What are Institutions?

And why and how they matter?
Institutional Economics Lecture 1

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6 Feb. 2017

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?

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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.

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.

The Importance of Institutions (North, JEP, 1991)
Property Rights

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;
- enforcing contractual obligations.

Discussion: What happens to output (inputs) if there is no efficient PR/contract 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

Early Institutional Evolution (North, JEP, 1991)

Institutions and division of labor

Household economy (autarchy) –> comparative advantage –> specialization and division of labor –> potential gains from trade –> transaction costs.

⇒ A rise of the need to:

- lower transaction costs –> encourage exchange and specialization
- protect private property from state and private predation

⇒ Property rights and transaction costs are fundamental concepts in economics, despite that mainstream economics just takes them as given.

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Why Are So Many Countries Poor?

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Daron Acemoglu, Simon Johnson (2012): Why Nations Fail? – a brilliant book on the origin and effects of economic institutions.

The core of institutional analyzis

Williamson, O. (2000). The NIE: Taking Stock, Looking Ahead, *JEL*

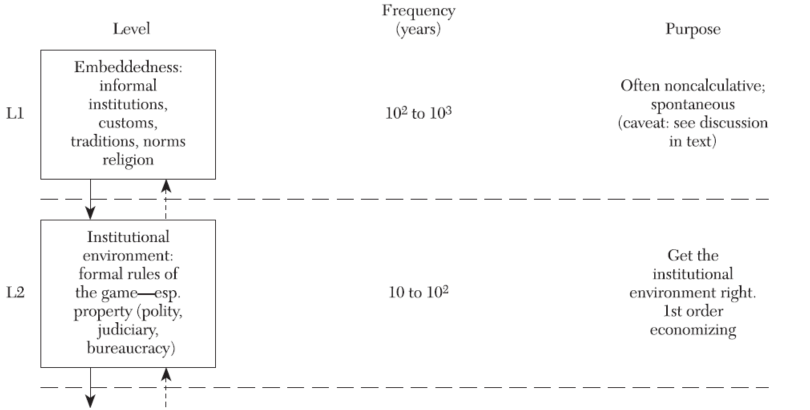
Williamson:

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.

Institutional Dynamics: Four Levels of Change

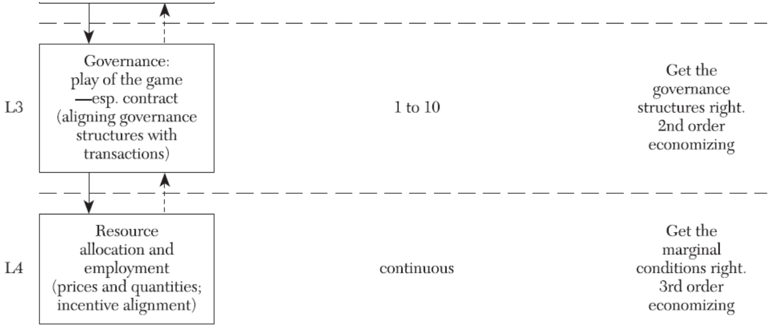
Williamson, O. (2000). The NIE: Taking Stock, Looking Ahead, *JEL*

Williamson: The New Institutional Economics 597



Institutional Dynamics: Four Levels of Change (2)

Williamson, O. (2000). The NIE: Taking Stock, Looking Ahead, *JEL*



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

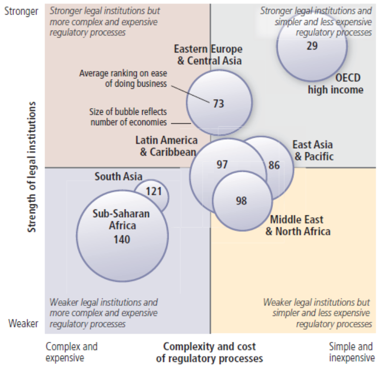
Figure 1. Economics of Institutions

How legal provisions affect the economy?

Correlation 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



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.

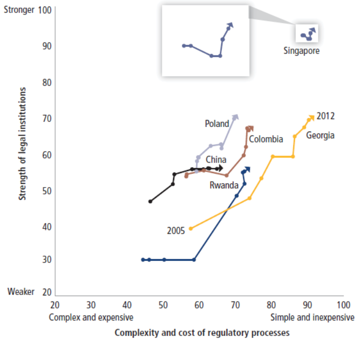
Correlation across countries

How legal provisions affect the economy?

Correlation b/w regulatory processes and the legal institutions

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).

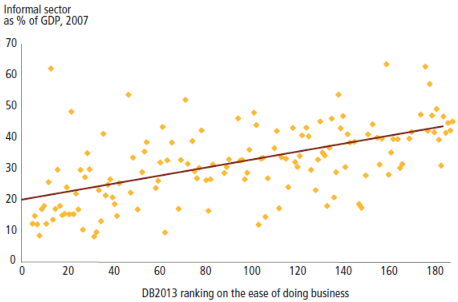
Source: Doing Business database.

Correlation within a country over time

How legal provisions affect the economy?

The role of cheaper doing business for informality

FIGURE 2.2 Higher levels of informality are associated with lower *Doing Business* rankings



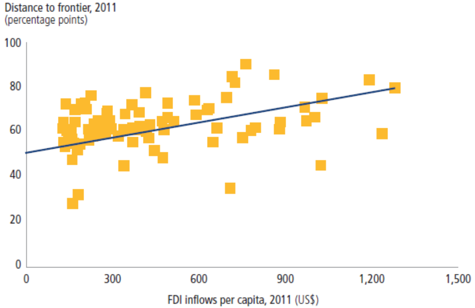
Note: The correlation between the 2 variables is 0.57. Relationships are significant at the 5% level after controlling for income per capita. The data sample includes 143 economies.
Source: Doing Business database; Schneider, Buehn and Montenegro 2010.

Expensive to do business in the legal economy: you start up in the shadow economy.

How legal provisions affect the economy?

Doing business and FDI

FIGURE 7.1 Better overall regulation is correlated with more FDI inflows per capita



Note: The distance to frontier measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier). Sample includes 157 economies with positive 2011 FDI inflows per capita of $1,500 or less. This includes all economies covered by *Doing Business 2012* for which data are available, excluding outliers with negative inflows or inflows greater than $1,500 per capita. Dropping these outliers does not significantly affect the trend line.

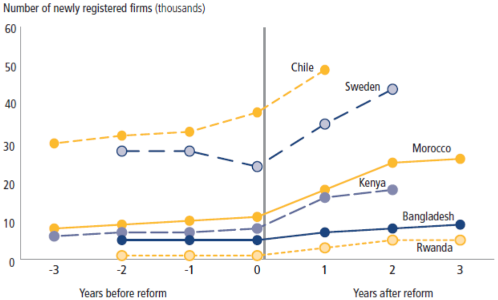
Source: Doing Business database; United Nations Conference on Trade and Development, UNCTADstat database.

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



Note: All 6 economies implemented a reform making it easier to start a business as measured by *Doing Business*. The reform year varies by economy and is represented by the vertical line in the figure. For Bangladesh and Rwanda it is 2009; for Chile, 2011; for Kenya, 2007; for Morocco, 2006; and for Sweden, 2010.

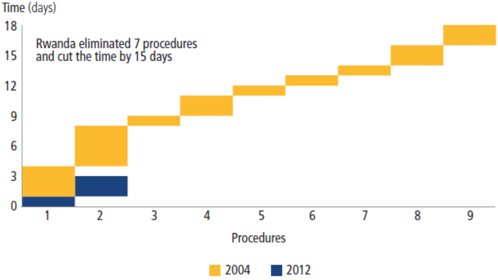
Source: World Bank Group Entrepreneurship Snapshots, 2012 edition.

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

FIGURE 5.1 Rwanda streamlined the procedures for starting a business



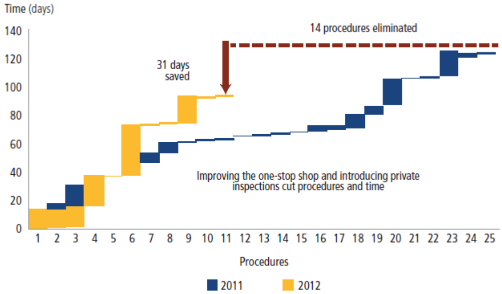
Source: Doing Business database.

Cheaper start-up reduces TCs –> makes more people start a business.

How legal provisions affect the economy?

Dealing with construction permits

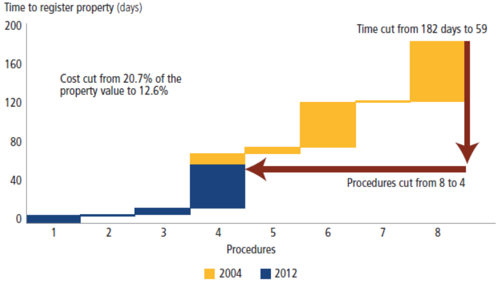
FIGURE 10.1 Taiwan, China, made dealing with construction permits faster and easier



Source: *Doing Business* database.

Supply-side policies in the REstate sector – WHY?

FIGURE 12.3 Burkina Faso made transferring property faster and easier



Source: Doing Business database.

Cheaper to transfer property – more deals.

Revision

1. What are institutions?
2. Are countries w 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

1. *** Coase, R. (2005): Institutional structure of production. In: C. Menard & M.M. Shirley (eds.) *Handbook of New Institutional Economics*, Springer, pp. 31-39.
2. *** North, Douglass C. (1994). Economic Performance through Time. *American Economic Review*, 84(3), 359-368.
3. *** Williamson, Oliver (2000, Sept.). The New Institutional Economics: Taking Stock, Looking Ahead, *Journal of Economic Literature*, 38, 595-613.
4. Ménard, Claude and Shirley, Mary (2005). Introduction. In: Ménard, C. and Shirley, Mary M. (Eds.). *Handbook of New Institutional Economics*, Springer, 1-18
5. North, Douglass (1991). Institutions, *The Journal of Economic Perspectives*, 5(1), 97-112.
6. McCloskey, Donald (1976, Jun.). Does the Past Have Useful Economics?, *Journal of Economic Literature*, 14(2), 434-461
7. Doing Business Database