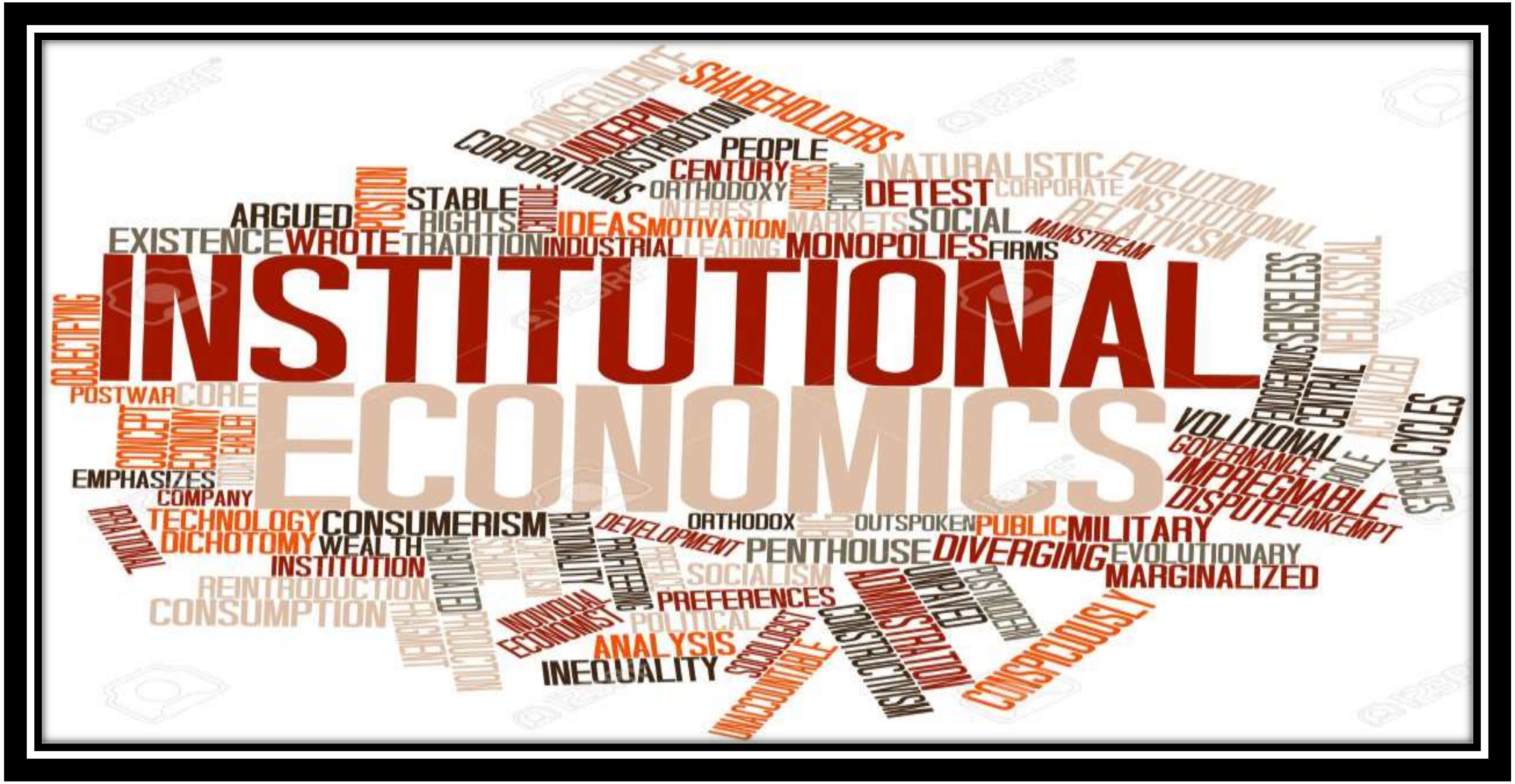


Socrates Majune
skmajune@uonbi.ac.ke

Lecture One: Introduction

Order of presentation

1. Announcement

✓AOB

2. Introduction to Institutional Economics: Key terms and history

Introduction to Institutional Economics

Welcome to Mission MarsInsEcon2023

- Flight is MarsInsEcon-2023
- Vessel id is Mars-Ins-Econ-2023
- Flight to take about 8 weeks of class time.

Definition of Institutions

- North (1990) “Institutions are the rules of the game in a society which define “the framework within which human interaction takes place”
- More formally, institutions are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic”
- Ostrom (1986): Institutions are commonly known rules used to structure recurrent interaction situations, such rules being endowed with a sanctioning mechanism in case of noncompliance
- Hence, Ostrom’s definition covers two components of institutions: the rule component and the sanction (or enforcement) component

Definition of Institutions

- Institutions are commonly known rules used to structure recurrent interaction situations, such rules being endowed with a sanctioning mechanism in case of noncompliance (Voigt, 2013)
- Acemoglu et al. (2005): Institutions are economic or political
- Economic institutions "determine the incentives of and the constraints on economic actors"
- Political institutions "determine the constraints on and the incentives of the key actors in the political sphere"
- Political institutions determine economic institutions as they are have *de jure* political power. Hence, these institutions are hierarchically structured

Characteristics of Rules

- Rules are: "prescriptions commonly known and used by a set of participants to order repetitive, interdependent relationships
- Prescriptions are about which actions (or states of the world) are required, prohibited, or permitted. Rules are the result of implicit or explicit efforts by a set of individuals to achieve order and predictability within defined situations"
- "commonly known" means that purely private rules not shared by other members of society are not rules
- Rules are the result of human action, but not necessarily the outcome of deliberate human design, as their origins can be traced to both explicit and implicit attempts of individual actors to structure interaction
- A rule can emerge over time due to the actions of individual actors even though those actors did not intend to create the rule

Characteristics of Rules

- Forms of rules: (1) commandments that prescribe specific behavior or a range of allowed actions or (2) prohibitions that disallow one or more specific actions
- Types of rule enforcement
- 1. Self-enforcement: Rules that are in one's self-interest to comply with because noncompliance would make you worse off- pure coordination games in which rule compliance is the dominant strategy for all players such as driving on one side
- 2.Self-commitment: Differs from self-enforcement as actors are likely to have internalized certain ethical rules that will make them follow the golden rule- paying bills?

Types of rule enforcement

- 3.Spontaneous societal enforcement: Arises from a collective action problem and involves an unknown number of persons informally monitoring compliance with societal rules
- 4.Organized private enforcement such as private arbitration courts
- 5.Organized state enforcement such as state courts
- The two differ such that organized state enforcement, in contrast to organized private enforcement, contains an element of hierarchical order in that private actors are subordinated to state control

More on Institutions

- Rules always constrains behavior. However, not every behavioral constraint is a rule; for example, constraints due to natural laws (e.g., the law of gravity) are not rules
- Promises are not institutions. Contracts contain mutual promises to act in specific ways and they do constrain future behavior. But they are not rules in the sense of commonly known prescriptions
- Most contracts are not institutions but they may be, and often are, based on institutions if they are framed within the boundaries of the relevant contract law

More on Institutions

- Institutions provide information and thus help reduce strategic uncertainty. Other phenomena also provide information, like newspapers, news broadcasts, or prices, without necessarily reducing strategic uncertainty. But none of these involve a rule or an enforcement mechanism and, hence, do not qualify as institutions

Types of Institutions: Voigt

- Institutions are varied and they differ in terms of enforcement and content of the rule component
- Internal institutions: Not enforced by the state and noncompliance is sanctioned from within society
- External institutions: Enforced and sanctioned by the state
- These institutions are hierarchically structured

Rule	Form of enforcement	Type of institution	Example
1. Convention	Self-enforcement	Internal type 1	Grammatical rules
2. Ethical rule	Self-commitment	Internal type 2	The Ten Commandments, the Categorical Imperative
3. Custom	Spontaneous informal societal enforcement	Internal type 3	Rules of social conduct
4. Formal private rule	Organized private enforcement	Internal type 4	Private arbitration courts
5. Rules of man-made law	Organized state enforcement	External	Private law, criminal law

Source: Voigt (2019)

Interactions between internal and external institutions

1. Neutral relationship where the institutions in question involve unrelated domains of human behavior
2. Complementary relationship where institutions constrain human behavior in a similar or equal manner and rule enforcement is organized via the state as well as by private actors
3. Substitutive relationship where institutions affect human behavior in the same or similar manner, but rule enforcement is organized via the state or privately
4. Conflicting relationship when compliance with the internal institution implies noncompliance with the external institution and vice versa

Types of Institutions: North

- ***Formal:*** **These are codified or spelt out in black and white and include constitutions, laws, legislations, policies both public and private, agreements and service contracts, conventions, codes of conduct, rules and regulations**
- ***Informal:*** **These are never written anywhere but people behave in accordance with them and are commonly understood by those for whom they apply. Examples include peoples values and norms, traditions, attitudes, worldviews, common etiquette**

Rules of football when we were kids

1. The fat kid was always the goalkeeper
2. The owner of the ball decides who plays
3. If you didn't participate in repairing the ball you were given a match ban
4. The guy who's never picked was to fetch the ball from the trees or bush when it got stuck, under the car or tunnel to play in the next game
5. When the owner of the ball got annoyed, game over
6. When you hit your toes against a stone and you notice blood, you quickly cover the area of injury with sand as a form of first aid and play continues
7. You can't dribble the owner too much, this may lead him to stop the game by taking away his ball.
8. No matter how many goals you scored, the winner would be determined by the last team to score
9. No offsides.
10. There is no referee.
11. There is fault only if the fault is serious .
12. The 2 best players can not play in the same team so everyone chooses their players.
13. If you are chosen last it is a humiliation and you will remain in defense.
14. If there is a penalty the goalkeeper is replaced by the best player of the team.
15. The best player on the field is always in the same team as the owner of the ball.
16. To distinguish the teams, one of the teams pulls off their shirts .
17. 3 or 5 corner kicks in a row equal to a penalty.
18. There is always a house where when the ball fell there, we knew that the game was over. so be careful !!
19. Game over when its dark and we can barley see the ball, we all disperse in groups teasing one another until we get home to face another punishment from our parents. 😂😂

Types of Institutions: North

- ***Formal/Informal:*** These are institutions that have formal and informal orientations
- Markets are such types of institutions. When you walk into Naivas Supermarket to buy some provisions, you can pick whatever you need but pay for what you have picked at the counters. Although there is nothing written that you must pay, it is commonly understood that people have no choice but to pay. The fact that you walk into the supermarket signals that you understand that rule of game since supermarkets are not set up for the express purpose of giving charity. However, when you pay at the counter you will be given and can insist on a receipt. A receipt declares what you have bought at what prices. It is a formal part of the shopping rule of game. Some supermarkets give customers the options of returning certain nonperishable items. When you can return, that becomes part of the rule of game pertaining to your shopping. Of course, you know that you do not bargain in supermarkets. Shopping in supermarkets is on a take or leave basis.
- The shopping rules change when you visit a shopkeeper, because you can drive down the purchase price through bargaining, which could mean the prices are inflated in the first place. But even shopkeepers give receipts to signal that a transaction has occurred

Distinction between Institutions and Organizations

- There is a vast difference between them. If institutions are human designed rules of game, such games play out in organizations
- We can view organizations as bundling of institutions i.e. specific groups of individuals pursuing a mix of common and individual goals
- An example is the University of Nairobi, which has student enrolment procedures, examination and graduations procedures, recruitment and promotion criteria, human resource practices including safety and ethical practices. Other than the academic and non-academic staff, the university has service provision contracts with other persons and organizations and procurement procedures
- All these procedures and practices are institutional. It is the bundling of these institutions that makes the organization referred to as the University of Nairobi

The Institutional Pyramid

- We can look at institutions as pyramids, where the informal institutions form the invisible institutional substructure while the formal ones form the superstructure
- Informal institutions are foundational in the sense that they take a while to segment and when they do, they tend to be passed on inter-generationally
- Formal institutions such as laws, legislations, policies and convention are easier to replace. In the middle of the institutional pyramid are those that are both formal and informal such as markets
- The strength of the institutional pyramid critically depends on the informal institutions

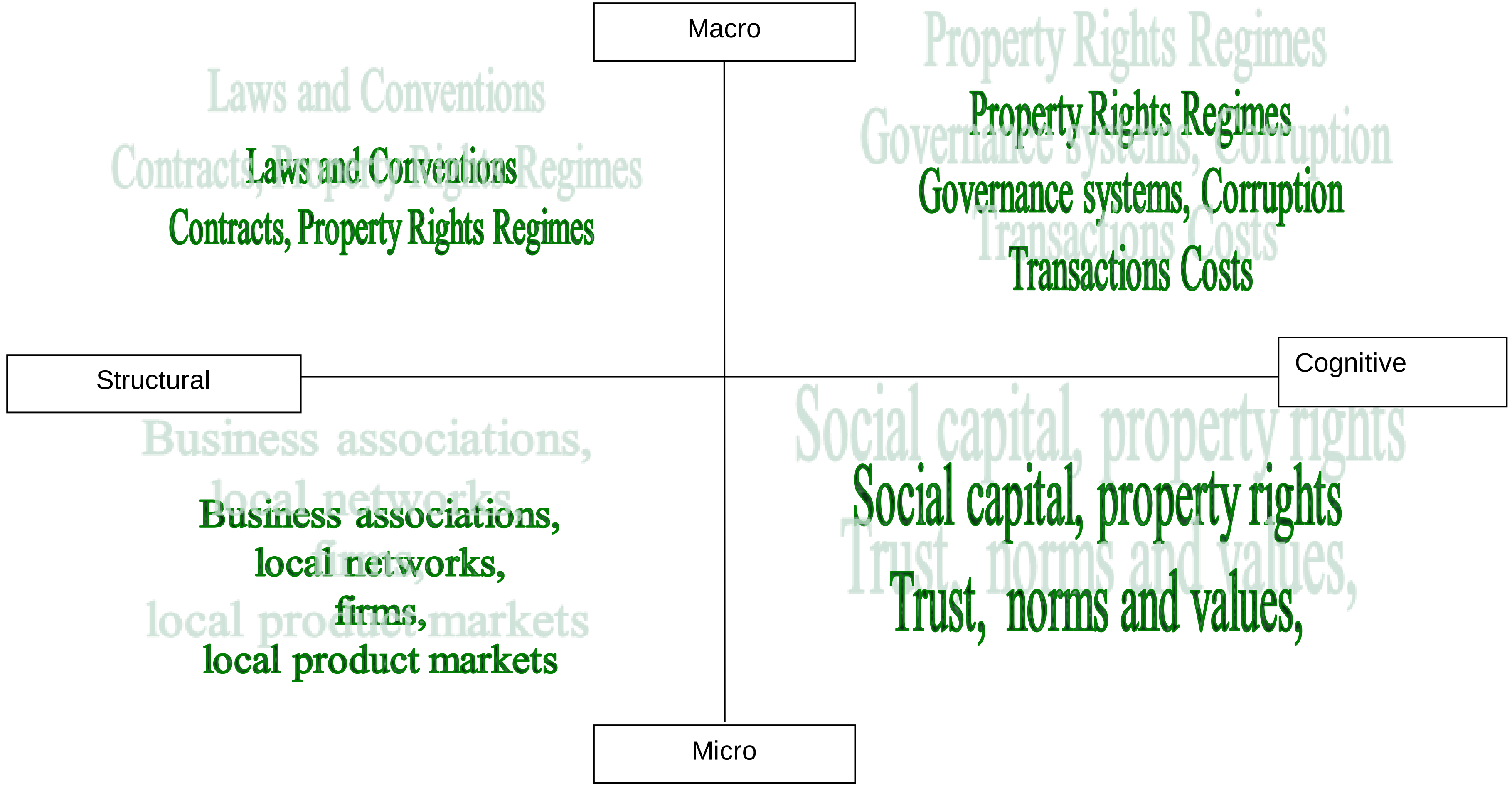
The Institutional Pyramid

❖ Organizational arrangements are the different modes of governance that agents implement to support production and exchange. These include:
  - ✓ Markets, firms, and the various combinations of forms that economic actors develop to facilitate transactions and
  - ✓ Contractual agreements that provide a framework for organizing activities, as well as
  - ✓ The behavioural traits that underlie the arrangements chosen

FIGURE 7.9 A management hierarchy. The coordinated effort of all three levels of management is required to achieve the goals of the business.

Institutional Space

- ❖Different institutions occupy different but inter related quadrants in institutional space
- ❖The horizontal axis ranges from structural to cognitive, while the vertical axis ranges from micro to macro through meso institutions
- ❖Along the structural-cognitive axis, on the top left hand quadrant, are placed institutions that are not only structural but largely macro such states and/or governance, national and global conventions and laws, markets and formal financial institutions
- ❖On the bottom left hand quadrant is an assortments that are both structural but micro in nature. Included among these are firms, households, product markets, business associations and local markets
- ❖On the bottom right quadrant are institutions that tend towards cognitive and micro, such as trust, local norms, values, ethnicity and gender
- ❖The top right quadrant captures institutions that make for governance


Macro
Laws and Conventions
Contracts, Property Rights Regimes
Property Rights Regimes
Governance systems, Corruption
Transactions Costs
Structural
Cognitive
Business associations,
local networks,
firms,
local product markets
Social capital, property rights
Trust, norms and values,
Micro

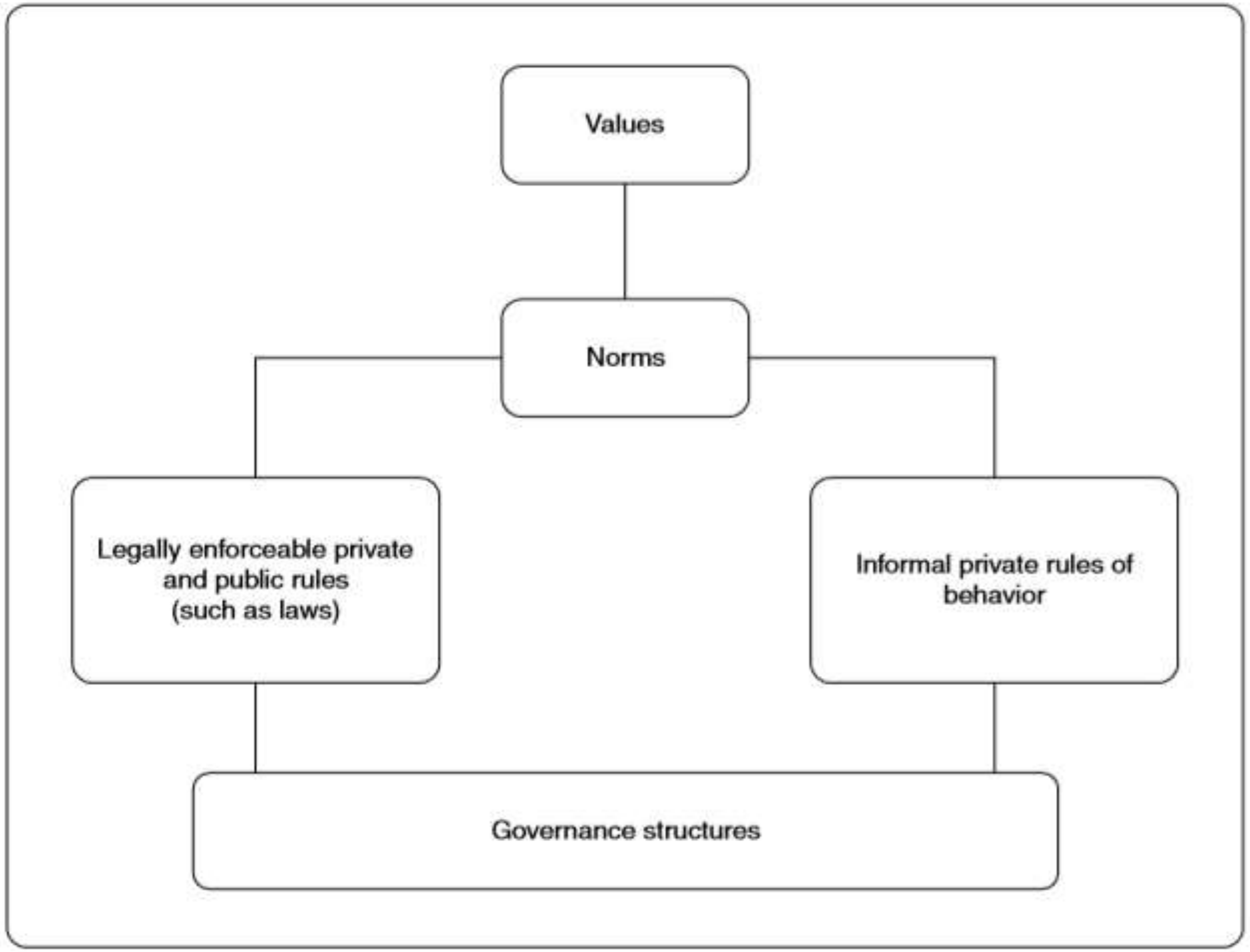
Institutional environment

- ❖Refers to the framework in which human action takes place
- ❖People do business in an institutional environment, which consists of all rules, formal and informal, that have an impact on behavior in economic transactions
- ❖It consists of a hierarchy of different kinds of institutions: values, norms, conventions, laws and specific rules, whether formal or informal
- ❖Values are embedded in a society's culture (all aspects of human behavior and society that are shared by all, or almost all, members of some social group), are generally-held preferences about pursuable goals, and embody what most citizens in a certain society consider to be 'good'
- ❖Norms are generally-held opinions about how to achieve the values. They define agreed ways in which people should behave, according to the members of a group, so that the values of society are realized, or at least not violated e.g. solidarity (to achieve justice) and competition (to achieve prosperity)

Institutional environment

- ❖Conventions are practical rules that structure behavior in complex situations. Conventions reduce coordination problems, which is particularly important in an increasingly complex world. Examples of conventions are the use of a common scale to measure lengths, weights and time with the aid of the same units, and rules on how to behave in social interaction and in traffic. So if the norm is that people should drive safely in order to contribute to the value of security in general, the convention is driving either on the right-hand side, or the left-hand side of the road
- ❖Laws (and regulations) are formalized rules enacted by the government, in the shape of codified norms and conventions
- ❖Values, norms, conventions and laws are interrelated hierarchically. From the above you can discern a hierarchy from more general to more specific, and from spontaneous adherence to formal sanctions. Values are the basis for norms, and norms are the basis for conventions, laws and the resulting specific rules

Institutional environment: Hierarchical institutional scheme



Efficiency of governance structures

- Explains the preferred governance structure by optimizing actors given a number of environmental factors like technology (this is standard know-how to produce the good), natural resources, laws and public regulations (concerning for instance competition), and the preferences of the producers and consumers (maximizing profits, minimizing transaction costs, maximizing utility)

Static efficiency approach towards institutions

- Static efficiency approach towards institutions makes analysis given a static environment of technology, values, norms and preferences. This optimizing behavior may or may not lead to static (allocative and/ or productive) efficiency, depending on whether the goal is to serve everybody's welfare or just the interests of a particular group in society, at the expense of other groups
- When optimizing decisions are taken on, the situation remains until a change takes place in one of the constraints
- To improve efficiency in a static sense would imply, on the one hand, the minimization of production costs, while on the other hand, it concerns the minimization of transaction costs (are the costs of the coordination of transaction minimized?), which is a central issue in the static approach of Institutional Economics
- In the static approach, the focus is on optimizing under given constraints
- Politicians make efficient laws and regulations, and actors at the micro level choose efficient governance structures. Since this analysis is made in a given static environment of technology, values, norms and preferences, we call this the static efficiency approach toward institutions

Static vested interest approach towards institutions

- ❖ Static vested interest approach assumes that actors in the economic system will constantly try to protect their own interests
- ❖ Suppose they have private property rights, and they are free to do what they want with the property to maximize their private profits. These actors might oppose any attempt to create institutions that constrain these possibilities
- ❖ Actors in the economic system will create opportunities to maximize their profits and utility, and they will use their power to protect their vested interests. They have their own objectives and use all kinds of instruments to realize these objectives, which do not always conform to fair competition

Dynamic efficiency approach towards institutions

- Dynamic efficiency approach explores the process of institutional change develops over time
- Interest is to identify drivers of institutional change and how the causal mechanisms of change in an economic system work
- In the case of efficiency, interested is in identifying existing information: how do firms in the market know about the most efficient scale of production, and how do they know about the most efficient governance structure? Is information available through the price system, so that actors know ex ante about the most efficient solutions? Do they learn over time in a process of trial and error? Are they able to imitate their most efficient competitors?
- Dynamic perspective questions the assumptions that the static perspective makes about the flexibility of actors to adopt more efficient alternatives

Dynamic vested interest approach towards institutions

- Sometimes circumstances allow for smooth changes to more efficient alternatives, but very often this is not the case
- This is not only because of inertia, but also because of the protection of vested interests, so we then have to make use of the dynamic vested interest approach
- Institutional change always implies a redistribution of costs and benefits: some actors are better off after the change and some worse. So, in the dynamic approach, the explanation of the change or the rigidity of the institutions can also be found in the strategies of powerful interest groups which protect their long-standing interests

Explanation of governance structures: the four approaches combined

	Static approach	Dynamic approach
Efficiency	Given the institutional environment and the characteristics of actors, which governance structure minimizes transaction costs?	How do institutional changes come about when actors operate out of an efficiency perspective?
Vested interest	Given the institutional environment and the characteristics of actors, which governance structure is chosen when powerful interest groups protect their vested interests?	How do institutional changes come about when actors operate out of a vested interest perspective?

Institutions matter

- Since the institutionalist, Douglass North, received the Nobel Prize in 1993, the saying 'Institutions matter' has become well-known
- As North said when accepting this prize: 'When it is costly to transact, then institutions matter. And it is costly to transact' (1994, p. 360)
- Countless empirical studies substantiate this proposition. They all demonstrate that when societies that are similar with respect to several indicators such as size of the population, size of the country, climate and natural endowments are compared there remain large disparities in economic prosperity that can only be explained by pointing toward differences in the institutional environment
- The core hypothesis of institutional economics is that growth and development are decisively shaped by the prevailing institutions

Institutions matter

- Informal and formal rules in a society have a large impact on whether or not economic transactions are performed with low contracting costs. Trust plays an important role here. Is there a reliable government and an objective judiciary to protect the rights of all individual actors? Is the community characterized by high ethical values that promote respect and create opportunities for all members? If people live in such circumstances, they have more incentives to engage in an economic activity, which in turn favors the development of society at large
- Institutions also distribute rights and duties with implications for who reaps the benefits and who meets the costs

History of Institutional Economics

- ❖Started in 1918 after the 1st World War (1914-1918)
- ❖Originated in America
- ❖Was dominant till 1950's when it was overtaken by Keynesian and Monetarist Schools after 2nd World War
- ❖Re-emerged recently (from 1970s)
- ❖As a result, Institutional School is divided into "Old" and "New"

Refer to Rutherford (2001)

Old Institutional Economics

- ❖ As aforesaid, was dominant between World War 1 and 2
- ❖ Mainly identified with Thorstein Bunde Veblen , Wesley Clair Mitchell , John R. Commons and John A. Hobson
- ❖ Major sentiments of this “old” school are:

- ✓ Advocated for social reforms by contributing on policy in their roles in the development of unemployment insurance, workmen’s compensation, Social Security, labor legislation, public utility regulation, agricultural price support programs, and in the promotion of government “planning” to create high and stable levels of output
- ✓ Incorporated elements of other subjects such as law, psychology, sociology etc. into Economics
- ✓ Introduced empirical analysis in economics such as establishment of NBER (National Bureau of Economic Research)
- ✓ Made contributions to a number of key debates in economics on issues such as psychology and economics, business cycles, the pricing behavior of firms, ownership and control of corporations, monopoly and competition, unions and labor markets, various types of market problems and failures, public utilities and regulation, and law and economics

New Institutional Economics

- ❖ **Recent school after the old school had lost prominence to Keynesian and Monetarists**
- ❖ **Old school lost prominence due to:**
- ✓ **Lack of a proper theoretical background. Specifically the failure to pin down foundations of modern psychology, social norms etc.**
- ✓ **Overtaken by introduction of Econometrics as tool of empirical analysis hence could not boast of being empirical**
- ✓ **Resurgence of new institutionalism began after 1970**

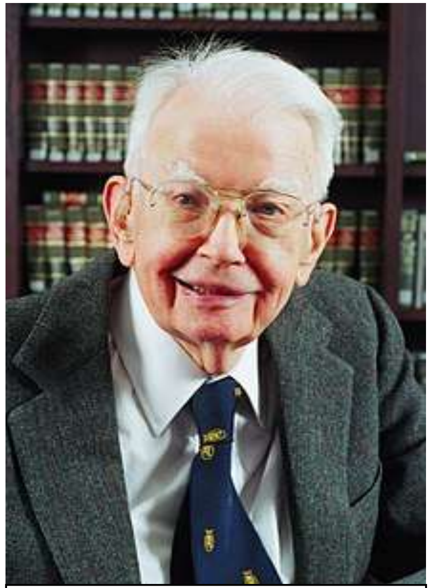
Major sentiments of New Institutional Economics

- ❖Abandons perfect rationality for bounded rationality: Influenced by strategic uncertainty and risk
- ✓The Neoclassical assumption of individual utility maximization is replaced by satisficing behavior, which involves individuals defining realistic acceptability thresholds
- ✓"Rule rationality" is used by actors to rationally cope with uncertainty
- ❖Strategic uncertainty-when the result of an action depends not only on one's own behavior, but also on that of another actor
- ❖Parametric uncertainty-the result of an action depends on the realization of some exogenous event, for instance, on whether it rains or snows

Major sentiments of New Institutional Economics

- Abandons the assumption of costless transactions. In reality, transaction costs –such as economic exchange entails information costs, search costs, negotiation costs, and fulfillment costs-exist. Transactions are assumed to be costless in Neoclassical Economics since information is perfect
- **NIE also follows strict methodological individualism: goals, plans and actions of individuals**

Faces of New Institutional Economics



- Ronald H. Coase (1910-2013)
- Nobel in 1991
- Chicago

- Douglass C. North (1920-2015)
- Nobel in 1993
- Washington

- Robert W. Fogel (1926-2013)
- Nobel in 1993
- Chicago

- Oliver Williamson (1932-2020) and Elinor Ostrom (1933-2012)
- Nobel in 2009
- UCB and Indiana

The Toolkit of Institutional Economics

- ❖Game Theory: A Tool for Analyzing Strategic Interaction Situations
- ➢A Coordination Game
- ➢A Mixed-Motive Game: The Prisoner's Dilemma
- ❖Comparative Institutional Analysis- identifying and comparing the effects of alternative institutional arrangements on variables of interest to economists
- ❖Case Studies Including Economic History - analyzing a small number of cases in great detail
- ❖Econometric Tests- institutions can be quantified, both their determinants and their effects can be tested and compared using econometric methods

NIE's Common Ground with and Differences from Other Research Programs

Research program	Central question	Relation to NIE
Transaction cost economics	Consequences of positive transaction costs (also with regard to political processes)	Precursor that became a component of NIE
Property rights theory	Consequences of different property rights arrangements	Precursor that became a component of NIE
Information economics	Interested in identifying ways to deal with situations of uncertainty	In both, uncertainty plays a central role
Constitutional economics	Legitimation of the state Consequences of alternative constitutional rules, determinants of constitutional rules	The normative variant is an addition to NIE The positive variant is a part of NIE
Public choice	Economic analysis of politics	Analysis of the incentive effects of exogenously given rules
Law & economics	Economic analysis of law	Analysis of the incentive effects of exogenously given rules (primarily concerning private and criminal law)

Any questions?

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