Institutional economics-October-January 2020

MARKING SCHEME FOR THE TEST
XET 402: INSTITUTIONAL ECONOMICS
Time: 11:30 am – 12:30 pm on 9th December, 2019

Instructions: This test has three questions which are **compulsory.** Please be concise and write legibly.

1. **For each statement, state whether it is true, false, or uncertain. Provide a brief explanation for each answer. Answer only five options (10 marks).**

Marks are only awarded when the first section of the answer is correct.

a) **Old Institutional Economics assumes individuals have incomplete information (2 marks).**

False **(1 mark).** Instead it is the New Institutional Economics that assumes individuals have incomplete information **(1 mark).**

b) **The concept of asset specificity was suggested by Douglas North (2 marks).**

False **(1 mark)**. This concept was suggested by Oliver Williamson, Nobel Prize Laurent for 2009. Asset specificity makes specific reference to the extent to which an asset can be redeployed to alternative uses and/or by alternative users without a substantial sacrifice of its productive value **(1 mark).**

c) **Arrow-Debreu contracts lead to the "first best" solution (2 marks).**

True **(1 mark)**. Arrow-Debreu contracts are also called complete contracts. They are based on every possible state of the world). They are optimal such that they anticipate and control for all possible ex post strategic behaviors leading to "first best" solution **(1 mark).**

d) **The effect of institutions on governance is exogenous in New Institutional Economics (2 marks).**

False/uncertain **(1 mark).** Scholars in New Institutional Economics treat institutions as exogenous to most people's behaviour in the short term, while being almost completely endogenous in the long term. Hence, it depends on the period of review **(1 mark).**

e) **Corruption always "sands the wheels" (2 marks).**

False **(1 mark).** Corruption can either sand or grease the wheels. Sanding the wheels means that it reduces economic growth while greasing the wheels means that it increases economic growth **(1 mark).**

f) **Social capital is the "horizontal associations" between people (2 marks).**

True/Uncertain **(1 mark).** This is a narrow definition of social capital Putnam 1993; Putnam and others 1993). Nevertheless, the definition can also be expanded to mean how entities operate (Coleman, 1988) and the political environment (North, 1990) **(1 mark).**

g) **Enforcement of property rights is a police function of the state (2 marks).**

True **(1 mark).** This has to do with the dynamics of property rights where the police are involved in enforcement of property rights **(1 mark).**

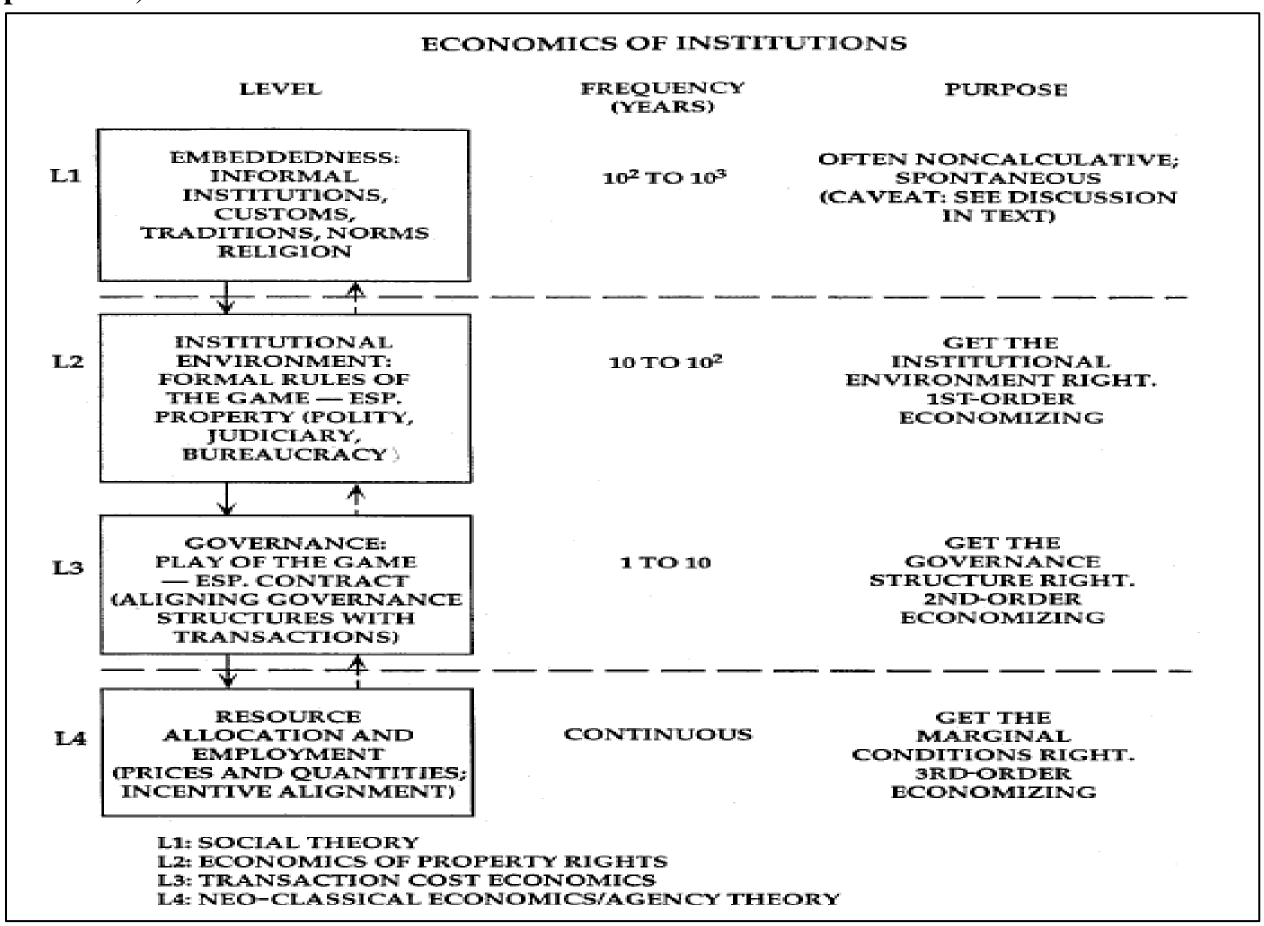
2. **Answer two questions in this section. (10 marks)**

a) **Briefly discuss the Williamson's framework used in Institutional economics (5 marks)**

The framework examines the role of "social, cultural, political, and economic institutions" on "economic behavior and performance" **(1 mark)**. This is done in four levels as follows:

Level 1: Embeddedness, or Social or Cultural Foundations. The is 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 **(1 mark)**.
Level 2: Basic Institutional Environment. This is the second level of the institutional hierarchy encompasses the basic institutional environment or what Williamson calls "the formal rules of the game." At this level are defined constitutions, political systems, and basic human rights; property rights and their allocation; laws, courts, and related institutions **(1 mark)**.
Level 3: Institutions of Governance. This is the third level of the institutional hierarchy encompasses what Williamson calls "the play of the game." Given the basic institutional environment, choices are made about the institutional (governance) arrangements through which economic relationships will be governed given the attributes of the basic institutional environment **(1 mark).**
Level 4: Short-term Resource Allocation (Neoclassical Market Economics). This level refers to the day-to-day operation of the economy given the institutions defined at the other three levels. Prices, wages, costs, and quantities bought and sold are determined here as are the consequences of monopoly, oligopoly, and other neoclassical market imperfections **(1 mark)**. Williamson would include agency theory and incentive alignment within and between organizations here

This discussion can still be presented in the following Figure (**4 marks if the Figure is correctly presented**).



b) Outline the key differences between Williamson's and Coase's approach to the Theory of the Firm (5 marks).

This is related to the paper by Bylund (2019) that we reviewed in class (**0.5 marks. The remaining 4.5 marks is awarded to two well explained answers**).

(i) The first difference is in definitions. Coase defines transaction costs as ex ante cost of discovering prices in the open market and he holds that resource allocation in the market and firm constant. He states that there are costs of carrying out a market transaction, which can make firm formation comparatively less costly. Williamson on the other hand defines transaction costs as the ex post cost that arises as a result of the inability of decentralised decision making to overcome opportunism within a firm and therefore hierarchical governance is a response to transactions structural distinctiveness **(2 marks).**

(ii) According to Williamson asset specificity is the most critical transactional dimension. This is because it gives rise to opportunistic behaviour it gives rise to the failure to adjust(dysfunctionality) that comes from it, the risk cost of which drives vertical integration over market exchange. Coase on the other hand does not identify a particular cause of marketing cost that leads to organizing transactions in firms, but refers only to the cost of discovering what the relevant prices are. Here transaction costs are expected to be integrated in the firm since a manager can organize transactions which are cheaper than in the market **(2.5 marks).**

(iii) The other difference between Coase and Williamson comes from resources allocation. Where Coase holds that resource allocation in the market and firms are constant that is there can be no efficiency gains created within the firm, to provide a cost rationale from the firm, to provide a cost rationale and explain its boundaries. Williamson identifies that the nature of a resource may change as it is being used. TCE thus allows the specificity of a resource to change over time so that it can be marketable and substitutable when acquired, whereas its use in production may radically increase its specificity. Resource allocation in the firm therefore is greater than the market in Williamson **(2 marks).**

(iv) According to another difference comes where, in Coase firms attempt to reproduce the markets efficient resource allocation thus saving on marketing costs whereas in Williamsons firms innovate thereby creating new and more specialized productive resources **(2 marks).**

(v) There is also a difference in the sense that Coase emphasises on managerial ability as the core of what makes a firm because this coordinates transactions that decides the firms the firm's boundaries and thus its size and also the firm's performance. Divergently Williamson explains the firm based on the nature of transactions especially its critical dimensions and certainty, frequency and asset specificity. He holds that the nature of transactions determines what form of governance should be adopted that is hierarchy, hybrid or market. He sees that if they aren't in hierarchies, the risk of opportunistic behaviour will cause transactions to become maladapted and therefore will not maintain profitability **(2 marks).**

(vi) In Coase specialization comes through market exchange such that specialization and market costs are not independent aspects of the market but develop each other, he does not rely on co-specialization. Williamson relies on specialization within the firms **(2 marks).**

(vii) The last difference we found between the two theories is in efficiency in the firm and the market. Coase assumes two types of efficiency which are allocative and technical efficiencies. Technical efficiency being maximised by price mechanism coordination and becomes the entrepreneur's problem of choosing a set of inputs under resource heterogeneity in the firm. Allocative efficiency is as a result of sensitivity to errors in assessing factor prices and to uncertainty due to varying supplies of substitutes and compliments in the market. To Williamson, the efficiency problem is primarily technical and allocative efficiency is not a relevant concern **(2 marks).**

A summary of Williamson's and Coase's approaches is per the following Table **(Consider 0.5 marks for this kind of answer but it must be explained).**

Table 1. Coase's and Williamson's transaction cost frameworks

	COASE	WILLIAMSON
Unit of analysis	Firm	Transaction
Transaction costs	Cost of price discovery	Adjustment cost due to opportunism (both in order to avoid and in response to opportunistic behavior)
Cause of transaction costs	Heterogeneity and spatial distance → costly to discover prices	Asset specificity combined with guileful self-interest seeking behavior → holdup, maladaptation
Resource allocation	Firm ≈ Market	Firm > Market
Specialization	Through market exchange	Within firms
Efficiency in firm	Technical	Allocative
Efficiency in market	Allocative	-

c) Explain the residual right of control using an example (5 marks).

Residual right of control explains a mechanism where gaps can be filled in as time passes in an incomplete contract **(1 mark).** An incomplete contract is one which is does not optimally use all commonly observable information and it is renegotiated at some point in time (bargaining). Hence, residual right of control explains how rights are distributed when gaps in a contract are to be filled at a future date **(1 mark).** To understand the concept, consider the following examples **(3 marks for any appropriate example).**

First, assume that you supply major parts of a car bodies for an automobile manufacturing plant in Thika. When demand rises, the automobile manufacturing plant will want you to increase the supply for major parts of a car. This was not in the agreement and it has to be renegotiated. The status quo point in any contract renegotiation will be where you do not provide the extra supply; in other words, you possess the residual rights of control **(3 marks).**

Second example, assumes that a tenant rents a house from the landlord. It happens that a friend of the tenant does not like the colour of the house. The decision to repaint lies with the landlord who has the residual right if control. Hence, the tenant has to persuade them **(3 marks).**

d) Using examples, distinguish between Institutions and Organizations (5 marks).

Often, literature treats these terms interchangeably. However, there is a vast difference. If institutions are human designed **rules of game (formal or informal)**, such games play out in organizations **(1.5 marks).** We can view organizations as bundling of institutions. It is an organized body of people with a particular purpose, especially a business, society, association **(1.5 marks)**. An excellent 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, 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 **(2 marks).**

3. Answer at least one question in this section (10 marks).
Option (a)

i. Give two reasons why corruption exists (4 marks).

Please refer to the papers by Jain (2001) and Tanzi (1998) that were sent with the notes on corruption.

Corruption is the misuse of public office for private gain **(1 mark).** It exists for the following reasons **(4 marks for two well explained reasons).**

a) Demographic and economic factors: Which might be influenced by monopolies and Penalty Systems in a country **(2 marks).**
b) Judicial and bureaucratic factors: regulation and authorizations such as licenses and permits, taxation. Level of Public Sector Wages **(2 marks).**
c) Geographical and cultural factors: Such as the culture of giving gifts **(2 marks).**
d) Quality of political institutions: inadequate institutional structures and weak processes, which trigger and enable corruption to thrive. Transparency of Rules, Laws, and Processes and also strength of the voting system **(2 marks).**

ii. Briefly describe the state of corruption in Kenya (6 marks).

Corruption in Kenya can be described in three ways **(Only award marks for three well explained answers):**

a) Using Opinion Surveys such as the index by Transparency International. According to this index, has been among the top 40 corrupt countries in the world. It has been rated as most corrupt in East Africa, especially compared to Tanzania and Uganda (for some years). Corruption can also be viewed among government ministries from several EACC reports. For instance, the Interior and Coordination Ministry has often been ranked as the most corrupt. Corruption can also be in the private sector. Particularly, business. Uisng the Enterprise Survey Data by the World Bank, the perception of corruption can be gauged from managers in the manufacturing, service and other service sectors between 2007 and 2018 **(2 marks).**
b) Corruption can also be described using scandals in Kenya. For instance, the National Youth Service scandal, Maize Scandal etc. Between 1986 and 2019, it is approximated that Kenya had lost over USD 1 billion in major corruption scandals **(2 marks).**
c) Corruption can also be described through the Public Expenditure Tracking Surveys and Quantitative Service Delivery Surveys and audits. Public Expenditure Tracking Surveys (PETS) and Quantitative Service Delivery Surveys (QSDS) are recent techniques that document delivery of services on the supply side with a major aim of establishing effectiveness

and accountability of service delivery. For instance, in their study of the efficiency of the Secondary Education Bursary Scheme, Oyugi, Riechi, and Anupi (2008) establish that 20% of schools receiving bursaries had non-existent students. In addition, students receiving multiple bursaries in excess of the school fees in 27% of schools. These inefficiencies were mainly attributed to miscommunication between the responsible agencies. PETS and QSDS by Onsomu, et al. (2014), and Gayle and Obert (2013) give more insights on misllaocation of public resources. Annual audit reports by the Auditor-General also offer more information on the subject of corruption and public-sector expenditure. For instance, only 1.05% of expenditure in 2014/2015 could be approved as having been spent lawfully and effectively by the Auditor General (ROK, 2016). This means that 98.95% of public expenditure was not accounted for and could have been lost to corruption **(2 marks).**

d) Corruption in Kenya can also be described through the supervisory body, The Ethics and Anti-Corruption Commission (EACC), was instituted in 2011. Prior to it, anti-corruption was driven by the Anti-Corruption Police Squad (1992-1995), the Kenya Anti-Corruption Authority (1997-2000), the Anti-Corruption Police Unit (2001-2003) and the Kenya Anti-Corruption Commission (2003-2010). A number of statutes have also been enacted since the pre-independence period to oversee control of corruption. Starting with the Prevention and Corruption Ordinance (CAP 65) of 1956, Anti-Corruption and Economic Crimes Act of 2003, section six of The Constitution of Kenya 2010, Ethics and Anti-Corruption Commission Act of 2011 and the Leadership and Integrity Act of 2012 among others. Bodies such as the Attorney General and Department of Justice, Office of the Director of Public Prosecutions (ODPP), the Office of the Controller of Budget *inter alia* are also mandated to control corruption **(2 marks).**

Option (b)

i. Describe the concept of inclusive and extractive economic institutions as explained by Daron Acemoglu and James Robinson (4 marks).

Daron Acemoglu and James Robinson wrote their book titled "Why Nations Fail." (https://www.youtube.com/watch?v=jsZDlBU36n0&t=668s). According to them, an Inclusive economic institution: Good institutions are not only those that provide secure property rights and such things, but they provide them in a way that is inclusive, that is, they are broad based. The access to opportunity for participating in economic activities, opening business, going and taking patents, etc. all of those are a part of the inclusive economic **(2 marks)**. Extractive economic institutions: the opposite of inclusive economic institutions such as- insecure property rights, entry barriers, regulations preventing functioning of markets, individuals choosing occupations that are lucrative, creating a non-level playing field etc. **(2 marks).**

ii. Why do Nations fail according to the authors in (i)? (6 marks).

According to Daron Acemoglu and James Robinson, nations mainly fail because of:

a) Institutions, institutions, institutions- Nations fail economically because of extractive institutions. These institutions keep poor countries poor and prevent them from embarking on a path to economic growth **(2 marks).** Other factors include **(1 mark for five correct answers):**

b) Theories that do not work: Poor countries are poor not because of their geographies or cultures, or because their leaders do not know which policies will enrich their citizens **(1 mark).**
c) The making of prosperity and poverty: How prosperity and poverty are determined by the incentives created by institutions, and how politics determines what institutions a nation has **(1 mark).**
d) The weight of history in institutions: Institutions change through political conflict and how the past shapes the present **(1 mark).**
e) Institutions evolve over time, often slowly drifting apart **(1 mark).**
f) Reversing development: European colonialism impoverished large parts of the world **(1 mark).**
g) The virtuous circle: Institutions that encourage prosperity create positive feedback loops that prevent the efforts by elites to undermine them **(1 mark).**
h) The vicious circle: Institutions that create poverty generate negative feedback loops and endure **(1 mark).**