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A NOTE: ON INSTITUTIONS AS REGULATORS OF ECONOMIC CHANGE

by

Timur Kuran

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A Note
On Institutions as Regulators of Economic Change

Timur Kuran

The subject of financial innovation calls for an understanding of the factors that make people desire to alter existing financial institutions and of the conditions under which a desire for change is likely to result in change. Observe, in this connection, that the financial system remains repressed even in countries where scientific and technological innovation is essentially unrestricted. Sweden, for instance, restricts capital mobility¹: a Swede is not permitted to buy equity in Tokyo. The reason is unlikely to be that no Swede has ever wanted to do this. Is there something special about financial innovation, as opposed to technological and scientific innovation, that makes this especially difficult to bring about? I am not going to pursue this tangled question myself. I will simply endeavor to put the presented exploratory papers into perspective, drawing attention to their strengths and weaknesses.

Let me begin with Eric Dahmén's distinction between *positive* and *negative transformation pressure*. If I understand the distinction correctly, positive transformation pressure is generated by opportunities for growth, market expansion, and higher profits, while negative transformation pressure is generated by developments that threaten to lower growth, shrink markets or reduce profits. It is well worth recognizing that the distinction need not be clear cut: whether a given development is characterized as providing negative or positive pressure will depend on human judgment, which, because of cognitive limitations, may vary drastically from one individual or group to another. Let me offer two illustrations.

In the 1950s and 1960s some less developed countries saw a golden opportunity for transforming their economies where most other developing countries saw acute dangers. A few countries in East Asia saw that the

¹ Since this note was written, Sweden has removed its restrictions on capital mobility.

volume of world trade was growing and that they could industrialize by producing for the growing (and receptive) markets of the advanced economies. In Dahmén's terminology, they perceived the post-war world economy as providing positive transformation pressure. Other countries, including virtually all those of Latin America, Africa, and South Asia, felt threatened by the international economy, and they reacted defensively by instituting policies aimed at economic self-sufficiency. Each of these responses drew support, of course, from rich intellectual traditions: neoclassical economics on one side, and on the other, Marxism and Third World nationalism.

My second illustration is a hypothetical case drawn from a current controversy. Suppose that some corporate raider expresses an interest in taking over firm *X*. The managers of *X* could interpret this development as signaling that there is an opportunity to do better, and proceed to search for ways of improving the firm's operations. Alternatively, they could perceive the development as a threat to the status quo in the firm, and then put pressure on the legislature to block the contemplated takeover.

The point I'm trying to make is that there is often room for disagreement as to whether a given situation is the source of positive or negative pressure. To render Dahmén's distinction useful, we need to understand why perceptions can differ so significantly.

In any case, even when there is a strong measure of agreement on this account, there may be vast disagreements as to the appropriate response. In the 19th century, it became painfully clear all over the Middle East that competition from Europe was destroying indigenous industries — including some that had long dominated the entire Mediterranean economy. In Dahmén's phraseology, a general agreement had formed as to the existence of negative transformation pressure. There was no consensus, however, as to how the Middle Eastern economies should respond. A few artisans sought to emulate the Europeans. But the political establishment and many powerful economic agents, including most of the guildmasters, saw the way out in the restoration and better enforcement of *old* ways of doing business, *old* market institutions, and *old* production methods. The beginnings of industrialization in the Middle East were thus delayed by at least a century — after, that is, the diagnosis had been made that some response was essential.

We do not need to step back in history, or travel to another exotic corner of the globe, to find other such examples. Today, all over the world, when government controls over foreign exchange transactions, or foreign trade, or the allocation of capital, or farm production, fail to achieve their intended results, and this becomes widely recognized, the response is often to tighten the controls even further. Trying to solve today's and tomorrow's problems with yesterday's failed solutions is a disturbingly common mode of response.

A related theme that emerges in these papers is the unpredictability of innovations. Innovations are indeed unpredictable if by this one means that in a given economic system it is virtually impossible to forecast, say, when a major change will take place in corporate finance – or, for that matter, what the change will entail. One should not lose sight of the fact, however, that innovations are more likely to occur in some settings than others. The next major innovation concerning finance is unlikely to originate from Tanzania or Paraguay. Certain economic systems are more conducive to the production of innovations than other systems, and in any particular economic system, innovative potential may rise or decline through time.

This observation raises the question of why some economies are innovative and others not. Relevant here is a point made by my colleague Richard Day, which is that many features of the political system are designed explicitly to counter the uncertainty and insecurity produced by innovations. Throughout history, in fact, political systems have been hostile to what we call Schumpeterian entrepreneurship. Financial, organizational, and technological decisions have tended to be tightly regulated – in relation, that is, to the available technologies of regulation. The modern economy is by historical standards an anomaly. The origins of this anomaly are often traced to the Protestant reformation in Europe, but the connection between the reformation and the growth-oriented, free-market economy is seldom stated, much less appreciated. The leaders of the Reformation, including Martin Luther and John Calvin, were anything but forward-looking economic libertarians. On the contrary, they advocated the restoration of the medieval economic controls, including controls on how much each guildsman could borrow and according to what terms. They attacked Church authorities for being lax in enforcing the usury laws. Paradoxically, the consequence of their

struggles with the Church was to weaken the power of the Church and, in the process, lower the barriers to Schumpeterian entrepreneurship. By the time the Church solved its internal problems, the entrepreneurs themselves constituted a sufficiently large, wealthy, and powerful pressure group to be able to resist the controls on their financial dealings and other activities.

Generalizing, I would argue that there must be some form of restriction on the powers of the political leadership for there to be a healthy flow of Schumpeterian entrepreneurship. It is no surprise, to my mind, that most important innovations in the last few centuries — whether financial, or organizational, or technological, or scientific — have originated in countries with essentially democratic political systems, featuring constant struggles among various powerful blocs.

This brings me back to Dahmén's notion of transformation pressure. In a centralized political system, where the political leadership dreads innovation for the instability it inevitably promotes, potential Schumpeterian entrepreneurs are restricted in their capacity to react to the positive or negative pressure they perceive. In a somewhat decentralized system, they will be able to react. And as a rule, different entrepreneurs will react differently. Being cognitively limited like everyone else, entrepreneurs think in terms of "patterns" (or "models of reality"), and the patterns carried by one entrepreneur need not match that of another. Consequently, a given crisis or opportunity might produce a wealth of responses, only some of which will result in success.

The observation that the cognitive limitations of entrepreneurs will make them react differently to a given opportunity or threat has been made by Herbert Simon, Richard Day, Dick Nelson, Sidney Winter, and others. Recent developments in cognitive psychology should enable us to go a step further: we should be able to explain *why* and *how* two or more entrepreneurs might differ in their responses to a given event. The research I have in mind is associated with such names as Amos Tversky, Daniel Kahneman, Richard Nisbett, and Lee Ross. It aims at discovering the heuristics people use to prevent informational overload and at identifying the biases these heuristics entail. On the basis of this research, Howard Margolis has gone a long way in a recent book (*Patterns, Thinking and Cognition*; Chicago: University of Chicago Press, 1987) in explaining, in the spirit of a police detective, why

medieval scientists looking at a given body of celestial data reached contradictory conclusions. We may be able to apply these recent findings in cognitive psychology to the question of explaining observed patterns of financial, organizational, and technological innovation. This, I think, is one of the very big challenges for this entire field.

Let me move on to what seems to me to be a puzzle pertaining to Rybczynski's distinction between bank-oriented, market-oriented, and securitized financial systems. It is not clear from the paper why financial evolution has been slower in Europe than in the United States, and slower still in Japan. Nor is it clear what this observation implies for the link between the real and financial sectors of an economy. The United States, which has advanced farthest financially, has also been a relatively slow grower. Are we to conclude that Japan's relative success has taken place in spite of her retarded financial development? Or are we to conclude, after all, that the real and financial sectors of the economy are independent?

Gunnar Eliasson's paper provides a key insight. He builds a theory of a firm that operates within an experimentally organized economy, using assumptions supported by the analyses of Dahmén (the size of the set of business opportunities), Day (the necessity of bounded rationality), and Rybczynski (the openness of markets). Part of the firm's competence, in Eliasson's theory, is to convert uncertainty (in Knight's sense) into computable risks. In so doing, the firms merge the financial and real dimensions of their operations. Participants in the economy recognize that mistakes are going to be made as a matter of course, and they try to make it easy to correct whatever mistakes occur.

Economic policy makers and researchers are not accustomed, in my view, to thinking of decisions as experiments that might generate unanticipated bad results. Policies tend to be made in the belief that their results are more or less predictable. They are not accompanied, therefore, by contingency plans to deal with unanticipated adverse consequences. Some firms, of course, are able to switch course quickly, following a decision that has turned out to be bad. We also observe, however, many instances of inability to readjust. Public enterprises are notoriously slow to adapt, since they must consult various political bodies before any major shift in direction. If we go back in history, we find that until recently there was rather limited

freedom to adjust and readjust to new information, even in the private sector. The typical guildsman was seriously constrained by law and custom in his decisions pertaining to production, finance, and marketing. He was not free to alter his inputs or to double the size of his operation.

Eliasson's conception of an experimentally organized economy should thus be seen as an *ideal* that no economy has yet attained. And in some respects, I think, we are at the present time moving away from this ideal — not closer. Private firms, especially big private firms, are expected by the public to refrain from making sudden switches, the rationale being that such switches cause employees and communities hardship. This expectation makes it difficult to cut its losses quickly, and it requires firms making corrections to compensate those adversely affected.

The case of General Motors, which Eliasson discusses, is instructive in this regard. The reorganization advocated by Ross Perot was opposed by GM's bureaucracy, because it would have upset some privileges and created new responsibilities. What is especially significant, though, is that the opposition did not come only from those who would have lost power. Opposition to restructuring was widespread, reflecting a sensitivity to forcing people to adjust. It is significant in this connection that public opinion polls reveal an extensive opposition to plant closings — much more than can be justified by people's direct stakes in the factories in question. American polls pick up much opposition in California to plant closings in Michigan.

Such observations lead me to believe that Eliasson's experimentally organized economy demands from the public more flexibility than it appears prepared to give — at least at this juncture in history.

Let me turn now to another facet of the experimentally organized economy: the identification of failures. This process, like that of correcting an identified mistake, has a social dimension. To a significant extent, our interpretations of success and failure are determined by interpretations we perceive others around us to have. In the context of a firm, managers do not form their opinions regarding the outcome of a particular experiment independently of one another. Being cognitively limited, they rely on each other, and there is no guarantee that the outcome of this collective "mistake identification" process captures objective reality efficiently. Research by cognitive psychologists shows that groups, like individuals, are capable of

reaching conclusions that rest on erroneous logic or spurious facts.

I want to draw attention, finally, to a feature to which Eliasson has given limited attention. The experiments in which a firm engages involve, in practice, not just activities aimed at raising profits within the given political rules of the game, but also activities aimed at bending those rules in the firm's own favor. I bring this up not as a criticism, but because I regard this paper as a serious effort to develop a genuinely dynamic and behaviorally sophisticated model of a growing, evolving economy. Precisely because it is more than a clever academic exercise, this paper ought to be followed by work on *whether* and *how* the scope of firm experimentation should be restricted.

