BOOK REVIEWS

Policy Analysis and Public Choice
William A. Niskanen
Northhampton, Mass.: Edward Elgar, 1998, 430 pp.

This volume is one of those happy cases in which the sum is greater than its individual parts, impressive as those individual parts are. This collection of essays by William Niskanen shows the impressive breadth of his contributions to applied economics, policy analysis, public choice, and constitutional political economy. Those contributions cover a wide range of policy issues from defense economics to crime, drugs, education, regulation, welfare policies and trade, monetary and fiscal issues, as well as positive and normative public choice analysis, political philosophy, and constitutional analysis.

Few economists have enjoyed Niskanen's range of high-level professional experiences. He started his career as a defense economist at the RAND Corporation and the Institute for Defense Analyses, and then had a stint as one of the ‘‘whiz kids’’ at the Defense Department, under Robert McNamara. Niskanen broadened his horizons as an assistant director of the Office of Management and Budget during the Nixon administration, and held senior faculty positions at a top public policy program (University of California, Berkeley) and a top management school (University of California, Los Angeles) sandwiched around a private-sector position as director of economics at Ford Motor Company. In the early 1980s, he returned to Washington, first as a member of the Council of Economic Advisers and then as chairman of the Cato Institute.

Niskanen's breadth of experience is well reflected in these essays, and they make it easy for us to understand how he has excelled in such a wide range of professional settings. While the essays will already be familiar to public choice scholars, any public choice researcher will gain new insights by sampling the breadth of Niskanen's contributions. (His marvelous essay on ‘‘The Reflections of a Grump’’ is this reviewer's favorite.) The volume's greatest value, however, is to students and young professionals who are making important career choices and developing

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their professional philosophies. For those who fit those categories, I cannot think of a more valuable read.

Like many of the best treatments of methodology, Niskanen's are short on explicit discussion and long on good examples. The entire volume is an eloquent confirmation of Niskanen's cogent comment that "wisdom cannot be taught but can be learned." And much there is to be learned from his essays. He has one of the most original minds in modern economics, not for career-making giant ideas—with the exception of his pathbreaking development of the economics of bureaucracy—but for his continued provision of fresh insights into a multitude of important issues. Niskanen's views are mixed with a huge dose of common sense and strong philosophical views that do not fall prey to the ideological blinders that so often plague policy discussions from both the left and the right. In other words, Niskanen demonstrates an unusual degree of immunity to the widespread tendency to conflate one's positive and normative analyses.

His work illustrates the value of analysis through simple lenses. He appropriately warns of the problems of "the standard practice of young economists," which is ". . . to bring advanced techniques to bear on standard problems," and of the resulting tendency to overlook important questions. And he suggests that, "As a rule, it is better to be roughly right rather than precisely wrong." Niskanen stresses the importance of "recognizing what we do not know" and the multiplicity of political forces that operate in various policy arenas. Many of his papers are wonderful antidotes to the all-too-widespread tendency to base policy recommendations on the perspective of a single public choice theory, such as rent seeking or median voter models. His essays also illustrate the tremendous scope for a positive synergy between policy analysis and public choice considerations. Too often public choice scholars treat the former as the exclusive domain of naive public interest do-gooders, while a decreasing but still significant number of policy analysts remain ignorant of public choice analysis or perceive it only as a source of ideologically motivated right-wing attacks on government.

On several occasions Niskanen grapples with the role of ideas in the policy process. In a moment of gloom he wonders whether public choice analysts "have much of interest to tell the rest of the world," but his personal contributions alone illustrate that the answer to his question is a resounding yes. A curse of public choice theory is that the same types of normative analyses that suggest widespread scope for improvements in policymaking and the structure of political institutions also suggest the positive prediction that such reforms will be difficult, if not impossible, to implement.

In confronting that dilemma we could do worse than emulate Niskanen's attitude of "optimism about the possible and pessimism about the probable." As he points out, "A policy adviser with strong views about what government ought to do (or not do) must learn to live with frustration."

We are fortunate that for so many years Bill Niskanen has been able to cope with that condition.

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Globaphobia: Confronting Fears about Open Trade
Gary Burtless, Robert Z. Lawrence, Robert E. Litan, and
Robert J. Shapiro
Washington: Brookings Institution, 1998, 150 pp.

Americans vote everyday with their dollars for globalization and, increasingly, reap its benefits, but they remain skeptical about the concept of open markets and economic integration. Bringing sense to that paradox is the focus of this pithy and user-friendly book.

The authors, all market-oriented New Democrats, bring a wealth of data, economic arguments, and real-world examples to bear on what could be an imposing subject. By using language that is accessible to a broad swath of readers and with the aid of more than 40 charts as illustrations, the authors explain the benefits of free trade and foreign investment, and then tackle the most commonly heard objections to growing U.S. engagement in the global economy. The book offers an effective antidote to the anti-trade bromides being peddled by the likes of Pat Buchanan, Global Trade Watch, and the AFL-CIO.

The opening section, "The Virtues of Openness," explains how trade leads to higher production by encouraging nations to specialize in what they can produce most efficiently, compared not only with other nations (absolute advantage) but with other domestically produced goods and services (comparative advantage). The competition stimulated by trade fosters innovation in production methods and new products, which results in better and more affordable goods for consumers and rising real wages for workers.

Like free trade, the flow of capital across borders enhances a nation's well-being by directing resources to their most productive use. Foreign investment in the United States has blessed us with lower interest rates and helped to introduce new production techniques, such as quality circles and just-in-time delivery. Investment abroad allows Americans to diversify their portfolios and reduce long-term risk, and also enables American companies, especially those in the service sector, to gain a foothold in foreign markets. "By investing overseas, American firms are in a vastly better position to gain the local knowledge that they need . . . to tap into markets around the world," the authors write.

The authors hit all the right notes on the contentious issues of the effect of trade on jobs, wages, regulatory standards, and national sovereignty. They slice and dice the myth that trade is all about creating jobs.

Although trade affects the level of employment within selected industries, they argue, the overall level of employment in an economy is determined by domestic factors such as labor-market flexibility and a stable monetary policy. "Trade is not about generating more or fewer jobs, but generating better jobs and a higher national standard of living," they write.

As evidence, the authors note that in the 1990s, as the U.S. economy has become more global, total employment has soared by more than 14 million and the unemployment rate has dropped to a three-decade low. One of the many helpful charts in the book shows a strong correlation since 1960 between the rise of two-way trade (exports plus imports) and total employment.

In one of the more politically savvy passages, the authors point out the hazards of using the job-creation argument to sell trade liberalization. In the debate over NAFTA, supporters of the agreement argued that it would stimulate net exports to Mexico and lead to a net creation of jobs north of the border. The peso crisis of 1994–95 plunged Mexico into a deep recession, which, almost overnight, turned America's bilateral trade surplus with Mexico into a deficit.

In reality, those events had only a small impact on the giant U.S. economy, which is more than 20 times bigger than Mexico's. But they did open the door for NAFTA's critics to turn the exports-equal-jobs argument on its head by blaming the bilateral trade deficit for hundreds of thousands of alleged job losses. The real benefit of NAFTA all along, the authors rightly note, was to lock in reforms in Mexico, which it did, but that is not how the public perceived its effects. "Indeed, discomfort over NAFTA has since played a significant role in souring the public mood toward freer trade in general." The authors conclude, "The moral of this story is that it does not pay to use bad economic arguments, even to sell good policies."

As for the impact of trade on wages and inequality, the story is more complicated, but the ending is the same. The authors acknowledge that average hourly wages, deflated by consumer prices, declined from the mid-1970s through the early 1990s, but this represents only part of the story. When other forms of compensation, such as nonwage benefits, are included and when compensation is deflated by the price index of the goods workers actually produce, it turns out that real compensation has actually been rising, and at virtually the same pace as productivity. The cause of slower wage growth since 1973, then, has not been trade, but slower productivity growth. It is no coincidence that as productivity has picked up in the last three years, so too has average compensation.

Growing wage inequality is also wrongly pinned on trade. The authors note that the growing gap between wages earned by workers with one to three years of college and those without a high school diploma has been driven by technological changes within our economy, not by trade. As evidence they note that the college wage premium is uniform across industries, whether their trade is foreign or purely domestic.

Globaphobia skillfully dismisses the notion that America suffers a disadvantage in global markets because of an unlevel playing field. Differences among nations in their regulatory regimes are a natural outgrowth of differing levels of development and national preferences. The authors advocate a "live and let live" approach, in which nations are free to determine their own tradeoffs between output in certain sectors and the level of pollution that is socially acceptable. "The countries with tougher pollution standards will get what they want: less pollution. The country with lenient standards will get what it wants: more output from pollution-intensive industries," they write. Even the most sacred cows of trade policy, the antidumping laws, come under attack in the book because they punish foreign producers for engaging in behavior that is perfectly rational, and legal, for domestic producers.

Finally, the authors drive a stake into the fear that trade treaties and membership in the World Trade Organization compromise America's "sovereignty." The modest legal and economic constraints of the global trading system allow wide latitude for nations to craft regulatory and welfare systems that match their own social preferences. Just consider the real differences between the United States and Canada. Canada has been able to maintain its more expanded welfare state alongside growing trade and integration with its economically dominant neighbor.

Entering into trade agreements should be seen as an exercise of national sovereignty, not as a surrender of it, the authors argue. "The real issue raised by international trade agreements is not whether they reduce national sovereignty, but whether the specific obligations and requirement that they impose on a nation are greater or less than the benefits that nation receives from applying the same requirements to others (along with itself). According to this standard, the benefits to the United States of joining the WTO vastly outweigh the costs."

If only the authors had stopped there, but in the final chapter they go on to propose measures that will, in their view, make globalization more politically palatable. "When open trade policies that benefit the country as a whole also extract a price from certain groups of workers, the country has a responsibility in some way to make amends. In addition, failing to do so would court a growing voter backlash that could reverse the progress already made toward more open markets and unravel the economic gains that the United States has enjoyed as a result of this progress," they warn.

Their central proposal is state-run, federally funded "time-limited earnings insurance." The program would replace 50 percent of any displaced worker's earnings should his new job pay less than the one he lost due to trade competition, with a ceiling of $10,000 in payments per year. So, for example, "a worker who previously earned $120,000 but was paid just $60,000 in a new job would be compensated at the ceiling amount of $10,000," raising that worker's new compensation package to $70,000 a year. They suggest funding the program by "slightly increasing a very broad-based tax, such as the personal or corporate income tax."

Their idea fails on two fundamental counts. One, it is not at all obvious why the country should "make amends" to people put out of work by more open trade. More than three-quarters of the approximately 2 million Americans displaced from their jobs in each of the last three years were working in the retail, wholesale, and services sectors, which are largely insulated from trade. Those workers lost their jobs because of new technology, more efficient organization, and changing consumer tastes. Surveys have shown that people put out of work by import competition do not face any special hardships that are not common to people who lose their jobs for other reasons. So why should they receive special treatment?

Second, higher taxes and targeted wage subsidies seem a poor way to build political support. Imagine the hay Pat Buchanan could make out of a special "trade tax" on our incomes so that somebody earning $60,000 a year can receive an extra $10,000 to help make the payments on a second sport utility vehicle!

The best way to build support for free trade and foreign investment is not to expand the welfare state at the margins, but to keep doing what the authors of *Globaphobia* do so capably for the first 126 pages of their book: Tell the truth about what economic openness means for the vast majority of American workers and their families.

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Unintended Consequences: The Impact of Factor Endowments, Culture and Politics on Long-Run Economic Performance
Deepak Lal
Cambridge, Mass.: The MIT Press, 1998, 287 pp.

In *Unintended Consequences,* University of California at Los Angeles economist Deepak Lal has presented a look at the past to explain Western economic development and a glance at the future of economic development and the relationships among economic, political, and cultural changes. Based on the Ohlin Memorial Lectures he gave at the Stockholm School of Economics in 1995, Lal expands upon some of the interests of Bertil Ohlin (a corecipient of the 1977 Nobel Memorial Prize in Economics for his work on international trade), such as the importance of factor endowments in influencing the development of economic and cultural institutions and, more unusual in writings in economics, in shaping the nature of religious thought. This is the most far-ranging, in terms of temporal and geographic scope, as well as explanatory models, of Lal's recent writings on economic development, which include his two-volume *The Hindu Equilibrium* (1988, 1989) and *The Political Economy of Poverty, Equity and Growth* (1996), his work on contemporary economic development for the World Bank that he coauthored with Hla Myint.

Unintended Consequences is rich in ideas and information, and it is always interesting and thought-provoking. Its aim is to explain the origins of economic growth in the Western world, and the nongrowth of the other parts of the world—at least until very recent times. The "Rest" discussed is a rather restricted set of areas—the ancient Near East, India, China, and the Islamic nations. Africa is excluded from consideration because of its poor soil and limited surplus, and Mesoamerica is excluded because the societies there were "assassinated civilizations." Economic historians and other scholars have examined the theme of differential regional growth, and there are some similarities between their writings and the explanations provided by Lal. Lal's contribution is unusual because he pays greater attention to the endogenous nature of institutions, reflecting differences in initial resource endowments, of factors of production as well as natural resources.

Lal argues that all societies have a need to tie down their labor supply in the interests of producing surpluses for the governmental elite. That need "was dealt [with] in very different ways, mainly due to differences in the polity," differences that arose as "partly the result of the different ecological—geographical—circumstances." In particular, he suggests that it was the limited scarcity of labor in Europe (caused by "a continuing agricultural revolution and the slowly rolling industrial revolution"), along with the decentralized and relatively limited government there, that helped spur what he calls Promethean growth. Those factors, plus the development of Western individualism and the presence of the "inquisitive Greek spirit" in generating technological and scientific change, differentiated the western economic performance from that of the Rest.

Regarding the religious basis of European economic development, Lal goes back in time, past Max Weber's Protestant ethic, to argue for earlier key changes in the Catholic Church that had the "unintended consequences" of providing the appropriate cultural framework. Based on the Church's "acquisitive hunger," Lal provides a different role for the Catholic Church in leading to growth than does economic historian John U. Nef, an earlier advocate of a similar claim. Some of the key ideas were seen in the writings of Saint Augustine in the 5th century, but the major changes were due to Pope Gregory I (590–604), whose policies had an impact on family structure, which in turn influenced patterns of fertility, social welfare, and intergenerational transfers; and Pope Gregory VII (1073–1085), whose policies led to the modernization of legal institutions and the regulation of property rights. Those policies created Western individualism, which led to the beginning of a "self-generating expansion" in the late 11th century. That is all suggestive, but perhaps a more detailed discussion on Catholic nondevelopers and non-Catholic (including Protestant) developers could have been helpful in tying up some loose ends.

The book also examines the very recent changes in economic and social development as the basis of forecasts of future developments. Whereas economic individualism is seen as having been necessary for the first centuries of intensive growth and the Industrial Revolution, Lal argues that it should be remembered that the political systems in Europe at that time were hereditary monarchies, not democracies, and that "there is no necessary connection between economic and political individualism." Thus, those present-day nations where economic growth has been achieved without extensive political freedoms are in accord with past developments and are not, historically, deviant cases. Economic modernization can now be achieved without westernization of politics and culture, as long as societies are "able to accept and absorb the commercial institutions of the West." Thus, some of the changes anticipated by convergence theories need not take place. That, according to Lal, has certain benefits, because the expansion of individualism in the West has led to numerous social problems because of the increasing decline of religious sentiments that have helped societies function. Lal presents data on trends in crime and the weakening of family ties (divorce, illegitimate births, single-female households), and discusses the erosion of trust and the social consequences of reliance on government transfer payments. The expectation for the West's future is not one about which he is easily optimistic.

Lal has succeeded in his intent to write a book of interest to scholars and to more general readers. By drawing together considerable material from various disciplines, *Unintended Consequences* will teach its readers a great deal and stimulate them to learn more. Along with recent writings by such economic historians as Eric Jones, David Landes, Douglass North, and Nathan Rosenberg and L.E. Birdzell, Lal's book does much to provide a more coherent view of the economic origins of the modern world.

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Institutional Economics: Social Order and Public Policy
Wolfang Kasper and Manfred E. Streit
Northhampton, Mass.: Edward Elgar, 1999, 516 pp.

There has been a revival of classical liberal thought around the world that is being fed by intellectual sources from Austrian economics to public choice, by practical policy experience, and by technical and economic change. Key to that revival is the insight that limits to human knowledge are the true cause of scarcity and that a better exploration and coordination of knowledge are the keys to economic progress. However, the pursuit of useful knowledge is a costly endeavor. Appropriate institutions economize on that exploration and on coordination costs and, therefore, are crucial to material progress.

Institutional Economics, which introduces the reader to that fundamental line of thought, is a pathbreaking, systematic text that develops institutional theory from fundamental tenets about human nature and then applies it to contemporary economic analysis. This book will therefore allow teachers to introduce evolutionary and institutional economics without having to rely on dispersed and sometimes hard-to-access literature. Laymen who wish to understand how institutions affect prosperity, individual freedom, and social harmony, and why institutional reforms such as privatization and deregulation promote those fundamental aspirations, will also welcome it.

In the first part of the book, the authors develop a theory of institutions based on the limited knowing capacity of humans and a few fundamental human values, such as liberty and justice. Taking their lead from Douglass North and Elinor Ostrom, the authors begin by defining institutions as rules of human conduct whose violations incur informal or formal penalties. This concept of institutions-as-rules is distinguished from the concept of organizations (such as firms, banks, insane asylums, or government bodies), which are defined as purposive alliances of production factors.

The book explains why scarcity, the core element of economics, is, in the final analysis, a consequence of limited, incomplete, and fallible human knowledge, and why limited knowledge is, as F.A. Hayek said, a constitutional part of the human condition. The authors make a distinction between total ignorance and genuine discoveries, on the one hand, and gaps in our knowledge that can be filled by systematic information search, on the other. Discoveries and scientific progress are made possible by entrepreneurial activities, which are the result of alertness coupled with the readiness to incur the transaction costs of finding and testing new knowledge. Such knowledge searching makes entrepreneurial behavior entirely rational. This institutional economics approach contrasts with neoclassical economics, which leaves no room for enterprise and discovery. The fundamental recognition of "ignorance" (as incomplete and fallible knowledge) and the evolutionary concept of knowledge and scientific progress have wide-ranging consequences for how one perceives economics and public policy, which is elucidated throughout the book.

(Several recent books have been published about institutional economics, but it seems that most treat institutions as a mere addition to the existing economic paradigm, which is based on perfect knowledge. This book does not suffer from the "birth defect" of perfect knowledge, and is therefore much more cogent in explaining the need for appropriate institutions.)

One consequence of the Hayekian knowledge problem is that agents can often get away with behaving in their own interest, rather than in the interest of the principals. This principal-agent problem is discussed in the context of the relationship between managers and owners of business firms. The authors show that appropriate institutions and competitive markets reduce the seriousness of agent opportunism.

The principal-agent problem is also discussed in the context of collective action, where it is potentially much more intractable because it deals with coercive power monopolies. The chapter on public policy enumerates possible controls on the opportunism of political agents. It analyzes a variety of institutional rules, with the ultimate backstop lying in openness, which allows exit, and forces political agents to rival each other for mobile resources, which limits their power and empowers the citizens.

Kasper and Streit maintain a healthy skepticism about the effectiveness of institutions in constraining political power (constitutionalism), a stance that may derive from the analysis of the track record of German *ordo* liberalism. The German *ordo* liberals had advocated certain rules to control rent seeking in modern interest-group–dominated democracies. But those rules proved too weak to withstand the redistributional attacks of interest-group politics.

One red thread running through the book is that the coordination of diverse human pursuits is not cost-free. Indeed, the transaction costs of finding and testing new knowledge and of coordinating specialists are a major share of all expenses in a modern economy. It is one of the key functions of appropriate institutions to contain those costs. The authors draw on the insights of jurists such as Bruno Leoni and Richard Epstein, as well as on those of Hayek: When simple, stable, and general institutions are credibly enforced, those costs are relatively low. That, in turn, encourages entrepreneurship and innovation, and, consequently, is likely to lead to faster economic growth.

Institutional theory leads to a discussion of social ordering by alternative rule systems along lines that are possibly more familiar to European than to American audiences. Order economizes on the need to acquire knowledge when one cooperates with others, and it is apparent that an imposed, constructed order is only effective in fairly simple and reasonably static circumstances. Thus, the visible hand of a librarian can order a library, but, as Kasper and Streit explain, a modern economy is far too complex and far too open-ended and evolutionary to be subjected to such a system of ordering. Drawing on insights from modern systems analysis, they show that complexity requires another ordering scheme, namely, the adherence of all concerned to shared, enforced rules. The order of rules allows different people to pursue different and changing purposes and facilitates a division of labor and the use of knowledge, which no centrally made order could ever hope to achieve.

In the second part of the book, Kasper and Streit deal with specific applications of institutional theory. First, they discuss private property rights in the context of various types of voluntary contracts. Private property is perceived as a bundle of rights. Those rights can sometimes be commonly held in voluntary associations, and such arrangements may be—and often are—more conducive to people attaining their purposes than when ownership is socialized. Private owners use their property to rival each other. The process of market competition is presented as a costly rivalry among suppliers—and among buyers also—for the favors of potential contract partners. When the institutional system forces suppliers and buyers to incur the transaction costs of competing, much new knowledge tends to be found. Those chapters constitute a powerful and comprehensive defense of capitalism.

The authors subsequently analyze cooperation within firms and the case for collective action. They show that for most tasks of economic coordination, private choice is advantageous from the viewpoint of prosperity and liberty. Collective tasks can often be met by means other than the socialized ownership of productive resources. They show that modern democratic governments have far exceeded the classical tasks of the state in protecting basic institutions. They are particularly vehement in showing the failures of the welfare state in redistributing income and wealth and point to the fundamental dilemma that redistributive policies often serve political interests in reelection, but erode the capacity of government to protect private property rights and individual liberties.

The book goes beyond institutional economics and suggests that the aspirations of the new constitutional economics (positive public choice theory) should be pursued; namely, that the consequences of alternative rule systems need to be systematically explored. Voting procedures and controls of political powers have great and predictable consequences for prosperity, security, justice, and liberty. In the context of analyzing constitutional arrangements, the authors are justly critical of the contractarian explanation of constitutions, seeing constitutions as collections of time-tested, high-level rules and provisions for the orderly adaptation of existing rules when circumstances change.

In chapter 11, we learn the amazing fact that merchants in different cultures and nations transact huge amounts of daily business on the basis of spontaneously evolved institutions. Informal institutions establish the necessary trust on which a huge and growing volume of world trade and investment is based, and there is no supranational authority to enforce the rules! That observation underlines the more fundamental point that human cooperation relies to a large extent on spontaneous rules that are embodied in voluntary orders, rules that are informally enforced. Habitual rule violators tend to be excluded, and they lose their reputation or meet with tit-for-tat retaliation.

Made-up rules and formal processes of rule enforcement can, however, sometimes make cooperation easier and cheaper. The classical social scientists saw the protection of institutions as the main function of government. When it is impossible to promulgate and enforce such external rules, human creativity may nonetheless create institutional systems that facilitate trade and exchange. When the institutional order is defective, middlemen are often needed to transact the trade, and entire middlemen networks develop, relying on effective institutions that middlemen themselves develop and enforce.

Chapter 12 deals with the difficult area of institutional evolution. It is based on the precept that changing circumstances may require (gradually) evolving rule systems. The conservative maxim that old rules are good rules is accepted, but not in all circumstances. When old rules stand in the way of attaining certain fundamental purposes, such as liberty or prosperity, new rules have to be adapted. The internal institutions of society—such as ethical rules, customs, or work practices—tend to adapt flexibly and at a low cost, whereas external institutions—such as man-made constitutions, legislation, and administrative regulations—often fail to adjust. That is so because specific interests are vested in old rules and established political rulemakers often lack the cognitive capacity to diagnose social change. It often takes political entrepreneurs to advocate institutional reform; openness to other jurisdictions often makes the case for such reforms more recognizable.

In that context, Kasper and Streit give a good introduction to the findings of the new economic history that has shown how private economic competition and political rivalry interacted in the West to create the institutional foundations of modern market capitalism. Different jurisdictions offered the owners of mobile capital and enterprising people different chances to make a gain. Some people migrated to locations where their chances of prospering were better because the arbitrary rule of opportunistic men was constrained by the rule of law, which led to economic growth.

That experience had a feedback effect into the production of "institutional capital" in other areas: rulers in backward areas frequently began to offer more enterprise-friendly rules to retain and attract productive capital and other mobile resources. This two-legged process laid the foundation for capitalism and constitutional government in the West, and was repeated in the outward-looking economies of East Asia after World War II. Modern communications and globalization are now generalizing the process, much to the discomfort of single-issue groups and self-seeking political agents who reject such constraints on their own particular pursuits.

That theme recurs in various parts of the book, including in the final two chapters, which contain many applications of the concept of institutional change and drive the point home that institutions matter. In Chapter 13, the concepts introduced earlier in the book are tested against the track record of socialism and the task of transforming the entire institutional system, not only in the former Soviet bloc, but also in China. The authors show that, after the total collapse of an institutional system, only a very simple rule system should be implemented. Anything else transcends the cognitive capacities of the ruled and the rulers. If the rule of law disappears, as is happening in Russia, then it is bound to have dire economic consequences.

The final chapter deals with institutional reform in mixed economies, both in the Third World and in affluent countries. The textbooklike chapter explains why privatization and deregulation have benefits, not only for prosperity but also for social harmony and individual freedom. We are presented with empirical evidence that underscores the importance of economic liberties for prosperity. We read how some countries have moved from universal institutions to growing case-by-case regulation, whereas others have streamlined the rule system, moving in the opposite direction, with predictable economic consequences.

It seems that the economics of perfect—or, at least, reliable—knowledge and the assumption of negligible transaction costs could be applied to the slow-moving age of steam and steel. In the fast-changing information age and for an economy dominated by diversity and service production, institutions matter a great deal more. In that sense, Kasper and Streit are offering an introduction to economics for contemporary conditions.

Institutional Economics presents an accessible introduction to one of the hottest areas of contemporary economic policy analysis and social philosophy. One cannot but concur with James M. Buchanan, who writes on the back cover of the book: ‘‘A solid and much needed book. . . . Modern Institutional Economics has ‘come of age’ when its central tenets can be so coherently packaged.’’

One does not have to be an economist to enjoy this important book. I recommend it most warmly to economists and noneconomists, to students and experienced old-timers alike.

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