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VALUES, INSTITUTIONS, AND ETHICS

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Abstract

Economic systems are built upon the foundations of the ideas and values of a particular society, and on a number of institutions and social norms, whose main function is to limit and guide human actions and behavior. Many social institutions and norms are the result of human action, but not of human design; they are stores of social experience accumulated over time whose efficiency goes beyond the results of the best plans human reason may construe. Many theoreticians contend that the morality of institutions is guaranteed by the process of social evolution. This means that either these moral norms are a kind of social institution –and thus contingent, relativistic and unable to control the morality of the other institution–, or that institutions are not subject to the control and guidance of ethics, because a kind of invisible hand takes care of them. The purpose of this paper is to study the characters and functions of institutions, the processes of change they undergo, and their relationships with ethics. We conclude that ethics are superior to institutions and necessary to control them and to verify the morality of institutional change.

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VALUES, INSTITUTIONS, AND ETHICS

Our economic system, the market economy, forms part of a broader system or “society”. We frequently study the operation of the market economy as if it were autonomous, even though there are many complex and mutual relationships between society, the economic system and the other systems -political, cultural, religious, legal, etc.- that form part of society.

In a market economy we may identify several components:

1. The historical, geographical, sociological, political, religious and cultural *frame* or *background* in which the economic activity takes place.
2. The set of *values and ideas* of the society. These ideas include descriptions, interpretations and representations of the world, the individual and society, as well as various theories, doctrines, ideologies and opinions. The values include basic and derived principles, precepts and imperatives that people give themselves, or that they receive and accept as a way of governing their behavior. Both values and ideas may be a part of the previously mentioned frame, but they deserve a specific mention.
3. *Theory* on the workings of the economic system, *i.e.*, the explanations - scientific or not, usually incomplete, and not always mutually compatible - about the relationships among economic - and also non-economic - variables. It may also be considered a part of the ideas mentioned above.
4. The set of *institutions, norms and rules* that control the economic behavior of people. Many of these institutions are also common to other systems - political, cultural, etc. -, which have their own specific sets of norms and institutions.
5. The *incentives* or *motivations* of the economic agents. I hesitate to label them as a specific element of the economic system because they are so interrelated with values and ideas that, in a sense, they form a whole; and moreover, because there are no specific *economic* incentives.

The play of these elements defines the operation of a market economy. In short, the *incentives* of the economic agents meet the restrictions and limits imposed firstly by the general *frame* and the history -the endowment of resources, for example- and secondly by the *institutions, norms and rules*. The result is a *division of functions* in society in order to attain the goal of the system, *i.e.*, economic *efficiency*.¹

¹ On the market economy and the role of institutions see Argandoña (1988, 1990a, 1990b, 1990c, 1991a, 1991b).

What is the *role of ethics* in an economic system? Does ethics form part of the institutions, norms and rules, or does it belong to the set of values and ideas? These questions are very relevant. If the ethical norms belong to the realm of institutions, (1) they will be purpose-oriented, contingent, and relativistic; (2) the other institutions and social norms will be independent of the ethical ones - or at least they will have contingent relationships with them; and (3) the set of values and ideas will not be subordinate to ethics, as institutions are the results of those values, and not the other way round; or alternatively, (4) there should be a set of superior ethical norms that rules the realm of values and ideas, and another set of second-level ethical norms that govern institutions - but, then, the question of the coherence between both sets of ethical rules arises.

In this paper I will discuss the role of institutions, norms and rules in society, with special reference to the economic system, in order to gain insight into the relationship between institutions and ethics. We discuss first the concept and features of social institutions and norms; second, we look at institutional change, and third, we deal with the relationship between ethics and institutions. The article ends with the conclusions.

Institutions

The aggregate behavior of a society is not the simple sum of the behavior of the men and women that make it up. There are intermediate structures that limit and guide the actions of people towards some social ends. We will label these intermediate structures *institutions* in a generic sense. A social institution is “a regularity in social behaviour that is agreed to by all members of society, specifies behaviour in recurrent situations, and is either self-policed or policed by some external authority” (Schotter, 1981, 11)².

Institutions in this broad sense may be sets of rules that *limit* individual behaviour and *define the social outcomes* that result from these individual actions. They may also be *unplanned and un-looked for regularities* that emerge organically in social behaviour.³ As *regularities*, they are types of human behaviour (though spontaneous) and not passive elements of the historical, political and physical frame. They are *social*, not individual. They refer to *repetitive situations*.⁴ They receive *social acceptance*, inasmuch as all or at least a majority of the members of the society share them and support them.⁵ Their function is to *limit, restrict or specify the behaviour of individuals in specific situations*, so that a regular and stable pattern of behaviour is created.⁶ This means that institutions also provide *information* about other people’s expected

² North (1981), 201-202, defines institutions as “a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals”. We prefer Schotter’s definition as it is more complete, avoids the inclusion *by definition* of the moral and ethical norms, and avoids also the reference to the human design.

³ Cfr. Schotter (1986).

⁴ This is why many experts treat institutions as the solution to repeated games; for example: Lewis (1969), Nozick (1974), Hammond (1975), Kurz (1977), Ullman-Margalit (1977), Schotter (1981), Sugden (1986), Eggertsson (1990b). There are also other explanations of institutions based on altruism (Schwartz, 1970; Becker, 1974; Collard, 1978, ch. 10; Arrow, 1981, and Margolis, 1982), or on the sociobiological approach (Wilson, 1975; Axelrod, 1984).

⁵ The approval or disapproval of a behaviour - including *external* shame, guilt, anxiety, punishment, etc. - means the social acceptance of the institution; there may also be *private* reasons for this acceptance, other than the social ones. Acceptance does not necessarily mean liking or enjoying something. It may be less than a hundred per cent: the relevant condition is regularity of behaviour, not the percentage of approval.

⁶ Cfr. Jackson (1990), 13.

behaviour.⁷ Institutions may be *auto-policed*, *socially policed* or *policed by an external authority*. And obviously, they leave room for *exceptions* (for example, cannibalism in case of hunger, or nationalization of property in case of public need).

In defining institutions we must include several kinds of norms and conventions, and exclude others. *Social customs* are included, as well as self-policing *social conventions*, *social norms* (which reinforce the patterns of behaviour, making them especially desirable or obligatory)⁸, *shared understandings* (which may be nonsensical for people of other societies or other epochs), and *social standards* (which lack the idea of a duty that is inherent in social norms)⁹. We are not interested in the precise definition of each one of them, as they frequently overlap. In any case, institutions include *spontaneous orders*¹⁰ (*i.e., they are the result of human action, but not of human design*) as they appear to be the impersonal consequences of social evolution. However, they also include *legal norms* created by a conscious act of men and enforced by an external authority, and even *organisations* (like the United Nations or General Motors), although they are the result of the action *and of the design* of men. All of them, evolutionary or not, are social institutions that rule the social behaviour of persons, either through formal arrangements or through informal norms, and this is why we are interested in studying them.¹¹ Moreover, these consciously designed institutions or organisations are frequently the *specification* of undesigned and evolutionary ones (just as, for example, Nestlé or Asean Brown Boveri are specific examples of the legal institution called *company* and of the economic institution called *firm*, and the French civil code specifies general institutions like *private property* or *inheritance* for a specific place and time).

The interaction of people in repeated situations gives them a superior knowledge of the interests, attitudes and behaviours of other people and of themselves, through a process of learning¹². This is why institutions *save decision and transaction costs* by collecting and spreading information¹³ and *social experience* and, at the same time, are loaded with ethical meaning. The role of institutions derives from these functions:

1. They *aggregate individual choices and preferences* in such a way that the outcome is not the mere addition of those actions and preferences - and this is due to the process of selection and admission or elimination of alternatives that the institution performs.
2. They *limit and guide human behaviour* - or rather, to be precise, the structure of *incentives* that guide human behaviour. This task of socialization may be achieved by developing behaviour from within (*i.e., making explicit their internal limits: psychological boundaries to knowledge, historical or traditional barriers, etc.*) or from without (for example, through the law).¹⁴ This may be done, first, through *incentives*, rewards or punishments, explicit or not, that lead to a re-evaluation of the alternatives;

⁷ Cfr. Bicchieri (1990), 840.

⁸ Cfr. Pettit (1990), 725; a definition of social norms in p. 751.

⁹ Cfr. Pettit (1990), 728.

¹⁰ Cfr. Hayek (1967, 1973, 1983, 1988), Nozick (1974), Buchanan (1975), Ullman-Margalit (1978).

¹¹ This is the reason why we don't include *individual norms* (not enforced by social approval or external authority, and frequently not shared by others), *individual habits* (private, not compulsory), *neurosis*, *psychological states*, etc.

¹² Obviously, agents and institutions interact, so that mutually change and adapt.

¹³ They are "interpersonal stores of coordinative knowledge" (Langlois, 1986b, 237). Cfr. also Frey (1990), Langlois (1986a).

¹⁴ Cfr. Jackson (1990), 11-12.

second, through *exhortations* that exploit the interdependence of utilities or manipulate them, or, third, through the *spread of information*. In any case, the ethical content of institutions is obvious.

The study of institutions and norms has experienced a great development in recent years. However, we are interested neither in institutions as such, nor in questions concerning the compatibility of rationality and institutions,¹⁵ efficiency as a normative predicate of them, or the trade-off between efficiency and flexibility.

Institutional change

Institutions are stable, but not unchanging, and the analysis of their changes¹⁶ is useful in helping us to clarify the relationship between institutions and ethics. There are three main causes of institutional change:

1. *Changes external to the agents*

There are many *variables external to the agents* that may induce a change in institutions - for instance, the growth of population (which alters the appropriate property rights), the endowment of resources, the available technology, the information set, constitutional law¹⁷, the market size, the cultural endowment of the agents (including tastes, beliefs and traditions), and many others.

The theoreticians of the *spontaneous order*¹⁸ maintain that, once a change in external factors occurs, cultural evolution will find and enforce the institution best fitted for the welfare of society.¹⁹ But this is an act of faith in the evolutionary order.

First, *there is no evidence that the best institution will be discovered*, unless we tautologically define any spontaneous institution as optimal. Moreover, the means society uses to introduce institutional innovations - trial and error, prestige of a minority, fashion, flashy behaviour, analogy, etc.-²⁰ are far from being a guarantee of rationality.

Secondly, the optimum institution must *win the approval of the majority*, a process that is far from inevitable in the short term.²¹

¹⁵ Cfr. Langlois (1986b), Williamson (1986), Elster (1989), Hargreaves Heap (1989).

¹⁶ Ullmann-Margalit (1990) uses *alteration* as a generic word for any change of norms; *change* when the alteration is spontaneous; *revision* when it is the result of the intentional action of an authority, and *appearance* or *disappearance* as special cases. Cfr. also Ullman-Margalit (1977). Here we use a loose terminology, with *change* as the generic word.

¹⁷ On the importance of constitutional law for institutional change, see Nicholson (1988).

¹⁸ A paradigmatic example is Hayek (1988).

¹⁹ The way these changes operate is not clear. A change in relative prices will probably occur, *i.e.*, in the incentives that rule human behaviour, making a kind of action profitable that previously was not; nevertheless, this process is not clear, nor devoid of contradictions (like the failure to adopt a socially beneficial institution or norm) (cfr. Elster, 1989). Moreover, new knowledge is provided to some agents, making a kind of action or institution feasible that previously was not. And finally, there is a place for *entrepreneurship* to identify new opportunities and to set in motion an institutional change.

²⁰ Cfr. Sugden (1989).

²¹ Cfr. Feeny (1988).

And thirdly, *the process will not be smooth and without costs*. The very change of an institution means that the whole set of social costs and benefits of related institutions will change,²² so that even the very notion of the “best” institution may lack sense (in fact, many scholars of institutional change agree that an optimum may be unattainable).

In the short term, then, the institutional change may be efficient or not, so that *the criterion of social evolution is not suitable* for judging its efficiency.

In the long term we may even admit that social evolution will bring about an efficiency optimum, but only if two additional conditions are fulfilled: (1) a very long time span, so that experience can accumulate (and the opposition to the innovation may be defeated),²³ and (2) low costs of transaction and adaptation, in order that the advantages of the new institution may prevail. Therefore, in a free market economy with rational agents the spontaneous institutional change may drive the economy towards a set of efficient institutions, but *only as a tendency and in the long term*.

Moreover, in the previous discussion we spoke of *efficient* alternatives or *efficient* results. But, are they *ethical*? Could social evolution guarantee the morality of the new institutions? If our answer is not conclusively affirmative in terms of efficiency, it will hardly be so in terms of morals. The end of the market mechanism is efficiency, not morality; hence, institutional changes enhancing the ability of the market to attain its ends contribute to efficiency, but not necessarily to morality. As a result of this Ethics has an independent role in the judgement and appraisal of institutional change.

2. Policy-induced changes

If we cannot disregard ethical criteria when considering spontaneous institutional changes then we certainly cannot do so when dealing with authority-induced institutional changes. In this case we cannot claim the existence of an invisible hand that turns any political decision into an ethical one. Thus, policy-induced changes guarantee neither efficiency²⁴ nor morality. Once more, there is a role for ethics in institutional change.

3. Value-induced changes

Changes in values and attitudes are also a cause of institutional change. In reality, the ultimate reason for such changes may also be the change of an external variable. For example, the growing popular attitude against slavery may have been the result of changes in the economic structure, but there is no doubt that many voices had protested against it over the centuries. Likewise, the changing role of women in our society may be the effect of economic and technological developments, but it is also the result of a change in ideas and values.²⁵

²² Cfr. Sugden (1989).

²³ On the problems of institutional transition, see Ostrom (1988).

²⁴ Some authors argue that the government intervention in the free market economy is always and necessarily inefficient (and, then, immoral). Cfr. Hayek (1988).

²⁵ On the effects of changes of ideas and values (or ideology) on norms and institutions, see Eggertsson (1990a).

Obviously, as values are not morally neutral, the institutional change induced by the change of values also needs to be evaluated in terms of its ethical impact.

Institutions, ethics and values

What are the relationships between ethics and social institutions and norms? Must institutions be ruled by ethics? Or do moral norms form a part of institutions and social norms, so that there is no ethical check on these? Although we provided some answers to these questions in the previous discussion, in this section we will further develop the subject.

In the first place, institutions are always the result of human action, be it purposeful or not. And as there are no ethically indifferent human actions, *by virtue of their origin*, they always have an ethical content.

Secondly, we maintain that *ethics is not a class of social institutions, norms or rules*.²⁶

1. Institutions and social norms – or at least some of them – may be used to *manipulate* other people, and this raises ethical questions that could not be solved if ethics were only another institution or social norm.
2. Ethical norms are not adhered to only out of *personal interest* (including social pressure). People behave in a moral way even if their private actions remain unknown to other persons (because of the learning process that ethical behaviour consists of).
3. Social norms are supposed to promote the *social good*, but this cannot always be tested or proved.²⁷ So therefore, a superior criterion, ethics, is necessary to make a judgement.
4. Social institutions and norms appear in *specific recurrent* situations, but ethics applies also to non-recurrent situations, and consists also of general, non-specific principles.
5. Ethics has an *individual* dimension in addition to the social one, so that it cannot be reduced to a set of social norms or institutions.
6. If ethics is a *normative* science it cannot be reduced to a description of social institutions. And, as we showed before, the normative content of social evolutionary institutions is at least very limited.

Do we really need ethics to judge institutions and social norms *from without*? The point of view of Hayek (1988) is opposed to this notion: institutions must be judged from within because the agents' belief that they must obey these institutions comes from social evolution, just like the institutions themselves.²⁸ But Hayek's assertion comes from an act of faith in social evolution

²⁶ This is also the position of Elster (1990), 864-865 (he refers to norms, but his arguments may be also applied to institutions in general). He argues: (i) that social norms are not consequentialists, as utilitarian norms are; (ii) that libertarian norms rest on consequentialist permissions, but social norms are social obligations, and (iii) that Kantian moral norms are not consequentialist, and so are coincident with social norms. We don't share this point of view, as we maintain that ethical norms are *always* superior to the social ones.

²⁷ Cfr. Elster (1989).

²⁸ Hayek recognises the need for some traditional *ethical* institutions (family, property, etc.) in the market economy, but he is not able to justify them from outside, so that finally he must support them in other norms embedded in traditional practices, i.e., through social evolution. Cfr. Warner (1988-89). Hayek's incapability to justify those institutions shows the limits of his anthropology.

(as was mentioned before) because he cannot prove that evolution yields the best solution either from the economic or the ethical point of view.

Hayek is right in his attack on *constructivism*, the ideology that asserts that one agent (or a group of them) is able to grasp all the relevant information needed to rule the social and economic life of a modern community. Hayek asserts that the experience accumulated in social institutions and norms will allow the creation, storing, processing and dissemination of the relevant knowledge better than any singular person or group could do it –and specifically that the market will perform better than any central planning agency. But this does not mean that human reason cannot identify the errors and flaws of the system– although it is not able to rebuild and improve the whole system.²⁹

Nevertheless, for the task of valuing and judging the system as a whole and its parts to be performed, human reason *needs a guide*. What is more, this *cannot be fulfilled by Hayekian moral norms* and institutions because they are always evolving, meaning that we cannot produce any evidence that they, in their present stage of development, are right and definitive. Hayek's surrender to social evolution as the basic criterion of right and good prevents him from finding a more general and stable rule in, for example, human nature or natural law.³⁰ As we said before, his criterion – the long term survival of a society – is a very arguable one, and not only on ethical terms.³¹

Let's move ahead a little, and ask what we could do as social scientists, as civil servants or simply as citizens in the face of an evolutionary social system, other than free it from any government intervention.³² There is no answer except to live within its norms and institutions. This means that from the scientific point of view, Hayek's theory is a kind of *determinism* – a logical consequence of evolutionism, be it biological or cultural. Even freedom is not a human task, as evolution takes care of it.

To escape from this intellectual trap, we need to find a better role for reason, and consequently a new function for ethics. *Reason* is the capacity of the human being to identify his or her end and to choose the means to achieve it. Hence, reason helps us to judge the ethical contents not only of human actions and behaviours, but also of social institutions and norms. Reason is extremely limited, so the building of a whole economic system is beyond its reach: in this, Hayek is right. But reason allows us to understand that some actions, behavior and institutions are harmful for the agent himself and perhaps also for others. This means that *the rules that govern the attainment of people's ends –the rules of ethics– are superior to their actions and also to the institutions that they create, purposeful or not*. In this sense, ethics is a *meta-institution* in relation to social institutions, and belongs to the *realm of ideas and values*.

²⁹ “His [Hayek's] generalisation of the understanding of the spontaneous order of the market to the evolution of the institutions that constrain this order must, I think, ultimately be rejected” (Buchanan 1988-89), 3.

³⁰ Bouckaert (1988-89), 19-20, and Huerta de Soto (1988-89), 10, maintain that the position of Hayek may be made compatible with natural law.

³¹ Sugden (1988-89), 15-16, shows that the superiority of a society may be due to extra-ethical reasons, and Gordon (1988-89), 17, argues that the survival of a group is not a proof of its superiority even in terms of biological evolution.

³² The question is Witt's (1988-89), 7.

Conclusion

The theoreticians of the *invisible hand* were usually optimistic about the capacity of a society to change its institutions and norms *in a direction that was always positive* for mankind, without the intervention of any ethical norm or rule. But their optimism was based on the hypothesis that social evolution always changes institutions for the better. We don't share this deterministic view either in the technical aspect - economic efficiency - or in the ethical one. The arguments for social evolution driving society towards an economic optimum *without the guide of ethics* are unconvincing. And there are no reasons for the attainment of an ethical optimum.

But if *ethics* controls the process, we may hold to this optimistic conclusion. A society of individuals with strong ethical criteria and behavior will provide the framework for a correct evolution of institutions - with errors and failures, but with many more successes. A society of morally sick individuals will be ruled by egotism, greed and arrogance, and their institutions -the barriers that were intended to check and limit unethical behavior- will hardly prevent its failure in the long term.

This means, *firstly*, that ethics, whilst inspiring the ideas and values of the society, may help the social evolution process in *producing a set of institutions and social norms that are both efficient and ethical*. *Second*, ethics provides criteria to *judge the morality of social institutions and norms*, as well as of behavior and actions. *Third*, these (ethical) institutions will *constrain the behavior* and actions of men and women, *driving them not only to efficiency, but towards morality*. *Fourth*, ethics also provides a *framework for the development and change of institutions and norms*, inasmuch as moral people with ethical ideas and values will organize the institutional change, even if spontaneously, towards ethical ends: the good of each individual and the good of others. And *fifth*, ethics is also a criterion for *judging institutional change*: a change that breaks an ethical rule cannot be an ethical way to attain a better society.

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