Can markets be expected to prevent themselves from self-destruction?

Bo Rothstein
The Quality of Government Institute, Department of Political Science, University of Gothenburg, Gothenburg, Sweden

Abstract
Even if competitive markets have shown themselves to be the most efficient organizational form for creating economic efficiency, the question of how they can avoid destructive influence from agents with opportunistic motives remains unresolved. Different institutional approaches have argued that to be efficient, markets need to be embedded in a set of formal and informal institutions. Because such institutions will in the long run make all market agents better off, they are labeled efficient institutions. Contrary to what is argued in neoclassical economics, it is unlikely that such institutions will be created endogenously by market agents because the institutions are to be understood as genuine public goods. Moreover, if such institutions have been established, we should expect market agents to face a collective action problem when sustaining them, leading to the destruction of the institutions. The conclusion is that if left to themselves, markets should be understood as inherently self-destructive.

Keywords: corruption, economic crisis, efficient institution, social trap, social trust.

1. Is there such a thing as legal corruption?
In his farewell lecture on 9 December 2008, former leading World Bank economist Daniel 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.” Whether 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 it covers 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 used their influence to “relax regulatory oversight and capital requirements.” Kaufmann specifically points to a meeting held in April 2004 when the CEOs of the (then) five big investment banks on Wall Street persuaded the US
Securities and Exchange Commission to relax regulation that stipulated their need for financial reserves (Labaton 2008).

By introducing the idea of legal corruption, Kaufmann makes it possible to connect the study of corruption to the analysis of the power special interests groups have in politics, not least in economic issues (see also Olson 1982; Geddes 1994; Olson 2000; Johnson 2009; Johnson & Kwak 2010). It should be underlined that the issue here is not related to the standard principal–agent theory where the problem is how the (honest) principal can use various incentives to control the (corrupt) agents. Instead, legal corruption is to be understood as a problem of collective action leading to a social trap situation in the following sense: The agents may all know that they all as a group would benefit from a certain set of regulations, but not knowing if the other agents will “play by the rules” it makes no sense to be the only agent that refrains from undermining them by opportunistic (i.e. self-interested) actions. According to Kaufmann the current financial crisis leads 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.” Another well-known economist, Simon Johnson, writes about the corrupting influence from Wall Street to the US government as a “quiet coup” (Johnson 2009). As Claude Rochet has argued, this line of reasoning can be traced all the way back to Machiavelli’s argument of how easily the “common good” can be undermined by corrupt practices from opportunistic agents and that this is an argument for strong (and ruthless) leadership (Rochet 2008). The problem with this argument is that in a corrupt setting, the leaders can be expected to get most of the rents from the corrupt practices and so have no incentive to change the system (Rothstein forthcoming).

There are now a great many explanations for the financial crisis that erupted in 2008 of which most have to do with either moral condemnations of excessive greed or lack of foresight among central agents. My argument is that, while valuable, these explanations do not touch the root cause of why the financial markets collapsed in October 2008. The main goal of this article is to provide such an explanation based primarily on insights from theories about corruption and the provision of public goods that have emanated from theories about the importance of institutions for understanding the variation in valued social outcomes. About the causes of the financial crisis, the well-known financial speculator and philanthropist George Soros has stated the following:

There are two features that I think deserve to be pointed out. One is that the financial system as we know it actually collapsed. . . . The other feature is that the financial system collapsed of its own weight. This contradicted the prevailing view about financial markets, namely that they tend toward equilibrium, and that equilibrium is disturbed by extraneous forces, outside shocks. Those disturbances were supposed to occur in a random fashion. Markets were seen basically as self-correcting. That paradigm has proven to be false. So we are dealing not only with a collapse of a financial system, but also with the collapse of a world view (Soros, Ferguson, Krugman, Wells, Bradley, & Madrick 2009, para. 29).

If, as Soros points out, we have to deal with the breakdown of a dominant ideology that markets are self-correcting, this would entail a change in how social scientists think about the supply of regulations. The two major questions are: Can market agents as they are portrayed in neoclassical economics provide the type of regulations markets need? If so, can they sustain them?
In this article I will present four interrelated arguments that sum up to a theory about the relation between the logic of markets, regulation, and social efficiency. The first, and least controversial, of the arguments is that competitive markets are, at least so far in human history, the most efficient organizational form of creating a utilitarian-based economic efficiency for the production of most goods and services. Such markets are characterized by 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. The second argument is that in order to reach this utilitarian-based (a.k.a. Pareto, but henceforth social) efficiency, markets need a large and complicated set of institutions, which are both formal as well as informal (North 1998a,b). Because 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 agents acting from the standard self-interested utility-maximization template. This is because such efficient institutions are genuine public goods and are therefore prone to the well-known problem of collective action.

The implication is that, contrary to what has been taken for granted by most policy-makers in the area of financial regulation (cf. Johnson & Kwak 2010), we should expect market agents to act in a way that either will prevent efficient institutions from being established, or if they are established, will try to destroy them by various forms of “free riding.” 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 the agents act from the standard template in neoclassical economics, markets are endogenously self-destructive, leading to a social trap type of situation. The fourth argument is that markets can only reach social efficiency if the agents that have the responsibility to produce and 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 organization; 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 emphasized by institutional economists working with these problems in developing countries. One example among many is Dani Rodrik, who writes that “the encounter between neoclassical 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. Most important, he criticizes neoclassical economics 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; cf. Geddes 1994).

If this is the case, the question of how such 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 & 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 in economics, political science, and economic sociology (Rothstein 2011).

2. Markets, social efficiency, and democracy

The argument about the social efficiency of markets should not be understood in an absolute sense, but rather in a relative one. The reason that markets cannot be seen as efficient in an absolute sense is that market agents cannot be presumed to be in possession of anything close to perfect information or be unboundedly rational or that transaction costs are instantaneous and costless (Ménard & 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 versus 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 sometimes have large costs, and so forth (Ostrom 1998; Loewenstein et al. 2004; Frohlich & Oppenheimer 2006). It is only in rare cases that markets can be expected to reach what economists call Pareto efficiency, because agents cannot 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 (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 & 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 such as 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 cannot be avoided (Smith 2003). This problem is especially acute in service delivery; for example, in health care, care of the elderly, and care of disabled persons, but also in preschools 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, because 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 (i) laws cannot be made with the required precision to account for all possible variations and (ii) there is often a need to let
professionals have discretion because they have the knowledge that is needed for handling different situations/cases (Rothstein 2005). 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 & Ghatak 2007). This will of course happen if the service in question is provided in 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. nursing home or preschool) an incentive to improve the service production and thus increase the overall efficiency of the policy in question. Thus, markets could be favored not only from an efficiency point of view, but also from a “making power legitimate” point of view (Besley & Ghatak 2007).

3. Institutions: The two main types and the two main forms

According to the New Institutional Economics approach (henceforth NIE), “institutions are the written and unwritten rules, norms and constraints that humans devise to reduce uncertainty and control the environment” (Menard & 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” or “work rules” (Ostrom 1990), which are known and generally agreed upon rules but 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, it is much more difficult with things such as “shared mental models” (Denzau & North 1994) and other such generally held basic beliefs that are rooted in a society’s historically established culture (Rothstein 2005). In any case, as a first distinction, we can differentiate between two basic forms of institutions: 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. Familiar examples of such formal redistributive institutions are most social insurance and tax systems. Informal redistributive institutions are 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 give favorable treatments to agents within this type of circle. Another normatively more problematic example of redistributive institution is 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 & 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 (March & Olsen 1989; Elster 1991). 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 because 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 behavior in economics. Seen in the light of non-cooperative game theory, these are institutions that make it possible to avoid situations such as suboptimal outcomes in n-persons prisoner’s 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” (Rothstein 2005; Mungiu-Pippidi 2006), “impartial” (Rothstein & Teorell 2008), or “impersonal” (North et al. 2009).

For market agents, these are institutions that secure property rights and those that produce reliable information about the solvency and credit record of firms, as well as an uncorrupt and impartial judiciary, a state government operating by the “rule of law” principles, and antitrust legislation that can secure “fair competition” by ruling out cartels or other forms of blockades against new agents entering a market. For most citizens, an honest, impartial, and reasonably efficient public administration would also be counted into this category of efficient institutions. In the labor market, these 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.

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 (Keeler & Knack 2005) Theoretically, what efficient institutions do is increase the likelihood that agents who are exchanging values will trust that the other agents will not behave in a treacherous way (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 simplification, we will distinguish between these two types of institutions (redistributive and efficient) 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 (Fig. 1).

It should be added that these forms and types empirically are strongly correlated. For example, high levels of corruption correlate with low levels of generalized trust, and high
levels of rule of law correlate with high levels of generalized trust (Rothstein & Uslaner 2005; Rothstein & Stolle 2008). However, while correlations in general 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 reinforcing entities in which causality operates with lots of feedback mechanisms over time. A good example of this is the analysis by Henry Farrell and Jack 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 scenes as a last resort possibility for agents to deal with opportunistic or treacherous behavior, while it is the informal trust-based relations that create the system of mutually beneficial cooperation (Farrell & Knight 2003). Other studies show that informal and formal efficient institutions can be functional substitutes (Widmalm 2008; Simon 2010). A case in point is China, which has experienced high levels of growth despite having mainly redistributive (in many cases outright corrupt) formal institutions. According to a recent analysis, this lack of efficient formal institutions in China is compensated by efficient informal institutions such as a high level of social trust in the form of personal reliance sanctioned by vast informal social networks (Li & Wu 2010).

4. 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 developing countries (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 seventeenth century (North 1990). While most scholars of 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 & North 1994; North 1998a,b).

The problem is often labeled as creating “credible commitments” between agents when they enter into contracts in a market (Keefer & Knack 2005). Without institutions that establish credible assurances that treacherous agents who renege on or violate contracts will be punished (or ostracized), so as to establish a general belief among most agents that such behavior is uncommon, transaction costs will skyrocket and people will be disinclined to make productive investments. The result will be that many otherwise profitable economic exchanges or investments will not come about because the agents will distrust one another to fulfill the contract. If dishonest and treacherous behavior becomes what is generally expected (“common knowledge”), almost all agents in the market will be losers and the market will not produce a socially efficient outcome. Such a situation is also known as a “suboptimal equilibrium” because it is self-reinforcing, as the existence of repeated and widespread dishonest behavior 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 they will all in the long run be better off if they can all 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 sense only if they can trust that (almost) all the other agents adhere to such a standard of behavior. What is “rational” for the individual agent is thus not primarily given by any cost or benefit calculation over the transaction(s) as such, but instead by what the agents think about the other agents’ beliefs about the strategy and trustworthiness of all other agents, including himself or herself. This type of rationality has been called “interactive rationality” by Robert Aumann and Jacques Dreze. Seeing rationality in this social perspective has important implications because it shows the indeterminate nature of standard neoclassical theory and standard game theory which solely build on the idea that individuals will act so as to maximize their own payoffs. The implication has been formulated by Aumann and Dreze 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 & 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 2011).
For example, if institutions that would make treacherous behavior the exception are lacking, market agents would come to believe that most other players cannot 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 in the market. This can be done in numerous ways by means of corruption, secret price negotiations, political lobbying, clientelistic networks, patrimonialism, organized crime, civil wars about the control of economic resources, and other sorts of violence. If the majority of agents, because of lack of trust in the honesty of the generalized “other agent,” acts 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 cannot assume that such institutions will be provided by agents in any organic of functionalist way.

Second, 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 favored at the expense of their competitors (Olson 1982). When it comes to the specific implementation of general rules, market agents 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 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 stated in a chapter in the *Handbook of New Institutional Economics*, “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 specific interests against their competitors. Such networks, also known as neocorporatist systems of exchange, have been, and are still, very common in many western European countries (Lindvall & Sebring 2005). One can add other forms for destroying universal/efficient institutions, such as clientelistic networks (Roninger 2004), powerful political–industrial complexes (Hossein-Zadeh 2006), and 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 (North 1998b).

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

The argument presented here is different from the standard “market failure” argument in neoclassical 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” (Cowen & Crampton 1988, p. 9). The standard market failure theory proposes that there are a number of specific situations or a certain type of goods for which markets cannot 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 neoclassical economists argue that there is a need for some form of government intervention or regulation. The argument from neoclassical 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 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 have 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; see also North et al. 2009). As Acemoglu and Robinson have put it, “an agreement on the efficient set of institutions is often not forthcoming because... groups with political power can not commit to not using their power to change the distribution of resources in their favour” (Acemoglu & Robinson 2008, p. 8).

Why can market agents not be expected to create the efficient institutions that they need in order to create an efficient market?” North states the problem as follows: “Neoclassical theory is simply an inappropriate tool to analyse 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 so-called 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, and 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 survey office, receivers, official agencies for the collection of debts, taxation and numerous inspection authorities, and so forth. 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 favor (Olson 1982; Malaquias 2007). These three problems – the strong state problem and the two collective action problems – should be seen as the general rule for what to expect.

One major exception to 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 Ostrom’s findings are not generalizable to modern competitive markets. First, all her cases are local groups in which the agents in question have been able to develop 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, p. 1). 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 et al. 2005, p. 639). They add that this is the case not only in such obvious and extreme cases as civil wars, but also in “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, Ostrom reports a number of cases where such local regulations have failed due to a number of reasons, most of them related to the failure of the agents to enter into what should be called a deliberative democratic process. Last, while the state is far away, it seems to be present in the shadows. 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 historical case dealing with the problem of producing efficient institutions has been examined by Milgrom et al. (1990) in an oft-quoted article. Their example illuminates how merchants of a certain region in fourteenth century Europe could develop legal praxis that greased the wheels of trade despite the lack of credible state institutions. The problem merchants were facing was that of managing situations in which contractual disputes arose between two merchants; that is, 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 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. (1990) claim that the merchants’ guilds of fourteenth century France appointed “law merchants.” The law merchants were empowered to act as judges in disputes between merchants and to publicize information about merchants who 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, because 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 (in these contexts, the appearance of credibility is a vital asset). Therewith, according to these authors, an institution for solving the problem of the social trap had blossomed from the market’s own inherent logic. The actors had a self-interest in both establishing the institution and 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 historical case to be sure. However, to generalize from this single case to the universe of the problems of supplying market with efficient institutions is in my view somewhat idealistic, if not to say naive, given what we now know about the pervasiveness of (legal or illegal) corruption, clientelism, and patronage in most countries. For one thing, merchants and trading companies are not homogeneous quantities. The logic of the market dictates that some will eventually become much stronger financially 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 destroy legal institutions (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,” and so forth (Rothstein 2005, ch. 6). These may very well be true, but in light of their utility-based rationalistic models, they are all ad hoc explanations and are thereby outside the reach of their theory. As Lichbach (1997) as well as Falaschetti and Miller (2001) have shown, within the rationalistic paradigm there is no solution to the problem of creating efficient institutions.
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 (Dobbin 2004; Block 2007). This approach entails a very relevant critique of the neoclassical models of how markets operate because 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 & 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 in Block 2007, p. 5). However, the problems with this approach – within the context of this discussion – are that, first, there is no such thing as efficient institutions in economic sociology, only different types of what here have been labeled redistributive institutions (Block 2007). Second, the concept of embeddedness lacks precision, because it can be almost anything that surrounds a market. Third, the approach is not well suited to handle variations across time and space because 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” varies so much across time and space (Sened 1997, p. 179). Overall, the results that come out from economic 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 conclude that “a large government increases corruption and rent-seeking” (Alesina & Angeletos 2005, p. 18). The problem with this result is that it flies in the face of almost all empirical measures of corruption, which indicate that among the least corrupt countries in the world are the Nordic countries, well known for having huge public sectors. Thus, an equally well-known and highly respected economist, Timothy Besley, states 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 2007, p. 233)

This type of contradiction from leading scholars in the social sciences on a crucial topic like this is, to put it mildly, not very reassuring. In sum, if the provision of efficient institutions is to be understood as a genuine collective action and public goods problem, and given what is known about this type of problem, it will be very difficult to solve in large-n settings. Shifting from a suboptimal equilibrium by providing a large enough set of efficient institutions may demand a “big bang” type of change (Rothstein 2011).

6. A concluding illustrative story

The main point in this article is that modern liberal societies face a behavioral paradox. On the one hand, markets based on utility maximization have been shown to create unsurpassed economic efficiency. On the other hand, in order to remain efficient, markets
require a large set of agency that is not driven by utility maximization but instead by a concern for establishing and sustaining institutions that operate for the common good. How to reconcile both these types of agency is an important and difficult challenge for our type of societies, especially if we preach to future elites that utility maximization is the only game in town (Ostrom 1998, p. 20).

The ever so popular HBO TV show “The Sopranos” contains a scene that speaks to the problem of legal corruption and 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, which 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 neighborhood and that he as a law-abiding citizen wants to help the police to clean up the neighborhood. 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 because they now seem to have what they need to put Tony Soprano behind bars. In the next scene, the eyewitness 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 newspaper. 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, whose 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” seems clear: In Robert Nozick’s minimal state, 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.

Acknowledgments

This research has been funded by the Bank of Sweden Tercentenary Foundation. A previous version of this article was presented at the 2009 Annual Meeting of the American Political Science Association in Toronto. I would like to thank Sheri Berman, Kathleen McNamara, Colin Hay, Sven Steinmo, Jan Teorell, and my colleagues at The Quality of Government Institute at the University of Gothenburg for valuable, intelligent, and sometimes very funny comments.
Notes

1 Kaufmann has led 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.

2 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 labor, which implies that capital will be more powerful than labor in how to organize the production process. However, labor can also hire capital (e.g. a group of workers or 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 labor and capital, in which case this third party will have most power in the production process. The common understanding in Marxist theory as well as non-Marxist of the relation between power in the production process and market economy has no logical underpinning. See Ellerman (1992) 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.

3 Eggersson (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 institutions “that cause relative economic backwardness” (p. 47). Such functionalist definitions should be avoided because they tend to become tautological (see Rothstein & Teorell 2008).

4 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 institution (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 labor market parties failed to establish similar efficient agreements. In many cases (Italy, Spain, Germany, Austria), the consequences for these failures were devastating.

5 Economists often use the term “opportunistic” to describe such behavior, which I think is too nice a term for this type of agency. However, to keep with established vocabulary, I limit myself to this endnote protest.

6 Joseph Stiglitz, winner of the Prize in Economics in 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 US 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 US government (Block 2007, p. 12).

7 It should however be noted that many neoclassical economists also warn that the effects of such government intervention could worsen the situation; see many of the chapters in Cowen and Crampton (1988).

8 Cowen and Crampton (1988) has a number of chapters describing cases where 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 largely “make believe” economics.

9 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.

10 According to Sened, some leaders are “smart” to make such long-term investments while others are “greedy” and shortsighted. It would be interesting to have a theory that explains this difference. Because the leaders of a society can be expected to earn most rents from corrupt
practices, they are not likely to go for public good type (efficient) institutions. My daily newspaper reports today that President Mubarak and his family have amassed almost a billion dollars during the time they have ruled Egypt.

References


Eggertsson T (2005) Imperfect Institutions, Possibilities and Limits of Reform. The University of Michigan Press, Ann Arbor, MI.


