

Institutional Economics and Development I

Theoretical Foundations

Development Economics, Lecture 5

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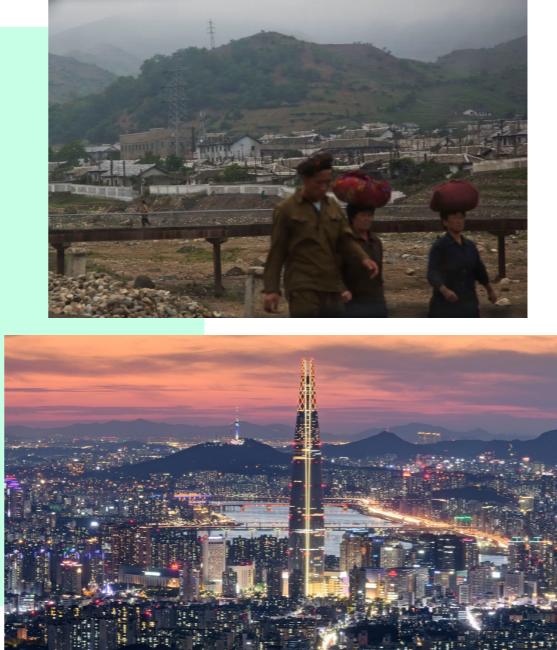
Digression: the term paper

Beyond Eurocentrism in Development

Contemporary postcolonial theory criticizes Eurocentrism in development thinking. Identify two specific tools or concepts from the course that embody this universalism and explain how they reflect Eurocentric assumptions. Also identify two theories or approaches from the course that offer alternatives to this universalism and explain how they address these limitations. **Justify your choice.**

- Formal requirements
 - Word count: 1000 - 1200 words
 - Format: PDF document
 - Timing: upload your pdf via Moodle until **November 22, 16:00 CET**
 - Essays will be graded on a pass/fail scale; in order to register for the final exam, you need to pass the essay!
- Important:
 - You must register for the *Vorleistung* **until November 8**. For the final exam you must register **until December 1st!**

The Development Puzzle



Same geography, similar resources, identical culture and same colonial heritage...
...but vastly different living conditions. Why?

Institutional economics pretends to have the answer....

Overview

- What are institutions?
- Original and New Institutional Economics
- New Institutional Economics and Development
- A Critical Appraisal
- Measuring Institutions
- Summary and Outlook

What are institutions?

Influential definitions

„Institutions are the **rules of the game** in a society...[and] the purpose of the rules is to define the way the game is played”

Douglass North (1990)

„There is only rational behavior, conditioned on expectations about the behavior and reactions of others...

‘Institution’ is just a name we give to certain parts of certain kinds of equilibria.”

Randall Calvert (1995)

„Institutions are **systems of established and prevalent social rules** that structure social interactions.”

Geoffrey Hodgson (2006)

What are institutions?

Examples

- **Legal and Moral Foundations:**
 - Property rights, contract law, constitutional rules
 - Social norms, trust, cultural practices
- **Organizational Forms:**
 - Firms, markets, cooperatives, guilds
 - Central banks, regulatory agencies, courts
- **Economic Structures:**
 - Agricultural vs. industrial economy
 - Market vs. subsistence economy

Broad concept with varying emphases depending on the theoretical tradition

Institutional economics

Two competing paradigms

Original Institutional Economics (OIE)



New Institutional Economics (NIE)



- Emerged in the early 20th century
- Evolutionary, historical, interdisciplinary
- Heterogeneous research program
- Focus: (institutional) change, power, social embeddedness

- Emerged in the 70s and 80s
- Integrates institutions into neoclassical economics
- Pretty coherent research program
- Focus: growth, transactions costs, property rights, contracts

Institutional economics

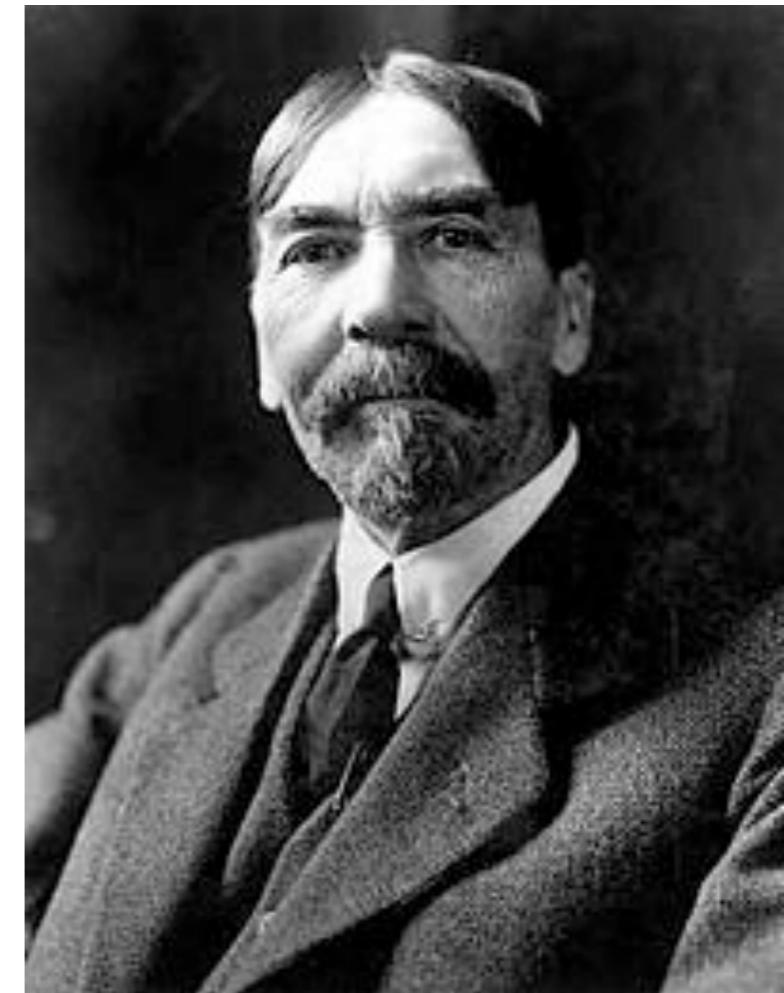
Two competing paradigms - an (simplistic?) overview

	Original institutionalism	New Institutional Economics
Actor modes	Socially embedded 'habit creature'	Rational optimizer
Institutions	Habits of thought, social rules	Specific rules: property rights, contracts,...
Change	Evolutionary, path-dependent, power-driven	Efficiency-driven, equilibria
Efficiency	Maybe, but ceremonial institutions persist	Eventually efficiency bias
Critical?	Yes, questions power, inequality, capitalism	Less so

Original Institutional Economics

The beginning of OIE

- Son of Norwegian immigrants and farmers
- Co-founder of the New School of Social Research in New York
- Founding father of evolutionary institutional economics
- Numerous works at the interface between economics and related disciplines
 - 1898: Why is Economics not an Evolutionary Science?
 - 1899: Theory of the Leisure Class



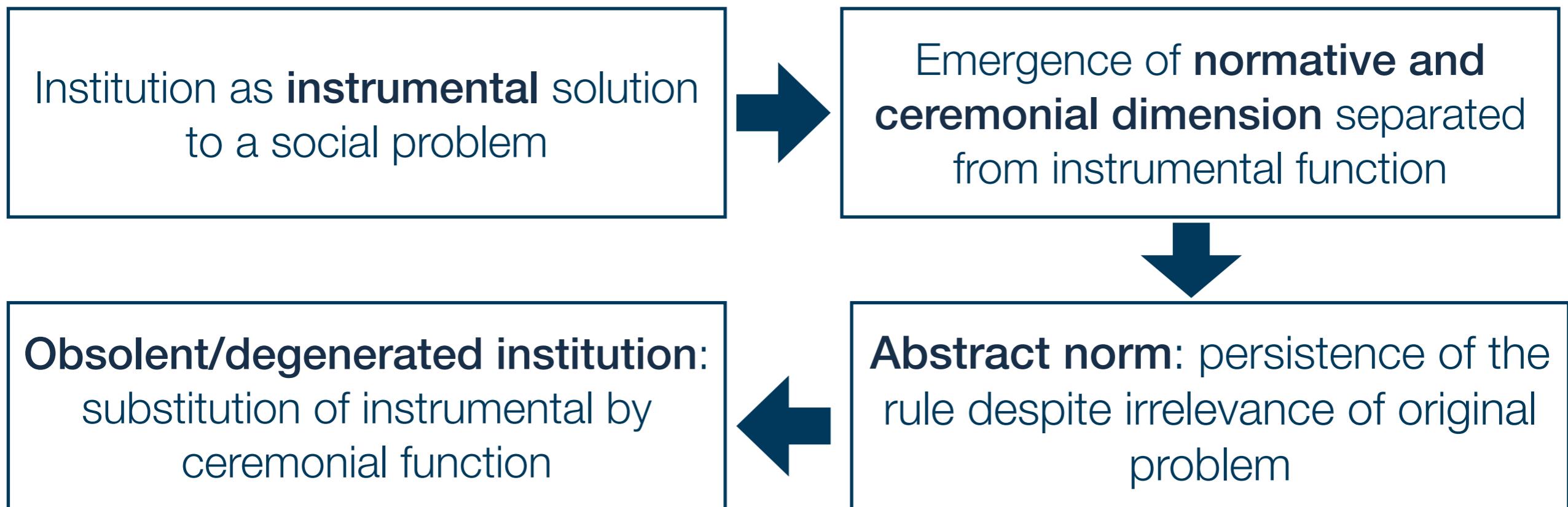
Thorstein Bunde Veblen
(1857 - 1929)

An Evolutionary Approach

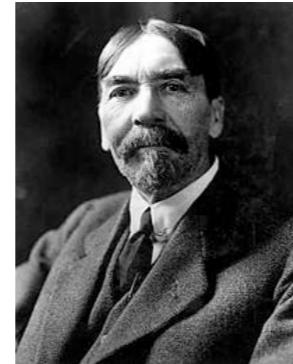
- Vision of economics as inspired by Darwinian sciences
 - Explain phenomena in terms of **causal** sequences ('cumulative causation')
 - Reference to Darwinian **selection** principles
 - Rejection of equilibrium-theorizing
- Examples for methodological elements:
 - **Conspicuous consumption** and social transmission of consumption practices
 - **Path dependency** and non-linear development
 - Relevance of both upward and downward effects → **systemist** framework
- Later writers extended Veblen's ideas into different directions

Institutions and their life cycle

- **Veblen:** institutions as habits of thought → backward oriented
 - Shaped the progressive and critical flavor of OIE
- **Example:** an institutional life cycle and ceremonial encapsulation



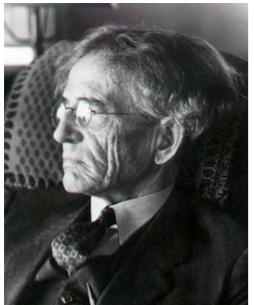
Different schools of evolutionary economics



Veblen's evolutionary-institutional approach

OIE in the strict sense

The Commons Tradition



The Ayres Tradition



The Radical Tradition



Evolutionary / Neo-Schumpeterian Economics



More in session on innovation and development

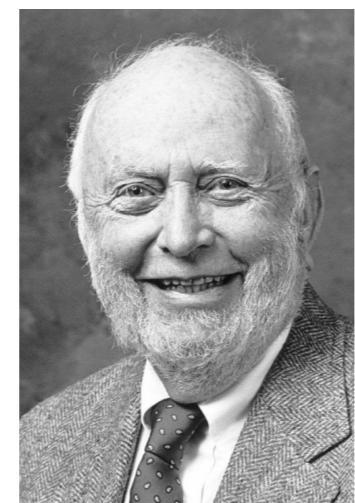
New Institutional Economics

From old to new (?)

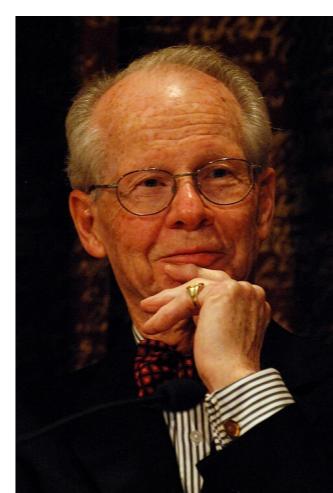
- Desire to **integrate institutions** into mainstream economics
 - Maintain formal framework and methodological approach
 - Keep rational choice as analytical foundation
- Key NIE Figures:



Ronald Coase:
Transaction costs



Douglass North:
History and economic
performance



Oliver Williamson:
Organizations



Daron Acemoglu & James Robinson:
Development and path dependence



The four traditional foci of NIE

Transaction costs

- Search costs, negotiation costs, enforcement costs
- Institutions reduce these costs

Property rights

- Secure, enforceable ownership → investment, exchange, development
- Institutions provide this security

New Institutional Economics and its rational choice framework

Incomplete contracts

- Contingencies always there
- Institutions for gap-filling and conflict resolution

Principal-Agent Problems

- Asymmetric information & hierarchies → conflicts of interest
- Institutions align incentives

Synthesis and outlook

Summary

- **Institutions clearly matter** for development
 - But: ‘institutions’ as a broad and contested concept
- **Two traditions** with different insights:
 - OIE: Institutional change, power, path dependence, inefficiency
 - NIE: Transaction costs, property rights, efficiency (eventually)
- **Next week:**
 - Famous application of NIE concepts on colonialism and global inequality
 - Critical discussion from an OIE perspective