

INSTITUTIONS AND INSTITUTIONAL DESIGN

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Part VIII: Origin and development II

NTNU, Trondheim

Fall 2003

2003-10-09

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Literature

- North, Douglass C. 1990 “**Institutions, Institutional Change and Economic Performance**”, Cambridge, Cambridge University Press,
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North Ch 9

Organisations, learning, and institutional change

- Organisations develop a demand for knowledge and skills (and generate tacit knowledge of their own activities)
 - Property rights (patents) has helped create the innovation feature of western economies
 - Technological innovations are path dependent
 - Ideology and knowledge directs the attention of investigations but also develops by new insights

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Institutional change

- From the particular demands for knowledge
- Shaped by interactions of
 - Existing institutions,
 - Stock of knowledge and
 - Maximising behaviour of agents
- Incremental changes in informal constraints caused by maximising behaviour

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Adaptive efficiency

- Allocative efficiency (Pareto conditions)
- Adaptive efficiency concerned with development through time; willingness to
 - Acquire knowledge and learning
 - Induce innovation
 - Undertake risk and creativity
 - Resolve problems and bottlenecks

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North Ch 10 Stability and Institutional Change

Stability is furthered by

- Rules hierarchically nested
- Informal constraints
- Habitual behaviour
- In equilibrium no actor find it profitable to devote resources to rule changes

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Most change is incremental

From shifts in

- Relative prices
 - Ratio of factor prices, cost of information, changing technology,
- Preferences
 - Changing relative prices (e.g. work-leisure, price of expressing ideas) may induce change in tastes
 - Ideas (moral, ethical) about the world

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Discontinuous change

- Does the institutions allow incremental change?
- Does the preferences allow bargaining and compromise?
- Successful revolutions require coalitions making final outcomes uncertain
- Successful revolutions require ideological commitment to overcome free riding
- Discontinuous change is not so very discontinuous!

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North Ch 11

The path of institutional change

- Technological paths of development
 - “QWERTY”, gas engines not steam, alternating current vs. direct
 - Fuelled by **increasing returns, learning by doing**
- Self-reinforcing mechanisms
 - Large set-up or fixed costs (falling unit costs)
 - Learning effects (improved products, lower costs)
 - Coordination effects (several agents using the same)
 - Adaptive expectations (further belief in prevalence)

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Competing Technologies

Consequences of self-reinforcement

- Multiple equilibria (outcomes indeterminate)
- Possible inefficiencies (best T may have bad luck)
- **Lock-in** (once a solution is reached, exit difficult)
- **Path dependence**

In reality the competition is between organisations employing the technology (institutions)

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The path of institutional change

- Increasing returns (self-reinforcement)
 - with increasing returns institutions matter and shape the long run path of economies. But with zero transaction costs the path is approximately efficient
- Imperfect markets (significant transaction costs)
 - With significant transaction costs the subjective models of actors as modified by imperfect feedback and ideology will shape the path
- Divergent paths and persistently poor performance may prevail

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The North-West Ordinance

- Governance and settlement of the lands in the West
 - Fee-simple ownership, inheritance, territorial government – self-governing, territory admittance as a state, a “bill of rights”, prohibiting slavery, and more
 - The law generated incremental change reinforcing its basic properties, but it was not inevitable.
 - Network externalities, learning of organisations, subjective models of the issues
 - Adaptively efficient economic and political processes

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Path dependence

- Entrepreneurs are constrained by existing institutions and by their imperfect knowledge
- Goals may not be reached
- Increasing returns of the institutional matrix means that even if specific changes may change history its direction remains the same
- USA vs Mexico: History matters

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A short summary

Institutions as

- Social facts by agreement (Searle)
- Thought worlds/ subjective models (Douglas)
- Rules of the economic game shaped by
 - Transaction and information costs
 - Subjective preferences and learning
 - Increasing returns and political processes

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Institutions are

Humanly devised rules with some

Humans mandated to monitor and sanction rules

- Created to aide in collective actions problems to safeguard life and livelihoods
 - Avoid conflicts, create justice
 - Allocate legitimate benefits and duties, profits and costs
 - Economize on transaction costs
- **Not** created to achieve efficiency or optimise economic performance(of the neo-classical model)

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Property rights institution

Tells that some person(s) have legitimate

- Rights and duties to be exercised in relation to
- Particular goods and services subject to possible
- Limitations on times and durations,
- Limitations of technology, and
- Limitations on organisation of exploitation

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The construction of social institutions

For example

- Property rights regimes
 - Public property
 - Common property
 - Private property
- Regulations regimes
 - Governing externalities
 - Protecting unitary/ universal values
- Bureaucracies

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The social construction of institutions

Informal institutions

- Conventions
- Customs
- Values, Preferences
- Norms, Standards of conduct
- Beliefs, Ideologies, Morals

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The dynamic of Institutions and organisations

- Rules of the game (the law)
- Guardians of the rules (the judge)
- Players (organisations)
 - Owners,
 - Local users,
 - Workers,
 - Professional managers, and
 - Firms of resource industries

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Strategies of the players

Our theory requires by assumption that players

- Optimise their returns from resource use activities by conforming to and **exploiting the existing institutional environment**, or to
- **Change the resource policy** in a desired direction if the expected outcome of a political effort is seen as cost effective.

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Lock-in of institutions and organisations

- Mutual interdependence institution-organisations
- Institutional changes by public initiative or revolution creates counter-forces
- Economic performance is **PATH DEPENDENT**
- Change occurs at the margins

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