UNIT 6 INSTITUTIONAL ECONOMICS

Structure

6.0 OBJECTIVES

After going through this unit, you should be in a position to:

- distinguish between emphasis institutional economics from neoclassical economics;
- differentiate between the two major approaches to institutional economics;
- appreciate the significance of major thrust areas identified in the more recent developments of institutional economics;
- delineate the boundaries of a broad institutional framework; and
- appreciate the linkage between institutional development and economic development.

6.1 INTRODUCTION

The term 'institution', in general, refers to a set of rules or an established law or custom governing the behaviour of persons in a society. For instance, in the context of discharging public services, organisations like schools, hospitals, banks, etc. are institutions established for meeting their specific needs to the society. As economic exchange can efficiently take place in an atmosphere of well-established quality institutions, their importance in aiding development is recognised by contributors from all genre. However, the emphasis laid in assigning institutions a due place are varied among the different schools of economic thought. In the light of this, literature in the field of 'institutional economics' distinguishes between two separate schools: original/old (i.e. earlier) institutional economics (OIE) and new institutional economics (NIE). Beginning with a background on the main differences in the approach of the institutional economics from that of the neoclassical economics, the present unit discusses the following four basic aspects in this field: the nature and type of institutions, the thrust of NIE in respect of some major factors, a classificatory framework serving as boundaries of distinct areas coming under the scope of NIE, and the concomitance with which institutional development is viewed with economic development in general.

6.2 NEOCLASSICAL TO INSTITUTIONAL ECONOMICS

Two schools of heterodox economic traditions – Marxian Economics and Institutional Economics – emerged more or less independently. Both of these traditions had a character of a social movement. They were critical of classical and early neoclassical economics on the grounds of some of the assumptions on which these theories were based. Early institutional economists criticized the conventional neoclassical economics because of its irrational assumptions and neglect of institutional factors to explain economic behaviour. They argued that the role of social, political, anthropological and organisational mechanisms is unaccounted for in the neoclassical theory. Such an approach ignores the dynamics of real economic issues creating a gap between reality and theory. One of the other main arguments of Marx and his followers against classical economics was that they lacked a historical perspective. Marx considered production a social activity. On the other hand, institutionalists' view of production goes beyond the traditional markets. They focus on human-made and human-centric institutions like state, firm, individual, social norms, etc. and consider economic performance a result of the complex interaction of these institutions.

The development of institutional economics in its present form is a 20th century phenomenon. Some of the classical economists like Adam Smith, David Hume and J.S. Mill also highlighted the importance of various social, cultural, political and legal institutions in economic development. They, however, failed to analyse the economic behaviour of human beings by taking the institutional factors into account. Similar shortcomings can be traced to Marxist economic theory. Against this background, institutional economics emerged as an alternative theory during the 'Great Depression' in the United States. The writings of the early institutional economists are also therefore referred to as 'American Institutionalism'. Thorstein Veblen is one of the prominent earlier institutionalists who considered economics as an evolutionary science. He held that an evolutionary economics is a theory of 'a process of cultural growth as determined by the economic interest'. It is thus a theory of a cumulative sequence of economic institutions stated in terms of the processes. Veblen's analysis of institutional economics is influenced by Spencerian-Darwianian evolutionary principles. Stressing the importance of psychological and cultural institutions in determining the economic behaviour of human beings, Veblen argues that there can be no 'normal equilibrium' but only a chain of evolutionary processes. His writings influenced others like J. M. Clark, J.R. Commons, etc. Clark analysed the concept of equilibrium raising the question 'why business adjustments (i.e. economic fluctuations) do not stop at a point (i.e. one of equilibrium) but continue to a point from which a more or less violent reaction inevitably take place'? Arguing that the concept of 'economic balance' (balance considered as synonym to equilibrium) is elusive and difficult to attain/prevail in practice, Clark holds that the concept of equilibrium is nonetheless a necessary element and tool as conditions necessary for equilibrium furnish a starting-point in the analysis of why equilibrium is not reached. Commons also notes that it was the classical assumption of full employment which allowed the consideration of equilibrium 'of all the factors among themselves'. However, accommodating the views of the traditional school, Commons holds that institutional economics is not divorced from the classical and psychological schools of economics but is an extension 'from commodities and individuals to transactions and working rules of collective action'. This also marked the transition from the classical school to the institutional school in economic analysis. Equilibrium signifies – what can take place if a system is left to operate on its own without a managed order by an effective interplay of institutions. Commons, thus, contrasts institutional economics with the ideas of classical-neoclassical school by observing that anything that focuses on: dynamic instead of static, a process instead of commodities, activity instead of feelings, mass action instead of individual action, heterogeneity instead of homogeneity, management instead of equilibrium, control instead of laissez faire, etc. is institutional economics. Further, maintaining that institutional economics deals with the rules of conduct enforced by the collective economic sanction, he identifies three types of sanctions relating to 'business ethics' viz. moral sanctions of collective opinion, economic sanctions of profit or loss, and organised sanctions of violence. Pointing out that institutional economics derives a large part of its base from the field of corporate finance, Commons says that institutional economics refers to the assets and liabilities of concerns in contrast to the Wealth of Nations theory put forward by Adam Smith.

Neoclassical economics defines economics as the study of alternative uses of scarce resources to meet the unlimited demands of people. They consider transaction a cost-free exercise. However, different forms of markets cannot be developed naturally as presupposed by the classicists as it obviously ignores the other important and influential factors making the relevance of their economic analysis unrealistic. Notwithstanding the differences, many economists consider institutional and neoclassical economics as having the same roots with significant overlaps. They consider institutional economics as both a complement and a substitute to neoclassical economics. It is complement in the sense that together with neoclassical theory, institutional economics attempts to explain the economic behaviour more appropriately. On the other hand, institutional economics is a substitute to neoclassical economics because it replaces many 'unrealistic' assumptions with more 'realistic' institutional factors thereby making the economic theory more practical. Thus, the sub-discipline of institutional economics attempts to bring the economic theory and the role of institutions closer making the mainstream economics more rational. This is realised by considering the performance of an economic agent a result of joint interaction of institutional and economic factors.

6.3 NATURE AND TYPES OF INSTITUTIONS

Broadly, institutions can be considered to be of two types: internal institutions and external institutions. Internal institutions evolve from experience incorporating solutions that have tended to serve people in the past. Examples include customs, ethical norms, good manners, conventions in matters of trade, etc. Violations of internal institutions are normally dealt with informally e.g. social exclusion. There can also be formal sanctions by way of a ban from professional practice or association. External institutions, on the other hand, are imposed and enforced through political and administrative machinery i.e. laws enacted through legislation. Institutions are thus rules of human interaction which constrain opportunistic and erratic individual behaviour making transactions predictable and facilitating in terms of division of labour and wealth creation. They mould social objectives by defining the norms for social and economic relationships.

Contributions to institutional economics have been made mainly by two groups of writers. Writers identified in the previous section (viz. Thorstein Veblen, John R. Commons and Maurice Clark) belong to the group of early institutional economists. They are also sometimes referred in the literature as traditional institutionalists or contributors to the original/old institutional economics (OIE). Such institutionalists radically opposed the mainstream neoclassical economists owing to the fundamental premise opposed by the neo-classicists that economics cannot be separated from the political and social system within which it is embedded. Later contributors like Oliver Williamson, Ronald Coase, Douglas North, etc. made an attempt to integrate institutionalism into the mainstream neoclassical framework. The contributions by the latter school of writers have come to be referred to as new institutional economics (NIE).

While both the OIE and the NIE include institutions within economics, they differ significantly in philosophical and methodological orientation as well as in the theoretical direction and normative content. One aspect on which the OIE focuses on the effects of technology and established institutional structures in which it particularly looks at the ways in which established social conventions and vested interests resist change. A second major area on which it concentrates encompasses the aspects of law, property rights and organisations. The evolution of all these three aspects, in terms of institutional structures to promote development, is examined by the OIE for their impact on the efficiency with which economic transactions are effected resulting in better distribution of income in the society. While the NIE also focuses on the importance of property rights as fundamental to economic development, it also emphasises on the processes of public choice and organisations. Like Veblen for OIE, Douglass North is one of the principal contributors to the NIE. According to North, institutional economics retains and builds on the fundamental assumption of scarcity and hence competition which is the basis of the 'choice theoretic approach' underlying micro-economics; what it abandons is the assumption of neoclassical economics on instrumental rationality which makes the economic process a institution-free theory. He maintains that human beings are in fact faced with incomplete information and limited mental capacity to process available information. Further, as transaction costs result in incomplete markets, ideas and ideologies play a major role in the analysis of choices forcing the imposition of constraints on human interaction with a view to structuring exchange. Agreeing that there is no implication that the consequent institutions are necessarily efficient, North advocates that the place to begin a theory of institutions is with a modification of the instrumental rationality assumption. In a significant reference to the concept of equilibrium, North suggests that owing to a continuum of theories that agents can hold there is not one determinate equilibrium but a situation of 'multiple equilibria'. The cost of transaction determined by informational asymmetry results in the formation of institutions. Acknowledging the contribution of another major contributor to NIE, Ronald Coase, for making the crucial connection between institutions, transaction costs and neoclassical theory, North states that the neoclassical result of efficient markets only obtains when it is costless to transact. And because a large part of our national income is devoted to transacting (in which respect he estimates that 45 percent of US's economy over 1870 to 1970 was devoted to transacting), institutions and specifically property rights are crucial determinants of the efficiency of markets. Ayres underlines the roles of culture in shaping institutions revealing a social vision in them.

The differences between OIE and NIE may, therefore, be dichotomised into the following:

- non-formalism versus formalism;
- holism versus individualism;
- behaviourism (i.e. unconscious or sub-rational) versus rational choice;
- evolutionary (i.e. invisible hand orders) versus collectivism (designed orders);
- interventionist (distribution of income and regulation) versus non-interventionist; and
- induction versus deduction.

In the above dichotomisation, the term formalism has a specific connotation in that it refers to the usage of mathematical modelling in economics. While the NIE adopts models (representing a set of assumptions, equations, estimation of parameters, testing, simulation, etc.) very commonly, the OIE's style of presenting theories is considered informal and rhetorical. However, it is said that the impression of the OIE as anti-theoretical or purely descriptive is not altogether correct as the work of Mitchell and Commons contain theoretical/formal underpinnings. But since many old institutionalists resisted (or avoided being formal), the trend gave the false impression that OIE lacked theoretical support. Acknowledging that the neoclassical economics was most formal than others, it is held that 'NIE is less formal than neoclassical economics but somewhat more formal than OIE'. In this context, there is an assertion that both the OIE and the NIE need more formalist and non-formalist methods to advance their own fields of institutional theories.

Check Your Progress 1

1) What is the major focus of institutionalists in describing the dynamics of economic issues?

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2) What, according to Commons, was the basic assumption of the traditional schools of economists in advancing the concept of equilibrium in their economic theories? How did Commons accommodate the views of the traditional school, while contributing to the advancement of institutional economics separately?

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3) What are the main areas of thrust of the OIE? In what respects does the NIE differ in its thrust from that of the focus of the OIE?

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4) What, according to North, are the crucial determinants of the efficiency of markets?

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6.4 NEW INSTITUTIONAL ECONOMICS

As noted earlier the new institutional economics (NIE), also sometimes referred to as the North-Williamson school, has extended its theoretical developments to areas like property rights, governance structure, etc. The theory of transaction costs is at the core of the NIE. NIE's perspective on institutions (like firms, markets, state, etc.) has been developed on the basis of transaction costs theory.

6.4.1 Transaction Costs Theory

The TCT assumes that there is always some efficiency rationale behind the evolutionary process of institutions in an economy. These institutions aim at reducing the transaction costs for the different economic agents in the economy. North defines institutions as a set of rules designated to constrain the behaviour of individuals in the interest of maximising the wealth or utility of principals. The dynamics of the theory derives from the continuous tension between the gains from specialisation in economic activities and the increasing costs that arise from the same process of specialisation. Such costs include information costs, agency costs, costs of shirking and opportunism, costs arising from uncertainty, costs of measuring quality of the goods and quality of the output, costs of enforcement of property rights, costs of compliance and costs of detecting violations. These costs have a dynamics of frequent change necessitating, in turn, changes in the structure of the social, political, and economic institutions over time. Such costs are therefore going to constantly redefine the rules of the transactions generating a virtuous cycle of competition and institutional growth. Political process is identified as the main medium by which the process of institutional growth is brought about. It is the costliness of economic exchange owing to the sheer dynamism of ever increasing transaction costs that distinguish the TCT from the traditional theories. For this reason, North asserts that economic history conceived as a theory of the evolution of constraints, should not only explain the past economic performance but also explain the current performance of the political-economic system.

North builds on Coase's transaction costs theory* by pointing out that the important elements in such costs arise from both formal and informal constraints. With regard to formal constraints (which refer to political, judicial, and economic rules) North underlines their function in facilitating exchange and reducing transaction costs. Coase had defined transaction costs as the cost of running the economic system. Williamson compares such costs as being equivalent to 'friction' in physical terms. He builds on the Coase's definition by providing a distinction between ex-ante transaction costs (e.g. drafting a document or contract, negotiating and safeguarding an agreement. etc.) and ex-post transaction costs (e.g. mal-adaptation costs, misalignments, etc.). Informal constraints are recognised by North as an important source of institutional stability having great survival tenacity as they succeed in resolving basic exchange problems among the participants at the social, political and economic levels. North had earlier advanced the theory that competitive pressures would lead to the elimination of inefficient institutions. However, based on later views developed he attributed the presence of inefficient institutions (continuing through centuries) to the changing incentive structures generated by the institutions. Such incentive structures are manipulated by influential segments which is a nexus needing to be broken by efficient institutional arrangements/developments. TCT brings about institutional change/development by resulting in two type of economic progression viz. (i) increasing returns via organisations acquiring feedback about the continuous changes between them and other institutions i.e. learning by doing and increasing profits as a consequence; and (ii) by affecting the behaviour of agents to acquire ideologies developed as a consequence of improving upon the imperfect markets (characterised by incomplete information) through exchange of transactions.

6.4.2 Property Rights Theory

In the context of legal environment obtaining for promoting smooth economic transaction, NIE has been particularly interested in the economic effects of property laws. Eggertsson (1990) notes that the cost of enforcing property rights and monitoring citizen's activities being extremely high, it is the State which has the economies of scale in the enforcement of property rights. This is despite the fact that there is no guarantee that the structure of property rights defined by the State is necessarily consistent with rapid economic growth. In practice, a system of property rights is defined according to the community's political structure prevailing in a society. The stock of knowledge and the endowment of resources define the technical upper limits

* Coase was the first to explain that the boundaries of the organisation depend not only on the production technology, but on the costs of transacting business. Linking the transaction cost theory, with the allocation of resources by the state he stated that "in the absence of transaction costs, all government allocation of property are equally efficient, because interested parties will privately bargain to correct any externality" (Coase Theorem).

for productivity and output. The firms which minimise transaction costs and maximise output determine the structural production frontier. Some political systems create incentives that bring the structural production frontier close to the optimum technological frontier. The joint effects of information asymmetries and the role of transaction costs, generate a propensity for States to create a structure of property rights suitable to the political structure prevailing. A credible commitment by the State to stable property rights helps in promoting investments and lower the transaction costs. However, there is a tendency for the States to generate inefficient property rights owing to continuous tensions between the ownership structures to maximise income. Although efficient property rights reduce transaction costs and promote growth, there is a utility maximising rule by which the State trades services (protection and justice) for revenues (taxes). The State therefore behaves as a 'discriminating monopoly' devising specific sets of property rights for each set of constituents in such a way that the State is able to maximise its revenue. According to North, the State has two basic constraints to contend with. One, to avoid offending powerful constituents (competitive constraint) and, two, the transaction-costs constraint itself by which the collection of revenues is affected by the structure of property rights. The necessity of a theory of ideology therefore arises from the contradiction that the State faces. On the one hand, the State specifies rules that maximise the income and, on the other, the State needs to devise rules that lower transaction costs to enhance growth. To achieve this, it is necessary to have a set of ideological conviction that constrains individual behaviour. Otherwise, the transaction costs of compliance, monitoring and enforcement will be very high. The overall cost of coordinating and integrating the various economic agents entail, therefore, an economy-wide restructuring including the development of a polity that will enact and enforce the rules of transaction necessary to the required integration. The implication is that the State can never be treated as an exogenous actor in development policy with its obligations to device a set of property rights and enforcement to create competitive market conditions. The thrust of development policy must therefore be the creation of polities that will create and enforce efficient property rights.

6.4.3 Institutions, Organisations and Institutional Change

It is necessary to distinguish between institutions and organisations. Institutions are the rules in a society which impose humanly devised constraints to facilitate human interactions. They are composed of formal rules (statute law, common law, regulations, etc.) and informal constraints (conventions, norms of behaviour, and self imposed codes of conduct, etc.), and the enforcement characteristics of both. Organisations, on the other hand, are the players i.e. groups of individuals bound by a common purpose to achieve specific objectives. They include political bodies (i.e. political parties, the senate, a city council, a regulatory agency, etc.); economic bodies (firms, trade unions, family farms, cooperatives, etc.); social bodies (churches, clubs, associations, etc.); and educational bodies (schools, colleges, vocational training centres, etc.). The dynamics involved in the interplay of institutions with organisations becomes the source for institutional change over time. The essential characteristics of such a change may be identified in terms of the following:

- the interaction of institutions and organisations in the economic setting of scarcity introduces competition among them;

- competition would entail continued investments by organisations for development of skills and knowledge acquisition required to survive in the competitive environment.

- the kinds of skills and knowledge individuals and their organisations acquire will shape evolving perceptions about opportunities and hence choices that will incrementally alter institutions. The institutional framework dictates the kinds of skills and knowledge perceived to have the maximum pay-off;

- perceptions in respect of the above are derived from the mental constructs of the players involved. Those organisations which lack the resources and/or decision making ability to invest in skills advancement will wither away to become inefficient/obsolete institutions ; and

- economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent.

While change is incremental and ubiquitous, the rate of learning will reflect the intensity of competition among organisations. While the rate of learning determines the speed of economic change, the kind of learning determines its direction. The latter is a function of the expected pay-offs of different kinds of knowledge reflecting the mental models of the players within the incentive structure embodied in the institutional matrix. Since the organisations owe their existence to the institutional matrix, they will be an ongoing interest group striving to assure the perpetuation of the existing incentive structure. This gives rise to the source of path dependence which is broken when different interest groups emerge as a result of dissatisfaction with the performance of existing organisations. In such a situation, the fundamental conflict between organisations cannot be mediated within the existing institutional framework. Such a phenomenon will result in institutional changes leading to economic growth over time.

6.4.4 Moral Hazard and Agency Theory

The moral hazard or agency-theory approach seeks to separate the ownership and control. Surveying the range of contracts observed in the economy with respect to incentives and cooperation, it generalises a range of relationships i.e. from employment contracts to the various other more complex relationships that make up the firm. The theory points out to the need for *effective incentive alignment* to promote smooth transaction among the different agents involved. As both the principal and the agent are opportunists seeking to minimise production/transaction costs while at the same time trying to maximise their benefits, the theory emphasises the need for *flexible means of coordinating activities*. Advocating vertically integrated (i.e. unified ownership) organisational structures with features of simple spot contracts, franchises or joint ventures, the theory claims that such arrangements provide discrete structural alternatives. The theory is critiqued to suffer from characteristic weaknesses like the 'proliferation of influence activities'. Referring to the *self-interested behaviour* of influential segments (i.e. the agents involved directly and other external influential segments like politicians, bureaucrats, and others), the theory points out that owing to the capturing of increasing portions of resources by powerful interest groups, institutional rigidities develop impacting adversely on the performance of the firms.

To ease the situation arising on account of institutional rigidities, the agency theory focuses on the design of ex-ante incentive-compatible mechanisms. It thereby seeks to reduce agency costs in the face of potential moral hazard by agents. Jensen and Meckling (1976) define agency costs as the sum of: (i) the monitoring expenditures of the principal; (ii) the bonding expenditures by the agent; and (iii) the residual loss. The residual loss represents the potential gains from trade not realised due to the principal's inability to provide incentives for agents. In a typical agency model, a principal assigns an agent a task, but has only an imperfect signal of the agent's performance. The optimal incentive contract balances the principal's desire by giving the agent incentives to increase efforts insuring also for the agent's fluctuations in compensations from factors beyond his control. Thus, in the agency literature the firm is an entity signifying a collection of contracts between owners and managers, managers and employees, the firm and its customers/suppliers. The focus on the firm is limited but significant to the extent that it brings the conflicting objectives of individuals into a desired state of equilibrium within a framework of contractual relations.

6.5 INSTITUTIONAL BOUNDARIES UNDER NIE

To understand the boundaries of NIE, it is necessary to focus on a more expansive description of a range of relevant institutions along with the relationships between them. A useful framework is proposed by Williamson (2000). It identifies four interrelated levels of institutional analysis as follows.

1) **Social or Cultural Foundations**: The highest level of the institutional hierarchy encompasses informal institutions, customs, traditions, ethics and social norms, religion and some aspects of language and cognition. This level provides the basic foundations for a society's institutions. The foundations of these basic social and cultural institutions change very slowly over time, with adaptation periods of as long as a thousand years and at no time less than 100 years.

2) **Basic Institutional Environment**: At this level, institutions like constitutions, political systems and basic human rights, property rights and their allocation, laws/courts/and related institutions to enforce political/human rights and/property rights, currency and related basic financial institutions including the government's power to tax, laws and institutions governing migration/trade and/foreign investment rules, and the political/legal and/economic mechanisms that facilitate changes in the basic institutional environment are included. In a society with dynamic equilibrium, a given set of basic institutions at this level will be compatible with the society's social foundations at any particular point of time. Changes in the basic institutional environment occur more quickly than changes in the cultural or social foundations i.e. level I institutions identified above. But change is still relatively slow and partially constrained by the slow rate of adaptation to the underlying social and cultural foundations, with response times varying from a low of 10 years to a high of 100 years.

3) **Institutions of Governance**: This level of the institutional hierarchy encompasses the governance arrangements through which economic relationships will be governed within the attributes of the basic

institutional environment. The other institutions included at this level are: (i) competitive markets through which individuals trade goods including services and labour; (ii) contractual/transactional relations including the vertical and horizontal structure of business firms and the boundaries between transactions mediated internally and those mediated through markets; and (iii) corporate governance, and financial institutions that support private investment and credit. The choice of governance arrangements is heavily influenced by the basic institutional environment as well as by a country's basic economic conditions like natural resource endowments. Changes in governance arrangements usually take place more quickly than changes in the basic institutional environment with a time frame ranging from 1 to 10 years.

4) **Institutions for Short-term Resource Allocation**: This covers the day-to-day operation of the economy given the institutions defined at the other three levels. Prices, wages, costs, quantities bought and sold are determined by the institutions established to govern the instruments at this level. Williamson includes agency theory and incentive alignment within and between the organisations covered here.

Check Your Progress 2

1) To which basic factor is the dynamics of the transaction cost theory (TCT) attributed?

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2) According to Douglas North, what are the two basic constraints which the State has to contend with in designing efficient 'property rights structure'?

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3) To ease the institutional rigidities that develop due to the power exerted by influential segments in the society, what is the remedy suggested by the Moral Hazard and Agency Theory?

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4) Mention the four institutional layers suggested by Williamson for a framework of institutional hierarchy under NIE?

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6.6 INSTITUTIONAL DEVELOPMENT AND ECONOMIC DEVELOPMENT

With the developments in institutional economics, economic development is no longer regarded as a gradual and inevitable transformation from lower to higher forms of specialisation. Instead, development is seen as a response to the evolution of institutions that support social and commercial relationships. Economic growth thus depends on the degree to which the potential hazards of trade (shirking, opportunism, corruption, etc.) can be controlled by institutions thereby achieving reduced information costs, encourage capital formation and capital mobility, allow risks to be priced and shared and facilitate cooperation. The growth of product and factor markets depends on establishing secure property rights which calls for significant institutional development on the legal front. Further, as an economy industrialises, more and more commercial activities are undertaken requiring finance, banking and insurance markets to efficiently coexist and support the economic exchange.

The characteristics of economic change, however, themselves prescribe no solutions to improve the performance of economies. Even now, very little is known about transforming ailing economies into successful ones. At best, some fundamental characteristics of institutions can be suggested on the following lines in this regard.

(i) **Efficient Institutional Support**: Institutions are made up of both formal and informal rules. While the formal rules can be changed overnight, the informal norms change gradually. In view of this, societies that adopt the formal rules of another society will have very different performance characteristics than the original country because of the differences in both the informal norms and the enforcement characteristics. The implication, therefore, is that transferring the formal political and economic rules of successful western market economies to weaker economies cannot automatically ensure good performance. For instance, in the transition economies of Russia and east Europe the passage to market economy institutions and pursuit of Washington Consensus policies (see Key Words) was associated with much greater and prolonged declines in output and income than had been originally expected. In particular, privatisation is not a solution to improve performance as it works only with efficient institutional base.

(ii) **Efficient Polity**: The prevailing polity contributes significantly to shaping economic performance by defining and enforcing the economic rules formed. The thrust of development policy must therefore be the creation of polities that will establish and enforce the rules and laws framed. This requires certain characteristics to be instituted into the polity of an economy by developing the required institutional/organisational systems. Policy prescriptions should vitally be country-specific recognising the binding constraints to growth, and taking appropriate account of the institutional context of each country. Some of the other requirements identified may be stated as follows.

- Political institutions, for instance, will be stable only if they are supported by organisations with an interest in their perpetuation. Therefore, an essential part of political/economic reform is the creation of such organisations.
- It is essential to change both the institutions and the belief systems for successful reform since it is the mental models of the actors that will shape choices.
- Evolving norms of behaviour that will support and legitimise new rules is a lengthy process and in the absence of such reinforcing norms polities will tend to be unstable.
- While economic growth can occur in the short run even with autocratic regimes, long run economic growth entails the development of the rule of law and the protection of civil and political freedoms.
- Informal constraints (i.e. norms of behaviour, conventions, and codes of conduct) are **a necessary but not sufficient condition** for good economic performance. Societies with norms favourable to economic growth can sometimes prosper even with unstable or adverse political rules. Very little is known about the evolution of belief systems and consequent informal constraints although religions have demonstrated to be a basic component of belief systems.
- Finally, the endowments of geography and the historical legacies of institutions also matter but not to the exclusion of economic policies. Development-friendly institutions and governance tend to support good economic policies with the latter, in turn, strengthening good institutions. Improvements in institutions and economic governance matter a lot over long periods, especially in sustaining growth.

(iii) **Adaptive Efficiency Versus Allocative Efficiency**: It is adaptive rather than allocative efficiency which is the key to sustain good economic performance. Allocative efficiency is, in a sense, static working well for a given set of institutions. However, in a situation of evolving technological and demographic changes with frequent shocks natural to the dynamic nature of changes involved, a flexible institutional matrix which can adjust to the changing context is essential to support the growth process in the economy. For this, the creation of a stable polity with complementary norms remains an essential prerequisite. Successful political/economic systems have evolved such characteristics over long periods of time. Efficient policies that are perceived to be inequitable have the potential to engender political reactions which can stall or reverse effective reforms.

The central issue of economic history and of economic development is therefore to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity. Viewed from this perspective, economic development can be equated with institutional development.

Check Your Progress 3

1) In treating 'institutional development as synonymous with economic development', what are the basic characteristics identified as required for promoting an efficient polity in the economy?

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2) Which of the two between 'adaptive efficiency' and 'allocative efficiency' is considered more important by the NIE and why?

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6.7 LET US SUM UP

Neoclassical economics made the fundamental assumption of instrumental rationality making it an institution-free theory. Ideas and ideologies were not given due place and efficient markets, both economic and political, were assumed to characterise economies. Institutional economics fundamentally departed from this approach. Two strands of contributions have emerged in the development of institutionalists. The first group of contributors, or the original institutional economists (OIE), laid emphasis on evolutionary, non-formal and behaviouristic approach to institutions. The later group of contributors viz. the new institutional economists (NIE) extended similar ideas but focusing more on the role of transaction costs as the connection between institutions and costs of production. The NIE's view of economic theory, incorporating ideas and ideologies including the political process as a critical factor in explaining the performance of economies (and as the explanation for inefficient markets), distinguished it prominently from the OIEs. Yet another significant stand taken by the NIEs was the primacy accorded to the characteristic of 'adaptive efficiency' over 'allocative efficiency'.

6.8 KEY WORDS

Corruption : Behaviour which deviates from the formal duties of a public role because of pecuniary gains.

Institution : Humanly devised constraints that structure human interaction. They are made up of formal constraints and informal constraints, and their enforcement characteristics.

Moral Hazard : The risk that the presence of a contract will affect on the behaviour of one or more parties.

New Institutional Economics : Incorporating a theory of institutions into economics, it builds by modifying and extending the neoclassical theory. By combining the essentials of political science with economics, and by uniting the theoretical and empirical aspects of economic process/development, the NIE has emerged as a major movement. It combines work on areas like transaction cost, political economy, property rights, hierarchy and organisation, and public choice. Douglass North and Oliver Williamson are two prominent contributors to NIE.

Organisation : A group of individuals bound by some common purpose to achieve specific objectives.

Original/ Old Institutional Economics : Refers to the contributions of earlier economists to the area of institutional economics. The words original and old and economics/economists are used interchangeably at places in the unit. This school focused on cultural and evolutionary aspects of change, focusing on Darwinian principles. Veblen, Commons, Clark, Cyres and Mitchell are some of the well known contributors to OIE.

Path Dependence : A condition that exists when the outcome of a sequence of economic changes can be significantly influenced by temporally remote events, including happenings dominated by chance elements rather than system forces.

Property Rights : Are of two types: economic property right and legal property right. The former refers to the rights of an individual over a commodity or an asset. It includes the right to use, the right to earn income and the right to transfer ownership rights. The legal property right refers to the rights that are recognised and enforced by the government.

Transaction : A transaction is said to occur when a good or service is transferred across a technologically separable interface.

Transaction Costs : Refers to the costs of resources utilised for the creation, maintenance, use and change of institutions and organisations.

Washington Consensus : Labelled as such by Williamson in 1990, it refers to the 10 broad policy prescriptions for sound development and management of an economy. These are: (i) fiscal discipline; (ii) reordering public expenditure in favour of education, health and economic infrastructure; (iii) tax reform towards broader bases with moderate rates; (iv) financial liberalisation; (v) competitive exchange rate; (vi) trade liberalisation; (vii) liberalisation of foreign direct investment; (viii) privatisation of public enterprises; (ix) deregulation of barriers to entry and exit; and (x) property rights.

6.9 SOME USEFUL BOOKS

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6.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Institutionalists focused on human-made and human-centric institutions like state, firm, individual/social norms, etc.

2) *The assumption of full employment*. Commons held that institutional economics is an extension from commodities and individuals to transaction and working rules of collective action.

3) The OIE's focus is on analysing the effects of technology in the economic process and the role of institutions in promoting/resisting change in the functioning of production/exchange. They also concentrate on law, property rights and organisations. NIE's emphasis is on the process of public choice and organisation in addition to the importance of property rights.

4) Institutions, and specifically property rights are considered the crucial determinants of the efficiency of markets.

Check Your Progress 2

1) The dynamics of the TCT derives from the continuous tension between the gains from specialisation in economic activities and the increasing costs that arise from the same process of specialisation.

2) See Section 6.4.2 and answer.

3) See Section 6.4.4, para 2, and answer.

4) Social/cultural foundations, basic institutional set-up, governance structures and institutions for short-term resource allocation are the four layers of institutional hierarchy classified by Williamson.

Check Your Progress 3

1) See Section 6.6 (ii) and answer.

2) See Section 6.6 (iii) and answer.