

# **INSTITUTIONS AND INSTITUTIONAL DESIGN**

**Erling Berge**

## **Cooperation and transaction costs**

NTNU, Trondheim

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## **Literature**

- North, Douglass C. 1990 “Institutions, Institutional Change and Economic Performance”, Cambridge, Cambridge University Press,

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## Neo-institutional economics

- Studies how alternative social rights and organisations affect behaviour, resource allocation and equilibrium outcomes
- Studies the variation of organization in various types of economic activity
- Studies the logic of political and social rules governing production and exchange

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## Transaction and information costs

Implies

- **Optimality** (Pareto/ Kaldor-Hicks) is **no longer an interesting** criterion
- **Efficiency** is **no longer an interesting** criterion
- Assignment of **property rights is paramount**, introducing economic organisation, and making political institutions a key to understanding economic growth

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## Transaction costs

- “The fundamental idea of transaction costs is that they consist of the cost of arranging a contract ex ante and monitoring and enforcing it ex post, as opposed to production costs, which are the costs of executing a contract.” (Matthew 1986)
- When information is costly, many exchanges give rise to transaction costs

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## Measurement

- Measurement cost will affect systematically the structure of contracts and the organisation of economic institutions.
- State regulations are often directed at lowering measurement costs, not only redistribution. Sometimes the goal is better measurement of the tax base: redistribution and growth are not necessarily opposites.

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## NIE extends the economic approach

1. Investigating the equilibrium outcomes resulting from constraints posed by property rights and transaction costs
2. Trying to endogenize the organization of markets and the structure of contracts
3. Seeing social and political institutions as outcomes of exchange between individual agents. Competition for survival among institutions leads to equilibrium institutions.

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## Property rights

- Use rights
  - Income rights
  - Alienation rights
- Social norms may lower substantially
- Costs of exclusion
  - Costs of enforcement
- Private property
  - State property or communal property
  - Common property or open access

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## The theory of agency

- Agency is established when a principal delegates some right to an agent bound by a contract to represent the principal's interest in return for some compensation
  - Asymmetric information
  - Shirking or opportunistic behaviour
  - Monitoring or measuring performance
  - Technology of monitoring
  - Bonding
  - Moral hazard
  - Adverse selection

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## Contracts

- The structure of contracts depends on the legal system, social customs, and technical attributes of assets involved in the exchange
- Introduction of new contractual forms may be compared to technical innovations in production
- The firm as a nexus of contracts. Alternatives:
  - Direct contracting consumer and input owners
  - Self-governance of input owners (bypassing the entrepreneur)

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## Competition among contractual arrangements

- Contractual forms that give rise to positive profits survive, other forms disappear
- Instead of modelling rational individuals and trace the consequences of their choices, we should start by assuming complete uncertainty and irrational behaviour and then add elements of foresight and motivation (Alchian 1950)

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## Theory of the state

- The state sets and enforces the fundamental rules that govern exchange
- The power of small groups in democratic polities: **interest** weighed by consequences, multiplied by **power**, and **governed by information and transaction costs**
- The logic of collective action: free riding

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## Equilibrium political institutions

- Condorcet's paradox (Arrow's impossibility theorem) is empirically suspect
- Voting and decision making in legislative assemblies are controlled by elaborate procedures that yield equilibrium outcomes
  - Structure induced equilibrium (Shepsle and Weingast 1981): committees with their own jurisdictions and agenda setting power

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## Problems in NIE

- Rational choice models do not work when ideological beliefs are unstable.
- Therefore, NIE needs a theory of ideology.
- Other problems include
  - Strategic interaction
  - Non-economic motives

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## Cooperation: game theory says

Difficult when

- Games are not repeated
- Information about other players is lacking
- Number of players is large
- Ratio of costs to benefits is large (Hardin)
- “Community” is lacking (Taylor)
- “Group oriented” preferences (Margolis)

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## Neoclassical behavioural assumptions

1. The economic world is reasonably viewed as being in equilibrium
2. Individual economic actors repeatedly face the same choice situations or a sequence of very similar choices.
3. The actors have stable preferences and thus evaluate the outcomes of individual choices according to stable criteria
4. Given repeated exposure, any individual actor could identify and would seize any available opportunity for improving outcomes and, in the case of business firms, would do so on the pain of being eliminated by competition
5. Hence no equilibrium can arise in which individual actors fail to maximize their preferences
6. Because the world is in approximate equilibrium, it exhibits at least approximately the pattern employed by the assumptions that the actors are maximizing

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## Problems in behavioural assumptions

- Empirical problems with standard expected utility theory
  - Violation of transitivity
  - Framing effects
  - Preference reversals
  - Problems with subjective probabilities in uncertain choices
- Need to understand
  - motivation
  - perception of environment

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## Motivation

- Wealth maximising
- Altruism
  - Family
  - Free riders, fairness, justice
- Self-imposed standards of conduct
  - Ideology

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## Deciphering the environment

- Real world
- Actor's perception of the world
  - Ideology: the “thought world” of the actor
- Uncertainty in choice situations
  - Personal and routine: small uncertainty
  - Impersonal and non-repetitive: large uncertainty
- Institutions exist to reduce uncertainty in human interactions

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## Transaction costs and exchange

- Production costs consist of resource inputs (labour, capital, land) needed for both transforming and transacting
- Transforming the physical attributes of a good
- Transacting: defining, protecting and enforcing property rights
  - Measurement costs
  - Enforcement costs

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## Measurement costs

- Asymmetric information
  - Adverse selection
  - Moral hazard
- Variety of characteristics and costliness of measuring attributes implies a variety of ownership rights
  - Ex: fruit and vegetable sellers leaving several valuable margins in the public domain

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## Asymmetric information costs

### **Adverse selection**

- occurs when different principals use different measures. The one with the least accurate measure will get the persons with the lowest qualities. (ex: seller of life insurance knowing less than buyer)

### **Moral hazard**

- measurement by proxy (or asymmetric information: agent knows more than principal) gives rise to temptation to shirk

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## Enforcement costs

- Negotiating agreements
- Policing performance (measurement costs)
- Enforcement
  - Self-enforcement (internal codes of conduct, socially sanctioned norms)
  - Second party retaliation
  - Third party retaliation

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## Institutions and transaction costs

- “Because with any property rights structure transaction costs are positive, rights are never perfectly specified and enforced; some valued attributes are in the public domain and it pays individuals to devote resources to their capture.” (North 1990:33)

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## Development history

- Personal exchange in small scale production and local trade were based on repeated dealings, cultural homogeneity, lack of third party enforcement.
- Increasing scale of production and division of labour leads to impersonal exchange where parties are constrained by kinship ties, bonding, exchange of hostages, and merchant codes of conduct. Frequently exchange is also constrained by being embedded in elaborate rituals and religious precepts. (in history the state at best was an ambiguous player by often increasing insecurity and transaction costs rather than being protector and enforcer of property rights).
- Impersonal exchange based on third party (state) enforcement.

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## Institutions determine

- “Institutions provide the structure for exchange that (together with the technology employed) determine the cost of transacting and the cost of transformation.” (North 1990:34)
- “..., effective third-party enforcement is best realized by creating a set of rules that then make a variety of informal constraints effective.”
- **How to do this is our main design problem.**

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## Informal constraints

- “Culture provides a **language-based conceptual framework** for encoding and interpreting the information that the senses are presenting to the brain.” (North 1990:37)
- The cultural filter provides continuity
  - Making informal constraints an important source of continuity in long range social change

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## Case I: No formal rules

- Exchange is not simple
- Order depends on dense networks
  - Kinship very important
- Threats of violence (feuds)
- Compensation rules (between tribes)
  
- (also Eggertsson on Icelandic Commonwealth)

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## Case II: Modern states

Informal rules are important also here, as

1. Extensions, elaborations, and modifications of formal rules
2. Socially sanctioned norms of behaviour
3. Internally enforced standards of conduct
  1. Meaningful only in terms of informal constraints, altering choices when individuals give up wealth or income for some other value

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## Explanations of institutions

- Conventions to solve coordination problems
- Making exchange viable by lowering transaction costs through organisations supporting norms of cooperation and instruments lowering measurement costs
  - Altering discount rates
  - Increasing information
- Positive payoffs to honesty, integrity, and living up to a reputation

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## Formal constraints

- Formal rules can complement and increase the efficiency of informal rules by lowering T-costs
- They may also be intended to replace informal rules, but that is difficult.
- Hierarchical (constitutions, statute law, common law, specific bylaws, contracts)
- Their function is to promote certain kinds of exchanges, but not all kinds of exchanges

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## Devising rules

- Rules are in good part devised in the interest of individual well-being rather than social well-being
- Rules are in general devised with compliance costs in mind
- Changes in technology or relative prices will alter the relative gains from devising rules

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## Developmental history

- Simple state: ruler as discriminating monopolist selling protection and justice
- Adding a representative body facilitating exchange between ruler and constituent groups. The ruler needs an administration.
- Democratic states and complex polities: how do credible commitments evolve to cover future payoffs on completely different issues?

## Democracy

- Reduces the legislative transaction costs (per exchange) but
  - Number of exchanges increase
  - Agency costs between constituent and legislator, and between legislator and bureaucrat are substantial
  - Rational ignorance of constituents increases the role of subjective perceptions for choices

## From political to economic rules

- “ But the high transaction costs of political markets and subjective perceptions of the actors more often have resulted in property rights that do not induce economic growth, and the consequent organisations may have no incentive to create more productive economic rules.” (North 1990:52)

## Enforcement

- Is not perfect and not constant, it is variable
  - Because of variable measurement costs of contract performance
  - Because of personal agenda's of enforcement agents
- Contracts are self-enforcing when it pays the parties to live up to them, that is when parties know each other and dealings are repeated
- In a world of specialization where exchange needs to extend through space and time self-enforcing contracts are not possible – in theory

## Impersonal exchange without third party enforcement

- Game theory: it is possible if games are played forever between the same players and compliance by other parties is observable
- In the real world such conditions do not obtain. Impersonal exchange does not seem possible without third party enforcement
- Are voluntary third party systems too costly?
- Can a state behave like an impartial third party?

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## The State as third party

- Third-party enforcement means the development of the state as a coercive force able to monitor property rights and enforce contracts effectively
- **No one knows how to create such an entity**
- In a wealth maximizing model those who run such a state will use the force of the state in their own interest at the expense of the rest of society

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## Transaction and transformation costs

- Costs of transforming land, labour and capital to goods and services depends on technology employed **and institutions**
- Contracts are written with enforcement costs in mind, and will therefore be incomplete and open to informal constraints (reputation, standards of conduct, conventions based on repetitions)

## Rights and constraints in an exchange: three levels

- Single straightforward exchange
  - Ex: buying real estate in the USA
- Transaction costs in a production process
  - See discussion of problems in third world
  - Institutions affect choice of technology
- Transaction cost at the level of society
  - Ex: capital market

## Buying a house

- Institutions affect the costs of buying a house. The costs are among others
  - Measuring the physical and legal attributes of the house
  - Policing and enforcing an agreement
  - Uncertainty discount reflecting the imperfections in measuring attributes and policing the agreement
    - Depends on asymmetric information (contact specific), effectiveness of crime prevention (community specific), and stability of prices (nation specific)

## Implications

- Institutions are a complex web of formal and informal constraints. This provides a basic stability, and also a host of margins where incremental changes may accumulate
- The higher the formal transaction costs, the more one will rely on informal rules (self-enforcing)
- Hard-to-measure costs such as time to acquire information, queuing, bribery, etc, losses due to imperfect monitoring and enforcement, imply that total transaction costs are hard to measure

## North Ch 4 (1)

- Measurement costs are important because of asymmetric information (adverse selection, moral hazard)
- Measurement costs + enforcement costs = transaction costs
- Explains why property rights are not perfectly specified

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## North Ch 4 (2)

- Enforcement
  - Policing agents: increasing marginal costs of measuring and policing performance
  - The agent acquires certain property rights in their own labour
- First party: principal disciplining agent
- Second party: friends, associates, kin
- Third party: the state

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## North Ch 5 (1)

- Informal constraints:
  - 1) extensions, elaborations and modifications of formal rules,
  - 2) socially sanctioned norms of behavior, and 3) internally enforced standards of conduct
- The same formal rules imposed on different societies give different outcomes
- Informal rules come from culture and language
- Primitive (stateless) society (not simple!) kinship ties important for sanctioning system
- Ideas, ideologies, convictions affect choices and matter more the lower the cost of their expression

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## North Ch 5 (2)

- Informal constraints
  - coordination rules are self-enforcing
  - norms of cooperative behavior need instruments of enforcement
  - Internal codes of conduct imply trade-off between wealth and other values (communism, religion)
- Payoff to honesty, integrity, reputation of trust poorly understood (a problem in the sociology of knowledge)
- How do we acquire, process, and utilize information?
- The cultural processing of information implies incremental change of institutions and path dependence of societies
- Changing formal rules do not immediately lead to changes of informal rules. Their interaction may lead to unexpected outcomes

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## North Ch 6 (1)

- Formal rules: a matter of degree, often making informal rules more effective
- Existing rules define the wealth maximizing opportunities of the players, promoting some kinds of exchange but not all
- Parts of the resources of the players will be devoted to protect or change existing rules
- Formal rules usually designed
  - with private wellbeing as a goal
  - With compliance costs in mind
- Changes in technology and relative prices will alter the relative gains from devising rules

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## North Ch 6 (2)

- Political rules leads to economic rules (and vice versa), but political rules have priority
- How do credible commitments evolve?
- Democracy gives greater political efficiency, but this is different from economic efficiency
- Democratic polities reduce transaction costs per political transaction but the volume increase
- Also increases in agency costs voter-parliament, parliament-government and rational voter ignorance affecting voting
- Inefficient property rights persist because powerful interest groups oppose changes, or because changes will lower tax returns
- Formal rules are incomplete – they depend on informal rules

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## North Ch 7 (1)

- Enforcement is neither constant nor perfect
  - Because of costly measurements, and because
  - Enforcement agents have their own agendas
- Contracts are self-enforcing when it pays all parties to live up to the promise (personal, small scale repeated deals will facilitate this)
- Impersonal exchange needs institutions providing
  - Information on the performance of contracting partners to determine when defection occurs
  - Incentives for some persons to actually carry out punishments

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## North Ch 7 (2)

- Institutions that facilitate exchange are costly and lowers the gain from trade
  - Dilemma: we cannot do without the state, but we cannot do with it either ...
  - With a wealth maximizing assumption not even a simple model of an efficient third party state can be constructed
- Are we a free people because of the constitution, or do we have this specific constitution because we are a free people?

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## North Ch 8 (1)

- Institutions and technology used in measurement and enforcement define transaction costs
  - Case study: Transfer of residential property in the USA
- Transaction costs also affect transformation costs (cost of monitoring output quality depends on and sometimes determine choice of transformation technology)
  - Case study: production of goods and services e.g. bargaining power of skilled labor, oil production
- The institutional structure of underdevelopment
  - See de Soto 2000

## North Ch 8 (2)

- The institutional constraints that define the opportunity set of individuals are a complex of formal and informal constraints. They make up an interconnected web that in various combinations shapes choice sets in various contexts.
  - The complex is basically stable but change incrementally along several margins
- The institutional framework is the critical key to the relative success of economies, both cross-sectional as well as through time

## Evaluation of Constitutions

Goodin (1997) discuss 4 commonly agreed upon requisites of a good constitution

- 1. democratic responsiveness
- 2. checking the abuse of power
- 3. protecting the minorities
- 4. social pluralism

## North Ch 9

### Organisations, learning, and institutional change

- Organisations develop a demand for knowledge and skills (and generate tacit knowledge of their own activities)
  - Property rights (patents) has helped create the innovation feature of western economies
  - Technological innovations are path dependent
  - Ideology and knowledge directs the attention of investigations but also develops by new insights

## Institutional change

- From the particular demands for knowledge
- Shaped by interactions of
  - Existing institutions,
  - Stock of knowledge and
  - Maximising behaviour of agents
- Incremental changes in informal constraints caused by maximising behaviour

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## Adaptive efficiency

- Allocative efficiency (Pareto conditions)
- Adaptive efficiency concerned with development through time; willingness to
  - Acquire knowledge and learning
  - Induce innovation
  - Undertake risk and creativity
  - Resolve problems and bottlenecks

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## North Ch 10 Stability and Institutional Change

Stability is furthered by

- Rules hierarchically nested
  - Informal constraints
  - Habitual behaviour
- 
- In equilibrium no actor find it profitable to devote resources to rule changes

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## Most change is incremental

From shifts in

- Relative prices
  - Ratio of factor prices, cost of information, changing technology,
- Preferences
  - Changing relative prices (e.g. work-leisure, price of expressing ideas) may induce change in tastes
  - Ideas (moral, ethical) about the world

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## Discontinuous change

- Does the institutions allow incremental change?
- Does the preferences allow bargaining and compromise?
- Successful revolutions require coalitions making final outcomes uncertain
- Successful revolutions require ideological commitment to overcome free riding
- Discontinuous change is not so very discontinuous!

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## North Ch 11 The path of institutional change

- Technological paths of development
  - “QWERTY”, gas engines not steam, alternating current vs. direct
  - Fuelled by **increasing returns, learning by doing**
- Self-reinforcing mechanisms
  - Large set-up or fixed costs (falling unit costs)
  - Learning effects (improved products, lower costs)
  - Coordination effects (several agents using the same)
  - Adaptive expectations (further belief in prevalence)

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## Competing Technologies

### Consequences of self-reinforcement

- Multiple equilibria (outcomes indeterminate)
- Possible inefficiencies (best T may have bad luck)
- **Lock-in** (once a solution is reached, exit difficult)
- **Path dependence**

In reality the competition is between organisations employing the technology (institutions)

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## The path of institutional change

- Increasing returns (self-reinforcement)
  - with increasing returns institutions matter and shape the long run path of economies. But with zero transaction costs the path is approximately efficient
- Imperfect markets (significant transaction costs)
  - With significant transaction costs the subjective models of actors as modified by imperfect feedback and ideology will shape the path
- Divergent paths and persistently poor performance may prevail

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## The North-West Ordinance

- Governance and settlement of the lands in the West
  - Fee-simple ownership, inheritance, territorial government – self-governing, territory admittance as a state, a “bill of rights”, prohibiting slavery, and more
  - The law generated incremental change reinforcing its basic properties, but it was not inevitable.
    - Network externalities, learning of organisations, subjective models of the issues
  - Adaptively efficient economic and political processes

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## Path dependence

- Entrepreneurs are constrained by existing institutions and by their imperfect knowledge
- Goals may not be reached
- Increasing returns of the institutional matrix means that even if specific changes may change history its direction remains the same
- USA vs Mexico: History matters

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## A short summary

### Institutions as

- Social facts by agreement (Searle)
- Thought worlds/ subjective models (Douglas)
- Rules of the economic game shaped by
  - Transaction and information costs
  - Subjective preferences and learning
  - Increasing returns and political processes

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## Institutions are

Humanly devised rules with some

Humans mandated to monitor and sanction rules

- Created to aide in collective actions problems to safeguard life and livelihoods
  - Avoid conflicts, create justice
  - Allocate legitimate benefits and duties, profits and costs
  - Economize on transaction costs
- **Not** created to achieve efficiency or optimise economic performance(of the neo-classical model)

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## Property rights institution

Tells that some person(s) have legitimate

- Rights and duties to be exercised in relation to
- Particular goods and services subject to possible
- Limitations on times and durations,
- Limitations of technology, and
- Limitations on organisation of exploitation

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## The construction of social institutions

For example

- Property rights regimes
  - Public property
  - Common property
  - Private property
- Regulations regimes
  - Governing externalities
  - Protecting unitary/ universal values
- Bureaucracies

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## The social construction of institutions

### Informal institutions

- Conventions
- Customs
- Values, Preferences
- Norms, Standards of conduct
- Beliefs, Ideologies, Morals

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## The dynamic of Institutions and organisations

- Rules of the game (the law)
- Guardians of the rules (the judge)
- Players (organisations)
  - Owners,
  - Local users,
  - Workers,
  - Professional managers, and
  - Firms of resource industries

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## Strategies of the players

Our theory requires by assumption that players

- Optimise their returns from resource use activities by conforming to and **exploiting the existing institutional environment**, or to
- **Change the resource policy** in a desired direction if the expected outcome of a political effort is seen as cost effective.

## Lock-in of institutions and organisations

- Mutual interdependence institution-organisations
- Institutional changes by public initiative or revolution creates counter-forces
- Economic performance is **PATH DEPENDENT**
- Change occurs at the margins

## Ch 12: Institutions, economic theory and economic

In this chapter **performance**

1. Changes needed in neo-classical economic theory
2. Implications for the static analysis of economic performance
3. Implications for a dynamic theory of long-run economic change

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### 1 Changes needed in neo-classical economic theory

- A procedural concept of rationality, based on
- The costs of transacting, and recognizing that
- Institutions imply market imperfections: there will always be incompatible incentives
- Institutions are provided in the political market: voter ignorance, incorrect perceptions, etc....

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## 2 Economic performance: statics

- Models as specific to particular constellations of institutional constraints

They do not recognise

- Subjective perception, incomplete information and complex environments
- Ideas and ideologies matter. Institutions determine how much they matter.
- Politics and economy are interlinked. This needs to be reflected in theories

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## 3 Economic performance: dynamics

New theory building on old elements

- Scarcity/ competition
- Incentives are the driving forces

And new elements

- Incomplete information
- Subjective models of reality
- Increasing returns characteristics of institutions

Increasing our understanding of path dependence

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## A case of path dependence

### Spain-Latin America

- 1500: not yet unified, centralized Castile
- Problem: rising costs of warfare - Cortes, taxing wool trade
- Fiscal crisis unresolved, evolution of church and bureaucracy, 300 years of stagnation
- Inherited by Latin America

### Britain-North America

- 1500: centralized feudalism and monarchy
- Problem: rising costs of warfare – Parliament, taxing wool trade
- Fiscal crisis resolved, evolution of polity, started the road to world hegemony
- Inherited by North America

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## Ch13: Stability and change in economic history

Institutions provide a basic structure permitting the creation of order and reduction of uncertainty

- What kinds of institutions permit the capture of the gains from trade inherent in the neoclassical (zero transaction costs) model?
- Some paths led to stable exchange patterns other paths led to dynamic change
- Why stability and why change?

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## Changing economies

- Growing specialisation and market access
  - From village markets to global markets
- Transaction costs change as scale increases
  - Agency problems (kin-networks, commenda)
  - Contract enforcement absent a state
- Ending up with first national, then global capital and commodities markets
  - The global system is now struggling to solve some of the same problems as the nation state of early modern Europe (standardized measurement units, medias of exchange, laws, enforcements agencies, taxation)

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## Stability of the Suq

- High measurement costs
- Continuous efforts at clientization
- Intensive bargaining at every margin

The name of the game is to raise the costs of transacting to the other party to exchange. One makes money by having better information than one's adversary

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# European institutional changes in medieval and early modern times

Organizational innovations at 3 cost margins

- Increasing the mobility of capital
  - Evading usury law
  - Bill of exchange, negotiability and discounting
  - Enforcement, accounting and auditing methods
- Lowering the information costs
  - Printing of prices and manuals
- Spreading the risk
  - Insurance
  - Organisations (portfolio diversification, limited liability)

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## Institutional stability?

- Normally, in history social change does not encourage maximizing actors to obtain knowledge and skills that increase productivity
- Neither does it normally induce institutional change conducive to increased productivity
- European history is special
  - Why the Netherlands and England?

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## Ch 14: Incorporating institutional analysis into economic history: prospects and puzzles

- Traditional history emphasis technology and the industrial revolution to explain change – but in many cases technology seems to make matters worse
- Application of neoclassical economic theory made it possible to focus on choices and constraints – but it was a static theory
- Neo-institutional theory can do it better

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## What makes for efficient markets?

- Technology provides an upper bound on economic growth
- Neoclassical models of growth crucially depends on an implicit incentive structure that drives the models
- Marxist models of exploitation have to demonstrate that the institutional framework produce systematic uneven consequences
- Are exploitative institutions imposed from outside or are they endogenously determined?

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## Incentives are the key

- Rationality
- Ideas
- Ideologies
- Maximising behaviour
- Relative prices
- Collaboration and organisation to exploit opportunities structured by institutions

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## The adaptive efficiency of the institutional matrix

- The informal constraints come from
  - Cultural transmission of values
  - Extension and application of formal rules to solve specific exchange problems
  - Solutions of straightforward coordination problems
- Traditions of hard work, honesty, and integrity - reinforced by ideologies lowers TC
- The transaction costs inherent in the political process are always high

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