Institutional economics

Institutionele economie (Radboud Universiteit Nijmegen)

Institutional economics

Lecture 1:

Basic assumptions of neoclassical economics.

1. Rational agent
2. Perceived value
3. Savings derive investment
4. Free markets
5. Market equilibrium
6. Relevant and perfect information
7. Marginal utility
8. Rational agents

Methodological individualism and reductionism are the idee that actions of the collective can by analyzed by analyzing a single.

Exogenous preference: we all have the same, given preferences.

Instrumental rationality, we want to maximize our utility it a balance between our budget and the prices of the goods and services we want to buy.

Perfect information:

From all these assumptions, resources are allocated through market systems. With this view there is a static view of equilibrium and that we don't need institutions and that is outside of the system. But in reality, its not straight forward.

Individual's choices and the outcome are also independent of others.

Lecture 2: from old to new institutional economics

It started as a reaction to the neoclassical economics school. And it started with Thorstein Veblen (1857-1929) and Oliver Williamson (1932- 2020).

The problem was that neoclassical economics was way to static understanding equilibriums under markets. The institutional economist said that it was about the dynamics and transformation processes. We need to understand the historical evolution of institutions and systems of economic exchanges and place humans as central.

Imperfections are part of free markets and markets are not efficient. And we need empirical studies to understand complex realities with different methodologies. Veblen was critical that the markets work on some sort of natural law, and he thought that empirical studies were important to understand economics.

The whole is greater than the sum of its parts. More than the sum of the parts as behaviours and institutions plays a role in going for individual levels to aggregates ones. This was a strong movement against the invisible hand.

To understand the human, you need to understand the society and to understand the society we need to study the human individuals.

Old IE was focused on substantive view of the economy is an instituted process of interaction between human beings and their natural ana social environment. This is a broader definition then we use today for economics. The question here was why do we organize the economy a certain way?

Reciprocity is non-monetary way of exchanging something that is not money. Its an exchange between friends and communities. The goal is about maintain social relationships think about giving gifts.

Redistribution is a group of people is producing for an entity. For example the government that redistributes money, services etc. it is about being a citizens for a country. Today we see it back in socialism and communism.

Exchange is the normal market we know

Householding is about a close group of family and what we have in rural economies. It is about being self-provision.

Now we talk about new institutional economics:

Our economy is mainly about markets and capitalism and this is the focus of NIE. Thay tried to refine the core of old IE.

The game is exchanging through markets and institutions as the rules of the game.

Game theory: is the study of interdepend decision making. When it is depend on how others make a decision.

Lecture 3:

Rivalry: in consumption, is when goods consumed are no longer available for someone else to consume.

Excludable: is if you can exclude someone from consuming the good.

Free riding: when people take advantage of being able to use a common resource, or collective good, without paying for it.

The tragedy of the commons is neglect of society's well-being in the pursuit of personal gain. Overconsumption and depletion of the common resource, to everybody's detriment.

For a tragedy of the commons to occur, a resource must be scarce, rivalrous in consumption, and non-excludable.

Transaction costs

Search and information costs: identifying different trading opportunities, outlets and exchange partners.

Bargaining costs: negotiating acceptable trading agreements

Policing and enforcement costs: monitoring trade conditions and enforcing contractual terms.

Trading characteristics

Uncertainty: generic uncertainty as well as bounded rationality and opportunism (behaviorale uncertainty)

Frequency: with which transactions recur. More uncertainty in small markets (few transactions). Administrative and bargaining costs in large markets (many transactions)

Asset specificity: exchange often involves investment in unique assets / resources that are non-marketable / non-re-deployable. Here we deal with **incomplete contracts and hold-up problems.**

Incomplete contracts

- Costs to think through all possible states of the world and then write down all possible contingencies
- Difficulty to describe a contingency unambiguously so that I can be verified by the courts even if the contingency is obvious to the contracting parties.
- Possibility for hold-up (when one party has made a prior commitment to a relationship with another party, and the latter can hold up the former for the value of that commitment.

Types of assets specificity

- Sites specificity, the co-location of power plants and coal mine
- Physical assets specificity, investment in specialized equipment
- Human asset specificity, firm-specific knowledge
- Dedicated capacity, designed for specific consumer
- Brand name capital, maintain reputation for example in franchise relationships.

High specificity means it is useful only for certain tasks or in certain circumstances.

External and internal transaction costs

Internal transaction costs are costs associated with transaction within a company. External transaction costs are transaction costs that occur between companies.

Lecture 4: markets and governance

Internalization: “execution of transactions within the organization rather than relying on an outside market” made by the company it self instead of buying it on the market.

Through vertical integration: “an arrangement in which the supply chain of a company is owned by that company.

Firms size and transaction costs

When the external transaction costs are higher than the internal transaction costs, the company will grow, when the external transaction costs are lower than the internal transaction costs the company will be downsized (outsourcing)

A higher degree of **asset specificity** lead to **more vertical integration**.

- Physical assets: chemical industry; transport is not possible or super expensive for some goods the service is made in house
- Human assets: even more important to explain vertical integration, you want to keep specific know-how to yourself.
- Frequency: nuclear power plant: frequent tasks (maintenance, reactor operation, waste processing) this will also be done inhouse.
- Uncertainty: the more uncertain, the more you want to have control over it.

Market governance involves transactions that are relatively simple, information on product specifications is easily transmitted, and producers can make products with minimal input from buyers (low external transaction costs).

Forms of hybrid governance (ally) are joint ventures, partnerships and franchises.

Lecture 5: allocation of property rights

1. Right to **use** good.
2. Right to **manage** good (and earn money from it).
3. Right to **transfer** good to others.

With all three of these rights you're the owner.

All three are owner/holder. Owner the only one who can transfer a good to someone else. Owner is the one who is ready to pay the highest price for the good.

Outsourcing meaning you use more market regulation. And firms exist because of markets failures, free riding, and transactions costs etc.

Market safeguard is the safeguard of opportunistic behaviour that comes from market pressure. If you do not have a good reputation, you lose customers.

Administrative safeguard is the safeguard of opportunistic behaviour that comes from for example international regulation.

Residual rights of control

Property rights determine who has the power to control within an institutional arrangement and consequently who has the right over the residual income.

- Renting your flat
- Renting a land, and farmers can make a benefit from using it
- But you are still the only one who can transfer the good at the end, you have the ultimate rights of disposal
- And you can exclude people from using your good.

Between rights and duties

From the owner: the owner of a fairground attraction can be hold responsible if a visitor gets injured. If you rent a flat and you have problems with electricity, the owner is going to take care of this.

For the user: less incentives to take care of the good so you have to pay a deposit for a flat.

Different forms of ownership

1. Free use/ access, clear property rights do not exist. (tragedy of the common)
2. Private property, individual or organization has right to use, manage and transfer.
3. State or government property, state or government has right to use, manage and transfer
4. Common property, group composed of individuals has right to use, manage and transfer. (multiple legal entities)

Prisons are a public service, use of force and quality of the food etc.

Public or private

Decision will be balance of condisrations between cost-cutting/quality/possibilities to innovate/effect of competition.

For the case of public ownership is stronger when: non-contractible cost reductions have large delirious effects on quality; innovations are not important. (no need for competition)

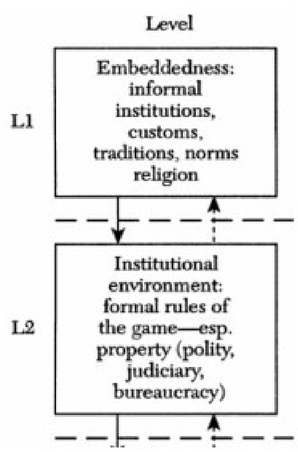
The case for privatization is stronger when: quality reducing cost reductions can be controlled through contact: incentives for innovations are important (competition can improve this).

Common is high rivalry low excludability. To overcome the tragedy, individuals vary in their preferences. So cooperation is the key and does not often occur because we have institutions, partnership etc.

efficiency

Making a choice is not only shaped by efficiency, the role of informal norms and values, ideologies, and debates in the discipline, but also by different forms in the world; in Africa,

\ there are more commons. And efficiency is not always the same.

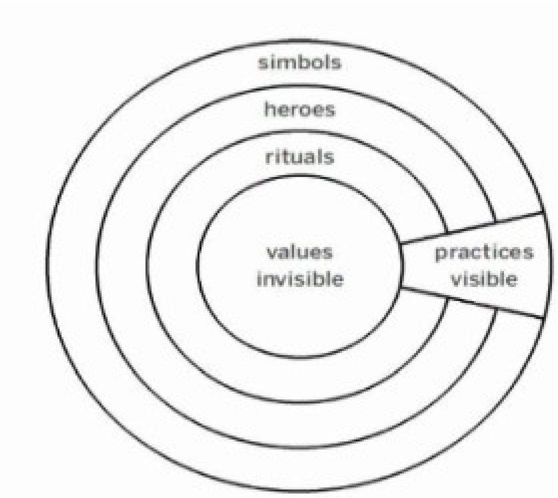


Lecture 7: between methodological individualism and methodology

Defining culture:

Guiso: those customary beliefs and values that ethnic, religious and social groups transmit fairly unchanged from generation to generation.

Hofstede: the collective programming of the mind that distinguishes the members of one group or category of people from others



Characteristics of national cultures:

1. Power distance (large versus small), related to solutions for the basic problem of human inequality (more hostile, less overall society, more polarization);
2. Uncertainty avoidance (strong versus weak), related to the level of stress in a society in the face of an unknown future (driving fast in some countries because you don't care about the uncertainty. Weak = not a lot of rules and laws, strong = a lot of rules and laws):
3. Individualism versus collectivism, related to the integration of individuals into primary groups (it will have an impact on relationships between individuals and the redistribution of national wealth);
4. Masculinity versus femininity, related to the division of emotional roles between women and men (Focused on economic growth and profits and less women elected is more masculine. If it cares about vulnerable people it's more femininity);
5. Long-term versus short-term orientation, related to the choice of focus from people's efforts; future or the present and past (short-term is more about national pride, vandalism and concerns for social obligations, much more about the individual. The long term is more about society and firms.);
6. Indulgence versus restraint, related to the extent of gratification of human desires for enjoying life. Indulgence is positively related to higher birth rates, more private internet, smaller police forces. Much more about freedom of behaviours. More restraint means limiting this type of freedom in your behaviour.

Methodological individualism: social science should be derived from the studies of individuals

Methodological collectivism: much more used in sociology, the idea that meaningful social knowledge should be derived from the study of groups, societies, institutions.

Social capital: your culture comes from the fact that you're in different groups. This support the construction of your own social capital. We share values, beliefs, and social relationships with these individuals. The role of social capital is as follows

1. Helps in accessing resources using your social network to try to find a job
2. Is related to social identity and can influence behaviours. You do the same as the people in your network (likelihood to recycle, steal, to eat fast food.
3. Is important when formal institutions are not enough to lower transaction costs/protection of property rights. Trust in your neighbours that they will look after your house when you are on holiday.
4. Can also lead to social exclusion. A lack of social bridges with other communities can turn into hinder their economic process (immigrant for example)

Lecture 8: institutions and development

De facto political power is about the influence that groups of people have on the official rules (policy making). Power is people of groups with (money and contacts).

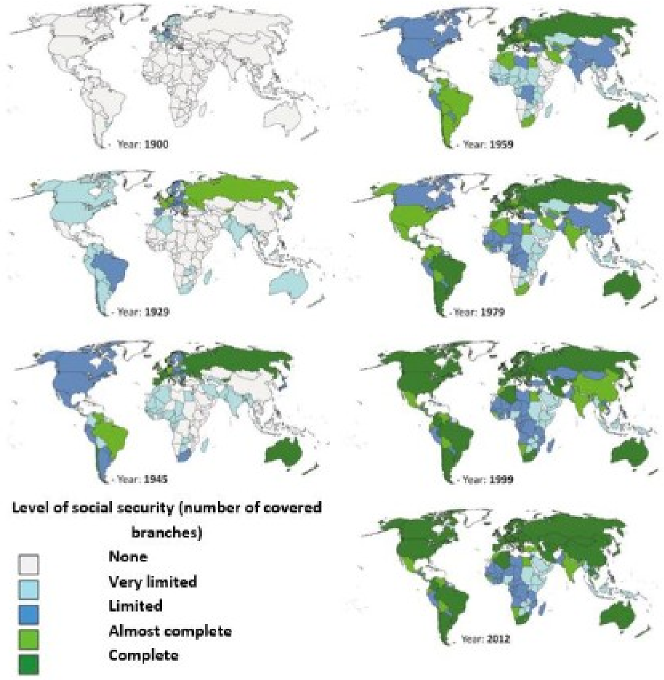
De jure politics is the way democracy is organized. In the Netherlands, how do we decide in parliament?

Economic institutions are endogenous because factors in the system of economics determine them. And also by other institutions and politics.

Institutions are not necessarily optimal because, for example, in the past, they are manmade. And they are dynamic and can change. And they are influenced by path dependency. But they are tough to change; think of revolutions. We can have very diverse and some good and some terrible ones.

More social cohesion leads to better institutions, and they lead to better economic growth.

Lecture 9: Evolution of welfare states



The level of social security is about the type of welfare programs, healthcare, etc.

In Africa, you have a lot of informal jobs, which leads to no taxes, so it is impossible to start a welfare state. Welfare states are costly.

Defining welfare states:

Concept of government in which the state plays a crucial role in the protection and promotion of the economic and social well-being of its citizens

Esping-Andersen (1990): it is a matter of rights + how state activities are interconnected with the roles of market and family in terms of social benefits provision

Welfare and markets

1. Decommodification: The possibility of living more or less independently of the labour market.
2. Social stratification system: the welfare state is conceived as a mechanism that intervenes and tends to correct the structure of social inequalities

Importance of context: 3 ideal-types of welfare models

	Social-democratic	Liberal	Conservative-corporatist
Aim	Full employment	Economic growth	Economic growth
Social rights	Universal	Individual	Employment-related
Stratification	Universal entitlements for preserving equality	Means-tested programs promoting market in social provision	Insurance-schemes to preserve social rights according to status
Funding	Taxes	Taxes	Contributions
Financial independence of labor market	High	Low	Average
Dominant welfare provider	State	Market	Family + Social insurance funds + State
Examples	Austria, Belgium, Netherlands, Denmark, Norway, Sweden	Australia, Canada, US, New Zealand, Ireland, UK	Italy, Japan, France, Germany, Switzerland

Emergence of two main models at first

- Bismarck model (19th century)

Improve economic productivity

Countering calls for more radical/socialist alternatives and unions

Goal = living standards

(//corporatist welfare)

- Beveridge model (1942)

Include the entire population, uniform contributions

Intervention of the State

Change of mindset

Goal = subsistence levels

(//social-democratic welfare, not followed by the UK that became a liberal one)

Emergence of two