

INSTITUTIONS AND INSTITUTIONAL DESIGN

Erling Berge

Part I: Introduction to the problem

NTNU, Trondheim

Fall 2003

2003-08-28

© Erling Berge 2003

1

Literature:

- North, Douglass C. 1990 “**Institutions, Institutional Change and Economic Performance.**”, Cambridge, Cambridge University Press, Ch 1,
- Peters, B Guy.1999 “**Institutional Theory in Political Science**”, London, Continuum, Ch1,
- Soto, Hernando de. 2000 “**The Mystery of Capital. Why Capitalism Triumphs in the West and Fails Everywhere Else**”, New York, Basic Books

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

What is it?

- Broadly speaking: An institution comprise all that make 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 fell wronged. Preventing you from doing it is illegitimate.
- The sources of this feeling are many.

...but basically they come from

- Other peoples opinions
- Informal rules of behaviour
- Formally defined rules of behaviour
- Specific interpretations of rules as laid out by courts or bureaucracies

This is quite similar to **the logic of appropriateness** (March and Olsen 1984)

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 ?

First principle: minimally sensitive to local traditions

Blue sky: minimally sensitive to constraining circumstances.

Blank sheets: minimally sensitive to past practice.

Design of formal institutions

Consists of

- Writing law
- Mandating a bureaucracy
- Staffing the bureaucracy

Without – for the moment – going into what institutions really consist of:

Our primary concern will be formal institutions. That is institutions created by politics through written law and budget allocations for people to administer that law.

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

In the case of formal institutions, fitting form to function implies

Learning about institutions from

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

Give out syllabus,

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

The practice of design

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

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

Instead of democratically accountable legislatures, we may make democratically representative juries

Instead of the external controls (constitutional courts, individual rights, division of power among branches of government) we may concentrate power in a responsible sovereign.

Instead of giving rights to minorities giving them a protected sphere (output filters) we may filter inputs: banning some types of arguments, questions, etc.

Problem: how to resolve: “presidentialism” vs “parliamentarianism” by varying democratic accountability

Will a democratically elected president inevitably clash with a democratically elected parliament? Is it possible to modify their democratic accountability to fit each other better?

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.

2003-08-28

© Erling Berge 2003

14

North(1990:3). “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.” ... “Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change.”

Institutions reduce risk by providing structure to everyday life. They limit the choice set for all kinds of human interaction.

Institutions may be informal or formal. Usually they are both. They range from the constitution of a country to the burial customs. They may be deliberately created or they may grow slowly from everyday activities as in common law.

Soccer as an institution: rules are both written and unwritten (e.g. not deliberately injuring a member of the opposing team). But sometimes rules are violated. Violations are punished. But detection of violations is often difficult (costly).

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

The goal of a game is to win. To win a team needs to organise itself, invest in skills, and complete the game. To what degree do unwritten “gentlemanly” rules constrain the activities? The organisation of the players of the game illustrates a crucial distinction: between organisation and institutions.

Modelling the evolution of organisation conditional on the rules of the game is something else than modelling the evolution of the rules themselves.

Organisations

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

If institutions are the rules of the game, organisations are the players of the game.

Organisations include:

Political bodies (political parties, the parliament, a municipal council, a regulatory agency)

Economic bodies (firms, trade unions, family farms, cooperatives)

Social bodies (churches, clubs, athletic associations)

Educational bodies (schools, universities, vocational training centres)

They are groups of people bound by some common purpose to achieve objectives. What kinds of organisations are created, and how they evolve, are fundamentally affected by the institutional framework. Over time their collective activities shape the development of the institutions. Therefore the interaction of organisations and institutions are important for the study of institutions.

Institutions affect the costs of exchange and production, and hence the performance of an economy. Institutions and technology determine the transaction and transformation costs.

Institutions evolve by incremental change in e.g.

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

Institutions provide stability, but are nonetheless constantly changing.

Conventions, Codes of conduct, Norms of behaviour, Contracts, Common law, Statute law are all evolving – sometimes slow and glacial, sometimes (almost) revolutionary. Changes at the margin may be a consequence of change in formal rules, informal constraints, as well as the kind and effectiveness of enforcement.

Formal rules may change overnight, but informal constraints evolve slowly with the culture, rather impervious to formal politics.

These culturally defined constraints are the key to path dependence of historical change.

Path dependent trajectories of development.

How does the past affect the future?

How does incremental change in institutions affect the choice set at any moment in time?

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?

1973 North and Thomas (The Rise of the Western World): institutions determine economic performance and changes in relative prices create incentives for institutional change. Efficiency is the key determinant.

1981 North (Structure and Change in Economic History) Efficiency is abandoned. In history rulers have devised property rights in their own interest and transaction costs resulted in typically inefficient property rights prevailing. But why do not rulers of inefficient economies emulate more efficient economies?

1990 North (this book): The answer hinges on the difference between institutions and organisations and the interaction between them shaping the direction of institutional change.

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.

North(1990:7) “The resultant path of institutional change is shaped by (1) the lock-in that comes from the symbiotic relationship between institutions and organisations that have evolved as consequence of the incentive structure provided by those institutions. And (2) the feedback process by which human beings perceive and react to changes in the opportunity set.

The increasing returns characteristics of an institutional matrix that produces lock-in come from the dependence of the resultant organisations on that institutional framework and the consequent network externalities that arise.”

The mutual dependence of organisations and institutions produces an institutional matrix or organisational network with increasing returns to scale and network externalities Profitability of some or most organisations will depend on particular characteristics of the institutional matrix. If entrepreneurs in business or politics perceive that they could do better with different institutional rules, they will devote time and resources to alter the institutional framework and thus contribute incrementally to institutional change.

The process of perception is crucial. Actors have incomplete information and interpret it by means of mental constructs that may deviate more or less from how the true world works. The result often is persistently inefficient paths.

Transaction costs in political and economic markets make for inefficient property rights. The imperfect subjective models used by players in attempt

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.

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

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"

North 1990 p 67 refers to de Soto 1989 "The Other Path" on transaction costs in third world countries and how the lack of enforcement leads to a third sector outside the law with mostly self-enforcing transactions.

Eggertsson, Thráinn 1990 "Economic Behaviour and Institutions", Cambridge, Cambridge University Press, p273-275 refers to the same study in addition to Litan, Robert E. and Schuck, Peter H. 1986 "Regulatory Reform in the Third World: The Case of Peru", Yale Journal of Regulation 4(No.1, fall)

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

The high transaction costs are leading to firms with

- Short time horizons
- Little fixed capital
- Small scale operation

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

Investigations in the Philippines, Peru, Haiti, and Egypt leads to a conservative estimate of a total of 9.34 trillion USD in dead (unregistered) capital in the extralegal sector.

Procedure to formalize informal urban property in **Philippines**: 168 steps, 13-25 years

Procedure to obtain legal authorisation to build a house on state-owned land in **Peru**: 207 steps, 6 years, 11 months.

Procedure to obtain a sales contract following a 5 year lease contract in **Haiti**: 111 steps, 4112 days (>11 years)

Procedure to gain access to desert land for construction purposes and to register these property rights in **Egypt**: 6-14 years

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

deSoto(2000:63): “Property, then, is not mere paper but a mediating device that captures and stores most of the stuff required to make a market economy run. Property seeds the system by making people accountable and assets fungible, by tracking transactions, and so providing all the mechanisms required for the monetary and banking system to work and for investment to function. The connection between capital and money runs through property.

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?

deSoto(2000:87): “This extralegal sector is a grey area that has a long frontier with the legal world, a place where individuals take refuge when the cost of obeying the law outweighs the benefits.”

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

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

deSoto(2000:157): “The crucial thing to understand is that property is not a physical thing that can be photographed or mapped. Property is not a primary quality *of* assets but the legal expression of an economically meaningful consensus *about* assets. Law is the instrument that fixes and realizes capital. In the West, the law is less concerned with representing physical reality of buildings or real estate than with providing a process or rules that will allow society to extract potential surplus value from those assets. Property is not the assets themselves but a consensus between people as to how those assets should be held, used, and exchanged.”

Legitimation

- 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

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

deSoto(2000:187): “Where have all the lawyers been? Why haven’t they taken a hard look at the law and order that their own people produce? The truth is that lawyers in these countries are generally too busy studying Western law and adapting. They have been taught that local practices are not genuine law but a romantic area of study best left to folklorists. But if lawyers want to play a role in creating good laws, they must step out of their law libraries into the extralegal sector, which is the only source of the information they need to build a truly legitimate formal legal system.”

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

deSoto(2000:204): “People do not want to get inside the formal property system because they are eager to be mapped, recorded, or taxed; they will join the system when its economic benefits are obvious to them and when they are certain their rights will continue to be protected.”

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” as man-made institutions. They disguise themselves as “nature”.