

CHAPTER 12
IMPROVING ECONOMIC PERFORMANCE

final

The problems of achieving sustained economic growth should be apparent from the preceding chapters. The economic history of the past half century is littered with the debris of economies that failed to develop, from sub-Saharan African economies to Russia. Yes, the economies of the world have generally achieved significant economic growth. A survey of the world economies at the beginning of the twenty first century reveals unprecedented prosperity as compared to economic conditions in the past. But--- more than a billion people around the earth still exist on less than two dollars a day; stop and go growth still characterizes most of Latin America; Japan as of this writing is still mired in stagnation after a whole decade; Indonesia is in a precarious position *viv a vis* surviving as an entity. And I could go on. On the face of it this is puzzling. We not only know the conditions underlying successful economic growth—the new growth economics spells them out—but we even know the kind of institutions necessary to undergird successful economic growth. Moreover the stock of “useful” knowledge—the

underlying determinant of the potential of economic growth—continues to develop at an undiminished pace.

Yet the problem is straightforward, as the previous chapters have attempted to make clear. If economic growth simply was a function of the growth in the stock of knowledge and technology then the future well-being of the human race would appear to be assured. But if you believe the story embedded in the previous chapters, no such assurance exists. We may very well achieve the phenomenal material well-being that the growing stock of knowledge has made possible. But once we taken into account the complex, and still far from understood, interaction between consciousness and evolving cultures no such assurance exists. The way in which beliefs>institutions>organization>policies>outcomes evolves has led to unparalleled economic well being and to endless disasters and human misery. We still have some distance to go before we understand completely the process of economic growth but we have learned a good deal. Let me elaborate on the fundamental stumbling blocks to economic growth so that we can understand better how to avoid them.

I

We begin with beliefs. Even the most cursory survey of the existing beliefs around the world does not offer an optimistic view consistent with the underlying implicit notions of the rationality assumption. Religious fundamentalism, ethnic hatreds, racist stereotypes, superstitions all shape choices with monotonous persistence. The plus factor is the growing understanding of the sources of productivity growth. In a Coasian world the players would always choose that policy that maximized aggregate well being with compensation for any losers; but the real transaction costs are frequently prohibitive

reflecting deep seated beliefs and prejudices that translate into such prohibitive transaction costs. It is more than two hundred years since Adam Smith explained the underlying sources of the wealth of nations but the extent to which such views are embedded in the decision making process of those shaping political/economic change is problematic

We have now come to understand enough about institutions to be able to pinpoint the sources of poor performance. They have their origins in path dependence. We inherit the artifactual structure—the institutions, beliefs, tools, techniques, external symbol storage systems—from the past. Broadly speaking this is our cultural heritage and we ignore it in decision making at our peril—the peril of failing in our attempt to improve economic performance. The degree to which such cultural heritage is “malleable” via deliberate modification is still very imperfectly understood. At any time it imposes severe constraints on the ability to effectuate change. Let me just enumerate the resultant problems:

1. The institutional structure inherited from the past may reflect a set of beliefs that are impervious to change either because the proposed changes run counter to that belief system or because the proposed alteration in institutions threatens the leaders and entrepreneurs of existing organizations. Where fundamentally competing beliefs exist side by side, the problems of creating a viable set of institutional arrangements are increased and may make the establishment of consensual political rules a prescription of short run disaster.

2. The artifactual structure that defines the performance of an economy includes interdependent institutions; changing just one institution in an attempt to get the desired performance is always an incomplete and sometimes a counterproductive activity.
3. It is a mixture of formal institutions, informal institutions and their enforcement characteristics that defines institutional performance and while the formal institutions may be altered by fiat, the informal institutions are not amenable to deliberate short run change and the enforcement characteristics are only very imperfectly subject to deliberate control.

If we had perfect feedback on the consequences of our institutional policies then we could correctly understand whether the consequences of our actions achieved the desired objectives. However, there is so much “noise” in the system that even if we desire to understand the results we might not be able to have clear signals; and the principal/agent problems in the hierarchical chain of information that produces feedback may militate against getting a correct appraisal.

Altering the performance of an economy for the better takes time—a lot longer than the time horizon of the politician who must approve such changes. In the short run the reform may necessitate alterations that leave some of the players worse off, and if they have access to the political process they may very well derail the reform.

. As the foregoing chapters have made clear we know a good deal about the determinants of economic performance and we are beginning to understand something about the complexities involved in altering economic performance, although our

understanding of the latter issue still has a long way to go to be satisfactory. But let us see what we can contribute to the practical policy problem of improving economic performance. First of all we need to delineate the fundamental characteristics that are the critical elements of good economic performance---the polity and the economic structure; second, to concentrate on how to achieve them. Institutions are all about incentives and good economic performance entails devising a political/economic structure that provides incentives for humans to be productive (and disincentives for anti-social behavior). I can be relatively brief on the first issue since the basic elements have been the subject of the earlier chapters.

II

It is easy to describe the ideal political model—both the authoritarian version and the consensual version have been briefly described above. The four “ideal” components can be restated again as follows:

1. an institutional matrix that produces a set of organizations and establishes a set of rights and privileges;
2. a stable structure of exchange relationships in both political and economic markets;
3. an underlying structure that credibly commits the state to a set of political rules and enforcement that protects organizations and exchange relationships;

4. conformity as a result of some mixture of norm internalization and coercive enforcement.

The ideal economic model comprises a set of economic institutions that provide incentives for individuals and organizations to engage in productive activity. But such a general formulation does not take us very far. The creation of a set of property rights that will lead to an effective price system is a necessary step, but again the substance is in the details. With transaction costs defined as the costs of measuring what is being exchanged and enforcing agreements we must devise a property rights system that provides low cost transacting in the production and exchange of goods and services. Because each factor and product market has different physical, technical, informational, and political characteristics the creation of the general conditions of a price system must be supplemented by structuring each market with the necessary institutional framework to produce “efficient” results. Moreover since the above characteristics will change over time it is essential that such structures be modified over time.

We need to explore in much more detail the sources of transaction costs in an economy. There are transaction costs:

- 1) in measuring the multiple valuable dimensions of a good or service;
- 2) in the protection of individual property rights;
- 3) in the integration of the dispersed knowledge of a society;
- 4) in the enforcement of agreements.

Let us explore each in more detail.

1. Goods and services typically have multiple dimensions that have utility to the individual. To the degree that these individual dimensions can be measured we can define property rights more precisely and thereby increase the utility to the individual and reduce the costs of exchange.
2. The development of effective third party enforcement with all that it entails in terms of institutions and organizations is always supplemented by resources the individual devotes to protection of his/her property.
- 3 The greater the specialization and division of labor in a society the more dispersed is the knowledge in a society and the more resources must be devoted to integrating that dispersed knowledge.
- 4 Enforcement of agreements involves the costs of monitoring and metering exchanges to see that the terms of exchange are being lived up to and of developing effective punishment for violations

Improving economic performance means lowering production and transaction costs and the key is modifying or altering institutions to accomplish this objective. We can specify the needed alterations in the sources of transaction costs described above.

They include

1. the development of a uniform system of weights and measures; technological research for better measurement, and improved specification of property rights;
2. the creation of an effective judicial system;
- 3 the development of institutions to integrate the dispersed knowledge in a society as well as to monitor and meter agreements and adjudicate disputes.

It should be emphasized that the institutions that have emerged in the western world, such as property rights and judicial systems, do not have to be faithfully copied in developing countries. The key is the incentive structure that is created, not the slavish imitation of western institutions. Starting with the household responsibility system, the Chinese have (so far) developed an incentive structure which has managed to produce rapid economic development without any of the standard recipes of the west. However down the road the Chinese must embed the incentive system in the political/economic structure if they are to continue their rapid development and that will probably require institutions that come much closer to the adaptively efficient features of western societies.

III

Poorly performing economies have an institutional matrix that does not provide incentives for productivity-improving activities. The explanation is twofold. One, the existing institutional structure of poorly performing economies has created organizations with a vested interest in the existing structure. Two, dispersed knowledge entails a complex mixture of institutions and organizations to create effective product and factor markets. We are still far from understanding all the requirements for such development, but we can make progress in improving knowledge integration. An effective price system takes us part way but must be supplemented by institutions and organizations that will overcome the externalities, information asymmetries and other impediments that may prevent market integration.

The dismal history of modern sub-Saharan Africa is a telling indictment of our inadequate knowledge of the politics of economic development; the political history of Latin America is only slightly less depressing; and the experience of Russia in the last ten years of the twentieth century is a compelling lesson in our poor understanding of the creation of an effective polity. Overcoming the entrenched interests perpetuating the status quo is one problem, the complex relationship between formal rules and informal constraints another.

The radical decline world-wide in information costs together with the obvious material success of the high income countries has provided an important impetus for change. Windows of opportunity for changes in the formal rules occur when the organizations supporting the status quo have been weakened by poor performance, exposure of corruption, or radical reduction in information about better performance elsewhere. Moreover the enactment of formal rules specifying the four components of an ideal political model can be at least superficially enacted. But making such formal rules effective requires both complementary informal constraints and enforcement. There is a good deal of argument and contradictory evidence on just how long it takes for the development of such informal norms. Certainly a key to the successful long run performance of the developed economies has been deeply entrenched informal norms that limit the degrees of freedom of the political players. And enforcement entails both the creation of the necessary institutions and organizations and the complimentary informal constraints. An authoritarian ruler dedicated to promoting economic growth has a substantial advantage in the short run. In effect he/she can establish the four conditions set out above for an effective polity. But in the longer run a consensual polity is essential

since the persistence of the ruler's dedication to the conditions making for good economic performance will ultimately be undermined by crises or mortality.

The creation of a stable consensual polity takes time and simply putting in place the formal rules is a recipe for disappointment, not to say disaster. As mentioned earlier most Latin American countries after independence adopted their constitution from that of the United States but with radically different consequences. Successful consensual polities require a deep underlying set of norms to constrain the players and that takes time. An incremental process of increasing indigenous skills, in which external aid in the process of providing educational, medical, or other assistance will explicitly be concerned with transferring those skills to the the developing country will gradually build up the human capital that is a necessary prerequisite for a consensual polity. Obviously any deliberate effort to broaden the human capital of poorly performing economies must be built on an explicit understanding of the cultural heritage of that economy.

IV

We take for granted the complex interdependent structure of our modern political economies. They have evolved their modern form over time and usually without deliberate planning. As a result we have very imperfect understanding of the complex interdependence that is essential to their performance. But as soon as we attempt to improve the performance of poorly performing economies we become very conscious of what complex problems results from this interdependence. The integration of the dispersed knowledge requires more than a price system for its accomplishment. As noted

in chapter 9 modern specialization introduces a specific kind of transaction cost-- that of ascertaining the measurement and performance characteristics of goods and services which are alien to one's specialized knowledge, a necessary requirement in order to be able to combine dispersed knowledge effectively.

Adam Smith's wealth of nations was a function of specialization and division of labor. But the logic of specialization and division of labor implies a world in which individuals know a great deal about their specialty but in consequence know less about the rest of their world. Hayek emphasized the crucial additional point that in consequence individuals can have only a very imperfect understanding of the overall character of the political/economic system. Hayek was certainly correct that our knowledge is always fragmentary at best and his pioneering study in cognitive science provided the foundation for accounting for our imperfect understanding. But Hayek failed to understand that we have no choice but to undertake social engineering even though we may certainly agree with him in his winning argument with socialist planners about the efficacy of a price system over alternatives. We must return to the nature of consciousness to put the overall argument in proper perspective. Consciousness is about human intentionality—an intentionality built upon the extraordinary imaginative and creative mind that humans have evolved. But as noted earlier, consciousness is the source both of our creative being and of our capacity for self-destruction.

The essence of understanding the role of institutions in a society is to recognize that they embody the intentionality of our conscious mind. The structure, whether of individual markets or an entire political/economic system is a human-made creation whose functioning is neither automatic nor "natural." Moreover the structure must be

continually altered with changes in the basic parameters of technology, information, and human capital if it is to function well (however defined). In the absence of externalities, imperfect and asymmetric information, and free riding we can envision a price system confronting the economic complexities of change. But such a vision leaves out human beings with the still incompletely understood complexities of human behavior set in a non-ergodic world. These complexities include the way humans interpret their evolving world, the interplay between economic changes and changes in the polity, alterations in military technology which destabilize an existing equilibrium between the parts of the society. As noted in chapter 2 in an ergodic world we would eventually get it right, but in the world of continual novel change the we live in no such guarantee exists. The best recipe for confronting such novel situations is the one that Hayek put forth many years ago and that has been the source of U. S. material success, which is the maintenance of institutions that permit trial and error experiments to occur. Such a structure entails not only a variety of institutions and organizations so that alternative policies can be tried but also effective means of eliminating unsuccessful solutions. Adaptive efficiency evolves only after a relatively long period of evolving informal norms and we know of no short cut to this process.

With all these caveats to our understanding of creating improved economic performance let us see if we can be more positive about the subject:

1. The first requirement for improving economic performance is to have a clear understanding of the sources of poor economic performance. Measuring the cost of transacting in various factor and product markets is an essential first step. With that information we can trace back the sources of poor performance to their origins in the

institutional/organizational structure. But high transaction costs will frequently have militated against any production at all of some goods and services that given the factor endowments should be profitable investments. Therefore an intimate understanding of the potential prospects of the economy is also necessary.

2. In order to improve the institutional structure we must first have a clear understanding of the sources of that institutional framework. We must know where we have been in order to know where we can be going. Understanding the cultural heritage of a society is a necessary condition for making “doable” change. We must not only have a clear understanding of the belief structure underlying the existing institutions but also margins at which the belief system may be amenable to changes that will make possible the implementation of more productive institutions. Only then will we have a knowledge of the sources of the existing institutions, their organizational underpinnings, and insights into possible structural reform.

3. In the face of competition from already developed economies underdeveloped economies face the additional problems involved in integrating the dispersed knowledge essential to low cost performance. The “global economy” is not a level playing field. The already developed economies have a major advantage in the institutional/organizational framework that (however imperfectly) captures the productivity potential inherent in integrating the dispersed knowledge essential to efficient production in a world of specialization. One cannot create that institutional/organizational matrix over night. Therefore a variety of governmental intervention—with all the caveats necessary for their termination over time—may be essential in the short run to be competitive.

4. A viable polity that will put in place the necessary economic institutions and provide effective enforcement is a necessary prerequisite for improved performance. Without a heritage of formal and informal consensual political institutions, the road to an effective political system requires either an authoritarian ruler with an understanding, desire, and ability to put in place the necessary economic rules and enforce them, or the much more lengthy process of piece meal development through NGOs and effective foreign aid in which educational, health, judicial, or other assistance is effectively designed and delivered with the objective of transferring the essential knowledge and skills to the resident population.¹ An externality by-product will be a gradual accumulation of the necessary political human capital to build an effective consensual polity. I know of no effective shortcut to this alternative and it entails the additional requirement that the existing government be “induced” not to intervene in preventing such local improvements and transfers of knowledge.

Where the essential conditions for a consensual polity exist, the development of institutional rules that provide for greater transparency in the polity will enable more effective monitoring of the polity. There is an immense literature on effective (that is, conducive to promoting economic growth) political policy, all variants to one degree or another of Madison’s insights in the Federalist Papers.

4. As noted above, alteration of the economic rules entails winners and losers and it is essential to be aware of them, of their access to the political process and therefore of the ability of losers to negate the proposed alterations. While “Coasian” solutions are not

¹ Social Provision in Low Income Countries, 2001, Oxford (edited by G. Mwabu, C. Ugaz, and G.White) discusses some of the issues involved in such provision

always possible, awareness of the costs and benefits can result in institutional alterations that can mitigate opposition.

This very general set of prescriptions can be little more than a set of very general guidelines for a reform program. They are built on a strongly held belief that the institutional/organizational structure is the key to economic performance and therefore must be the focus of effective reform.