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State Reforms and the Theory of Institutional Policy

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A theory of institutional reforms must recognize what policy instruments are available, how politics restrains the choice sets of reformers, and whether spontaneous counter-policy by ordinary actors is likely to undermine reforms. A discussion of the so-called Determinacy Paradox concludes that it is not a practical issue. Insights suggested by the new institutionalism include measures to reduce political risks, increase the durability of reforms, and reduce transaction. The main weakness of NIE as a guide to policy is its limited understanding of the role of norms in undermining reforms and of long-term internal dynamics of social systems.

1. INTRODUCTION

In this essay I discuss the relevance of the New Institutional Economics (NIE) for public policy aimed at structural reform. Within the new institutionalism, I follow the approach which relies on methodological individualism and weak or strong versions of the rational actor assumption.[1] NIE is concerned both with the effects of institutions and with institutional choice — while recognizing that the choice of institutions is not independent of their effects (Weingast, 1996). Institutions are defined as social constraints (North, 1990a), and deliberate (in contrast to spontaneous) institutional choice — the subject of institutional policy — is made by organizations which create and enforce rules.

Because it studies economic, social and political phenomena, NIE crosses traditional borders and draws on theoretical and empirical findings in various scholarly fields. When studying the impact of institutions on economic outcomes, NIE relies on economic analysis, usually modified by concern with transaction costs, information problems and uncertainty. Public policy is made by or authorized by political organizations and therefore the study of institutional policy borrows from positive

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[1] I used to refer to this approach (neoclassical institutionalism) as Neoinstitutional Economics — which also is abbreviated as NIE (Eggertsson, 1990). In this essay I make no distinction between Neo- and New Institutional Economics because we still don't have generally accepted names for the various approaches to institutional analysis.

political economy and public choice (Alt & Shepsle, eds., 1990).[2] When attempting to explain historical change or the variation among contemporaneous economic systems, NIE often cannot avoid recognizing the role of differences in world views, principled beliefs, and causal beliefs (Goldstein & Keohane, 1993), and account for changes in preferences and mental models (North, 1993). Such explorations leave the usual territory of rational choice methodology but they need not be consistent with methodological individualism.

Until the present, research in NIE has concentrated on explaining the causes and consequences of institutional arrangements. Although this work has created considerable interest among people involved in institutional reforms in various parts of the world, the new field has not developed a theory of institutional policy, which explicitly lays out the implications of institutional analysis.[3] In this essay I discuss a research agenda for a theory of institutional policy. The next two sections examine the relevance of NIE for economic reforms: Section 2 presents NIE as the study of alternative mechanisms for controlling access to scarce resources, and Section 3 discusses the two main ways in which the literature has modeled institutional change. Section 4 discusses general issues involved in formulating institutional policy and looks for guidance in the history of macroeconomic policy from Frisch and Tinbergen to Sargent. The two sections that follows discuss the implication of select findings in the literature for the politics and economics of institutional policy: Section 5 discusses the political aspects of institutional policy, and Section 6 examines economic aspects. These two sections are intended as a brief introduction into the type of policy issues and questions, which the literature suggests. A final section concludes.

2. INSTITUTIONS AS CONTROL MECHANISM

For the purpose of studying institutional policy, it is best to think of institutions as providing a framework for controlling access to scarce resources and as arrangements for facilitating cooperation within the social system. In my view, policymakers are most likely to value NIE studies which analyze non-obvious methods of control and non-obvious control failures — for instance studies of control mechanisms (gov-

[2] In this paper the term 'institutional policy' only refers to public policy. Of course, non-governmental organizations also design and enforce rules, subject to limits imposed by higher state institutions. For instance, we can talk about the institutional policy of business firms and refer to the fundamental rules of a corporation as its constitution (Voigt, 1997). The constitution of a corporation is nested in national law, but similarly national law is nested in international law. The distinction between public and private institutions varies from one economic system to another. Sometimes political organizations (governments) allow, or cannot prevent, that non-governmental organizations such as trades unions or farmers' organizations set rules in areas that traditionally lie in the public domain. At one point in Iceland, the Ministry of Agriculture gave the national federation of farmers the right to determine certain tax rates for modern high-productivity farming, allegedly to protect the *status quo* of traditional low-productivity farming. Eventually, the country's Supreme Court ruled the practice unconstitutional. Wiesner (1997) discusses how powerful labor unions in Colombia have constrained the government's privatization programs.

[3] I do not deny that NIE has inspired policymakers and given them tantalizing insights into various policy issues, but the field also has frustrated and confused people in the front lines (Shirley, 1997). Policymakers are frustrated by the field's preoccupation with methodology, by the many contending institutional schools, and (until recently) by the lack of empirical results.

ernance) in corporations (Williamson, 1985); methods of control in modern markets (Barzel, 1997); in medieval long-distance trade (Greif, 1997); in informal economies (de Soto, 1989); in private oil fields (Libecap, 1987); in legislatures (Shepsle and Weingast, 1987).

In this context, the term "control" has roughly the same meaning as "property rights" in the economics of property rights. The structure of control has critical implications for economic systems because it affects incentives; because scarce information and costly enforcement often makes control incomplete (Barzel, 1997); because political processes often give rise to inefficient structures of control; and because incomplete knowledge makes actors uncertain about which structure of control best meets their goal (North, 1981; 1990a). Transaction costs are the costs of establishing and enforcing property rights and protecting these rights in transactions. Therefore transaction costs are the costs of control.

In NIE it is institutions that provide control. Institutions are social constraints: rules that are enforced in some way by public agencies, social groups or private individuals. The methods of enforcement include threats of force, social sanctions, moral codes, and expectations about reciprocity. For policy-making there is a critical distinction between those institutions which the policymaker is able to change — at least in principle — and those that are not subject to direct control such as principled beliefs, world views, and causal beliefs. These mental constructs appear to be important ingredients in social constraints. For policymaking the critical distinction is not whether existing rules are formal (laws, regulations) or informal (customs, norms, conventions) or whether they originate with political units or with social groups (external versus internal rules), but whether reformers are able to change those social constraints which conflict with their policy goals. The authorities easily can turn informal conventions (coordination rules, such as the rules of behavior which people follow when they simultaneously approach a narrow bridge) into formal laws, and they also can change such conventions. Norms and customs often support particular modes of production and fade away when new modes are introduced and provide no obstacles for institutional policy. Problems for policy arise, however, when various shared mental and social constructs of the public conflict with the goals of policymakers, making new laws and regulations inoperative through lack of general support. NIE scholars disagree on the importance of reform-resistant social beliefs, and so far the literature provides little guidance on these issues, yet they may be of crucial importance for institutional policy. Therefore we need to know more about how experience and learning affect the way in which people model their world, and this line of inquiry probably must draw on findings in cognitive science, social psychology and related fields.

3. TWO MODELS OF INSTITUTIONAL CHANGE

Typically the NIE approach involves comparative institutional analysis which either compares the effects of two or more institutional arrangements in a stable general environment or the effects on a particular system of changes in the environment. Here NIE differs from traditional economic analysis, which usually takes for granted the existence of ideal-type institutional arrangements and environments. However, unlike evolutionary economics, NIE, has not attempted to develop a dynamic analysis of social processes or such efforts have been rare.

A policymaker, who searches the NIE literature for advice on institutional reforms, will find two general approaches to positive analysis of institutional change: A functional approach, which I refer to as the *naive model* (Eggertsson, 1990), and the political economy approach.

The naive model is demand oriented and recognizes both the cost of installing and maintaining institutions and the benefits that institutions bring by increasing economic efficiency. According to this view, society (somehow) installs new institutions when marginal social benefits exceed marginal social costs. The *naive model* does not deal with the supply of institutions, but the model is relevant in situations where collective action is forthcoming, free-riding and the politics of redistribution do not intervene, and when competition selects the most efficient institutional forms. Many of the most interesting theoretical and empirical findings in NIE have been derived from studies that (at least implicitly) use the naive model. The approach makes it possible to focus on arrangements, which minimize transaction costs in various lines of production, and in various technological and transactional environments (Williamson, 1985; Barzel, 1997).[4]

The *naive model* has considerable relevance for institutional policy. The main lessons are (1) that reformers who seek economic efficiency sometimes can achieve their results indirectly by setting up selection mechanisms, particularly ones which involve competition among economic units; and (2) that the approach provides insights into the nature of relatively effective control and coordination mechanisms which have evolved in the market but may find applications in the public sector and improve its performance.

The political economy approach of NIE introduces the supply side of institutional change, the role of collective action and governments, and distributive struggles. Unlike the *naive model*, this approach recognizes problems of collective action, government failures, and the possibility of inefficient institutional equilibria (North, 1990a; Knight, 1992). The political economy approach has greater relevance for institutional policy than the *naive model*, although the two approaches are complementary. For instance, the political economy model suggests that the political process may reject and even dismantle efficient selection mechanisms in the economic sector (see note 4).

However, when we jointly consider the politics and economics of institutional change in terms of rational choice, the approach appears to lead to the determinacy paradox (Bhagwati, Brecher, & Srinivasan, 1984; O'Flaherty & Bhagwati, 1997; Basu,

[4] NIE studies also have applied the naive model to explain the structure of primitive and archaic societies, which are assumed to play a game against nature, with nature eliminating inefficient arrangements (Posner, 1980). The notion of an impersonal selection mechanism, of course, can complement theories which explicitly recognize political economy. The story of markets and their emergence can be told partly as a political economy story. Weingast's (1995) model of market preserving federalism combines political economy and a spontaneous selection process — resources leave federal units when they introduce inefficient (or unjust) institutions. However, political economy suggests that political actors are capable of dismantling the social institutions on which selection mechanisms rest. Finally, note that the criterion for selection in social systems need not be efficient or desirable in any way — for instance, social systems can enter a spiral of decline.

1997; Eggertsson, 1998). The argument runs like this: with all actors — economic actors and rulemakers — optimizing under their constraints, and with the social system in institutional equilibrium: (1) By definition all institutional arrangements are efficient in the standard Pareto sense: all opportunities for Pareto improvement have been utilized; (2) No actor or groups of actors that are endogenous to the system have both the ability and the incentive to introduce institutional reforms. Admittedly actors exogenous to a nation state (the IMF) can apply pressure (offer loans, withhold loans) to force a new institutional equilibrium. However, once extra-territorial actors are incorporated in the model of institutional equilibrium, we are back to the determinacy paradox.[5]

The determinacy paradox casts doubt on the independent role of experts in institutional reforms. Does expert advice have any role in rational choice political economy? The answer is not straightforward and involves two opposing elements. In the first place, it cannot be denied that the determinacy paradox introduces a real problem which economists often fail to recognize: the critical issue of political feasibility in institutional reforms. The economics and politics of institutional reforms can be thought of as a set of equations which in principle must be solved simultaneously (Dixit, 1996). As we recognize the complex interactions between economics and politics, we should not forget, however, that in its most rigorous version the determinacy paradox is a problem of methodology and modeling rather than a practical problem. The paradox arises because rational choice political economy does not recognize or deal with the implications of fundamental uncertainty. The approach not only assumes that people act consistently in terms of fixed preferences but usually also that their basic models of the environment are stable, including their understanding of the nature of economic systems. The approach suggests, therefore, that changes in economic or institutional policy always are due to new political interests and a new political equilibrium and never reflect new beliefs about the nature of social, economic, and political processes.

In practice, turnabout in institutional policy often is associated with the rejection of particular policy models, frequently in response to outcomes which (rightly or wrongly) are seen as negative test results for the models (Eggertsson, 1997b). Unexpected outcomes can be caused by external events or by poorly understood internal dynamics which disturb social systems. Such events sometimes create states of institutional disequilibrium which open key players (politicians and their constituents) to new ideas and new methods for reaching their goals. Institutional policy, therefore, depends not only on the balance of various interests but also on the outcome of the competition between alternative models and ideas about social processes.

And, finally, rational leaders have use for expert advise even when they are not plagued by system crashes and fundamental uncertainty about the nature of social structures. Within stable systems of beliefs about the nature of social structures, traditional economic arguments about the division of labor and investment in information sug-

[5] The determinacy paradox does not exclude the possibility that the balance of social forces may allow societies to respond efficiently to exogenous changes in the environment, for instance to opportunities provided by new technologies or new markets. However, some scholars emphasize that certain cultures entertain perverse social beliefs and mental constructs which trap these communities in pernicious equilibria at low levels of income (Putnam, 1994). Hedlund and Sundström (1996) have expressed such extreme reform pessimism about Russia.

gest that some actors will specialize in accumulating information about the structure of social systems. "To be rational, an agent needs resources for recognizing the logical consequences of beliefs, [and] checking the coherence of preferences..." (Levi, 1997: 222). People's circumstances determine how much they invest in developing expertise and accumulating information relevant for institutional reforms. The role of experts is to help their clients to improve the consistence and rationality of their ideas about social structures. "Giving advice to a client as to how to be coherent or rational enhances the client's capability to be rational. The advice is valuable because it is enabling — not because it is coercive." (Levi, 1997: 222).

I now turn to a brief discussion of policy models and their central role for all policymaking, including the making of institutional policy.

4. THE THEORY OF INSTITUTIONAL POLICY

Although institutional policy and macroeconomic policy deal with different issues, they share a systemic perspective and a concern with the general environment of economic activity. Furthermore, both research programs shared an initial interest in studying perverse equilibrium outcomes (Keynes, 1936; Olson, 1965), but, unlike NIE, macroeconomics almost immediately developed an explicit policy perspective (presumably in response to the Great Depression). The pioneers of applied macroeconomics formulated a methodology of policymaking which they called *the theory of economic policy*.[6] In recent essays I have argued that institutional policy can learn important basic lessons from the theory of macroeconomic policy and its evolution in the course of more than half-century. (Eggertsson, 1977a; 1997b; 1988).

The first lesson from macroeconomic policy is that all policymaking requires a formal or informal model which specifies the key elements of the policy process. Reformers require a policy model to

(1) identify the desired policy *targets* or goals

(2) identify the available *instruments* of policy

(3) describe the relationship between instruments and targets

(4) evaluate possible outcomes and select the best available outcomes (Tinbergen, 1952).[7]

Although the initial approach to macroeconomic policy reflects a holistic engineering perspective, which is quite different from the current approach which traces aggregate outcomes to micro-level incentives, it nonetheless clearly identifies the basic elements of any policy process. In recent decades the traditional theory of macroeconomic policy (the Keynesian perspective) has been modified substantially and three developments are of particular interest for institutional policy:

[6] The pioneers were Ragnar Frisch, the Norwegian economist, and Jan Tinbergen, the Dutch economist (Johansen, 1977; Eggertsson, 1998).

[7] According to Johansen (1977) the old theory of institutional policy divided the policy process into the following components: (1) A set of relevant exogenous factors such as climate; (2) A set of all possible policy measures; (3) A model of the structure and functioning of the economy; (4) A set of outcomes corresponding to all possible policy measures; (5) A preference scale for weighing policy outcomes.

(1) The early work on macroeconomic policy did not recognize political motives and assumed, implicitly or explicitly, that policymakers aimed at maximizing general well-being as defined by the criteria of welfare economics. Recent work recognizes the self-interest of politicians and various political constraints which they face (Alesina, 1988; 1995) and in that way resembles the political economy approach to institutional change.[8]

(2) Early work on macroeconomic policy did not recognize that the public might respond creatively to government policy measures and take evasive action — engage in *counter-policy* — to limit its costs (or maximize its benefits) from government measures (Lucas, 1976; 1986). Rational expectations macroeconomics generalizes Tinbergen's notion of a public policy model and assumes that private actors also rely on policy models of the economy. I believe that the notions of private policy models and counter-policy have important implications for institutional reforms.

(3) Finally, early work on macroeconomic policy did not explicitly recognize that knowledge of economic relationships is a scarce resource and that actors entertain different ideas about these structures. Bounded rationality macroeconomics (Sargent, 1993) has recognized this diversity and explores how actors adjust and coordinate their models through various forms of learning.

5. POLITICS OF INSTITUTIONAL REFORMS

Ideally reformers need a policy model which provides answers to two related concerns: (1) Which goals can we reach through institutional reforms, if we ignore political constraints? In other words, what are the non-political limits to institutional reforms? (2) To what extent do political factors exclude otherwise available options? And what measures can policymakers take to soften their political constraints and expand the choice set? In this section I try to give some flavor of recent work in NIE which bears on the second of these issues.

Many people object to the way in which political economy and public choice theory typically picture politicians as selfish maximizers of votes and wealth but fundamentally uninterested in the common good. The justification for these modeling practices, however, is the need of politicians to receive at least some critical minimum level of support for their programs in order to survive in political competition. Therefore the policy goals and behavior of a successful politician are determined by interactions between the politician and his/her coalition of supporters. For instance, a politician, who for ideological reasons seeks general institutional reforms aimed at maximizing wealth in the spirit of normative economics, must build a coalition which supports such goals.

[8] Although the pioneers of macroeconomic policy mostly were concerned with stabilization within a fixed institutional framework, they recognized that their methodology also applies to structural change. Tinbergen (1952; 1959) makes a distinction between quantitative policy within an unchanged system and qualitative policy which changes the structure of the system. In summarizing the early literature, Johansen (1977: 147-8) divides institutional reforms into minor qualitative policy and basic qualitative policy. Basic qualitative policy involves radical restructuring of property rights (and of the social power base), and Johansen suggests that such radical changes usually are associated with political upheaval.

Substantial institutional reforms are seldom pure Pareto improvements but inflict costs on some groups, at least in the short run. Therefore the survival of institutional reforms is closely tied to the distribution and timing of the costs and benefits which the measures generate. Positive political theory and empirical evidence (Dewatripont and Roland, 1995; Rodrik, 1996; Williamson, 1993) already provide some answers to questions such as: Under what circumstances do those in authority have political support for substantial institutional reforms? To what extent do reforms depend on exogenous events, for instance unforeseen economic shocks and economic failure or aftermath of wars and natural disasters? When during its term of office should a government introduce reforms? How do reformers build support for their reforms? How do reformers ensure that their reforms will survive once they leave office?

To better illustrate how political factors constrain institutional reforms, I will consider two issues: The potential threat that institutional reforms may be dismantled by future governments; and the problem of forming coalitions of supporters for institutional change when economic actors associate high *political risks* with giving up the *status quo* for a new institutional regime.

Once reformers (and, generally, those who pursue any type of institutional change) have built their coalitions of ideologies and special interests and persuaded their supporters of the merits of particular institutional targets, the policymakers face one more problem: subsequent governments may reverse the measures. The series of nationalization, denationalization, and renationalization of certain industries pursued by successive Labor and Conservative governments in post-war United Kingdom is a celebrated example of sequences of institutional reversals. When they design their projects, policymakers, therefore, have an incentive to seek arrangements which raise the cost to subsequent governments of dismantling these projects. The exception would be, of course, projects which are expected to become successful enough to be self-enforcing. However, the spread of knowledge about ways to lock in new institutional arrangements is a double-edged sword because the promoters of narrow self-interest can use such knowledge to ensure the durability of inefficient institutions.

One method of lock in, which the NIE literature discusses, creates an equilibrium by relying on the professional ethics of subgroups of specialists such as lawyers and economists. According to this approach, politicians transfer to experts of appropriate convictions the legal right to make decisions in specific areas. In each situation, the politicians select experts who are professionally committed to theories and policies which favor key constituents and enhance the political fortunes of the politicians themselves (Bates, 1993; Kiewiet & McCubbins, 1991). Along with such transfers of authority come arrangements to protect the experts from political pressure, for instance through the way in which they are appointed and how long they can serve. An independent central bank can be seen as an example of this approach.

Empirical evidence from the United States suggests that attempts to insulate experts in semi-autonomous agencies only are partly successful. A new political balance and a related change of interests on congressional committees which oversee regulatory agencies seems to affect the types of policy which these agencies pursue. Furthermore, the agencies seem to feel pressure not only from Congress but also from other political units, such as the presidency (Weingast, 1996). Studies suggest that American politicians sometimes respond to the threat of manifold interference by designing exceedingly rigid rules of conduct for the agencies. The understanding here it is that, for those who want to change the direction of an agency, it is more costly to rewrite the law than to informally interfere when the rules are open-ended. Moe's (1989) study of the U.S. Environmental Protection Agency argues that a pro-environmental political majority in Congress used this reasoning when it created particularly detailed and inflexible rules for the EPA. Rigid rules come at a price: their opportunity cost is inflexibility, which in the long run can reduce the ability of a bureaucracy to pursue its basic goals. The strategy may also backfire when legislative support for the original purpose of the agency increases rather than decreases over time, but rigid rules prevent the agency from expanding its role.[9]

The issue of durability of reforms is irrelevant if policymakers fail to build support for their proposals and pass the required measures through the political process. However, in a world of uncertainty, *political risk* often makes it difficult for reformers to build the necessary support (Weingast, 1994). The problem is this: Substantial institutional change requires policymakers to persuade coalitions of supporters to give up the *status quo* in return for an uncertain future mix of costs and benefits which are expected to flow from the new measures. As reforms often involve certain immediate start-up costs but with uncertain benefits flowing in future periods, even those who are supposed to benefit directly from the new arrangements face political risk, to use Weingast's (1994) term. When potential supporters see institutional reforms as involving high political risk, policymakers may be unable to build support for their measures.

There are many reasons why the general public and key actors often find the political risk of institutional reforms unacceptable. The reformers may fail to convince the public of their true commitment to reforms or the public may see the reformers as sincere but poor judges of the political opposition which they face from various adversaries. Potential supporters also may think that the country lacks the administrative capacity to enforce complex new institutional arrangements. For instance, widespread corruption often creates pessimism about prospects for reforms.

Policymakers build support for reforms by making the success of their proposals credible to those who are likely to benefit from the measures. The concept of *credible commitment* has found useful application in the new theory of the firm (Williamson, 1985), but NIE also has used the concept to analyze political transactions (North, 1990b; North & Weingast, 1989). Studies of credible commitment to institutional reforms which assume that the actors are rational and selfish typically rely on auxiliary *ad hoc* assumptions to achieve a cooperative equilibrium. To explain efficient equilibria these studies often refer to the influence of historical developments, such as civil wars, the particular balance of power between contending groups, or the existence of a potent ideology. These intervening factors usually are specific to time and place and cannot be replicated. So far NIE offers little practical help to reformers in countries which are unable to commit to political stability and the rule of law. However, future research

[9] When reformers have the opportunity to rewrite the constitution of a country they may try to use constitutional rules and parliamentary and judicial procedures to prevent later reversals of their institutional reforms. Formal constitutional rules, however, are notorious for having a low correlation with the behavior of key actors which the constitution is supposed to constrain. NIE does not yet offer reliable methods — policy instruments — for creating binding constitutional constraints in countries which have a history of (partly) ignoring written constitutional principles.

into mechanisms of commitment may reveal principles and suggest policy instruments which have general application. Root (1996) reports how governments of high-growth countries in South-East Asia have signaled credible commitment to the business community by involving business leaders in their development strategy. Of course, such cooperation also can create incentives for cartellization and rent-seeking.

6. ECONOMICS OF INSTITUTIONAL REFORMS

The discussion in the previous section was concerned with the politics of institutional reforms. In this section I ignore the political factor and focus on the economics of institutional reforms. From a narrow economic perspective one can say that successful institutional reforms require:

(a) that the policy authority and its advisers know what structural adjustments of the economic system will produce the desired results;

(b) that the policy authority controls instruments which can reach the desired targets.

To further simplify the discussion, I assume that a high rate of economic growth, constrained by a ceiling on wealth inequality, is the ultimate target of institutional reforms. At the time of writing it is probably fair to say that a majority of NIE scholars share with mainstream economists the belief that a competitive market economy — based on private ownership and not unduly burdened by negative-sum regulations — is the economic system most likely to meet the growth target. Of course, there are numerous dissenters to this view, but if we accept the relative merits of the competitive market model, then NIE suggests that the overarching target of institutional reforms is to create a market environment with low transaction costs. And the relative strength of NIE, as stated in an earlier section, involves studies of control structures both inside organizations and in market transactions. In fact, some of the most illuminating lessons for reforms are found in studies which investigate the consequences of insecure control — poorly define or enforced property rights (Libecap, 1989).

A low-transaction-cost environment requires clearly defined and secure property rights and various legal and administrative processes for facilitating exchange in situations where the transaction costs of private parties are inherently high because of the nature of the transactions (Posner, 1992). In areas where conventional individual exclusive rights are impractical because of high costs of definition and enforcement (the environment, occupational and consumer safety, or ocean fishing), reformers should seek when possible to create institutional arrangements which mimic market processes (Milgrom & Roberts, 1992). Finally NIE shares with related fields, such as industrial organization, an emphasis on institutional arrangements which enhance the selection mechanism of the market by facilitating entry into markets and exit for those organizations which fail the market test.

The most readily available instruments for creating low-transaction-cost environments fall in two categories: (1) laws and regulations created by political organizations; and (2) administrative agencies, including the justice system, which supply transaction services (including registration of titles), enforce the law, solve disputes, and modify rules in response to new experience.

Although the NIE literature has studied extensively how business firms solve various transaction problems (Williamson, 1985), it does not follow that institutional policy should aim at directly reforming the structure of economic organizations. The structure of economic organizations and the forms of exchange are best left to the learning and selection processes of the market. Except for antitrust policies, the primary relevance of NIE studies for the organization of business involves reforms of the public sector. However, techniques for reducing transaction costs in private firms which have evolved through market competition may provide reformers with insights of how to improve the operations of legislatures, administrative agencies and state enterprises.

Institutional reformers should not forget that the transformation of a poorly functioning economy into a successful market system requires not only secure and well-defined property rights, reforms in public administration, and special measures to reduce the costs of complex externalities, but also more traditional economic reforms, especially macroeconomic stabilization. Here NIE and traditional economics clearly complement each other.

The main weakness of rational choice NIE and the comparative equilibrium approach, especially when reforms involve major system changes, is the limited competence of the theory in analyzing and forecasting the dynamic properties of economic (and political) systems. Observers often report that social systems — national health systems, regimes of subsidy or import controls, industrial policy, soviet-type economies, market miracles in Germany and in Asia, incomes policies, the historical economy of China — initially often perform well or tolerably well but then degenerate. Sometimes, of course, the interplay of exogenous and endogenous forces makes the performance of institutional arrangements improve with time. Some of these evolutionary paths are well understood but others are not. There exist, for instance, rather convincing explanations of the perverse evolution of regulatory mechanisms in foreign trade regimes (Krueger, 1978). Other cases are less well understood: Why did economic and technical progress more or less stop in historical China when the country had become the most advanced one in the world? (Mokyr, 1990); why did the Swedish welfare system gradually decline (Lindbeck, 1995); or why did England in the 19th century enter on a path of long-term relative decline? Presumably such developments have no single or simple explanation and, in many cases, they may be impossible to forecast — which certainly has serious implications for institutional reforms.

7. CONCLUSION

The New Institutional Economics is a successor to, or closely related to, the old fields of comparative economic systems, development economics, and other scholarly programs which are concerned with variance and change in economic systems. Policymakers who struggle to reform malfunctioning economic systems are likely to turn to NIE for inspiration, if they believe that structural change is a precondition (or necessary complement) for successful economic reforms. NIE has little offer reformers, if they believe that macroeconomic stabilization policy and freeing of prices will somehow spontaneously bring about required structural changes in the economy. There is little doubt that policymakers can improve the economy of many countries without introducing large-scale structural changes: Tinbergen's qualitative policy is not needed and quantitative policy is sufficient to obtain satisfactory performance. In other countries, successful reforms are likely to require some mix of qualitative and quantitative policy.

NIE has spent much of its initial energy demonstrating that institutions matter, why they matter, and what is missing from mainstream economics. The field has paid little systematic attention to policy questions: Are policymakers able to design and implement institutions for prosperity? What are the limits to such social experimentation? In this essay I do not provide a blueprint of an ideal economic system and show how to get there. My purpose is less ambitious, namely to discuss a research agenda for institutional policy based on a particular version of the new institutionalism: one that is concerned with micro-foundations of social structures and assumes some form of individual rational behavior. The essay emphasizes that reformers must aim at developing a policy model which identifies the instruments of policy and the relationship between instruments and targets. If possible, the policy model should indicate how politics restrain the reformers' choice set, and how spontaneous "counter-policy" by ordinary actors can undermine institutional arrangements. A discussion of the so-called Determinacy Paradox concludes that the paradox essentially is a problem in modeling and not a practical issue: Limits to our knowledge and the cost of information create a role in reforms for specialist advisers. The essay provides a sample of recent work in NIE to give some flavor of policy questions and reform measures suggested by this approach. For instance, reformers need to find ways to reduce the political risk to potential supporters, and also forestall future reversal of their policies by political opponents. In the economic area, NIE emphasizes different ways of creating institutional environments and arrangements which lower the cost of transacting. Finally, I identify two major weaknesses of NIE for policy: (1) NIE has little to say, so far, about internal dynamics of social systems which gradually may weaken institutional arrangements that initially appear to work well (for instance, various welfare programs); (2) the field is divided on the question whether and when (certain) informal norms are resistant to public policy measures and capable of blocking reforms, and, generally, NIE provides reformers with very little hard evidence about the role of social norms.

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