

## The Open Society, Institutions and Economic Performance

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**Abstract:** Development and economic prosperity illustrates undoubtedly nodal objectives of every nation worldwide. Economic freedom and democracy are the proper way to achieve such performances in an open society but in conditions of risk, high uncertainty and information asymmetry. In such terms, the laissez-faire policy requires institutional support in order to facilitate social relations integrity, honesty between economic agents, the rule of law and a stable and efficient economic climate able to generate trust and development. The purpose of this paper is to highlight the major contribution of institutions to the economic performance of a free society where life is guided by “the invisible hand” of the market and spontaneous discipline in order to emphasize that order might be compatible with freedom but also with the idea of economic progress.

**Keywords:** institutions, freedom, order, path dependence, economic performance.

### 1. Introduction

Growth and economic development are subjects of great interest which remained on focus within economic analyses. As neoclassical economic theory highlighted the progress and social welfare is compatible with the capitalist system based on competition, innovation, free initiative or private property. However, all these major objectives might be reached in terms of neoclassical specific assumptions, such as: rational preferences of the individuals, the maximization principle of utility or profit and the independently act of individuals in circumstances of complete and relevant information (Weintraub, 2007). Through contribution of economists like Alchian, Coase, Demsetz or North and other leading figures of Institutional Economics, institutions as rules of the game started to raise the proper interest and attention redressing the deficiencies of the neoclassical vision. As Richard Langlois pointed out “*the problem of many of the early Institutionalists is that they wanted an economics with institutions but without theory; the problem with many neoclassicists is that they want economic theory without institutions*” (Langlois, 1986). The institutionalist approach deeply rooted in reality allows the analysis “in time and space” of the economic sphere. In other words, there is a critical need for a healthy institutional system in order to promote trust discipline, transparency in human interaction and moreover, the freedom of the economic system. Taking into consideration the impersonal nature of transactions in such a globalized world, the market, as “the queen of the game” is not able to provide the necessary protection. In such circumstances institutions, the “rules of the game” have the power to generate order and balance within the open society which requires not only freedom and the rule of law, but also social codes of conduct able to stimulate cooperation and efficiency in all its spheres.

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### 2. The fundamental institutions of the open society

When referring to the concept of *free society* the Austrian School of Economics remains an authority in the field. Leading figures like Friederich von Hayek, or Ludwig von Mises highlighted the individual and social liberty, the freedom of the economic system guided by the reign private property and freedom, as the supreme value of economic and social edifice, as major coordinates of the free

society construct. From this perspective, we might distinguish the two valences of the *liberty* term, perceived as nodal institution of the free social organism. First, there is the liberty of individuals noted as having an inner nature. Second, there is the liberty of society, which has a civil dimension and is strictly linked to the principle of non-aggression. As Mises indicated, this liberty must be first an economic liberty. It is certain that people are not equal from the nature. On the same way, they are not free when they born, they depend on somebody: family or society they live in. In such circumstances, when liberty does exist, it is manifested first from the economic perspective. However, what *is liberty after all?* The same Mises presents it as “*the state of affairs in which the individual’s discretion to choose is not constrained by governmental violence beyond the margin within which the praxeological law restricts it anyway*” (Mises, 1996). Furthermore, Hayek describes it as “*the source and condition for most moral values*” (Hayek, 1993).

Economic freedom is based on private property as fundamental pillar and market as the queen of the game, but also on competition, free initiative, individualism, efficiency, profit being the driving force of the entrepreneurial activity. As the Austrians economists emphasized, the free economy is strictly dependent on the non-intervention of state in market activities. Besides, they clearly define the mission of the state that must create and guarantee a healthy environment for the proper activity of market economy. How does it provide such incentives? Through *institutions*; they are the rules, which guide human interaction furnishing the necessary trust and order. After all, the society implies a concerted action, and moreover, cooperation. From this viewpoint, Ludwig von Mises noted that “*society is nothing but the combination of individuals for cooperative effort*” (Mises, 1996). This relationship between individuals and society is essential in explaining the appearance of institutions. The action always belongs to the human being, but its shape is designed only within the society. A society cannot exist without strict rules, responsible for social harmony. From the Hayekian perspective, individuals tend to be animals that create and comply with the rules. In such circumstances, Hayek could not imagine a society in the absence of order and human cooperation, but all these are based as he pointed out, on specific and clear norms which govern human behavior in order to induce discipline within the social life (Hayek, 1980).

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The necessary basis for the proper activity of society is represented by normative rules, the rule of the law which is not spontaneous, but imposed. Practically, human behavior is guided by norms, customs, traditions, even laws through which individuals are satisfying their own needs under the umbrella of an ordered society. From this point of view, it is important to focus on what we might consider *the* institutional approach of Hayek’s vision. First, we have the spontaneous order (Kosmos), as a natural and endogenous order that comes from the inside and is self-imposed (Hayek, 1980). Second, there is the manufactured or imposed order, which is organized (taxis). It pertains to objectives imposed by an authority and implies subordination and hierarchy relationship (Pohoată, 2008). Family, the firm, society, public institutions even Government are forms of artificial order integrated within a vast spontaneous order, the macro spontaneous order (Hayek, 1993). These two components coexist and together shape the *open society*, where the natural component illustrates the hard core and represents the institutional correspondent of informal or organic institutions. Spontaneous order implies values such as: honesty, competition, individualism, liberty, entrepreneurship, responsiveness to new stimulus, the rule of law, even owelty.

There is a vital relationship between freedom and property, as nodal institutions of free economic system. Freedom illustrates an extension of property, besides it derives from it. Taking into consideration the rarity of resources which might generate conflicts between individuals, legal property requires a strong connection with the economic perspective. In the absence of property, the common usage of resources would generate *the tragedy of the commons* in Garret Hardin’s perspective. In such circumstances, the Adam Smith principle of invisible hand plays exactly the reverse. The excessive consumption of resources for satisfying personal needs implies wastefulness and will induce the so called “tragedy”. Property rights are “*the fundamental institution of market economy*” (Marinescu, 2004). Reflecting in Hardin terms, we might acknowledge that private property

was organized with the purpose of avoiding the decay of economic environment caused by the common usage of limited resources. Furthermore, as owners and users of such resources, people were encouraged to use them with parsimony and responsibility. Hereby, the conflicting relations of human interaction are highly diminished and economic behavior converges to efficiency. The useful allocation of property to most efficient practices determines the appearance of wealth as a natural consequence (Marinescu, 2007).

We might observe the preeminence of institutional background in building and protecting the free economic system, but furthermore, the entire society. As Hayek underlined, economic liberalism is strongly connected with political liberalism. From a general perspective, individuals are to be blamed when the balance is broken. Human greed for power is the major problem in maintaining this equilibrium. Individuals illustrate a cultural synthesis, but culture is extremely important; it guides the changing process of any society. As Institutional Economics studies highlighted, some nations tend to be *power oriented* while other is *wealth oriented*. While the former category encounter significant difficulties in adopting the institutions of the free market and suffer from a *cultural handicap*, the latter have the ability to activate the precise institutions which induce growth and development (Fudulu, 2007). The remarkable phrase of Friederick von Hayek according to which is not the system we need to fear, but the people who manage it, remains illustrative (Hayek, 2006). This is the reason why Austrian economists propose the minimum state, or its total absence. In Hayek's perspective, society must be guided by a Legislative assembly and a Governmental assembly. Besides, the legislative component is superior and imposes the general rules, spontaneous rules, unable to be modified by Government. Practically, the rule of law encloses the power of the State. Its role is to interfere where natural order is not able to guarantee social harmony. The state rule must be the rule of law, responsible to protect liberty, the hard-core value of humanity (Pohoățã, 1993). When spontaneous order is replaced by artificial rules emerges the coercion. The intervention of the State in the economic and social life becomes prominent and mainly dangerous. This expansion brings deep pressures for the market and entire society, which explains the attitude of Murray Rothbard, according to whom State cannot be a protector of freedom (Rothbard, p. 226).

As Hayek pointed out, *liberty* and *individualism* are nodal conditions for economic evolution and prosperity. A healthy freedom policy must minimize coercion and its negative effects, even if is not possible to completely erase it (Hayek, 1993). The open society of Friederick von Hayek engages integral human freedom and an active rule of law. Economic freedom is based on private property and the market is the queen of the game, which provides its endurance. As we might observe, the whole mechanism of a free society is strictly dependent of clear and efficient institutions, oriented to liberal values and order. Humans are not perfect, neither the institutions they create. In the next section, we will focus our attention on the major contribution of institutions on economic dynamics of the nations. These rules, as Hayek highlighted, in both versions: *thesis*, as created rules and *nomos*, as abstract rules of conduct are responsible for economic growth or decline. In specific terms of Institutional Economics, the efficiency of these official and unofficial norms has the ability to explain economic development or conversely, the poor economic performances.

### **3. Institutions - determinant of economic performance**

The vast literature of institutions is abundant in definitions. This subject obviously required the intellectual effort of many economists from this research area. In absence of a unanimously accepted definition, the common denominator of all these contributions might be resumed to the idea of *behavioral regularity*. In other words, individuals tend to act in a specific manner when they are confronted with some specific situations. According to Douglass North, institutions are "*the rule of the game*" or "*constraints created by people in order to shape human interaction*" (North, 2003). From another perspective, institutions appear as "*a system of rules, beliefs, norms, and organizations that*

together generate a regularity of social behavior” (Greif, 2006). Hodgson provides also a resembling stance according to which “institutions are systems of social rules created and widespread that is able to coordinate social contacts” (Hodgson, 2006). Taking into account the bounded rationality of individuals and furthermore, the uncertainty and risk that govern everyday life, their role is to create a stable and certain environment based on trust and transparency.

Under the generic umbrella of *institutions*, there is a formal and an informal component. On the one hand, *formal institutions* might be translated according to Hayek as “thesis”. These are created rules which have a direct impact on the free market and an important contribution to its development. Property rights for example, rule of law, macroeconomic stabilization norms, or those which coordinate currency or market competition are illustrative examples. On the other hand, there are *informal institutions*, such as tradition, ethical rules and codes of conduct. Taking into consideration their strong inertial character and connection with past experiences, these rules are extremely powerful in guiding the transforming process of entire society (Pohoată, 2009). Such norms allow the endurance and extension of spontaneous order through imitation and have a particular dose of wisdom. For Hayek, this collective wisdom is progressively accumulated, in time, and shapes society’s tradition (Longuet, 1998). Undoubtedly, these two components of the institutional environment coexist and mutually interfere; consequently, we might endorse the idea that institutions should be examined as an entire piece.

As inner institutional analysis highlighted the interaction between formal and informal institutions might generate economic growth, or conversely, poor economic results, depending on complementarities and discrepancies between created rules and unofficial norms. According to the *interaction thesis* of Pejovich, institutional dynamics encourage economic performance when formal institutions metamorphosis is in total accordance with the informal background. Consequently, the institutional mix will reduce transaction costs and will encourage growth. The situation is even more favorable when rules are focused on individual freedom protection, labor division or conflict settlement. Conversely, when the changing process of formal rules is incompatible with tradition and norms of behavior, the interaction will generate higher transaction costs and limited opportunities for further economic expansion (Pejovich, 1999). From this perspective, economic dynamics seem to be a kind of response to institutional dynamics. In other words, the efficiency of the institutional background, in his both, formal and informal dimensions, is the driving force of the entire social system. Within this complex social structure, wealth and economic performance are the major achievements.

Evenmore, we might uphold that there is a circularity relationship between institutions and economic development (Pohoată, 2009). This interdependence highlights certain features which tend to migrate from institutional sphere to economic sphere and vice-versa. The quality of inland rules proceeds from the economic evolution, which is also a starting point for further economic dynamics. The preeminence of the past is essential in explaining development gaps between nations. Using the institutional terms, the astonishing influence of past experiences is synthesized in the so-called *path dependency* process. Accordingly, countries which were conducted by good rules in the past have encouraging perspectives to achieve development in the future; healthy institutions inherited from the past serve as solid basis for new ones. In the opposite, countries which encountered difficulties, due to their poor institutional efficiency, or complete inefficiency, have a strong inertial character. Their ability to adopt the free market institutions is limited, as well as further economic development perspectives. Transition economies are an illustrative example in this case. Romania for instance, is undoubtedly path dependent. The hereditary mark engraved from the soviet period inhibits any possibilities to build a healthy economy and society. The old values from the past remained alive and interfere with progress. In such inauspicious conditions, free market signals tend to be poor and unable to sustain economic performance. Bureaucracy, corruption, the improper definition of property rights, the lack of effectiveness are just a few examples of the inland problems. Unfortunately, after more than six years of European Union membership, Romania is still incompatible with European norms

and values. In such conditions, Titu Maiorescu's *theory of forms without substance* remained in force. Practically, the formal institutional initiatives borrowed from European Community were totally incompatible with the unfavorable native substance, still path dependent. In such circumstances, such successful norms became unable to generate development within Romanian area. Romania definitely needs a radical institutional facelift, from inside to outside, in order to gain economic advantages through efficient institutions, but such major metamorphosis requires a long period of time.

General economic theory pointed out a set of key elements which are able to stimulate economic growth. Freedom and private property are essential in this respect. Economic freedom, freedom of trade, foreign direct investments attractiveness, competitive markets, a healthy currency and property rights are mainly nominated. But all these factors are activated and proper coordinated via institutional network. As we have already highlighted, private property seems to be the most important pillar of the free economic system so far, but its appearance was preceded by the establishment of property rights, a nodal rule of capitalism. Institutions promote welfare enhancing cooperation and action (Zamagni, 2010). A society is unable to function without institutions. They are the guiding lines that structure human interaction, promote confidence, freedom and equal rights for individuals and transparency within the open society. Labor division, innovations, investments, exchange relations, democracy, human capital, social capital, entrepreneurship, all are basic requirements for a healthy and free economy, but impossible to achieve in conditions of chaos and disorder. In such a globalized world, everything is placed under the uncertainty mark, the incomplete information, bounded rationality and risk. All these circumstances create a fertile soil for opportunistic behavior and transaction costs expansion. This is precisely the purpose of institutions, to remedy all obstacles which interfere with fundamental values of a free society. Good institutions permit rational choices to be made in the absence of reliable knowledge of specific circumstances. Moreover, they have the ability to correct the bounded rationality and to encourage human cooperation. An open society requires not only freedom and order, but also security of contracts, exchange relations, labor division, the specialization of economic activity and significant investments in human and physical capital, able to promote further expansion. Wealth and economic performances will arise only when institutional framework will be able to provide the necessary support. In such conditions, the rule of law and social norms became a sort of instruments that guide the success and offer the needed protection.

Efficient institutions maximize the performance of economic factors, in order to generate highest benefits for the entire society, but also shape the necessary climate for achieving such results. It is impossible to acquire growth and social wealth in the absence of proper rules, order and transparency. Regrettably, the State is not able to create and maintain a stable and reliable social environment. As Adam Smith highlighted, nations are becoming poor because of waste and bad behavior of governance (Smith, 2001). Most of times, Government representatives take advantage of their liberty to manipulate rules in order to satisfy their own needs and not those of collectivity who voted them. Homo politicus learned quickly the market lesson that of being individualist and self-centered illustrating the „leisure class” model of Thorstein Veblen. Taking into account that polarization of the wealth in their own „pockets” requires society deprivation of capital and resources, democracy might serve sometimes as the necessary “tool”. In such conditions, the pecuniary interests of those who have the power are to be satisfied first to the injury of social problems. This is the reason why the intervention of the State in social and economic activity might become toxic and harmful. Obviously, in the process of economic growth, evenmore in an open society, institutions do matter. As long as rule of law and freedom serve as the basis for the entire social and economic system, order and wealth accumulation will appear as a natural response.

#### 4. Conclusions

Freedom remains the supreme value of both: humanity and any society that aspires to wealth and social progress. Unfortunately, State as separate entity tends to be the largest enemy given the fact that its representatives are also humans, with an imperfect rationality and conduct. In such circumstances, of interferences between created norms and spontaneous rules, the situation is imprecise. Both components are consistent parts of the *open society* organism, but there is a critical need for the prepotency of the informal pillar. As liberal economic theory emphasized, the prevalence of the rule of law illustrate the proper way to accomplish and ensure liberty, order, human cooperation and moreover, to minimize the sphere of State intervention. As we have already highlighted, the idea of social and economic performance is incompatible with the prominence of the State. Centrally planned economic systems are far from being developed nations with prosperous standards of living and efficient institutions. Conversely, their inland conditions for promoting growth and social progress are illusory. However, this is the great virtue of the State. Its excessive intrusion is responsible for the collapse of the entire economic activity and social abjection.

Undoubtedly, there is a vital necessity for institutions, but healthy rules able to rectify social imperfections and human errors in order to facilitate living in such a fallible world. Such norms have the power to activate the just values of a free society and furthermore, to protect it against internal and external pressures. According to Institutional economists, institutional efficiency is responsible for economic and social performances, mainly in an open society, where everything is unpredictable. Elements like property rights, the rule of law, but also informal institutions which encourage transparency, honesty, accuracy are important pillars of freedom and wealth. While these values remain alive, economic and social prosperity is ensured, otherwise everything tends to be a utopia. Economic performance is highly influenced by the process of institutional change. In other words, the invisible hand of institutions has the power to place economic evolution on an ascending or descending trend. In other terms, the combination between healthy rules and an efficient State with limited functions seems to be the perfect match for freedom, discipline, and social advancement.

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