What are Institutions?
And why and how they matter?
Institutional Economics Lecture 1

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1. What are Institutions?

2. What is the (New) Institutional Economics?

3. How does IE Help in Understanding History?

4. Ronald Coase and History

5. Contemporary Issues
What are Institutions?

Institutions
Menard and Shirley, 2005: Rules of the game: the written and unwritten rules, norms and constraints on human actions shaping the incentives of economic agents.

1. within-organization and cross-organization written and informal rules and agreements: contractual relations and corporate governance
2. constitutions, laws and rules that govern politics, government, finance, and society
3. informal institutions: unwritten codes of conduct, norms of behavior, and beliefs

Discussion: institutions you know of?

Institutional Economics
An economics discipline studying how institutions emerge, persist and change, and what the results of their operation are.
How did IE come to exist?
Theories that don’t work...

Core neoclassical economics assumptions which don’t (always) work:
1. perfect information, perfect foresight
2. rationality
3. transactions are costless
4. transactions are instantaneous
5. (secure property rights) – implicit assumption in neoclassical econ

Do institutions have any role in the neoclassical world?
How did IE come to exist?
Theories that don’t work...

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Do institutions have any role in the neoclassical world?
North, AER, 1994: Only under the conditions of costless bargaining will the actors reach the solution that maximizes aggregate income regardless of the institutional arrangements. When it is costly to transact, then institutions matter. And it is costly to transact. Wallis and North have found (1986) that 45% of GDP was devoted to the transaction sector in 1970.
The assumption in IE: people create institutions to:

1. reduce transaction costs
2. enforce property rights and ownership
   - enforce contractual obligations
   - protecting private property from state and private predation,

so that people have incentives to prosper.
Recall:
\[ Y = AK^\alpha L^\beta H^\gamma \]

\( Y \) requires having efficient markets. However, efficient markets cannot function without property rights over factors and output, and without a system enforcing contractual obligations *both* within, and across firms.

Discussion: What happens to output (inputs) if there is no efficient PR enforcement?

The objective of institutional research (North, AER, 1994):
- shed light on economic past (understand history)
- provide an analytical framework for thinking about economic change
Household economy (autarchy) $\rightarrow$ comparative advantage $\rightarrow$ specialization and division of labor $\rightarrow$ potential gains from trade $\rightarrow$ transaction costs.

$\Rightarrow$ A rise of the need to:

- lower transaction costs $\rightarrow$ encourage exchange and specialization
- protect private property from state and private predation

$\Rightarrow$ Property rights and transaction costs are fundamental concepts in economics, despite that mainstream economics just takes them as given.
A brief institutional history of the West

Key points (North, JEP, 1991)

The rise in specialization and division of labor → gains from long-distance trade → local markets become bigger → transaction costs rise. Naturally:

1. mobility of capital increased
   - usury laws broke down: the Christian church banned charging interest; 1545 Act, "An Act Against Usurie" of King Henry VIII of England allowed it
   - the development of the bill of exchange: a method to defer payment and transact

2. information costs plummeted: printing of prices of various commodities; manuals on measures; and of exchange rates

3. risk started spreading: the transformation of uncertainty into risk. (What is the difference?). Insurance companies developed.

4. the role of the state changed: from arbitrary stealer to secure revenues to protector of private transactions; and issuer of government debt
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Williamson:

1. Institutions matter – but how? \(\rightarrow\) Micro and Macro empirical studies

2. The determinants of institutions are susceptible to analysis by the tools of economic theory: explaining institutions and finding evidence.
Williamson: The New Institutional Economics

Level | Frequency (years) | Purpose
---|---|---
L1 Embeddedness: informal institutions, customs, traditions, norms religion | $10^2$ to $10^3$ | Often noncalculative; spontaneous (caveat: see discussion in text)
L2 Institutional environment: formal rules of the game—esp. property (polity, judiciary, bureaucracy) | $10$ to $10^2$ | Get the institutional environment right. 1st order economizing
Institutional Dynamics: Four Levels of Change (2)


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**Figure 1.** Economics of Institutions

L1: social theory  
L2: economics of property rights/positive political theory  
L3: transaction cost economics  
L4: neoclassical economics/agency theory

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L3: Governance  
- play of the game  
- esp. contract  
- (aligning governance structures with transactions)

L4: Resource allocation and employment  
- (prices and quantities; incentive alignment)

1 to 10

Get the governance structures right.  
2nd order economizing

continuous

Get the marginal conditions right.  
3rd order economizing
Coase’s contribution:

(1) The Nature of the Firm (1937): (1931 observation): The view of the pricing system as a coordinating mechanism was clearly right, but there were aspects of the argument which troubled me... we had a factor of production – management – whose function was to coordinate. Why was it needed if the pricing system provided all the coordination necessary? I found the answer by the summer of 1932. It was to realize that there were costs of using the pricing mechanism.

Prices have to be discovered. There are negotiations to be undertaken, contracts have to be drawn up... arrangements have to be made to settle disputes... These costs have come to be known as transaction costs.

The contribution of this article: the explicit introduction of transaction costs into economic analysis. The existence of transaction costs leads to the emergence of the firm.
Coase’s contribution:

(2) **Coase theorem**: In a regime of zero transaction costs – an assumption of standard economic theory – negotiations between the parties would lead to those arrangements being made which would maximize wealth and this irrespective of the initial assignment of rights.

The significance of the Coase theorem:
- there is no economy with zero TC
- inefficient allocation of resources is normal
- reducing TC may bring the economy closer to efficient allocation of resources – institutions matter

“The time has surely gone in which economists could analyze in great detail two individuals exchanging nuts for berries on the edge of the forest and then feel that their analysis of the process of exchange was complete...”
How legal provisions affect the economy?
Correlation b/w regulatory processes and the legal institutions

FIGURE 1.1 OECD high-income economies combine efficient regulatory processes with strong legal institutions

Average ranking on sets of Doing Business indicators

Correlation across countries

Correlation across countries

Note: Strength of legal institutions refers to the average ranking on getting credit, protecting investors, enforcing contracts and resolving insolvency. Complexity and cost of regulatory processes refers to the average ranking on starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders.

Source: Doing Business database.
How legal provisions affect the economy?
Correlation b/w regulatory processes and the legal institutions

Correlation within a country over time
Expensive to do business in the legal economy: you start up in the shadow economy.
Countries closer to the reform leaders attract more FDI.
How legal provisions affect the economy?

Starting a business made easier

Cheaper start-up reduces TCs → makes more people start a business.
How legal provisions affect the economy?
Starting a business made easier: the case of Rwanda

Cheaper start-up reduces TCs → makes more people start a business.
How legal provisions affect the economy?
Dealing with construction permits

Supply-side policies in the REstate sector – WHY?
How legal provisions affect the economy?

Transferring property

Cheaper to transfer property – more deals.
1. What are institutions?
2. Are countries with better institutions better off (and why?)?
3. What are the transaction costs?
4. Why are property rights important for economic prosperity?
5. Can we employ a transaction costs perspective to outline a brief history of wealth and growth?
6. Why does the firm emerge?
7. What is the significance of the Coase theorem?
8. Where can I find more contemporary data on the parameters of the doing business environment? (+ BEEPS)
9. What is the main message of the Doing Business Database?
Further reading


7. Doing Business Database