Institutional change and political economy

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After more than a decade of empirical and theoretical work on the political economy of advanced capitalist societies, our knowledge of these types of economies, both how they operate and why they differ, has increased dramatically. It is sufficient to scan the areas where a reasonable (quasi-)consensus has emerged or is emerging to drive this point home. We have a reasonably good idea of why companies in different capitalist systems are organised differently, and of how the institutions governing capital and labour markets influence those differences. We know a lot more of how actors try to work within those systems to shape or reshape them in their image. We have a fairly good idea of how both levels and ‘types’ of economic performance are related to different institutional matrices, and of the impact of globalisation on these differences – reinforcing, questioning or reshaping them. We also understand to some extent how actors use globalisation to reinvent institutional frameworks, and how this might lead to different trajectories of economic change. And the overwhelming picture that emerges from all this work is one of relatively stable different worlds of capitalism -- sometimes focusing on variation between, sometimes within capitalist systems.

This is not meant to give a false impression of idyllic consensus within the field of political economy. The recent rise of rational choice-based theories has, to put it mildly, not gone unchallenged by others relying on more complex, often explicitly political or even interpretative approaches; the debates on the determinants of economic performance are pitting those who believe in the viability of a broadly social-democratic model for Europe against those who argue that it is time to embrace a soft version of the neoliberal orthodoxy, reorganise labour markets and let market forces sort out the problem; and even within the broad group of scholars who agree that capitalism is institutionally embedded, there are important debates about what this embeddedness actually entails. But stepping back for a moment and
looking at these debates from a distance, the overwhelming impression that comes across is that the points of disagreement are quarrels within one family rather than fundamentally different visions of the world. What all of the current work in political economy shares, is an institutionally, politically and socially embedded understanding of economic action and markets, which fundamentally questions the basic assumptions of neo-classical economics, and has led to both a deeper and richer understanding of capitalism in its many forms. In sum, at the beginning of the twenty-first century, there appears little disagreement in the field that there are different models of capitalist economic organisation; the issue that much of the research addresses today is if the institutional and social embeddedness of these differences is sufficiently strong to persist in a rapidly integrating, liberalising world economy. And even within that position it is not entirely clear if the OECD economies are converging on a single ‘liberal’ model, sustaining crucial difference in their institutional frameworks, or fragmenting into different subnational –sectoral or regional—governance models.

While it might seem easy enough to trace the genealogy of this line of arguments back to the late 1970s (and even earlier), we know considerably less about how the real world actually got there, ie. how change occurred over the history of industrial capitalism, what is happening today, and what was at the basis of institutional and economic change. If this is indeed a new frontier to be explored, as many seem to agree, given the critiques of the static nature of much of the ‘comparative capitalisms’ literature, the books reviewed for this article, and the way they reflect a broader trajectory of political economy (which, for the purposes of this article, includes political science as well as institutional economics and economic sociology), are excellent places to start.
Institutional change unpacked

While institutional analysis has always been very strong in comparative statics, it has been much weaker in understanding institutional genesis and change. The origins of institutional frameworks make up the central theme of two of the volumes discussed here. Both Thelen’s analysis of different regimes of skill formation and North’s broader theoretical analysis of how economic change comes about examine the origins of institutions. According to North, economic change is the result of shifts in institutional frameworks.

Institutional frameworks reflect belief systems – intersubjectively held understandings of the world – and some of these belief systems are better suited to ‘adaptive efficiency’ than others: that is, they allow for more flexibility in moving between different understandings of the world and therefore between potential solutions than others are. Underlying this entire construct is the idea, borrowed from evolutionary psychology, that our mental processes are significantly constrained by our origins as hunter-gatherers. Thelen’s argument addresses the issue of how institutions can gradually be transformed. Her core idea is that institutional frameworks never change wholesale, but undergo processes of gradual redefinition and transformation as a result of how actors engage the strengths and weaknesses of existing set-ups. The edited volume by Streeck and Thelen builds on these insights and develops a more general framework for understanding how institutional frameworks evolve beyond the simple dichotomy of continuity and change. Since these volumes arrive in a similar place from different starting points, it makes sense to put these arguments into a slightly broader perspective by reorganising them into four generic debates on institutional change that have become central to this literature.

The first broad discussion in the literature on institutional change is -- in large part related to the strengths of institutional analysis in comparative statics -- between arguments that identify the sources of economic change as
exogenous, and others that emphasise their endogenous nature. If an institutional framework is ‘in equilibrium’ – that is, if none of the relevant actors either see any reason or have the power to shift it in another direction – then change can, almost by definition, only come from outside the framework. Such external challenges can be the result of large systemic shocks, such as wars or a deep economic crisis, or from the (surprising) rise to power of a new group that was excluded in the old set-up (e.g. the Green parties in Western Europe). Endogenous sources of change, in contrast, find their origins within the institutional framework itself, often as a result of the accumulation of small changes (e.g. changes in consumers’ tastes as a result of increasing wealth, the slow appearance of shareholder value in a continental financial system as a result of gradual moves in interest rates, or as Thelen shows, when new elements are introduced that in themselves do not necessarily upset – and might even be designed to improve the operation of – the framework as it existed).

In the real world, however, the ultimate sources of change, endogenous or exogenous, are often overdetermined – there is almost always ‘a bit of both’ going on. Think back at Piore & Sabel’s (1984) seminal analysis of OECD economies after the first oil shock: one of the things that made this work so compelling was the combination of the slow internal exhaustion of mass production and the new forms of competition emerging all over the world and which put pressure on the existing production regimes. In other words, the external shocks threw into relief internal tensions and both the internal tensions and the external shocks were necessary conditions for any meaningful change to take place. Even Hall & Soskice’s analysis (2001) of coordinated market economies leaves open the possibility that, despite the internal robustness of these systems, external pressures toward liberalisation may undermine them, and that some of the cracks that are visible now will become more important. However, if change often has both important
exogenous and endogenous elements, arguments about which one is more important are likely to become vacuous –unless we redefine the initial question: when, if ever, are exogenous sources of change more important than endogenous ones or vice versa? And why and how do the external and internal elements interact?

The second large divide in studies of institutional change is related to what we could label ‘functionalism’. According to the functionalist view, change reflects increases in the performance of the system as a whole or, at the very least, institutional change resolves systemic problems. The opposite view gives prevalence to politics: change is the outcome of actors struggling over the distribution of gains and benefits or, in the limiting case, over a vision of the world that reflects their deep identities. Examples of the first abound in contemporary comparative political economy. Change occurs through positive feedbacks, which reinforce the underlying logic of the system.

The main problem with the functionalist view is, as Thelen & Van Wijnbergen (2003) have argued, that it reads all feedback as ‘positive’, ie. contributing to the integrity and survival of the system. But the world is definitely more complex than that: an interpretation of the current problems in the German economy that is gaining currency, for example, suggests that the interaction between the specific skill profile of the typical German employee, and the increased uncertainty as a result of rising unemployment and deregulation policies, are leading households to save more –thus inducing a sharp drop in private domestic consumption, economic growth and increasing unemployment.1 The virtuous interaction between skills and growth that characterised the German political economy in the past therefore appears to be broken.

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1 Thanks to David Soskice for bringing this argument to my attention.
However, politics, the alternative to functionalism, may well be more constrained by wider functional systemic needs than many of us are willing to admit. The transplant of the much-hailed German training system to both the former GDR and to France was, as Culpepper (2001) convincingly demonstrated, severely limited by the lack of systemic prerequisites in the adopting systems: neither in (most of) France nor in eastern Germany did well-developed employers associations and trade unions exist, and often the Chambers of Commerce that were supposed to oversee the practical implementation of training systems were empty shells. The result was that the attempt to transfer the training system, either wholesale as in the former GDR, or in an adapted version as in France, fell on very dry and inhospitable institutional terrain. Thelen, in turn, shows quite convincingly that the development of the German training system over the past 100 years has been a matter of carefully balancing pre-existing elements in the institutional framework with new needs that emerged. Both systemic needs and politics were at the basis of these processes of institutional adaptation, and in my reading of her analysis, neither of the two ultimately dominated.

How, then, can we think about this interaction between systemic needs and politics? One way might be to be simply more careful about how systemic needs and politics interact: at which point do actors understand the shortcomings of and limits by the existing institutional frameworks and then use their power to move in the direction of a framework that fits their needs better? Another way into this question might be to understand how systemic feedback, especially negative feedback, might shift existing coalitions. Does the vicious circle of skills, savings and low private consumption in Germany alluded to above, open the door to a realignment of the underlying coalitions, with new policies as a result that force the whole system onto another trajectory? Yet another way might be to think of systemic needs as precluding options but without necessarily imposing single scenarios of the world that
might develop within those reduced degrees of freedom (Hancké & Goyer 2005). Any of these approaches may be able to help us develop better understandings of how functional systemic needs and politics interact. But they need to make more explicit the conditions under which new coalitions emerge, or when institutional frameworks shift.

The third organising axis of the debates about institutional change pits models of crisis versus models of continuous adaptation and gradual transformation (see also below). The standard view can perhaps best be understood in terms of punctuated equilibrium models: initially a system is in equilibrium; it then encounters a shock that leads to a crisis which gives way to a new system. The gradual transformation argument borrows from a Lamarckian idea of rapid inter-generational change – and therefore inter-generational learning. (In fact, since the relevant units of observation are single acts, learning takes the form of intra-generational learning as actors learn from their mistakes). Learning in this form is a core element for North, whose book can be read as an attempt to rewrite the implicit argument in Becker’s (1976) last chapter. For Becker, preferences were ultimately determined by our genetic make-up. For a variety of reasons that need not be discussed in detail here, this is clearly not a very satisfactory position: it leaves out the possibility of changes in preferences and ignores the fact that human beings are creative agents. North’s point of departure is that since we now know things about evolutionary psychology that we did not know at the time, we can correct Becker’s model by explicitly engaging consciousness and how that influences institutional change.

The problem is that the simple punctuated equilibrium models, which require a big crisis as a mechanism of change, between long-term path-dependent periods when the world simply ‘hobbles along’, are not very convincing. Are we to understand the last two decades in the OECD-economies as punctuations or as equilibrium? If the former is true (and given
the turmoil that OECD-economies have been in since at least the second oil shock, there are good reasons to assume that we are not in a period of ‘equilibrium’), it would imply that the punctuation lasts longer in time than the period of stability before it. This may not be logically impossible, perhaps, but it certainly does not provide a very strong argument in favour of the model. The learning models, on the other hand, have their own problems. Too often, learning is depoliticised in these arguments, as if actors simply understand that a better world is possible; but policy learning, like every form of institutional change is a highly political process, in which neither the problem nor the institutional arsenal that can be brought to bear on it are given. Obviously actors learn; but learning itself is institutionally embedded, and positive feedbacks emanating from the prevailing institutional framework may circumscribe the capacity for adjustment within a system.

The fourth and final cleavage takes us (finally) beyond the traditional ‘actor versus structure’ debate and explicitly addresses the degrees of freedom that actors have at their disposal. Two types of arguments seem to be emerging there. The first one is associated with radical constructivism (Charles Sabel’s work, as well as that of collaborators such as Jonathan Zeitlin, since the early 1990s has been critical in developing this position). This view emphasises strategic action before constraints: there are, in principle, no limits to the types of solutions that economic actors can bring to bear on problems they identify. Indeed, since even the identification and conceptualisation of a problem is socially constructed, institutions cannot be assumed to have any fixed quality whatsoever --neither for identifying problems, nor for finding solutions (Sabel & Zeitlin 1997). Institutional frameworks matter because they offer elements to construct novel strategies --but these elements are always subject to a protracted process of redefinition and reconstruction, often up to the point that they may have little to do with what they were initially.
The second view could be labelled ‘institutional reconfiguration’. Thelen as well as Streeck & Thelen explicitly develop this, but some of the basic ideas, as they acknowledge, have been around for a while. In essence the argument here is that institutional frameworks never entirely disappear, are reorganised wholesale, or invented anew. Instead, new elements are introduced into existing frameworks without each one of them necessarily undermining them. But as more of these novel elements accumulate, the logic of the initial set-up, and its effects, change dramatically in nature. In the introduction to their edited volume, Streeck & Thelen identify five mechanisms, thus giving us a vocabulary for understanding the process whereby institutions still look the same, but seem to be producing different outcomes. Displacement refers to how dormant institutions come to displace defunct existing ones; layering to new elements that are grafted onto existing institutions; institutional drift to how institutions begin to produce outcomes that are very different from the initially intended ones, conversion to a process whereby existing institutions are used for new purposes, and exhaustion to a situation where the institution simply loses its function.

Both reconfiguration and active construction offer meaningful ways to understand change: actors always reinterpret their situation and evaluate the institutional tools at their disposal (regardless of how these may be interpreted). The outcome of such a process of institutional engagement then may or may not be institutional subversion. But there seem to be two things we need to understand better. One is when exactly institutional frameworks lead to a novel situation (ie. when the path changes); the other the extent to which actors were reflexively designing the institutions with those novel outcomes in mind.

The upshot of this short review of contemporary debates on institutional change seems that any view is not necessarily intrinsically better than any other. We know that change can be exogenous, driven by crisis and
can almost instantly lead to radical change. But we also know of instances where endogenous pressures forced a gradual transformation of the institutional framework that was only recognised as such later on, and perhaps even required the active intervention by powerful actors to realise that potential. Without being more precise about the conditions under which one mechanism or set of mechanisms as opposed to another was at work and why these mechanisms led where they did, this debate runs the risk of becoming very sterile. Similarly, without a more methodologically self-conscious approach, which forces itself to distinguish between interesting examples that can be explored and case studies that offer analytical leverage, this debate is bound to go on for years without a resolution. Since we see the world in a probabilistic way, it is almost always possible to find at least one instance where the opposite of the prevailing interpretation happened; without a clear indication of the methodological status of the case, it is hard to assess how significant such an ‘outlier’ really is.

**Taking stock: elements of a research agenda**

For the sake of this article, think of the work we do as consisting of two different but complementary tasks. The first one is to identify and resolve puzzles, ie. empirical instances which run against the conventionally accepted possible explanations that the literature can give us. Contributions to the social sciences, in this perspective, are never *sui generis*, but have to be framed in a pre-existing debate (even though that debate itself has to be constructed by the researcher –there is nothing ‘objective’ about it). The other is to use that research as a way of making statements about the world that contributes to a better understanding by political-economic actors of what they are trying to accomplish.

If this is a fair description of our work, four areas in particular, all directly related to institutional change in general, and specifically to the
conditions under which some of the mechanisms discussed above operate, seem research avenues worth exploring. The first has to do with the question of institutional complementarities. Implicit in much work on different forms of capitalism, both in the body of literature focusing on the supply-side and in the debates on the welfare state, is the idea that institutional frameworks have some form of internal coherence, i.e. that they operate as systems where every elements influences the performance of the other. Note the sharp contrast with conventional economic methodology, which relies on marginalism: it is possible to change individual elements in a framework to improve overall performance (See Shalev’s recent critique (2005) of multiple regression: if you want to know how about those small changes, regression techniques are fine.) A lot of the processes we study, however, do not involve marginal but systemic changes. What we need therefore is a more explicit engagement, both conceptually and methodologically of the relation between systemic coherence --as expressed in, among other things, institutional complementarities (see Höpner 2005 for interesting contributions to that debate) and institutional change. Do institutional complementarities set limits on the direction of change? Do they help shed light on why 'old' institutions survive (and can they then be resuscitated)? Do theories of institutional complementarities help us locate institutions that meet functional 'systemic requirements'?

A second big issue --and perhaps somewhat surprisingly so, given the origins of the debates on institutional change— is how politics fits into this picture. The political economy literature has, especially in the last decade, been relatively silent on the influence of party politics on institutional change and vice versa (cf. Boix 1999 and recent work by Torben Iversen as important exceptions). Similarly, class structures (often translated in the more clinical term 'distributive conflict') has had a slightly better press, but even so, as Howell (2004) points out, one of the most remarkable things about the
contemporary literature on advanced capitalism is how carefully it treads around class as an organising category. Finally, we know very little of how state action, especially in the shape of legal frameworks, influences economic action. This is not to say that no work has been done on these issues over the last few years; but the relative weight of the analysis, in almost all of the excellent work on contemporary capitalism, is on the economy, and much less on the political processes that have accompanied economic adjustment.

Capitalism as it is emerging in Central and Eastern Europe (CEE) provides an excellent third area to analyse how new institutional set-ups emerge. Quite a few studies focus on single countries, but the real value for the field writ large may well reside in within-CEE comparisons (do the Poles and the Hungarians develop different models of capitalism and why?) as well as in comparisons with transitions to democratic capitalism in Southern Europe in the late 1970s? How important was the fact that these two groups of countries entered democratic capitalism at different moments in time (in the timeline of capitalism); and how important was it that they did so from nominally opposite sides in terms of state ideology and economic structures? What was the role of international institutions (EU, IMF) in shaping the trajectories of the different countries, both within each group and across them? And how can studies of CEE address more explicitly the political economy frameworks that have been developed for the OECD countries: how does what happens in CEE relate to the theories and arguments that allow us to understand capitalism elsewhere?

Finally, we also need a more direct engagement of processes of policy learning, benchmarking, and conditionality. Remember that we are increasingly living in a world where everybody is looking across borders for inspiration, and where international organisations such as the EU, OECD, IMF, and ECB impose some form of soft and/or hard convergence. While learning, benchmarking and institutional transfer are always political
processes (neither defining what is learned, how and by whom are politically neutral decisions), their effects are frequently not clearly identifiable and we know little—although increasingly more—about the particular ways that such ‘learning’ and benchmarking processes influence domestic processes.

There is a last issue which requires some reflection: the inter- and (multi-)disciplinary nature of political economy. As I pointed out in the opening paragraphs of this essay, there appears to be a relative consensus on a few core points in the field of political economy as it has developed over the last two decades. The first is diversity, related to differences in institutional frameworks, and their effects on the distribution of power among relevant actors. The second relates to the institutional frameworks themselves, which are not static, but adjust to new challenges, either through a reinterpretation of these new challenges into things actors know how to handle, by reconfiguring themselves, or, in the limiting case, by replacing old with new institutions (but note that ‘old’ institutions rarely entirely disappear and often can be resuscitated later on, as Thelen as well as Streeck & Thelen argue).

Stepping back from the debates as they grew within political science, what appears to be missing in the debates is a more explicit bridge between the different disciplines engaged in these debates. The book by North (2005) is perhaps the most salient illustration of this problem: the project on the genesis of institutional frameworks he is embarking on in his book may constitute a gigantic step for economists (and for narrow-minded rational choice political scientists), but much of the political economy literature of the last two decades has been debating his core points for a while. In fairness, and despite the difficulties that we may have with the arguments that North develops, he deserves credit for opening this debate to economists. But the problem is that the book simply sidesteps a large empirical and theoretical literature in neo-institutionalism. North’s reference to genetic predispositions and how they translate into the ability to learn and therefore adjust simply ignores the major
steps that have been made by political scientists in endogenising sources of institutional change: rather than looking at the cognitive development of the human brain, as North does, political scientists would argue that institutional change has its roots in the political-economic processes themselves.\(^2\) If endogeneity is indeed an expression of parsimony, political scientists have not done badly –why then are many economists oblivious to these contributions?

Political scientists have been considerably better in embracing the contributions of economists. Methodologically, rational choice and game theory models have become part of the stock in trade of political scientists. And most of what is published under the broad rubric of political economy these days explicitly engages standard explanations in economics, tries to incorporate these into research designs and then either builds on or attempts to refute them. Importantly, whatever ultimately happens to those arguments, they are never ignored (even though there are some particularly prosaic versions of what economists think that are doing the rounds in political science circles). North’s book, however, does not offer a single reference to any of the debates that I addressed above --not even those, such as Pierson (2000) or Hall & Soskice (2001), that explicitly engage core concepts in contemporary neo-institutionalist economic theory and could help economists understand how to use their own concepts more creatively. Disappointingly, despite the growth of rationalist models in political economy, and despite the increasing importance of arguments built on strategic action --both steps in the direction of a common conceptual language between political scientists,

\(^2\) In fact, the way North goes about in his book is an unpleasant reminder of the literature on 'Political Economics' that has become fashionable in recent years (Persson & Tabellini 2000): it starts from extremely simple --even simplistic-- assumptions about politics and politicians, without any reference to the last 50 years or so of post-war empirical political science. The problem is not that political scientists are right, but that there are highly sophisticated arguments in those debates that are not even mentioned, let alone engaged in the new 'Political Economics' literature.
sociologists and economists—few economists engage the arguments produced in that literature.

The fact that the different debates are evolving alongside one another with the cross-fertilisation going in one direction only, is a product, no doubt, of the academic division of labour that is expressed in disciplines with their own journals and departments that reward scholars for publishing in these journals (and probably also of the imperialistic attitude of economics vis-à-vis the other social sciences). But this balkanisation of the literature has not helped us in the past, leading as it often does to a reinvention of the wheel, or worse, a colonisation of existing debates without much regard for what was there already. If we want to understand both contemporary capitalism and how it is changing, therefore, we all need to be more concerned with looking across the borders of the disciplines, engage the substantive debates in the different disciplines that make up the broad field of political economy today, and be more aware of the strengths of different methodologies. Political scientists have made the first steps in that direction. Let’s hope others follow suit.

Bibliography


