

# The Economic Theory of Institutional Change (ETIC) and the Emergence of Public Activities

– The Case of Public Employment Services in Germany –\*

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## 1. Introduction

Following the German economist Adolph Wagner (1835-1917) and his famous “*Law of Increasing Extent of Public Activities*” (or: “*Wagner’s Law*”),<sup>1</sup> the economic studies on the *positive explanation of public sector activities* have mainly identified the size of public activities with public expenditure levels;<sup>2</sup> by doing so, they more or less totally failed to answer the following questions:

1. Why has just the provision of *certain* goods and services been assigned to the public – rather than to the private – sector?, and
2. Why have just *certain* organizational arrangements been chosen for the public provision of these goods and services?

But without answering these two questions, any attempt to explain the growth and changing structure of the public sector must remain fragmentary. (See Littmann, 1977, 113) *A certain level and structure of public expenditures will always only result from a public choice in favour of certain institutions in the sense of public responsibilities and competences*, which have the task of securing the public (non-private) provision of certain goods and services, and creating a specific organizational arrangement for this provision.

Today, with the modern approach of an *Economic Theory of Institutional Change (ETIC)*,<sup>3</sup> which has been influenced, above all, by the work of Douglass C. North, we have an economic theory which tries to explain the emer-

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<sup>1</sup> Or: “*Law of Rising Public Expenditures*”. See Wagner, 1893, 892-915.

<sup>2</sup> See e. g. Fehr, 1984, especially p. 32. For a summary of some of the more recent economic studies on the growth of public expenditures see Mueller, 1989, 320-347.

<sup>3</sup> I. e. the evolutionary version of New Institutional Economics (NIE).

gence and the change of institutions of all kinds.<sup>4</sup> The capacity of this ETIC-approach for an explanation of the institutional bases for today's public activities is the subject of this article: is the ETIC-approach able to answer our two above-mentioned questions?

After a short survey on the general structure of the ETIC (*section 2.*), the article's main section (*3.*) presents an exemplary application of this approach to explain the *historic emergence* of the institutions for public activities; as an example for new public activities in general, we will look at the *introduction of the institutions for Public Employment (or: Employment-Exchange-) Services (PES) in Germany*, in the 1890s. Finally, we will ask for the possible conclusions from this application for a theory of the emergence of the institutions for public activities in general (*section 4.*).

## 2. The General Structure of the ETIC-Approach

All the recent attempts in the context of New Institutional Economics (NIE)<sup>5</sup> for an explanation of the change<sup>6</sup> of institutions in the sense of the "formal" institutions (= rules which are written down in constitutions, laws, statutes, or contracts)<sup>7</sup> for a national economy may be reduced to the following three basic hypotheses from *three different "areas of explanation"*, which are shown in *Figure 1* and explained in the following:<sup>8</sup>

### 2.1 Explanation Area A ("Change-Inducement Explanations")

The first of the three basic hypotheses of the ETIC tries to explain why *certain* actors (individuals or organizations<sup>9</sup>) become induced at a *certain*

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<sup>4</sup> For the details of this approach see this article's *section 2*, below. As some of the most important contributions to the ETIC-approach see North and Thomas, 1973, North, 1981, and North, 1990.

<sup>5</sup> For a survey on NIE and its various sub-theories see e. g. Schenk, 1992.

<sup>6</sup> As the ETIC explanations do not distinguish between the cases of an "emergence" and a "change" of institutions, both cases will be subsumed, in the following, to the term of "institutional change".

<sup>7</sup> For the differentiation between "formal" and "informal" institutions see e. g. North, 1990, 4 and 46.

<sup>8</sup> For these hypotheses see especially Pejovich, 1972, 313-316, Hesse, 1980, North, 1981, Gäfgen, 1983, 34-48, Hesse, 1983, Wallis, 1989, 98-105, and North, 1990, 86-87. As some authors want to emphasize the impact of just certain factors (e. g. transaction costs) on institutional change, which they consider as the most important (or: the most neglected) ones, they often concentrate their research on just one or two of these hypotheses; but a comprehensive explanation of institutional change will always have to take into account all the three "areas of explanation".

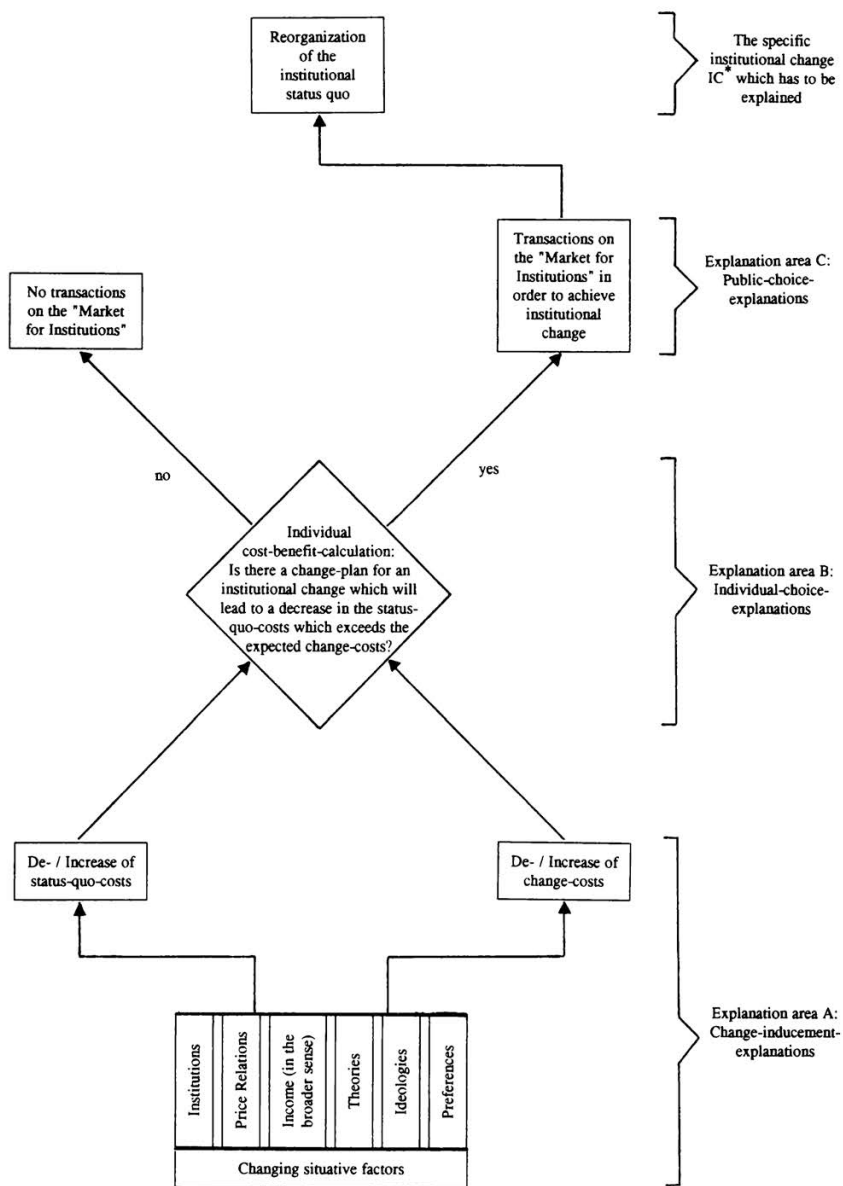


Figure 1: Synopsis of the Basic Explanations of Institutional Change, as Proposed by the ETIC

time to start considerations and developing plans for institutional change: *an actor will always start with considerations on the advantages of institutional change, if there has been a significant increase in his costs of the institutional status quo ("status-quo costs")<sup>10</sup> and/or a significant decrease in his expected costs of achieving an institutional change ("change costs")<sup>11</sup>* (basic hypothesis I).

The *status-quo costs* for an actor are all kinds of disadvantages for this actor which are generated by the existing institutions. The *change costs* include in particular all the compensations or fees which are to be paid to those actors who have the competence to decide on the enforcement of institutional change; these actors will be referred to, in the following, as the "*decision-making agents*".

The forces behind the variations of the status-quo costs and the change costs are always changing "*situative factors*"<sup>12</sup>. These are all the existing constraints of economic behaviour: the institutions of an economy, the stocks of theories and ideologies, the price relationships within an economy, the preferences of all the actors of an economy, and the disposable income of these actors; the term "income" is used in its broader economic sense to include such factors as property rights and the power to force other actors to do something ("coercive power").

## 2.2 Explanation Area B ("Individual-Choice Explanations")

The second basic hypothesis of the ETIC focuses on the reaction of an actor (an individual or organization) to the change inducement: *An actor's demand for institutional change depends on his status-quo costs, on the var-*

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<sup>9</sup> In the real world, the relevant demanders for institutional change may be identified regularly as the large organizations within an economy: Political parties, special interest groups, large enterprises, governmental units. See North, 1990, 4-5, 7-8, 99-100. The behaviour of these organizations has always to be explained by analyzing the individual activities of their members, who act, of course, only in accordance with their own preferences, not in order to achieve the objectives of their organizations. But as this article focusses on the ETIC as an approach to explain new activities of the *public* organizations (= the governmental units at the national, regional, and local levels of government; in the jargon of Wagner: "Zwangsgemeinwirtschaften" [see Wagner, 1893, 856-869]), we will try to reduce the complexity of possible explanative factors and their interrelations by abstaining (for this article) from an analysis of the internal decision-making processes of all the *other* large organizations (including the sub-units of the governmental units) within an economy.

<sup>10</sup> For this term see e. g. Fürst, 1975, 147.

<sup>11</sup> For this term see e. g. Hesse, 1983, 83 and 102-104.

<sup>12</sup> For this term in the context of the ETIC see e. g. Gäfgen, 1983, 36. How changing situative factors may lead to increasing status-quo costs (or to decreasing change costs) will be pointed out in detail in *subsection 3.1*, below, for the case of the introduction of the PES.

*ious situative factors of the status quo, and on the expected change costs* (basic hypothesis II):

It seems reasonable to assume that an actor will always search for a plan to achieve that kind of an institutional change (“*change plan*”) which will lead to an expected maximum reduction of his status-quo costs; but this search cannot be carried out without taking into account several of those given situative factors of the status quo, which are hard to be changed immediately<sup>13</sup> or which shall be (in the short run) preserved: It is always profitable for an individual or organization to preserve all those situative factors (especially: those institutions) which are necessary for the operation of an organization and/or for securing the private income position of an individual or organization<sup>14</sup>.

In addition, the demanded institutional change will also be influenced by an actor’s expected change costs, which depend on the specific contents of his change plan<sup>15</sup>; an actor will become “change demander” and carry out transactions in order to achieve institutional change only if his change plan promises him a decrease of status-quo costs which exceeds his expected change costs.

### 2.3 Explanation Area C (“Public-Choice Explanations”)

The third basic hypothesis of the ETIC is based on the idea that in each economy there is some kind of a political “*Market for Institutions*”, as a place where the demanders of institutional change (“*change demanders*”) may get into contact with other actors, who have the legal right to offer and “sell” changes in the institutional status quo (“*change suppliers*”):<sup>16</sup>

<sup>13</sup> Because the expected change costs are much too high.

<sup>14</sup> The large organizations within an economy have often developed a kind of “symbiotic relationship” (North) with the existing institutional pattern of the economy. See North, 1990, 7-8 and 99-100. They were established *because* of this existing institutional pattern, in order to maximize the returns for their members on the basis of just this pattern; thus, the representatives of the large organizations will normally have no intention of changing the basic structure of this pattern, but try to achieve “incremental” institutional changes in order to develop further this existing institutional pattern (“Lock-in Effect” [North]). See North, 1990, 7-8 and 99-100. Consequently, the given basic institutional pattern of each economy will always lead to a specific national “path of institutional change”, which will normally not be left by any kind of institutional change (= “Path-Dependence Hypothesis” [North]); see North, 1990, 7-8 and 99-100.

<sup>15</sup> Or on the loss of benefits which is to be expected for the decision-making agents in the event that the demanded institutional change (according to a specific change plan) will really take place.

<sup>16</sup> The ETIC-explanations in this area have mainly the character of an application of the general Public-Choice explanations of governmental activities on the decisions on economic institutions. See Gäfgen, 1983, 43.

*Institutional change is always the result of – cost-effective – transactions between change demanders and suppliers on the “Market for Institutions” (basic hypothesis III).*

According to the ETIC, the transactions on the “Market for Institutions” are affected and directed by numerous situative factors of the status quo, in particular by the existing institutions. These factors may bring about that the change suppliers have a tendency to favour more or less systematically the demand of certain actors (individuals or organizations) and the preservation of certain institutions of the status quo. This may lead to the creation of new institutions which raise the efficiency and/or the private income only for *certain* actors, while these institutions may be totally inefficient and may bring no progress for the economy as a whole.<sup>17</sup>

Those actors who have decided – according to their individual choice, as discussed in subsection 2.2 – to become change demanders and to carry out transactions on the “Market for Institutions” (in order to “buy” a certain institutional change) are the relevant initiators of any change in the institutional status quo and may be referred to as “*change agents*”<sup>18</sup>. The change-suppliers are primarily the “*decision-making agents*” of the public sector organizations,<sup>19</sup> who act in order to raise their private income and/or “. . . to attain the . . . prestige and power which come from being in office” (Downs, 1957, 28).

The compensations or fees which have to be paid (to the decision-making agents) by the change agents for the enforcement of their demanded institutional change have for the change agents the character of “change costs”. These compensations will always depend in particular on the demand of those actors who oppose the institutional change in question and are willing to pay for the preservation of the institutional status quo, because of their “status-quo benefits”; these individuals or organizations may be called the “*preserve agents*”.

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<sup>17</sup> For an illustration of how some of the existing situative factors may have worked in history to influence the introduction of property rights which were inefficient for the economy as a whole see e. g. North, 1981, 148-152. See also this article's subsection 3.4.

<sup>18</sup> For the use of this term in the theory of “Planned Organizational Change” see e. g. Dienstbach, 1972, 62-63.

### 3. An Application of the ETIC-Approach on the Emergence of Public Employment Services (PES) in Germany

#### 3.1 What has to be Explained

To answer the question as to the ETIC-approach has the capacity to explain the historic emergence of institutional arrangements for new public activities, we have to make empirical investigations into the history of today's public activities, in order to identify the relevant change, preserve, and decision-making agents; then we must try to trace back the transactions of these actors to (changes in) the various categories of costs and situative factors, as they have been described in the previous section of this article.

In the following, the results of such kind of empirical investigations are presented, which were carried out by the author of this paper for the case of the "*Public Employment Services*" ("*PES*") – or: "*Public Labour-Exchange-Agencies*"<sup>20</sup> in Germany: The sudden emergence of the institutions for the German<sup>21</sup> PES took place, at first, only in about two dozens of larger cities, which will be referred to, in the following, as the "*pioneer cities*"<sup>22</sup>, in the mid 1890s.

#### 3.2 The Inducement for a Change of the Institutional Status quo

According to the ETIC-approach, it may be expected that in the early 1890s (just short before the introduction of the PES), a significant increase in the status-quo costs, which were caused by some of the existing institutions, took place for some actors.

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<sup>19</sup> Also the rivals of the decision-making agents, who are hoping to replace the present decision-making agents (they may be called the "*potential decision-making agents*"), may try to "sell" future institutional change to the change agents. In an absolutist monarchy, the "king" or the "prince" is the decision-making agent at the national or federal level of government; in a modern representative democracy, the relevant decision-making agents may be identified as the members of the national parliament.

<sup>20</sup> The contemporary German term for this public activity is "Öffentliche Arbeitsvermittlung", while in the late 1800s and early 1900s, it was more common to use the term "Öffentlicher Arbeitsnachweis".

<sup>21</sup> In the field of the PES, as in other sectors of social policy, Germany was, in the late 19th century, somewhat like the "pioneer economy". For the state of nonpublic Labour-Exchange Agencies in other economies in the 1890s see Reitzenstein, 1897, 17-41, 227-247, 274-289. The rise of the PES in the United States is described by Atkinson, Odenrantz, and Deming, 1972, 19-37.

<sup>22</sup> Up to the end of World War I, the new institutions of the PES were gradually adopted by more or less all German municipalities; see for this dissemination process in the area of the PES e. g. Uhlig, 1970, 100-101, 120-135; Faust, 1986, 292-293.

The empirical evidence shows, that by far the most important change agents for the introduction of the PES were the *local authorities* (“*Stadtverwaltungen*”), the executive at the local level of government, which had expressed their demand for PES institutions since about 1890; therefore, we will restrict the following explanation of the change inducement (3.2) and the individual choice of a change plan (3.3) to this group of actors.

As has been indicated in *subsection 2.1* above, an increase in the status-quo costs (as a change-inducement) for certain actors may always be explained with (changes in) the various situative factors. *Figure 2* gives an overview on those situative factors, which played a major role for the introduction of the PES and will be explained in the following.

There is one group of situative factors which has probably always a special importance for the change inducement: The “*preceding institutions*” of the newly emerged institutions, i. e. in this case the institutions for the non-public job (and labour) -search-activities, which were in use before the introduction of the PES in the mid 1890s:<sup>23</sup>

Up to this time, the institutional status quo in the field of job-(and labour) -search-activities was by far dominated by the workers’ traditional custom (as an “informal” institution [= a rule which is not written down in constitutions, laws, statutes, or contracts] of individual self-search activities) of “*Looking-Around*” (“*Umschau*”) for jobs, i. e. “travelling” or “wandering” from place to place, and from factory to factory, asking potential employers for job opportunities.<sup>24</sup>

Among the “formal” institutions, those for the provision of employment services by private “*Profit-motivated Employment Agencies*” (“*PEAs*”) had the greatest importance.<sup>25</sup> Further “formal” preceding-institutions of the

<sup>23</sup> It is to be noted that with the introduction of the PES in the mid 1890s, the non-public job (and labour) -search-activities were not stopped. The PES and the non-public job (and labour) -search-activities existed in Germany side by side for more than two decades, although, with the introduction of the PES in the mid 1890s, it was intended by the relevant change agents to replace the private job (and labour) -search-activities by the PES; but this goal was not achieved prior to World War I. During and soon after World War I, the majority of the Charitable Employment Agencies, the Union Employment Agencies, and the Employer’s Employment Agencies had been closed, see e. g. Thiemann, 1925, 52. The Profit-motivated Employment Agencies were prohibited by the German “*Arbeitsnachweisgesetz*” (§ 48) in 1922. It should also be noted that even before the mid 1890s, there had been already several experiments by local welfare-departments with some kind of public employment services for welfare recipients only. See for these experiments of the local welfare departments e. g. Reitzenstein, 1887, 4-6 and 46-47. These experiments were operated at a very small scale (by the local welfare officials) and caused quite similar status-quo costs for the relevant change agents as the employment agencies of the private charities. It is for these reasons that, in this article, we will leave the “*Local Welfare Employment Services*” out of consideration.

<sup>24</sup> For more details see e. g. Reitzenstein, 1897, 51-52.

<sup>25</sup> For the central features of the PEAs see e. g. Conrad, 1904, 150-165.



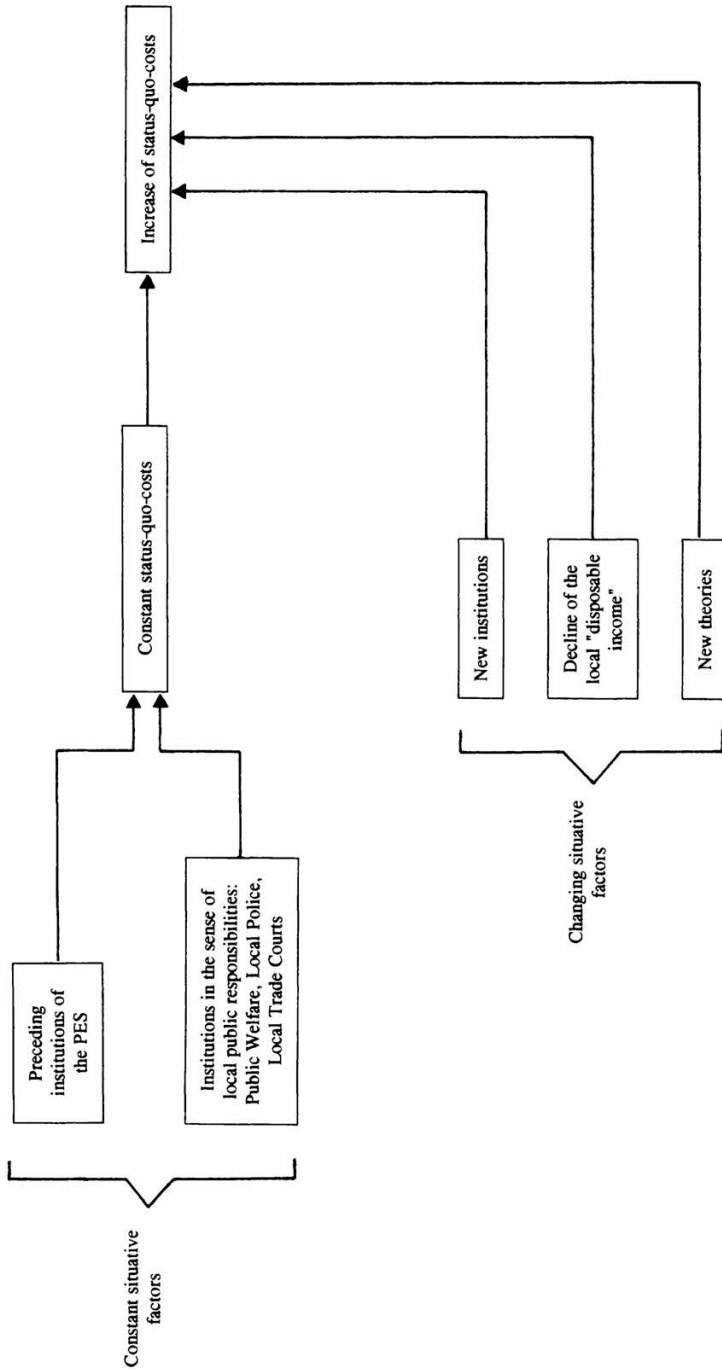


Figure 2: Situative Factors as Determinants for an Increase of the Status-quo-Costs and the Change-Inducement for the German Local Authorities in the Case of the PES, in the 1890s

PES-institutions were those for the provision of employment services by the “*Charitable Employment Agencies*” (which were controlled and financed by charitable organizations),<sup>26</sup> the “*Union Employment Agencies*” (which were controlled and financed by the local trade unions),<sup>27</sup> and the “*Employer’s Employment-Agencies*” (which were controlled and financed by the local employers’ federations)<sup>28</sup>. The majority of these employment-agencies concentrated their services always on just only one sector or some few sectors of industry.

These non-public arrangements for job (and labour) searching were quite unable to reduce, instead they had a tendency to *increase the (local) unemployment*,<sup>29</sup> were not able to give a true picture of the local labour supply and demand conditions,<sup>30</sup> tried to exploit their clients (this was true for the PEAs; see e. g. Conrad, 1904, 155-159) or were used in order to *support industrial actions* (as it was true for the Union Employment Agencies and the

<sup>26</sup> For the central features of the Charitable Employment Agencies see e. g. Conrad, 1904, 165-178.

<sup>27</sup> For the central features of the Union Employment Agencies see e. g. Michalke, 1912.

<sup>28</sup> For the central features of the Employer’s Employment Agencies see e. g. Kessler, 1911.

<sup>29</sup> The custom of “Looking Around” is always successful only by chance; as the majority of the “wandering” workers had as their destination always the very big cities (where they hoped to find work), they contributed to an increase in the unemployment in these cities. The PEAs also worked in this direction, as they had a strong tendency to stimulate the migration from the land to the cities. Furthermore, the PEAs (in the 19th century) were not at all interested in stable, long-term employment contracts, but tried to stimulate the tendency to change jobs (and workers). The efforts of the Employers’ Employment Agencies and the Union Employment Agencies to support the individual job (and labour) -search were often dominated by their secondary goals, to support industrial actions and to oppress the labour movement (as it was true for the Employers’ Employment Agencies). And the Employers’ Employment Agencies had no intention to “export” labour from the big cities to the rural areas or to other cities, because it is always profitable for the local employers if the labour supply exceeds the demand. For the Charitable Employment Agencies, as well as for the Union Employment Agencies, it was extremely difficult to get job-offers from the employers, because the employers regarded the trade unions as their “natural” enemies and expected that always only physically or mentally handicapped workers would make use of the Charitable Employment Agencies. The workers rejected the use of the Employers’ Employment Agencies (because of their oppressive activities) and of the Charitable Employment Agencies (which were regarded as “partial” in favour of the demand-side of the labour market). And finally, each of the non-public employment agencies always concentrated its efforts only on one or a few sector(s) of the local industry (or: occupation) and had only a rather small share of the market for employment services; thus, the non-public employment agencies were not able to reduce the number of the unemployed by an employment exchange between the sectors; and because of their small market shares, the chance to find the “right” person (job) for the “right” position (person) was always only small. For more details see Rosenfeld, 1996, 128-140.

<sup>30</sup> Each of the non-public employment agencies had supply and demand information only for its own small segment of the local labour market, and no incentive to reveal this information to the public authorities; and there was no kind of registration for the labour exchange which took place by the custom of “Looking-Around”.

Employers' Employment Agencies; see e. g. Conrad, 1904, 27-30; Kessler, 1911, 130-131 and 163-164); this led for the local authorities probably to the following *categories of status-quo costs* :

(I) *Increased local public welfare expenditures*, as – in the absence of special unemployment benefits –<sup>31</sup> many of the unemployed applied for welfare benefits.<sup>32</sup>

(II) *Increased expenditures for the local police forces*<sup>33</sup>, because unemployed and impoverished persons have always a tendency for illegal activities (in the sense of stealing or begging<sup>34</sup> in order to “earn” their living); in addition, the police had to cope with the PEAs' attempts to exploit their clients, and with the social tensions in connection with wage-disputes, which were supported by the activities of the Employers' Employment Agencies and the Union Employment Agencies.

(III) *Increased expenditures for the tasks of the local trade courts* (“Gewerbegerichte”), because the local trade courts had to decide on the compensation which had to be paid by employers (employees) who had broken the contracts with their employees (employers); for these decisions, it was necessary to be informed about the supply and demand conditions on the local labour markets. (See Reitzenstein, 1897, 315)

We may conclude from these explanations of how the preceding institutions of the PES-institutions have probably caused status-quo costs for the local authorities, that aside from the preceding institutions, there is always another important group of situative factors in the status quo which work as co-determinants of the status-quo costs: The *institutions in the sense of an actor's responsibilities in the status quo*, in this context: the *local responsibilities of public welfare, local police, and local trade courts*; only in interaction with these local public responsibilities, the preceding institutions of the PES-institutions produced the three categories of status-quo costs, as described above (see Figure 2).

But so far, our explanation of several categories of status-quo costs (as the result of the interaction between the various preceding institutions of the PES-institutions and local public responsibilities) gives us no clue to explain the fact that the local authorities *started to announce their demand for an institutional change (= started to act as change agents) just about a*

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<sup>31</sup> In Germany, at the federal level of government, general unemployment benefits were firstly introduced in 1918.

<sup>32</sup> See for these interrelations e. g. Anträge des Gewerbegerichtes Stuttgart, 1894, 209-210.

<sup>33</sup> For the local responsibilities in this field of public goods and services, in the 19th century, see Krabbe, 1989, 39-41.

<sup>34</sup> For the prosecution of beggars in the 19th century see e. g. Balkenhol, 1976, 139.

*certain time*, the beginning of the 1890s. We may suppose that about this time, a *significant increase in the status-quo costs* of the preceding institutions of the PES-institutions took place for the local authorities (which probably worked as the relevant change inducement for the local authorities), because of important changes in at least three groups of situative factors (see *Figure 2*):

(A) *Institutional Change*: Some of the institutions among the situative factors which have just been described as status-quo cost determinants had been created only shortly before the local authorities started to act as change agents.

(A.1) This is in especially true for the local trade courts, which were installed after the enacting of a federal “Trade Court Law” in 1890 (See Jastrow, 1902, 140 and 405-425)<sup>35</sup>.

(A.2) Several preceding institutions of the PES-institutions, especially those for the majority of the Employers’ Employment Agencies and the Union Employment Agencies, were introduced in the late 1880s and the early 1890s. (See Reitzenstein, 1897, 112-115; Kessler, 1911, 4-11)<sup>36</sup>

(B) *Declining Disposable Income*: There was a significant decline of the situative factor “disposable income” of the local authorities (or the local level of government) in the early 1890s, because the heavy economic depression of the years 1892-1894 produced high rates of unemployment and a resultant significant increase in the local public welfare expenditures<sup>37</sup>; and on the other hand, the depression led to a severe drop in the local tax revenues (“gross local public income”).<sup>38</sup> For the local authorities, this decline of their “disposable income” probably led to an increase in their status-quo costs which were caused by the preceding institutions of the PES, in the sense of an increased relative importance of these cost categories (in particular: cost category I) for the local budgets. But we have to be cautious not to overestimate the influence of this changing situative factor on the change inducement, because the unemployment numbers of the early 1890s might have been lower than those of earlier depressions;<sup>39</sup> this could mean that

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<sup>35</sup> In some cities, local trade courts had already been installed (voluntarily) before the federal law was enacted (see Uhlig, 1970, 97); but the federal law increased probably the importance of these trade courts in relation to other parts of the local administrations.

<sup>36</sup> Only the employment agencies of the trade guilds had a much longer history, see e. g. Faust, 1986, 54-55.

<sup>37</sup> For the local governments, the welfare expenditures have always the character of (to some extend) non-variable expenditures, which reduce their “disposable income”, because it is not possible to fix the costs of a “welfare case” below a certain minimum level.

<sup>38</sup> The relevance of this depression and the increased unemployment for the emergence of the PES was stressed e. g. by Conrad, 1904, 181.

during these earlier depressions the preceding institutions of the PES institutions might have caused much higher status-quo costs than in the early 1890s.

(C) *Changing Theories*: It may be assumed (and supported with empirical evidence) that the *theory of a strong relationship between unemployment and the local public expenditures for police and welfare* has been recognized by the local authorities, for the very first time, in the early 1890s, because of the following changes:<sup>40</sup>

(C.1) There were changes in the attitude of the unemployed, who turned, in the early 1890s, presumably far more often to illegal activities than in previous periods of economic decline. (See Wermel and Urban, 1949, Vol. I, p. 16)

(C.2) During former economic depressions, the influence of unemployment on public welfare expenditures had been *covered by the costs of poverty by those persons who were not able to work* because of their old age, illness, or because of accidents. These costs were independent of business cycles. The *institutional change* in the sense of the introduction of the German social security laws in the 1880s (public pension scheme, public health insurance, public accident insurance) reduced these costs significantly, while there was a sharp increase in the proportion of the “unemployed” welfare recipients in the total number of welfare recipients, thus revealing the true importance of unemployment for public welfare expenditures.<sup>41</sup>

Without this change of theories, the preceding institutions of the PES would probably have caused much lower status-quo costs for the local authorities, because they would not have had the idea to trace back the increased expenditures for police and welfare to unemployment and the preceding institutions of the PES.

### 3.3 The Individual Choice in Favour of Certain New Institutions

The reaction of the local authorities to the change-inducement, their individual choice for a certain kind of institutional change (the introduction of the PES) may probably be explained by the status-quo costs and some of

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<sup>39</sup> This possibility may not be proved, because there are (so far) no exact data on the unemployment numbers for the years before the 1890s, see Niess, 1979, 22 and 28-30.

<sup>40</sup> Such a change of theories may be referred to – in the terminology of Peacock’s and Wiseman’s investigation into the growth of public expenditures in the United Kingdom – as an “inspection effect”, see Peacock and Wiseman, 1961, XXIV.

<sup>41</sup> For these interrelations see Balkenhol, 1976, 109 and 117.

those situative factors which may be regarded as “constant” (in the short run),<sup>42</sup> as will be shown in this subsection.

The most important features of the local authorities’ plan for a PES were the following ones: (See e. g. Conrad, 1904, 195-196, 198-199)

(a) For each municipality, only *one* “centralized” and “general” employment agency should be installed, which should be responsible for all the districts of the municipality, and for the labour supply of all the local sectors of industry.

(b) The PES should follow the principles of “neutrality” (“Neutralität”) and “impartiality” (“Unparteilichkeit”). “Neutrality” means that there should be no interference by the PES in the labour market’s supply and demand conditions (in favour of either the demand or the supply side). The institution of “impartiality” should prevent the PES from being able to treat some persons (non-)preferentially, because of their (non-)membership in certain political parties or (interest) groups.

(c) The services of the PES should be *free of charge*, i. e. they had to be financed by general local public revenues.

All these features of the local authorities’ demand for a PES were probably chosen as *instruments to reduce the status-quo costs of the preceding institutions of the PES* :

- The local authorities have probably followed the idea that a “centralized” and “general”, publicly controlled employment agency would supply them with a *true picture of the local labour market as a whole*, at least if it was achieved to drive the non-public employment agencies more or less out of the market for employment services.
- A “centralized” and “general” employment agency could also *promote the employment exchange between the various sectors of the local industry and trade and thus reduce the number of the unemployed*.<sup>43</sup>
- The principles of “neutrality” and “impartiality” probably had the task of ensuring that the PES was operated only for the purpose of finding adequate positions for people out of work and the “right” persons to fill the vacancies, and of increasing the trust of both parties in the labour market in the PES, while many of the non-public employment agencies had always some kind of secondary aims<sup>44</sup>, which sometimes dominated

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<sup>42</sup> The expected change costs were probably only of minor importance for the change plan in the case of the PES.

<sup>43</sup> The majority of the non-public employment agencies had always concentrated their services more or less on only one single sector or a few sectors. See above, footnote 29.

<sup>44</sup> See above, footnote 29.

the primary purpose of employment exchanges (and led to an increase in the number of the unemployed). As the Union Employment Agencies, the Employers' Employment Agencies, and the Charitable Employment Agencies served (or: were regarded) as instruments in favour of the supply or the demand side of the labour market,<sup>45</sup> many employers or job-searchers rejected the use of these agencies. It is for these reasons that it was probably expected that a "neutral" and "impartial" PES would *attract much more customers than all the private employment agencies together, drive them more and more out of the market for employment services, reduce the job-search by the custom of "Looking-Around", increase the chance to fill the "right job" with the "right person", and reduce the number of the unemployed significantly.*

- The institution of free-of-charge delivery of the PES should probably support these tendencies by allowing the PES to *drive those of the non-public employment-agencies out of the market*, (See e. g. Jastrow, 1902, 153) *which were not free of charge*<sup>46</sup>.

There would have been one major other possible institutional choice for the local authorities to reach some of these results (in order to reduce the various status-quo costs which were caused by the preceding institutions of the PES institutions): The introduction of public regulations for the non-public employment agencies for prohibiting some of their cost-effective activities. But such regulations could never have created something like a "centralized" and "general" employment agency. And *one of the "constant" situative factors*, the given allocation of competences between the various levels of government, did not allow the municipalities to introduce such regulations (as a "repressive" public activity)<sup>47</sup>; thus, *the given allocation of competences probably influenced the choice of the local authorities in favour of the PES* (as a "supporting" public activity).

### 3.4 Transactions on the "Market for Institutions" for Achieving Institutional Change

We have to complete our explanation of the emergence of the PES in this subsection by looking at how the local authorities succeeded in getting approval for their individual change plan (the introduction of the PES) by the relevant decision-making agents (the suppliers of institutional change):

<sup>45</sup> See above, footnote 29.

<sup>46</sup> For those employment agencies which were not free of charge see e. g. Conrad, 1904, 61, 137, 155, 168-169.

<sup>47</sup> Only the federal level of government would have had the competences for such regulations, as for the trading-regulation laws ("Gewerbeordnung") in general.

For the historical situation of the German municipalities in the late 19th century, *the decision-making agents may be identified as the members of the local councils* (= local councillors or local parliamentarians), who were, according to the pre-World War I electoral laws, *in the main representatives or “agents” of the property-owning bourgeoisie*, and tended to be in favour of the political demands of the local employers and the employers’ federations (See e. g. Jastrow, 1902, 139-140; Uhlig, 1970, 97). Therefore, and as the institutional status quo in the field of job (and labour) –search-activities produced considerable status-quo *benefits* for the local employers,<sup>48</sup> the local councillors had to reject the local authorities’ demand for the PES and acted as “*preserve agents*” (See e. g. Uhlig, 1970, 101-102, 129-133).

If there had been more democratic electoral institutions in pre-World War I Germany, the local authorities would have probably had no difficulties in achieving the demanded institutional change, because the employees and the trade unions, and probably the great majority of the voters, were in general in favour of the PES-plan;<sup>49</sup> this illustrates the effects of a given political constitution on delaying the institutional change<sup>50</sup>.

But also in the real world of the 1890s, the decision-making agents in the “pioneer cities” gave up their resistance to the PES after several months or even years and agreed to the change plan of the local authorities (See e. g. Uhlig, 1970, 101-102, 129-133).

For an explanation of how this could happen, we may refer to the following *two basic strategies* which may be used by a change agent in order to “buy” (and achieve) institutional change.<sup>51</sup>

<sup>48</sup> Particularly the Employers’ Employment Agencies contributed to these status-quo benefits, because they served as instruments for industrial actions and for the purge of the labour force from persons reluctant to work, from persons who had broken their employment contracts, and from members of the labour movement. See e. g. Conrad, 1904, 57-58; Keßler, 1911, 131. During World War I, the status-quo benefits which were caused by the Employers’ Employment Agencies dropped dramatically, because of the surplus demand on the labour market; this – among other factors – allowed the change agents in the field of Employment Services to disseminate the new institutions of the PES to more or less all German municipalities by the end of World War I.

<sup>49</sup> Although some of the local trade unions resisted at first against the PES, they changed their mind during the next couple of years and turned to support the change plan of the local authorities. See for the position of the trade unions: Faust, 1986, 80-86.

<sup>50</sup> The influence of changes in the allocation of the political decision rules on the growth of government in general has been stressed especially by Timm, 1961, 226-227, 232, 234.

<sup>51</sup> The following arguments are based on the assumption that the decision-making agents have all the information they need about how the change plan would affect their individual cost-benefit calculations. Otherwise, it would be a possible third strategy for the change agents to “persuade” the decision-making agents (by supplying them with relevant information) that the demanded institutional change would prove profitable for them.



- (1) *Playing for time*, i. e. waiting for decreasing change costs (= the costs of compensating the decision-making agents for their consent to the demanded institutional change); such a decrease will take place especially in connection with fundamental constitutional changes (e. g. in the sense of the introduction of a more democratic electoral system, as compared with the status quo).
- (2) Making some kind of payment (compensation) in exchange for the demanded consent ("*Exchange Transactions*"). In connection with this strategy, the decision-making agents will always have to explain their change of mind to their electors; thus, those actors who are able to supply the decision-making agents with theories which are suitable for such justifications will have a greater chance of getting what they want. (See e. g. Hesse, 1983, 104)

As there is no evidence for a decrease in the change costs for the local authorities in the early 1890s, the local authorities must have turned to strategy (2). The possibility of achieving a demanded institutional change by this strategy will always increase, if

- the change agents have property rights of some relevant resources for compensating the decision-making agents, and if
- it is possible to construct strong theoretical connections between the demanded institutional change and increasing individual benefits for the electors (or: "principals") of the decision-making agents.

In the 1890s, in the case of the PES, the historical evidence met both conditions:

(I) Under the pre-democratic German constitution of the late 19th century, the local authorities had a position which was to some extent independent of the local councillors;<sup>52</sup> this gave them probably the opportunity for some kind of "log-rolling" with the decision-making agents: The local authorities may have threaten, e. g., to block some decisions of the local councillors, if the decision-making agents were not willing to support the introduction of the PES.

(II) The PES could be interpreted as an instrument to create new benefits for the local employers, because an increase in local employment was expected to secure the income for the landlords<sup>53</sup> and to bring about a higher quality of the local labour force (as unemployment goes always along with a reduction of personal skill, knowledge, and discipline)<sup>54</sup>. In addition, the

<sup>52</sup> See for the position of the mayors in the late 19th century e. g. in Hesse: Reh, 1922, 308; in Prussia: Riess, 1924, 56-59; in Württemberg: Ruck, 1922, 295.

<sup>53</sup> See for this argument: Zahnbrecher, 1914, 142.

<sup>54</sup> See for this argument: Conrad, 1904, 252.

expected results of the PES in the sense of decreasing costs of public welfare, local police, and the local trade courts<sup>55</sup> could easily be described as benefits for the tax-payers and voters of the decision-making agents.

Our *empirical knowledge* about which kind of Exchange Transactions took place in the real world of the 1890s is still very limited, so far; there are only a few descriptions of the political bargaining processes on the PES in the pioneer cities. These sources provide a lot of clues for the local authorities' attempt to supply the decision-making agents with theories which were suitable for them to justifying their change of mind (the support of the PES) to their electors, as described under (II), above. This empirical evidence may *indicate* that there had really been some kind of "payment" of the local authorities to the decision-making agents, as a compensation for their support of the PES, although the empirical sources include no *definite* clues for such a compensation. An explanation for this lack of empirical evidences could simply be that the "payment" on the "Market for Institutions" may often take place in secret, without any kind of written documents or "contracts".

#### 4. Conclusions

As has been illustrated with our exemplary analysis of the PES, the ETIC-approach avoids any kind of a monocausal explanation of institutional change and tries to bring out the various interrelations (and their specific "anatomy") between a lot of explanative factors. But as there seems to be *no possibility for "weighting" all these factors against each other*, in order to select the "more important factors" from the "less important" ones, it is more or less impossible to find out which factors have been – and perhaps: will be – the very "dominant" forces behind the growth and the changing structure of the public sector as a whole.

Another problem of the ETIC is the asymmetry between the possibilities for empirical investigations for the two areas of the change-inducement explanations and the individual-choice explanations on the one hand, and the area of the public-choice explanations on the other hand. As to the first two areas, the empirical investigations may often be done with the study of various kinds of documents, written statements, articles in newspapers and journals, etc. But the possibility for isolating the relevant determining factors within the third area, the public-choice explanations, will probably always be limited.

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<sup>55</sup> For these benefits see *subsection 3.3*, above.

These results suggest that even with many future empirical studies into the emergence of public goods and services, based on the theoretical framework of the ETIC, there is probably no great chance for elaborating something like a “general” economic theory of public activities and their evolution.

But this does not mean that the ETIC brings no kind of progress for the economic analysis of public sector change: Our application of the ETIC to the “birth” of the German PES has shown that the ETIC-approach has not only the advantage of a *great capacity for integrating various rather different determinants of public activities in just one theoretical framework*, but also the ability to serve us as a very productive method for *detecting some relevant determinants of public activities which have been so far underestimated by the traditional economic analysis of public sector growth* :

This may especially be supposed for two of those determinants which have probably influenced the emergence of the PES, the “*disposable income*” of the public sector and the status-quo institutions in the sense of the *existing public responsibilities* for public goods and services:

(A) In the traditional economic analysis of public sector growth, it has been proposed by many authors that the situative factor “*private income*” and its *increase* has been of special importance for the long term evolution of the public sector. (See e. g. Timm, 1961, 231) The study of the PES suggests that for the introduction of public responsibilities for new public goods and services, another “income” category is of the greatest importance: The situative factor “*disposable public income*” and its *significant decline* have probably been (and will be) some of the central causes for the representatives of the public sector to become change agents.<sup>56</sup>

(B) The traditional economic analysis of public sector growth has put much more stress on the impact of *changing situative factors* for increasing public expenditures than on the impact of – in the short run – “*constant*” *situative factors*; our analysis of the PES has shown that changing situative factors may do their “work” always only in combination with “constant” situative factors. In particular, with our analysis of the PES, the “constant” situative factor “*existing public responsibilities for the provision of public goods and services*” has been isolated as one of those factors which may be in general very crucial for the introduction of the institutions for new public activities:<sup>57</sup> The demand of the representatives of public organizations for

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<sup>56</sup> It was the significant decline of the “disposable local income” in the early 1890s that led the local authorities to demand an institutional change (= the introduction of the PES).

<sup>57</sup> In the case of the PES, the public responsibilities for public welfare, the local police forces, and the local trade courts caused (in combination with the decrease in

new institutions has probably very often the task to securing or improving the provision of the existing public goods and services.

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the “disposable public income” and other factors) the increasing status-quo costs for the local authorities.

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## Zusammenfassung

In der ökonomischen Analyse des "Wachstums der Staatstätigkeit" fehlt es noch immer an einer geschlossenen Erklärung der *Neuentstehung öffentlicher Aktivitäten*. Der Beitrag untersucht, welche Möglichkeiten die "*Ökonomische Theorie des Institutionellen Wandels*" ("*ÖTIW*") hierfür bietet, und zwar am Beispiel der Einführung der "*Öffentlichen Arbeitsvermittlung*" als einer neuen kommunalen Aufgabe in den 1890er Jahren. Es wird gezeigt, daß die ÖTIW vor allem durch ihre besondere Fähigkeit zur *systematischen Erfassung von höchst heterogenen Erklärungsfaktoren* und zur *Entdeckung von "neuartigen" Erklärungsfaktoren*, die in der bisherigen Diskussion über das "Wachstum der Staatstätigkeit" vernachlässigt wurden, zu einer allgemeinen Theorie der Evolution öffentlicher Aufgaben beitragen kann.

## Abstract

Up to now, in the economic analysis of public sector growth, we are missing a comprehensive explanation of the *emergence of new public activities*. The article reports on an exemplary attempt to explain the emergence of public activities with the *Economic Theory of Institutional Change (ETIC)*. It is shown that the ETIC-approach has the *capacity for integrating various rather different determinants of new public activities in just one theoretical framework*. Another advantage of the ETIC is its capacity for *detecting some relevant determinants of public sector change which have been so far under-estimated* by the economic analysis of public sector growth.

*JEL-Klassifikation: H 11 und H 42*