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QUALITY OF GOVERNMENT

Preventing Markets from Self-Destruction:

The Quality of Government Factor

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QoG WORKING PAPER SERIES 2009:2

THE QUALITY OF GOVERNMENT INSTITUTE
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January 2009

ISSN 1653-8919

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QoG Working Paper Series 2009:2
January 2008
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Abstract

Four interrelated arguments are presented to form a theory about the relation between the logic of markets, social efficiency and the quality of government. The first is that competitive markets with a certain set of characteristics are the most efficient organizational form for creating a utilitarian based economic efficiency for the production of most goods and services. The second argument is that in order to reach this utilitarian based social efficiency, markets need large and complicated set of institutions, formal as well as informal. Since such institutions will in the long run make all market agents better off, they are labelled *efficient institutions*. The third argument is that it is unlikely that such institutions will be created endogenously by market agents. Moreover, if such institutions have been created, we should expect market agents to try to destroy them. Based on insights from various approaches (institutional economics and research on neo-corporatism, clientilism, and corruption) there is no reason to expect that efficient institutions will evolve by any selection mechanism that is generated from the sum of agency that exists in markets. The conclusion reached is that if left to themselves, markets are inherently self-destructive. The fourth argument is that markets can only reach social efficiency if the agents that reproduce the necessary efficient type of institutions act according to a logic that is different from the logic that market agents use when operating in the market. This operational logic is the ethical dimensions of what should count as quality of government

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Is there such a thing like legal corruption?

In his “farewell lecture” on December 9th, 2008, former leading World Bank economist Dani Kaufmann introduced the concept of *legal corruption*. The term certainly seems like an oxymoron, but Kaufmann motivates it by arguing for the need to redefine corruption to include “how elites collude and purchase, or unduly influence the rules of the game, shape the institutions, the policies and regulations and the laws for their own private benefits”. If this is done illegally, as in the traditional use of the term corruption, or legally, is according to Kaufmann of minor interest from the viewpoint of economic and social efficiency. The term “legal corruption” covers processes when public policy is thwarted or “captured” by various private interests instead of serving the common/public interests, thus all forms of “privatization of public policy”. Kaufmann’s case in point is the background to the current financial and economic crisis and he points out how powerful agents in the financial sector have used their influence to “relax regulatory oversight and capital requirements”.[1] By this important theoretical move, Kaufmann makes it possible to connect the study of corruption to the analysis of special interests politics, also known as neo-corporatism. The current financial crisis leads according to Kaufmann to the following conclusion: “If anybody thought that the governance and corruption challenge was a monopoly of the developing world… that notion has been disposed completely”.[2]

In this paper I will present four interrelated arguments that sum up to a theory about the relation between the logic of markets, social efficiency, and what has been named quality of government. The first, and least controversial, is that competitive markets with a certain set of characteristics are the most efficient organizational form of creating a utilitarian based economic efficiency for the production of most goods and services. Such characteristics include free entry, low transaction costs, reasonably good and freely available information, goods that are not by their very nature collective, low external effects, and efficient protection of property rights.[3] The second argument is that in order to reach this utilitarian based (aka

[1] Kaufmann points to a meeting held in April 2004 when the CEO:s of the (then) five big investment banks on Wall Street persuaded the U.S. Securities and Exchange Commission to relax regulation that stipulated their need for financial reserves. See also article in New York Times, October 3, 2008, “Agency’s ’04 Rule Let Banks Pile Up New Debt” by Stephen Labaton

[2] Kaufmann has lead the World Bank Institute’s work in on “Governance Issues” . His farewell lecture can be found at http://info.worldbank.org/etools/bspan/PresentationView.asp?PID=2363&EID=1056

[3] Such markets need not entail what is known as the domination of capitalist power in the relations of production. In a market economy, capital can hire labour which implies that capital will be more powerful than labour in how to organize the production process. However, labour can also hire capital (e.g., a group of

"pareto", but henceforth social) efficiency, markets need a specific kind of large and complicated set of institutions, which are both formal as well as informal. Since such institutions will in the long run make all market agents better off, they can be called *efficient institutions*. The third argument is that we have little reason to expect that such institutions will be created endogenously by market agents. Instead, we should expect market agents to act in a way that either will prevent such institutions to be established, or if they are established, will try to destroy them. To use a metaphor from evolutionary biology, we have no reason to expect that efficient institutions will evolve by any selection mechanism that is generated from the sum of agency that operates on markets. Instead, my argument is that if left to themselves, markets are endogenously self-destructive. The fourth argument is that markets can only reach social efficiency if the agents that reproduce the necessary institutions act according to a logic that is different from the logic that market agents use when operating in the market. In short, my ambition is to make the case for the existence of a paradox in social organisation, namely that *you can have a market about anything as long as you don't have a market about everything.* The need for efficient informal and formal institutions has recently been emphasised by institutional economists working with these problems in developing countries. One example among many is Dani Rodrik who writes that "the encounter between neo-classical economics and developing societies served to reveal the institutional underpinnings of market economies." Among such institutional underpinnings Rodrik lists a well specified system of property rights, effective regulation that hinders monopolies to dominate markets, uncorrupted governments, the rule of law, and social welfare systems that can accommodate risks. Interestingly enough, Rodrik also mentions the importance of informal societal institutions that foster social cohesion, social trust and cooperation. He criticises neo-classical economics for omitting the importance of such institutions by arguing that "these are social arrangements that economists usually take for granted, but which are conspicuous by their absence in poor countries" (Rodrik 2007, p. 153).

workers/professionals can start a cooperative and take loans or issue bonds on a stock market), in which case the employees can elect (and hold responsible) a board that employs managers. Moreover, a third party (usually a group of managers or an entrepreneur) can hire both labour and capital, in which case this third party will have most power in the production process. The common understanding in Marxist and well as non-Marxist understandings of the relation between power in the production process and market economy has no logical underpinning. See Ellerman Ellerman, David P. 1992. *Property and contract in economics: The case for economic democracy*. Oxford: Blackwell. and Rothstein Rothstein, Bo. 1992b. Social Justice and State Capacity. *Politics & Society* 20:101-126. for more on this. Contrary to Marxian thoughts, it is the nature of the hiring contract, not the market economy as such, that entails power in a market based production process.

Another example comes from Lawrence Summers, former US Treasury Secretary, Chief Economist of the World Bank and also former President of Harvard University. Asked to review the lessons of the World Bank policies for alleviating poverty in developing countries, he argues that "an overwhelming lesson that I think we have learned in the 1990s is… the transcendent importance of the quality of institutions and the closely-related questions of the efficacy of political administration." (cited in Besley 2007a, p. 571). If this is the case, the question of how such efficient institutions can be established and maintained should be a top priority for the social sciences, especially if Acemoglu and Robinson are right when they state that "differences in economic institutions are the major source of cross-country differences in economic growth and prosperity"(Acemoglu and Robinson 2006, p. 674). As I will argue below, so far the question of how such efficient institutions can be established and reproduced has attracted surprisingly little attention both in economics, political science and in economic sociology.

Markets, Social Efficiency and Democracy

The argument about the social efficiency of markets should not be understood in an absolute, but in a relative sense. The reason that markets can not be seen as efficient in an absolute sense is that market agents can not be presumed to be in possession of anything close to perfect information or be unboundedly rational or that transaction costs are instantaneous and costless (Menard and Shirley 2005). On the contrary, empirical research about how market agents act shows the opposite. Agents are often myopic; they rarely have perfect information; they make computational mistakes when calculating costs vs. benefits; even if the value/risk is the same they are more likely to avoid losses than opt for gains; their beliefs can often be manipulated; transactions have sometimes large costs, etc. (Frohlich and Oppenheimer 2006; Jones 1999; Loewenstein, Rabin, and Camerer 2004; Ostrom 1998). It is only in very rare cases that markets can be expect to reach what economists call Pareto-efficiency, because agents can not be expected to meet the assumptions made in the standard welfare economics theorem. As stated by Joseph Stiglitz, "a closer look at those assumptions, however, suggests that the theorem is of limited relevance to modern industrial economics" (Stiglitz 2002, p. 43). My argument for markets as efficient is based on the much more mundane argument that so far, for most goods and services, the alternatives to democratically regulated competitive markets have not delivered. Neither systems of central planning nor "market socialism" have lived up to expectations of creating a reasonable degree of efficiency or anything close to social or economic equality (Rothstein 2008; Wright 2006). For most goods and services, competitive markets are more efficient than known or tried alternative forms of production. This is also a central lesson from much of development studies (Bigsten and Fosu 2004). In addition, markets seem to have important advantages when it comes to innovation and in furthering a Schumpeterian "creative destruction" (Olson 1982).

While economists deal with aggregate individual-based utilitarian efficiency, political scientists are engaged in understanding power and what can be considered as ways to make the use of political power legitimate. The standard argument from most political scientists is that for large groups (cities, regions, states), the best way to make power legitimate is through some form of electoral-representative democracy. Such a system can in many cases solve the problem of power for macro-decisions like tax laws or social security schemes. The reason is that such laws or policies are mostly universal and can be applied according to an "equality before the law" principle, without involving much (or any) micro-level discretion at the point of delivery. In other cases, research on the implementation of public policies has clearly shown that such micro-level discretion can not be avoided (Smith 2003).[4] This problem is especially acute in service delivery - for example in health- or elderly care, care of disabled persons, but also for example in pre-schools and schools. What takes place between the public employee(s) that delivers the service and the citizen in such areas is problematic from a micro-power approach, since the citizen/client is often in a situation of dependence. These are situations where the electoral-representative system for making the use of public power legitimate reaches a limit because a) laws can not be made with the required precision to account for all possible variations and b) there is often a need to let professionals have discretion because they have the knowledge that is needed for how to handle different situations/cases (Rothstein 2009). From this perspective, a right for the citizen to "exit" and opt for another service provider is likely to increase his or her power, either directly by actually exiting or by the fact that the service providing organization anticipates that the citizen/client may exit and that such an exit will carry losses for the organization (Besley and

[4] The legendary Swedish Trade Union Economist Gösta Rehn made the same kind of argument in the late 1940s for power relations in the labour market. According to Rehn, workers' influence in their workplaces would increase if they were in high demand and thereby easily could find new jobs Milner, Henry, and Eskil Wadensjö, eds. 2001. *Gösta Rehn, the Swedish model and labour market policies : international and national perspectives*. Aldershot: Ashgate..

Ghatak 2007). This will of course happen if the service in question is provided on a “pure” market system where the client pays directly for the service. However, the same effect can apply if the service is provided by the government and paid for by taxes by using some form of voucher system. Such a system may, as is the case with pure markets, give the service providing organization (e.g., the nursing home or the pre-school) an incentive to improve the service production and thus increase the overall efficiency of the policy in question. Thus, markets could be favoured not only from an efficiency point of view, but also from a “making power legitimate” point of view (Besley and Ghatak 2007; Blomqvist and Rothstein 2000; Rothstein 1998).

Institutions – the two main types and the two main forms

According to the “New Institutional Economics” (henceforth NIE), “institutions are the written and unwritten rules, norms and constraints that humans devise to reduce uncertainty and control the environment.” (Menard and Shirley 2005, p.1). The implication of such a broad definition is that institutions can come in many *forms* - from constitutional laws to what has become known as “standard operating procedures” (Hall 1986) or “work rules” (Ostrom 1990), which are known and generally agreed upon rules but that are unwritten. The idea that institutions include not only formal but also informal rules means that it is difficult to distinguish them from a society’s basic cultural traits. From a policy perspective this is problematic because, while it is possible to change written rules and “standard operating procedures/work rules” through for example a democratic process, this is much more difficult with things like “shared mental models” (Denzau and North 1994) and other such generally held basic beliefs which are rooted in a society’s historically established culture (Rothstein 1996). In any case, as a first distinction, we can differentiate between two basic forms of institutions, namely formal and informal.

Institutions can of course have many functions and roles. George Tsebelis has made a valuable distinction between “redistributive” and “efficient” institutions (Tsebelis 1990). The former is simply a rule that moves resources or power from one group of agents to another. A familiar example of such a formal redistributive institution would be most social insurance- and tax systems. Informal redistributive institutions would be systems known as tribalism, clan-based societies and societies characterized by what has been termed “amoral familism” (Banfield 1958). In such societies, economic agents are reluctant to deal with agents outside their clan, tribe or extended family because they distrust such agents. On the other hand, they would give favourable treatments to agents within this type of circle. Other normatively more problematic examples of redistributive institutions are the type of extortion used by organized crime against small- and medium sized businesses (Varese 2001).

The existence of redistributive institutions is in general not difficult to explain using standard assumptions about the consequences of the allocation of various power resources in a society. For example, variation in the extension and coverage of different social insurance systems has been explained by the variation in class-based power resources (Korpi and Palme 2003). One can generally expect that those with lots of power resources will establish institutions that make it easier to dominate those that have fewer resources. As I will argue below, we should expect market agents with lots of resources to try to establish institutions that will limit the possibilities for competition from other agents in their market with fewer resources. There are, however, also instances when social norms about decency and appropriateness play a role (Elster 1991; March and Olsen 1989). One example is the strengthening of legal norms in many Western countries about how to treat and take care of animals. However, the general assumption here is that market agents, when trying to establish or change institutions, will act according to a “logic of exchange” and maximize their material gains.

Efficient institutions, on the other hand, have quite the opposite character since their effect is to improve the welfare of all actors in a specific system of exchange. As such, they are genuine collective (or public) goods and therefore, as will be discussed further below, difficult to explain from standard assumptions about human behaviour in economics. Seen in the light of non-cooperative game theory, these are institutions that make it possible to avoid situations such as sub-optimal outcomes in n-persons prisoners’ dilemma type of games. In the closely related social dilemma theory, efficient institutions make it possible for agents to avoid ending up in situations known as social traps. Such formal efficient institutions have also been described as “universal” (Mungiu-Pippidi 2006; Rothstein 2005) or “impartial” (Rothstein and Teorell 2008) or “open access orders” (North, Wallis, and Weingast 2006).[5] For market

[5] Eggertsson (2005) differentiates between “imperfect” and not so imperfect institutions. The problem is that he operates with a functionalist definition of what should count as such “imperfect institutions”, namely those

agents, this would be institutions that secure property rights, that produce reliable information about the solvency and credit record of firms, as well as an un-corrupt and impartial judiciary, a state government operating by the "rule of law" principles, and anti-trust legislation that can secure "fair competition" by ruling out cartels or other forms of blockades against new agents entering the market. For most citizens, an honest, impartial and reasonably efficient public administration would also be counted into this category of efficient institutions. On the labour market, this can be general agreements between trade unions and employers' federations that facilitate the possibilities of solving wage negotiations without having to resort to costly open conflicts.[6]

The most well-known example of informal efficient institutions is when generalized trust and social capital are widespread in the population. Institutions like this increase the likelihood that other market agents will not use opportunistic or treacherous strategies but instead follow contracts in a benevolent way. Generalized trust and other forms of social capital thereby decrease transaction costs (Keefer and Knack 2005; Svendsen and Svendsen 2004) Theoretically, what efficient institutions do is to increase the likelihood that agents that are exchanging values will trust that the other agents will not behave in a treacherous way (Levi 1998; Levi 2006). Thus, efficient institutions induce change in agents' choice of strategy by increasing the likelihood that most agents will believe that most other agents cooperate honestly, which in turn will make it more rational for the individual agent to behave honestly. It should be added that the distinction between "efficient" and "redistributive" institutions is a theoretical ideal-type construct. In real life, many efficient institutions have some redistributive effects and vice versa (Tsebelis 1990). However, for the sake of theoretical simplifications, we will distinguish between these two *types* of institutions (redistributive and effective) and forms of institutions (informal and formal). If the two institutional forms and the two institutional types we have identified are cross-tabulated, the following typology and examples come out.

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institutions "that cause relative economic backwardness" (p. 47). Such functionalist definitions should be avoided since they tend to become tautological, see Rothstein & Teorell (2008).

[6] Elsewhere I have argued that the famous so called Saltsjöbadsagreement that was established in Sweden in 1936 can be seen as such an efficient type of institutions (Rothstein 2005, ch. 8). It should be underlined that in the European context, Sweden and the other Nordic countries were exceptions and that in most countries, the labour market parties failed to establish similar efficient agreements. In many cases (Italy, Spain, Germany, Austria), the consequences for these failures were devastating.

Figure 1. Institutional forms and types: Examples

	Formal	*Informal*
Effective	**Impartial state adm.** **Rule of Law** **Audit systems**	**Generalized trust** **Social capital** **Public service norms**
Redistributive	**Progressive tax systems** **Industrial rel. laws** **Welfare policies**	**Neo-corporatism** **Lobbying/corruption** **Clientilism**

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It should be added that these forms and types empirically are strongly correlated. For example, high levels of corruption correlates with low levels of generalized trust, and high levels of "rule of law" correlates with high levels of generalized trust (Rothstein and Stolle 2008; Rothstein and Uslaner 2005). However, while correlations are strong between formal and informal institutions in both cases, how the causality works between them is a very complicated and mostly unresolved matter. The most plausible explanation is that formal and informal efficient institutions are mutually re-enforcing entities in which causality operates with lots of feedback mechanisms over time. A good example of this is the analysis by Farrell and Knight of how firms in a certain district in Northern Italy use trust-based collaboration to strengthen their market position as a collective, while also being competitors in the very same market segment. What they show is that the formal efficient types of institutions work, so to say, behind the scene as a last resort possibility for agents to deal with opportunistic/treacherous behaviour, while it is the informal trust based relations that create the system of mutually beneficial cooperation (Farrell and Knight 2003). Other studies show that informal and formal efficient institutions can be functional substitutes (Ahlerup, Olsson, and Yanagizawa 2008; Widmalm 2008).

The difficult art of supplying efficient institutions

The central claim from the NIE approach is that efficient formal institutions are necessary for creating economic efficiency and economic growth, especially in poverty stricken Third World countries (Acemoglu, Johnson, and Robinson 2005; Eggertsson 2005; Menard and Shirley 2005; North 2006; Rodrik 2007). It has also been claimed that such institutions explain the "miraculous" economic growth in Western Europe that started in the late 17th century (North 1990). While most scholars in the NIE approach concentrate on formal institutions, Douglass North has again and again emphasized the importance of the informal ones with concepts such as "shared mental models" and "norms of behavior, conventions, and internally imposed codes of conduct" (Denzau and North 1994; North 1998a; North 1998b; North 2006).

The problem is often labelled as that of creating "credible commitments" between agents when they enter into contracts in a market (Keefer and Knack 2005). Without institutions that establish credible assurances that treacherous[7] agents who renege on or violate contracts will be punished (or ostracised), so as to establish a general belief among most agents that such behaviour is uncommon, transaction costs will skyrocket and people will be disinclined to make productive investments. The result is that many otherwise profitable economic exchanges or investments will not come about because the agents will distrust one another to fulfil the contract. If dishonest and treacherous behaviour becomes what is generally expected (also known as "common knowledge"), almost all agents on the market will be losers and the market will not produce a socially efficient outcome. Such a situation is also known as a "sub-optimal equilibrium" because it is self-reinforcing, as the existence of repeated and wide-

[7] Economists often use the term "opportunistic" to describe such behaviour, which I think is too nice a term for this type of agency

spread dishonest behaviour establishes mutual distrust (Bardhan 1997). Moreover, once generalized trust is broken, it becomes for a number of psychological reasons hard to mend. Because of this, agents can be "trapped" in a situation of mutual distrust. The efficiency that markets are supposed to generate is thus threatened by what has been called a "social trap" type of situation in which mutual distrust makes all agents worse off (Rothstein 2005). A social trap is a situation in which all agents know that they will all in the long run be better off if they all can be trusted to follow the rules emanating from the efficient institutions and thus compete on the market in an honest and fair way. However, this makes only sense if they can trust that (almost) all the other agents adhere to such a standard of behaviour. What is "rational" for the individual agent is thus not primarily given by any cost/benefit calculation over the transaction(s) as such, but instead by what the agents think about the other agents' beliefs about the strategy/trustworthiness of all other agents, including herself. This type of rationality has been called "interactive rationality" by Robert Aumann and Jacques Dreeze. Seeing rationality in this social perspective has important implications because it shows the indeterminate nature of standard neoclassical theory and standard game theory that solely build on the idea that individuals will act so as to maximize their own pay-offs. The implication has been formulated by Aumann and Dreeze in the following way:

> if one is given only the abstract formulation of a game, one cannot reasonably hope for an expectation and optimal strategies. Somehow, the real-life context in which the game is played must be taken into account. The essential element in the notion of context is the mutual expectations of the players about the actions and expectations of the other players. (Aumann and Dreze 2005, p. 9)

Thus, the outcome of social and economic interactions depends on how the "real-life context" has constructed the "mutual expectations," such as the expectations of whether the other agents can be trusted or not. In, sum, the argument is that this "real-life context" to a large extent consists of historically established and "often taken for granted" formal and informal institutions. Corruption and its related problems should thus according to this perspective not be seen as a "principal-agent" problem but a "collective action" type of problem (Rothstein 2005; Teorell 2007).

For example, if institutions that would make treacherous behaviour the exception are lacking, market agents would come to believe that most other players can not be trusted in economic transactions. If such trust is lacking, it makes no sense to be the only honest player in a "rotten game". Instead, it makes more sense to try to change the "efficient" institutions to become "redistributive" so that they will support the specific agents' (or, more likely, group of agents') position on the market. This can be done in numerous ways by means of corruption, secret price-negotiations, political lobbying, clientilistic networks, patrimonialism, organized crime, civil wars about the control of economic resources, and other sorts of violence. If a majority of the agents, because of the lack of trust in the honesty of the generalized "other agent", act in these ways, the market will not deliver anything that can be expected to come even close to a socially efficient outcome. In sum, we face two interrelated problems. The first is that efficient institutions as they have been defined here are a genuine public good and, as with all such goods, they are collectively rational but it is in many cases irrational for the individual agent to contribute to them or respect them. As will be shown below, given standard assumptions about the operational logic of market agents, we can not assume that such institutions will be provided by them in any organic of functionalist way.

Secondly, if efficient institutions have been established, we should expect market agents to try to change them to become redistributive. When it comes to formal institutions, they are likely to use various forms of lobbying to change the general rules (laws, regulations) so that they will be favoured at the expense of their competitors (Olson 1982).[8] When it comes to the specific implementation of general rules, they are likely to use bribes or take part in other similar forms of corruption. One need only take a quick look at many of the different indexes of corruption that are provided by organizations such as Transparency International and the World Bank Research Institute to conclude that systemic or semi-systemic corruption is the rule around the world, not the exception. As Shirley states: "The vast majority of humans today live in countries that have failed to create or sustain strong institutions to foster exchange and protect persons and property" (Shirley 2005, p. 612). Another example of means to destroy well-known efficient institutions is when powerful economic networks establish systems of organized collaboration with government agencies to further their

[8] Joseph Stiglitz, winner of the Prize in Economics to the memory of Alfred Nobel, recalls that when he was chair of the Council of Economic Advisors under former US President Bill Clinton, CEOs of major U.S. companies regularly came to his office stating their support for the free-market principle that governments should not interfere in the market. However, as a rule they told Stiglitz that their particular industry was a special case that needed strong support from the U.S. government (from Block 2007, p. 12).

specific interests against their competitors. Such networks, also known as neo-corporatist systems of exchange, have been, and are still, very common in many Western European countries (Lindvall and Sebring 2005; Streeck and Crouch 2006). One can add other forms for destroying universal/efficient institutions such a clientilistic networks (Roninger 2004), powerful political-industrial complexes (Hossein-zadeh 2006) or organized crime (Varese 2001). In sum, as Douglass North has put it: "institutions are not necessarily or even usually created to be socially efficient" (North 1998a, p. 249). The earlier idea in economics that market agents would in a sort of functionalist trial-and-error fashion be able to create efficient institutions is simply not credible given the known historical record (Bendor and Swistak 2004; North 1998b).

The problem is failures in creating and sustaining markets, not market failures.

This argument presented here is different from the standard "market failure" argument in neo-classical economics which has a long history dating back to Adam Smith's famous statement that "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices" (cf. Cowen 1988; Smith 1776). The standard "market failure" theory proposes that there are a number of specific situations or a certain type of goods for which markets can not attain social efficiency, such as when the goods have large costs that are not reflected in the price, when the consumption of the good is not exclusive, when the production of the good has large social benefits, or when information problems become too extensive. In such cases, most neo-classical economists argue that there is a need for some form of government intervention or regulation.[9] The argument from neo-classical economics is thus that in general markets will create efficiency if left to themselves, but that there are a number of special or exceptional circumstances that call for external government intervention. In contrast, my argument is that also for "perfect market goods" with low externalities and when consumption is exclusive and information is (almost) free and perfect, market agents behaving like market

[9] It should however be noted that many neo-classical economists also warn that the effects of such government intervention caould worsen the situation, see many of the chapters in Cowen & Crampton (2002) and in

agents can generally not be expected to generate efficiency because we have very little reason to believe that such agents will create the necessary type of what has been defined above as efficient institutions. This is slowly becoming clear from the NIE research program. For example, Avner Greif argues that such institutions exist only “in a few advanced contemporary countries and only in recent times” (Greif 2005. p. 737). The same argument has been put forward in a recent paper by Douglass North, Joseph Wallis and Barry Weingast with the immodest title “A conceptual framework for interpreting recorded human history” (North, Wallis, and Weingast 2006). As Acemoglu and Robinson recently have put it: “An agreement on the efficient set of institutions is often not forthcoming because... groups with political power cannot commit to not using their power to change the distribution of resources in their favour” (Acemoglu and Robinson 2008).

Why can market agents not be expected to create the efficient institutions that they need in order to create an efficient market?[10] North states the problem as follows: "Neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with markets, not with how markets develop" (North 1998a, p. 247). One problem is that if political leaders successfully create a state that is administratively strong enough to protect property rights, they will also have access to an administrative machine that can violate those rights (North 1990, p. 59). If those in control of the state are the type of actors assumed by the utility maximizing model, they will also exploit that power to enrich themselves at the expense of the people’s rights (Weingast 1993, p. 287). As the situation in the many “failed states” in Africa has been described by Robert Bates: “The civil service assumes the role of a specialist in violence, using its command over the bureaucracy to redistribute income from the citizens to themselves” (Bates 2008, p 29). In so doing, they inevitably create distrust of the state as an institution, which is a barrier to the willingness to invest or take other economic risks. A second problem has its background in the fact that creating efficient institutions is a large, complicated and costly enterprise. As Hernando de Soto has shown, it took centuries for the efficient type of institutions upon which modern Western market economies are based to emerge (De Soto 2000). The jurisprudential regulations are complicated; the institutions required are many, costly and comprehensive (Greif 2005). It is not solely a matter of police and public courts, but also of institutions like registrar offices that establish ownership rights to real property, a working land

[10] Cowen (1988) entails a number of chapters describing cases when economic agents have been able to overcome the collective action problem and produce public goods. The cases are all interesting but they are clear cases of exceptions bordering on the anecdotal. This is large “make believe” economics.

survey office, receivers, official agencies for the collection of debts, taxation and numerous inspection authorities, etc. Precisely because it is a large and costly enterprise, the creation and reproduction of such institutions must be seen as a classic collective action problem and, as such, it is impregnated with all sorts of free-riding problems (Sened 1997). In addition, there is ample empirical support for the claim that even if such institutions are created, individual market agents have strong reasons to try to bend them to become redistributive so to work in their favour (Bennich-Björkman 2002; Malaquias 2007; Olson 1982). These three problems - the strong state problem and the two collective action problems - should be seen as the general rule for what to expect. There are however, as is well known, exceptions. Research on neo-corporatism shows that in some cases, market agents (for example employers' federations, trade unions or trade organizations) have been able to establish efficient types of institutions through negotiations. It should be noted that in almost all cases, this has been carried out either in close collaboration with government agents or in the shadow of a threat form government agents that if the market agents can not establish such efficient institutions through some form of compromise, the government would step in (Katzenstein 1994; Lewin 1992; Rothstein 1992a; Scharpf 1997).

The other main exception from the general rule that market agents are generally unable to create efficient institutions is the work on "common pool resource problems" by Elinor Ostrom. She has shown that groups of economic agents who are all dependent on a local natural resource can create (efficient) institutions that prevent free-riding types of extraction that would be detrimental to the sustainability of the resource in question. Finding out that economic agents, if left to themselves without government interference, can overcome the famous "tragedy of the commons" problem is a major achievement and her research has rightfully gained a lot of attention (Ostrom 1990). Other studies, for example of water control systems, have confirmed her results (Kaijser 2002).

However, there are a number of arguments for why her findings are not generalizable to modern competitive markets. First, in all her cases, the group in question has developed strong social bonds and mutual trust over a very long time. Second, the groups are socially and ethnically homogeneous, something that other scholars have put forward as critical. For example, a recent paper reviewing the literature concludes that "the negative association between ethnic heterogeneity and public goods provision is widely accepted" (Habyarimana et al. 2006). Other scholars contend that the negative relation between ethnic heterogeneity and public goods production is "one of the most powerful hypotheses in political economy" (Banerjee, Somanathan, and Iyer 2005). They add that this is not only the case in such obvious and extreme cases like civil wars, but also under "normal" times. Third, success depends on the opportunity for the group to enforce strict rules about who has the right to use the resource in question, which implies that a cartel-like situation already exists. Fourth, she reports a number of cases where such local regulations have failed due to a number reasons, most of them related to the failure of the agents to enter into what should be called a deliberative democratic process. Lastly, while the state is far away, it seems to be present in the shadow. For example, in her famous case about water regulation in Southern California, it is government institutions that provide the forum for discussions and decisions. In her conclusion, Ostrom states that "most of the institutional arrangements used in the success stories were rich mixtures of public and private instrumentalities" (Ostrom 1990, p. 182).

Another well known case dealing with the problem of producing efficient institutions has been examined by Paul Milgrom, Douglass C. North, and Barry Weingast in an oft-quoted paper (Milgrom, North, and Weingast 1990). Their example illuminates how merchants of a certain region in 14th century Europe could develop legal praxis that greased the wheels of trade despite the lack of credible state institutions. The problem they were facing was that of managing situations in which contractual disputes arose between two merchants, i.e., how they should handle the deceptive behavior of certain merchants in terms of various kinds of breach of contract. The situation may be likened to a classic social trap – all merchants have a vested interest in everyone behaving honestly, but there is no point in being the only honest actor if everyone else is engaged in trickery and deceit of one kind or another. If "everyone does it," the financial gains to be had from trade decline substantially, in part because fewer transactions are completed and in part because the actors are forced to devote considerable resources to protecting themselves from the deceptive actions of others. The costs incurred by merchant A to enter into a financial contract with merchant B, who intends to swindle A, are substantial. Even if the wronged A spreads information that the dishonest merchant B is not to be trusted, B could of course counter that information with contrary disclosures. Absent credible information institutions, other merchants have little or no means of determining who is in the right.

Milgrom et. al. claim that the merchants' guilds of 14th century France appointed "law merchants." The law merchants were empowered to act as judges in disputes between merchants and to publicize information about merchants that refused to voluntarily accept the verdicts of their deliberations (e.g., by paying compensation to the wronged party). This made deceptive behavior and refusal to comply with the verdicts of the law merchants an expensive business, since merchants who did so gained a reputation for lacking credibility and for being unreliable trading partners. This led to a strong decline in deceptive behavior, because it was in the merchants' own interest to avoid getting such a reputation (see chapter five: in these contexts, the appearance of credibility is a vital asset). Therewith, according to Milgrom et al, an institution for solving the problem of the social trap had blossomed from the market's own inherent logic. The actors have a self interest both in establishing the institution and in obeying the verdicts of the law merchants, which made the institution as such self-reinforcing. According to this analysis, a type of society under the rule of law had sprung up by itself; the problem of the social trap had been resolved by the self-interested utility maximizing actors of their own volition and with no outside involvement by something like a state or some form of social norms.

This is a neat and very appealing analysis to be sure, but also supremely idealistic, if not to say naïve. Merchants and trading companies are not homogeneous quantities. Market logic dictates that some will eventually become much more financially strong than others. If they are economic rationalists, the large trading houses will use their financial strength to bribe or corrupt the law merchants in one way or another to gain economic advantages. They will also try to get their confidants in corruption installed in those positions in order to render verdicts in their own trading house's favor. And if the law merchants are also economic rationalists, their integrity will be for sale as long as the price is right and the transaction can be kept secret. Secret interactions are the hallmark of corruption. Such a scenario is a rather apt description of events in Russia after the privatizations of the 1990s. The economic oligarchs seem to have become so strong that they have managed to buy attempts to build universal legal institutions out of existence (Hedlund 1999; Ledeneva 2006).

As I have shown elsewhere, when well-known scholars in this tradition try to solve the problem of how efficient institutions can be created, they introduce a number of non-economic explanations such as "beliefs", "norms", "legitimacy", altruistic actors", etc (Rothstein 2005, ch. 6). This may very well be true, but in light of their utility-based rationalistic models, these are all ad-hoc explanations and are thereby outside the reach of their theory. As Lichbach (1997) as well as Falachetti and Miller have shown, within the rationalistic paradigm "there is no solution" to the problem of creating efficient institutions (Falaschetti and Miller 2001).

An alternative and in many ways more promising approach to the problem of markets and institutions can be found in the economic sociology literature. The main claim from this approach is that markets are always socially embedded. (Block 2007; Dobbin 2004). This approach entails a very relevant critique of the neo-classical models of how markets operate since it shows that markets are almost never based on a pure utility-maximizing logic but depend on historically established and often "taken for granted" formal and informal institutions that can vary a lot between different settings (Fligstein and Dauter 2007). A part of this literature is inspired by Karl Polanyi's theoretical framework developed in his well-known book "*The Great Transformation*" published in 1944. Central to Polanyi's claim is also a strong critique of the idea of the possibility of a "self-adjusting market" (cited inBlock 2007, p.5).[11] However, the problem with this approach - within the context of this discussion - is that there is no such thing as "efficient" institutions in economic sociology, only different types of what here has been labeled redistributive institutions (Block 2007). Second, the concept of embeddedness lacks precision, since it can be almost anything that surrounds a market. Third, the approach is not well suited to handle variations across time and space since it does not entail a well specified theory of why embeddedness differs.

The same critique can be launched against Sened's otherwise very informative work on the political institutions of private property, which talks very little about why the ability of political leaders to invest in "the design of legal codes that endow their citizens with the necessary framework for a productive life" vary so much across time and space (Sened 1997, p. 179).[12]

The science of politics versus the science of economics and the problem of the supply of efficient institutions

During my first year as a PhD student, I remember attending a seminar where one of the then most influential Swedish professors in Political Science, the late Jörgen Westerståhl, presented a new undergraduate level textbook with the title "The Swedish Democracy" (Birgersson and

[11] Polanyi is not always clear and easy to interpret. My understanding is that he sees markets as exogenously self-destructive, that is, they will if not properly embedded destroy their external conditions. Understood in this way, he differs from the argument presented here which is that markets are also endogenously self-destructive.
[12] According to Sened, some leaders are "smart" to make such long-term investments while others are "greedy" and short sighted. It would be interesting to have a theory that explains this difference.

Westerståhl 1979). His presentation (and the book) was heavily criticized by the then “young turks” in the profession, for giving a far too rosy picture of how the Swedish democracy actually worked. In a very elegant way, Westerståhl managed to effectively silence his opponents by arguing that the intention with the book was not to give a realistic picture of how the system worked, but instead of how it was intended to work according to the new Swedish constitution (which he had been instrumental in drawing up). Westerståhl’s eloquence did in my opinion shield the fact that he in the book never made this distinction clear. I am retelling this to show that it has not been uncommon in Political Science to distort the political reality with idealistic pictures of how the state works. However, since then, the discipline has changed dramatically and I think it is fair to say that the normatively negative sides of how even well-established democratic systems operate have come to the forefront in teaching as well as in research. One example is how far from the ideals in the theory of representative democratic theory that actual representative parliamentarian democratic systems work even in well-established democracies such as Sweden and Norway (Esaiasson and Holmberg 1996; Østerud and Selle 2006). Another example is the research about policy implementation, which shows the many difficulties in getting the policy intentions of the legislatures realized by the government authorities (O'Toole 2004; Saetren 2005). A third example is research on the not-so-democratic influence of powerful interest groups (Katzenstein 1985; Lewin 1992). I think it is fair to say that most political science research nowadays eschews the romantic and idealistic view of the democratic process that Westerståhl’s textbook from 1979 represented.

It should be underlined that while political scientists have put quite some effort in analyzing government failures, the public choice approach, in which politicians and civil servants were assumed to operate from the same narrow self-interest as market agents, was refuted by most political scientists and public administration scholars. In my opinion, this refutation came not so much from ideological reasons but instead because empirical research could not confirm the hypothesis (Brehm and Gates 1997; Dunleavy 1991). It should however be added that while most scholars in public administration and implementation research were interested in various dysfunctional tendencies of the political-administrative process, corruption-related problems have for the most part been outside their agenda, at least as long as their studies have been related to the developed Western democracies (Johnston 2006, p. 809). In addition, in the important approach known as the “Variety of Capitalism,” that has emanated within Political Science, this problem is not dealt with, probably since the difference between redistributive and efficient institutions is not recognized. In principle, all institutions in this approach are the outcome of differences in social or economic power and thus redistributive (Hall and Soskice 2001).

In comparison to political science and sociology, I believe that economics in general, since the fall of the Keynesian paradigm in the 1970s, have been engaged in what can be described as an ideologically driven “love affair” with the market. The most problematic in this is that the supply and reproduction of efficient type institutions, which according to the NIE approach are necessary for market efficiency, have either been taken for granted or not problematized at all. For example, standard and widely used major textbooks in (macro) economics do not deal with the possibilities of corrupt, clientilistic or similar forms of behavior by market agents. In fact, such problems (e.g., corruption) do not even have an index entry in these books even if they have titles such as “Law and Economics” (Cooter and Ulen 2007), “Markets and Politics” (Hultkrantz, Söderström, and Bergman 2007), “Applied Macroeconomics” (Persson and Skult 2005), “International Economics” (Appleyard, Cobb, and Field 2008), Macroeconomics: Theory, Politics and Institutions (Fregert and Jonung 2005). If corruption, clientilism and other forms of destruction of efficient types of institutions by powerful economic interest groups are at all described, it is only as a warning against the use of government regulation as a response to the standard type of market failures (Romer 2005, p. 146). The assumption behind this seems very unrealistic, namely that market agents “by nature” are interested in upholding efficient institutions, while only political/government agents have incentives to block the establishment of, or an inclination to hinder or destroy, such institutions. The old idea that “it takes two to tango” seems not to have penetrated this literature. In short, the important insights from institutional economics seem to have had very little impact in the study of general economics as it is taught in standard education at a typical business school.

The results that come out from economic theory and the research about how to minimize corruption also seem to be contradictory. On the one hand, there are well-known economists, such as Alberto Alesina, who concludes that “a large government increases corruption and rent-seeking" (Alesina and Angeletos 2005, p. 18). An equally well-known and respected economist, Timothy Besley, states in a recent book that;

> There is a section of opinion that equates good government to small government. Moreover, this has been a dominant tradition in political

> economy in the past. However, there is nothing in modern political economics to support this claim (Besley 2007b, p. 233).

This type of contradictions from leading scholars in the social sciences on a crucial topic like this is, to put it mildly, not very reassuring (cf. La Porta et al. 1999). It should be added, as stated above, that there is very little research in economics about how efficient institutions can be established. This holds also for what is known as "political economy". For example, in the recently published "Handbook of Political Economy", North criticises that none of the sixty-seven(!) chapters deals with the problem of how to establish efficient institutions. (North 2006).

Standard textbooks in economics regularly refer back to Adam Smith's famous "invisible hand" theory from his "Wealth of Nations" as an argument for why markets if left to themselves will become efficient. However, thirteen years before the publication of "Wealth of Nations", Adam Smith published another book titled "A Theory of Moral Sentiments", which is a work that put strong emphasis on things like virtues, self-restraint, and also on the role of proper government regulations. There is now a large literature in the "history of ideas" field that shows that these books should be seen as a unified theory that can be viewed as supporting the idea that markets can only be efficient if embedded in what here has been conceptualized as (formal and informal) institutions (Brown 1994; Darwall 1999; Griswold 1999; Werhane 1994). What comes out from this research approach is that it is only from a superficial understanding of Adam Smith that he can be used for the argument that markets endogenously can generate economic efficiency.

Another plausible reason for why mainstream economics has a problem with the questions of supply and reproduction of efficient institutions may come from the relatively strong position of the "public choice" approach within the discipline. The argument looks as follows: Agents operating efficient institutions must operate according to a core value (or basic norm) which I (together with Jan Teorell) in a recent paper have identified as *impartiality* (Rothstein and Teorell 2008). For example, if agents competing in a market are to trust the institutions that are there to uphold the rule of law in order to handle conflicts about contracts, property rights and security, etc., the personnel that operate these institutions have to be seen as impartial between the conflicting parties. However, if these agents are solely motivated by furthering their material interests as the public choice approach takes as its starting point, their impartiality will eventually be corrupted by one of the parties in the conflict if the money is good enough. This problem can not be handled according to the “principal-agent” theory by employing incentives or control from above, since this will only create a “second order” collective action problem because the agents at the top are likely to get most rents from such rent-seeking behaviour by agents that operate further down the system (Ostrom 1998). Thus, the idea that agents who operate efficient institutions, in order to be seen as trustworthy, have to act according to the ideal of impartiality instead of self-interest is difficult to handle, in particular within the public choice approach but apparently also in mainstream economics. It is noteworthy that economists that carry out empirical research in this area emphasize the need for a strong public interest orientation for public employees (Besley and Ghatak 2007; Collier 2007; Miller and Hammond 1994).

A Concluding Illustrative Story

The ever so popular HBO TV show “The Sopranos” contains a scene that speaks to the problem of the supply of efficient institutions. In a state of rage, the mob leader himself, Tony Soprano, with a gun in his hand goes after a low level gang member that has betrayed him and kills him. Usually, he would of course have used an underling for an operation like this, but this time (due to his mental instability that is a central theme of the series) he is so overtaken by emotions that he forgets the golden rule that mafia bosses should never do any of the dirty work themselves. As it happens, he is seen by an “ordinary citizen” chasing after the victim. This eyewitness goes to the police, not knowing that it is the local mafia leader that he has seen. The “ordinary Joe” tells the police that he is just sick and tired of all the violence in his neighbourhood and that he as a law-abiding citizen wants to help the police to clean up the neighbourhood. When the police commissars show him a bunch of photos of known criminals, he directly identifies the perpetrator - still not knowing who the person he identifies is. After he has left the police station, the police commissars are in a state of joy since they now seem to have what they need to put Tony Soprano behind bars. In the next scene, the eye-witness is sitting comfortably in what seems to be a middle-class home listening to classical music. A woman his age, probably his wife, is sitting close to him reading the newspaper. Suddenly she starts screaming and then shouts at him to read an article in the paper. The article makes it clear to this honest and law-abiding citizen that the person he has identified at the police station as the perpetrator is the well-known local mafia leader Tony Soprano. The law-abiding citizen then throws himself at the phone, calls the police commissar who's direct number he has, and in a terrified voice says that he did not see anything and that he will not become a witness. The interesting thing is the book our law-abiding citizen was reading before his wife showed him the newspaper article. An observant spectator has about one second to see that it is the philosopher Robert Nozick's modern classic *Anarchy, State and Utopia* - an icon for all ultraliberal, anti-government and free-market proponents ever since it was published (Nozick 1974). The message from the people behind the Sopranos show seems clear: In a "stateless" Robert Nozick type of society, where everything should be arranged by individual, freely entered contracts, markets will deteriorate into organized crime. The conclusion is again, that there can be a market for anything as long as there is not a market for everything. Or in other words, if everything is for sale, markets will not come close to what should count as social efficiency.

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