The Impact of Rules on Economic Activity

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Abstract

The aim of this paper is to present the importance of the rules, the importance of those rules that influence economic activity. It will be presented the institutions starting from the "rules of the game" until the "rule of law". Then it will be explained the concept of "spontaneous order" and the importance of that order in society. For a good economic activity, we need a “good governance”. It will be explained what this means good governance and how addiction affects about institutional change.

Keywords

Rules, governance, path dependence, order, institutions

JEL Codes: H11, H50, E61

Introduction

From a long time ago, people have been trying to find the perfect city, perfect state, perfect society and perfect institution. Even in primitive societies, there was no chaos. To can communicate and to produce, there were rules; there was a self-imposed framework as a condition of survival. Today, the condition for a good business establishment is the membership to an economic system. The concept of economic system is influenced by judgments, which reflect the doctrinal options and experience of observers. For new-institutionalists, the key roles in economic development are the institutions.
Over the time, in economic theory, are used different definitions and interpretations of the term institution. Starting from the everyday language, which often is confused with the organization and till to North's definition, which presented institutions as a rule of the game or constraints created by the people to emphasize human interaction[1], the institution represents the key, the governor of the economic activity.
New institutional economics examines the community's various effects and determinants of the institutional change. In the new-institutionalism current, institutions can be defined by rules commonly accepted and used to structure interactions, different situations and to penalty the mechanism in case of non-compliance with these rules. This trend, new-institutionalism, appeared as a reaction, or rather as a supplement to neoclassicism and economic welfare and is a heterodox approach.

Why we need rules?

The rules (institutions) are the heart of the analysis, carried out on the market and in conditions of limited rationality (bounded rationality). Individuals do not act purely rationally as the neoclassic theory tended to show and for this reason we need institutions.

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[1] North D. (2003), *Institu ii, schimbare institu ională i performan ă economică,* Ed. tiin ifică, Chi inău, p.11

They are seen as rules of the game for human interaction, but the questions which often arise are how are occurring and how these institutions can change the behavior of individuals.[2]
The free market is that one that can achieve efficient resource allocation, that's the reason the term should not be confused with the economic governance of state intervention or with the social planning.
We require rules for living together for the simple reason that without them we would surely fight. We would fight because the object of desire for one individual would be claimed by another. Rules define the private spaces within which each of us can carry on our own activities. We require rules in society because, without them, life would indeed be "solitary, poor, nasty, brutish, and short", as Thomas Hobbes told us more than three centuries ago.
The most familiar association for the word "rules" is with "games". All games have rules that define the parameters within which play takes place—the actions allowed by the players, the equipment used, the means of settling disputes, the way in which the winner is determined, and so on. That is the association with the game and also Adam Smith emphasized the importance of the "laws and institutions" of economic order.
The relevance of rules is best exemplified by reference to the familiar example of common-property resource utilization, the "tragedy of the common". If utility maximization is describes the behavior of users, the "common" will be predictably overgrazed. The market is alleged to "fail" in generating efficient usage of the scarce resource. The problem is not with the workings of the market process, but with the rules within which the users operate. A change in the rules so that the scarce resource is separately and privately owned, along with means for enforcing and protecting individuals in rights of ownership, will remove the inefficiency. The example suggests that economists' proclivity to look at outcomes rather than at the rules that generate such outcomes has been a source of profound confusion. Reform of results or outcomes comes about through reform of the rules rather than through manipulation of the outcomes directly.
Friedrich von Hayek analyzed and demonstrated the existence of two types of social order, a spontaneous order and constructed order. Spontaneous order is not a feature of the anarchic society, it is a complex development of society around a coordinator principle of human action; it is the institutional set of rules that govern human relations. He divides the rules in those informal rules discovered by trial and error and rules established by rational political decisions. Hayek said that society can't function only in the spontaneous order. Essential is the rule of law. A society can't be governed by the power of state, but by the legitimate power of law, the law developed as an evolutionary system, not a built system by the state. He spokes about the system of rules codifying informal conventions of individuals. Epistemological, the view of Hayek is based on methodological individualism, in which the main actor is the individual and not the whole society or the state. [3]
In any group, collaboration will always rest both on spontaneous order as well as on deliberate organization. The two kinds of order will coexist in every society of any degree of complexity, but this doesn't mean that we can combine them in any manner we like. What we find in all free society is that, although groups of men will join in organizations for the achievement of some particular ends, the co-ordination of the activities of all these separate organizations, as well as of the separate individuals, is brought about by the forces making for a spontaneous order. The family, the farm, the firm, the corporation and the various association and all public institutions including government, are organizations which in turn are integrated into a more comprehensive spontaneous order.

What we need for a good governance?

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[2] Kasper W., Streit M. (1998), *Institutional Economics: Social Order and Public Policy*, Cheltenham, U.K. pp. 27-41

[3]Hayek, F. A. (2006), *The Road to Serfdom,* Ed. Humanitas, Bucure ti, p.25

More and more often appears in economic literature the term of governance. If in the 1970s we have only a few references to the term, in 2008, it appeared in the literature about 30,000 times. The term economic governance means the structure and functioning of the legal and social institutions that support economic activity and economic transactions by protecting property rights, enforcing contracts and taking collective action to provide physical and organizational infrastructure.[4]

Good governance is needed to secure three essential prerequisites of market economies. Good governance is required to ensure security of property rights, the enforcement of contracts and collective actions. Without security of property rights, individuals will lack the incentives to save and invest, because they will fear that others will deprive them of the fruits of these activities. They will also forgo capital market trades to achieve efficient allocation of assets, because they will fear for the principal and not just the return on the capital they invest in others' enterprises. [5]

Economic transactions promise gains to all voluntary participants. But each party may lose if the other fails to fulfill its promised role in the transaction, but instead acts opportunistically. Fear of such counterparty cheating may prevent people from entering into the contracts, and mutual gains will go unrealized.

Much private economic activity depends on an adequate provision of public goods and the control of public "bads." In this is included not just physical but also institutional and organizational infrastructure. Provision of social safety nets, facilitation of internalization of externalities, and the control of public bads. All involve problems of collective action to avoid free-riding.

Good economic governance thus underpins the whole Smithian process whereby individuals specialize in different tasks and then transact with one another to achieve the full economic potential of the society. As a first reaction might be said that good governance requires a good government, but authors such as Dixit, Vanderbilt, Grief, Greenspan admitted that alternative institutions can be used to ensure good governance. The authors argue that government itself may violate private property, and even to not perform his duties. This situation is possible in less-developed countries or those in transition, but even in developed economies, governments cannot achieve full governance. Hence private institutions exist to serve similar goals. They work on specific niches where the government cannot work.

In a free society, governed by the rights and responsibilities of citizens, the vast majority of transactions require trust and reputation. Trust is essential attribute of the capitalist market. But other social institutions of economic governance also exist in almost all countries. They function especially in niches that the government serves poorly, or not at all. Sometimes they work better than the formal law, because they have better expertise or information. And they are essential for guarding against the government's own misbehavior. [6]

If authors such as Grief, Dixit, Ostrom believes that these alternative institutions should be a solution for good governance, the constitutionalists authors (Buchanan, Tullok, Voigt) demonstrated that a government (Leviathan as Hobbes calls it) is efficient as long as he provides a higher utility to a situation of anarchy, and that government is the agent of citizens. One problem facing the constitutionalists is the information asymmetry Always the government (Leviathan) will have an advantage over individuals. For this reason, the assumptions on which they rely and which are hard-core site in this area relate to methodological individualism, rational choice, homo economicus behavior and democratic foundations.

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[4] Dixit A. (2009), *Governance Institutions and Economic Activity,* American Economic Review, 99(1), pp.5–24

[5] Field E. (2007), *Entitled to Work: Urban Property Rights and Labor Supply in Peru,* The Quarterly Journal of Economics, 122(4), pp. 1561-1602

[6] Greenspan A. (2007), *The Age of Turbulence*, The Penguin Press, New York, p.256

The individual is the last source of value and this is the reason why the individual should have autonomy, but this does not mean that it will be isolated from others preferences; collective action are seen as a sum of values and mutual influences. Rational choice means the choice of alternative situations, ordering them to their preferences and without restrictions from the outside.

If in the neoclassical economics, homo economicus was seen as an individual acting on its own, rational and selfish, constitutionalists economists wonder why this postulate is not true for those involved in politics. They can't admit that a person can act in the market, rational, selfish, and only pursuing their own interests and in politics he is purely altruistic.[7]

Decisions should be taken by unanimous choice, at least as far as possible, since only so there are no complaints from those left outside the law. Individuals are the last source of value and decision making must take account of this fact and not by supraindividualistic body like state. [8]

Path dependence

Changing institutions has a great influence on the proper course of business; institutional change is a key component of economic dynamics. But once chosen a particular path of development, this will have path dependence. After an institutions change, the costs to adapt to the new institutions will be higher and will raise problems. Often the rules come from an unconscious cognitive process, become like a routine. These rules should not necessarily be express, or written, but the people have accepted due to a custom practiced by all individuals (such as driving a car on the right side of the road). [9]

Another problem that the institutionalists are debating is whether these institutions can develop into other forms and how they may be subjected to possible reforms. On that issue there can be observed in the literature, contradictory ideas. While North consider the transaction an exchange of goods and the transaction depended on the characteristics of institutions, Williamson puts transaction characteristics to choose the most effective governance structures. The two authors do not accept the idea of an ideal form of organization. North explains how institutional changes affect economic change and how some good institutions may be effective for some and inefficient for some others. The link between economic change and institutional change is the efficiency to adapt to new institutions and shows the degree of compatibility between the economic environment and new social and political institutions.

One of the central themes of the new political economy is a theoretical and empirical explanation of alternative institutional arrangements and their influence on political decisions. The insitutionalists are not denying classical or neoclassical methods; they gave to the economy a social representation, integrating in the analysis the direct sciences and human sciences.[10]

Conclusion

Following the ideas presented above, we concluded that only romantic anarchists may believe that there is a natural harmony between individuals, which can eliminate all conflicts

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[7] Persson T., Tabellini G. (2006), *Democracy and Development*, American Economic Review, 96(2), pp. 319–324

[8] Buchanan J. (1987), *The Constitution of Economic Policy,* The American Economic Review, no. 77, pp.243-250

[9] Frey B. (1990), *Institutions matter*, European Economic Review no. 34, pp. 443–449

[10] Besley T. (2007), *The New Political Economy,* Economic Journal no.117, pp. 540-557

in the absence of rules. We need institutions to live and define our private space in which we operate. These institutions are represented by the invisible hand of the state, or there are the rules of law, or are unwritten practices, but practiced over time. Institutions are the key of the existence and function of a society.
The influence of a specific set of rules puts the mark on a system, and changing them will not lead immediately to a different result; the path dependence makes the system to have a long term orientation.

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