Forum Series on the Role of Institutions in Promoting Economic Growth

Comments on McCabe's Reciprocity and Social Order: What do experiments tell us about the failure of economic growth?

Prepared by Paul J. Zak
Claremont Graduate University

Forum 6

The Interaction Thesis: Alternative NIE Perspectives on Development Economics and the Dilemmas of Foreign Aid Policy

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About the Series

The objectives of the Forum Series are to help USAID make its donor assistance more effective and sustainable by incorporating insights from the New Institutional Economics into USAID's programming and delivery of development assistance. Services for Forums 6,7, and 8 are provided by the Mercatus Center at George Mason University and its consultants and the Center for Institutional Reform and the Informal Sector (IRIS). Editor for Forums 6, 7, and 8 is Peter Boettke, the project director for this portion of the Series with support from the overall project director, Clifford Zinnes, and the Forums Steering Committee (Ed Connerley, Jim Ellliott, Jonathan Sleeper, and Tham Truong), chaired by the activity's COTR, Fred Witthans. Funding for the Series is provided by USAID's Bureau for Economic Growth, Agriculture, and Trade, Office of Economic Growth through SEGIR/LIR contract PCE-00-97-00042-00, Task Order 07.

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<u>Summary</u>

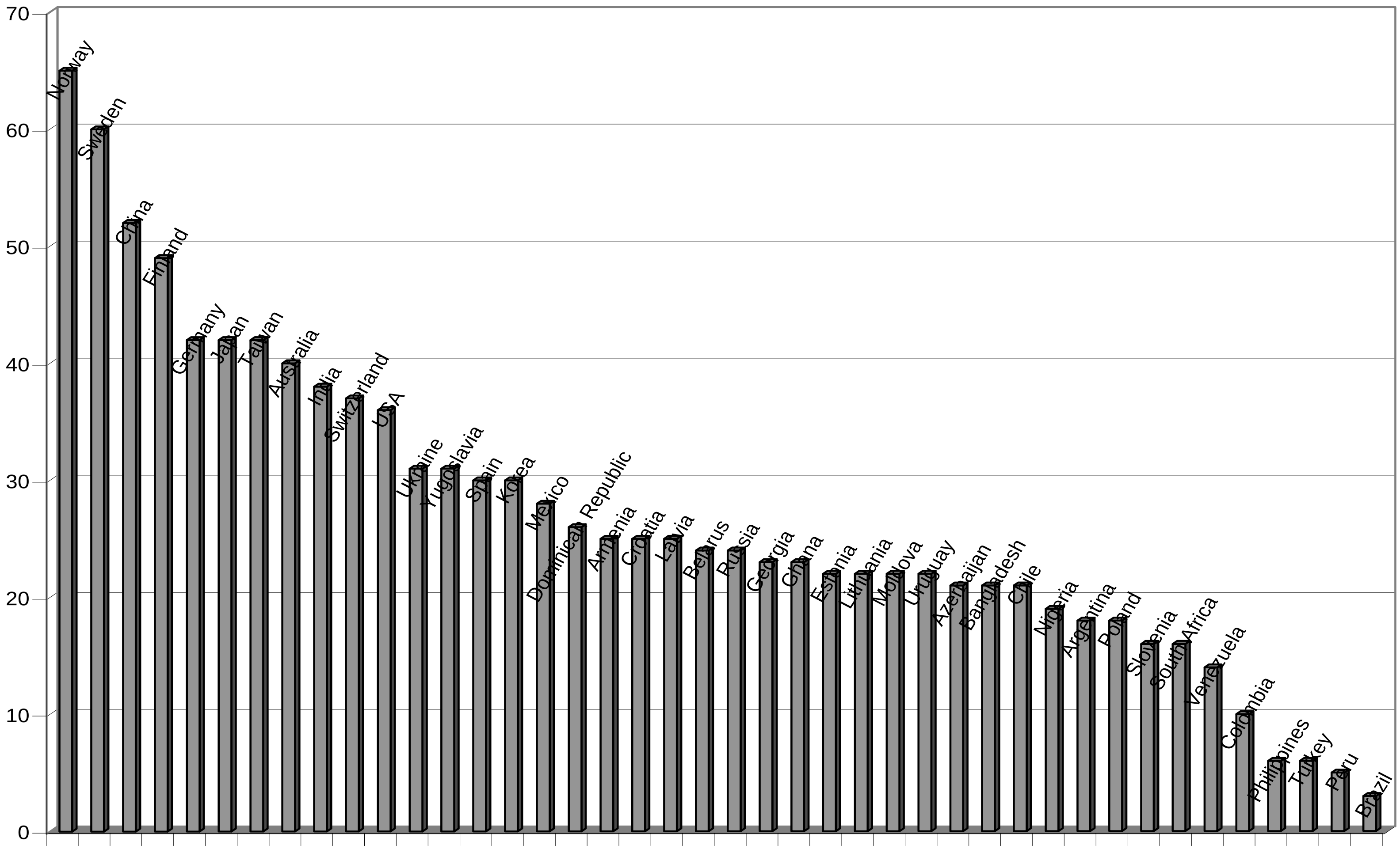
1. Humans are designed for (by) personal exchange.
2. Personal exchange limits economic growth since the extent of the market is small (Adam Smith).
3. Institutions can solve this dilemma (Douglass North), but need not (Vernon Smith, Kevin McCabe).
4. Better institutions are cheaply test-bedded in the laboratory.
5. Adopting better institutions is difficult (Zak & Denzau).

<u>Humans are Designed for Personal Exchange</u>

The leading model of how the brain constructs the mind (Hayek-Hebb) identifies the critical feedback between genes and environment. Our earliest trading experiences are personal (e.g. trading toys) and our "social brain" is adept at detecting cheaters, doing social accounting, etc. In short, personal exchange is cognitively cheap. Further, personal exchange literally molds the mind.

<u>Personal Exchange Limits Growth</u>

Growth requires investment which is intertemporal. Since there are no complete contracts, <u>every</u> intertemporal contract has some degree of trust in it.
Zak & Knack "Trust and Growth," *The Economic Journal* 2001, show that trust arises in intertemporal exchange even absent reputation because it reduces transactions costs. Low trust countries are poor because investment lags, high trust countries are by and large wealthy. In addition, there exists a low-trust poverty trap (if trust is sufficiently low, <u>no</u> growth occurs).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Institutions Can Promote Impersonal Exchange by Raising Generalized Trust

Zak & Knack 2001 show that the amount of trust in one-shot transactions depends on:

- Formal institutions enforcing contracts
- Informal institutions enforcing contracts
- Social & economic heterogeneity
- Income levels

Trust is among the most powerful factors affecting growth: a 15 percentage point increase in the proportion of those who are trustworthy raises growth 1% per year per capita thereafter!

Institutions Affect the Efficiency of Exchange

McCabe and collaborators have shown that market rules substantially affect efficiency. Further, he shows that "better" rules may not be used if there are alternatives that economic agents prefer or are simply accustomed to.

The most efficient market institutions are those that take advantage of our proclivity for personal exchange, while opening up exchange to a large number of participants.

How are such institutions discovered? Trial and error within a country is very expensive, but this can be done cheaply in a laboratory setting.

Moving from Inefficient to Efficient Institutions is Difficult

Because of the constructed mind, humans have "cognitive inertia" (Zak & Denzau, "The Evolution of Institutions," in *Evolution, Human Nature, and Public Policy*, Albert Somit and Stephen Peterson, eds. Palgrave Press, 2003) that makes them biased against change with an uncertain outcome.

The politically and economically powerful are exploiting the existing institutions and will seek to block reform.

McCabe's experiments show that humans do respond to incentives, so to promote development USAID must:

1. Identify a set of feasible new institutions.
2. Provide the incentive for the adoption of these new institutions.