

THE ROLE OF INSTITUTIONS AND LAW IN ECONOMIC DEVELOPMENT

*Tom G. Palmer
Cato Institute*

Prepared for “A Liberal Agenda for the New Century: A Global Perspective,” a Conference cosponsored by the Cato Institute, the Institute of Economic Analysis and the Russian Union of Industrialists and Entrepreneurs, April 8-9, 2004, Moscow, Russian Federation.

Thanks substantially to the pioneering work of a number of scholars, the attention of scholars, policy makers, and the public has been focused on the role of law in shaping institutions and the role of institutions in shaping economic development.¹ Liberalism has contributed to human well being primarily by its focus on simultaneously authorizing and limiting a set of institutions that find, create, and enforce law. To understand the relationship of liberalism to those institutions, it helps to make a rather simple distinction. That is the distinction between being “anti-government” and being in favor of “limited government.” The two are frequently confused, especially by avowed enemies of liberalism who favor unlimited government, but they could not in fact be more different. Criminals and terrorists, for example, who seek to destroy life, liberty, and property, are “anti-government.” They seek to weaken government. In contrast, liberals, who seek to limit government, are not seeking to destroy it, but to strengthen it so that it can effectively perform a limited set of valuable functions.

What liberals seek is not weakened government, but effective, lawful, legitimate, limited government – government that can carry out certain functions effectively and efficiently, but which is limited to those and only those functions. What is needed is a government of law, rather than of simple force or violence.

Most governments around the world currently do both too much and too little. They do too much when they carry out functions that either should not be carried out at all, such as imposing monopolies or restraints on voluntary trade, or that could and should be carried out by the organizations of civil society, whether providing telephone services or running child care centers. They do too little when they fail to define rights to

¹ See the pioneering papers on property rights in Arnold Plant, *Selected Economic Essays and Addresses* (London: Routledge and Kegan Paul, 1974) and in R. H. Coase, *The Firm, the Market, and the Law* (Chicago: University of Chicago Press, 1988).

the use of scarce resources and when they fail to provide the service of defending life, liberty, and property. One way to free up resources to allow government to carry out its valuable functions well is to stop it from doing all those things that it shouldn't be doing, either because they are unjust by themselves or because they could be done better by the free and voluntary coordination of citizens. Not only would government do its job better, but when government does a better job of defining and defending rights, markets and voluntary organizations do a better job of creating wealth and progress.

Why Do Institutions Matter?

Institutions matter because incentives matter. Incentives induce individuals and groups to behave in some ways and not in others. Good incentives induce individuals and groups to cooperate to produce value by production and exchange and to eschew and avoid violence. Good incentives induce individuals and groups to transfer responsibility to those who are best capable of producing value. Incentives are given particular form by institutions, which include not only formal organizations and procedures, such as legislative and executive governmental bodies, courts of law, written legal rules, and police agencies, but also informal and non-governmental bodies and procedures, such as moral and ethical norms, reputation, mutual behavioral expectations, and much more. Enforcement of rules and procedures can be internal, i.e., by the parties affected by a transaction, or external, i.e., by third-party arbitration or the organs of the judiciary system.² When someone anticipates shame, a loss of valuable reputation, a missed

² See Douglass C. North, *Structure and Change in Economic History* (New York: W. W. Norton & Co., 1981), esp. chap. 15: "Institutions are a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principles." (pp. 201-2) See also World Bank, *Building Institutions: World*

opportunity for gain, or a punishment or a reward imposed by others, whether organized in a governmental body or not, he or she is facing an incentive.³

Getting the institutions right matters. Many people simply don't understand that. They don't understand it because they still believe in magic. Few people believe that the chanting of magic words or incantations exercises power over the world. Most of us believe in cause and effect, in tracing out the effects to their causes. The scientific approach has been triumphant in such fields of inquiry as physics, chemistry, biology, and geology. Unfortunately, when it comes to the science of human behavior, many people – possibly most – still believe in magic, because they believe that a special class of wizards and magicians actually can change the world just by the power of words. Those wizards and magicians are called legislators, rulers, governors, and presidents and, so most people believe, when they say such words as “It shall be the law that all shall have the right to good health care, or a good education, or a higher living standard,” those words carry the power to bring about the intentions behind them.

Those who believe in the principles of cause and effect are not content to inquire into the intention announced in a law. They inquire not only about the intention of the legislators, but also into the mechanism of causation. How will that intention be realized? What is the likely effect of the law announced by the legislators? To ask about the likely effects is to ask about the incentives individuals and groups will face. Will the law create incentives that will induce people to create better health care, or better

Development Report 2002 (New York: Oxford University Press, 2002), esp. chap 1, “Building Institutions: Complement, Innovate, Connect, and Compete.”

³ “Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline.” Douglass C. North, “Institutions,” *Journal of Economic Perspectives*, Vol. 5, No. 1 (Winter 1991), p. 97.

education, or higher living standards? To ask about incentives is to ask about the institutions that give particular form to incentives.

The difference between North Korea and South Korea is clear from night-time satellite pictures. The north is completely dark, while the south is ablaze with light. What accounts for that? The incentives people have to create light. And the incentives are shaped by the institutions.

Institutions and Technology

It has been well demonstrated that the long-term determinant of economic growth is not simple capital investment – the addition of more machines or buildings, but the growth and application of knowledge. As Joel Mokyr points out, “differences in institutions are better at explaining differences in income *levels* in cross section at a given moment. Knowledge can and does flow across national boundaries, if not always with the frictionless ease that some economists imagine. If the only reason why Germany is richer than Zimbabwe today were that Germany possesses more useful knowledge, the difference might be eliminated in a relatively short time. If we were to ask, however, why Germany is richer today than it was in 1815, the importance of technology becomes unassailable—though better institutions might still be of importance as well.”⁴

Nonetheless, as Mokyr shows, the growth of technology is itself deeply dependent on the maintenance of the right institutions. Some institutions are more propitious to the growth of knowledge and technology than others, and even when technology is available in books or other forms, the lack of protected property rights may make it virtually

⁴ Joel Mokyr, *The Gifts of Athena: Historical Origins of the Knowledge Economy* (Princeton: Princeton University Press, 2002), p. 286.

useless.⁵ The good news is that a change to new institutions may allow very poor countries to increase income and human welfare through economic growth with remarkable rapidity, by adapting “off-the-shelf” technology from other countries and putting it to good use. As Johan Norberg points out, “History shows that economies can grow faster by riding on the prosperity and technology of other countries. From 1780, it took England 58 years to double its wealth. A hundred years later, Japan did it in only 34 years, and another century later it took South Korea only 11 years.”⁶ The rapid rise in living standards in previously deeply impoverished countries such as South Korea is strong evidence of the ability of workable institutions to allow poor people to skip the hundreds of years of slow upward development that other countries experienced and to arrive in a relatively short time at extraordinary prosperity.

On a smaller scale, the recent leapfrogging of many countries into mobile telephony when state monopolies were removed shows that technology can be rapidly imported when the right institutions are created, thus allowing rapid advances in economic growth and well being. That’s the good news. But first the institutions have to be sorted out properly.

Cargo Cults vs. Scientific Inference

A scientific approach can’t, however, stop at merely invoking the magic word of “institutions.” One must go further and ask, what institutions account for the difference, and how? Would it be enough simply to copy all the institutions of the rich societies and recreate them in poor societies?

⁵ See the treatment in chapter three of William Easterly, *The Elusive Quest for Growth: Economists’ Adventures and Misadventures in the Tropics* (Cambridge, Mass.: The MIT Press, 2002), pp. 47-69.

⁶ Johan Norberg, *In Defense of Global Capitalism* (Washington, D.C.: Cato Institute, 2003), p. 134.

The effort to do so is reminiscent of the “cargo cults” of the South Pacific. The famous physicist Richard Feynman described what he called “cargo cult science” in a commencement address at the California Institute of Technology,

In the South Seas there is a cargo cult of people. During the war they saw airplanes land with lots of good materials, and they want the same thing to happen now. So they've arranged to imitate things like runways, to put fires along the sides of the runways, to make a wooden hut for a man to sit in, with two wooden pieces on his head like headphones and bars of bamboo sticking out like antennas – he's the controller – and they wait for the airplanes to land. They're doing everything right. The form is perfect. It looks exactly the way it looked before. But it doesn't work. No airplanes land. So I call these things cargo cult science, because they follow all the apparent precepts and forms of scientific investigation, but they're missing something essential, because the planes don't land.

Now it behooves me, of course, to tell you what they're missing. But it would be just about as difficult to explain to the South Sea Islanders how they have to arrange things so that they get some wealth in their system. It is not something simple like telling them how to improve the shapes of the earphones.⁷

Too often policy makers in underdeveloped countries – and, more importantly, policy makers in developed countries and in international aid organizations – simply tell people in underdeveloped countries to improve the shape of their earphones. They conclude that if the poor only had the institutions enjoyed today by the rich, they, too, would be rich. I recall working in the USSR and running into American government officials who were busy setting up a copy of the Securities and Exchange Commission of the United States, since that was clearly a necessary prerequisite to the existence of a functioning capital market. Although there was virtually no private property yet, they applied a simple – but fallacious -- logic:

A) the U.S. has an SEC;

B) the U.S. has a highly developed capital market;

⁷ Adapted from the commencement address given in 1974 at the California Institute of Technology (Caltech). http://www.physics.brocku.ca/etc/cargo_cult_science.html

therefore C) the U.S. has a highly developed capital market because it has an SEC;

therefore, D) if Russia is to have a highly developed capital market, it first needs its own SEC.

In Romania soon after the fall of the Ceausescus a great effort was made to install computerized trading systems for a stock market that didn't yet exist. Similar stories could be told about the attempt to copy the outward forms – the shape of the earphones – of banking and financial systems, competition law, and other institutions. Those are examples of “cargo cult policy making.” If you create a Securities and Exchange Commission or a system of computerized trading stations, the stock traders, the entrepreneurs, and the capitalists will see them as they fly overhead and they will decide to land, lured by the cleverly designed decoys set up by policy makers.

The cargo cult approach to economic development is hardly a new one. Indeed, one of the most disastrous examples of that mentality was given by V. I. Lenin at the very foundation of the socialist experiment. As Lenin pointed out, managing factories is easy: “All citizens become employees and workers of a *single* nationwide state ‘syndicate.’ All that is required is that they should work equally, do their proper share of work, and get equally paid. The accounting and control necessary for this have been *simplified* by capitalism to the extreme and reduced to the extraordinarily simple operations – which any literate person can perform – of supervising and recording, knowledge of the four rules of arithmetic, and issuing appropriate receipts.”⁸ What could be simpler? Lenin and his colleagues had observed capitalist enterprises as carefully as had any stone-age

⁸ V. I. Lenin, *The State and Revolution* (Peking: Foreign Languages Press, 1973), pp. 120-21.

Melanesian had observed airstrips and control towers. They knew what had to be done and did it. And with much the same result

If one is going to make such comparisons, in any case, it would be better to look, not at what wealthy countries have today, but at what they developed during the period when they were changing from underdeveloped to developed nations. Not what institutions rich countries have today, when they are rich and can afford inefficient policies, but what they had that accounted for their development.⁹

In 1992 Milton Friedman warned an audience at a conference like this in Mexico City that “The United States is not the model for Mexico or any of these countries.... take as your model the U.S. in its first hundred and fifty years.” In recent years, as Friedman pointed out, a number of highly inefficient institutions had been created in the United States that had diminished economic growth below what it could have been, but which were nonetheless affordable to a very wealthy nation. “We can afford our nonsense because we had so long a period during which to build a base, so we can afford the waste.”¹⁰ Let’s apply Friedman’s reasoning by looking at the current edicts of the regulatory state in the United States. In 2002 those edicts filled 75,606 pages of the Federal Register and cost Americans \$860 billion in lost wealth opportunities and \$25 billion in administrative expenses, for a combined cost of \$885 billion. In comparison, all combined United States corporate pre-tax profits in that year came to \$699 billion, or \$186 billion less than the cost of regulations.¹¹ A poorer nation – especially one at a

⁹ A good place to start would be Nathan Rosenberg and L. E. Birdzell, Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* (New York: Basic Books, 1987)

¹⁰ Milton Friedman, Keynote Address, Liberty in the Americas: Free Trade and Beyond, Cato Institute conference in Mexico City, May 19, 1992.

¹¹ Clyde Wayne Crews, *Ten Thousand Commandments* (Washington, D.C.: Cato Institute, 2003); Crews bases his analysis of the costs of regulatory compliance on the work of W. Mark Crane and Thomas D. Hopkins, “The Impact of Regulatory Costs on Small Firms,” Report prepared for Small Business

subsistence level of existence – would more directly feel the cost of such complex regulatory structures. Such regulatory institutions, although they coexist with substantial wealth, would be disastrous in poor countries that could not afford such enormous compliance costs. The World Bank recently reported that “For regulatory systems in developing countries to have a realistic chance of success, they need to be simpler, often less information-intensive, and less burdensome on the courts.”¹² They could have added that such criteria would be welcome in wealthy countries, as well.¹³

Mere Copying Won’t Do

Another example of cargo-cult policymaking is the attempt to copy American capital structures as the foundation for industrial organization in developing countries. America has a system of widely held stock ownership, with some fifty percent of American households holding shares in publicly traded firms. But as former World Bank official Robert Anderson points out, widely held stock ownership is not a necessary condition for economic growth: “Of the large public companies, the proportion that is widely held is not high except in the United States, the United Kingdom, and Japan. In these three countries, the proportion is 80 to 100 percent. In other countries, the proportion is smaller, for example, 60 percent in Canada, Switzerland, and France; 50 percent in Germany; and 10 percent or less in Hong Kong, Austria, Belgium, and

Administration, Office of Advocacy, RFP no. SBAHQ-00-R-0027, October 2001, www.sba.gov/advo/research/rs207tot.pdf.

¹² World Bank, *Building Institutions: World Development Report 2002*, p. 12.

¹³ See Richard Epstein, *Simple Rules for a Complex World* (Cambridge, Mass.: Harvard University Press, 1995), p. 21: “The proper response to more complex societies should be an ever greater reliance on simple legal rules, including older rules too often and too easily dismissed as curious relics of some bygone horse-and-buggy age.”

Greece.”¹⁴ Belgium is hardly a third world nation, despite the fact that its economy has a capital structure that differs dramatically from that of the United States. In countries that lack American-style legal systems and supervisory institutions, American-style capital structures merely invite conflict between managers and shareholders and between different classes of shareholders. (It should also be pointed out that such conflicts exist in the United States, as well, and are typically exacerbated by dysfunctional “anti-takeover rules” and complex tax rules that make it harder for investors to monitor the behavior of managers.¹⁵)

What matters is not whether the shape of the earphones is the same as the shape in the United States, but whether they actually produce wealth and freedom. And that requires attention to patterns of cause and effect and to the constraints surrounding the implementation of procedures and rules. We cannot escape the problem of delineating cause and effect.¹⁶

Complex Orders Require Simple Rules

One causal relationship that has been well established is that simplicity of rules and institutions tends to promote complexity of orders. For example, when it is simple to

¹⁴ Robert E. Anderson, *Just Get Out of the Way: How Government Can Help Business in Poor Countries* (Washington, D.C.: Cato Institute, 2004), p. 43.

¹⁵ See, for example, Christopher L. Culp and William A. Niskanen, eds., *Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations* (New York: John Wiley & Sons, 2003)

¹⁶ A good example of such a causal account is given in Daron Acemoglu, Simon Johnson, and James A. Robinson, “An African Success Story: Botswana,” July 11, 2001, <http://econ-www.mit.edu/faculty/acemoglu/files/papers/Botswanafinal.pdf>. As the authors point out, in Botswana, “The basic system of law and contract worked reasonably well. State and private predation have been quite limited. Despite the large revenues from diamonds, this has not induced domestic political instability or conflict for control of this resource....we argue that Botswana’s good economic policies, and therefore its economic success, reflect its institutions, or what we call institutions of private property [which] protect the property rights of actual and potential investors, provide political stability, and ensure that the political elites are constrained by the political system and the participation of a broad cross-section of the society.”

gain legal title to land, people can create complex systems of economic and social order. Hernando de Soto has documented how complex are the rules that must be followed to gain legal title to land in many countries: in the Philippines it is a process taking “168 steps, involving fifty-three public and private agencies and taking thirteen to twenty-five years” and in Egypt the process involves “at least 75 bureaucratic procedures at thirty-one public and private agencies,” taking “anywhere from five to fourteen years.”¹⁷ The contrast with wealthy nations such as Canada, Germany, or Japan could not be clearer. Technological innovations, such as internet registration, may help, but they are no substitute for eliminating excessive bureaucratic complexity.¹⁸ Complex and costly procedures are typically induced (or at least maintained) by the opportunity to create or sustain government employment or to generate extra-legal income for government officials.¹⁹

Titling property acquired through occupation and conveying property through sale are not the only property systems that are made needlessly complex by institutions that are poorly designed from the perspective of the majority of the population, but well designed from the perspective of small groups who are endowed with monopoly privileges. In some countries the transfer of title through inheritance is enormously complex, while in others it’s relatively simple. The difference is institutional. For example, I learned during a trip to Guatemala that the legal profession has a monopoly in that country on the making of wills; a lawyer must be engaged to draw up a legally valid

¹⁷ Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), p. 20.

¹⁸ In some cases technology can improve the procedure, as in the case of Andhra Pradesh in India, where computerization cut the time to register a change of land title from 10 days to 1 hour, but in most cases it’s far more valuable simply to eliminate the number of agencies involved and the number of permissions required. See the case study of Andhra Pradesh prepared by Subhash Chandra Bhatnagar: <http://www1.worldbank.org/publicsector/egov/cardcs.htm>.

¹⁹ World Bank, *Building Institutions: World Development Report 2002*, p. 13.

will. The result is that only a small percentage of the population – the wealthy elite – enjoy the protection of legally enforceable testaments. In contrast, in anticipation of a trip to Baghdad, I recently revised my will using a commercially available computer program called “Willmaker.” Had I not had a computer available, I could have purchased a simple form at a stationery store for less than a dollar. I filled out the forms, signed them before three witnesses who also signed, and the result was a valid will. The consequence of that difference is that where inheritance procedures are made complex by such monopolies, family members expend a much higher percentage of inherited wealth fighting over its distribution than is the case in countries where inheritance procedures are simple and available to all.

There is also a strong connection between the scourge of governmental corruption and the extent of governmental intervention into the market. The more obstacles the state places in the way of willing buyers and sellers, for example, the more opportunities for bureaucrats to exact a toll.²⁰

The lesson of such experiences is fairly clear: the rules and procedures governing transactions need to be simple to be effective. Governments can assist in simplifying rules by focusing on setting basic rules of procedure, not on guaranteeing outcomes. Rules governing conveyances that insist on fairness in outcomes, rather than simplicity of procedure, are likely to guarantee neither fairness nor simplicity.

²⁰ See the account of the information from the *International Credit Risk Guide* in William Easterly, *The Elusive Quest for Growth*, pp. 248-252.

Markets Need Regulation, Not Intervention

The extended order of the free society rests on what F. A. Hayek terms “an order of actions.” As Hayek noted, “What is required if the separate actions of the individuals are to result in an overall order is that they not only do not unnecessarily interfere with one another, but also that in those respects in which the success of the action of the individuals depends on some matching action by others, there will be at least a good chance that this correspondence will actually occur.”²¹ What is needed is a system that can make transactions regular through reliance on simple and straightforward rules and procedures.²²

What is currently called “regulation” is typically not regulation at all, but rather a system of arbitrary, capricious, and unpredictable intervention, with legislators or bureaucrats empowered to change the rules when and as they please and to impose on market participants enormously complex, burdensome, and unpredictable edicts and commands. “Rules” is not a very useful term to describe something so unpredictable and so changeable. James Madison, the principal author of the United States Constitution, described the perils of allowing legislators or bureaucrats to exercise such arbitrary power as is currently exercised in the name of “regulation.”

The internal effects of a mutable policy are still more calamitous. It poisons the blessings of liberty itself. It will be of little avail to the people that the laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is today, can guess what it will be tomorrow. Law is defined to be a rule of action, but how can that be a rule, which is little known, and less fixed?

²¹ F. A. Hayek, *Law, Legislation, and Liberty: Volume I, Rules and Order* (Chicago: University of Chicago Press, 1973), pp. 98-99.

²² See the treatment of the meaning of regulation in Randy Barnett, *Restoring the Lost Constitution: The Presumption of Liberty* (Princeton: Princeton University Press, 2004), esp. pp. 302-313.

Another effect of public instability is the unreasonable advantage it gives to the sagacious, the enterprising, and the moneyed few over the industrious and uninformed mass of the people. Every new regulation concerning commerce or revenue, or in any manner affecting the value of the different species of property, presents a new harvest to those who watch the change, and can trace its consequences: a harvest, reared not by themselves, but by the toils and cares of the great body of their fellow-citizens. This is a state of things in which it may be said with some truth that laws are made for the *few*, not for the *many*.²³

Not only is the modern so-called regulatory state not productive of actual regulation, but regulation can be provided effectively by the voluntary institutions, such as credit bureaus, quality certification, financial ratings, performance standards, and the like.²⁴ Such non-state regulatory systems provide a high degree of predictability, but, because they are competitive and cannot command a coercive monopoly on setting regulations, they can nonetheless evolve in response to changes in technology and the needs of the market.²⁵

Conclusion

Liberals, more than people of any another political perspective, are concerned with institutions. They emphasize the application of scientific principles to social relations, rather than magical thinking, and therefore liberals focus on incentives, which means that they are deeply interested in the design and evolution of institutions.²⁶ More

²³ James Madison ["Publius"], Federalist Number 62, February 27, 1788, in James Madison, *Writings*, ed. by Jack N. Rakove (New York: The Library of America, 1999), p. 343.

²⁴ See, for examples, Yesim Yilmaz, "Private Regulation: A Real Alternative for Regulatory Reform," *Cato Policy Analysis* No. 303, April 20, 1998, <http://www.cato.org/pubs/pas/pa-303es.html>, and the studies in Daniel B. Klein, ed., *Reputation: Studies in the Voluntary Elicitation of Good Conduct* (Ann Arbor: University of Michigan Press, 1997).

²⁵ See the treatment of the relationship between regulation and technology in Fred E. Foldvary and Daniel B. Klein, eds., *The Half-Life of Policy Rationales: How New Technology Affects Old Policy Issues* (New York: New York University Press, 2003).

²⁶ For a theoretical framework for the study of institutions, with some case studies, see the papers in Martti Vihanto, *Discovering a Good Society through Evolution and Design* (Turku, Finland: Turku School of Economics and Business Administration, 1994).

is required than the *post hoc, ergo propter hoc* reasoning behind much of the attempt to copy institutions existing in wealthy societies, without asking whether the wealth of those societies is caused by the institutions, or the institutions – no matter how inefficient – are affordable because of the preexisting wealth of those societies, wealth that was caused by other institutions altogether. Free and wealthy societies need simple, predictable rules. Limited government can provide the basic framework of rules that makes social complexity possible. Regulation, understood as rules and principles that make transactions regular, should be contrasted with the empowerment of legislators or bureaucrats with the powers to change rules arbitrarily and to impose their will on others through edicts and commands. Such regulation can be provided by the formal legal institutions of government, including legislatures and courts of law, or by voluntary institutions of civil society, such as credit bureaus and standard-setting associations.

Liberalism is the philosophy of freedom, law, and prosperity. It is the institutions of law – that is, of limited government – that create the framework within which we exercise freedom, and it is through freedom that people create wealth and general prosperity.