

INSTITUTIONS AND
INSTITUTIONAL DESIGN

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Part I: Introduction to the problem

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Literature:

- North, Douglass C. 1990 **“Institutions, Institutional Change and Economic Performance.”**, Cambridge, Cambridge University Press, Ch 1,
- Scott, W. Richard 1995 **“Institutions and Organisations”**, London, Sage
- Soto, Hernando de. 2000 **“The Mystery of Capital. Why Capitalism Triumphs in the West and Fails Everywhere Else”**, New York, Basic Books

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Goals

- **In general** further the understanding of
 - Historical development, and
 - Economic and Social development
- **In particular** further the understanding of how institutions shape the use of resources and the path of economic development

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What is it?

- Broadly speaking: An institution comprise all that makes you feel that what you do is the right thing to do. You have the right to do it. What you do is **legitimate**. If anyone prevents you from doing it you feel wronged. Preventing you from doing it is illegitimate.
- The sources of this feeling are many.

Institutional design

What do we mean by design?

- Fitting form to function
 - In architecture?
 - In clothing?
 - In writing contracts?
 - In writing constitutions?
 - In writing laws and bylaws?

Is design suspekt?

- Because designers are out of touch with the real world?
- Working from
 - First principles ?
 - Under a blue sky ?
 - On blank sheets ?

Design of formal institutions

- Consists of
- Writing law
 - Mandating a bureaucracy
 - Staffing the bureaucracy

Fitting form to function

- **Function:** the goals the institutions is supposed to achieve
- **Form:** the diverse combinations of legal rules, bureaucratic organisation and the goals and competences of the bureaucratic staff
- **FIRST IMPLICATION:** we need to understand how institutions work

Learning about institutions from

- Neo-institutional economics
- Political science, anthropology, sociology
- Philosophy, law, history, game theory, experimental psychology/
- Classical institutional theory in sociology, political science, and economics

Preliminary concepts

- **Structure vs. Agency**
- **System of action** including
 - Resources/ assets
 - Appropriators/ possessors
 - Technology (incl. organisation)
- **Public goods**
- **Collective action**
- **Non-actor systems/** customary law / stateless societies
- **Actor-systems/** law-maker /state

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The practice of design

- Do not borrow off-the-peg models
- Look around for more options

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Options for constitutions

- Democratic responsiveness: making vs. applying laws
- Checking the abuse of power: external vs. internal controls
- Protecting the minorities: output vs. input filters
- Social pluralism: tolerating diversity vs. promoting it.
- Ensuring functional fit for democratic accountability

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Reading North 1990:

- Douglass C. North provides a condensed survey of
 - The nature of formal institutions,
 - Their relations to political processes and
 - Their path dependence

INSTITUTIONS

- Rules of the game
- Humanly devised constraints
- Providing structure for human interactions (political, economic and social)

- The cost of detecting rule violations, and the enactment of punishments are essential parts of all institutions.

Organisations

- Games: rules and players
 - Institutions – organisations
- Organisations are groups of people bound by some common purpose to achieve objectives

Institutions evolve by incremental change in e.g.

- Conventions
- Codes of conduct
- Norms of behaviour
- Contracts
- Common law
- Statute law

ECONOMIC PERFORMANCE

- How is it possible to explain or understand the various developmental trajectories of e.g. North American and Latin American countries?
- Why is there no convergence of economic systems in comparisons of developing and developed countries?

Institutions determine the opportunities of a society.

- Organisations are created to take advantage of those opportunities.
- As organisations evolve they change the institutions. The path of change is determined by
 - A lock-in between institutions and the populations of organisations evolved to exploit the institutions
 - Feedback processes from perception of and reaction to changes in the opportunity set.

Case 1: USA in the 19th century

- The constitution and the North West Ordinance
- Norms of behaviour rewarding hard work
- Political organisations (congress, local bodies, family farms, merchant houses, shipping firms)
- Economic growth led to demand for education, which led to public education.
- Changes in the organisational population and characteristics of organisations led to changes in institutions both formal and informal. (e.g. changing attitudes to slavery, the role of women, and temperance)
- Not all changes were in the direction of more efficient institutions. Changes usually will open opportunities both for productive activities and for activities reducing productivity.
- On balance: the institutional framework persistently rewarded productive activities.

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Case 2: Some developing country today or most states in known history

- Economic opportunities are also here a mixed bag, but on balance they favour activities that
 - Promote redistribution rather than production
 - Create monopolies rather than competitive conditions
 - Restrict opportunities rather than expand them
 - Rarely induce investment in education
- Organisations will become more efficient, but at redistribution rather than production
- These organisations will induce institutional changes making the economy even less efficient

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From theory to data

- North 1990 can be read as a theoretical foundation for De Soto’s study of “Why Capitalism Triumphs in the West and Fails Everywhere Else”

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Reading de Soto 2000:

- Hernando de Soto provides empirical observations of the dysfunctional consequences of
 - Illegitimate and insecure property rights
 - Poorly enforced laws
 - Barriers to entry of markets
 - Monopolistic restrictions
- Resulting in permanent underdevelopment

5 mysteries of capital

- Missing Information
- Capital
- Political Awareness
- Missing Lessons of US History
- Legal Failure

Missing Information

- On the continuous creation of wealth in the large urban sprawls of the developing world
- On the extraordinary inapplicability of existing legislation, currently creating an extra-legal sector comprising some 50-85% of the population

Capital

- Is created by the formal property system of a society. It
 - Fixes the economic potential of assets
 - Integrates dispersed information
 - Makes people accountable
 - Makes assets fungible
 - Networks people
 - Protects transactions

Political Awareness

- People move away from agriculture and small scale society to urban life and large scale society: a new industrial revolution is brewing
- Law has not kept pace and the result is a growing extralegal sector
- The problem is not new. The West experienced it, and solved it.
- How long will it take for governments to recognise it?

Missing Lessons of US history

- Squatting was common
- Pre-emption: squatters improving land could recover its value or buy the land before it was offered in public sale
- Gradually the extralegal sector was recognized and integrated in to the formal system

Legal Failure (1)

- Misconceptions of current policy
 - People go to the extralegal sector to avoid paying taxes
 - Extralegal real estate exist because of inadequate surveying and mapping
 - Mandatory law is sufficient, compliance costs irrelevant
 - Existing extralegal social contracts can be ignored

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Legal Failure (2)

- It is possible to change people’s conventions on how they can hold their assets, both legal and extralegal without high-level political leadership

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Legitimisation

- Law must build on existing social contracts
- The extralegal sector has developed their own law, their own understanding of what property is and what they can do with it
- Unless land reform builds on this, it will fail miserably as the many failed attempts at land reform already should show us

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Making better formal law

- Study the various extralegal sectors
- Extract the principles used by the people
- Compare it to existing law
- Adjust formal law and insert the principles used by people
- The result is much nearer a self-enforcing system of law

The political challenge

- Changing status quo of property rights is a major political task requiring
 - Taking the perspective of the poor
 - Co-opt the elite
 - Deal with the legal and technical bureaucrats guarding the current system

Next

We shall concentrate on one particular problem:

- Even the most formal institutions are founded on belief, on the consensus of people, in our heads. One way to come to understand this is to see it as a socially constructed fact.
- The strongest institutions are in reality “invisible” and man-made. To become invisible they disguise themselves as “nature”.
