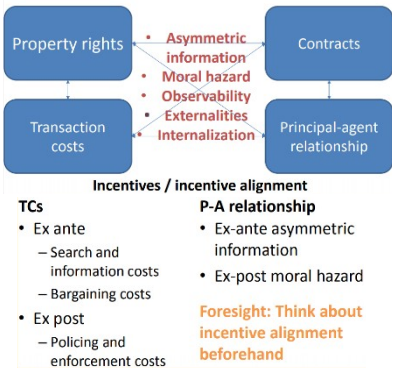
Summary 2 Institutional economics week 50

Institutionele economie (Radboud Universiteit Nijmegen)

Summary 2 Institutional economics (Lecture 6 t/m 10 week 50)



- Lecture 6: Transaction costs and the firm:. Incentives and monitoring as solutions to P-A problem. The greater the autonomy of the agent, the more less prevention and invention cost but the higher the consequential costs. Sources of transaction costs (TCs) 1. Search and information costs 2. Bargaining costs. 3. Policing and enforcement costs. Ex-ante vs. ex-post TCs→ Ex ante; search and information costs, bargaining costs. Ex post; Policing and enforcement costs– Ex-ante contracts to deal with ex-post risk of opportunistic behaviour • One-off simultaneous (spot) transaction vs. sequential) PRT: Focus on ex-ante incentives; without property rights, no exchange • Contracts – Incomplete • TC theory – Focus on efficient ex-post governance of exchange. How TCs are used in practice – Comparative → likelihood. Comparative transactional characteristics: 1. Uncertainty 2. Frequency 3. Asset specificity Williamson's matrix of transactions → determines choice to make or buy/likelihood internalization. • Transaction-specific investment – Ex ante → sunk costs • Transaction-specific investments↑ → Flexibility↓ – Hold-up problem (The hold-up problem is a situation where two parties may be able to work most efficiently by cooperating but refrain from doing so because of concerns that they may give the other party increased bargaining power, and thereby reduce their own profits)– Once investment is made, bargaining power shifts • Ex-ante fear of hold up → underinvestment – Market failure. Hold-up is one party's opportunistic behaviour to extract the quasi-rents of a transaction. Hold – up as a game→ first movement idea→ agency theory. Not always optimal outcome. Williamson's fundamental transformation – Change in nature of relationship from "large bidding" to "small number bargaining" situation • results in constrained choice • "Lock-in" • Logical solution → Internalization or vertical integration • As opposed to arm's length • single firm (reason why exchange often happens within firms and not on the market, TC is reason why firms exist, NE assumed efficient markets). Exchange is organized so as to minimize sum of production costs + transaction costs. • Firms more likely when: risk of opportunism ↑ – Incompleteness ↑ – Asset specificity ↑ → Hold -up problem ↑ • Internalization provides safeguard against risk of opportunistic behaviour. Markets vs. firms (hierarchies) • Allocation by authority rather than prices=privatization• Power of incentives – Markets: high-powered • Direct link between performance and earnings – Lower production costs – Hierarchies: low-powered • Indirect link between performance and earnings – Lower transaction costs • Inefficiencies due to P-A type problems (hierarchies) • Trade-off between these effects. 1. Why do firms exist? – Quasi rents of team production – Minimizing of TCs 2. Why are firms of limited size? – Costs of monitoring – Inability to offer high-powered incentives. Increase with size → Diseconomies of scale. Conclusion above: • Organization of exchange can be studied • Governance = f(TCs) – TCs = f(Asset specificity, etc.) • Minimize sum of production + transaction costs • Relation with property rights & contracts.

-Lecture 7: Governments and government failure: The difference between private vs public goods based on 2 characteristics: 1. Rivalness 2. Excludableness. Common pool resource: nobody can be excluded. Anti rival goods: goods that become more valuable as more use it. Private, because market will not produce it, risk of free-riding. State intervention as governance structure: 2.1 **Static approach** (effect can be positive, but on long run dynamic different (negative) = efficiency 2.1.1 Imperfect information: Security→public/government provides information disclosure + monitoring 2.1.2 Market Power: Government stimulates competition. Natural monopoly due to economies of scale: Cost efficient • Allocative inefficient (deadweight loss. Regulation vs creation of competition, sometimes monopoly is needed; Legal monopoly • Last resort: state-owned enterprise 2.1.3 Externalities; Coase theorem → private enterprises will be able to solve the problem of externalities, no matter the division of property rights, equal bargaining power assumed. 2.1.4 Pure public goods 2.1.5 TCE • 2.2 **Dynamic approach** = pro-active (how it develops over time). • Pro-active government to achieve a certain development • Indicative planning: government provides information that market cannot give • Embeddedness criterium. 3**. Government failures**: 3.1.Static approach – 3.1.1 Perfect information: . Balance of intervention • Public interference has a cost – Enforcement costs – Monitoring costs – Compliance costs – Administration costs • Cost/benefit analysis. What is the most optimal decision? –Pareto optimality – Second best solution: Kaldor-Hicks criterion→ 'a decision can be more efficient as long as in theory, everyone can be compensated to offset any potential costs' – 3.1.2 Property rights problem: Public provision of goods – Lack of competitive forces – Low-powered incentives – Citizen behaviour: moral hazard & oppertunistic behavior • Solutions – Private provision – Institutional solutions– 3.1.3 Imperfect information.

Lecture 9: Emerge and dynamics of institutions Make vs. buy (L6) • Internalization of exchange / allocation by authority . – Government "interference" can improve on market outcomes / sustain markets that would not exist otherwise. • Fundamental problem of exchange (FPOE) – Opportunism • Ex ante vs. ex post • Contracts Game theory: "the formal study of decisionmaking where several players must make choices that potentially affect the interests of the other players " – Cf. externality • One-shot games vs. repeated games – Later today • Cooperative vs. non-cooperative games. Institutions: – Emerge as solution to fundamental problem of exchange (FPOE) • Ensures ex-post commitment to ex-ante promises through sanctions – Enforcement• Fundamental problem of exchange: – Small-scale solutions • Informal sanctions →limited scope →personal exchange – Large-scale solutions • Formal, third-party sanctions →broad scope →impersonal exchange • Institutions are: – Evolving – Stable and self-enforcing – Not necessarily optimal. Solution FPOE: Commitment through enforcement • Some sort of incentive not to cheat or renege – Sanctions • But enforcement can take different forms • Difference between small-scale community exchange and large-scale impersonal exchange. Nature of exchange: – Personal – Repeated • Possible sanctions: – Reciprocity / punishment – Reputation • Social ostracism • Easy flow of reputational information within community – Also: Group identity / collective reputatio • Further: – Genetic relatedness / kinship ties; Kinship is the relationship between members of the same family. Kinship is the relationship between members of the same family. • Third-party enforcement if no repeated transaction – An impartial party not involved in exchange has power to coerce parties into fulfilling contractual obligations. Formally (by states) + High transparency + Broad scope + Impersonality - High costs. Informally (by reputation & tit-for-tat; steeds zelfde behaviour otherwise punished. = cooperative strategy) - Low transparency - Limited scope - No impersonality + Low costs. Formal enforcement↑ →Scope for exchange↑ →Specializa3on↑ →Welfare↑. Evolution of institutions: • Survival of the fittest – Selection on traits that increase survival - Institutions also evolve – Institutions that increase human survival remain • Institutions that decrease human survival become extinct • Norms, habit, conventions have all evolved. Institutions & coordination • Institutions also help coordinate human action • Not only governance of exchange 1. Provision of public goods – Institutional enforcement reduces free-riding • Still form of economic exchange 2. How individuals interact when not transacting – Social exchange • Facilitated by, shared language and shared conventions. Multiple stable equilibria • Example: Coordination game ste • Self-enforcing. • Moving from suboptimal to optimal institutional equilibrium is difficult • Trapped in poor economic performance. Institutions get perpetuated because people internalize them – Externalization: regularity in social behaviours must become visible to others – Objectivation: regularity in social behavior must become a reliable fact of life •– Enculturation: same behaviour is exhibited by all people in society. "Coordinated" change – The agreement to change the social norm must be known to others • Cf. externalization – People must be seen to adhere to the new norm by others • Cf. objectivation – The new norm must be adhered to by all people in society • Cf. enculturation. Summary: Fundamental problem of exchange – Small-scale solutions • Informal sanctions →limited scope →personal exchange – Large-scale solutions • Formal, third-party sanctions →broad scope →impersonal exchange. Institutions are: – Evolving – Stable and self-enforcing – Not necessarily optimal. 2. Conceptualizing institutional differences 2.1. "Good" vs. "bad" 2.2. Formal vs. informal 2.3. Varieties of capitalism 3. Measuring institutional differences 3.1. World Bank's Worldwide Governance Indicators 3.2. Social norms and culture 3.3. Liberal market economy vs. coordinated market economies.

Lecture 10: Comparing institutional environments**:** Conceptualizing institutional differences based on comparative approach. • Enforcement improves with 1. Transparency↑ 2. Scope↑ • Different Exchanges • Different forms of contracts 3. Impersonality↑ • Independent of social class or group membership • Property right protection – Idem • Transparency, scope, impersonality. Both contracts & PRs need enforcement. Informal institutions: – Provide context for formal institutions – Provide complementary enforcement. 2.3. Varieties of Capitalism (VoC) • Any institution is part of a wider system of organization & coordination in a society • Institutions reinforce each other through institutional complementarities • Different societies have different priorities & resulting institutional comparative advantages. Two key concepts in VoC 1. Institutional complementarities: Two institutions can be said to be complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other 2. Comparative institutional advantage: The institutional structure provides firms with advantages for engaging in specific types of activities – Cf. standard H-O trade theory. World wide government indicators: Operationalizing the WGI • The process by which governments are selected, monitored and replaced 1. Voice and Accountability 2. Political Stability and Violence • The capacity of the government to effectively formulate and implement sound policies 3. Government Effectiveness 4. Regulatory Quality • The respect of citizens and the state for the institutions that govern economic and social interactions among them 5. Rule of Law 6. Control of Corruption. No dimension can be measured directly • However, different measures / data sources together may tell us something about an underlying institutional dimension. Very important social norm/informal institutions: trust. Trust complements formal enforcement – Counterparty can be trusted not to exploit a contract's incompleteness • Trust as outcome of: – Repeated interaction & reciprocity – Reputation – Emotional bonds.