

# CREATIVITY AND FORMALITY: TOWARD A FRAMEWORK OF INSTITUTIONAL PERFORMANCE

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## ABSTRACT

*Using new institutional and neo-Austrian characterizations of institutions, it is possible to construct a matrix of characteristics that underlay institutional performance. Such performance can be classified in terms of institutional efficiency, enforcement characteristics, and systematic error. This performance matrix shows that in the face of creativity and novelty, formal-synthetic institutions face greater systematic error, while informal-organic institutions face lower institutional efficiency. Intermediate forms exist as well. Identifying institutional forms and the propensity for them to face creativity and novelty will allow for the critical examination of institutional performance.*

## INTRODUCTION

In the New Institutional Economics framework, institutions are coordinating mechanisms of human behavior or “rules of the game” under which economic activities are undertaken (North, 1994). They consist of: 1) formal constraints such as rules, laws, and constitutions, 2) informal constraints including behavioral norms, social conventions, and individual codes of conduct, and 3) enforcement characteristics, being the economic manifestation of infrastructure, physical and human capital, and opportunity costs of enforcing behavior within constraints.

In the Neo-Austrian framework, institutions can be classified with regard to their origins, arising with varying degrees of purposefulness. At one extreme lay processes that can be called *organic* - qualified as useful to individuals through trial and error over time. As Menger (1883, 1985) described these institutions are emergent over time, not created. At the other extreme lay a *synthetic* origin where institutions are created prospectively, designed to be useful to individuals or organizations with regard to the creation of specific future benefits to the individual, organization, or third party.

Institutions can further be described as serving as a *frame of expectations* upon which much human action regularly depends. Their value is inferred by their ability to coordinate relevant information into knowledge of prospective outcomes outside of any generalized decision process. However, these frames do not guarantee certainty but rather serve as guides to likely outcomes, or “points of orientation” (Lachmann, 1971). Stated differently, institutions reduce the transaction costs associated with *obtaining* specific knowledge but they do not eliminate the risk that arises from *not possessing* specific knowledge.

The preceding observation has not been well-discussed in the literature and is at the crux of understanding the conditions under which institutions succeed or fail. In order to identify these conditions it is necessary to understand the nature of information with respect to: 1) knowledge, 2) error, 3) risk, and 4) creativity. By integrating the nature of information with the three aforementioned conceptions of institutions, this paper will show that the formality and origins of institutions infer their capacity to successfully process information that arises from beyond their frame of knowledge and expectations. Furthermore, by defining the characteristics of information and knowledge this paper will show the pattern of costs that emerge from institutional failure.

## THE NATURE OF INFORMATION

The words “information” and “knowledge” are often used interchangeably. For the purpose of this paper, knowledge should be understood as information that is relevant with regard to individual’s plan of action. Having clarified the difference, it is clear that both information and resultant knowledge share common characteristics. First, it is limited, inasmuch as it too complex to be known to anyone in its entirety. Second, it is widely dispersed among individuals in terms of both space and time. Third, it is

sometimes tacit, that is to say that it is understood, but not explicable, or yet again, applicable, but not teachable. Fourth, it is sometimes novel: outside the boundaries of what is known prior to its emergence.

“Error” comes from a failure to identify all relevant information relative to a desired outcome. Error exists as either an error of commission (process error); using information and knowledge incorrectly within a frame, or as an error of omission (systematic error); the failure to include relevant information within the frame. “Risk” is the acknowledgement of the probability of error with respect to any planned outcome (Knight, 1931).

Creativity can be described as the ability to overcome the characteristics of information and knowledge in such ways as to satisfy new and emergent human wants, or existing wants in new ways. Creativity can occur within an institutional frame. When it does, it may be a source of process error. However, creativity outside an institutional frame is a source of systematic error for the institution.

## ANALYSIS

Assuming that an institution exists to frame expectations for relevant outcomes in a cost effective way, it will minimize transaction costs by reducing its participants’ propensity for error, reducing their risk of non-effective or harmful outcomes. This can be described as institutional efficiency. If an institution is regularly efficient, the participants within it may, over time, come to view it as infallible.

In addition, formal institutions provide explicit enforcement mechanisms to promote certain outcomes for its participants. That is, they may reward those who respond positively to the institutional arrangement, or punish those who respond negatively. These strong incentives are designed to keep behaviors and associated flows of information and knowledge arranged predictably in order to maximize the likelihood of positive outcomes within the institutional frame. However, the mutual reinforcing characteristics of institutional efficiency and strong enforcement mechanisms means that formal institutions will be especially resistant to new knowledge and information from outside the institutional structure. The membership, leadership, and assets of the formal institution may be adversely affected by the existence of any new information that is contrary to the institution’s purpose. As a consequence the institution may attempt to enact new enforcement mechanisms to constrain the creation of new information. In summary, the beneficial characteristic of a formal institution is that there is high reliability within the institutional frame. The drawback is that there are considerable costs of enforcement.

In contrast, informal institutions generally only provide opportunities for benefit to those individuals and organizations who choose to engage the institution. Those that choose not to use it are excluded from the benefit. The weaker incentives exist because participating individuals and organizations are either not willing or able to bear the cost of establishing stronger enforcement mechanisms. If the informal institution becomes more valuable and reliable over time, or exhibits public goods characteristics, it may evolve to a more formal structure. Nonetheless, since engagement with it is voluntary, if new knowledge and information come from outside, it will either respond by integrating that new information or the individuals and organizations within it will respond by leaving it, possibly creating a new institution that better serves their needs. Summarizing, the positive characteristic of informal institutions are low enforcement costs, however they are less reliable than formal institutions.

Organic institutions embrace external change as it is integral to their existence. Their purpose is to assimilate relevant new information and knowledge and incorporate it to the benefit of the individuals and organizations within it. It could be said that the frame of an organic institution is *pliable*. However, when new information becomes available, routines within the institution change and the membership bears the costs of changing their institutional frame.

Conversely, synthetic institutions may not view external change as positive. By definition, they are created to secure specific outcomes for their members. The frame of a synthetic institution can be described as being *fixed*. New information causes no change in internal routines, but since the realm of

possible outcomes has been affected by new options outside the institution, the membership bears the cost of institution's systematic error.

Given that creativity is the ability of individuals and organizations to overcome the general characteristics of information and knowledge to do things better or differently than has been done in the past it can be concluded that creativity is a potential source of error for institutions. Likewise, novelty, the appearance of previously unforeseen information, is another source of error.

Integrating the formal-informal and organic-synthetic dichotomies creates a matrix of four quadrants whose characteristics can be generalized.

*Formal-synthetic* institutions demonstrate high institutional efficiency and reliability. The combination of specific purpose and strong enforcement mechanisms help to guarantee that but also results in path dependency (David, 1985). However, since it has a specific frame and has highly-vested enforcement capital, it is both resistant to and susceptible to damage from novel and creative activities from outside the frame. As a consequence it is the institutional form most likely to suffer from systematic error. An illustration of this could be the reliance of the citizens of New Orleans on the national state and local government institutions to maintain the levee system that kept the city from filling with water. No one expected that a hurricane would hit the city and its environs with enough rain and wind to weaken them to the point of failure. When it actually occurred, the loss of life and property was astounding. It appears that the current global financial crisis may fit this model, as well.

*Informal -organic* institutions demonstrate low institutional efficiency and low reliability as a consequence of weak enforcement mechanisms. Moreover, in the face of creativity or novelty individuals and organizations are free to accept the costs of changing the institutional frame, or abandoning it. Openness to change and creativity leave the members open to multiple paths. As a consequence this form is least susceptible to systematic error. As an example, consider an ideal free market, such as those that emerged in Eastern Europe after the fall of communism. Here, a system of relative prices emerged from the supply of and demand for goods. Relative prices then drove purchasing and production activities, and changes in relative prices allowed individuals to freely enter or exit the market, and rewarded the value-enhancing creative activity of entrepreneurs.

*Informal-synthetic* institutions have low institutional efficiency as a consequence of weak enforcement mechanisms. However, its likelihood of path dependence is than that of a formal-synthetic institution. Moreover, since it has a specifically-defined purpose it is open to higher levels of systematic error than the informal-organic institutions. Additionally, since they resist external change, individuals and organizations must choose between remaining in the frame and leaving it. In both cases, the costs of change are imposed after the fact. Religions can be characterized in this way. For example, during the Reformation, the Roman Catholic Church was faced with new interpretations of the faith. As a consequence over time, entire segments of Europe came out of the church, founding new Christian denominations. The Catholic Church suffered from lower power, and the new churches suffered from a lack of respect or persecution.

*Formal -organic* institutions demonstrate a moderately high level of institutional efficiency and, and face the higher costs of strong enforcement mechanisms. They are accepting of external creativity, and reactive to novelty, but will be spread the costs of creative change (necessary modifications to the enforcement mechanisms) to all individuals and organizations within the frame regardless of the unique exposure facing individuals or organizations within it. It will suffer less from systematic error than formal-synthetic institutions, however.

## **Conclusion**

These categories are not meant as imperatives. They are simply generalizations or institutional structures and their relative propensity for efficiency, enforcement, and systematic error. Institutions may be more or less formal, or tend towards organic or synthetic characteristics. These generalizations may be useful when examining issues in a deeper context.

Many talk of the value of creativity in all aspects of our lives, imagining the characteristics of a society defined by improvement in the human condition. However, institutions often limit our ability to be creative within a frame in order to maintain its efficiency. Moreover, creativity itself may destroy or damage an institution and its related efficiencies. Yet, strong enforcement mechanisms may allow institutions to increase the likelihood of systematic error and increased human suffering. In today's world change is occurring at an ever-increasing pace, new ideas and novel events will require us to discern whether the tradeoff of institutional efficiency against systematic risk is appropriate.

## REFERENCES

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