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

Petar Stankov

petar.stankov@gmail.com

5 Feb. 2015
Outline

1. What are Institutions?
2. What is the (New) Institutional Economics?
3. How does IE Help in Understanding History?
4. 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...

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?

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.
How did IE come to exist?
Theories that sometimes work...

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.
North, AER, 1994: “Institutions are not necessarily or even usually created to be socially efficient;”
North, AER, 1994: “Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are \textit{created to serve the interests} of those with the bargaining power to create new rules.
North, AER, 1994: “Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules. It is the polity that enforces property rights, and in consequence it is not surprising that efficient economic markets are so exceptional.”
North, AER, 1994: “Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules. It is the polity that enforces property rights, and in consequence it is not surprising that efficient economic markets are so exceptional. That is, if the institutional framework rewards piracy then piratical organizations will come into existence; and if the institutional framework rewards productive activities then organizations-firms - will come into existence to engage in productive activities.”
North, AER, 1994: “Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules. It is the polity that enforces property rights, and in consequence it is not surprising that efficient economic markets are so exceptional. That is, if the institutional framework rewards piracy then piratical organizations will come into existence; and if the institutional framework rewards productive activities then organizations-firms - will come into existence to engage in productive activities.”

Williamson:

1. Institutions matter – but how? → 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 L1**
- Embeddedness: informal institutions, customs, traditions, norms, religion
- Frequency: $10^2$ to $10^3$
- Purpose: Often noncalculative; spontaneous (caveat: see discussion in text)

**Level L2**
- Institutional environment: formal rules of the game—esp. property (polity, judiciary, bureaucracy)
- Frequency: $10$ to $10^2$
- Purpose: Get the institutional environment right. 1st order economizing
Institutional Dynamics: Four Levels of Change (2)

![Diagram showing four levels of institutional change with labels L3 and L4, and descriptions of governance and resource allocation.]

- **L3**: Governance: play of the game—esp. contract (aligning governance structures with transactions)
  - 1 to 10: Get the governance structures right. 2nd order economizing
- **L4**: Resource allocation and employment (prices and quantities; incentive alignment)
  - Continuous: Get the marginal conditions right. 3rd order economizing

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

*Figure 1*. Economics of Institutions
How legal provisions affect the economy?
Correlation between regulatory processes and the legal institutions

Correlation across countries

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

Average ranking on sets of Doing Business indicators

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 between regulatory processes and the legal institutions

Correlation within a country over time

FIGURE 1.7 Different economies have followed a variety of regulatory reform paths
Average distance to frontier in sets of Doing Business indicators (percentage points)

Note: Strength of legal institutions refers to the average distance to frontier in getting credit, protecting investors, enforcing contracts and resolving insolvency. Complexity and cost of regulatory processes refers to the average distance to frontier in starting a business, dealing with construction permits, registering property, paying taxes and trading across borders. Each dot refers to a different year, starting in 2005 and ending in 2012. The reform progress of Singapore, the economy with the most business-friendly regulation for the seventh year in a row, is shown for purposes of comparison. For visual clarity the series for Singapore starts in 2007. The distance to frontier measure shows how far on average an economy is from the best performance achieved by any economy on each Doing Business indicator since 2005. The measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier).
Source: Doing Business database.
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

FIGURE 1.9 More new firms are registered after reforms making it simpler to start a business

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

FIGURE 10.1 Taiwan, China, made dealing with construction permits faster and easier

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

Transferring property

FIGURE 12.3 Burkina Faso made transferring property faster and easier

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. Where can I find more contemporary data on the parameters of the doing business environment? (+ BEEPS)
7. What is the main message of the Doing Business Database?
Further reading and homework

7. Doing Business Database