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Institutional Transition and the Problem of Credible Commitment

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I went back to graduate school with the clear intention that what I wanted to do with my life was to improve societies, and the way to do that was to find out what made economies work the way they did or fail to work. I believed that once we had an understanding of what determined the performance of economies through time, we could then improve their performance. I have never lost sight of that objective.

—Douglass North, 1993

1. Introduction

The last quarter of the twentieth century witnessed amazing political and economic transformations throughout Africa, Latin America, and Eastern and Central Europe. Between 1975 and 2000 over thirty countries were democratized. At the same time, around 1975 a transformation in economic policy ideas started to challenge the post WWII Keynesian hegemony, and free-market economic reforms were introduced to off-set economic stagnation in the democratic West and to promote economic growth in the less developed world. The track record on this democratic politics and free market policy transformation has been more mixed than one might have thought given political theory and economic theory.

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The track record is ambiguous because while democratic politics might have been introduced in form, the substance of liberal rights and limits on state power was absent. The result has been the rise of illiberal democracy. With regard to economic policy, the story is also one of a disjoint between theory and practice. In this case, the market-oriented rhetoric was divorced from the reality of government regulation and activist policy. The IMF and the World Bank, for example, were formed during a Keynesian era to pursue Keynesian policies based on Keynesian economic theory. When Keynesian economic theory was called into question and Keynesian policies were challenged empirically, these Keynesian institutions were asked to pursue non-Keynesian policies. The so-called “Washington Consensus” emerged, which in rhetoric was supposed to promote worldwide free market reforms such as low inflation, balanced budgets, privatization, less red-tape by lowering regulation, and free trade. But in practice, the policies of these institutions are associated with macroeconomic stabilization, conditionality, and globalization. Keynesian institutions are not well constituted to pursue free market policies. Instead, what we got, even in the period of so-called market romanticism was simply an oscillation between “conservative” Keynesianism and “liberal” Keynesianism. But aggregate demand management remained the name of the game, and regulation and public sector programs were designed to address a plethora of so-called market failures.

By the late 1990s and early 2000s, tensions over globalization and debate over the failure of the Washington Consensus to generate an economic growth miracle for the less developed economies and the reforming former socialist economies of the world led to an increasing disillusionment with the laissez faire policy rhetoric of the past generation. Just as democratic transitions without liberal limits on the state resulted in illiberal democracy, economic transitions without liberal limits on the state resulted in weak growth and frustrated populations. Whenever we discuss democratic and economic reforms, it might be useful to remember that we neither desire voting just for the sake of voting or growth just for the sake of growth, but always provide instrumental value to voting and economic growth in relation to the production of effective freedoms and life improving conditions. Freedom of press, freedom of religion, freedom of association, improved sanitation, greater educational opportunities, better nutrition, wider-spread literacy, longer and less onerous lives: these are some of the things positive social change is supposed to produce. And we must recognize that many improvements to the human condition were in fact experienced by

populations that for too long suffered under oppressive governments throughout Africa, Latin America, India, China, and Eastern and Central Europe. The past two decades did see progress. But there were also many examples of frustration, backtracking, and regime failure over the past ten years as well.

So why the disjoint between the rhetoric and the reality in this era that promised so much to so many throughout the world? Each case would require detailed examination in a way that is beyond the scope of any one paper, let alone a book-length treatment. Rather than promise something I cannot deliver, I will instead focus on what I consider to be an essential element in political and economic transitions of post communism—the establishment of a binding and credible commitment to liberal limits on state action. As I suggested earlier, without those liberal limits in place, democratic and economic transitions easily go astray and we end up with illiberal democracy and severely distorted and hampered market economies. The issue is not only solving a commitment problem, but also specifying the correct content to the commitment. In other words, what you are credibly committing to matters even more than whether you can commit to the policy rules required for reform.

2. What Have We Learned Since The Collapse of Communism?

In the immediate aftermath of the collapse of communism in Eastern and Central Europe and then the break-up of the Soviet Union, the focus of economic reform was on “getting the prices right.” This phase lasted from roughly 1985 to 1995.

During the last phase of state socialism, struggling economies in Poland, Hungary, and even the Soviet Union attempted economic reforms that sought to allow market prices and limited use of the profit motive to address the systemic stagnation in these countries. In Poland this took the form of decentralized administered pricing and bonuses for state enterprises; in Hungary, market socialist tinkering with the price system (in the attempt to realize efficiency) was introduced in the 1960s; and even in the former Soviet Union, Khrushchev’s “regionalism” and Gorbachev’s perestroika involved both price reform, decentralization of decision-making, and limited introduction of the profit motive to provide incentives and mobilize the requisite information to allocate resources efficiently.

The experience in Hungary during the 1960s through the 1980s demonstrates

the failure of these limited price reforms to fix the fundamental economic problems with state socialism. Free pricing actually constituted a small part of the reforms as the goods and services in the economic system were divided into those subjected to fixed prices, limited prices, and free prices. The same sort of limited reforms were introduced with respect to state enterprises. State enterprises were given more control of decision-making and basic incentive compatibility in that success was measured in “profitability” of the enterprise, but they existed in a world of soft budget constraints and lacked the market discipline that would follow from competitive entry. So-called “goulash communism” was better than traditional socialism, but still paled in comparison to the market economy in terms of production efficiency and consumer satisfaction. The experience with perestroika in the Soviet Union is similar. Market reforms were introduced in the context of state socialism but the basic ownership structure of state socialism was left in place. So again, the reforms failed to produce what was required for the economic system to become more efficient.

The failure of perestroika highlights both points about credibility that was raised in the introduction. Gorbachev introduced during his relatively short time in office (1985–1991) at least ten “radical reforms” to improve the economic situation, only to have the reforms reversed within months of introduction. A major reason for the reform measures to result in frustration was that the reforms were incentive-incompatible with basic economics. Cooperatives, for example, were permitted to freely price, but those cooperatives that priced at market prices were taxed at a higher rate than those cooperatives that priced products at the state price. As a result (as the Russian joke went at the time) a state shortage of buns and a state shortage of sausage became a sandwich sold out the backdoor. In other words, while all acts between consenting capitalist adults were supposedly freed under Gorbachev, economic actors in the Soviet Union still chose to transact in the black market rather than the newly legitimated above-ground market.

With the collapse of communist regimes in Eastern and Central Europe in 1989 and the former Soviet Union in 1991, the “getting the prices right” phase of reform began to be joined with a wide-scale recognition that prices exist within an institutional setting of private property and freedom of contract. In other words, the mantra of “getting the prices right” transformed into “getting the institutions right.” At a fundamental level this was a return to the main lesson of the socialist calculation debate that prices without property were a grand

illusion, as G. Warren Nutter put it. Privatization efforts throughout Eastern and Central Europe and the former Soviet Union swept through in the late 1980s and early 1990s with varying results, but mostly resulting in frustrations. Private property and freedom of contract it turned out required also a more fundamental institution—the rule of law. This led Milton Friedman to modify his advice to reforming countries from “privatize, privatize, privatize” to “privatize, privatize, privatize, provided there is a rule of law.” The “getting the institutions right” message evolved over the period from 1993 to 1999. Economists paid more attention to origins of legal systems and the relationship between fundamental legal and political institutions, the institutions of policy making, and exact economic policies. As economic thinkers devoted more attention to these questions, they were led to think about the transportability of institutions across countries and cultures.

After a decade of reforms in Eastern and Central Europe and the continued frustration with foreign aid programs in Africa, along with the apparent failure of “neo-liberalism” in Latin America, the consensus on free market policy started to fracture and economists started to search for answers to the lingering puzzle of failed reform, not in terms of the price system and public policy, but in deeper social structures that produced belief systems and bonds of trust. By 2000, rather than focusing exclusively on prices and formal institutions of governance and public policy, the intellectual agenda turned to “getting the culture right.” In the wake of the terrorist attacks of September 11, 2001, questions of religion and cultural preconditions for democracy and the free market took on a new sense of urgency.

This evolution of thought from prices to institutions to culture should not be interpreted as superseding what was learned during the earlier stage. But instead the stages should be viewed as the outgrowth of delving deeper into the original question of how to get an economy on track to provide generalized prosperity to the people within that economy. Generalized prosperity cannot be had without a private property market economy, but such an economy cannot be established on a wide scale without a system of governance bound by general rules and strict limits established on state action, and a country cannot meaningfully institute general rules and strict limits unless the informal beliefs and institutions of the people in question legitimate those rules and limits. It is not, as Dani Rodrick seems to suggest, “one economics and many recipes” but rather “one economics, few recipes, and even fewer favorable conditions.” Transplanting the “good” rules

from successful countries to aid the failing countries is a more difficult task than either humanitarian peacekeepers or military adventurists ever imagined. In this negative sense, we just have another confirmation of Hayek's (1988, 76) quip that "the curious task of economics is to demonstrate to men how little they know about what they imagine they can design."

Douglass North has argued that the general lesson we have learned from the post-communist experience (and the long march of human history toward political freedom and economic progress) is that we must see beliefs that legitimate the ends of government; limits on the stakes of politics must be in place; property and personal rights must be defined; and credible and binding commitments to respect these rights must be established (2005, 107–108). Unless these conditions are met, North argues, the transition from personal exchange to impersonal exchange relations will be thwarted and economic progress will be stunted. "The way in which beliefs → institutions → organizations → policies → outcomes evolves has led to unparalleled economic well-being and to endless disasters and human misery" (2005, 155).

To put this another way, Adam Smith argued that human beings have a natural propensity to truck, barter, and exchange, and it is this propensity that separates us from other animals. However, human history also demonstrates that we humans have a tremendous capacity to wreak havoc on one another—to rape, pillage and plunder. Progressive social change, which entails the movement from personal to impersonal exchange and the structuring of the economy and the polity as open access systems, depends on an intricate institutional matrix being in place. It is the institutions in operation as defined by the formal rules in place and the social norms that reside in the culture of the society, that ultimately will dictate whether the human propensity to "truck, barter, and exchange" dominates the darker tendency to "rape, pillage, and plunder." Human betterment follows from exchange, human misery from predation.

3. Social Cooperation under the Division of Labor

Understanding social change is made more complicated once we focus our attention on the issue of the transition from personal to impersonal exchange and what that entails for progress. To put it bluntly, we cannot have economic progress while mired in personal exchange networks. Expansion of the economic well-being of humanity requires that impersonal exchange is not only made

possible but defines our daily existence. As Adam Smith famously put it, we stand in need of the cooperation of a great multitude of others for our daily survival, yet in a lifetime we have but the time to make a few close personal friends. How then are we to prevail against nature “red in tooth and claw” as frail human creatures? It is not from benevolence that we can expect our daily sustenance, the clothes on our back, or the roof over our heads. It is through channeling self-love, through exchange and the desire to profit. The butcher, the baker, and the brewer provide us with our dinner, Smith taught, not due to their benevolence, but with regard to their self-interest.

Early on in *The Wealth of Nations*, Smith actually uses the example of a common woolen coat on the back of a day laborer to communicate to his readers both the complex interdependency of exchange and production and the anonymous nature of the cooperation that must be achieved even to produce the most common products we enjoy. Explaining the emergence of this extended social cooperation under the division of labor represents the central mystery of economics, whether we are talking about woolen coats, or pencils, or automobiles, or computers. Advances in the well-being of humanity require extending specialization and exchange, and realizing those gains from trade requires both the coordination of disparate activities and the cooperation of hundreds, sometimes thousands, perhaps millions of individuals spread around the globe who will never be able to put a name or face to others in the intricate chain of economic activities yet will do their part day in and day out so that the chain is uninterrupted.

The threat to this smooth process of realizing the gains from specialization and exchange is predation. Let me distinguish between first-level and second-level predation. By first-level predation I mean the threat of predation by private actors, whereas by second-level predation I mean the threat of predation by public actors. The dilemma is that we create second-level predation only because of the way we attempt to deal with first-level predation. In our attempt to solve the problem of private predation through public means, we create the problem of public predation.

Private solutions to private predation rely on the self-regulating capacity of actors. The most common mechanisms of self-regulation are reputation and punishment. In standard treatments, these mechanisms are said to be effective only in small group settings with homogenous agents. But in such a group, the gains from exchange are limited only to the span of personal exchange networks

as the gains from specialization and exchange to be had by interaction with anonymous others would be too vulnerable to predation without any recourse to be justified. To realize those gains from specialization and exchange, the theory goes, we establish institutions of governance and third-party enforcement of contracts. In most presentations, these institutions are identified with the establishment of the state—a geographic monopoly on the use of coercion. But once the state has been established to provide third-party enforcement so that anonymous exchange relations can be realized and the gains from trade and innovation can produce wealth and economic growth, the opportunity for confiscation of that wealth by public officials presents itself. The opportunism of public actors in their effort to profit through predation must be curtailed. It is this dilemma that led North (1981) to conclude that the state is both the source of economic development and the greatest threat to economic development.

4. Credible Commitment and the Paradox of Government

“The key to political order,” North (2005, 107) writes, “is the establishment of credible bounds on the behavior of political officials.” Private predation that is unabated may thwart economic progress by curtailing the progression from personal exchange networks to the extended order of impersonal exchange and realizing the gains from specialization, exchange, and social cooperation under the division of labor. But public predation has the potential to destroy an otherwise healthy and wealthy economy. To put it another way, if the discipline of economics is to explain the wealth and poverty of nations, then the explanation is to be found not in geography or in natural resource abundance or even in the character of the people, but instead in the fundamental institutions of governance that curb the predatory proclivities of man.¹

If we successfully limit predation between private actors, then the gains from exchange and the gains from innovation are powerful enough to put any country on the path to prosperity. If we fail to limit the predatory behavior of public actors, even the most advantaged country in terms of location, resources and people will be mired in poverty and squalor. But, if, and only if, we are successful

¹ Just a note of clarification, this does translate into specific public policies as well—inflation is confiscatory, so a regime that sought to curb predation would fight against inflation, and a similar story could be told about taxation, public debt, regulation, and restrictions on foreign trade.

at establishing limits on private and public predation, then the creative powers of the citizens in that society will generate unimagined economic wealth and betterment of the human condition.

Establishing those limits on state action in a binding and credible way requires a level of constitutional craftsmanship and institutional innovativeness that has proven elusive in human history. The paradox of government has been recognized through the political history of liberalism. A government strong enough to establish a constitution is almost by definition strong enough to break the constitutional bindings anytime it desires for political expediency. The tying of the rulers' hands in politics appears to be much more difficult than Homer's depiction of tying Ulysses to the mast and putting wax in his sailors ears so he could both hear the call of the Sirens yet successfully navigate the passage without destroying the ship. The parable of Ulysses and the Sirens does capture the self-constraining behavior that is required, but in the world of politics Ulysses is also always left in possession of a knife in his hands to cut through the rope.

But in addition to the problem of credibly binding the rulers' hands, in the transition and developing countries context, the rulers must also signal specific content to the actors in the economy who have experienced public predation by the state far greater than the private predation the state was created to ward off. In the former Soviet Union, for example, the citizens had in fact heard many times before that reforms were being introduced that would grant them more freedom in economic and political life, only to have those promises broken almost as soon as they were uttered. Russian citizens referred to the "Big Lie" to describe the relationships between the citizen and the state. So rulers must not only establish credible bounds on their behavior, they must do so in a manner that credibly signals to citizens that this time they will keep their promise.

Credible commitments to curb predation are more likely to be established in high trust societies. In low trust societies, the societies that are struggling to realize the gains from trade and gains from innovation precisely because of the prevalence of predation, will have the most difficult time establishing credible commitments and signaling the content of that commitment in a way that solicits confidence that promises will be kept. Constitutions understood to be written figuratively on a word processor, for example, are not very effective constitutions. Neither were ones written on parchment, unless they were written on hearts and minds first.

So we have now come back again to beliefs and their role in easing the

establishment of credible commitments. Binding constitutions are self-sustaining constitutions, and the self-sustaining characteristic is a function both of institutional craftsmanship and underlying beliefs. A free society works best when the need for the policemen is least. This statement is true because it is literally impossible to monitor every social transaction in a modern society. Most social intercourse goes on unaffected by cheating because the parties to the intercourse never consider doing the opportunistic act due to internal norms. In doing so, they lower the costs of enforcing the general rule of promise keeping. Work at the cutting edge of political economy from development economics to regulatory studies is examining this relationship between high and low trust societies and the effectiveness of regulation. The main lesson to be drawn so far from this literature is that in high trust societies, self-regulation is already in operation so state regulation is redundant at best, and in low trust societies, where one might argue that regulation is needed more, there are difficulties with getting state regulations to work.

To sum up what we have argued: in order to realize the great benefits of social cooperation under the division of labor, credible commitments that bound the behavior of public officials must be established; this binding of government must be done in a way that signals to citizens that promises made will be kept; and finally, the constitution being put in place must be self-sustaining both in terms of its institutional design and with respect to its consistency with the underlying belief system in that society.

5. Conclusion

The classical political economists emphasized that the source of social order was to be found in the stability of possession, transference by consent, and the keeping of promises (e.g., Hume). Smith referred to this set of institutional arrangements as the “system of natural liberty,” and he often emphasized that deviations from that system would not only fail to bring wealth to nations but also could only be supported by tyrannical means. In the twentieth century, F. A. Hayek sought to restate the classical political economist argument for his age. Hayek emphasized the need to craft a constitutional order where bad men can do the least harm, and to do that, the task of the political economist was to discover the set of institutions that induce men to cooperate through their own interest and with respect to their own limited cognitive abilities.

Among political economists still working into the twenty-first century, Douglass North has probably done more than any of his peers to put institutions and ideology in the forefront of the research community in economics, politics, and the social sciences. A nice summary statement of his position is found in his essay on “The Chinese Model of Development,” where he states, “The way the game is actually played is a function of the underlying intentions embodied in the rules, the strength of informal codes of conduct, the perception of the umpires, and the severity of the punishment for violating rules.” Let me add that we have learned as well from Douglass North that progressive social change is not only about the shift in the rules, but also about the content of those rules to limit the predatory proclivities of man, which are nowhere as dangerous as in the geographic monopoly of coercion known as the state.

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