

# **INSTITUTIONS AND INSTITUTIONAL DESIGN**

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### **Part XII: Policy and design I**

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Literature:

Chapters 12-14 in

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

# Ch 12: Institutions, economic theory and economic performance

In this chapter

1. Changes needed in neo-classical economic theory
2. Implications for the static analysis of economic performance
3. Implications for a dynamic theory of long-run economic change

North (1990:107) "We cannot see, feel, or even measure institutions; they are constructs of the human mind."

# 1 Changes needed in neo-classical economic theory

- A procedural concept of rationality, based on
- The costs of transacting, and recognizing that
- Institutions imply market imperfections: there will always be incompatible incentives
- Institutions are provided in the political market: voter ignorance, incorrect perceptions, etc....

North (1990:108) “If ... the actors are incompletely informed, devise subjective models as guides to choices, and can only very imperfectly correct their models with information feedback, then a procedural rationality postulate ... is the essential building block to theorizing.”

North (1990:109) “There is a vast gap between better and efficient (in the neoclassical meaning of the term) outcomes, as a vast literature in modern political economy will attest.”

North (1990:110) “And the modern Western world provides abundant evidence of markets that work and even approximate the neoclassical ideal. But they are exceptional and difficult to come by, and the institutional requirements are stringent.”

## 2 Economic performance: statics

- Models as specific to particular constellations of institutional constraints

They do not recognise

- Subjective perception, incomplete information and complex environments
- Ideas and ideologies matter. Institutions determine how much they matter.
- Politics and economy are interlinked. This needs to be reflected in theories

North (1990:111) “Our preoccupation with rational choice and efficient market hypotheses has blinded us to the implications of incomplete information and the complex environments and subjective perceptions of the external world that individuals hold.”

# 3 Economic performance: dynamics

New theory building on old elements

- Scarcity/ competition
- Incentives are the driving forces

And new elements

- Incomplete information
- Subjective models of reality
- Increasing returns characteristics of institutions

Increasing our understanding of path dependence

North (1990:112) “The source of incremental change is the gains to be obtained by organisations and their entrepreneurs from acquiring skills, knowledge, and information that will enhance their objectives. Path dependence comes from the increasing returns mechanisms that reinforce the direction once on a given path. Alterations in the path come from unanticipated consequences of choices, external effects, and sometimes forces exogenous to the analytical framework.”

# A case of path dependence

## Spain Latin America

- 1500: not yet unified, centralized Castile
- Problem: rising costs of warfare- Cortes, taxing wool trade
- Fiscal crisis unresolved, evolution of church and bureaucracy, 300 years of stagnation
- Inherited by Latin America

## Britain North America

- 1500: centralized feudalism and monarchy
- Problem: rising costs of warfare – Parliament, taxing wool trade
- Fiscal crisis resolved, evolution of polity, started the road to world hegemony
- Inherited by North America

Spain: a centralized bureaucracy administering an ever growing body of regulations and legislation in the most powerful empire since Rome. Revolt of the Netherlands, loss of bullion from overseas revealed that expenditure far outstripped tax revenue resulting in bankruptcies, confiscations and insecure property rights. Only the church and the judiciary were rewarding occupations. In general disincentives to productive activity.

Britain: expenditures were early on tied to tax incomes, bank of England, a private banking system, more secure property rights, and decline of mercantilist regulations. In general incentives to productive activity.

This legacy lives on. On page 116-117 there is a quote from Coatsworth (1978:94) which parallels de Soto's statements exactly.

# Ch13: Stability and change in economic history

Institutions provide a basic structure permitting the creation of order and reduction of uncertainty

- What kinds of institutions permit the capture of the gains from trade inherent in the neoclassical (zero transaction costs) model?
- Some paths led to stable exchange patterns other paths led to dynamic change
- Why stability and why change?

North (1990:118) "The argument advanced in this study is that the current forms of political, economic, and military organization and their maximizing directions are derived from the opportunity set provided by the institutional structure that in turn evolved incrementally."

# Changing economies

- Growing specialisation and market access
  - From village markets to global markets
- Transaction costs change as scale increases
  - Agency problems (kin- networks, commenda)
  - Contract enforcement absent a state
- Ending up with first national, then global capital and commodities markets
  - The global system is now struggling to solve some of the same problems as the nation state of early modern Europe (standardized measurement units, medias of exchange, laws, enforcements agencies, taxation)

“Primitive” forms of exchange still exist. Village markets still flourish in many parts of the world. Only in western Europe the early medieval long distance trade created a long term dynamic, a sequence of internal developments of more complex forms of organisations that led to our present global economy.

What are the forces behind stability in one case and change in the other?



# Stability of the Suq

- High measurement costs
- Continuous efforts at clientization
- Intensive bargaining at every margin

The name of the game is to raise the costs of transacting to the other party to exchange. One makes money by having better information than one's adversary

North (1990:125) "Tribal organisation, the suq, and caravan trade are characteristic of stable patterns of very limited cooperation that have persisted through history. In each case, the skills and knowledge requisite to success on the part of the organisations or individuals involved did not entail or induce productive modifications of the institutional framework. In each case the sources of institutional change were external.

In contrast, the history of long-distance trade in early modern Europe was the story of sequentially more complex organization that eventually led to the rise of the Western world."

# European institutional changes in medieval and early modern times

## Organizational innovations at 3 cost margins

- Increasing the mobility of capital
  - Evading usury law
  - Bill of exchange, negotiability and discounting
  - Enforcement, accounting and auditing methods
- Lowering the information costs
  - Printing of prices and manuals
- Spreading the risk
  - Insurance
  - Organisations (portfolio diversification, limited liability)

Innovations from Byzantium or Italian city states.

The increasing returns from a growing volume of trade made it profitable to devise mechanisms for lowering costs and spreading risks, and the lower costs and spreading of risk encouraged more trade.

Development of the Law Merchant:

- Common law interfering with trade – no protection of bona fide purchases of stolen goods,
- Responsibility for agents

# Institutional stability?

- Normally, in history social change does not encourage maximizing actors to obtain knowledge and skills that increase productivity
- Neither does it normally induce institutional change conducive to increased productivity
- European history is special
  - Why the Netherlands and England?

North (1990:130) "A traditional explanation for European success in contrast to China, Islam, or other areas is competition amongst political units. There can be little doubt that this competition is an important part of the story, but clearly it is not the whole story. Parts of Europe failed to develop. Spain and Portugal stagnated for centuries and economic growth in the rest of Europe was uneven at best. It was the Netherlands and England that were carriers of institutional change. The characteristics of path dependence, described in the previous chapters, set within the context of the contrasting *initial* conditions produced the diverging stories of Spain and England."

# Ch 14: Incorporating institutional analysis into economic history: prospects and puzzles

- Traditional history emphasis technology and the industrial revolution to explain change – but in many cases technology seems to make matters worse
- Application of neoclassical economic theory made it possible to focus on choices and constraints – but it was a static theory
- Neo-institutional theory can do it better

North (1990:133) “There is a different, and I think, better story. It concerns the endless struggle of human beings to solve the problems of cooperation so that they may reap the advantages not only of technology, but also of all the other facets of human endeavour that constitute civilization.”

# What makes for efficient markets?

- Technology provides an upper bound on economic growth
- Neoclassical models of growth crucially depends on an implicit incentive structure that drives the models
- Marxist models of exploitation have to demonstrate that the institutional framework produce systematic uneven consequences
- Are exploitative institutions imposed from outside or are they endogenously determined?

North (1990:134) "If poor countries are poor because they are victims of an institutional structure that prevents growth, is that institutional structure imposed from without or is it endogenously determined or is it some combination of both?"

# Incentives are the key

- Rationality
- Ideas
- Ideologies
- Maximising behavior
- Relative prices
- Collaboration and organisation to exploit opportunities structured by institutions

North (1990:136) "In fact, it was the adaptively efficient characteristics of the institutional matrix (both formal rules and the informal constraints embodied in attitudes and values) that produced an economic and political environment that rewarded productive activity of organisations and their development of skills and knowledge."

North (1990:137) "Whatever the real underlying sources of the farmers' plight that produced discontent in the late nineteenth century, it was the farmers' perceptions that mattered and resulted in changing the political and economic institutional framework."

# The adaptive efficiency of the institutional matrix

- The informal constraints come from
  - Cultural transmission of values
  - Extension and application of formal rules to solve specific exchange problems
  - Solutions of straightforward coordination problems
- Traditions of hard work, honesty, and integrity - reinforced by ideologies lowers TC
- The transaction costs inherent in the political process are always high

North (1990:138) “The subjective perceptions of the actors are not just culturally derived but are continually being modified by experience that is filtered through existing (culturally determined) mental constructs. Therefore, fundamental changes in relative prices will gradually alter norms and ideologies, and the lower the costs of information, the more rapid the alterations.”

North (1990:140) “One gets *efficient* institutions by a polity that has built-in incentives to create and enforce efficient property rights. But it is hard – maybe impossible – to model such a polity with wealth maximising actors unconstrained by other considerations.”