Institutional Change and Economic Behavior.

Introduction

The Fourteenth World Congress of the International Economic Association took place in Marrakech between August 29 and September 2 2005. The main themes of the Congress were "New Trends in Economics" and "Understanding the Great Changes in the World". These two volumes published by Palgrave present to the reader the presidential address by János Kornai, most of the distinguished invited lectures (by Yingyi Qian and Jinglian Wu, Timur Kuran, Edmund Phelps and Philippe Aghion) and many of the papers presented at the different invited sessions organized by Masa Aoki (Mechanisms of Institutional Change, Herbert Gintis (The Implications of Experimental Economics For Economic Theory**),** Mustafa Nabli (Is Democracy a Binding Constraint for Economic Growth in the Middle East and North Africa Region?**),** Susan Rose-Ackerman (Trust and Distrust in Post-socialist Transition), .Jan Svejnar (15 Years of Post-Socialist Transition**),** Oded Stark (The New Economics of the Brain Drain: Analytics, Empirics, and Policy**)** and Claude Menard (Institutional Design and Economic Performance**).**

There have been many changes both in the world and in economics these last twenty years. A fundamental change has been the end of the cold war and the post-socialist transition in Central and Eastern Europe, China and Vietnam. Countries like China and India have engaged on an impressive growth path. Globalization has continued to unravel with goods, capital and people moving more freely around the globe. With 9-11 and the Iraq war, but also Chechnya, Kosovo, Afghanistan and the continued conflict in the Middle East, new concerns have arisen about fault lines of conflict in the twenty first century. Simultaneously, the spread of democracy continues throughout the world. The world in 2006 is completely different from the world in 1976 or even 1986.

Many of these important changes in the world have been concomitant to changes in economics. This is not surprising. Some of the changes in economics have been brought about by important changes in the world. The large-scale economic transition from socialism to capitalism has contributed in a significant way to put institutional economics firmly in the mainstream. The large output fall and strong variation in macroeconomic performance across countries came quite unexpected to the mainstream of the profession who thought that liberalization, stabilization and privatization should put these economies on a virtuous growth path. Economists started taking very seriously the idea that the dismal performance of the Russian economy and of most of the Former Soviet Union economies in the nineties could be attributed to institutional failures. The transition experience convinced a large part of the economics profession of the importance of institutions as the underpinning of a successful market economy. The Marrakech Congress is a good reflection of the current strength of institutional economics as various distinguished lectures and invited sessions related to institutional issues. Another important change in economics is the increasing success of behavioral economics. The standard model of rationality is being put into question as several of its core components are contradicted by a large body of work in psychology. Models of behavioral economics or of economics and psychology are introducing changes to the standard assumptions of *Homo Oeconomicus* and deriving new predictions about economic behavior. More and more evidence is produced by experimental economics about individual and group behavior, testing standard assumptions about rationality but also about game theory and the new behavioral models.

The two main themes -- „Understanding the Great Changes in the World" and „New Trends in Economics" -- are the *Leitmotifs* of both volumes containing the papers of the Marrakech congress. Each paper is reflecting either one of the main themes, or both. In the present first volume under the title „Institutional Change and Economic Behavior" we collected the papers discussing *general* topics and/or problems of *large geographical areas*. (The other volume under the title „Corruption, Development and Institutional Design" is dealing with more specific topics that were also discussed prominently at the Congress such as corruption, immigration, enterprise reform and regulatory reform.)

The presidential address by János Kornai is devoted to the transition process in eight former socialist countries that became members of the EU in 2004: the Czech Republic, Estonia, Poland, Latvia, Lithuania, Hungary, Slovakia and Slovenia. More than fifteen years after the transition started, the paper reflects on the successes and disappointments of that great transformation. He compares the transformation in those countries compared to other great transformations in modern history such as the transformation from medieval to modern societies, West Germany's transformation after World War II or the inverse transition from capitalism to socialism, the transformation in Central Europe occurred with incredible speed, was non violent and was not preceded by a war; it was a complete transformation both of political institutions and the economic system and went in the direction of the mainstream of historical transformations in recent history, i.e. towards democracy and capitalism. By most measures, this transformation represents an immense success story. Nevertheless, the inhabitants of those countries are not euphoric and express much dissatisfaction. Despite an undeniable general increase in the standards of living as compared to socialism, inequality has increased strongly and job security has disappeared and unemployment became part of the economic landscape. There is dissatisfaction with corruption and with existing politicians. Feelings of discontent and unhappiness are quite widespread compared to Western Europe. Kornai argues that one needs to go beyond the standard economic model to understand these disappointments and take into account phenomena studied in other social sciences such as the sociology of reference groups, cognitive flaws, etc..

The transformation in China is analyzed in the paper by Yingyi Qian and Jinglian Wu. They document carefully the phenomenal growth that has been taking place in Chine in the last three decades. Real GDP per capita has increased by nearly 700% between 1978 and 2003. At the same time, the Chinese economy has opened up tremendously, its foreign trade now representing over 60% of its GDP. They document not only the spectyacular increase in living standards but also the social transformations that have taken place in the most populated country on earth. Urbanization has been very fast as jobs in industry and services have increased. Poverty has declined but inequality has gone up. Corruption is still a serious problem and China ranks with Peru and Turkey in the Transparency International but better than Russia and the Ukraine. Despite spectacular increases in living standards, aspirations of Chinese citizens are growing even faster. At the same time, there has been slow progress on political reform. Little has changed in the authoritarian rule of the Communist Party. They interpret the recent economic developments in China as growth maximization under the constraint of Party control. The hunger for growth is stronger than in many other nations because of China's past. For millennia, it was the most affluent country in the world. It entered the modern era a poor country and experienced tragedy after tragedy in the twentieth century, culminating in the Cultural revolution. This policy of growth under party control explains why economic reforms and opening up of the economy is faster than internal reforms, why the rule of Law is being established before democracy and why control over firms has been abandoned. In the latter case, the growth advantage was stronger than the loss of overall control for the party. Obviously, the tension between the economic dynamism and the absence of important change in the political sphere is a source of uncertainty. Today, most Chinese probably prefer an increase in living standards to increases in freedom. This may not always be the case.

Timur Kuran, in his distinguished lecture gave a historical perspective on the causes of economic underdevelopment in the Middle East. He analyzed in particular how institutions that played a negative role in the development of the region: Islamic inheritance law and its form of trust, the waqf. Contrary to other religions, Islam has very specific prescriptions about inheritance. The Qur'an specifies that two third of the estate is reserved for children, spouse and other family. The share of a female must equal half of that of a male. As a consequence, successful businesses tended to become fragmented after the death of the founder. In contrast, in European countries where no such religious prescriptions on inheritance existed, there was room for more experimentation, allowing primogeniture to emerge as a more efficient institution to prevent fragmentation of businesses. As a consequence, the Middle East failed to adopt the organizational and institutional innovation that led to the development of the modern limited liability corporation. The waqf is an unincorporated trust overseen by Islamic courts. Its purpose is to provide a service allowed under Islamic law and the service must be provided in perpetuity. The establishment of a waqf was a way to secure assets since a waqf was considered sacred and rulers were reluctant to expropriate waqfs. The perpetuity rule made waqfs very rigid as the service was supposed to remain the same. The waqf system also had a negative effect on the development of civil society. Indeed, leaders of a waqf were not accountable to its beneficiaries. While these factors shed light on reasons for why the Middle East failed to catch up with the industrial revolution, they should not necessarily be seen as obstacles for the future as countries from the region have been importing modern institutions in the last two centuries.

Closer in time, the lecture by Ed Phelps, the economics Nobel laureate for 2006, analyzes the large changes in the world economy since the end of World War II. In particular, he analyzes the evolution of Western European economies that were catching up on the US for the thirty years after World War II but now are trailing in productivity growth. The catch-up is best explained by technology transfer. However, productivity growth started slowing down in the late seventies and the gap with the US has been increasing since the nineties. Phelps blames the European corporatist institutional system with big Unions, big employer organizations, large banks and large state sector. It main deficiency is its lack of dynamism and entrepreneurs. Central European countries accessing the European Union have not proven to be growth tigers either as their performance pales in contrast to China. They might be in transition to the European corporatist system.

One likely factor that might be behind the disappointing performance of Europe is the weakness of its higher education system. The US devotes a twice larger share of GDP to higher education than Europe and, also, a larger proportion of the population has tertiary education. Philippe Aghion examined the link between education and growth in his lecture. The argument is that the closer one approaches the technological frontier the more important the role of higher education because of its role for technological innovation. He sets up a model where one of the main results is that the effect of marginal increases in higher education spending becomes more important the closer one approaches the technological frontier. He reports both cross-country panel as well as cross US-state evidence on this question. The cross-country evidence of interaction between distance to the frontier and higher education is significant but only when country fixed effects are omitted. However, the results for the US are quite convincing. Instrumenting research university education by the presence of a state representative in the House on the appropriations committee allocating funds for research universities but not other types of schools, an additional $1,000 per person in research education spending increases the state's per employee growth rate by a third of a percent if a state is at the frontier but by less than a tenth of a percent if it is not.

Masa Aoki, the president of the Association in 2008, organized a session exploring various of the themes of institutional economics. He presented himself a paper proposing a conceptual framework for analyzing mechanisms of institutional change. This is based on the definition of an institution as the summary representation of a Nash equilibrium path held as players'shared beliefs about how to act and not to act. Institutional change happens as changes to the environment occur and strategic experimentation shows new actions to become optimal crating momentum effects. The framework applies to the evolution of organizational forms in modern corporations; the interaction between community and market relationships and more broadly interactions between different institutions within society; and also to institutional complementarities which may facilitate momentum for institutional change. There is in general a continuum between exogenous institutions enforced by other institutions and endogenous institutions that are self-enforcing.

Gérard Roland also offers a conceptual framework to try to understand institutional change. He distinguishes between fast-moving institutions, such as political institutions that can move very fast and in a very discontinuous way, and slow-moving institutions such as culture and social norms that can only move more slowly and a continuous way. Using this framework, he proposes a Weberian view of institutions where culture which moves quite exogenously has a determinant impact on legal and political institutions. Several conclusions are derived such as the difficulty of transplanting political and legal institutions in alien cultural environments, the recognition of institutional diversity and a tolerance towards cultural and institutional experimentation within a spirit of openness.

Herbert Gintis develops an evolutionary model where respect for private property is not related to institutions but to evolutionary forces that are also present among animal species where ownership over territory is recognized and often not contested. The model is inspired by the Hawk, Dove Bourgeois game. It features an endowment effect whereby a resource is prized more highly by the agent possessing it than by one who is not due to loss aversion: the disutility from losing a good is higher than the utility from acquiring it.

Geoff Hodgson and Thorbjorn Knudsen present an agent-based model of the emergence of a traffic convention when agents are boundedly rational. The traffic example is illustrative because it is a very simple convention. They find in particular that strength of habit is an important factor in explaining the convergence towards a convention and avoiding cycling behavior. They also examine how an individual's behavior is influenced by the behavior of others.

Experimental economics tests directly assumptions about human behavior and social interaction which undoubtedly are related to institutions and institutional change. Herbert Gintis discusses in another paper from the session he organized on experimental economics some of the lessons we draw from the latter on how to think about economics. He discusses in particular the implications of the findings from experimental economics about the importance of reciprocity and gift exchange in situations of contractual incompleteness. This should be seen as a definite enrichment of the economic paradigm and more enrichment is expected with the development of neuroscience.

How much of the neo-classical paradigm is really refuted by the evidence produced by experimental economics in recent years? This question is addressed by Ken Binmore and Joe Swierzbinski who argue that a broadening of the Homo Oeconomicus paradigm can be consistent with the results from the laboratory. The ultimatum game is the experiment that has been argued to refute standard game theory since. Indeed, the only subgame perfect equilibrium is one where the first player takes nearly all the money and the second one acquiesces. However, experiments show different results. But many of these outcomes such as the 50-50 split can be seen as Nash equilibria related to social norms. They report experimental evidence on perturbed Rubinstein bargaining with unequal discount rates. These results are consistent with the idea that actions of players in experiments are to a certain degree conditioned by norms of fairness that exist in society.

Other topics that were the object of invited session are published in the second Congress volume. These two volumes should be seen as a whole. All in all, we hope that the selection of papers in these volumes will give the readers a snapshot of recent trends in economics and how they reflect important changes taking place in the world.

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