

INSTITUTIONS AND INSTITUTIONAL DESIGN

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Part VII: Origin and development I

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Literature

- North, Douglass C. 1990 “**Institutions, Institutional Change and Economic Performance**”, Cambridge, Cambridge University Press,
- Williamson, Oliver E. 1996 “The Mechanisms of Governance”, New York, Oxford University Press, Ch 3 **Transaction Costs Economics**, pp54-87
- Peters, B Guy 1999 **Institutional Theory in Political Science**, London, Continuum

North Ch 4

- Measurement costs
 - Because of asymmetric information (adverse selection, moral hazard)
 - Plus enforcement costs = transaction costs
 - Explains why property rights are not perfectly specified
 - Enforcement: second party, or third party.

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

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

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

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

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

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?

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

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

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.

See also Goodin 1996, Hanna 1996, and Peters 1999

Stinchcombe (1997:2) "Institutions, I learned then, shaped the creation and functions of units in market and the relations between them. But unlike the institutions of modern institutionalism, people ran these institutions by organizing activities on their behalf."

Stinchcombe (1997:4) "The impoverished view of modern institutional theorists (especially in the "organizational ecology branch") reduces the conception of competition to that of the relations among organizations that have the "legitimate" organizational form for that "population." This conception leaves out many aspects of what the traditional institutional theorists actually thought about competition. The transaction costs literature (e.g. Williamson 1975) preserves more of this content, except that it does not study legitimacy of the market itself, and so it has

a vacuous description of what firms (as hierarchies) are contrasted to. The conceptions of Commons and Schumpeter of how competitive markets came to be legitimate are not vacuous."

Stinchcombe (1997:5) CASE 1: "a clear case in which legitimacy of rituals in courtrooms varies with how well they substantively achieve justice in the use of evidence in the law and so produce legitimate decisions. My argument is that unless the rules of evidence are guided by considerations of justice, they do not produce legitimacy."

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

The court system as an institution producing legitimate decisions
Stinchcombe (1997:2-3) "It is a peculiarity of such courts that they produce legitimate decisions, and so legitimacy is absolutely central to their survival, and that in order to produce legitimate decisions they have to use legitimate means, especially legitimate evidence."

Stinchcombe (1997:8) "I believe we have recently underestimated the degree to which people accept institutions because they think the institutions have the right answer, because institutions embody a value that the people also accept." ... "The old institutionalist theory of Selznick and others is that reason and good sense are values, and formality a means to reason and good sense."

Stinchcombe (1997:9) "The more justice matters, in short, the greater the formality of the application of the law of evidence. This point is crucial to our differences with the new institutionalism. We want to predict when the *institution* will demand more formality, not when the *organization* will more enthusiastically adopt the institution's standards, as Meyer & Rowan (1977) do. It is precisely because the behavior of institutional authorities in enforcing standards varies that it is important to notice that institutions are staffed, rather than being merely collective representations."

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.

Stinchcombe (1997:5-6) CASE 3 “The third outlines why it ever becomes legitimate for competitors to do damage to each other, and how civil law has had to be arranged so that that competitive conflict gives rise not to claims in court, but instead to “legitimate” competition.”

Stinchcombe (1997:3) “The basic intuition here is Durkheim’s observation that there is a noncontractual basis of contract. In particular, the set of contracts that constitute a firm has a particular kind of noncontractual basis, outlined with great depth and perception by Commons.”

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.

Stinchcombe (1997:13) “But one of the positions he (Schumpeter) holds in common with the old institutionalists is that the form of competition among organizations is historically variable, depending a good deal on the values of the governing classes and their challengers.”

“Thus Schumpeter was primarily interested in the institutions that allowed the peaceful destruction of whole populations of organizations.”

Stinchcombe (1997:14) “In human history, competition has not ordinarily been legitimate. It is a wonder that modern organizational ecologists have not noticed this. Most institutional conditions restrict competition. Institutions that allow people’s livelihoods and capital to be destroyed by competition are rare.”

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

Stinchcombe (1997:15) “Edward Banfield, in *The Moral Basis of a Backward Society* (1967 [1958]). The basic idea of that book was that some sorts of institutions undermine capitalist organizations, and that they do so by failing to provide integrity in the achievement of public goods”

“Banfield’s basic notion was that if the nuclear family was so set up that its solidarity and interests invariably overrode those of other institutions, then those other institutions could not do their job. Institutions that depend on generosity of spirit and attention to collective welfare are especially vulnerable.”

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

Stinchcombe (1997:16) “Durkheim held that the division of labor rested on the noncontractual elements of contract, the commitment to values of commercial honesty, nonstrategic use of bankruptcy, advertising with some information value, competence in one’s occupation, and the like. Banfield’s argument then might be read as asserting that both the contracts between firms, and between governments and firms, are not institutionalized under “amoral familism.””

Stinchcombe (1997:16) “The capacity of the population to create public goods, such as industry standards-setting, credit extension and its credit-rating system, honest brokerage in stock and bond markets, is crippled because that capacity used to be all embedded in the central planning system.”

“The basic postulate here 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.”

Stinchcombe (1997:17) “The combination of resources and believable commitment can only be created, so the old institutionalists argued, if people believe that the institutional enforcers themselves believe the values.”

Concluding

- 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

Stinchcombe (1997:6) “Much of the narrowness in modern institutionalism in organizational theory is explained by lack of detail in the conceptions of institutions.”

Stinchcombe (1997:17) “In short, the trouble with the new institutionalism is that it does not have the guts of institutions in it. The guts of institutions is that somebody somewhere really cares to hold an organization to the standards and is often paid to do that.”

Stinchcombe (1997:18) “And 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.”