

INSTITUTIONS AND INSTITUTIONAL DESIGN

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Part VII: Origin and development I

NTNU, Trondheim

Fall 2004

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Literature

- North, Douglass C. 1990 **“Institutions, Institutional Change and Economic Performance”**, Cambridge, Cambridge University Press,
- Ostrom, Elinor 1990 “Governing the Commons. The Evolution of Institutions for Collective Action”, Cambridge, Cambridge University Press,
- Stinchcombe, Arthur L 1997 “On the Virtues of the Old Institutionalism” Annual Review of Sociology Vol. 23, pp.1-18

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North Ch 4 slide 1

- Measurement costs are important because of asymmetric information (adverse selection, moral hazard)
- Measurement costs + enforcement costs = transaction costs
- Explains why property rights are not perfectly specified

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North Ch 4 slide 2

- Enforcement
 - Policing agents: increasing marginal costs of measuring and policing performance
 - The agent acquires certain property rights in their own labour
- First party: principal disciplining agent
- Second party: friends, associates, kin
- Third party: the state

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North Ch 5 slide 1

- Informal constraints:
 - 1) extensions, elaborations and modifications of formal rules, 2) socially sanctioned norms of behavior, and 3) internally enforced standards of conduct
- The same formal rules imposed on different societies give different outcomes
- Informal rules come from culture and language
- Primitive (stateless) society (not simple!) kinship ties important for sanctioning system
- Ideas, ideologies, convictions affect choices and matter more the lower the cost of their expression

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North Ch 5 slide 2

- Informal constraints
 - coordination rules are self-enforcing
 - norms of cooperative behavior need instruments of enforcement
 - Internal codes of conduct imply trade-off between wealth and other values (communism, religion)
- Payoff to honesty, integrity, reputation of trust poorly understood (a problem in the sociology of knowledge)
- How do we acquire, process, and utilize information?
- The cultural processing of information implies incremental change of institutions and path dependence of societies
- Changing formal rules do not immediately lead to changes of informal rules. Their interaction may lead to unexpected outcomes

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North Ch 6 slide 1

- Formal rules: a matter of degree, often making informal rules more effective
- Existing rules define the wealth maximizing opportunities of the players, promoting some kinds of exchange but not all
- Parts of the resources of the players will be devoted to protect or change existing rules
- Formal rules usually designed
 - with private wellbeing as a goal
 - With compliance costs in mind
- Changes in technology and relative prices will alter the relative gains from devising rules

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North Ch 6 slide 2

- Political rules leads to economic rules (and vice versa), but political rules have priority
- How do credible commitments evolve?
- Democracy gives greater political efficiency, but this is different from economic efficiency
- Democratic polities reduce transaction costs per political transaction but the volume increase
- Also increases in agency costs voter-parliament, parliament-government and rational voter ignorance affecting voting
- Inefficient property rights persist because powerful interest groups oppose changes, or because changes will lower tax returns
- Formal rules are incomplete – they depend on informal rules

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North Ch 7 slide 1

- Enforcement is neither constant nor perfect
 - Because of costly measurements, and because
 - Enforcement agents have their own agendas
- Contracts are self-enforcing when it pays all parties to live up to the promise (personal, small scale repeated deals will facilitate this)
- Impersonal exchange needs institutions providing
 - Information on the performance of contracting partners to determine when defection occurs
 - Incentives for some persons to actually carry out punishments

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North Ch 7 slide 2

- Institutions that facilitate exchange are costly and lowers the gain from trade
 - Dilemma: we cannot do without the state, but we cannot do with it either ...
 - With a wealth maximizing assumption not even a simple model of an efficient third party state can be constructed
- Are we a free people because of the constitution, or do we have this specific constitution because we are a free people?

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North Ch 8 slide 1

- Institutions and technology used in measurement and enforcement define transaction costs
 - Case study: Transfer of residential property in the USA
- Transaction costs also affect transformation costs (cost of monitoring output quality depends on and sometimes determine choice of transformation technology)
 - Case study: production of goods and services e.g. bargaining power of skilled labor, oil production
- The institutional structure of underdevelopment
 - See de Soto 2000

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North Ch 8 slide 2

- The institutional constraints that define the opportunity set of individuals are a complex of formal and informal constraints. They make up an interconnected web that in various combinations shapes choice sets in various contexts.
 - The complex is basically stable but change incrementally along several margins
- The institutional framework is the critical key to the relative success of economies, both cross-sectional as well as through time

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Analytical levels of institutions

Ostrom 1990: 50-55

1. The practical: Operational choices
2. The organisational: Collective choices
3. The constitutional: Constitutional choices

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1. The Practical Level

- Application of rules to activities
- The everyday interpretation of operational rules by individuals or groups assigned tasks by an organisation
- The Lifeworld

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2. The Organisation Level

- Making rules about activities
- The day to day monitoring, evaluation and adaptation of rules of operation for production and distribution
- Law, Police, and Judiciary

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3. The Constitutional level

- “Rules about the making of rules”
- Constitution: Rules and procedures used to shape the internal activity of an organisation and the rules of its operation
- The “Legislature” of the Organisation

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Evaluation of Constitutions

Goodin (1997) discuss 4 commonly agreed upon requisites of a good constitution

- 1. democratic responsiveness
- 2. checking the abuse of power
- 3. protecting the minorities
- 4. social pluralism

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ON THE VIRTUES OF THE OLD INSTITUTIONALISM

- Institutions are staffed and are created to do the job of regulating organizations.
- This staffing of the institution, and all the creative work that is involved in funding, governing, training, and motivating institutional actions by that staff, has been lost in recent institutional theorizing.

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Ritual Means of Survival vs. Institutionalized Values

- Variations in the bindingness of institutional rituals are to be explained by beliefs about what the institution is for
- When the value system informing an institution ranks something as of high priority, it is more likely that the keepers of the institution will formalize conformity with the institution in a ritual designed to monitor, enforce, and enact the value of that something

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How contracts in the market come to be legitimate

- by the way they are constituted,
- by **the mutual belief of the contracting parties that each is committed** to the line of action promised in the contracts,
- **especially the commitment of a firm to be competent** in the future to carry out the activities specified in the contracts.

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Legitimacy in the law of market competition as a system,

- is related to the legitimacy of being able to do things better than competitors as a moral and legal claim on the profits of such competence.

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The failure of institutions (1)

- Institutions, and commitment to institutions, are essential to the creation of public goods
- Economic progress involve the production of public goods, including obvious ones such as roads or civil order, and not so obvious ones such as the willingness to discuss what we should do next in a spirit of honesty and compromise

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The failure of institutions (2)

- When the institutional means to create public goods are not available, welfare seems to people to depend on looking out for themselves and their immediate kin, rather than on trying to create greater welfare for all
- Some sorts of institutions undermine capitalist organizations, and do so by failing to provide integrity in the achievement of public goods

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Concluding (1)

- The basic postulate is that organizations that work well do so by paying people to serve values, to try to be competent, to conduct their business with integrity
- An organisation seen as a working sustainable combination of resources and believable commitment can only be created if people believe that the institutional enforcers themselves believe the values.

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Concluding (2)

- The guts of institutions is that somebody somewhere really cares to hold an organization to the standards and is often paid to do that
- Sometimes that somebody, or his or her commitment, is lacking, in which case the center cannot hold, and mere anarchy is loosed upon the world

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