Institutional Economics most important things

Institutionele economie (Radboud Universiteit Nijmegen)

Institutional Economics most important things

Institutions govern economic transactions between people and assist in coordinating transaction smoothly and at low costs.

We need institutions because: Exchange is not frictionless or easy. Exchange is a transfer of ownership.

Institutional economics is about:
- Opportunistic behaviour
- Bounded rationality
- Asymmetric information
- Risk & uncertainty

NE (Smith, Menger & Marshall)	**OIE** (criticises NE) – broad dynamic perspective	**NIE** (supports NE) – efficiency analysis
Actors are hyper rational	No adequate reality	Bounded rationality and opportunistic behaviour
Markets always exits and never fail	How do these markets and institutions evolve?	Difference between governance structures and institutional environment
Prices reflect relevant information	Markets reflect social power structures	Actors choose the best institutions to coordinate a transaction
No transaction costs	TC's, externalities, imperfect information	TC's, externalities, imperfect information
Exchange is frictionless	Not frictionless	Not frictionless
Laissez-faire	Government is pro-active in formulating societal objectives	Government needs to set the institutions right

Property rights
1. Right to use good
2. Right to earn income of good
3. Right to transfer good

Externalities: External effects arise from costs or benefits imposed involuntarily on other parties/party that are not directly involved in the transaction.

Tragedy of the commons: Lack of clearly defined property rights van lead to inefficient allocation of resources

Coase's insight: If (1) there is no frictions of some sort, and (2) if property rights are clearly defined and transferrable, then people can always negotiate to an efficient outcome, allocation of resources will always be efficient.

Coase's theorem in reality
1. Frictions → TC's (bargaining power)
2. Property rights not always well-defined (tragedy of the commons)

Modern property rights theory: residual rights of control

Residual rights of control: right to make any decision concerning an asset not controlled by other means.
- Decisions not controlled by law
- Decisions not controlled by contracts involving the asset
- Residual rights are vital link between property rights and contracts

Contracts: transfer property rights (=exchange)

Contracts are incomplete
1. Bounded rational (world is too complex)
2. Information asymmetry (Unequal access to information)
3. Immeasurable key features of contracted performance

Asymmetric information
- Before the transaction (ex ante) → Adverse selection
- After the transaction (ex post) → Moral hazard

Free-riding solutions
1. Paying individuals for their input
2. Paying individuals for their output

Principal-agent theory challenges
- Asymmetric information
- Not sharing the same interests
- Opportunistic behaviour
- Shirking

Solutions:
- Monitoring
- Incentives
- Signing

Sources of transaction costs
1. Search & information costs
2. Bargaining costs
3. Policing and enforcing costs

Transaction costs characteristics
1. Generic uncertainty
2. Frequency
3. Asset specificity

	Investment characteristics		
Frequency	**Nonspecific**	**Mixed**	**Idiosyncratic**
Occasional	Purchasing standard equipment	Purchasing customized equipment	Construction a plant
Reoccurring	Purchasing standard material	Purchasing customized material	Site specific transfer of intermediate products across successive stages

Williamson's matrix of transactions

Hold up problem: The problem that bargaining power shifts after that the transaction is made.

High powered markets: Markets with a lot of market institutions. This leads to lower productions costs
Low powered markets: Markets with a lot of government institutions: This leads to lower transaction costs.

Last resort: State owned enterprise.

Private governance structures may fall because of:
- Large number of globally diffused actors
- Lack of awareness
- Determined polluters
- Power imbalance
- Tracking and monitoring cots

Progressive government intervention	**Example**
Indicative rules	Information disclosure
Monetary incentives	Taxed and subsidies
Constraining rules	Qualitative demands
Strict requirement	Competition authority
Complete state control	State owned enterprise (last resort)

Public interference:
- Enforcement costs
- Monitoring costs
- Compliance costs
- Administration costs

Arrow's impossibility theorem: Vote maximization, budget maximization and conflict minimization don't create an efficiency.

Number of exchanges go up if institutions are:
- Stable
- Credible

- Impersonal

Types of enforcement

Formally	Informally
+ High transparency	-Low transparency
+ Broad scope	-Limited scope
+ Impersonality	-No impersonality
-High costs	+ Low costs

Institutions are:
- Evolving
- Self-enforcing
- Not always optimal

Perpetuation is created by
- Externalization (regularity or change must be visible to others)
- Objectivation (must become a reliable fact)
- Enculturation (same behaviour is exhibited by all people in society)

Five spheres of coordination
1. Industrial relations
2. Vocational training & education
3. Corporate governance
4. Interfirm relations
5. Employee relations

Trust as key informal institution:
- Contracts are incomplete → Vulnerability remains, even when quality of enforcement is high
- Trust complements formal enforcement → Counterparty can be trusted to exploit a contract's incompleteness.
- Trust as outcome of: Repeated interaction & reciprocity/reputation/emotional bonds

CCCI (cross country cross industry) analysis: Which type of value added activities benefit from which types of institutions.

Criteria	LME	CME
Employment	Full time, general skill, short term, fluid	Shorter hours, specific skill, long term, immobile
Training & Education	Formal education from high schools & colleges	Apprenticeship imparting industry specific skills
Innovation	Radical	Incremental
Comparative advantage	High tech and service	Manufacturing

Why does management differ across firms and nations?
- Imperfect competitive markets
- Family ownership of firms

- Regulations restricting management practices
- Informational barriers

Corruption: The abuse of public power for private gain

Institutional pressure that affects firms:
- Coercive processes – reflect pressures imposed by an authority
- Normative processes – reflect established paradigms in the society
- Mimetic processes – reflect pressures for firms to imitate successful enterprises in their organizational field.

National system: Term to collectively describe the complex milieu of interrelated social and economic factors, or institutions, that characterize the nations state within which a firm is principally located or headquarter.

Three interrelated institutions (part of the national system)
- National values → deeply held preferences shared by a society's member are fundamental institutions.
- Corporate ownership values → Formal institutions that deals with the matter of how and by whom public company shares are owned.
- Board governance arrangements → Formal institution, involves the mechanisms by which the assets and activities of public firms are overseen.