Chapter 5

Interplay among (formal and informal) institutions

There is a possible link between "culture" and formal institutions/policies

- $\text{institutions}_{\text{today}} \rightarrow \text{culture}_{\text{tomorrow}}$
- culture $\rightarrow$ institutions and their functioning

and they both affect economic outcomes

It is an open issue: $(\cdot)$ explicate the links and $(\cdot)$ verify/quantify the links

5.1 Putnam's conjecture

Putnam 1993:

- social capital is not uniformly distributed across italian regions
- conjectue:
  - regional differences can be explained by the experience of free city states in Northern Italy (c.a. 1300)
    - civic tradition: individuals learnt how to behave with public goods
    - such tradition has been passed down over centuries
  - by contrast the South of Italy has experienced an autocratic government
    - the Norman Kingdom prevented the accumulation of social capital
- After unification (1861) $\rightarrow$ same formal institutions that in practice work differently

$$+\text{social capital} \rightarrow -\text{corruption} \rightarrow +\text{efficiency}$$

5.1.1 Civic Tradition

The Concept and Measures of Civic Tradition

Concept:

- civic commitment (interest for the "public good")
- solidarity
- trust

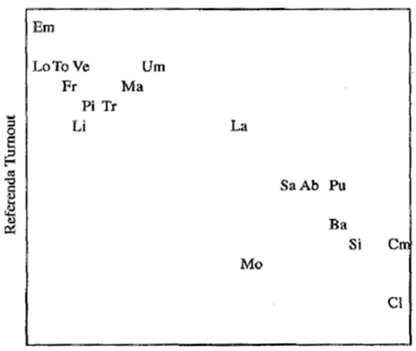
- tolerance

Measures:

- number of voluntary associations
- newspaper readership
- voting turnout at referenda
  - no vote-buying
  - sanctions for abstention
- preference voting
  - vote-buying

Civic Tradition in Italy

FIGURE 4.3
Referenda Turnout and Preference Voting



Preference Voting
Correlation: $r = -.91$

5.1.2 The Experiment

Creation of regions in 1970

- Responsibility for healthcare, agriculture, urban affairs housing, public works, vocational education (expenditure c.a. 10% GDP in 1990)
- same legislative framework

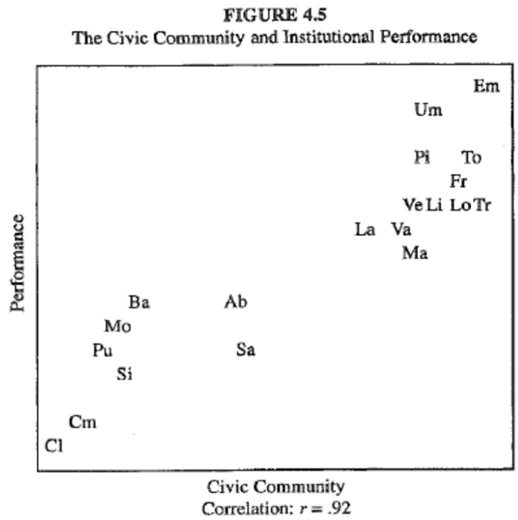
> "*The Italian regional experiment was tailor-made for a comparative study of the dynamics and ecology of institutional development. Just as a botanist might study plant development by measuring the growth of genetically identical seeds sown in different plots, so a student of government performance might examine the fate of these* ***new organizations, formally identical, in their diverse social and economic and cultural and political setting***"

Performance of Institutions

Outcome of interest: performance of institutions (but we have no data on economic output) $\rightarrow$ aggregation of 12 indicators:

- cabinet stability
- budget promptness
- statistical and information services
- reform legislation
- legislative innovation
- day care centers
- family clinics
- industrial policy instruments
- agricultural spending capacity
- local health unit expenditures
- housing and urban development
- bureaucratic responsiveness

The Experiment: role of Civic Tradition



5.1.3 The Hypothesis

Historical experience of Communes influences the civicness at the time of unification (1860 - 1920) and the current civicness (1970)

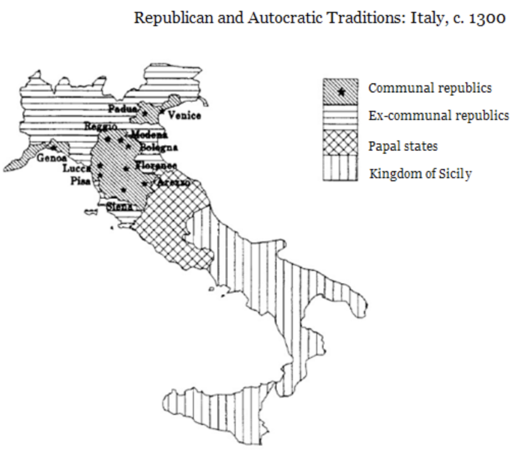


Figure 5.1: historical experience of communes

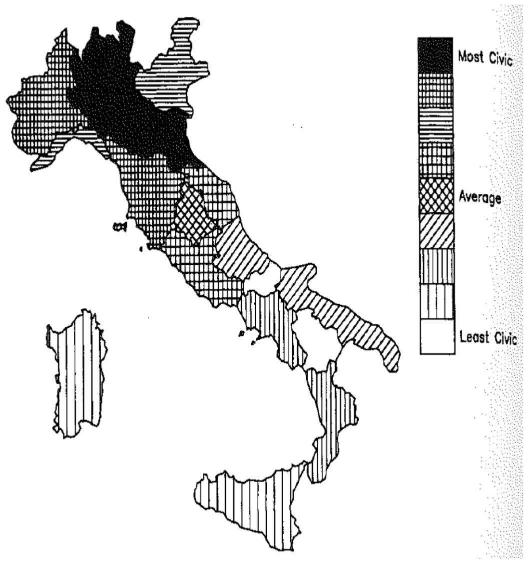


Figure 5.2: civicness at the time of unification

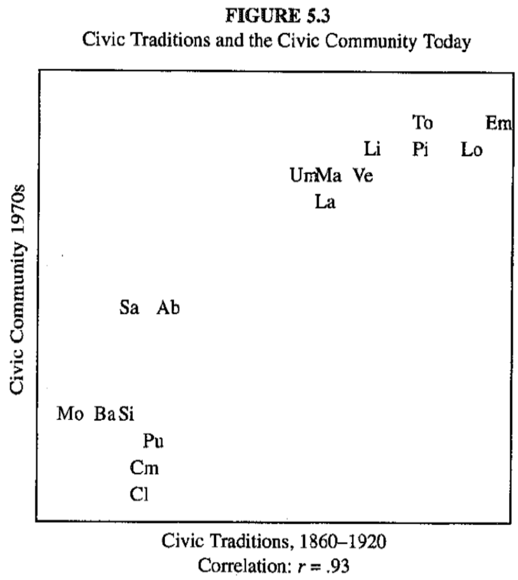


Figure 5.3: current civicness

Historical experience of communes explaines differences in performance

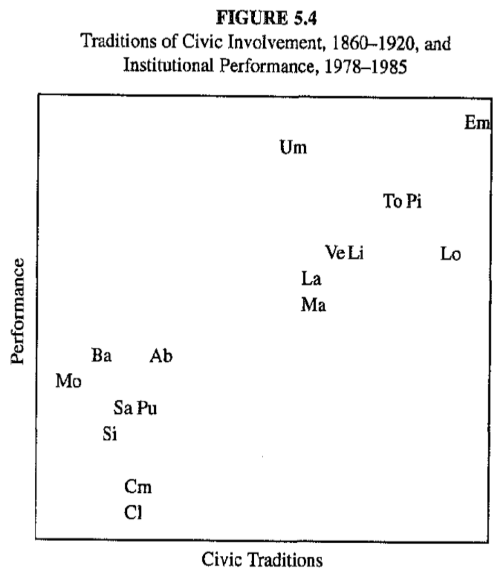


Figure 5.4: current civicness

Large Empirical Literature

- history to address endogeneity
- several papers explore the effects of institutions (and policies) on culture
- and the complementarities between culture and formal institutions

5.2 Institutional complementarities and the Varieties of Capitalism

5.2.1 "Varieties of Capitalism" - Hall & Soskice (2001)

- accept methodological individualism
  - the firm as the core actor of the capitalist economies
- accept North's definition of institutions
  - institutions solve coordination failure
- acknowledge that markets themselves are institutions
  - market are one of the possible ways to coordinate individuals' behavior
- highlight the existence of institutional complementarities
  - interplay between different formal institutions (and informal institutions as well)

The Firm at the Center

> Our conception of the firm is relational. Following recent work in economics, we see firms as actors seeking to develop and exploit *core competencies* or *dynamic capabilities* understood as capacities for developing, producing, and distributing goods and services profitably (Teece and Pisano 1998). We take the view that critical to these is the quality of the relationships the firm is able to establish, both internally, with its own employees, and externally, with a range of other actors that include suppliers, clients, collaborators, stakeholders, trade unions, business associations, and governments. As the work on transactions costs and principal–agent relationships in the economics of organization has underlined, these are problematic relationships (Milgrom and Roberts 1992). Even where hierarchies can be used to secure the cooperation of actors, firms encounter problems of moral hazard, adverse selection, and shirking. In many cases, effective operation even within a hierarchical environment may entail the formation of implicit contracts among the actors; and many of a firm's relationships with outside actors involve incomplete contracting (cf. Williamson 1985). In short, because its capabilities are ultimately relational, a firm encounters many coordination problems. Its success depends substantially on its ability to coordinate effectively with a wide range of actors.

Five spheres in which firms must develop relationships to resolve coordination problems

- industrial relations
  - Wage moderation (with respect to productivity growth)

> The first is the sphere of *industrial relations* where the problem facing companies is how to coordinate bargaining over wages and working conditions with their labor force, the organizations that represent labor, and other employers. At stake here are wage and productivity levels that condition the success of the firm and rates of unemployment or inflation in the economy as a whole.

- education and training:
  - High level professional competences of managers and workers (Product/process innovation)

> In the sphere of *vocational training and education*, firms face the problem of securing a workforce with suitable skills, while workers face the problem of deciding how much to invest in what skills. On the outcomes of this coordination problem turn not only the fortunes of individual companies and workers but the skill levels and competitiveness of the overall economy.

- corporate governance:
  - Management of, and access to, sources of long-term financing (innovation requires investment with delayed returns)

> Issues of coordination also arise in the sphere of *corporate governance*, to which firms turn for access to finance and in which investors seek assurances of returns on their investments. The solutions devised to these problems affect both the availability of finance for particular types of projects and the terms on which firms can secure funds.

- external relations (clients and suppliers):
  - Interact with customers and providers (exchange information and build up fiduciary networks)

> . The fourth sphere in which coordination problems crucial to the core competencies of an enterprise appear is the broad one of *inter-firm relations*, a term we use to cover the relationships a company forms with other enterprises, and notably its suppliers or clients, with a view to securing a stable demand for its products, appropriate supplies of inputs, and access to technology. These are endeavors that may entail standard-setting, technology transfer, and collaborative research and development. Here, coordination problems stem from the sharing of proprietary information and the risk of exploitation in joint ventures. On the development of appropriate relationships in this sphere, however, depend the capacities of firms to remain competitive and technological progress in the economy as a whole.

- internal relations:
  - Cooperation among managers and employees (competences, work)

> Finally, firms face a set of coordination problems vis-à-vis their own *employees*. Their central problem is to ensure that employees have the requisite competencies and cooperate well with others to advance the objectives of the firm. In this context, familiar problems of adverse selection and moral hazard arise, and issues of information-sharing become important (see Milgrom and Roberts 1992). Workers develop reservoirs of specialized information about the firm's operations that can be of value to management, but they also have the capacity to withhold information or effort. The relationships firms develop to resolve these problems condition their own competencies and the character of an economy's production regimes.

Modes of Coordination

National political economies can be compared by reference to the way in which firms resolve their coordination problems in these five spheres.

The core distinction we draw is between two types of political economies, (1) liberal market economies and (2) coordinated market economies, which constitute ideal types at the poles of a spectrum along which many nations can be arrayed

Two ideal types of coordination among rational agents:

1. Liberal Market Economies (LME) (e.g. US)
   - hierarchies
   - market relations

> In *liberal market economies,* firms coordinate their activities primarily via hierarchies and competitive market arrangements. These forms of coordination are well described by a classic literature (Williamson 1985). Market relationships are characterized by the arm's-length exchange of goods or services in a context of competition and formal contracting. In response to the price signals generated by such markets, the actors adjust their willingness to supply and demand goods or services, often on the basis of the marginal calculations stressed by neoclassical economics.[7] In many respects, market institutions provide a highly effective means for coordinating the endeavors of economic actors.

2. Coordinated Market Economies (CME) (e.g. Germany)
   - cooperation/collaborations
   - relation and network

> In *coordinated market economies,* firms depend more heavily on non-market relationships to coordinate their endeavors with other actors and to construct their core competencies. These non-market modes of coordination generally entail more extensive relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative, as opposed to competitive, relationships to build the competencies of the firm. In contrast to liberal market economies (LMEs), where the equilibrium outcomes of firm behavior are usually given by demand and supply conditions in competitive markets, the equilibria on which firms coordinate in coordinated market economies (CMEs) are more often the result of strategic interaction among firms and other actors.

in brief, the role played by the market in CME is limited relative to other actors/institutions (State, Third Sector, Social bodies, various forms of solidarity)

Two ideal types

	CME (Germany)	LME (US)
Industrial relations	• Negotiation at the industry/sector level ✓ Large engagement of the social bodies ✓ Labor protection	• Individual negotiation ✓ Layoff relatively easy
Education and Training	• Firm specific competences ✓ Social partners' oversight	• General competences ✓ Training institutions
Corporate governance	• Financing, mainly from banks ✓ Network e reputation building ✓ Low responsiveness in the short term	• Financing from the market ✓ Relevance of public information ✓ Dependence from short term profitability
External Relations	• Cooperation	• Competition
Internal Relations	• Consensual decisions ✓ Social partners' involvement	• Hierarchical decision

The Role of Institutions and Organizations

Institutions, organizations, and culture enter this analysis because of the support they provide for the relationships firms develop to resolve coordination problems. Following North (1990: 3), we define institutions as a set of rules, formal or informal, that actors generally follow, whether for normative, cognitive, or material reasons, and organizations as durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy.[9]

From this perspective, markets are institutions that support relationships of particular types, marked by arm's-length relations and high levels of competition. Their concomitant is a legal system that supports formal contracting and encourages relatively complete contracts, as the chapters by Teubner and Casper indicate. All capitalist economies also contain the hierarchies that firms construct to resolve the problems that cannot be addressed by markets (Williamson 1985). In liberal market economies, these are the principal institutions on which firms rely to coordinate their endeavors.

Although markets and hierarchies are also important elements of coordinated market economies, firms in this type of economy draw on a further set of organizations and institutions for support in coordinating their endeavors.

The Role of Culture, Informal Rules and History

Relevance of informal institutions and of history

- multiple equilibria

As we have noted, the presence of a set of formal institutions is often a necessary precondition for attaining the relevant equilibrium in contexts of coordination. But formal institutions are rarely sufficient to guarantee that equilibrium.

- culture helps to select/coordinate on specific equilibria

> In many instances, what leads the actors to a specific equilibrium is a set of shared understandings about what other actors are likely to do, often rooted in a sense of what it is appropriate to do in such circumstances (March and Olsen 1989).
>
> Accordingly, taking a step beyond many accounts, we emphasize the importance of informal rules and understandings to securing the equilibria in the many strategic interactions of the political economy. These shared understandings are important elements of the 'common knowledge' that lead participants to coordinate on one outcome, rather than another, when both are feasible in the presence of a specific set of formal institutions. By considering them a component of the institutions making up the political economy, we expand the concept of institutions beyond the purely formal connotations given to it in some analyses.

no model is preferable:

- CMEs possibly better at producing incremental innovation, whereas LMEs are better at radical innovation
- more inequality in LMEs

Institutional Complementarities

The existence of institutional complementarities widens the differences between Liberal Market Economies and Coordinated Economies

> The presence of *institutional complementarities* reinforces the differences between liberal and coordinated market economies. The concept of 'complementary goods' is a familiar one: two goods, such as bread and butter, are described as complementary if an increase in the price of one depresses demand for the other. However, complementarities may also exist among the operations of a firm: marketing arrangements that offer customized products, for instance, may offer higher returns when coupled to the use of flexible machine tools on the shop floor (Jaikumar 1986; Milgrom and Roberts 1990, 1995).
>
> Following Aoki (1994), we extend this line of reasoning to the institutions of the political economy. Here, two institutions can be said to be complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other.

Example: Germany

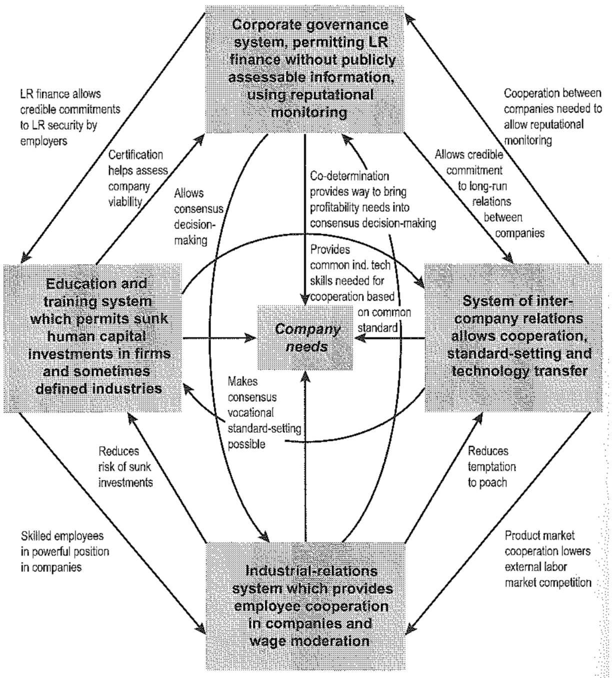


Fig. 1.3 Complementarities across subsystems in the German coordinated market economy

Example: United States

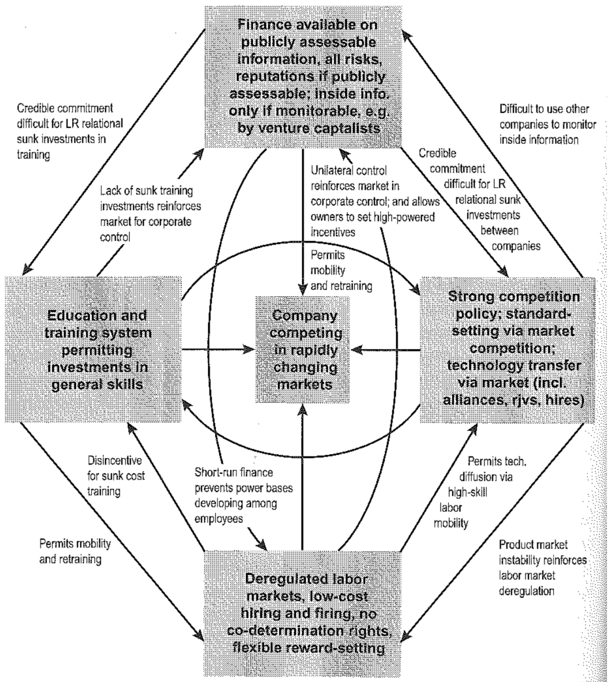


Fig. 1.4 Complementarities across subsystems in the American liberal market economy

5.2.2 Issues with "Varieties of Capitalism"

- complexity of (numerous) relations
- difficulty to establish causal relations: endogeneity at the core of the conceptual model
- unclear identification of the varieties of capitalism

VARIETIES OF CAPITALISM:

TYPE OF CAPITALISM (circa 2006)	CHARACTER	CAPACITY TO PROVIDE WORK (% adlts employed)	LEVEL OF INEQUALITY (Gini index)
Nordic Coordinated Economy	Strategic Crdtn in Lab/Cap Mkts, Soc Dem WS: Sw, Nor, Dk, Fin	HIGH 74	LOW 25
Liberal Market Economy	Fluid Cap/Lab Markets, Lib WS: UK, US, Ire, NZ, Can, Aul	HIGH 71	HIGH 33
Continental Coordinated Economy	Strategic Crdtn in Lab/Cap Mkets, Cont WS: Ger, Neth, Aus, Belg	MODERATE 68	LOW 26
Mediterranean Market Economy	Strat Cdtn in Cap Mkts, less in Lab Mkts, Med WS: Fr, It, Port, Spn	LOW 62	HIGH 32

5.2.3 Main Insights of "Varieties of Capitalism"

- the policymaker has to drive economic agents to cooperate in an effective way
- Large socio-economic consequences of different models
- No clear rank of alternative institutional models
  → no "best practice" (contrary to the consensus that states the superiority of the LME model)
- it is probably more complex moving from LME towards CME

5.2.4 Policy implications of "Varieties of Capitalism"

- No (need of) institutional convergence
- Impossible to apply "one-size-fits-all strategies"
- Parts of institutional context cannot be transplanted to other contexts
  - Even accepting the LME superiority, the transition remains difficult
  - Non-transferability of institutional blocks
- As a consequence, institutional reforms can deliver unexpected/unpredictable outcomes
  This might explain the failure of many reforms inspired by the Consensus

5.2.5 New Developments of "Varieties of Capitalism"

Palley (2023):

- Review of the fragmented literature of VoCs
- Distinction between varieties and varietals of capitalism
- TINA ("there is no alternative") – mainstream economics – Washington Consensus
  - Obscures the existence of choices
  - Promotes the notion of convergence
  - Variety and varietal is the product of societal and policy choices

"*VoCs approach has the potential to transform economics*"