Institutions Are Not Fundamental

Deirdre Nansen McCloskey

deirdre2@uic.edu

Feb 11, 2011

Proposal for the EHA Meetings, Tucson 2021. Oct 29-31

Abstract: Neo-institutionalism says it is new, but is not. Economic history has been in this business, always. And it says it is obvious, but is not. "Institution" has a baggy definition, tempting its advocates to tautology. And it mixes up necessary with sufficient causes in economic history. The Master Narrative of neo-institutionalism is that we had bad institutions that made us poor. The narrative does not pass historical or economic tests. We once had bad, illiberal ideas: that was the elemental problem, evident in some places still. Institutions are at best molecules—the atoms are moral sentiments. We need an "ideational," not institutional, economic history, illustrated with the history of sharecropping, financial development, slavery, investment, and above all the Great Enrichment after 1800.

The neo-institutionalism of Douglass North and followers since the 1990s, in economic history and at the World Bank, has always seemed highly plausible. That "institutions matter" sounds obvious. After all, if a place does not have the rule of law, with the institution of independent courts, or does not have customs admiring of entrepreneurship, with the institution of business schools and all, how can economic activity prosper? Numerous brilliant works of economic history recently have said so, and have said that they have shown it: witness North himself, and Avner Greif, Barry Weingast, Guido Tabellini, Daron Acemoglu, Geoffrey Hodgson, James Robinson, Douglas W. Allen, and a host of other economic historians, economists, and political scientists.

Yet economic history has never not been the study of institutions, which undermines the persistent claim of novelty by the neo-institutionalists. North himself claimed repeatedly that he was going beyond neoclassical economics. But he and his followers in fact use it, and only it, as for example non-cooperative game theory, and more loosely a cost-benefit reasoning at the margin. Economic history since its birth in the 19th century has studied, say, open-field agriculture, the regimes of free-trade and protection, institutions of transport, organization of business, free banking, the gold standard, slavery, serfdom, the company store, Jim Crow, sharecropping, and the rest, all of which were institutional studies before the name. True, the tools of the *old* institutionalism or Schmoller and Veblen were sociological rather than economic, at any rate by the standard of neo-classical economics, which the oldsters called "English." But all economic historians of any sort studied "institutions," Schmoller a century and a half ago on guilds with qualitative early pre-sociology, Sheilagh Ogilvie in the past decade on guilds with quantitative late-Austrian economics.

One reason the claim that "institutions matter" seems obvious, then, is that in case after case the economic history since the discipline began obviously fits. The Peculiar Institution undoubtedly "mattered" for, say, the contrast in labor force participation in the south and the north. Listen to that acute observer, Alexis de Tocqueville, about the contrast in 1831 between the two banks of the Ohio River. On the Kentucky bank, "society is asleep; man seems idle," because slavery had made physical labor undignified for whites. On the Ohio bank, by contrast, "one would seek in vain for an idle man." (Compare white Afrikaners in the 19th century.)

But the word "institution" is baggy. At one point it is used as formal, black-letter laws, the Fugitive Slave Act, say. At another point it is used as "informal" institutions, what Acemoglu and Robinson in their recent book call "norms," such as the norm that Blacks whether free or enslaved are to be treated as inferior. The trouble, then—and another source of the obviousness—is that institutions are bring defined as all human practices. Obviously, human practice can be "explained" by naming its cause as the same human practice. The problem is similar to the definition of utility maximization as anything that a human does, making the theory into a tautology—maybe a useful one for orderly accounting, but not therefore a proposition that could be contradicted by evidence. Slavery is explained by the institution of slavery. *A* is *A*. If Congress passes a Fugitive Slave Act, and if it is enforced, and if enough people agree with it, and if courts exist, and if any number of other ancillary conditions hold, then fugitive slaves will be captured. The legal institution ordering that fugitive slaves be captured, modulo ancillary norms, results in fugitive slaves being captured. Thus an institutionalist pseudo-explanation. It doesn't get down to the elements.

Note that neo-institutionalism, and in fact in much of economics and history and economic history, mixes up isolated and ancillary *necessary* conditions for an outcome, such as the Great Enrichment since 1800, with jointly *sufficient* conditions. The literature on financial institutions—an active capital market, say, though mainly in British bonds to pay for war against the French—supposes that the ill-name "capitalism" depends on them. So Schumpeter argued, pointing to an alleged origin of banking in Italy. Obviously, capital is necessary for any economic system. Obviously, any economic system requires some way of marshalling the abstention from consumption for accumulating the capital. Obviously, it is then said, without such institutions—such as in the actual British event the Bank of England and the market for consols—"capitalism" cannot take place. So it is argued. But there is no showing that the "some way" had to be the way it was done in 17th century Holland and then 18th century Britain. That was Fogel's point in *Railroads and American Economic Growth,* a characteristically economic point that there's more than one way to skin a cat, that substitutes are possible. In finance as in transport and manufacturing other "ways" back to the Mesopotamians and Chinese sufficed to marshal the savings. Medieval villagers borrowed from each other, and from the lord of the manor. Savings rates in the Middle Ages were arguably higher than in 18th-century Britain. Some "way" is obviously necessary. But considering its substitutes—the point is Gerschenkron's—it is by no means a sufficient perquisite in explaining what we want to explain, modern economic growth.

Necessary conditions are historically infinite in number—the existence of banks or their substitutes, courts of their substitutes, peace or its substitute, and on and on: water liquid above zero centigrade, a labor force, some means of transport, some literacy, the arrow of time, the universe. But the historically salient *sufficient* conditions are strictly limited, and are what we seek as historical scientists. Neo-institutionalism elevates a widely extant necessary condition such as peace (as in the Dutch Republic 1568-1648? As in Britain 1692-1815?) or a questionably necessary condition such as this or that institution of property rights (corporations, say). Yet some ways with peace and property rights have been enforced in every society since Eden. Calling such a one The Cause of modern growth would be like elevating the existence of the tomato in Europe after the Columbian Exchange to the cause of the glories of *sauce tomate* in French cuisine. It was necessary, obviously. But not sufficient, equally obviously. The British and the Dutch and the Germans had the necessary tomatoes, too, but did not have the sufficiencies of royal traditions and common tastes that made for their glorious Italian and then especially French use. Tomatoes, labor, and capital in France made for French cuisine; in Germany, German.

This is to say institutions, unless defined tautologically as all human practices, are intermediate causes, not ultimate causes. They are social mixtures or molecules, not atoms, not to speak of subatomic particles. In Mill and Marshall the institution of sharecropping was taken as given, as ultimate, and its results were treated therefore as a tax. The tax model implied that sharecropping would not be efficient compared to either fixed-rent tenants or outright owners. But D. Gale Johnson in agricultural economics, then more precisely Joseph Reid, Steven N. S. Cheung, and Robert Higgs in historical economics, and then Joseph Stiglitz on the blackboard, noted that all three forms of tenure often exist side by side. The fact implies by elementary economics that at the margin sharecropping must have been equal in efficiency to the other tenures. The tax model is false. Something more basic, such as risk avoidance or transaction cost, is the cause, and may even be the ultimate atoms of human action.

Neo-institutionalism has a Master Narrative, mistaken in such matters. The Narrative is that once we had bad economic institutions (compare Mill on *métayage*, French sharecropping), but now they are better, and so we are rich. Or once we had bad political institutions, but now we have constitutions, and so we are liberated. The classic article by North and Weingast on the three-hundredth anniversary of the Glorious Revolution of 1689 argued that English law was until then defective in property rights, but then became good, and made the modern world. The book that North, Wallis, and North wrote in 2009 had a similar theme. Good institutions (call them ***N***) imply growth and liberty, ***G***. So the Narrative is that $\boldsymbol{N} \rightarrow \boldsymbol{G}$**.**

There are two scientific problems here. The first, an historical and comparative one, is that numerous places have had good institutions, ***N***, but did not experience the Great Enrichment and liberal outcomes, ***G***. Ancient Israel had the rule of law, as did imperial China, in some ways better ***N****s* than Europe in the 18th and 19th centuries. For that matter, England had good property and contract law from the time of Edward I, that is, 1272. Yet northwestern Europe had a Great Enrichment, only after 1800, and those places, including medieval England, did not.

The second, an economic and quantitative one, is that the Great Enrichment was far larger than any correction of, say, legal disabilities can explain. The Enrichment was, more or less 3,000 percent over the miserable base in 1800. The base of 100 could have experienced static inefficiencies caused by very bad laws of, say, 30. Adding 30 to 100 does not get to 3,000. Changes in ***N*** do not have oomph anything close to the changes in ***G*** to be explained. The uniquely liberal ideas of the late 18th century permitted ordinary people to have a go, and go they did, liberated from conventions of hierarchy that had long suppressed human creativity. Ideas, as Paul Romer has observed, have economies of scale that no material or legal input can match. Once the steam engine in invented, anyone can use it. Sheer investment in physical and human capital without new ideas experience sharply diminishing returns. A legal change such as the limited liability corporation requires, as indeed liberalism more widely did, moral sentiments supporting it.

The correct model of modern economic growth, contrary to neo-institutionalism, and indeed much of modern economics (as Dani Rodrik has observed), is not $\boldsymbol{N} \rightarrow \boldsymbol{G}$, but ***N*** <u>and</u> ***I*** <u>and</u> $f(\boldsymbol{N},\boldsymbol{I}) \rightarrow \boldsymbol{G}$. Ideas, ***I***, are to be thought of as sound, pretty favorable ethical ideas about bourgeois and then working-class people acting in voluntary trades and trying out betterments such as the steam engine or, as Huck Finn put it, lighting out for the territories. Likewise, the Institutions, ***N***, are to be thought of as not perfect but pretty good incentives, such as permission to invent in 1892 mail-order retailing or to move in 2012 to North Dakota to work as a roughneck on an oil rig. It includes as well the interests (another ***N*** in its second letter) that drive rational-choice neo-institutionalism. The function f($\boldsymbol{N,I}$) acknowledges that ideas and institutions (and interests) interact. Ideas shape institutions and vice versa What actually changed in the 18th century in Britain and offshoots was $\boldsymbol{I}$—ideas such as that commerce is not evil and that all people are created equal—not mainly $\boldsymbol{N}$, the sluggish institutions such as English common law.

If one believes the simple neo-institutionalism $\boldsymbol{N} \rightarrow \boldsymbol{G}$, then it follows in strict logic that not-G → not-N. The hunt is on for institutions $\boldsymbol{N}$ that failed, and that kept nations failing, resulting in a sad not-$\boldsymbol{G}$, as in Acemoglu and Robinson's book of 2012, *Why Nations Fail*. But if one believes that $\boldsymbol{N}$ <u>and</u> $\boldsymbol{I}$ <u>and</u> f($\boldsymbol{N,I}$)→ $\boldsymbol{G}$, then it follows in equally strict logic that not-**G** → <u>either</u> not-$\boldsymbol{N}$ (bad institutions) <u>or</u> not-$\boldsymbol{I}$ (bad ideas) <u>or</u> bad consequences of f($\boldsymbol{N,I}$), or all of them. (This elementary point in logic has been known in the philosophy of science since 1914 as Duhem's Dilemma; it disposes in a line of symbolic logic the Samuelsonian /Friedmanite falsificationism underlying econometrics.) The hunt is on for *either* bad institutions *or* bad ideas *or* bad interactions between the two, with no presumption that hunting for the bad-idea or the bad-interaction possibility is somehow less of a scientific priority.

Consider, for example, an institution that undoubtedly did encourage growth, a large free-trade area, in which a highly local vested interest could not block betterment. A typical product of early liberalism was to divest the local interests, for example the fiercely protectionist cities of medieval times, or royal protectionism in early modern times. The large free-trade area was expressed in black-letter law in the American Constitution, though requiring later ideational defenses (I interacting with another $\boldsymbol{I}$) by Supreme-Court justices ($\boldsymbol{N}$).

But the trouble is that even with a large free-trade area in black-letter law, the irritating competition from across the mountains or the seas might inspire people to petition the State for protection. Consider K Street in Washington. In the individual states of the US, for example, widespread state licensure laws for professions (tightening in recent decades) and the state prohibition of branch banking (though loosening in recent decades) have such a source. Without a moral sentiment of a liberal $\boldsymbol{I}$ such as spread in the UK and in lesser ways in the US during the early 19th century that such petitioning is shameful, the black letters will be dead letters. Not-$\boldsymbol{I}$ → not-$\boldsymbol{G}$. Ideas matter, ideology matters, ethics matters, and what the Austrian economists call "human action" (as against Samuelsonian re-action) matters—in themselves and in their interactions with institutions formal and informal.

The argument suggests a reorientation for economic history, or indeed for economics and history more widely, a turn away from an historical materialism that came to dominate social science after Marx, towards what Joel Mokyr and Jack Goldstone and a few other have conjured with recently, an "ideational" turn. The Great

Enrichment, to mention a central scientific concern of economic history, was caused by the coming of liberal ideas, not by trade, investment, law, coal, or canals. As Tocqueville put it in 1855, "Looking at the turn given to the human spirit in England by political life; seeing the Englishman . . . inspired by the sense that he can do anything . . . I am in no hurry to inquire whether nature has scooped out ports for him, or given him coal or iron." If we are going to get the economic history right, or the economic policy, we need to get down to the ultimate causes, and not keep treating intermediate "institutions" as causal. We have to get down to chemical elements, and not tarry with the intermediate "institutions" of air, earth, fire, and water.