – through the mechanisms examined by social psychology – the ideology of the welfare state was able to permeate the West. An additional support has been granted by notorious collectivist doctrines.

Collectivist psycho-social forces are always active, but they become considerably strengthened under the influence of certain events and shocks which may be explained by those forces plausibly (though not necessarily correctly) as irrefutable proof that the free market fails, and therefore, this is a convincing case for the necessity of state intervention. Such a nexus of events occurred evidently after the Great Depression of 1929 in Western countries. This is why the expansion of statism is often stepwise.

It is difficult to reverse statism once it has been spread, because its groups of interests mushroom around, and validating doctrines and myths multiply, as mentioned earlier. A chance for the reversal is given by the dramatic events with a "reverse sign" – e.g., the stagnation of capitalism in the 1970s which was shocking for adherents of Keynesism, and increasing problems in countries which engaged in statism mostly, e.g., Great Britain before Margaret Thatcher's era. In these circumstances, some liberal doctrines became important among a part of Western elites and public opinion, previously regarded as intellectual aberration, e.g., treatises by F. A. Hayek and M. Friedman. Subsequently, liberal forces have been strengthened versus collectivist ones, and triggered a tide of market reforms in practically all Western countries, though not to the same degree. Besides, the advancement of the deregulation in capitalist economies is much more profound than that of the reduction of the state's fiscal position which increased considerably after World War Two.

In this context, some important questions arise: if the forces of statism win, but after some time the outcomes of this victory become, at least partly, reversed, then maybe free societies tend to long-term "institutional cycles" which affect the economic performance? Do market reforms put down roots in a free society, thanks to their good economic performance, or quite the opposite – does good economic performance reduce economic pressures thus encouraging the expansion of statism, e.g., in the form of welfare state build-up? This is a question about the nature of national memory – how much past experience is present in it as a learnt lesson? Why did the advancement in the reduction of social and fiscal interventionism appear to be much more insignificant than that in the reduction of the regulatory interventionism?

These and other questions require further research.

The system of extreme statism and its disintegration

I mean here mainly the communist system. All the cases of its installation were based on the powers eliminating ruthlessly all those in favour of liberal solutions. The mechanism was different, much more brutal than in the case of less extreme forms of statism's expansion in the West. There is no need here for subtle theoretical analyses, but instead, deep historic studies are necessary.

The system of extreme statism, once established, will result after some time in poor economic performance suffered by the population. The economic figures worsen even more with the passage of time as compared with those in market economies, and sometimes worsen absolutely (cf. North Korea or Cuba). One would naively believe that this should weaken the forces of statism and lead to market reforms, i.e., that the mechanism of self-adjustment should be activated. But communism persisted in the USSR for over 70 years, Maoism in China for 30 years, and the people of Cuba and North Korea are still suffering under its yoke. Evidently, even if some mechanism of self-adjustment functions under extreme statism, it requires lots of time. When the system disintegrates, it is not clear whether it is due to such mechanism or to external factors. The moment itself and the form of the disintegration are practically unpredictable. This was unmistakably seen in the case of the former USSR.

The cause of the weakness or lack of the self-adjustment mechanism is simple: the extreme statism generating bad performance for society has it under drastic control thus preventing or suppressing any social protest (an exception was the "Solidarity" movement in Poland in 1980-81. However, the movement was eventually delegalized in December 1981, and subsequent transformations in Poland overlapped with centrifugal forces in the USSR, activated by Gorbachev.). Hence, a radical change must be started either from outside or from within the "black box" of political elites. Incapacitated and unarmed society is simply not able to overthrow a bad political system. However, the symptoms of its disintegration – activated by the mentioned factors – may trigger wider social protests. As the De Tocqueville remarked, dictatorships start disintegrating after they become less drastic. Primary impulses generated by the state apparatus may not appear until a long time of dictatorship due to the fact, among other things, that the state apparatus does not suffer from the bad economic consequences of extreme statism, and that it is subject to control, too. The external isolation of the country and internal control make the prediction of a moment and a form of these impulses exceedingly difficult.

Reforms after the collapse of the extreme statism

Although it is impossible to predict a moment and form of disintegration of anti-market dictatorships, sometimes such cases – luckily – happen. The recent and fundamentally important example is obviously the collapse of communism in the former Soviet block. It paved the way for deep-seated reforms. Empirical research shows that post-socialist countries significantly differ with respect to economic results over the past decade, and that the more market reforms have been cumulated – i.e., the more reduction of the inflated state has been achieved, and the more free-market economy institutions have been built – the better were economic results indeed (Åslund, 2002).

Hence, a question arises of how to explain those differences in the scope of reforms? Why is a resultant force of statist and liberal forces so much different in post-socialist countries? This is another issue requiring further extensive research. Here I shall formulate a few hypotheses as regards that research.

- Post-socialist countries differed with respect to linkages between reforms and other factors perceived in a society positively or negatively, depending on its history and geopolitics. In some cases such linkages were positive, e.g. in the EU candidate countries many reforms were connected with the EU accession, which was generally perceived as positive. On the other hand, the market reforms in the former USSR have been perceived in the context of the disintegration of the empire, and therefore, it was probably a negative linkage.
- Countries could differ with respect to a scope of various collectivist doctrines and trends, and also as regards the degree of populism in the just liberated mass media.
- Definitely, there were some differences in various political shocks, e.g., actual or alleged scandals, which – depending on the circumstances (who was ruling at the time of their occurrence) – could strengthen either statist or liberal forces.
- When pro-reform forces rule, they are inclined to pursue reforms both during economic downturn and upturn. When statist parties rule, they are rather inclined to give up reforms, or even to increase statism. Such parties follow reforms only under the pressure of economic crisis. It follows that the more periods of economic prosperity under the rule of statist parties have been experienced, the less reforms have been accumulated (unless pro-reform parties were able to catch up on negligence by statist government). It is probable that post-socialist countries differed by the aggregate duration of such periods.

All the above thoughts on institutional dynamics ignored one factor: **the role of the individual.** However, this is a very important factor, particularly during the deep transformations of systems, both into a statist or liberal model. At the same time, it is also a random factor, whose influence makes it difficult to predict such transformations.

4. INSTEAD OF A CONCLUSION

It is worth mentioning that the forces of statism will always exist in any society, although, they will take on different shapes with different intensities. Therefore, in order to prevent their expansion and to introduce necessary liberal reforms, the proponents of a free market economy, civil society, and constitutionally limited state, have to be well-organized and efficient, both in research and in mass communication. Adequate intellectual and organizational groundwork is needed in order to be able to promptly take advantage of any conditions convenient for reforms. Effective mass communication is necessary so as to contribute to generating such conditions and to providing a social shield for the introduced reforms.

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