Staff Papers Series

P86-21 June 1986

ETHICS, ECONOMICS, AND INSTITUTIONAL INNOVATIONS

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Introduction

In more recent times, institutions have become subject to economic analysis to a growing extent. Three different approaches can roughly be distinguished. First, institutions are analyzed as such with respect to their economic rationality, mainly from a microeconomic point of view emphasizing the role of transaction costs. This in essence is the approach of the New Institutional Economics (Furubotn and Richter, 1984). The role of institutions within and vis-a-vis economic development and growth has, second, become subject of interests and research by some historians, but especially by economists and agricultural economists (Ruttan, 1984). Third, the political decision making process on institutions and changes thereof within a given institutional framework of those political decisions has been and still is analyzed by economists, mainly under the heading of Public Choice Theory (Mueller, 1976). Although all three approaches are based on the same methodological foundations,

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namely economic theory of its neoclassical nature, it seems to be obvious that until now, a fruitful integration of these three approaches has not yet been achieved, despite the fact that institutions are the common subject of research and despite the fact that these approaches sometimes are combined as New Institutional Economics in the most extensive meaning (Furubotn and Richter, p. 3). This assertion seems to be especially relevant with respect to a special area of institutions, namely ethics and morality or, more precisely, ethical and moral rules of human behavior. As far as these rules of behavior are concerned even the relations between economics and economic theory on the one hand and morality as a base of moral behavior on the other hand are obscured to a large extend and so are the potential contributions of the three approaches just mentioned to the analysis of moral rules according to their methodologies applied. However, there is no rational justification to exclude ethics and moral rules because such rules have to be considered as a part of the prevailing institutional settings even in developed countries. You may argue how significant moral rules in these countries really are. However, besides the fact that significance as such is not a demarcation line for economic analysis, one has to admit that more formalized institutions such as property rights are based on ethical principles in one way or the other. This, however, is not the subject I will deal with. Instead of this, I intend to discuss the relationships between economics and ethics which seems to be a rather important issue especially at a time where economics and economic behavior are called into question from various moral points of view. More precisely, such a question refers to the basic problem whether morality is something which has to be justified against economic reasoning or whether ethics and moral rules can be explained and justified by and with economics. This problem and relevant implications of the answer I will deduct are the central issue of this paper.

However, I will begin my reflections with a discussion of institutions and institutional innovations on a more general base. The reason for such a procedure is rather simple: We have already defined moral rules as a part of institutional frameworks being relevant for economic behavior. Institutions and especially changes of prevailing institutions have been and still are subject of theoretical as well as empirical analyses in this Department of Agricultural and Applied Economics. Such analyses have resulted in a theory of induced institutional innovations formulated as an almost logical continuation of the well known theory of induced technological innovations by Ruttan and his scholars (Binswanger and Ruttan, 1978).[1/] Therefore, the problem to be discussed with respect to moral rules or norms defined as a part of the institutional setting and therefore being relevant as such for economic decisions of individuals, is the question how such normal rules fit into such a theory of induced institutional innovations. We therefore have to analyze this theory more basically at the beginning. Such an analysis will facilitate the following discussion of the economic dimensions of ethics and morality. Some conclusions to be drawn out of this discussion will end up in this paper.

On the Theory of Induced Institutional Innovations

The theory of induced institutional innovations (Ruttan and Hayami, 1984) - or as I would prefer to call it: endogenous innovations - has a great scientific appeal insofar as, first, this theory demonstrates the decisive role of institutions with respect to economic development and growth. In a world which is governed by institutions and which obviously needs institutional arrangements in order to overcome anarchy, economic progress only can be achieved if these institutions permit or even stimulate the generating of technological innovations by research as well as the application of those innovations generated. Due to the fact that the use of advanced production technologies changes the prevailing economic conditions, especially factor price relations and transaction costs, different factor combinations and organizations of firms will occur which only can be realized if either existing institutions are not preventing such adjustments or these institutions will be adjusted themselves to changed economic conditions. Therefore, it seems very obvious that economic development only can be achieved by appropriate institutional changes. Insofar such a theory may contribute to our understanding of economic progresses much more than an explanation of economic growth in terms of factor endowments or other economic characteristics of various nations as for instance Denison has mentioned (Denison, 1967). And, insofar, the theory of induced institutional innovations is very much in line with the interpretation of long run economic development by some historians such as North and Thomas (1973).

The outstanding appeal of Ruttan's theory is founded, second, by the fact that this theory tries to explain the economic rationale of institutional innovations by recurring to changes in demand for such innovations on the one hand and to changes in supply of innovations on the other hand. Whereas changes in demand are the outcome of altered economic conditions as described above, changes in supply of institutional innovations is the result of scientific progress in the field of social sciences. According to Ruttan, "advances in social science knowledge act to shift the supply of institutional change to the right". And: "Knowledge in economics and in other social sciences as well as in related professions such as law, business, and social services themselves are derived primarily from a demand for institutional changes" (Ruttan, 1984, p. 550 resp. 552). According to such an analogy of building and rebuilding of institutions to markets of goods and services, institutional changes almost automatically will result if changes in demand and supply are occuring.

However, such an analogy seems to have at least one fundamental and far reaching weakness. Whereas changes in supply or demand in markets are reflected in changes of relative prices stimulating respective adjustments of demand and supply, no such a mechanism is to be found in the "market" of institutions. Changes of instutions are subject to non-market decisions, i.e. political decisions.[2/] Even if one admits as Ruttan does that "it seems more apparent today than a decade ago that in non-market environments or in environments where prices are severely distorted, the shadow prices that reflect the real terms of trade among factors and products (or the gap between shadow and market prices) convey information to economic and political entrepreneurs that leads to shifts in the demand for institutional innovation and performance" (Ruttan, 1984, p. 550), - such a statement seems rather insufficant as an explanation of changes of institutions. The reason for this is that changes in demand for and supply of institutional changes - the latter interpreted as the results of social science research - can only explain actual institutional innovations if the political decision making process on those innovations is incorporated in such a theory of institutional changes. Insofar the decision making process seems to be the missing link which has to describe and explain, why and how changes in demand as well as supply are really transposed in corresponding changes of institutions.

By excluding the rather unrealistic concept of a well informed and benevolant dictator as well as the model of the radical libertarians, relying only on voluntary and private contracts between individuals and therefore omitting all institutional arrangements based on collective decisions (Nienhaus, 1985, pp. 185-193), we have simply to consider the fact that non-market decisions are subject to political decisions within the given institutional framework being relevant for these political decisions. Such political decisions have to be legitimized by these institutions which, as is well known, differ to a great extent between various societies. By the way, we have to add that these institutional settings for the political decision making process themselves are subject to changes. We have to add furthermore that even markets as an institution being relevant for transactions of goods and services of course are the outcome of political decisions. Markets can be and have been changed into "non-markets", for instance as far as centralized and planning economies in socialistic countries are concerned.[3/]

Now let me come to some conclusions which have to be drawn out of those more general statements:

1. In order to become an empirically more powerful theory, the theory of institutional changes has to incorporate relevant hypotheses concerning the decision making process on institutions. In other words, the process of legitimization of institutional changes demanded and applied has to be considered as well. To rely only on some historical examples of more or less successful institutional innovations must be seen as insufficient insofar as one has to assume that the process of economic development almost automatically is linked to permanent changes in demand for institutional innovations. Even if one admits that the supply of institutional innovations is linked to discontinous advances in social science research, the realization of such innovations by political decisions is not only a matter of demand and supply. Several other factors are responsible whether and to what degree innovations demanded as well as supplied by social sciences are finally realized. This in essence is the message of the theory of public choice which

focuses on the mechanics of non-market decisions.

2. Public choice theory, as well as a systematic analysis of the history of institutional changes, may demonstrate that these changes are far away from following a one-way-street as the theory of induced innovations does assume. History shows clearly that nations do rise as well as decline economically. If one assumes that, as stated earlier, economic development and growth depend to a great extent on the capability of nations to adjust the prevailing institutions adequately to the conditions and requirements of economic growth, then it follows that economic decline may have its cause either in the resistence of the political system towards institutional changes or in inadequate decisions. Let me mention only a few examples of inadequate institutional reforms; namely first the collectivization of agriculture in the Soviet Union in 1929 and the stereotyped adoption of this model of agrarian reforms by most other socialistic countries after World War II despite the negative experiences of the collectivization in the Soviet Union.[4/] Obviously there was a strong demand for land reforms, especially in the East-European countries, but this demand has had several sources, economic as well as political ones. There has been a "supply" of land reforms by social scientists as the long discussion on the appropriate strategy for industrialization of the Soviet Union before Stalin's decision in favor of a radical collectivization of agriculture in 1929 may demonstrate. This decision of course

was mainly dictated by political motives, whereas the economic implications have been only of second order. These political motives did, of course, play a similar role as far as the collectivization in the other socialistic countries is concerned. Therefore, it seems to be justified to conclude that collectivization of agriculture in these countries has much to do with the fact that these countries achieved relatively slow rates of economic growth.

3. The example of collectivization of agriculture may also reveal important aspects of the political dimension of institutional changes. First, whether and to what degree such changes being demanded as well as supplied theoretically are legitimized by the political decision making process depends to a large degree on the political system of the country in mind, i.e., the design of institutions in which the demand for as well as supply of changes are transformed into relevant political decisions. Next and in a narrow connection with the prevailing political systems, it has to be recognized that in most cases there is not only a demand for institutional changes but there is also a "demand" for resistance to such changes. The reason for this is to be seen in the simple fact that institutional changes are demanded by those which will benefit and those will resist which are expected to loose economically or politically. Insofar the decisions on institutional changes is not only a decision on economic growth to be achieved but also a decision on the distribution of income between various

groups, beside the fact that these decisions are subject to the prevailing order of political decision making.[5/] Third, with respect to the supply of institutional innovations by social science research, it has to be seen that rather seldom social scientist fully agree on appropriate policy measures. The present controversies on adequate economic and agricultural policies among scientists are cases in point. Such controversies very often are due to diverging views not only with respect to the efficiency of various policy measures but, more basically, with respect to a diverging assessment of fair or acceptable impacts on income distribution. Again, we come to the conclusion that institutional changes are subject to political decisions which by no way are straight-lined towards economic progress.

4. One further and important conclusion may also be drawn out of our reasoning. It seems quite clear that an efficient adaptation of institutions to changing demand and supply conditions will be achieved in those areas of the prevailing institutional framework which are not the subject of direct political decisions, because they can be achieved by voluntary contracts between individuals. Whether firms or farms are combining various economic activities horizontally or vertically in order to increase their profits, whether they prefer to act as independent firms or prefer other organizational types of coordinating their activities is first a matter of the particular transaction costs involved (Williamson, 1975) and second a matter of the specific design

of prevailing property rights (Furubotn and Pejovich, 1972). If the design of property rights - or more generally the prevailing institutional framework - provides many degrees of freedom for individuals from which to choose, the most appropriate type of organization of firms or farms, without being forced to generate political decisions in order to restructure inefficient property rights, then of course an economically efficient resource allocation over time has to be expected ceteris paribus.[6/] Therefore the proportion of institutions being subject to private contracts between individuals, these institutions which only can be changed by political decisions, seem to be of great importance with respect to economic growth. Insofar the poor performance of socialistic economies can be explained to a great extent by the fact that in these economies there is almost no freedom of individual firms to choose among alternative institutional arrangements which fit best to prevailing economic conditions. And insofar the theory of induced institutional innovations might be more relevant for those institutional changes which may be achieved within a given legal framework and outside political decisions which are necessary if this legal framework has to be changed in order to obtain adequate institutional adjustments. Again, however, it must be stressed that the legal framework enabling individuals to select economically efficient institutional settings is themselves subject to political decisions. Therefore, a more general theory of institutional innovations has to be incorporated in the political decision making process, at least as far as such a theory claims to be capable to explain and predict institutional changes beyond those changes within the prevailing legal framework of institutions.

<u>Ethical Norms and Institutions</u>

Until now we have considered ethics, especially ethical rules or norms as the realization of ethical principles being relevant and decisive for human behavior only as a more or less important part of the prevailing institutional framework without being very specific. Ethics as a "part" of the institutional framework can basically defined in two different ways. First, it has to be assumed that moral commitments, such as fairness and loyality etc., are reflected in economic as well as political decisions of individuals and collective units beside of ideological, religious or pure economic commitments. Insofar moral commitments are reflected in the result of these decisions and decisions on institutional arrangements. The question which arises in this respect refers to the problem of the foundations of economic policy decisions, a question which is analyzed and better known under the heading of the normative aspect of economics (see especially Albert, 1985). We will however not deal with this aspect of ethics as well as economics. Second, moral commitments such as fairness, truthfulness, loyality, honesty, reliability, etc., are however guiding and channeling human actions more directly without being transposed in formal institutional settings in terms of legal or statutory regulations due to public or private decisions. Insofar, such ethical norms have to be seen as a part of institutional frameworks and only on this aspect of ethics materialized in corresponding ethical norms or rules we will further rely upon.

With respect to the latter definition of ethics resp. moral norms several questions have to be asked. The first question refers to the (economic) explanation or rationalization of morality and behavior in corrspondence with moral norms. What, in other words, is the reason for human beings to obey moral rules although such an obedience might very often be bound to welfare losses because such rules may be a hindrance for human beings to act as selfish as economists expect they would according to the utilitarian foundation of economics? This question has to be seen with respect to the widely accepted proposition that there is a deeply rooted conflict between ethics on the one hand and economics on the other, insofar as economic theory intends to explain (and predict) economic choices of individuals on the base and only on the base of selfishness as the dominant motive of such choices. Ethical rules, however, do rely on quite the opposite assumption of an altruistic behavior of individuals in favor of the benefits of other people or objectives which only can be achieved if individuals neglect or suppress selfishness as well as the benefits bound to such a behavior.

There are at least two important consequences of such an assumption of diverging or opposing norms of "economic" versus moral behavior. First, and more general, ethics and ethical rules have to be seen as "superior" to economics and rules of decisions based on economic cost-benefit-ratios - "superior" in a moral or philosophical sense. In other words, ethics is "domesticating" and has to "domesticate" economics.[7] Furthermore, moral rules have not to be rationalized or justified by economic reasoning but by something else such as "moral sentiments" as David Hume and Adam Smith have assumed.[8] If, however, ethical rules could be rationalized and explained in pure economic terms, then things look quite different. In such a case, the supposed conflict between morality and economics seems to be irrelevant, ethics has not to be justified <u>against</u> economies but by and <u>with</u> economics, and there is no reason to assume that ethics has to domesticate economics.[9] We will return to this problem in the next paragraph. Second and with special reference to the theory of induced institutional innovation discussed before: If ethical rules or norms cannot be rationalized in terms of economics, then, of course, this theory of induced innovations is also irrelevant with respect to such norms based on morality, although we have defined these rules as a part of prevailing institutional settings affecting economic choices. Insofar moral rules as well as changes of such moral rules cannot be captured by such a theory. Given that such norms do play a more or less important role in guiding and affecting human behavior, it follows that this theory misses or neglects an important part of institutional frameworks and changes thereof. Therefore the theory of institutional innovations seems to be fairly restricted as far as its explanatory power is concerned.

There are still other questions which have to be raised with respect to ethics in relation to economics beside those problems already mentioned. For instance, the question has to be asked, how and why ethical norms are affecting individual decisions. We will see that this question only can be answered on the base of an economic interpretation of moral rules already mentioned. Therefore we will return to this problem later. Next, the question concerning the substance of ethical norms could be discussed. Finally, the problem of the process of legitimization of such norms could also be analyzed. However, both questions are beyond the scope of this paper.

With respect to those problems to be analysed, it seems appropriate to call the attention to the more or less common definitions of institutions. Confronting such a definition with moral rules may help us to clarify the specific characteristics of such rules in accordance resp. in contradiction with institutions which are usually considered and analyzed by economists. According to Rawls (and others) institutions are defined "as a public system that specify certain forms of action as permissible, others as forbidden, and provide certain penalities and defences where violations occur" (Rawls, 1971, p. 55). Runge has recently added that "institutions channel the behavior of people with respect to each other and their belongings, possessions and property, providing assurance by setting the rules of the games. They increase the value of a stream of benefits associated with economic activities by coordinating behavior and reducing uncertainity in the realm of human interaction" (Runge, 1984, p. 807).

Being principally in accordance with these definitions of insitutions as such, it seems however necessary to add some remarks to clarify things a little bit more especially with respect to moral rules as institutions in order to improve our understanding of such rules as institutions.

1. As we have already said, ethical principles are materialized in ethical norms and these norms are "channelizing" human behavior as long as those norms are respected by human beings. Insofar such rules fit rather easily in our definition of institutions and insofar such rules or norms have to be seen as a part of the prevailing institutional order. However, contrary to "formal" institutions based either on private contracts between various (economic) agents or based on public prescriptions legitimized by political decisions and enforced by (economic) sanctions and/or by jurisdiction, ethical norms are not enforced by any sanction--if you are not willing (as a rational man) to accept sanctions and renumerations somewhere else, as still Imanuel Kant has done. This distinction between formal resp. informal institutions such as morality with respect to sanctions is a rather important one, but not only due to the fact that the so called erosion of the Western world with respect to morality is very often the topic of social philosophers projecting the decline of Western civilization such as Oswald Spengler.[10/]
2. Besides this characterization of moral rules, the fact also has to be stressed that moral rules are not at all subject to

any political decision contrary to formalized institutional arrangements. Ethical norms cannot be generated or changed by political decisions. These decisions, of course, might be based on ethical norms, they may furthermore transpose these unwritten moral rules into written and formalized norms, laws and provisions and these political decisions can finally (try to) correct or to abolish moral rules in some way or the other. The Reislamization in some parts of this world has, by the way, been stimulated by political decisions which have been considered as being in opposition to accepted moral rules. There are several implications of these statements concerning the nature of moral rules involved. For instance, such norms seem to be more inflexible than formal or formalized institutional arrangements. Insofar, such norms are less suitable to a theory of institutional innovations, a proposition we have already made from another angle of this problem. Next, it depends to a great extent on the specific nature of prevailing moral norms whether and to what degree they favor or disfavor economic development. This is, in essence, the message of Max Weber's explanation of the rise of capitalism in the Western world due to the ethics of Calvinism stimulating economic growth. However, if ethical norms are opposing to economic rationality, then economic development is not only handicapped but also a social conflict between prevailing moral norms and the "demand" for institutional innovations will occur. Political decisions favoring such institutional innovations by substituting and correcting those moral norms may result in political unrest and instability, even in political counterrevolutions. This phenomenon may be interpreted as "moral erosion" and history has provided us with many examples of such counterrevolutions such as the Reislamization already mentioned. By the way, formalized institutional arrangements never can substitute all moral rules because even such formalized rules of behavior are depending to a great extent on morality insofar as the observance of "written" laws by individuals is very often only due to the "morality" not to violate such norms--even in the case where no prosecution (because there is no police around) is to be expected. Due to social costs involved, it is quite impossible to regulate and supervise all aspects of human behavior by formalized institutions as most socialistic countries or the rise of the underground-economy demonstrate.

3. Such reflections stimulate the question concerning the optimal size and structure of institutional arrangements, the latter implying the optimal combination of formalized and informal rules of behavior. Beside the answer given to this question by radical libertarians, arguing in terms of a or the minimal state by assuming that institutional settings only are justified and necessary as long as they are based on voluntary contracts between individuals, economists would of course, reply that the optimal size as well as the optimal structure of institutions is to be achieved as soon as marginal costs equal marginal revenues. Beside the fact that

we are, at least at the time being, not able to measure the costs and benefits of institutional arrangements as a whole,[11/] this question has to be seen as the most important problem of the economic order of an economy. The prevailing discussion on regulation versus deregulation in the Western as well as in the "Eastern" (socialistic) world is just a part of this basic problem. Returning to our specific problem of ethical norms, these general questions might be concentrated on the problems of social costs and benefits of ethical norms. I will return to this problem in the following paragraph. I touched on this problem in this context due to two reasons. First and more generally spoken, institutional settings channeling the choices of people are bound to social costs, opportunity costs which are the consequence of the fact that "channeling" economic choices of individuals prevents these individuals to choose those alternatives which are more profitable, alternatives which, in other words, are guided by selfishness. Otherwise no institutional arrangements, providing sanctions in the case of violations would be necessary. Insofar as such institutions are or at least should be restricted to such areas of human behavior where decisions of individuals guided by selfishness are to be seen as inefficient with respect to the superior objectives of the society--the general feature of public goods. The rational of efficient institutions has therefore to be seen in the fact that these institutions provide benefits to the individual members of the society which exceed opportunity costs. Moral rules already defined as a part of the prevailing institutional framework are especially subject to these individual positive cost-benefit-ratios due to the specific characteristic of such norms that no sanctions are provided in order to enforce obedience of individuals to these norms. Insofar the theory of induced institutional innovations (including moral rules) may be reinterpreted in such a way that these institutional frameworks are generated by market forces as well as by processes of political decision making which are economically (in terms of welfare gains) preferable to any other institutional arrangement. Because of the fact mentioned earlier that moral rules are not subject to political decisions, such an interpretation of the theory of institutional innovations seems especially relevant to such moral rules.

Ethics and Economics or the Economics of Ethics

After having discussed the definitional aspects of moral rules and some implications thereof, I have to return to the basic problem of such rules in their relation to economics and economic reasoning. The question to be answered is whether moral rules can be explained and rationalized in economic terms or whether these rules are basically "uneconomic" in a sense that they are based on something else and superior to economic behavior guided solely by selfishness. Until now, we have come to the conclusion that the obedience to (moral) rules is bound to opportunity costs. Next, we have said that contrary to formal institutions moral rules cannot be enforced by any sanction (excluding renumerations somewhere beyond). Because as economists we are convinced and rely on selfishness as the decisive motive of economic and, more recently, human behavior in general, we have either to retreat to altruism as the source and motive of human behavior in accordance with moral rules--such a proposition would of course have far-reaching implications with respect to economic theory--or we have to search for economic benefits to individuals exceeding opportunity costs. Such an explanation of moral rules would solve the supposed conflict between ethics and ethical rules on the one hand and economics or selfishness as the major motive of human choices on the other hand. Furthermore, such an explanation of moral rules would help economists to avoid the conflict between theoretical and empirical analyses based on selfishness as the major motive of human choices and the contradicting assumption of altruistic behavior.

The crucial question therefore simply refers to the benefits which accrue out of individual decisions corresponding with moral rules avoiding free-riding as well. Several answers to this question have been tried in more recent times. I will mention only four, namely:

1. In a more recent article Vanberg has suggested "that a main interest that may motivate an actor to act morally is his concern about his reputation." He proceeds by saying "to have a reputation of being a moral person, a man of principle, may considerably increase an individual's

productive efficiency, his capability in producing the ultimate objects of choice" and "the reputation of being a moral person can be viewed in this sense as a kind of human capital, 'human' capital understood as a general label for all inalienable sources of a person's productivity" (Vanberg, 1986, p. 30). Almost in order to immunize his proposition against the critique whether such a reputation-oriented behavior may really survive the competition of decisions based solely on selfish motives, Vanberg adds finally that "one has to take into account that theories about payoffs from reputational capital are typically about the very long run and therefore not as readily testable as theories about short run gains and losses from usual behavior" (p. 29). Although such an explanation of behavior in correspondence with moral rules seem to be in accordance with economic cost-benefit consideration, but unfortunately only in the "very long run". Thus the question arises, how such decisions may survive competition by individuals which in the short run are profit maximizing. Is, therefore, moral behavior restricted only to wealthy people which are able to maintain such competition in the shorter run? It follows that we need a hypothesis which may explain moral behavior in terms of economics also in the short run, although we may admit that Vanberg's theory may be relevant in the long run.

2. Almost a similar difficulty arises if morality and moral rules are explained and justified by reflections on a long run reasonability or rationality as has been expressed by

some modern utilitarists such as Rawls. The basic idea of such a rationalization is that we have to distinguish between short run or "daily preferences" on the one hand and long run or "meta-preferences" on the other hand, as Sen has called it (Sen, 1977) - meta-preferences which are more deeply reflected and rationalized. Such a distinction is quite similar to a distinction between less important choices based mainly on traditions and experiences and more important choices based on a rational calculus of costs and benefits. Beside the fact that preferences as such are by no way empirically testable and beside the fact that decisions guided by tradition and experiences may well be efficient with respect to their relative costs, it has to be asked whether and why such long reasonability of human decisions might be in correspondance with moral rules. In other words, meta-preferences may also directing human decisions towards objectives to be achieved by pure self-interests and insofar as it is not to be seen, whether and why such long run decisions may really differ according to their relevant motives.

3. According to our reasoning until now, we have to find an economic explanation of moral conduct, which is relevant for human behavior generally without any retreat to a most dubious distinction between long run and short run rationality of decisions and/or to an even more questionable because untestable distinction between daily and meta-preferences. In reminding us of the definition of

institutions, a first access to such a general and economic rationalization of moral rules can be found in Runge's statement that "institutions provide assurance" and "therefore increase the value of a stream of benefits associated with economic activity by coordinating behavior and reducing uncertainty in the realm of human interactions." This notion of "assurance", if understood in its full significance, gives a first reliable source of an economic foundation and explanation of institutions in general and moral rules specifically. Assurance of individuals with respect to the decisions by other individuals which all are mutual interdependent, insofar as the decisions of one individual affects the decision of others and vica versa and insofar as the mutual expectaions concerning decisions of other individuals is to be considered as a base of their decisions. Assurance as a pure public good in the strongest sense"[12/] provided by institutional arrangements "channeling" individual choices therefore means stability and reliability of mutual expectations of actions and decisions of human beings. This definition and explanation of institutions implies that these institutional arrangements seems to be such a valuable good exceeding all other benefits of non-observance (opportunity costs). Even more, stability and reliability of decisions guided by institutions is the precondition of any rational behavior of human beings in the view of the extensive mutual interdependencies of those human beings. Therefore, it is not surprising that originally it has been Thomas Hobbes who clearly recognized that human life without institutional arrangements channeling human actions and providing mutual security and stability of expectations would be "solitary, poor, nasty, frutile and short" (Hobbes, 1968 [1651], p. 186). The way out of such an anarchistic and unpleasant world can only be seen in a voluntary renunciation of the fight of everyone against everybody, a renunciation which is only possible under the conditions that "all others are willing to do the same", so that all can benefit from such an agreement, a contract or, in other words, institutional arrangements. This formulation of Hobbes, that "others are willing to do the same" reflects exactly the nature of such mutual agreements as a collective good being a precondition for survival of human beings and for an organization of their life and their choices in a rational manner.[13/] This is furthermore the basic reason, why institutions such as morality do not restrict liberty as Buchanan has assumed by speaking of the "limits of liberty" (the title of his book) which might be the consequence of institutional arrangement between individuals (Buchanan, 1982). Quite the opposite is true. Such arrangements are expanding individual freedom by offering more choices to individuals as would be possible without such institutions. However, such an interpretation is completely in line with Buchanan. The title of his book is just a misinterpretation of his own findings. In this regard, the fact however has to be emphasized that moral rules especially are relevant with respect to the extension of individual freedom because, as we have seen, they are respected by individuals solely on a voluntary base: No sanctions enforce the obedience of individuals vis-a-vis moral norms.

4. Buchanan himself has added a further economic interpretation of morality as a capital good beside being a public good (Buchanan, 1982, p. 178). In analogy to the theory of capital formation by renunication of consumption in order to increase the productive capacity by saving and investing, the mutual and voluntary restrictions of choices due to institutional arrangements as well as moral rules will create "a predictable role, security and stability with respect to the realm of individual decisions". The "input" in the form of such restrictions, in other words, creates chances and possibilities of an enlarged "output" which without such institutional settings could not be achieved. The reason for this is that these inputs would have to be used for the establishment of security and stability which is now supplied by such institutional arrangements in a much more efficient manner. The experience that individuals accept and respect such arrangements channeling their behavior voluntarily has to be seen as the evidence of the fact that the violation of such moral rules would be inefficient and irrational. If, however, such an "individual" behavior turns out to be efficient and rational due to changing economic or social conditions as compared to choices in accordance with traditional moral rules, the process of erosion of such rules

will be initiated. In this respect, but only in this respect, it seems to be permissible to argue in terms of the theory of induced institutional innovations because changes in moral rules are contrary to formulized institutional settings not subject to political decisions.

We, therefore, come to the conclusion that morality or ethics being materialized in moral rules of human behavior can be explained and rationalized in conformity with those motives which explain and determine economic choices of individuals and which are the basis of economic theory analysing and predicting such economic choices. Therefore, no modification can be found for the proposition that there is a conflict between ethics and economics as well as for the further proposition that ethical rules are domesticating economic rules of behavior. Moral rules as an important part of institutional arrangements rely and are subject to economic factors to a larger extent than formalized institutions due to the fact that such rules are not subject to political decisions. Insofar the theory of induced institutional changes may therefore be an important contribution toward a rational explanation of changes of moral rules, because it is allowed to postulate that selfishness as a motive of behavior might turn out as the most moral manner of human behavior.

Footnotes

[1/]For a discussion of some aspects of the theory of induced technological innovations see Schmitt, 1986.

[2/]I am of course aware of the fact that Ruttan has not completely neglected this difference between market and non-market decisions. Several remarks in his publications refer to "political entrepreneurs" which are expected to inaugurate institutional innovations. However, it seems almost obvious that such political entrepreneurs are only a mechanical "substitute" for market prices on political "markets" because such an entrepreneur is by definition restricted to a person who "only" realise welfare increasing institutional changes. Insofar it seems not to be too unfair to assume that such entrepreneurs are quite similar to the well informed and benevolant dictator on which some economists rely implicitely by asking for rational policy decisions in a pure economic sense.

[3/]Over a long time the question whether collectivizatism of agriculture has to be evaluated economically as a success or as a disaster has been answered very controversial by Western economists. However, since the publication of Barsow, a Soviet economist, showing that during the thirties there was a net-transfer of resources to agriculture instead of agriculture to the rest of the economy, most Western economists agree basically with such an evaluation.

[4/]According to our understanding, it seems to be appropriate to define "markets" in (centrally) planned economies as "non-markets" as long as on those "markets" the exchange of goods is not directed by market prices reflecting supply and demand conditions but by administered prices fixed politically.

5/Welfare economists are used to recure in those cases to the principle of compensation formulated by Kaldor and Hicks, according to which policy measures are to be favored as long as the benefits to be achieved are at least sufficiant to compensate welfare losses of other individuals. However, Rawls (1971, p. 48), has questioned this principle as well as the foundations of welfare economics on individualistic utilitarianism by asking what motives other than unselfishness may induce an individual to agree to welfare gains of other individuals given that he himself does not benefit in one way or the other.

6/It is quite obvious that the political decisions on a proper balance between "private" and public institutional arrangements as well as the specific design of property rights is the crucial question of an economic order. This at least is the message of the German "Ordnungspolitik" (Schmidtchen, 1984).

7/The expression of "domestication" of economics by ethics has been introduced, as far as I can see, by Homann (Homann, 1986).

8/It has to be reminded that Smith published his "Theory of Moral Sentiments" seventeen years (1759) before his "Inquiry into the Nature and Causes of Wealth of Nations"(1776).

9/For a more detailed description and analysis of this proposition of "domestication" of economics by ethics and the very diverging philosophical foundations see Homann (Homann, 1986).

10/There can be of course offered quite different explanations of this phenomenon of "moral erosion." In a modern, highly complicated world traditional moral norms simply may be inadequate to institutional frameworks required. Obviously, such a provision seems to support quite a different issue, namely the verdict that such a modern world becomes more "immoral" to a growing degree. However, this is problem of value-judgement to which one might agree or disagree.

11/Again, the implications of the theory of induced technological innovations mentioned earlier with regard to institutional innovations being required in order to provide optimal research resources (Ruttan, 1982, pp. 252-261) are directed towards this issue, although being restricted to a specific area of institutions.

12/Buchanan has stressed the fact that morality as a pure public good (such as not to lie) provides no benefits to the person in mind, contrary to normal public goods which provide to those who produce such a public good with (marginal) benefits thereof (Buchanan, 1984, p. 154).

13/Homann who has elaborated this proposition more detailed demonstrates the significance of institutions based on mutual agreement by explaining that when Friday happened to meet Robinson Crusoe for the first time, both had first to make a contract concerning rights and duties of each of them before they could start their "economy" (Homann, 1986, p. 17). The alternative to such a contract, of course, only could be the fight for survival of Friday <u>or</u> Crusoe.

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