The New Institutional Economics –
Basic Concepts and Selected Applications

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1. Introduction

- Globally, only few people have high incomes, but billions have very low incomes; why?
- Formally identical constitutions can lead to vastly different outcomes; why?
- Why do many development programs not lead to sustainable development?
- Is there a relationship between individual rights and income?
- Why has the international trade order been relatively stable although there is no international government that could force governments to play according to the rules?
- Why do some cross-border mergers succeed while others fail?

↳ All these questions are dealt with by institutional economists. They don't pretend to be able to answer them in their entirety, but they claim to deal with them more extensively than more traditional economists.

The central hypothesis of the New Institutional Economics (NIE):

Economic Growth and Development crucially depend on institutions.

Douglass North (1990, 54): "... the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World. "
In economics, the relevance of institutions has long been neglected; e.g. in growth theory (labor, capital, technical progress)

Additional ingredient of the NIE: take the effect of state-enforced rules (e.g. speed limits) as well as the effect of society-enforced rules ("at a wedding, one wears a black-tie suit") on individual behavior explicitly into account.

As long as societal conventions, mores, customs etc. are more difficult to change than state-enforced rules, a second hypothesis follows:

The possibilities to implement formal institutions conducive to economic growth and development are constrained by the informal institutions of a society.

↳

That means that the relationship between formal and informal institutions should be analyzed explicitly.

Content:

2. The behavioral model of economics – and of the NIE in particular

Economics today is a certain approach of analyzing interactions, rather than a certain topical area.

Assumptions:

- All actors maximize their utility;
- Means are restricted;
- Preferences of the actors are constant;
- Constraints /restrictions:
  - Laws of Nature;
  - Budget;
  - Time;
  - Information / knowledge.
  - Laws enforced by the state;
  - Customs, traditions enforced by members of society;
- People act rationally in maximizing utility under given constraints.

Purpose: Explain behavioral changes by changes in the restrictions (trying to explain them with „changes" of the preferences would not be an explanation but simply a reformulation of the problem).

Modifications of the NIE

(1) Object of inquiry;
(2) Assumptions used:
  i. From perfect or complete to bounded rationality;
  ii. Transaction costs > 0.

(i) From perfect or complete to bounded rationality

Kreps (1990, 745): „A completely rational individual has the ability to foresee everything that might happen and to evaluate and optimally choose among available courses of action, all in the blink of an eye and at no cost."

Frank Knight (1922): Uncertainty vs. Risk.

Herbert Simon (1955): bounded rationality.
➩ *Satisficing* instead of individual utility maximization;

In a world without uncertainty there is no place for rules and institutions, because the actors can foresee every possible contingency without any cost.

(ii) Transaction costs

Ronald Coase (1937): Cost of using markets;

If transaction costs = 0, then the market functions costlessly and efficiently.

Dahlman (1979):"search and information costs, bargaining and decision costs, policing and enforcement costs."

Close relationship between positive transaction costs and bounded rationality.

(North 1990b and 1993) introduces „political transaction costs."

3. Institutions: Functions, Definitions, Types, Tools

- Two cars approach each other on a narrow street;
- Two strangers want to exchange a good whose characteristics are not ascertainable on first sight;
- Two students want to start a firm. Each of them wonders how they can make sure that "the other guy" works as hard as oneself.

↳ These are 3 examples for situations with *strategic uncertainty*

Strategic vs. parametric uncertainty

If uncertainty prevails,

↳ Some transactions might simply not take place;

↳ Moreover: short time horizon, low degree of specialization, low division of labor, low income level.

Necessary: instruments for reducing uncertainty

↳ this is exactly the function of institutions

We have thus approached institutions functionally; but: do not commit a functionalist fallacy!

Defining Institutions

E.g. North (1990a, 3); Institutions are „… humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic."

Critique: too constructivistic

Another proposal: the 2 components of institutions: (1) rule component and (2) enforcement/sanctioning component

Definition: Institutions are commonly known rules to structure repetitive interaction situations which are complemented by an enforcement mechanism that ensures that non-compliance with the rule-component is sanctioned

Types of Institutions

Kind of rule	**Kind of enforcement**	**Type of Institution**
1. Convention	Self-enforcing	Type-1 internal
2. Ethical rule	Self-commitment of the actor	Type-2 internal
3. Customs	Via informal societal control	Type-3 internal
4. Private rule	Organized private enforcement	Type-4 internal
5. State law	Organized state enforcement	External

Comparative Institutional Analysis – compare realizable states of the world;

⇘ new definition of "efficiency" (Williamson [1996, 195]: „An outcome for which no feasible superior alternative can be described and implemented with net gains is presumed to be efficient.")

Path dependency ("time matters")

4. Horizontally structured transactions

David Hume:

(1) Property Rights (*usus, fructus, abusus;* the more exclusive the delineation, the higher c.p. the price);

(2) Contract Law (restrictions can reduce the number of transactions and/or increase the price; drugs, opening hours of stores etc.);

(3) Process Law (costs of using courts, time necessary to get your rights etc.).

<u>On the Relationship Between External and Internal Institutions</u>

If external institutions are costly to use, unreliable, do not structure the relevant interactions etc., then they will not be used much and much activity will take place in the informal sector, the black market etc. which relies much more on internal/informal institutions.

De Soto (1990): informal housing, informal trade, informal transportation in Peru.
p. 12: „We can say that informal activities burgeon when the legal system imposes rules which exceed the socially accepted legal framework – does not honor the expectations, choices, and preferences of those whom it does not admit within ist framework – and when the state does not have sufficient coercive authority.“

This comes at high costs:

- Potential economies of scale cannot be realized;
- Undercapitalized;
- Use of some marketing instruments excluded;
- Transactions connected with substantial transaction costs.

<u>An example from international trade: international arbitration courts</u>

More than 90% of all contracts between firms from different jurisdictions contain a clause to turn to a private arbitration court in case of conflict

Various reasons:

- Decisions often unpublished ("*Face saving";* continuation of business relations possible);
- Time to descision shorter;
- More expert knowledge can be used;
- Homeward-trend of national state courts.

↳ Interesting phenomenon, because it shows that institutions created and run by private organizations can fulfill some functions traditionally fulfilled by the state. Yet

- unclear whether they would work as effectively, if threat to use state courts were entirely absent;
- does not lead to emergence of uniform case law.

5. Vertically structured transactions

Basic questions: why do firms exist at all?

➯ Costs of using the market (transaction costs) > 0.

Then: why not one single firm?

➯ Costs of using organizations (organization costs) > 0.

➯ Firm will grow until the transaction cost savings from using a firm will equal the additional cost of using a hierarchical structure (the organization costs).

Institutional Economists are interested in the incentives created by various organizational structures (the firm as "nexus of contracts"; problems of asymmetric information: principal agent theory; specific organizational structures fit to specific assumptions such as bounded rationality, opportunism, asset specificity).

An example for the relevance of internal institutions:

Kreps (1990): Corporate Culture; the mores and customs within a firm

Work ethic; informal control of workers amongst each other

Can have substantial effects on (formal) control costs; difficult to change intentionally

Can be relevant for mergers, especially international ones.

Can also be relevant for organizational structure of international organizations.

6. Government Transactions: The Dilemma of the Strong State

Everybody maximizes utility, politicians included

(Given) institutions can also constrain them in their behavior

But: special problem here; they also have the power to establish and change institutions.

Assume politicians to be income maximizers; incentive to promise secure property rights in order to make people invest; as soon as they have invested, incentives to attenuate property rights or to expropriate them right away.

Rational citizens will expect this and invest less; this will lead to lower economic activity which – in turn – leads to lower tax income.

Everybody could thus be made better off if politicians were able to credibly commit to their promises.

Possible solutions:

- Horizontal separation of powers;
- Vertical separation of powers;
- Membership in international organizations

↳ An example for recent empirical evidence: Feld and Voigt (2002) find that in a survey of 56 countries, *de facto* judicial independence is robustly correlated to economic growth

7. Putting it all Together: Institutions and Economic Growth

Hypothesis: Economic growth can be explained with the quality of the institutions prevalent in a given country

How to measure and make comparable different "institutional qualities"?

One Example: Index of Economic Freedom by Fraser Institute

21 variables in 7 different groups

↳ Policy Implications: Secure economic rights (in the constitution)

Critique:

- can only be secured if adequate internal institutions exist;
- what does "maximum" of economic freedom mean, anyways?

UPSHOT: institutions – external as well as internal – are crucial for economic growth;

they have been relevant internationally, but promise to become even more important in the future;

more research efforts with a clear international focus needed.

Some – more general – policy implications:

Policy Advice #1: Do not focus primarily or even solely on the direct improvement of physical capital. Rather, try to get the institutions right.

Policy Advice #2: Modifying institutions should be the exception rather than the rule. If change promises net gains, it should be administered with as much transparence as possible, which allows the actors to form expectations that have a good chance of turning out to be true.

Policy Advice #3: Government should only pass institutional change that is in tune with its possibilities to credibly commit itself.

Policy Advice #4: Reforms of external institutions should take the prevalent internal institutions explicitly into account. External institutions should by and large be compatible with the internal ones.

Policy Advice #5: Try to identify the productive potential and hitherto unexploited potential of internal institutions and help private actors to realizing it by acting as a catalyst.

The SLIDES on which this talk are based can be downloaded from:

http://www.wirtschaft.uni-kassel/voigt.htm

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