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How to make institutional economics better

ROBBERT MASELAND*
University of Groningen, Groningen, The Netherlands

Abstract: This comment criticizes Ha-Joon Chang's assessment of contemporary institutionalism, in his article entitled 'Institutions and Economic Development: Theory, Policy and History', for failing to show fundamental problems in the discourse. I argue that the current discourse's insights are structurally biased because it fails to satisfactorily address methodological problems of doing meaningful comparative research. The discourse is characterized by a limited focus on differences of degree, a neglect of interaction, and a tendency to represent societies from a partial perspective. The result is an unbalanced debate that tends towards equating developed country institutions with economic success.

1. Introduction

In this issue, Ha-Joon Chang (2011) presents a very welcome review of critiques of the dominant institutional discourse in economics. Chang organizes his argument around three themes, directed at the theoretical insights of the discourse, the empirical support for it, and the policy implications taken from it.

Although the current institutional debate in economics certainly deserves the scrutiny Chang gives it, I argue that Chang (2011) ultimately fails in his attempt to reveal fundamental problems with the theoretical and empirical aspects of the discourse. There are two reasons for this. First, some of the critique leveled by Chang seems unfair, as it targets a misrepresentation of institutional thought. Second, many of Chang's objections may be valid in themselves, but do not affect the validity of institutionalism's main theoretical insights. The result is a loose collection of apparently unrelated arguments that all together fail to stick.

This note attempts to make up for these limitations, trying to translate individual issues into a single, fundamental critique of the contemporary institutional discourse. After critically discussing some of Chang's arguments, I go on to argue that the fundamental challenge facing institutionalism is not theoretical or empirical but methodological in nature. It is the challenge of doing meaningful comparative research.

Ultimately, this stems from the basic tension between institutionalists' recognition of diversity in how economies function and economists' search for a

*Email: r.k.j.maseland@rug.nl

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single, universally applicable theory. Although the issue of comparative research is thus at the heart of institutional economics, contemporary institutionalism has by and large ignored it. The result is that its insights are structurally biased and flawed. This note ends with a call and some suggestions to remedy this situation.

2. Institutionalism: a reluctant defense

Chang's critique of the dominant discourse in institutional economics has a theoretical and an empirical pillar. Theoretically, the argument is that the discourse (a) exclusively focuses on causality from institutions to development, (b) refuses to see the impossibility of the free market, and (c) erroneously claims that the freest market and most secure property rights are best for development. Empirically, (d) support for these claims comes from cross-section studies that are rather shaky.

It is hard to argue with most of these objections. One may question, however, whether they invalidate the institutional discourse. Take the reverse-causality issue. Chang is to some extent correct in arguing that the discussion mostly focuses on the causality from institutions to development.[1] However, it is not at all evident that taking reverse causality into account would somehow change or invalidate the insights gained so far from focusing on one side of the relation. A possible defense of the approach by institutionalists such as Daron Acemoglu is that they address one issue at the time, gradually adding complexity to expand our understanding. After showing that at least part of the correlation between institutions and development is attributable to causality from institutions to development (Acemoglu *et al.*, 2001), later works address reverse channels and interaction effects between various institutions (Acemoglu *et al.*, 2005; Acemoglu, 2010). None of this later work repudiates earlier findings.

Similarly, Chang (2011) rightly argues that economic freedom is impossible to define and not self-evidently good for development. But this critique of the vagueness, subjectivity and ambiguity of a concept like 'economic freedom' has little to do with the literature relating much more specific institutions, such as contract enforcement and property rights, to specific economic outcomes. Giving maximal 'economic freedom' to business firms is indeed not evidently good for development (ibid.: 7); creating dependable and transparent contract enforcement probably is. A few ideologues apart, it is at this lower level of abstraction that the discussion mainly takes place.

At this level of abstraction, benefits of institutions such as property rights are in the end empirical issues. Chang (ibid., 10–14) identifies important problems with the empirics of institutionalism, targeting its use of cross-section studies lumping all kinds of societies together and of questionable indices to measure institutional

1 Although North (2005) and Acemoglu *et al.* (2005) are hardly 'the latest statements along this line' (Chang, 2011: 4).

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quality. Most of this critique is well deserved. But the question remains: were we to add time-series and better measures, do we have reason to believe insights would change? Or would it lead to the same results with more certainty? In the latter case, Chang's argument falls flat. To argue the former, we need to take the critique further, identifying problems in institutionalist reasoning that cause structural biases in its conclusions.

3. Institutionalism: methodological critique

I argue that such structural biases are present in the dominant discourse and that they arise from the fact that institutional economics is essentially a comparative economics (Djankov *et al.*, 2003). Institutionalism attempts to fit the diversity in the way economies function into a single model, which allows us to compare societies with varying degrees of economic success with each other. This methodology creates pitfalls and limitations.

First, it results in a focus on differences of degree, neglecting differences of kind. Meaningful comparisons require factors held in common by all cases; otherwise we end up comparing apples with oranges. Chang's (2011: 8) criticism of the property rights discourse for failing to allow other forms than, private, state, and open access illustrates this. All forms of property rights are forced onto a few dimensions; aspects of property rights regimes that cannot be fitted are ignored.

Second, a strict comparative focus results in a neglect of potential interactions. Differences in economic performance between societies are attributed to the differential effects of their respective institutions. But what if performance and institutions of one society are linked to the performance and institutions of another? What if the effect of certain institutions is dependent upon the position of a society in the world? The classic study by Alice Amsden (1989), for example, suggests that late-comer development requires different institutions than early development. Also, the fact that emerging economies nowadays seem to benefit from so-called market-friendly institutions is probably related to the fact that today's rich countries are market economies. Would market-friendly institutions still be good for development if the Soviet Union had won the Cold War and communist countries dominated the world?

What an open eye for interactions teaches us is that the relationships we observe in institutional studies are not necessarily universal, but depend on the context in which they occur. This brings us to the third and most important pitfall of institutionalism: a neglect of the context-laden character of the perspective from which we conduct comparisons. As institutionalists, we recognize diversity in the laws and mechanisms by which societies are governed. As economists, we seek to develop universally applicable theories which cover all possible institutional settings. As a result of this basic tension, institutional economists have the tendency to adopt a partial perspective and assume it to be

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universally relevant (Beugelsdijk and Maseland, 2011). The civil *versus* common-law opposition (LaPorta *et al.*, 2008), for example, is taken from a Western context and adopted as the lens through which to interpret all societies. Had we started out from an Asian context, we would have probably come up with different dimensions and results.

Other aspects of the institutional-comparative framework are similarly vulnerable to partiality. For example, researchers often use nation-states as units, not recognizing that these are relatively recent phenomena. The 'historical experiment' literature, all the craze in institutional economics nowadays, illustrates this. It focuses on finding factors that exhibit variation across countries centuries ago to relate them to (institutional) divergence between countries today (Acemoglu *et al.*, 2001; Easterly and Levine, 2003; LaPorta *et al.*, 2008; Haber and Menaldo, 2010). But that logic only works as long as one assumes a fixed one-to-one relationship between territory and society, something that is more nationalistic myth than historical fact.

All these issues – a focus on differences of degree, a neglect of interactions, and the tendency to apply institutionally specific perspectives – work together to create a discourse in which currently successful societies are often held as universal and objective 'best practices'. Others are represented only from the perspective of their dissimilarity to these winners – their otherness being put forward as explanation for their lesser performance. One does not have to be a cynic to see in the many institutional measures developed over the years measures of Anglo-Saxonness.

There is a pressing need to be more aware of the partiality and limitations of the current institutional discourse. Economists need to come to terms with the fact that the kind of universal frameworks and single-peak thinking that we have grown used to in economics simply do not fit the fundamental diversity inherent in institutionalism. Unfortunately, the level of reflection still present in the work of the frontrunners in the debate (North, 2005; Rodrik, 2006) is lacking in that of many of their followers. The result is an often naive equation of developed-country institutions with good institutions.

4. Conclusion

Chang (2011) does a fine job reviewing the current institutional paradigm in development economics. Although one might disagree with some of the arguments, many of Chang's objections are valid. Yet Chang (2011) eventually fails to translate his criticism into an argument about what is fundamentally problematic about institutional economics.

The fundamental problems of the discourse are rooted in its essentially comparative focus. This causes researchers to (1) neglect differences of kind, focusing on differences of degree; (2) neglect interactions, focusing on differences between societies in isolation; and (3) interpret other societies from a partial

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perspective often informed by their own institutional background. The result is an unbalanced debate that is biased towards equating developed-country institutions with economic success.

To improve, we need to abandon the quest to identify unidimensional 'good' and 'bad' institutions, recognizing that what works and does not work in a particular case is itself informed by the institutional context. Genuine historical analysis, addressing differences of kind and adopting a dynamic perspective of societal evolution and interaction, is required. Second, we need awareness of our own biases. Setting up an analysis from a partial perspective is in itself not necessarily problematic and may actually be very informative. But we need to recognize that it only tells us a limited and very specific part of the story. Third, it is imperative that the institutional discourse becomes less dominated by a single institutional background. We are rapidly reaching the limits of what we can learn by looking at emerging economies from a developed country-institutional perspective. It may be fruitful to start looking the other way around.

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