Debre Markos University

Department of Economics

Lectures on

INSTITUTIONS AND DEVELOPMENT (DEC-551)

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Course introduction

In this Course we will study

Description: *Institutions and Development (DEC-551)*

Rational:

- Institutions are arguably accepted as the ultimate sources of economic development and income disparities among countries
- They should be well studied

COURSE OBJECTIVES

Successfully completing this course will enable the student:

- To join the debate on the role of institutions to economic development
- To investigate the position of informal institutions in development
- To appreciate the role of property rights institutions in nations' economic development

COURSE OUTLINE

In this Course we will study

1. Introduction on Institutions and Development
2. The role of formal institutions an empirical evidence
3. Informal institutions and Development
4. Property rights ,institutions and development

CHAPTER ONE

INTRODUCTION ON INSTITUTIONS AND DEVELOPMENT

CHAPTER OUTLINE

In this chapter we will study

1. Motivation for Institutions and Institutional Economics
2. Defining and characterizing an institution
3. Understanding Institutions
4. Forms and roles of Institutions

1A. Motivation for Institutions and Institutional Economics

- Key questions
  - Why are we motivated to study institutions and institutional economics?
  - How did the subject mater **Institutions and Institutional Economics** come to the discourse?
  - Why institutions have emerged at the center of attention in development economics?
  - What institutions have critical importance for economic growth and development and how should they be shaped?
  - Why institutions matter in economics?
  - What do institutions do?
  - Do they matter for development and how?

1. Motivation for Institutions and Institutional Economics
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1A. Motivation for Institutions and Institutional Economics

- How did the subject mater **Institutions and Institutional Economics** come to the discourse?

Resulted due to the inefficiency of the neoclassical economics

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1A. Motivation for Institutions and Institutional Economics

From the discussion of neoclassical economics (Standard economics)

- Economics is the theory of choice……..
  - But how do we make choices- Neoclassical Economists say we use the **rationality assumption**
- Neoclassical economics evolved in the late nineteenth century & assumes that people are perfectly informed (know all of the alternatives) act on the basis of pure logical calculus (rationality)
  - BUT human actions are also influenced by the belief system that determines the incentive structure
- The Neoclassical economics objective was to explain efficient resource allocation in developed economies
  - Thus, **Neoclassical economics – happens a world without** Friction

1A. Motivation for Institutions and Institutional Economics

Neo-classical economics – a world without Friction- attributed to

- Perfect market
    - Homogeneous goods
    - No personal or temporal preferences
    - Spot market
    - Full market transparency
    - Response of market participants extremely fast
    - Unique price
  - Number of participants: Polypoly, Oligipoly, Monopoly
  - Transaction costs not taken into account but seen as **market imperfectness or market failure**

1A. Motivation for Institutions and Institutional Economics

- Neoclassical Economics
  - Rational choice as maximzing individual or social utility
  - Stable preferences
  - Equilibrium outcomes
  - No information costs
  - No transaction costs
  - Private property rights for all goods which are exchanged in competetive markets
  - *As a consequence, institutions, for example different market rules, are not analysed.*

1A. Motivation for Institutions and Institutional Economics

Analysis of the neoclassical assumptions

- The rationality assumption at its best says that people are consistent and logical maybe, but **it does not say how people make choices in the face of enormously complex information, imperfect knowledge and imperfect feedback on the consequences of their actions**
  - **In practice the rationality or free market ideology did not exist in a frictionless world where there is no uncertainty**
- Assuming perfect markets, neoclassical economists argued that price mechanism plays a role in exchange **while ignoring the fundamental importance of institutions**
- Neo-classical theory is concerned with the operation of markets (efficient markets), not with **how markets develop** (so it cannot address neither the problem of development nor the rise and decline of communism and Soviet Union) – D.C. North, AER, 1994

1A. Motivation for Institutions and Institutional Economics

Analysis of the neoclassical assumptions

- As economics is the science of scarcity, excluding institutions means to neglect the main issue of scarcity in real societies
    - In other words, conventional economics excludes the more complex part of economics and politics
- The neo-classical result of efficient markets only obtains when it is costless to transact; requirements necessary to achieve a Pareto optimum are very stringent

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1A. Motivation for Institutions and Institutional Economics

Analysis of the neoclassical assumptions

- **The institutional context** is largely missing from most neo-classical models of market exchange and human interaction
  - In the neo-classical view, rules, social norms and preferences are a given – thus understanding of economic institutions and human behavior that does not conform to economic notions of the 'rational individual' is left to other disciplines such as politics and sociology
- It had two gigantic failures
  - It was frictionless
  - It was timeless, static rather than dynamic in terms of its issues

1A. Motivation for Institutions and Institutional Economics

Conclusion

- It was never intended to deal with the issues of economic development
- Some of these problems with Neoclassical economics helped **TO STUDY INSTIITUTIONS AND INSTITUTIONAL ECONOMICS**
- When transaction costs are non-zero, then institutions matter!
  - [Transaction costs are those costs born when making economic exchanges: search and information costs; costs of negotiating and writing contracts; enforcement costs]
- Institutions are brought into the analysis precisely to expose the limits of the **"one-size- fits-all"** argument deployed by orthodox economists regarding economic policy
- In a world without institutions we would not know how to deal with each other

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The developmental side of institutions

- The neoclassical approach could not help more
  - First, the institution-free technocratic reform programmes promoted by the IMF and the World Bank and by many donor governments since the 1980s have **almost universally failed-** b/c they deliberately **ignored institutional differences across countries,** thereby recommending identikit policies, in what has come to be known as the **'one- size-fits-all'** approach to economic policy

The developmental side of institutions

- The neoclassical approach could not help more
  - Today, it is widely accepted that policies directly derived from the experiences of the developed countries – or, even worse, from economic textbooks – are **likely to fail in developing countries**, where certain institutions whose existence these policies take for granted (e.g., well-defined private property rights, a developed government bond market) simply do not exist

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1A. Motivation for Institutions and Institutional Economics

The developmental side of institutions

- Second, a number of devastating large-scale financial crises in developing countries around the turn of the century (Mexico in 1995, Asia in 1997, Russia in 1998, Brazil in 1999, and Argentina in 2002) have **prompted debates on the need for reforming a range of institutions** in order to prevent and deal with such crises

- Within the study of economic growth, the belief developed that an exclusive reliance on so-called economic factors **failed to explain why some countries had developed economically and others had remained poor, relatively and/or absolutely**

- **All these contributed, why institutions have emerged at the centre of attention in development economics**

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1A. Motivation for Institutions and Institutional Economics

The developmental side of institutions

Following the framework developed based on various empirical and theoretical findings

- The proposition that 'institutions matter' for economic growth and development has received intense attention
- Nowadays, there is a widespread recognition of the important role that institutions play in the economy (Stiglitz, 2000; North, 1997; Tridico, 2003; Prasad, 2003).
- ***Institutions are arguably accepted as the ultimate sources of economic development and income disparities among countries***

1A. Motivation for Institutions and Institutional Economics

The developmental side of institutions

Nevertheless,

- We are still some way away from **knowing exactly which institutions in exactly which forms are necessary,** or at least useful, for economic development in which contexts. For example, everyone may agree that a 'good' property rights system is essential for economic development.
- Even when we understand what role a particular institution can play in economic development, we often do not know how we can build such institution.
- **Filling these intellectual gaps calls for new approaches to the study of the role of institutions in economic development.**

1B. The subject of Institutional Economics

- **The theoretical foundation for bringing institutions to economics is due to *the frictionless and 'one- size-fits-all' framework of the neoclassical economics and the resulting failure***
- This foundation for bringing institutions to economics may be tracked back to the writings of Coase (1937), with the theory of the firm
- New Institutional Economics emerge to work on further by modifying the neoclassical orthodoxy
- **The fundamental argument of the NIE is that: "institutions matter and are susceptible to analysis" (Williamson, 2000)**
- It was at this time that Coase (1937) in his title: ''theory of the firm" becomes a base for the new institutional economics

1B. The subject of Institutional Economics

- Coase argued that, in the world of imperfect information, enforcement problem and uncertainties, the firm represents an alternative governance structure to the market **by providing an environment in which the price mechanism replaced by the power and authority of an entrepreneur**.
- He justified that the existence of the firm implies that there are costs to market transactions
- Similarly, Williamson (1979) argued that in a competitive world in which information is costly, different institutional environments imply differences in commitment and the cost of transaction

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1B. The subject of Institutional Economics

- Institutional economics may be seen to **bring economics closer** to other disciplines by arguing that individuals make choices that are **at least partly culturally determined** – thus moving beyond the longstanding focus of economics on individual utility as the main guide to resource allocation
- ***Institutional economics maintains that social, political and economic institutions set the frame for economic transactions and thus influence economic development***
- Institutional economics at the heart of institutional roles
- Old and new Institutional economics divide

1B. The subject of Institutional Economics- Old Institutional economics. What is that?

- Emerged as the protest against methodological individualism of the mainstream Neo-classical Economics
- Emphasized importance of institutions but lacked rigorous and systematic theoretical foundations, as well as empirical support
- Often it was country specific or even case specific
- Concerned more with description of institutions

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1B. The subject of Institutional Economics

New Institutional Economics (NIE)

- New institutional economics is recently developed theory that takes a new view on economics and focuses on transactions rather than on agents that take a decision (Williamson, 1989)

Adds

- A theory of institutions (rules of the game) to neoclassical economics

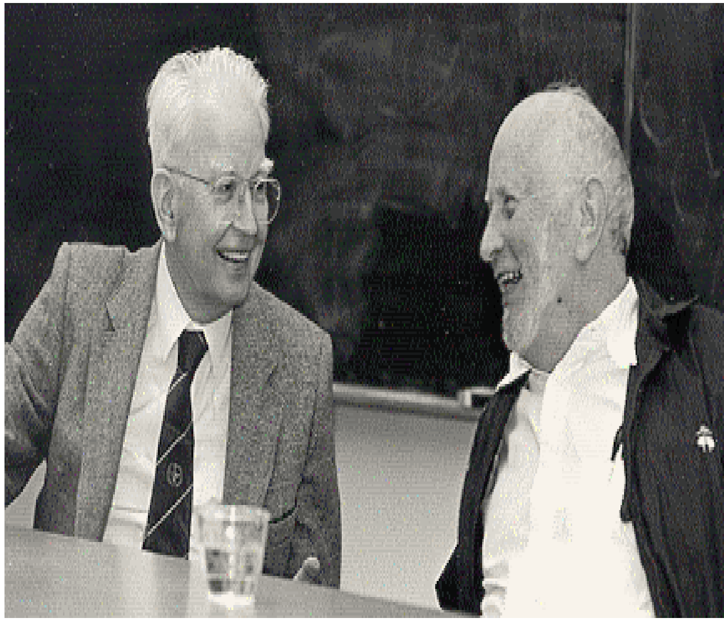
Examines

- How the rules of the game affect economic growth and the structure of the economy
- How the rules of the game evolve

1B. The subject of Institutional Economics

New Institutional Economics (NIE)

- Three main founders and **authors**
- Ronald Coase (Law and Economics)
    - 1937 – The Nature of the Firm
    - 1960 – The Problem of Social Costs
    - 1974 – The Lighthouse in Economics
- Douglass North (Economic History)
    - 1973 – The Rise of the Western World
    - 1981 – Structure and Change in Economic History
    - 1992 – Institutional Change and Economic Performance
- Oliver E. Williamson (Economics and Organization)
    - 1975 – Markets and Hierarchies
    - 1985 – Economic Institutions of Capitalism
    - 1996 – Mechanism of Governance



Coase R. and North D.

Williamson O

1B. The subject of New Institutional Economics

Focus on

- Economic analysis of institutions
- Institutions
  - Formal and informal rules that structure interactions
  - Rules of the game, contracts, cooperation, and more
- Economic analysis
  - Methodological individualism
  - Utility maximisation
  - Bounded rationality
  - Opportunism
  - Imperfect information

1B. The subject of New Institutional Economics

Assumptions

- **Methodological individualism:** the organisation or collectivity *per se* is no longer the main focus. Rather, the theory bases its explanations on the actions of their individual members.
- **Utility maximisation:** individuals are assumed to seek their own interest and maximise utility subject to the constraints established by the existing organisational structure. This assumed behaviour is extended to *all* individual choices.
- **Bounded rationality:** individuals have only limited ability to acquire and process information. With *non-zero transaction costs* they cannot deal with all aspects of the real world.
- **Opportunistic behaviour**: some individuals are likely to be dishonest in the sense that they may disguise preferences, distort data, deliberately confuse issues, etc. Since it is very costly to distinguish opportunistic from non-opportunistic actors *ex ante*, comprehensive contracting is not successful

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1B. The subject of New Institutional Economics

Bounded Rationality and Opportunism

- Bounded Rationality
    - Incomplete information
    - Incomplete processing of information
- All complex institutions are incomplete
- Opportunism
    - Taking advantage of information asymmetries
    - Following self interest with the help of guile (lying, cheating)
- Institutions need to be safeguarded against opportunistic behavior

1B. The subject of New Institutional Economics

Branches of NIE

- Transaction Cost Economics (Coase, Williamson, North)
- Property Rights Theory (Alchian, Demsetz, Furubotn, Bromley, Barzel)
- Contract Theory
    - Principal Agent Theory (Stiglitz, Tirole)
    - Incomplete Contract Theory (Hart, Moore)
- New Economic History
- New Political Economy

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Elements of NIE

- Property rights
- Transaction costs
- Path dependence: role of historical experience
- Law and Economics
- Regulation
- Governance
- Informal norms of behavior

1B. The subject of New Institutional Economics

Questions addressed by NIE

- Effects of institutions, e.g. property rights, on
    - Resource allocation
    - Income distribution
    - Incentives (efforts, investments, innovation)
    - Transaction costs
- Choice and change (evolution) of institutions
    - Designed or spontaneous development?
    - Efficiency or distribution oriented
    - Reduction of transaction costs

Analytical levels of New Institutional Economics

	LEVEL	FREQUENCY (YEARS)	PURPOSE	THEORY
L1	**Embeddedness:** Informal Institutions, Customs, Tradition, Norms, Religion	10^2 to 10^3	Often oncalculative, spontaneous	Social Theory
L2	**Institutional Environment:** Formal Rules of the Game – esp. Property (Polity, Judiciary, Bureaucracy)	10 to 10^2	Get the Institutional Environment right, 1st order economizing	Economics of Property Rights, Positive Political Economy
L3	**Governance:** Play of the Game – esp. Contract (aligning Governance Structures with Transactions	1 to 10	Get the Governance structure right, 2nd order economizing	Transaction Cost Economics
L4	**Resource Allocation and Employment** (Prices and Quantities, Incentive Alignment)	continuous	Get the marginal conditions right, 3rd order economizing	Neoclassical Economics/Agency Theory

Williamson (1998)

- **Four Levels of Institutional Analysis (Williamson)**

Levels of Institutional Analysis (Williamson approach)	
EMBEDDEDNESS IN LONG-TERM CHANGES OF SOCIETY	
Informal institutions, customs, traditions, norms, religion	Often noncalculative, spontaneous, slow = responds also to non-economic forces
INSTITUTIONAL ENVIRONMENT	
Institutional environment: formal rules of the game, especially property rights (polity, judiciary, bureaucracy)	Get the institutional environment right = 1st order economising
INSTITUTIONAL ARRANGEMENTS	
Governance: play of the game, especially contract and co-operation	Get the governance structures right = 2nd order economising
RESOURCE ALLOCATION, BY ENTREPRENEURIAL DECISIONS AND BY POLICY INTERVENTION	
Resource allocation and employment (prices and quantities, incentive alignment)	Get the marginal conditions right = 3rd order economising

2. Defining and characterizing an institution

What are institutions? - institutions Defined

- In order to determine what institutions are, and which institutions are relevant for an economic system, it is necessary to define precisely what is meant by the term "institution".
- **Different actors have different views about institutions**
- The debate on the function and importance of institutions is complicated because they are complex and hard to define
- Moreover, there is a lot of misunderstanding; some people use the term institutions and organisations as if they have the same meaning
- This is a mistake because an organisation is just a subcomponent of an institution

2. Defining and characterizing an institution

What are institutions? - institutions Defined

Let us listen yours

2. Defining Institutions and Organisation (North)

- Institutions are the rules of a society, or, to put it in a more formal way, constraints on human interaction created by the people themselves“ (North 1992, p. 3.)
- “In order to express it in the language of economists: institutions define and **limit the choices of individuals**“ (North 1992, p. 4)
- „The main purpose of institutions is to establish a stable (but not necessarily efficient) order in order to reduce insecurity in human interaction“ (North 1992, p. 6)

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2. Defining Institutions and Organisation (North)

- Institutions: the rules of the game in economic, political and social interactions.
- Institutions understood as 'rules'. Two 'schools': The new and the classic institutional tradition
- The new: Institutions are 'the rules of the game'.
- They are external constraints. The individuals are still (mainly) seen as autonomous. Focus on transaction costs as dependent on institutional structures
- The classic: Institutions are also forming individuals. They simplify. They offer meaning to the situation. Support values and protect and produce interests
- **North (1990):** Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction

2. Defining Institutions and Organisation (North)

- Institutions are generally defined as “constraints that human beings impose on themselves” (North, 1990)
- Following this definition, institutions prohibit, permit or require specific type of action, i.e. political, economic or social, that are important for reducing transaction costs, for improving information flows and for defining and enforcing property rights
- **However, this definition does not have universal acceptance**

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2. Defining Institutions and Organisation

Let us see some varieties

- **Berger and Kellner (1981):** .. every human institution is, as it were, sedimentation *of* meanings, or, to vary the image, a crystallization of meanings in objective form
- These definitions are very different. They represent each side of the divide between methodological individualist and social constructivist ontologies – between the 'new' and the 'classic'
- **Veblen (1919):** (Institutions are) settled habits of thought common to the generality of man
- **Commons (1931):** (Institutions are) collective action in control, liberation and expansion of individual action
- **Bromley (1989):** (Institutions are the) rules and conventions of society that facilitate coordination among people regarding their behavior

2. Defining Institutions and Organisation

- **Sjöstrand (1995):** An institution is described as an infrastructure that facilitates or hinders human co- ordination and the allocation of resources. Institutions thus function as a kind of 'rationality context', which simultaneously emerges from and governs human interaction

- **Scott (1995):** Institutions consist of cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior. Institutions are transported by various carriers – cultures, structures, and routines – and they operate at multiple levels of jurisdiction

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2. Defining Institutions and Organisation (Schumpeter)

- The main point is the capacity of institutions to structure people‘s behaviour in societies:
- “By ‚institutions‘ we mean ... all the patterns of behavior into which individuals must fit under penalty of encountering organized resistance, and not only legal institutions, such as property or the contract, and the agencies for their production or enforcement” (Schumpeter, 1983, p. 191).
- In this way, processes of social interaction are **economized**: by standardising actions and responses, resources otherwise required for case-to-case decisions are saved.

2. Defining Institutions and Organisation (Blaas)

- *'An institution is a system of rules that can be applied to recurrent (social) situations and is, in general, **accepted** by the members of a society.*
- These constraints on interactions can either be **explicitly fixed** by laws, rights, constitutions, etc. or, so to say, imposed by the people themselves and be effective without external supervision (**self-policed).**
- The essential aspect of an institution is that it offers people the possibility to specify the **consequences** of individual or collective action, which can be **expected** by the respective actors.
- If such a well-established institution exists, an individual is able to **predict** to a certain extent, what **response** from other individuals will be provoked by his or her own actions'.

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2. Defining Institutions and Organisation (Boettcher)

- Often the term "Institution" is used without any differentiation if people, strictly speaking, actually mean "organisation".
- Boettcher (1983, p. 9) understands institutions, at the general level, as primarily being **„rules shaping relationships".**
- Only in a second step, such rules can also lead to more concrete forms of organisation.
- Accordingly, the market can lead from an institution to an organisation, if it is established at a certain location following certain rules. In other words, it is being organised, for example, as a stock market or a foreign trade agency, etc."

2. Defining Institutions and Organisation

Summary

- A definition that combines and develops the most important aspects emphasized by classical institutionalists:
- Institutions are the conventions, norms and formally sanctioned rules of a society. They provide expectations, stability and meaning essential to human existence and coordination. Institutions regularize life, support values and protect and produce interests
- Institutions are incentive systems that guide human behavior
  - Key point: institutions
    - Are humanly devised
    - Set constraints
    - Shape incentives

2. Defining Institutions and Organisation

Summary

- Institutions are incentive systems that guide human behavior "In consequence they structure incentives in human exchange, whether political, social, or economic"
  - An **institution** is any *structure* or *mechanism* of social order and cooperation *governing the behavior* of a set of individuals within a given human community.
  - Humanly devised constraints that structure political, economic and social interactions.
  - *Institutions* are rules and social norms which structure social interaction. They can effectively enlarge/diminish capabilities, by the way in which they affect political rights (freedom, democracy, participation) and social rights (public resources for collective purposes).

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2. Defining Institutions and Organisation

Summary

- An institutional economic definition:
  - The set of rules actually used by a set of individuals to organize repetitive activities that produce outcomes affecting those individuals and potentially affecting others

2. Institutions VS Organisations

- Institutions understood as organizations
- This understanding is often found in political science and is quite similar to much of 'every day use'
- We will not use this definition. Organizations are agents. The 'institutions-as-organizations' definition hence mixes up institutions and agents
- **Institutions constitute both organizations and individuals**
- **„The term organisation refers to public bodies (political parties, the Senate, a city council, an administative authority), legal persons in economic life (firms, trade unions, family farms, cooperatives) and agencies of the educational system (schools, universities, centers for vocational training).**
- They consist of groups of individuals who undertaake joint action, because they want to achieve a common objective“ (North 1992, p. 5).

2. Institutions VS Organisations

- **If institutions are the rules of the game, organizations are the players who play the game according to the rules….(North)**
- While organisations **are the players** (in: Shirley, 2004, pg. 3) and can be defined as *"groups of individuals bound together by some common purpose to achieve certain objectives,"* (North, in: Shirley, 2004, pg. 3) and include legislatures, firms, trade unions, churches, clubs, schools, etc. (Shirley, 2004).
- **Institutions can be** defined as: *"humanly devised constraints that structure political, economic and social interaction"* (North, 1991, pg. 97)

The nature and characteristics of the institutions

- Institutional change

- **Institutional change:** Changes in formal rules, informal constraints and effectiveness of enforcement
- Formal institutions often easier to change than informal
- Incremental change is often the case for informal institutions
- Because exchange is more complex in modern economies→ need for increasing formalization of institutions
  - Specialization in modern economies (lower transformation costs higher transaction costs)
  - Impersonal exchange in modern economies
  - Weaker communities in modern economies→ increasing need for formalized enforcement

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The nature and characteristics of the institutions

How do institutions form?

- Institutions can and will likely result in an elite forming who will attempt to retain their position of power. There may be successful or may not be, but they can be replaced by an alternative elite.
- For the basis of this lecture we assume that institutions can be (i) developmental or (ii) predatory
  - (i) **Developmental Institutions** – encourage investment, growth and productivity.
  - (ii) **Predatory** – extractive institutions that favour the few.

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Understanding Institutions

- Different dimensions and forms of institutions
- Purpose of institutions
- The nature of the institutions
- Key function of institutions
- Formation of institutions

Understanding Institutions

- Different dimensions and forms of institutions
- **There are many levels of institutions - here distinguish at least between**
  - **Formal and Informal – institutions**
- Can also be useful to distinguish between:
  - **Economic institutions** (individual property rights, contracts that can be written and enforced, patent laws etc.,.
    - Shape economic incentives, contracting possibilities, distribution
  - **Political institutions** (form of gov., constraints on politicians and elites, separation of powers, democracy vs non-democracy, electoral rules, extent of checks and balances etc.)
    - Shape political incentives and distribution of political power.

Understanding Institutions

- A broad cluster including many sub levels:

Social institutions

- **A *social institution*** is an important human organization in a culture group that helps a society to survive.
- Anthropologists have identified ***government, religion, education , economy and family*** as the five basic social institutions that are necessary for a society to survive
- An easy way to remember the social institutions is by using the initials ***GREEF***

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Understanding Institutions

A broad cluster including many sub levels:

- Important distinction between: Formal and Informal institutions
  - **Formal institutions**: codified rules, e.g. in the constitution
  - **Informal institutions:** related to how formal institutions are used, to distribution of power, social norms, and equilibrium.
    - Constitutions in U.S. and many Latin American countries similar, but the practice of politics, and constraints on presidents and elites very different.
    - Why? Because distribution of *political power* can be very different even when formal institutions are similar.

1. Motivation for Institutions and Institutional Economics
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3. **Understanding Institutions**
4. Forms and roles of Institutions

Understanding Institutions

Institutions = **rules of the game**

- Formal rules
- Informal rules
- Their enforcement

Understanding Institutions

Some central questions regarding formal and informal institutions

- In what way are they different?
- How do they interact?
- What comes first? Which matters most?

- Formal institutions – property rights, legal system, rule of law, constitution.
- Informal institutions – how to behave in everyday life (linked to religion, history, social acceptability).

Understanding Institutions- Formal vs. informal

Formal and Informal – institutions

- **Formal** - are those whose norms, rules and sanctions are guaranteed through formal processes that are usually but not always official, and are written and enforceable through legal recourse or arbitration; can be associated with organizations of the state, market or civil society.
- Rules that are readily observable through written documents or rules that are determined and executed through formal position, such as authority or ownership
- Institutions based on existing legislation. Identifiable within the legal framework of the country/region.
    - Example: constitutions, laws, property rights, rules and regulations put in place by the government, explicit incentives, contractual terms, and firm boundaries

Understanding Institutions- Formal vs. informal

Formal and Informal – institutions

Informal institutions

- Rules based on implicit understandings, being in most part socially derived and therefore not accessible through written documents or necessarily sanctioned through formal position.
- Are social norms that represent evolved practices with stable rules of behavior outside the formal system
- Are how to behave in everyday life (linked to religion, history, social acceptability).
- Institutions arising due to cultural factors or non-legal conventions between individuals. May be difficult to detect.
    - Ex: social norms, routines, and political processes, Sanctions, taboos, customs, traditions, and codes of conduct, norms of behavior, conventions

Understanding Institutions

Formal and Informal – institutions

DEGREE OF FORMALITY	EXAMPLES	SUPPORTIVE PILLARS
Formal Institutions	▪ Laws ▪ Regulations ▪ Rules	▪ Regulatory (coercive)
Informal institutions	▪ Norms ▪ Cultures ▪ Ethics	▪ Normative ▪ Cognitive

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Different forms of institutions: Structural and Functional aspects (SF)

Conventions

- Complexity → conventions as simplifiers → simplifies communication and coordination
  - The body receives information equivalent to 11 mill bits per second
  - The conscious part of the brain treats 10-30 bits per second
- Types of conventions
  - Language (meta convention)
  - Time
  - Space
  - Weight etc
  - Acts (how to greet; which side to drive etc.)
  - Etc. …

Different forms of institutions

Norms

- S: Behavioral prescriptions (should/should not etc.)
- F: Creating common values/negotiating or avoiding conflict

- Shared prescriptions that are known and accepted by participants themselves.
- Self-enforced and do not rely on material sanctions and inducements
- Create meaning
  - Construct the social – define relations and common values – 'harmonize' interests
  - Operates in the overlapping field of coordination and conflict
    - Solve coordination problems where various value dimensions are involved
    - 'Takes side' in conflicts over values and interests
- Combine a certain situation with a required act that supports a specific value

Different forms of institutions
Formal rules

- S: Legal structures, formal controls and punishments
- F: Regulating conflicts (large 'C' coordination)

- Regulate conflicts
  - Formally defined rights and sanctions
  - The collective defines these rights and sanction mechanisms/ sanction levels
    - Takes side in conflicts over interests and values
  - Formalized authority structure: State vs. no state based formal rules
- Different legal relations (Hohfeld):
  - Static: Right – duty; Privilege – no right;
  - Dynamic: Power – liability; Immunity – no power

Different forms of institutions

Rules

- Shared prescriptions, mutually understood and enforced in a predictable way by agents responsible for monitoring conduct and imposing sanctions. Rules determine
  - Who can make decisions
  - What actions are allowed or constrained
  - What aggregation rules will be used
  - What information must or must not be provided
  - What payoffs to individuals depending on their actions (Ostrom, 1990 p51).

1. Motivation for Institutions and Institutional Economics
2. Defining and characterizing an institution
3. Understanding Institutions
4. Forms and roles of Institutions

Different forms of institutions

Levels of Rules

Operational: affect day-to-day decisions

- When, where and how to withdraw resource units,
- Who should monitor the actions of others and how
- What information must be exchanged/ withheld
- Rewards or sanctions

- Collective-choice: used by members, their officials, or external authorities in making policies
- Constitutional choice: determine who is eligible to participate in making collective choice decisions
- Rules are nested in other rules that define how the first set of rules can be changed

Forms of institutions

Strategies

- Regularized plans that individuals make
  - Within the incentives produced by rules, norms
  - Relate to expectations of the likely behavior of others in a situation
  - Affected by relevant physical and material conditions.

Different forms of institutions
Power and freedom

- Institutions are not neutral instruments – they take side. They may have quite oppressive effects
  - The process of institutional development and change
    - Whose interests gets to count
- Institutions both constrain and liberate – power can be used both to oppress and to liberate
- Formal vs. actual equality
  - The wage contract
  - The access to (fundamental) resources

Different forms of institutions

Institutional systems

- Systems of rules and roles
- The market – consumer and producers
- The firm – employers and employees
- The family – parents and children
- The community – neighbors; friends
- The political arena – politicians and voters;
    - Citizens; stakeholders

Purpose of institutions- What do institutions do?

Key function

- Protection of property rights
- Enforcement of voluntary contracts among individuals
- Provision of the physical and regulatory infrastructure

- Define and limit the set of choices of individuals
- They structure and shape incentives in human exchange (be it economic, political or social) while they make interaction (both formal and informal), in consequence, are the underlying determinants of economic performance”
- „Institutions affect the **cost of exchange and production** and, in this way, have an influence on the performance of an economy“ (North 1992, p. 6)

1. Motivation for Institutions and Institutional Economics
2. Defining and characterizing an institution
3. Understanding Institutions
4. Forms and roles of Institutions

Purpose of institutions

- "Institutions (*have been designed by human beings*) to create order and reduce uncertainty in exchange" (D.C. North, *journal of economic perspectives*, 1991)
  - Key role is to reduce uncertainty by influencing individuals' and firms' decision making by signaling which conduct is legitimate and acceptable and which is not
- „Institutions **reduce insecurity** by providing us with a certain degree of order in our every day life (north 1992, p. 4)
- Influence level of transaction costs (TCs)
  - Institutions and how they are enforced determines the cost of transacting (north 1990)
- Have distributing rights
- Influence perceptions
- Influence rationality and preferences

Purpose of institutions- What do institutions do?

- A means of living and working together (Knight, 1992)
- Allow social actors to act with others to produce benefits they would fail to achieve by acting alone.
- Knowledge of stability shared by the members of a group enable behavior necessary to achieve these benefits
- So institutions may encourage collective action and cooperation

Purpose of institutions- What do institutions do?

- How Do Institutions Reduce Uncertainty?
  - Relational contracting - informal, relationship-based, personalized exchanges
  - Arm's length transaction - formal, rule-based, impersonal exchange with third part enforcement
  - Institutional transitions - fundamental and comprehensive changes to the rules that affect all organizations

Purpose of institutions- What do institutions do?

Influencing the level of TCs

- The market vs. the firm; private vs. common property; individuals vs. the state etc
  - Why is not all markets: Why firms?
  - Why are some resources commonly owned?
  - The state as reducing TCs – environmental policy
- The new institutionalists focus analyses very much on the second order efficiency issue: Which institutional structures offers the lowest TCs

Purpose of institutions- What do institutions do?

Defining rights

- Human rights – type of norm
- Property rights – formal constructs/third party control. Bromley (1989): A social relation – a relation between the rights holder and the rights regarders under the control of a third party
- General types
  - Private property
  - Common property
  - Public/state property
  - Open access

<u>Purpose of institutions- </u>What do institutions do?

Influencing perceptions, interests and values

- Perceptions
  - The concepts we use are conventions and influence how we perceive external stimuli
- Interests
  - Institutions define the positions/right we hold and the roles we 'play' - hence the interests we have
- Values
  - The values we hold are general to the wider culture and goes beyond our individual interests. They are carried by the normative structures of a society – cf. the stakeholder vs. the citizen|

Purpose of institutions- What do institutions do?

Influencing rationality

- Institutions as rationality contexts
  – The institutional structure influences the logic or meaning of a certain context or situation
- Individual rationality – 'I' rationality
  – What is best for the individual – egoism
  – Fostered by structures like markets and firms
- Social rationality – 'We' rationality
  – What is best for the group – may imply personal sacrifice. Solidarity
  – How the group is defined is crucial here. Solidarity turning into 'us and them'

The nature and characteristics of the institutions

- The formal state institutions that enact and enforce the laws:
  - Legislature, police, judiciary, and regulatory agencies;
- Institutions of private ordering that function under umbrella of state law;
- Private for-profit institutions that provide information and enforcement;
- Self-enforcement within social or ethnic groups and network;

CHAPTER TWO

THE ROLE OF FORMAL INSTITUTIONS ON DEVELOPMENT

CHAPTER OUTLINE

In this chapter we will study

1. Motivation for determining the role of formal institutions in development
2. Formal Institutions on growth and development
3. Empirical issues in determining the role of institutions

1. Motivation for determining the role of formal institutions in development

Growth and Development Fundamentals

Economic Development

- **Development** = Growth *plus* Change
- **Growth**: sustained improvement in the level of per capita income
- **Change**: sustained improvement in institutions and organizations that support growth

Growth

- Gross Domestic Product (GDP): Market value of all final goods and services an economy produces in one year
- Real GDP: GDP in constant prices
- GDP Per Capita = (Real GDP / Population) or income per person
- Economic Growth = percentage change in Real GDP per capita

1. Motivation
2. Role of Formal Institutions on economic development
3. Empirical issues in determining the role of institutions

1. Motivation........

Sources of growth and development, and the status

[Szirmai, 2012]

- There are vast differences in per capita incomes between the most developed countries and the least developed countries
  - In 1820, the average living standard between the West and all other regions differed by about factor two VS In 2007, high income countries were on average 21 times wealthier than their low income counterparts
  - Average income levels in the world's richest and poorest nations differ by a factor of more than 100
  - Sierra Leone, the poorest economy for which we have national income statistics, has a per capita GDP of $490, compared to Luxembourg's $50,061
  - Similarly, the degree of income inequality varies sharply from the developed world to the developing world, as well as among countries and entire regions

1. Motivation …. Sources of growth and development, and the status

- Few questions have been at the forefront of empirical growth research recently???????
  - What are the deep and robust determinants of economic growth?
  - How can the differing convergence experiences of different countries be explained?
  - What accounts for these differences, and what (if anything) can we do to reduce them?
  - What are the fundamental causes of the large differences in income per capita across countries?
  - Where is the place or role of ***institutions as the cause of current economic performance?***

1. Motivation …. Sources of growth and development, and the status

- There is still little consensus on the answer to this question
- There is general agreement that the factors determining Economic Development are debatable
- One such area of recent interest and debatable factors are *institutions*
- ***Are institutions the cause of current economic performance?***

1. Motivation ….

Trebbi et al,

In the voluminous literature on this subject, **FOUR strands of thoughts** stand out on the determinants of development

1. Endowment View on Economic Growth

- First, there is a long and distinguished line of theorizing that places geography at the center of the story
- It essentially argues that geographical factors directly shape the output, income distribution or technology adoption in the society
- Geography is a key determinant of climate, endowment of natural resources, disease burden, transport costs, and diffusion of knowledge and technology from more advanced areas
- It exerts therefore a strong influence on agricultural productivity and the quality of human resources

1. Motivation …. Sources of growth and development, and the status

The endowment view …

- **Direct Impact of Geography**
- The endowment view claims that natural resources to population determine the productivity and technology in production
- Earlier works like Engerman and Sokoloff (1997) provide a **historical account** and qualitatively argue that the composition of population, climate, soils and native populations in the United States and Canada significantly explained the relative distribution of wealth, human capital and the decentralized political power developed **<u>as compared to the development experiences of Latin America economies</u>**

1. Motivation …. Sources of growth and development, and the status

2. The role of international trade

- A second camp emphasizes the role of international trade as a driver of productivity change
- They call this the integration view, as it gives market integration, and impediments
  - Thereof, a starring role in fostering economic convergence between rich and poor regions of the world

1. Motivation ….

3. institutional View on Economic Growth

- Finally, a third group of explanations centers on institutions, and in particular the role of property rights and the rule of law. In this view, what matters are the rules of the game in a society and their conduciveness to desirable economic behavior
- This view is associated most strongly with Douglass North (1990)- receiving careful econometric treatment recently in Hall and Jones (1999), who focus on what they call ""social infrastructure,"" and in Acemoglu et al. (2001), who focus on the expropriation risk that current and potential investors face
- North and Thomas (1973) argue that institutions are the sources of cross-country differences in growth.
- This view was further echoed by Acemoglu*, et al.* (2005) and IMF (2005), claiming that institution is a more fundamental cause of growth.

1. Motivation ....

- **Institution View: Economic vs. Political Institutions**
- The institution view essentially argues that institution is the fundamental source of growth
- Empirical studies have been developed into two separate strands, namely the effect of economic and political institutions

1. Motivation ....

4. Combined View on Economic Growth

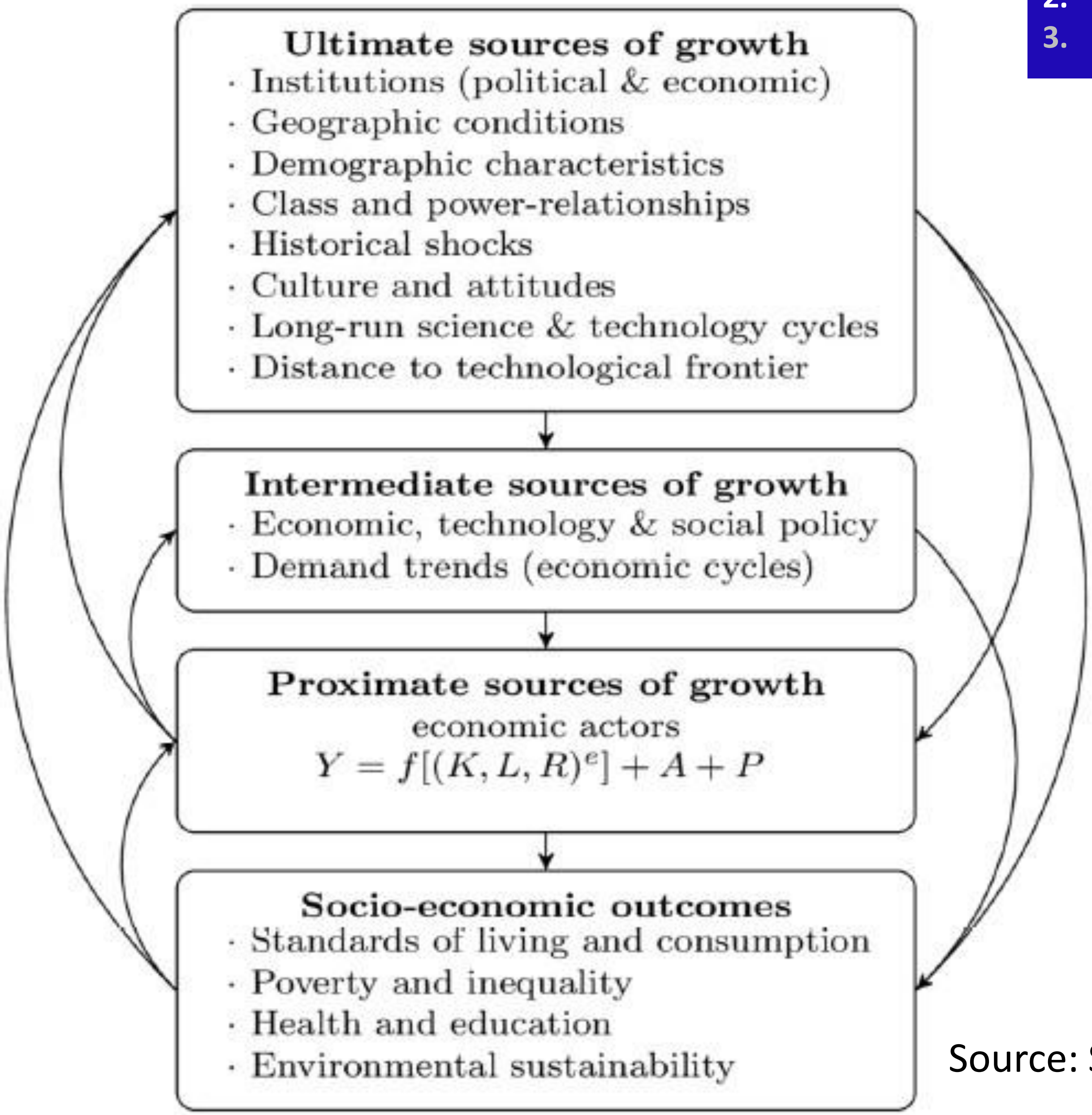
- A fourth strand of the literature, hereafter developed, combines the essence of the institution and endowment views on growth
- This strand opines that economic growth is not directly determined by natural factor endowment, but it will shape the policy and institutional choices of politicians and/or colonizers
- These choices in turn have a positive and long-term effect of economic prosperity
- Most provoked by Szirmai, 2012 in their framework

2. Role of formal Institutions on economic development

Institutions first!!

- Although there is still little consensus on the answer to the question who primarily causes growth and fundamental causes of the large differences in income per capita across countries- This lecture provide an analytic review of the role of Institutions
- Scholars like DARON ACEMOGLU, Szirmai, Barro…. place institutions first among the many factors that influence economic growth using a framework developed by Szirmai (2005, 2008, 2012a).
- There is now a growing consensus that institutions matter for growth, but disagreement about how exactly, the extent to which this is the case, and which institutional arrangements affect growth more than others

1. Motivation
2. **Role of Formal Institutions on economic development**
3. Empirical issues in determining the role of institutions



Proximate and intermediate causes of growth

Source: Szirmai, 2012

2. Role of formal Institutions on economic development

[DARON ACEMOGLU]

•Acemoglu, Johnson, and Robinson (2002) AJR suggest that economic institution were developed by colonial transplantation and thus refute the endowment view completely

•Their key observation of "reversal of fortune" is that, among countries colonized by European powers during the past 500 years, those that were relatively rich in 1500 are now relatively poor

- They find that economic prosperity in the past, measured by urbanization and population density, does not link to geographic factors
- In contrast, they suggest that this reversal actually reflects changes in the institutions resulting from European colonialism
- Most famously, Acemoglu, Johnson, and Robinson (AJR) (2001, 2002) use settler mortality and indigenous population density in the year 1500 to instrument for institutional quality: where settlers could thrive, they established strong institutions; elsewhere, they concerned themselves primarily with resource extraction.
- Relying on instrumental variables, Acemoglu et al. show a strong causal effect of institutions on growth

2. **Role of formal Institutions on economic development**

- AJR propose a theory of institutional differences among countries colonised by Europeans, and exploit this theory to derive a possible source of exogenous variation.
- Their theory rests on three premises;
- Firstly, there were differences in colonization policies which created different sets of institutions.
    - At one extreme, European powers set up ‘extractive’ institutions, exemplified by the Belgian conquest of the Congo; these institutions did not introduce much protection for private property, nor did they provide many checks and balances against government expropriation.
        - The main purpose of these extractive institutions was to transfer as much of the resources from the colony to the colonizer and were detrimental to investment and economic development.

2. Role of formal Institutions on economic development

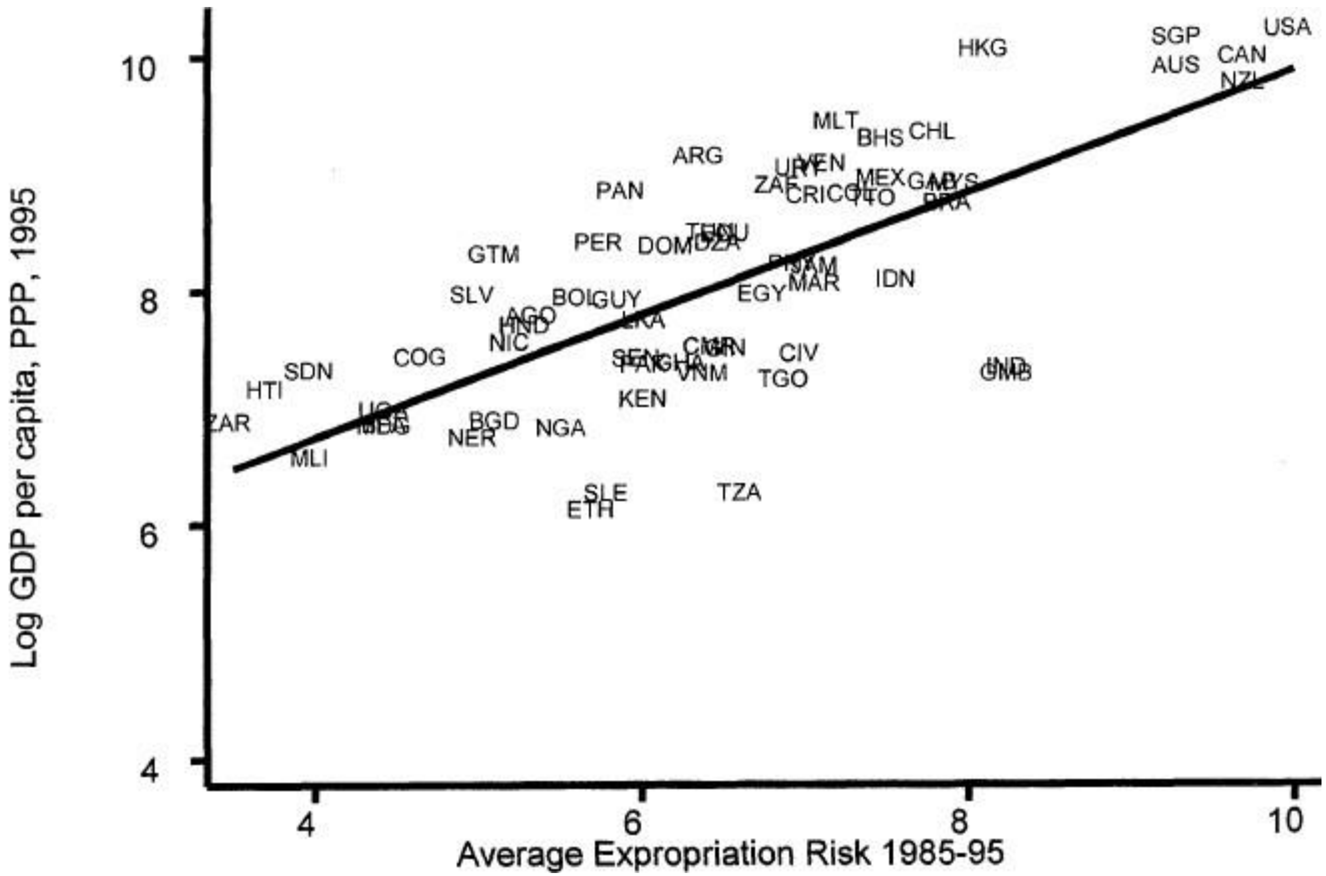
  - At the other extreme, many Europeans migrated and settled in a number of colonies where they tried to replicate European institutions, with strong emphasis on private property and checks against government power.
  - These institutions enforced the rule of law and encouraged investment; primary examples of this include Australia, Canada, New Zealand, and the United States.
- Secondly, the colonization strategy was influenced by the feasibility of settlements; i.e. in places where the disease environment was not favourable to European settlement, the formation of extractive institutions was more likely.
- The final premise of AJR's theory is that the colonial state and institutions persisted after independence – this is because the political elite that came to power at independence in the previously colonised countries had a strong self-interest in maintaining the extractive institutions established during colonial times and the access to revenues obtained from the control of these institutions.

2. **Role of formal Institutions on economic development**

- AJR validate their theory by regressing current economic performance (log GDP per capita in 1995) against current institutional quality (the average protection against expropriation risk for the period 1985- 1995), and by instrumenting the latter by the settler-mortality-rate during the colonial period compiled by the historian, Philip Curtin.
- The settler-mortality-rate is an indirect measure of the disease environment in the colonies, and thus, measures the likelihood of Europeans settling in a particular colony and setting up institutions of private property
- AJR find that there is a high correlation between the mortality rates faced by soldiers, bishops and sailors in the colonies and European settlements and early measures of institutions, and between early institutions and current institutions;
- AJR estimate large effects of institutions on income per capita using this source of variation.
- They also find that this relationship is not driven by outliers, and is robust to controlling for latitude, climate, current disease environment, religion, natural resources, soil quality, ethnolinguistic fragmentation and current racial composition.

2. **Role of formal Institutions on economic development**

AJR literature documenting positive correlations between certain institutions and economic performance.



2. Role of formal Institutions on economic development

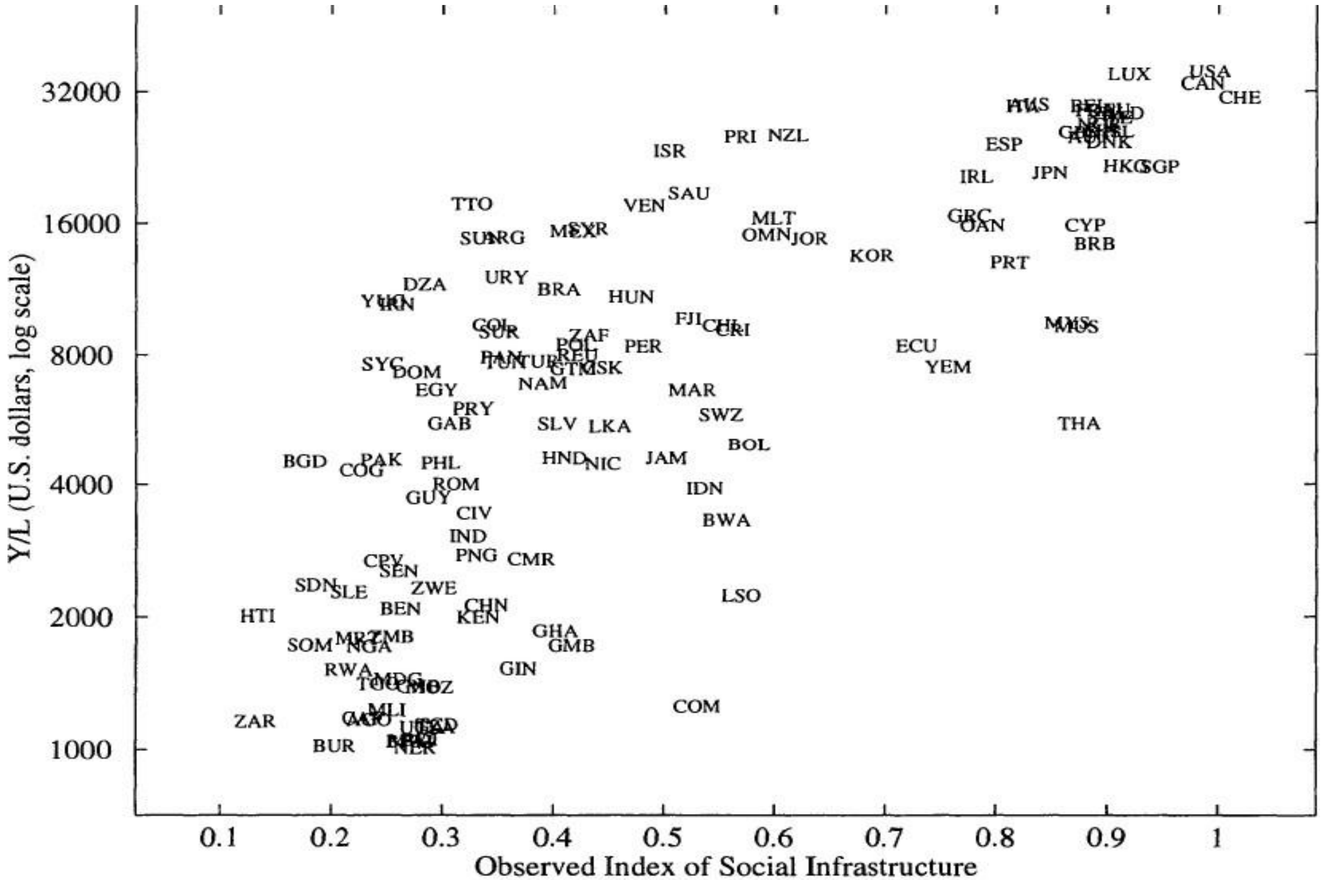


FIGURE II
Social Infrastructure and Output per Worker

2. **Role of formal Institutions on economic development**

- ACEMOGLU, also place institutions first among the many factors that influence economic growth using another evidence
  - For example, the divergent paths of North and South Korea, or East and West Germany, where one part of the country stagnated under central planning and collective ownership, while the other prospered with private property and a market economy.
- As discussed before, AJR(2002) suggest that economic institution were developed by colonial transplantation and thus refute the endowment view completely.

2. **Role of formal Institutions on economic development**

- More recently, Acemoglu and Johnson (2005) attempt to unbundle which institutions affect economic development.
- They define institutions into two forms –
- (i) "Property rights institutions", which protect citizens against expropriation by the government and powerful elites, and
- (ii) "Contracting institutions", which enable private contracts between citizens. In practice, they are measured by "protection against risk of expropriation" and "constraints on executives"
- Using settler mortality rate as instruments, their cross-sectional IV estimations show that property rights institutions have a first-order effect on long-run economic growth, investment, and financial development
- Contracting institutions appear to matter only for the form of financial intermediation, including credit and stock market capitalisation

2. **Role of formal Institutions on economic development**

- Barro's (1997) seminal contribution to the empirical growth literature, two measures of institutional quality – political stability and the rule of law index – are included in the determinants of growth of GDP per capita.
- In Barro's empirical implementation of the neoclassical growth model, a higher degree of political stability and a greater presence of the rule of law have a positive effect on the investment rate, which leads to higher economic growth.
  - However, a major weakness of Barro's work (and other similar studies such as Knack and Keefer [1995]) is the possibility of reverse causality – countries that grow faster will tend to adopt better institutions and be more politically stable.

2. **Role of formal Institutions on economic development**

Summary on Institutions and Growth

- The two important papers by Acemoglu, Johnson and Robinson (henceforth, AJR, 2001, 2002) that gave a serious attempt to control for the possibility of reverse causality in establishing a causal role for institutions in economic development, and with pioneering nature focus in the cross-country literature on institutions and economic development that have used quantitative methods, we provide below a summary of the key arguments and methods of the two papers.
- In the surveyed literature, we find strong support for the proposition that institutional arrangements are indeed among the ultimate sources of long-run growth since 1500.
- Several studies explicitly argue that more extractive or exploitative colonial institutions resulted in slower long-run growth and more inclusive institutions in more rapid growth.
- Their findings indicate that institutional differences explain the *largest* part of cross-country differences in GDP per capita. A diverse body of political economy contributions focusing on the degree of access of large segments of the population to economic, political and social organizations is in line with these results.
- With regards to the kind of institutional arrangements that are conducive to growth, some studies focus specifically only on property rights and the rule of law, while others emphasize the overall degree of inclusiveness of institutions.

2. **Role of formal Institutions on economic development**

But how they result growth and development????????

- Broadly, the view is that institutions shape policies
- They establish clear and enforceable property rights, keep the costs of transacting business to a minimum, and reduce the threat of coercion.
- Precisely, institutional quality directly affect income levels through three channels:
  - (i) Reduced information asymmetries, as institutions channel information about market conditions, goods, and participants;
  - (ii) Reduced risk, as institutions define and enforce property rights; and
  - (iii) Greater restrictions on the actions of politicians and interest groups, as institutions make them (more) accountable to citizens.

2. Role of formal Institutions on economic development

But how they result growth and development????????

- Positive association between quality of institutions and per capita income (IMF Economic Outlook, 2003)
- Countries with better *"institutions,"* more secure property rights, and less distortionary policies will invest more in physical and human capital, and will use these factors more efficiently to achieve a greater level of income (e.g., Douglass C. North and Robert P. Thomas, 1973; Eric L. Jones, 1981; North, 1981)
- This view receives some support from cross-country correlations between measures of property rights and economic development
  - (e.g., Stephen Knack and Philip Keefer, 1995; Paulo Mauro, 1995; Robert E. Hall and Charles I. Jones, 1999; Dani Rodrik, 1999), and from a few micro studies that investigate the relationship between property rights and investment or output (e.g., Timothy Besley, 1995; Christopher Mazingo, 1999; Johnson et al., 1999).

2. Role of formal Institutions on economic development

- Institutions affect both the costs of production/ transformation and exchanges/transactions
  - The latter is particularly focused on in North
- Institutions and reduction of TC. Make exchanges more productive and in some cases even possible. Institutions:
  - Provide information
    - Alleviation of asymmetric
    - Reduction "pure" uncertainty
  - Make enforcement, policing etc cheaper
  - But: Some institutional constraints increase TC
- Institutions and the incentive to develop technology that reduces transaction costs

2. **Role of formal Institutions on economic development**

- How do each institution contribute for growth?
- *Political Institutions*: encourage participation and democracy, rule of law.
- *Economic Institutions*: encouraging investment through incentives, human capital, entrepreneurship, innovation, occupational choice, land ownership, property rights.
- *Market Institutions*: permit the efficient allocation of resources, e.g., financial markets; insurance.
- *Culture*: values, beliefs, religions
- *Geography*: climate (affects productivity and worker effort), agricultural (technological) productivity higher in temperate zones than in tropics, burden of infectious diseases, natural endowments, transport costs
- *Trade and Integration*: affects productivity changes.
- *Human capital*: capability of being active and produce wealth

2. **Role of formal Institutions on economic development**

Growth contributing Institutions can be (i) developmental or (ii) predatory

1. Developmental Institutions – encourage investment, growth and productivity.
2. Predatory – extractive institutions that favour the few.

- Problem: institutional quality itself is determined by lack of equity in a society: **inequitable economies develop exploitative and inefficient institutions**.
  - Unfair wealth distributions can block the emergence of effective democracy because it makes redistribution too costly for the elites in power. Inequality shapes, and is shaped by, political institutions.
- Initial conditions matter and change is very slow and difficult to initiate.

2. Role of formal Institutions on economic development

Types of Institutions

(i)Institutions that protect individual property rights – e.g. defend against expropriation of resources.

(ii) Institutions related to democratic political rights (Sen)

(iii)Institutions correcting co-ordination failure – efficiency of government for example in implementing policy (e.g. South Korea).

Countries can have good and bad institutions then – e.g. South Korea has one party political system.

2. Role of formal Institutions on economic development

Evidence of Institutions and Economic Growth

- Korea – natural experiment since split into North and South Korea in 1948. Same geography, history and culture. North Korea went Dictator and Socialism, South Korea went Dictator and Capitalist that involved private property rights and in 1980 to a democracy.
- Micro level evidence of importance land property rights have on investment in agriculture in LDCs.
- Macro level evidence looking at within country and between country – problem with this is though that we cannot control for whether 'better' institutions cause growth or growth then leads to 'better' institutions.

3. Empirical issues in determining the role of institutions

- Large literature documenting positive correlations between certain institutions and economic performance.
- But the emperics should be conidered with a level of caution
- The identification problem
- Endogeneity
- Proximate vs fundamental causes

3. Empirical issues in determining the role of institutions

- The relationship between institutions and growth is undeniably complex.
- it is likely that institutions affect growth in many ways: perhaps directly, but also by affecting variables that in turn affect growth, and by affecting the aggregate production function determining how other variables affect growth.
- Nevertheless, this line of research on institutions still faces major methodological, empirical and theoretical problems

3. Empirical issues in determining the role of institutions

Brief summaries of ambiguities

- The effects of political and economic inequality remain ambiguous, because they are still imperfectly quantified or sometimes not empirically distinguished at all
- In all of these analyses, institutions are still treated as an aggregate "black-box".
- Too often, the focus is exclusively on property rights related variables only, such as the risk of expropriation, the rule of law or constraints on the executive.
- A pure property rights focus neglects the interactions among different types of institutions in bringing about stability, social cohesion and safe investment climates.

3. Empirical issues in determining the role of institutions

- Much still needs to be added to these investigations
  - Such as studying the effects of institutional characteristics in more specific historical contexts in a Gerschenkronian tradition,
  - Investigating the interactions between specific institutional domains and technological advance, and developing a broader approach to institutions which is not exclusively focused on property rights only.
    - Such approaches will require better measurement of a variety of institutional characteristics and better empirical methods to separate these into distinct and meaningful dimensions.

Szirmai, 2011

3. Empirical issues in determining the role of institutions

- Studies suggest a positive correlation between institutional quality and development outcomes around the world.
- However, such correlation may not imply a straightforward causal relationship and possibly invite two further (and perhaps related) questions.
- Firstly, there might be some other factors affecting both institutions and economic development.
- Reverse causality is also possible since richer economies may have more resources to build up better institutions.
- Secondly, these snapshots ignore any institutional change over time.
- The IMF (2005) indeed has also concurred that rapid institutional change was possible in the past 30 years despite the tendency to institutional persistence.

1. Motivation
2. Role of formal Institutions on economic development
3. Empirical issues in determining the role of institutions

3. Empirical issues in determining the role of institutions

- The proposition that domestic institutions matter to economic growth is not new Nevertheless, there are competing views arguing that the role of institutions is too overplayed.
- Amongst others, critiques claim that geographical endowments, culture, religion, historical events are also key determinants. Other empirical works suggest that in fact human capital is an even more fundamental cause of economic growth.
- Exactly what institutions matter to economic growth is also very loosely defined.
- Others criticise that the *institution view* literature present evidence in a very long-run timeframe, assuming that institutions are persistent and without considering the effect of institutional change on the economic outcome today.

3. Empirical issues in determining the role of institutions

- Although there is a vast amount of empirical evidence to support the institution view, the estimation strategies are being severely scrutinised.
- Critics rightly point out that the existing empirical literature is predominantly cross-sectional in nature, thereby ignoring the dynamic impact of institution on growth.
- Furthermore, they do not control for the country-specific and time characteristics. In addition, both institutions and economic growth understandably can be endogenously determined.
- Even though instrumental variable (IV) estimations are widely used to tackle such problem, the validity of instruments has called for many doubts. Last but not least, data quality and definition of institution are also subject to many criticisms.

3. Empirical issues in determining the role of institutions

- **Critics of Existing Institutions and Growth Literature**
- Although the claim that institutions matter to growth has come to an academic conclusion, empirical evidence remain inconclusive
- This indeed reveals several key technical problems.
- Even in those works that provide support to the institution view, the estimates obtained are arguably biased, primarily because of the endogeneity problem in these growth empirics.
- The instruments used are also subject to many critics and do not robustly show their validity. Also, despite all the positive empirical results, there is no consistent measurement of what institutions are referring to.
- To discuss the various critics of the existing literature in proper perspective, we highlight 6 key shortcomings of the relevant literature below

3. Empirical issues in determining the role of institutions

- **Critics of Existing Institutions and Growth Literature**

1 Data Problem: Availability, Credibility and Comparability

- The lack of consensus of exactly what institutional variables should be used in empirics is partially caused by the availability of data.
- Firstly, the lack of an operational and consistent definition of institution hampers the comparability of the empirical studies. The scope of measurement also invites more

3. Empirical issues in determining the role of institutions

2 Reverse Causality: Economic Growth causes Institutional Change

- The literature also suggests reverse causality between institutions and economic growth. Amongst others, Chong and Calderon (2000) argue that that most of the studies concerning institution and economic growth have not paid enough attention to the possibility that economic growth may lead to better institution. Their hypothesis is that the poorer the country, and the longer the wait, the higher the influence of institutional quality on economic growth once growth kicks off.

3 Endogeneity and Validity of Instrumental Variables

- The problem of endogeneity induces biased results. Briefly discussed before, IV estimation appears to be the most favourable strategy for this subject. The instruments used for IV estimation so far are principally derived from La Porta*, et al.* (1997) and La Porta*, et al.* (1998)'s legal origin, Acemoglu*, et al.* (2001)'s European settler's mortality rate and Alesina, Devlieeschauwer, Easterly*, et al.* (2003)'s religion, ethnic and languages fractionalization.

- Collectively, these instruments intend to introduce time-invariying factors, e.g. geography (distance from equator and predicted trade share, oil exporters, disease burden etc) and colonial origins into the analysis of current income.

3. Empirical issues in determining the role of institutions

4 Institutionnel Persistance vs. Institutionnel Change

- Most of the empirical works done so far are cross-sectional analyses, aiming at estimating the long-run impact of institutions on growth.
- They are designed in the way to investigate how the average scores of institutions over a long period of time can associate with the present GDP per capita.
- The use of time-invariant instruments implicitly assumes that institutions are quite persistent. Technically speaking, such design of the instruments also does not allow the researchers to identify the consequences of institutional *change* for growth.
  - In other words, these cross-country studies cannot capture the effect of dynamic institutional change on growth, in particular, within country variation over time.

3. Empirical issues in determining the role of institutions

5 Omitted Variables: Country- and Time-Specific Effects

- In terms of econometrics, the time-invariant instruments could not be used in a panel-setting, especially in a fixed-effect model, since all these time-invariant characteristics will be absorbed into the unobserved fixed-effects.
- Unfortunately, such country-specific and time-specific effects are too significant to be ignored in growth empirics. Acemoglu, *et al.* (2008), while showing that democracy and higher income may well be mutually reinforcing, suggest that the strong correlation between the two may be driven by variables that related to colonial heritage and early institutions.
- This also implies the importance of incorporating that country-specific effect in growth empirics. Only recently, there are very few studies on the subject using panel data
- analysis, although it has long been recognised that the dynamic nature of institutional change is very important (Acemoglu and Johnson (2005)).

3. Empirical issues in determining the role of institutions

6. Specification Problem: Growth Rates vs. Income Level

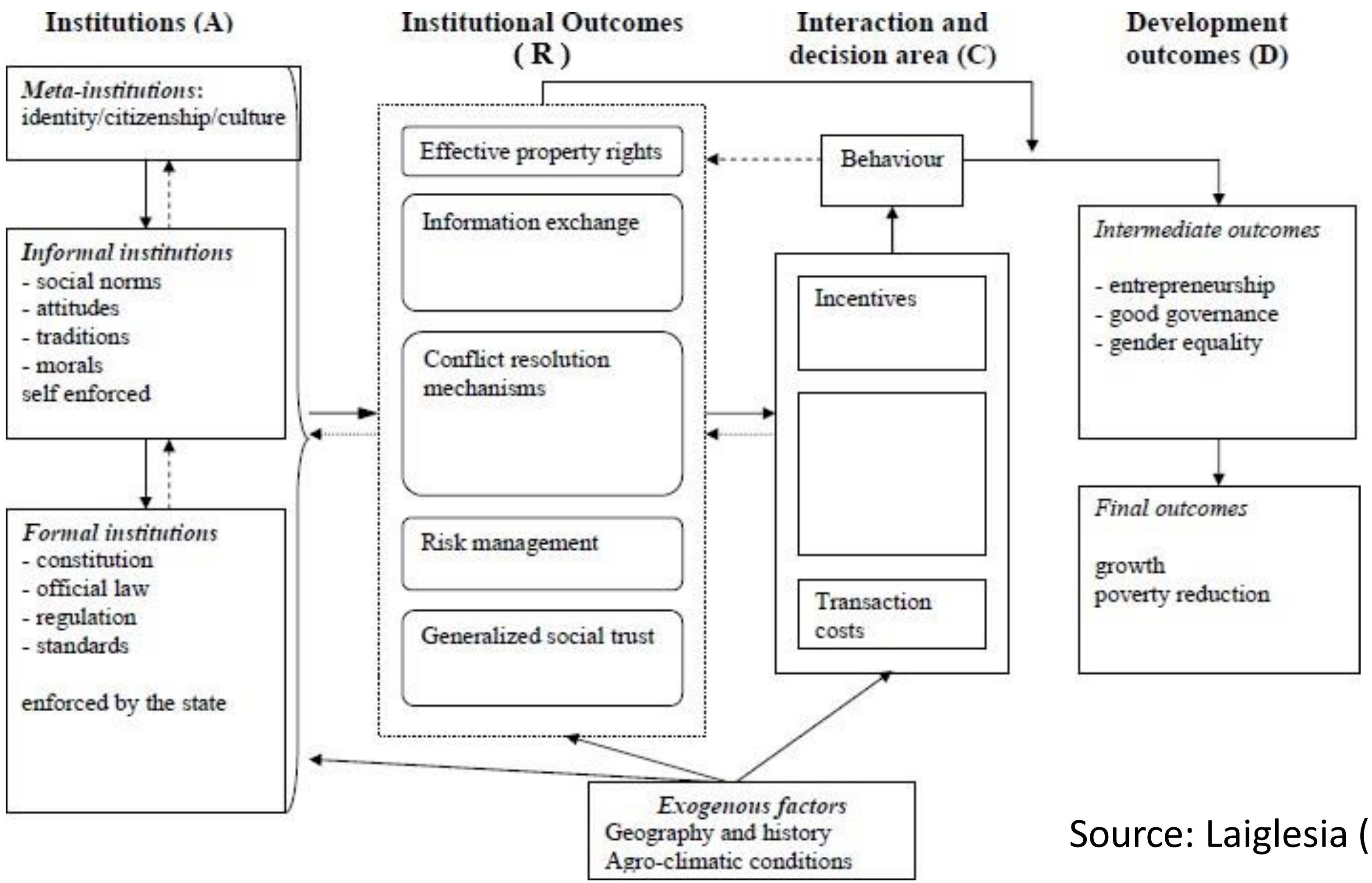
- Sachs (2003) criticised the institution view that empirical studies of institutions and growth suffer from specification problem, in particular to static versus dynamic growth models.
- Economic theory suggests that per capita income should be specified as a *dynamic process* (e.g. Barro and Sala-i-Martin, 1997), in which the growth of income during a time interval [0,t] should be a function of the income level at the start of the period and some kind of average of the values of the regressors during the time interval [0,t].
- In short, growth models typically specify cross-country growth in country *i* as

3. Empirical issues in determining the role of institutions

7. Can development outcomes hardly be attributed to one single institution say only formal?

- In a nutshell No
- Laiglesia (2006) illustrates a basic framework for understanding how institutions affect development outcomes
- In a nutshell this figure shows that Development Outcomes (D) can hardly be attributed to one single institution (A) rather it is a complex issue
- More recently, greater importance has been attributed to the role of property rights as a mainstay among institutions of promoting growth (Besley and Ghatak 2009) and the role of the state in formalising and protecting such rights (Acemoglu and Johnson 2000, 2004).

3. Empirical issues in determining the role of institutions



Source: Laiglesia (2006)

3. Empirical issues in determining the role of institutions

- Take the example of "growth and poverty reduction" as important goals in development
- The above framework shows that (D) depends critically on the complex interaction between
  - i) the behavior of individuals,
  - ii) institutional outcomes and
  - iii) The Various institutions themselves and finally
  - v) external factors like geography and history.

3. Empirical issues in determining the role of institutions

- From this it becomes immediate clear that the search for “high quality institutions” such as “good governance”, “conflict resolution mechanisms” and “effective property rights” is a very tricky task and the result depends heavily on context and external factors.
- It also finally dictates to the role of informal instituions despite, greater importance has been attributed to the role of formals like property rights as a mainstay among institutions of promoting growth (Besley and Ghatak 2009) and the role of the state in formalising and protecting such rights (Acemoglu and Johnson 2000, 2004).

CHAPTER THREE

INFORMAL INSTITUTIONS AND DEVELOPMENT

CHAPTER OUTLINE

In this chapter we will study

1. Informal institutions in Development
   - Informal institutions and how they matter for development
   - Primary roles of Informal institutions
   - Growth promoting institutions in developing countries
2. The debate behind the roles of particular institutions
   - The debate behind the role and which institutions are growth-promoting
   - Relationship between formal and informal institutions
3. Informal Institutions in Ethiopia

1. Informal institutions in Development

1. Informal institutions and how they matter for development

- The proposition that 'institutions matter' for economic growth and development has received intense attention
- Today the idea that institutions are one of the central factors explaining the Industrial Revolution and the differences in economic development around the world is widely accepted in academic and policy circles
- First of all, we are still **some way away from knowing exactly** which institutions in exactly which forms are necessary, or at least useful, for economic development in which contexts.
- **Are they formal or informal, and at what quality?**
  - It becomes immediate clear that the search for "high quality institutions" such as "good governance", "conflict resolution mechanisms" and "effective property rights" is a very tricky task and the result depends heavily on context and external factors

1.1. Informal institutions and how they matter for development

- Organizational economists have focused on *formal* institutions (Coase, 1937; Williamson, 1985; Barzel, 1982; Holmstrom & Milgrom, 1994 etc…)
- Formal institutions defined a deep determinant of development as a variable that **affects income per capita** via the proximate determinants of development (physical and human capital and the level of total factor productivity)
- Yet informal institution has also good place

1.1. Informal institutions and how they matter for development

- Grass-roots institutions, which are more likely to exist in a high-trust environment, can also **facilitate the accumulation of factors of production** and raise the level of productivity.
  - For example
    - In developing countries where credit markets are incomplete, revolving-credit and micro-credit schemes provide an alternative source of funds for those wishing to invest in physical or human capital
    - Collective action problems may well be resolved either by norms, or grass-roots institutions, leading to efficiency gains
    - Externalities are more likely to be internalised, and public goods provided, in societies where cooperative norms exist
- It is suggested that the presence of informal institutions can potentially lead **to higher levels of investment in physical and human capital and higher levels of total factor productivity**.
- Informal institutions, therefore, affect the level of income per capita, via their effect on the proximate determinants of development
- Hence, informal institutions, like formal institutions, can be thought of as a deep-determinant of economic development.

1. Informal institutions in Development
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1.1. Informal institutions and how they matter for development

- Informal institutions (e.g., morals, customs, traditions, norms, ideologies, and religion) will be economically productive in so far as they **encourage cooperation and reduce transactions costs** North (1990, p.138)
- "[e]ffective traditions of hard work, honesty and integrity simply **lower the cost of transacting** and make possible complex, productive exchange."
- If transactions costs can be minimised, this will **increase productivity** as more time and resources can be devoted to production
    - Cooperative norms and grass-roots institutions may lead to the resolution of collective action problems, increasing the level of productivity
- Grass-roots institutions may also facilitate the **accumulation of factors of production**
- In addition, high levels of trust will also increase the number of trades and increase the incentive for firms and individuals to **invest in either physical or human capital**

2. primary roles of Informal institutions

In developing country context informal institutions all have about three primary roles

1. *Institutions provide guidance*
2. *Institutions allow for routines*
3. *Institutions reduce uncertainty*

1.2. Primary roles of Informal institutions

Institutions provide guidance

- If institutions frame the behavior of individuals, they also, as a consequence, structure the incentives that individuals face in their activities.
  - In other words, if one cannot win a certain game by playing outside the lines, then the players will be motivated to develop the capabilities to play within the boundaries
  - If one know that he can only win by playing within the lines, it will force him to become good at hitting the ball within the limits of the court.
  - This will also guide my actions and my expectations regarding what my opponent in the game can or cannot do [In this sense, institutions **are "a guide to human interaction,**
    - So that when we wish to greet friends on the street, drive an automobile, buy oranges, borrow money, form a business, bury our dead, or whatever, we know (or can learn easily) how to perform

1.2. primary roles of Informal institutions

<u>Institutions provide guidance</u>

- Institutions through institutional outcomes affect the behavior of individuals by **providing incentives or placing restrictions**
- Institutions are thought to facilitate economic development in two broad ways: **reducing the costs of doing business (transaction costs**) and **ensuring competitive processes (Islam 2001)**
- In the first instance, development is the expansion of economic activity (markets), the degree to which individuals and groups are able to enter into arms-length transactions.
  - If the costs of transacting are high, then economic activity would be constrained. Institutions ease the effectiveness with which transactions take place, minimizing the costs of doing business
- In the second instance, competitive processes drive development by **ensuring efficiency**. Since institutions **determine the incentive structure** for affecting individual and group behavior, the rules governing the market affects the nature of how competitive that market will be

1.2. primary roles of Informal institutions

Institutions provide guidance

- The role of formal and informal institutions in many respects is about managing social relations, and therefore the **management of conflict**
- When humans come together in any form of activity they require rules to govern behavior and maintain the public good of harmony
  - Where these rules work poorly, social frictions may arise to increase transaction costs and reduce the effectiveness of these institutions

1.2. primary roles of Informal institutions

<u>Institutions provide guidance</u>

- Only efficient institutions are growth- promoting
- They encourage individuals to engage in productive activities by providing appropriate incentives and establishing a stable structure of human interactions, which reduce uncertainty

Posner (1998; in Chu, 2003) defined two types of efficiency:

- Substantive efficiency (i.e., a rule promotes allocative efficiency)
- Procedural efficiency (i.e., a rule is designed to reduce the cost or increase the accuracy of using the system of rules)

1.2. primary roles of Informal institutions

Institutions allow for routines

- By guiding actions, institutions facilitate social interaction in **our daily lives**
- For instance, driving on the right-hand side of the street is a rule which guides motorists in ways that permit the coordination of cars
- Such a coordination of vehicles happens because everyone follows the same rule, which facilitates the choices drivers must make on the road.
- As North explains, it is the existence of an imbedded set of institutions in our

  daily lives which **removes many difficult choices** that, in the absence of institutions, would have to be made in order to obtain social interaction
- On the road, we don't have to choose which side to drive on every time we encounter another vehicle because we all accept and follow the same rule.

1.2. primary roles of Informal institutions

Institutions reduce uncertainty

- It follows that institutions reduce the uncertainty of social interaction by providing a structure within which everyone can act.
- This function is very important because it allows for the coordination of plans.
- Indeed, one could not interact socially in the total absence of knowledge about what guides the actions of others in the social context.
- If I don't know the rules which my opponent will follow, I cannot engage myself in any game because it would be too uncertain.
- The same is true in the "economic game". Because institutions guide human action in the social context, they reduce the uncertainty of social interaction.
- To go back to the "rules of the road" example, the uncertainty every driver faces with regard to the actions of every other driver is reduced by the existence of rules. Because of rules, driving on the road is more certain.

1.3. Growth promoting institutions in developing countries

- Although there is now a consensus that institutions “matter,” the process of integrating institutions and institutional change into economic theory is still fairly new (Aron, 2000)
- Which institutions are growth- promoting is not yet completed
- Thus, the causality of the various links and channels of influence between the institutional set-up and development outcome is still not well or fully understood (Jütting, 2003).
- We can argue
  - **Only efficient institutions are growth- promoting- may be formal or informal**

1.3. Growth promoting institutions in developing countries

- Chu (2003) argues that affluence in developed countries is a cumulative result of **efficient institutions**; poverty in poor countries is a result of **inefficient institutions**.

- According to Greif (2005; in Carden, 2005), successful institutions are both contract-enforcing and coercion- constraining; that is, they reward production and exchange rather than expropriation and redistribution.

  - However, the institutional frameworks in developing countries "overwhelmingly favor activities that **promote redistributive** rather than **productive activity**, that create monopolies rather than competitive conditions, and that restrict opportunities rather than expand them" (North, 1990: 9; in Hasan et al., 2006)

3. Growth promoting institutions in developing countries

Key questions …

- **Is Institutional development/reform necessary?**
- **Can underdevelopment be overcome by simply importing institutions ?**

Is Institutional development/reform necessary?

- In previous years, the issue of institutional development or "governance reform" has become more prominent (Chang, 2005)
- If developing countries are poor because their current institutions provide a weak basis in terms of incentives that promote growth, this raised the question not only of what type of institutions they should acquire, but more importantly of **how they could develop such institutions**
  - There is more agreement in the literature on former rather than on the latter (Hasan et al., 2006)- reforming may be necessary

1.3. Growth promoting institutions in developing countries

Is Institutional development/reform necessary?

- As Shirley (2005) concedes, NIE has had less to say about institutional change, except that it is hard to accomplish.
- This is due in particular to the complex interactions between the different typologies of institutions (i.e., interaction between formal and informal institutions, between different levels of institutions, and between economic and political institutions), which have different horizons for change and are therefore subject to very different evolutionary dynamics.
  - Institutional reforms typically deal with formal institutions, which can be changed immediately
  - But informal institutions that serve to legitimize any set of formal rules, such as beliefs and norms, change only gradually.

1.3. Growth promoting institutions in developing countries

Should the reform be by simply importing institutions abroad?

- As Shirley (2005) if a country **chooses to adopt the formal rules** of another country, it will have very different performance characteristics compared to the original country if both the informal norms and the enforcement characteristics are different.
- This implies that transferring successful western market economies' formal political and economic rules to developing economies **is not a sufficient condition** for generating good economic performance (North, 2002).
- Another reason why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries is **<u>institutional path dependency</u>**. That is, those who make policy and design institutions have a stake in the framework they created, and will therefore resist changes that may rob them of power or property
  - North (1992) does note that path reversal is possible, and has occurred. However, it is a difficult process given that too little is still known about the dynamics of institutional change, especially the interplay between economic and political markets.

1.3. Growth promoting institutions in developing countries

Previous initiatives to tackle underdevelopment by exporting institutions

- the IMF and the World Bank and by many donor governments since the 1980s attempted to 'harmonize' institutions across countries so- called **'global-standard**' institutions for developing countries
- such pressure have been the IMF and the World Bank, which have increasingly attached 'governance-related conditionalities to their loans (Kapur and Webber, 2000).
- Developed country governments have strengthened such conditionalities by making their aids conditional on countries passing the 'health test' by the IMF and the World Bank
- In addition, the WTO's unique sanctioning power has made the adoption of institutions mandated by it (e.g., strong patent law) unavoidable.

1.3. Growth promoting institutions in developing countries

Previous initiatives to tackle underdevelopment by exporting institutions

- On the other hand, Since the late 1990s, the view that poor-quality institutions are the root cause of economic problems in developing countries has become widespread.
- In accordance, the IMF and the World Bank started to impose many 'governance-related conditionalities', which required that the borrowing country adopts 'better' institutions that improve 'governance' (see Kapur and Webber, 2000).
- Around the same time, many rich country governments also started to attach governance conditionalities to their bilateral aids. There is no agreed definition of what these 'better' institutions, often called the **Global Standard Institutions** (GSIs), are.
    - However, they are institutions that are typically found in Anglo- American countries, which are seen as maximizing market freedom and protecting private property rights most strongly.

1. Informal institutions in Development
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1.3. Growth promoting institutions in developing co u

Previous initiatives to tackle underdevelopment by exporting institutions

Was this initiative successful?

Possibly no

- First, the institution-free technocratic reform programmes promoted by the IMF and the World Bank and by many donor governments since the 1980s have almost universally failed.
- Many of these reform programmes blatantly **ignored institutional differences across countries**, thereby recommending identikit policies, in what has come to be known as the **'one- size-fits-all**' approach to economic policy.
- Today, it is widely accepted even by many orthodox economists that policies directly derived from the experiences of the developed countries – or, even worse, from economic textbooks – are **likely to fail in developing countries**, where certain institutions whose existence these policies take for granted (e.g., well-defined private property rights, a developed government bond market) simply do not exist.
- Of course, many critics point out that not only are many of the 'global-standard' institutions inappropriate for developing countries but they are also unlikely to **take root within the 5–10 years' 'transition period'** that is typically granted by international agreements that mandate the institutional change.

1.3. Growth promoting institutions in developing countries

Can underdevelopment be overcome by simply importing institutions ?

- Possibly no
- Thus, if a country chooses to adopt the formal rules of another country, it will have very different performance characteristics compared to the original country if both the informal norms and the enforcement characteristics are different
- This implies that transferring successful western market economies' formal political and economic rules to developing economies **is not a sufficient condition** for generating good economic performance (North, 2002).
- Another reason why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries is **institutional path dependency**

1.3. Growth promoting institutions in developing countries

Can underdevelopment be overcome by simply importing institutions ?

- That is, those who make policy and design institutions have a stake in the framework they created, and will therefore resist changes that may rob them of power or property (Shirley, 2005)
- North (1992) does note that path reversal is possible, and has occurred. However, it is a difficult process given that too little is still known about the dynamics of institutional change, especially the interplay between economic and political markets.
- This is not to say that developing countries cannot learn from the experience of developed economies.
  - Just that **pure institutional imitation is rarely enough**. Making imported institutions work would require some degree of adaptation. Some institutional innovation would also be required, that is, coming up with "unique" institutions (Chang, 2005).
  - This is where local knowledge is vital, since good institutions are heavily dependent on local context, traditions, habits, and political culture. Without local knowledge, it would be difficult to even understand how existing institutions actually work, much more how to reform them (Fukuyama, 2006).

1.3. Growth promoting institutions in developing countries

Can underdevelopment be overcome by simply importing institutions ?

- Thus, for institutional reforms to be successful, what is required is what Levy and Spiller (1994; in Shirley, 2005) refer to as **"goodness of fit"** between the specific innovation and the country's broader institutional environment
- In particular, Shirley (2005) describes a "good fitting" institutional innovation as one that is not dependent on absent or weak institutions, and is as much as possible insulated from or adapted to perverse institutions
- The successful developing countries such as the People's Republic of China; the Republic of Korea; and Taipei, China, which have almost always combined unorthodox elements with orthodox policies (Rodrik et al., 2004), bear this out

1.3. Growth promoting institutions in developing countries

Can underdevelopment be overcome by simply importing institutions ?

- This was also another key theme that Rodrik (2003) identified from a collection of analytical country narratives.
- That is, "Good institutions can be acquired, but doing so often requires **experimentation, willingness to depart from orthodoxy**, and attention to local conditions"
- Ignoring the role of local variation and institutional innovation would be adequate at best, and harmful at worse
- Since institutional and governance shortcomings vary across national contexts, the focus of institutional reform agendas must be on the most binding local constraints.

2. The debate behind the roles of particular institutions

1. The debate behind the role and which institutions are growth- promoting

- First of all, we are still some way away from knowing exactly which institutions in exactly which forms are necessary, or at least useful, for economic development in which contexts.
- For example, everyone may agree that a 'good' property rights system is essential for economic development. However, what is in fact a 'good' property rights system?
- That it is not necessarily Western-style private property rights system is clear from the excellent economic performance of China over the last two decades, where such a system simply does not exist.
  - To focus on a more concrete aspect, should this 'good' property rights system include strong intellectual property rights? That this may not be the case for developing countries was revealed in the debate surrounding the TRIPS (trade- related aspects of intellectual property rights) agreement in the WTO (Chang, 2001)

2.1. The debate behind the role and which institutions are growth-promoting

- Since the late 1990s, the view that poor-quality institutions are the root cause of economic problems in developing countries has become widespread.
- In accordance, the IMF and the World Bank started to impose many 'governance- related conditionalities- through what they call 'better' institutions, often called the Global Standard Institutions (GSIs),
- There is no agreed definition of what these 'better' institutions, often called the Global Standard Institutions (GSIs), are.
- However, they are institutions that are typically found in Anglo- American countries, which are seen as maximizing market freedom and protecting private property rights most strongly.

2.1. The debate behind the role and which institutions are growth-promoting

- Theoretical problems on *do better institutions lead to more effective economic development or effective economic development lead better institutions*
- The currently dominant discourse on institutions and development suffers from two categories of theoretical problems.
- The first is that it almost exclusively assumes that the **causality runs from institutions to economic development**, ignoring the important possibility that economic development changes institutions.
- Second, even when we focus on the 'institutions to development' part of the causality, the relationship is theorized in a rather simplistic, linear, and static way.

2.1. The debate behind the role ....

- *Do better institutions lead to more effective economic development or effective economic development lead better institutions*
- The currently dominant view is that institutions are the ultimate determinants of economic performance (e.g., for the latest statements along this line, see Acemoglu *et al.*, 2005; North, 2005)
- However, the causality in the other direction – that is, from economic development to institutions – is usually neglected
- Economic development changes institutions through a number of channels
- First, increased wealth due to growth may create higher demands for higher-quality institutions (e.g., demands for political institutions with greater transparency and accountability).
- Second, greater wealth also makes better institutions more affordable. Institutions are costly to establish and run, and the higher their quality the more 'expensive' they become (see below).
- Third, economic development creates new agents of change, demanding new institutions. In the 18th century, the rising industrial capitalists supported the development of banking against the opposition to it by landlords, while in the late 19th and the early 20th centuries, the growing power of the working class led to the rise of the welfare state and protective labour laws, against the capitalists who thought those institutions would bring about the end of civilization as they knew it

2.1. The debate behind the role and Which institutions are growth- promoting

- Indeed, there is quite a lot of historical evidence to suggest that the causality may be stronger in the latter direction (economic development improving institutions) than in the former (better institutions promoting economic development).
- Today's rich countries acquired most of the institutions that today's dominant view considers to be prerequisites of economic development *after*, not before, their economic development – democracy, modern bureaucracy, IPRs, limited liability, bankruptcy law, banking, the central bank, securities regulation, and so on (Chang, 2002a).
- More specifically, the Anglo- American countries, whose institutions today are considered to be GSIs, themselves did not have most of those institutions in their earlier stages of development and acquired most of them only after they became rich (Chang, 2005).
- If the causality runs more strongly in the **direction of development to institutions**, rather than the other way around,
    - ***The financial and human resources that developing countries are expending in order to acquire GSIs may be better <u>used for other policies that more directly stimulate economic development</u> – be they educational expenditure, infrastructural investments, or industrial subsidies – especially when they also indirectly promote institutional development, which can then further promote economic development.***

2.1. The debate behind the role and Which institutions are growth- promoting

- Further complicating the picture regarding causality is what may be called the 'late-comer' effect (Chang, 2002a)
- In the same way in which they can import better technologies without having to pay the full cost of developing them, late-comer countries can import superior institutions without having to pay for their development.
- Therefore, today's developing countries tend to have institutions that are more developed than what their standards of material development would strictly demand, making it difficult to identify the exact relationship between institutions and development
- Given all of this, by almost exclusively looking at one direction of causality, that is, from institutions to economic development, the currently dominant discourse on institutions and development gives us **only a partial picture.**
- We need to look at the causality in the other direction as well, if we are to have a full understanding of how institutions and economic development interact with each other and give the right policy advice.

2.2. Relationship between formal and informal institutions

- Informal institutions interact with formal institutions as they affect outcomes in four stylized ways (Helmke and Levitsky 2004):

    1. Complementary
    2. Accommodating
    3. Competing
    4. Substituting

2.2. Relationship between formal and informal institutions

<u>**Complementary**</u>

- Informal institutions are complementary with formal ones when they converge and the formal institutions are effective.
- Suppose that a new state decides to adopt better anti-corruption laws
  - The content of the specific laws may matter very little if in fact pre-existing norms already form informal checks and balances on public officials. In this scenario, knowing what about anti-corruption law matters requires that one understand how the norm and law interacts to form the beneficial outcome. Both might reinforce the check on corruption, or the formal laws (due to some quirk) may hinder the informal checks in place.
    - Yet again, the formal law may evolve to be an even better check than previously existed, since the informal 'norm' might have evolved only as a second best solution.

2.2. Relationship between formal and informal institutions

Accommodating

- the informal institutions may accommodate the formal ones when they diverge and formal institutions are effective by not violating the letter of the law but violating its spirit.
- In other words, it coexists with the formal institution and drives the outcome that is not entirely intended by the formal rules.
- The hiring practices of many universities, where departments tend to hire each others students despite formal search committees that go through the motions of interviewing other candidates and writing reports might be a good example of accommodating institutions. The letter of the law is followed; committees are set up, they meet, they review applicants etc, but the spirit of the law is violated because the committee has already agreed informally on the outcome.
- Here again, the outcome might be more efficient because hiring committees may run the risk of being hamstrung by veto players, delaying the process and perhaps souring good relations within departments. Formal committees might spend time and money debating candidates.
  - Thus, even if the informal institution may be identified as corrupt, it might be more efficient. The desirability of the rules depends on the criteria for judging (efficiency versus fairness).
  - It should be recognized that much formal institutions are products of politics, which means fairness criteria will have mattered as much as efficiency ones in what has determined them (Soltan 1998).

2.2. Relationship between formal and informal institutions

Competing

- Informal institutions compete with formal ones when formal institutions are ineffective and the two diverge.
- This is true where formal law is poorly enforced, or simply ignored by authorities. The literature on legal pluralism shows how people resort to multiple sources of justice where competing laws and norms operate at various levels, particularly where inherited legal systems after colonial rule operate side by side with customary law.
- This situation exists because states do not feel the need to enforce the laws (they ignore it) or they do not necessarily have the capacity to enforce (costs are too high).
- In this instance, not accounting for state capacity to enforce formal institutions in any analysis of any relevant outcome potentially yields highly biased insights. Here again, the criteria used to judge the outcomes are crucial.
- While many laws protecting women and human rights in poor countries may exist on the books, customary laws contravene these rights in practice.

2.2. Relationship between formal and informal institutions

Substituting

- informal institutions can substitute for the lack of effectiveness of formal institutions.
- Like complementary institutions, these informal institutions are designed to achieve what formal institutions should be doing but is ineffective or ignored by official sources.
- Informal credit markets and insurance schemes might very well be thought of as substitutions for formalized market or state organs that usually provide such services.
- Informal neighborhood associations that form to prevent crime or collect garbage off streets may be substituting a city government's function.
- Since many of these voluntary associations pose little threat to formal institutions, they are usually encouraged by state authorities.
- However, such voluntary groups may also form vigilante groups, such as the 'Minutemen' in the US that have taken upon themselves the task of policing the US-Mexican border
- The effectiveness of formal versus informal would have to be judged on the desirability of the outcome—again efficiency versus fairness.

3. Informal Institutions in Ethiopia

- It has been argued that informal institutions and institutional mechanisms (governance structures) contribute a lot for development and explain differences in growth rates and development paths in developing countries
- But what are these informal institutions in Ethiopia?
- The study by **Habtu (2012)** obtained the possible informal governance structures in Ethiopia such as Iddir, Mahber, Eqqub, Elder's Group, Gadaa/Cheffe Kore, Debo/Wobera/Wonfel/ Oxen sharing (labor sharing) and Women's Association

3. Informal Institutions in Ethiopia

- These informal institutions or governance structures engaged in different economic and social activities.
- The major benefits include risk coping, provision of credit, common property regulation, manpower and traction force, conflict resolution and information.
- Based on the functions they provide as primary, secondary and none, we classified these informal institutions/governance structures in to three major categories:

    i) Which cover a large range of governance issues,

    ii) Which avoid specific market failures and

    iii) That serve social duties and conflict resolution

3. Informal Institutions in Ethiopia

- As a signal of their role, significant number of the people of Ethiopia is members of the informal institutions
- Some of these institutions played a significant role in various activities
  - Mainly in natural resource management as a means to address the needs of people and the environment in a way that is also participatory (Degefa, 2010),
  - In credit and saving (e.g., Eqqub), informal burial institutions (e.g., Iddir) and others which have greater contribution in development agenda.
  - Moreover, these institutions help the poor in addressing the destructive effects of shocks and insuring them to cope with the high cost of funerals and health related issues (Mariam, 2003).

3. Informal Institutions in Ethiopia

Iddir

- Iddir- is one of the informal or local informal institutions in Ethiopia established voluntarily by the community and involved in self-help and other social activities. Iddir is established primarily to provide mutual aid in burial matters but also to address other community concerns (Pankhurst & Mariam, 2000).
- It is an association established by a group of persons united by ties in families, friendship, neighborhood, or belonging to the same job (Teshome, 2008). Furthermore, Iddir is a local association with long history, most widespread, commonly known in rural and urban settings of Ethiopia
- It organizes people according to gender, generation, wealth, education, religion, kinship, ethnicity and some other special relations. To mention some of the associations the Iddir formed: *Iddirs* based on professions like the teachers' *Iddirs,* on gender such as women's *Iddirs,* or on ethnicity or clanship such as those formed by migrants from specific areas.

3. Informal Institutions in Ethiopia

Mahber/Senbete

- Mahbers/Senbetes- are voluntary and mutual aid community (religious) associations peculiar to Orthodox religion followers. The members gather together at church or in one of the member's house so as to pray together to get blessing from God and saint and discuss their problems and further share information.
- In doing so, the members bring food and drinks to church to feed the poor and themselves and discuss matters of common interest (Moges, 2006).
- Mahbers are also very crucial informal institutions involved in various community activities such as risk coping, provision of information, addressing manpower and traction force and conflict resolution. Also People in the sample were asked if their 5 best friends in the same Mahber.
- Accordingly, the IFPRI ERHS data revealed that, 28% of the households are members of the same Mahber and the rest (72) are not. The number of the members looks smaller. One important reason could be the Mahber members are those who have 5 best friends. And the other might be those members who are only Orthodox religion followers.

3. Informal Institutions in Ethiopia

Eqqub

- Eqqub- is an informal institutions established voluntarily to collect a specific amount of money from the members on a specific date to be paid on round and lottery basis to the members. The members know each other and thus trust each other to make the Eqqub function smoothly (Dessalegn and Aklilu, 1999; Desta, 1995). Interestingly enough, Eqqub also lends a hand to the members in many aspects such as provision of credit and sharing important information.
- The IFPRI ERHS shows only 10% of the interviewed households were members of an Eqqub. This could be, the people in the Eqqub are gathered only for pooling of money but do not have well established group like other informal institutions such as Iddir, Mahber, etc and have no another purposes.

3. Informal Institutions in Ethiopia

Debo/Webera /Jigie/ Wonfel(Labor sharing)

- Debo/Webera /Jigie/Wonfel/oxen or labor sharing- are arrangement of agricultural work groups in rural Ethiopia that create structures for "pooling the labor of a number of people from an area to assist one or more individuals with building a house, cultivating a large piece of land, or ploughing, harvesting crops, clearing forests for ploughing and similar tasks through promises of future reciprocity among member participants (Getachew, 1998; Daniel, 2003)
- But in Debo or Wobera, a form of festive labor, where a person will provide food and drink for a large work

3. Informal Institutions in Ethiopia

Gadaa /Cheffe Kore/ Kedo Aba

- Gadaa/Cheffe Kore/Kedo Aba/Seera - is one form of social organization based on the age- grade classes of males that succeed every 8 years to serve the community in economic, political, military and social issues.
- The system assigns right and obligations or responsibilities to all males in the society (Edossa et al., 2007).

Elder's group

- Elder's group- commonly called Shimagelay is a traditional association of Elders people who are elected by the local community in order to serve the society in times of disagreements and coordinate them in common resource management like water and forest and disseminate information (Frankenberger et al., 2007; Spielman et al., 2008).

Women's Association

- Women's Association- is a voluntary association of women group who have explicit agreement to help each other in a specified way when well-defined events occur. These associations help the members in cash or in kind, in capacity building and by sharing of information (Dercon et al., 2005).

CHAPTER FOUR

PROPERTY RIGHTS INSTITUTIONS IN DEVELOPMENT

CHAPTER OUTLINE

In this chapter we will study

1. Property rights basic concepts

- Definition and types/regimes of property rights
- Characteristics of property rights
- A property rights structure **key components:**

2. Property rights theory

- Property rights and transaction costs, productivity, interest and value
- **Two important discourses that are related to property rights**

3. The economic role of property rights

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1. Property rights basic concepts

1.1 Definition and types/regimes of property rights

Property

- Many people regard property as a tangible 'physical object' Institutional economists use a different conceptual language
- ***Property*** is considered as a "benefit (or income) stream" in that the owner controls this benefit stream (Bromley 1991)
- Something is "property" if it has value to someone after costs are considered
    - Property is not a thing
    - Property is about rights in a thing
    - Property is a social relation
    - Something is a "property" if it has value to someone after costs are considered

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1. Property rights basic concepts

1.1 Definition and types/regimes of property rights

What is a "Right"

- *A right* may be a 'set of actions and behaviors that possessor of a property may not be prevented from undertaking, or a duty on all others to refrain from preventing those actions or behaviors'
- Therefore, rights are not relationships between the right holder and an object, but rather are relations between the right holder and other people with respect to the object (Bromley 1991:15)

Recognized, Enforced

1. Property rights basic concepts

1.1 Definition and types/regimes of property rights

What is a property right?

- Property Rights, are the social institutions that define or delimit the range of privileges granted to individuals to specific resources, such as parcels of land or water
- Property rights refer to the sanctioned behavioural relations among actors that arise from the existence of physical entities and focus on the cost and benefit streams from using them Effectively, property rights assignments specify the norms of behaviour with respect to these cost and benefit streams that each person must comply with, or bear the cost for non-compliance
- “Rights individuals appropriate over own labor and goods and services they possess
    - Right to exclude non-owners from access;
    - Right to appropriate the stream of economic rents; and
    - Includes “fruits” of labor and “fruits” from goods and services
    - Includes rights to trade property

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1. Property rights basic concepts

1.1 Definition and types/regimes of property rights

- Claims to use or control a resource that are recognized as legitimate by some entity(ies) larger than the individual and protected through some type of social or legal sanction
- *A property right is a bundle of characteristics that convey certain powers to the owner of that right*
- **Property rights** - legal rights to use an economic property (resource) and to derive income and benefits from it
- **Patents** - legal rights awarded by government authorities to inventors of new products or processes, who are given exclusive (monopoly) rights to derive income from inventions through activities such as manufacturing, licensing, or selling

1. Property rights basic concepts

1.1 Definition and types/regimes of property rights-Some issues

- Categories:
- "Bundles of rights" including access and withdrawal, exclusion, management and alienation rights (Schlager and Ostrom 1992: 249-251)
- The right to use the asset
- The right to appropriate the return from the asset
- The right to change its form, substance and location

1. Property rights basic concepts

1.1 Definition and types/regimes of property rights

- Property rights are weak if transaction costs are high!
- Property right holder has an "ability, without penalty to exercise a choice over a good, service, or person" (Allen 1998)
- Property rights to a resource are social and institutional arrangements by which individuals are aware of what parts of the resource are their and others' property, what duties are imposed on them and upheld by the state (Bromley 1991)
- Property rights define: "who has access to which resources or benefit streams and under what conditions" (Vatn 2005)
- Property rights are 'rules of the game' (Williamson 1998)

1. Property rights basic concepts

1.1 Types/regimes of property rights

- Property regimes can be defined as a **structure of rights** and duties characterising relationship between individuals with respect to specific good or benefit stream (Vatn, 2005)
- Property regimes consist of two elements (1) property regimes which govern use and transfer of rights to a resource and (2) rules can govern the transactions concerning the results from the resource use
- Property regimes:
  - **Private:** private, individual
  - **Common:** as a private of a group of co-owners
  - **State (public):** national or local state
  - **Open access:** no property

1. Property rights basic concepts

1.1 ......Private Property Rights

- Assigns ownership to individuals-Individual or "legal individual" holds rights
- Guarantees those owners control of access and the right to bundle of socially acceptable uses
- Requires owners to avoid specified uses deemed socially unacceptable
- Private ownership may lead to most efficient resource use and management
- Private ownership must be consistent with the social norms and traditions of the society and then they could work appropriately

1. Property rights basic concepts
2. Property rights theory
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1. Property rights basic concepts

1.1 ……Private Property Rights

- Private
  - “Single” owner - natural or corporate person
  - Complete control
  - Owner assumed to maximum long-term value of property
    - Capital asset value (resale value)
      - Protects against misuse
      - Optimizes rate of utilization
    - Income flow - make best economic use of property

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1 Property rights basic concepts

1.1 ……Private Property Rights

Advantages of Private PRs

- Private PRs can decrease transaction costs
- Government allocates property rights; market allocates resources
- Private PRs have low administration costs & minimize government price intervention
- Private PRs can be decreased to remove externalities
- Private PRs adjust automatically to market changes
- Regardless of distribution, efficiency can be ensured

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1. Property rights basic concepts

1.1 ……Private Property Rights

Limitations of Private PPs

- Distribution of property rights is subject to rent-seeking, corruption, & political interest
- Major distributional implications: give rights to whom, for free or for a price, through auction?
- Private PRs are most applicable to land & soils, water, and minerals but less applicable to mobile resources
- Not suitable if the resource itself generates significant, widespread externalities

1 Property rights basic concepts

1.1 ………Common Property Rights

- They could be defined as private rights to a group of co-owners (Bromley 1991)
    - Owned by an identified group of people
    - Owner group has right to exclude non-owners (exclusivity characteristic)
    - Group (eg community) holds rights
    - Can manage, exclude others
    - Importance of rules to manage, distribute
- They are more appropriate if externalities or public goods are not dominating
- They consist of access, use and control rights to the resource
- At local level, they could be combined with private use rights (regulated by the community institutions)
- 'Tragedy of the commons' (Hardin 1968)

1. Property rights basic concepts
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3. The economic role of property rights

1 Property rights basic concepts

1. ………Common Property Rights

- Owner group has duty to maintain property through constraints placed on use
- Often implemented for common-pool resources
  - Difficult to divide or bound these resources
- Still rivalries consumption within group
- Community addresses efficient use through rules and means
- Right of control is collective rather than individual, due to absence of complete set of contractual relations governing duties of individuals
- Membership in group limited by legally recognized and enforceable rights

- Common pool ("commons")
  - Open to a defined group
  - Problems arise as scarcity increases
    - Do users have means for "effective control"

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1 Property rights basic concepts

1. ………Common Property Rights

- Membership in group is limited by legally recognized and practically enforceable rights
- Common property rules and resource use can break down if defined group grows too large or there is significant technical change
  - May pay any one individual to break ranks and maximize individual utility at expense of community's overall interests
- Lies between open access and private property
- Local Commons
  - Local commons are often assets owned by reasonable small communities, such as villages
  - Local commons include grazing lands, inshore fisheries, collectively managed irrigation systems, subterranean aquifers and oil reserves, wildlife, some forests

1 Property rights basic concepts

1. ………Common Property Rights

- Local vs Global Commons
  - Two Main Differences

1. Local: Main members of local commons (community) are few enough to be known to each other with observable actions
   - Gives incentives for cooperative behavior
2. Global: Absence of potential for intervention by state more powerful is more powerful than any individual
   - For example, in the case of governments making decisions about global ocean issues, this means that no world government exists to tackle this issue

1 Property rights basic concepts

1. ………Common Property Rights

- Common property and open access have often been confused in the literature
  - Under common property, the *right of exclusion* is assigned to a well-defined group
  - Under open access, a *right of inclusion* is granted to anyone who wants to use the resource
  - If (1) information is perfect and (2) there are no transactions costs, regulated common property and private property are equivalent from the standpoint of the efficiency of resource use
    - Both property regimes can support a Pareto-optimal equilibrium

1.1 ………Common Property Rights

Tragedy of the Commons?

- Open access resource
  - tragedy inevitable when use exceeds sustainable level
- Common pool resources
  - tragedy less likely but control mechanism must be effective

1. Property rights basic concepts

1. ……State Property Rights/Public Property
    - State holds rights
    - Is it effective in managing, excluding?
- Owned by citizens of political unit
- Rule-making authority assigned to public agency
- Public agency has duty to ensure that rules promote social obligations
- Citizens have right to use resource within established rules
- More appropriate if externalities or public goods aspects dominate
- Combined with regulated individual use rights through concession and licensing
- Management by state agencies or through regulations & incentives
- Global conventions & international mechanisms for global public goods and externalities

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1. Property rights basic concepts

1.1 ……Open Access

- No effective management
  - Access to resource use is not restricted
  - Lack of property rights or ownership
  - No exclusivity – exclusive use
  - Rivalrous consumption with depletion
  - Its exploitation results in symmetric or asymmetric externalities
  - Agents have to decide whether or not they should ‘enter’ and start exploiting the resource
  - Their choice is based on comparison between price of entry they have to bear (their opportunity cost) and expected returns

1. Property rights basic concepts

1. ……Open Access
   - As long as net expected benefit is positive, they decide to enter and exploit the resource
   - Open to anyone to use
   - Use will increase until no user can make a profit
   - Degree of scarcity is critical issue
     - Degradation will occur if level of use exceeds sustainable level
   - The problem is that their private evaluation of expected benefits does not take into account the fall in others' incomes which is caused by their entry

1. Property rights basic concepts
2. Property rights theory
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1. Property rights basic concepts

1. ……Open Access

- By their action, they impose an externality on the other agents
- Since they do not account for it, resulting situation will be typically Pareto inefficient
- Source of inefficiency in open-access situations lies in fact that agents use non-free resources (resources carrying a positive opportunity cost)
- Problem is simply that there is no way in which the resource exploiter can reap future benefits of restraint in the present and total amount of exploited resource is independent of the individual decisions taken by the participants
- A distinction can be drawn between unfettered open access and open access which is managed by some form of regulation
- Regulated open access is open access which is managed by some form of regulation

1. Property rights basic concepts
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1. Property rights basic concepts

Hybrid Property Rights

- Combinations of alternative property rights regimes
- For example, state and private property

- Unregulated vs Regulated Common Property
  - The group, or community, must control both:
    - Access to the resource and
    - its use by members of the community
- Unregulated vs Regulated Common Property
  - *Regulated common property is a common property regime in which group with exclusive right of access to a particular resource succeeds in designing and enforcing rules or arrangements that allow them to control the use of the resource in a systematic and effective manner*
  - In other words, human groups (of restricted size) can impose enough discipline upon their members to save common property resources from destruction or degradation

1. Property rights basic concepts
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1. Property rights basic concepts

1.1 Types/regimes of property rights

Types of Property-Right Regimes (Hanna et al 1996)

Regime	Owner	Owner rights	Owner duties
Private property	Individual	Socially acceptable uses, control of assets	Avoidance of socially unacceptable uses
Common property	Collective	Exclusion of non-owners	Maintenance, con-strain rate of use
State property	Citizens	Determine rules	Maintain social objectives
Open access	None	Capture	None

1. Property rights basic concepts
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1. Property rights basic concepts

1.1 Types/regimes of property rights

Bundles of Rights Associated with Positions

	Owner	Proprietor	Claimant	Authorized user	Authorized entrant
Access	X	X	X	X	X
Withdrawal	X	X	X	X	
Manage-ment	X	X	X		
Exclusion	X	X			
Alienation	X				

Source: E Ostrom and Schlager (1996: 133)

1. Property rights basic concepts

1.2 Characteristics of Property Rights

- Characteristics of a given "thing" affect how rights are "structured"
- Use and manage - control of property
- Income - right to receive it
- Capital - use for production of income
- Possession - physically occupy
- Security - borrow against it
- Absence of term - rights don't terminate
- Prohibition of harmful use - can't create hazards or nuisances
- Residuary character - owner has all rights not specifically excluded

1. Property rights basic concepts

1.2 Characteristics of Property Rights

- **Key components:**
- Property rights entail ***rights*** with respect to benefit streams of value and ***duties*** of others to respect those rights
- Granting rights and enforcing duties requires ***competent legal or social authorities*** who can be called upon to enforce rights and duties In some cases the authority may need to defend individual rights over the apparent interests of the collective

The Legal Pluralism Approach

- **property rights are supported by formal state legal systems, communities, customary authorities, projects and programmes that modify the distribution of power**
  - **implies opportunities for “forum shopping” and “negotiation over resource use and resource rights” A key role for research is to provide objective support to these negotiations**

1. Property rights basic concepts

1.2 Characteristics of Property Rights- Efficient property right structures

Generally, Property rights have the following main characteristics

1. Universality
2. Exclusivity
3. Transferability
   - Voluntary exchange
4. Enforceability
   - Secure from involuntary seizure
5. Security

1. Property rights basic concepts

1.2 Characteristics of Property Rights

1. Universality

- *All resources or assets are privately or collectively owned and all entitlements must be completely specified and effectively enforced*

1. Property rights basic concepts

1.2 Characteristics of Property Rights

2. Exclusivity

- *All benefits and costs from use of a resource accrue to the owner*
- Holder, whether individual or group, has exclusive use, and doesn't have to share the resource with others
- Applies to resources owned in common or privately by individuals (including firms)
- <u>Durability</u> is an important feature of exclusivity
- *Duration of a property right – durability -- is the length of the entitlement*
- Length of entitlement can range from renting (shortest) to leasing (longer) to ownership (longest)

1. Property rights basic concepts
2. Property rights theory
3. The economic role of property rights

1. Property rights basic concepts

1.2 Characteristics of Property Rights

3. Transferability

- *All property rights should be transferable from one owner to another in voluntary exchange*
- Transferability provides the owner with an incentive to conserve a resource beyond the time the owner is expected to use it
- Allows arbitrage efficiency or gains from trade
- Divisibility is an important feature of transferability
- Divisibility facilitates transferability

1. Property rights basic concepts

1.2 Characteristics of Property Rights

4. Security

- *Property rights should be secure from involuntary seizure or encroachment by other individuals, firms, or governments*
- Owner has incentive to improve and preserve a resource while under his/her control rather than exploit the assets
- If the owner cannot enforce exclusivity, then cannot enjoy all benefits and rights

1. Property rights basic concepts

1.2 Characteristics of Property Rights- key attributes of property rights

- One's property rights to a particular benefit stream are rarely absolute
- From the perspective of the right holder, key attributes of property rights are <u>assurance</u>, <u>duration</u> and <u>breadth</u>
- <u>Assurance:</u> probability of enjoying the same right in a future period
- <u>Duration</u>: length of time period of right
    - *Tenure defined* the distribution, assurance, breadth and duration of rights and duties to resources / property

1. Property rights basic concepts

1.2 Characteristics of Property Rights

Property rights: de jure and de facto

- De jure: property as defined legally
- De facto: property in practice
    - Difference is unit of enforcement
- Relationship between de jure and de facto
    - Match
    - Co-existence
    - Conflict

1. Property rights basic concepts
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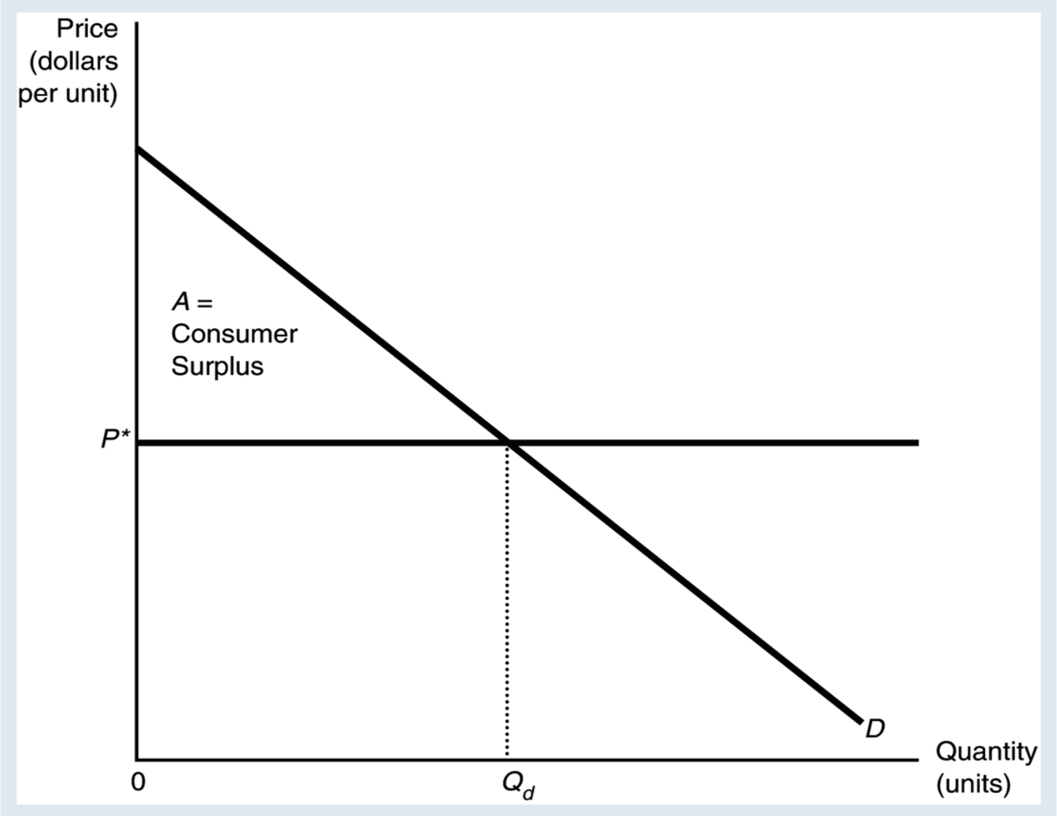
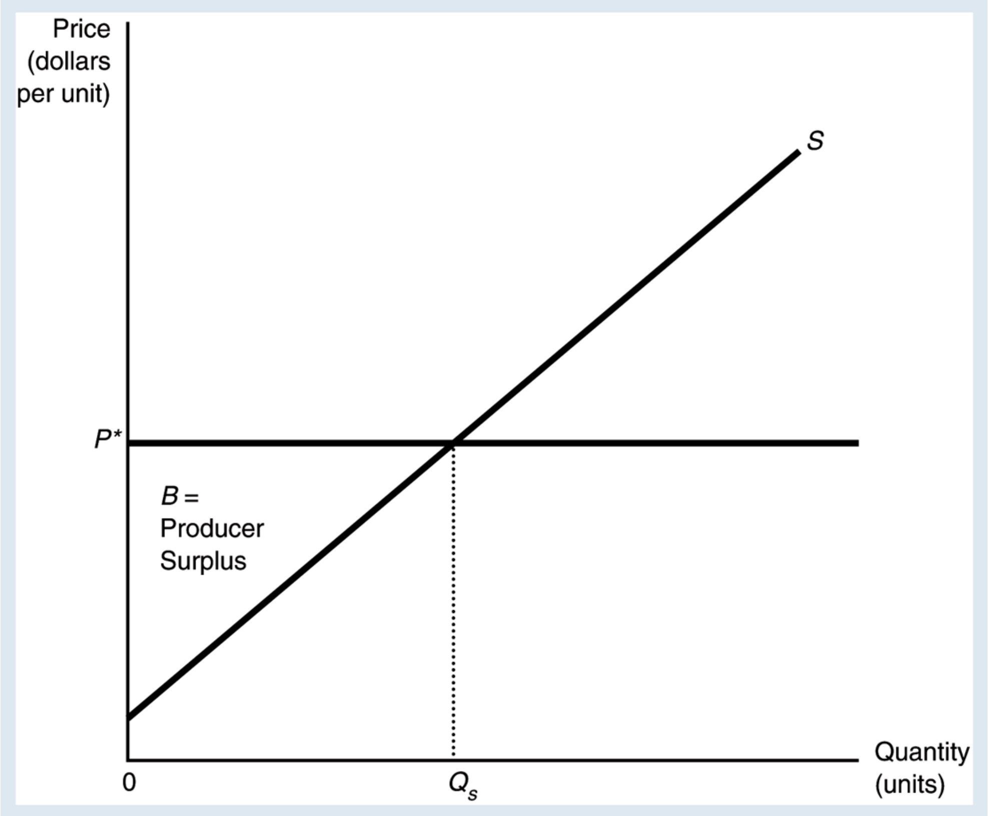
1. Property rights basic concepts

1.2 Characteristics of Property Rights- Efficient property right structures

Consumer's choice



Producer's choice



1. Property rights basic concepts
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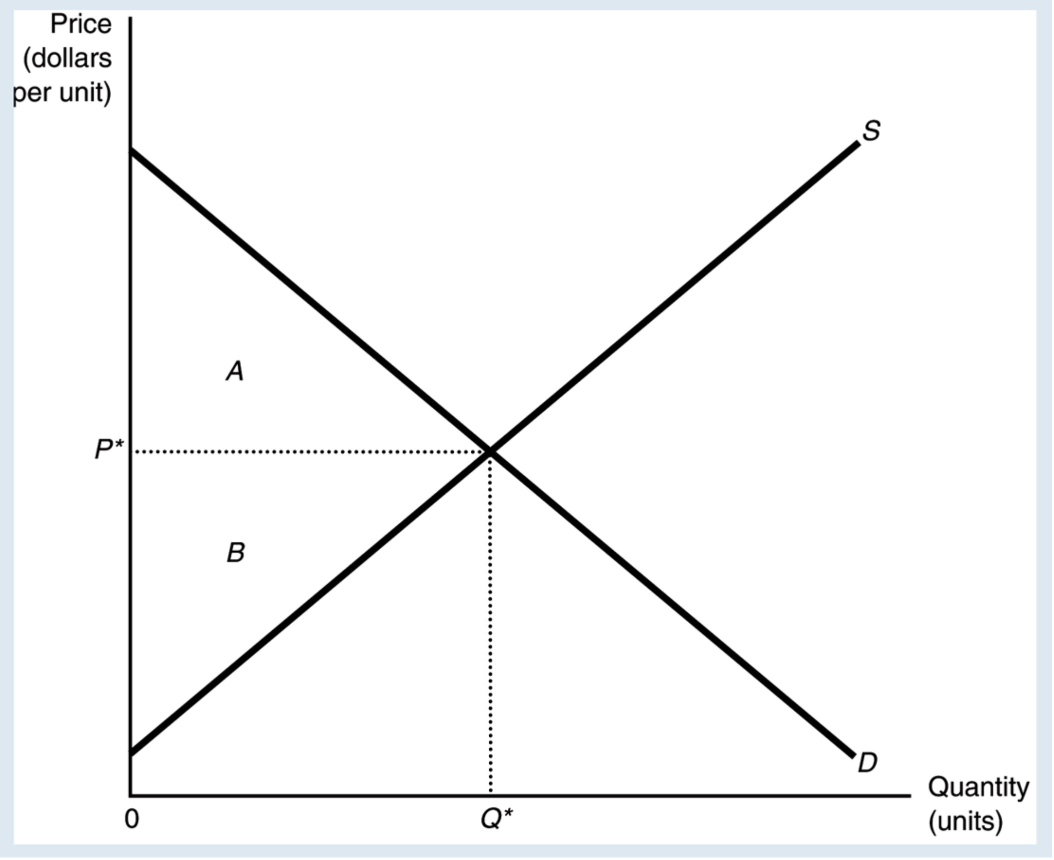
1. Property rights basic concepts

1.2 Characteristics of Property Rights- Efficient property right structures

Market equilibrium



In a system of well-defined property rights, consumers and producers act in own self interest, resulting in an efficient outcome (invisible hand)

2. Property rights theory

Two Important Discourses that are Related to Property Rights

- The Tragedy of the Commons
- The Coase Theorem

2. Property rights theory

The Tragedy of The Commons

- The lack of clearly defined property rights and ownership can lead to an inefficient allocation of resources
  - Greenhouse effect (global warming)
  - Over-fishing
- If many people have the right to use a single shared resource, then they have an incentive to overuse the resource
- If many people share the obligation to provide some resource, then they have an incentive to undersupply that resource

1. Property rights basic concepts
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2. Property rights theory

- To maintain the stock of fish, a large enough portion must survive for breeding. If large numbers hold commercial fishing rights, there is a danger of overfishing, (too many taken for recovery)
- An appropriate assignment of ownership or property rights might alleviate this problem:
  - Group ownership A fishery association gains exclusive right of control
    - Rights to determine who may fish
    - For how large a total catch, and
    - Rules of fishing (hours and seasons when allowed, mesh size of nets, etc)

2. Property rights theory

- Individuals are assigned rights to participate in various ways
  - They could share the total catch equally, or be assigned a quota
  - The association has a collective incentive to safeguard the fish population
- Problems: it may be costly to keep out interlopers, there may be severe moral hazard problems among the individual members of the association (cheating on the quota), differing ideas about how many can safely be taken, etc

2. Property rights theory

- Single Ownership This approach works well with private ownership (*eg,* private automobiles)
  - Same incentives to preserve the resource
- Major problem: deciding who will be the lucky owner
- Rotating property rights is terribly inefficient, (permits over-harvesting since current fisher doesn't gain from preserving a harvest for next year)
- Rights could be auctioned and the highest bidder could compensate losers by distributing proceeds of the auction among them
  - But it's hard to determine just compensation

2. Property rights theory

- Libecap (1989): Contracting for Property Rights
- North (1990): Institutions, Institutional Change and Economic Performance
- Barzel (1989): Economic Analysis of Property Rights
- Eggertsson (1990): Economic Behavior and Organization
- Hart (1995): Firms, Contracts and Financial Structure

1. Property rights basic concepts
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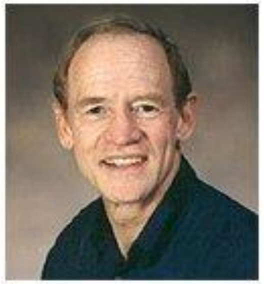
2. Property rights theory



Libecap (1989): Contracting for Property Rights

- Property rights provide the basic economic incentive system that shapes resource allocation
- Libecap (1989) maintains that property rights are formed and enforced by political entities, and that property rights reflect the conflicting economic interests and bargaining strengths of those affected
- Property Rights, are the social institutions that define or delimit the range of privileges granted to individuals to specific resources, such as parcels of land or water
    - Right to exclude non-owners from access;
    - Right to appropriate the stream of economic rents; and
    - Right to sell or otherwise transfer the resource to others

2. Property rights theory

Libecap (1989): Contracting for Property Rights

- Property rights institutions range from formal arrangements, including constitutional provisions, statutes, and judicial rulings, to informal conventions and customs regarding the allocations and uses of property
- Such property rights institutions critically affect decision making regarding resource use and, hence, affect economic behavior and economic performance
- Pressures to change existing property rights can emerge from the following factors:
    - Shifts in relative prices;
    - Changes in production and enforcement technology; and
    - Shifts in preferences and other political parameters
- All else being equal, the greater the size of the anticipated economic benefits of institutional change (the greater the economic losses of the common pool), the more likely new property rights will be sought and adopted because it is more likely that a politically acceptable share arrangement can be devised by politicians to make enough influential parties better off so that institutional change can proceed

1. Property rights basic concepts
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2. Property rights theory

North (1990): Institutions, Institutional Change and Economic Performance

- North (1990) abandons the efficiency view of institutions, which he himself promoted in the 1970s, and maintains that **rulers devise property rights in their own economic** interests and that **positive transaction costs result in the persistence of inefficient property rights**
- As a result, it is possible to provide an account for the widespread existence of property rights throughout history (and in the present) that did not produce economic growth
- The contrast between the neoclassical assumptions about the evolution of property rights evolving toward efficiency and the performance of economies (however defined and measured) is surprising
- The forcible power of the state has been employed throughout most of history in ways that have stymied economic growth

1. Property rights basic concepts
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2. Property rights theory

North (1990):

- The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the third world
- Enforcement in the third world economies is uncertain not only because of ambiguity of legal doctrine (a measurement cost) but also because of uncertainty with respect to the behavior of the judicial system
- Property rights and economic incentives are the underlying determinants of economic performance
- One gets efficient institutions by a polity that has built-in economic incentives to create and enforce efficient property rights
- Path dependence is the key to an analytical understanding of long-run change in property rights

1. Property rights basic concepts
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2. Property rights theory

Eggertsson (1990): Economic Behavior and Institutions

- Property rights to a resource are often partitioned
  - For example, in the case of land, person A and person C may possess the right to dump ashes on the land, person A and person B may possess the right to grow wheat on the land Person C may possess the right to dump ashes on the land Person D may possess the right to fly an airplane over the land And each of these rights may be transferable
  - In sum, private property rights to various partitioned uses of land are "owned" by different persons

1. Property rights basic concepts
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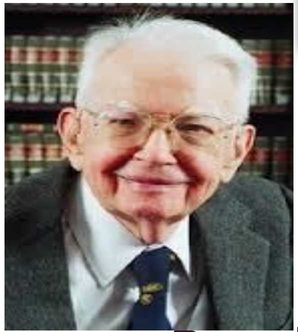
2. Property rights theory:



The Coase Theorem

- Initial Assumption of Coase: Production and exchange can be solely carried out through the price mechanism
  - (However) In the process of determining price rate, there is a cost of discovering prices (Cheung 1983)
- The idea that "Perfect markets direct all production in the absence of transaction costs (zero)" is a fiction, leading to the Coase Theorem:

2 Property rights theory: The Coase Theorem

- "In the absence of transaction costs, the most efficient solution to maximize aggregate income will be obtained irrespective of the original distribution of resources or liability" (the Theorem)
- However, if transaction costs are positive, then property rights institutions do matter. This occurs in a real world
- Later on, he introduced the notion of positive transaction cost, which is the cost of carrying out market transactions: costs of organization (the contribution of Coase to NIE)

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2 Property rights theory: The Coase Theorem

- **Coase (1937)**
    - **Market exchange is not costless**
    - **Firms emerge to economize on transaction costs**
    - **Boundary of the firm determined by nature and extent of transaction costs**
- <u>**Question**</u>: Imagine a private library located next to a hotel organizing a night-club, where noise pollution can undermine the use of the library affecting the business of the library owner. Would private bargaining between the two resolve the externality problem without involvement of the state?
- Infact bargaining will enable the two parties settle the conflict b/n the two parties but it depends on the profit that each firm make at each specific time.
- For instance if the night club is making higher profit during the night than day, it has to componsate the library owner for the decline of its customers and hence its profit the amount equal to the difference b/n the profit obtained with out the sound polution and with sound poution Under this condition the night club organizer It depends on the amount of profit each firm gains at agiven specific time

2 **Property rights theory**: The Coase Theorem

Example 1: Smoking

- Two people are sitting in a room: A is smoker, B is non-smoker
- Smoking causes for A a benefit of 5 Birr, but for B a harm of 6 Birr The social optimum, therefore is Non-Smoking

 (1) A has the right to smoke B negotiates with A and offers 5 Birr if A doesn‘t smoke A accepts and doesn't smoke

 (2) B has the right to clean air A negotiates with B and offers B 5 Birr if he is allowed to smoke B refuses and A doesn’t smoke

- In both cases A doesn’t smoke! The allocation is the same
- However, the cases have very different distributional impacts (1) A has a net utility of 5 Birr, B of 1 Birr (2) A has a net utility of -0 Birr and B a net utility of 6 Birr

2 Property rights theory: The Coase Theorem

Example 2: Nitrate

- Farmer use fertilizer to increase their yields, simultaneously they pollute the groundwater with nitrate
- Water companies face increasing costs to clean the groundwater from nitrate to produce drinking water

- Who has the property rights? How do they handle the problem?
- If ground water is state property it could be expected that farmer have to pay to pollute the groundwater
- But this solution has unacceptable distributional effects: state compensates farmer for constraining the use of fertilizers

2 Property rights theory: The Coase Theorem

- If transaction costs are zero, the distribution of private property rights is irrelevant for economic efficiency since negotiations between the parties will always result in the **same** Pareto-efficient level of the externality
- If there are no l**egal, strategic, or informational b**arriers to bargaining, and if p*roperty rights* are clearly defined,…… then people can always <u>negotiate</u> to an efficient outcome

➢ Normative conclusion: What matters is that private property rights are assigned not how they are assigned

- Preconditions
  - No transaction costs
  - Well defined property rights
  - No „Income Effects“

2 Property rights theory: The Coase Theorem

- Seminal work by Coase (1960) and Demsetz (1967)
- <u>Coase theorem:</u> property rights should be well-defined, no transaction costs, perfect competition and perfect market, and then resources can be used efficiently

  Is this theorem applicable?

  For instance to air, groundwater, fish in ocean?

- <u>Demsetz:</u> property rights is an instrument of the society to identify who has rights to benefit and harm from the resource

2 Property rights theory: The Coase Theore

Problems With The Coase Theorem

- Transaction Costs May Exist
  - bargaining may be expensive
- Property Rights May Not Be Clearly Assigned

- Sometimes there are legal impediments to what society considers immoral This can effect the achievement of an <u>economically</u> efficient solution
- Sometimes there are costs of determining, writing, and enforcing an agreement in a world of bounded rationality, imperfect communication, private information, observation and verification difficulties, and opportunism
- If property rights are not transferable (subject to purchase and sale), the Coase theorem cannot work. That is, they will not tend to be acquired by those who can use them best
- If property rights are not secure, there will be no incentive to invest in or improve assets

2 Property rights theory: The Coase Theorem

Transaction costs

(1)„A transaction occurs when a good or service is transferred across a technological separable interface One stage of activity terminates and another begins“ (Williamson 1985)
Or

(2)A transaction is the „alienation and acquisition between individuals of the rights of future ownership of physical things“ (Commons 1935, S58) (incl services and knowledge)

- A transaction is a transfer of property rights!
- Cost of establishing, using, maintaining and changing institutions“ Richter und Furubotn 1996, p 49
- Resources spent on initiating, negotiating, safeguarding, monitoring, enforcing and adjusting transactions (Dahlman, 1979) (“direct” TC) ***or***
    - Costs of running the economic system (Arrow 1969)
    - Includes utility losses (“direct + indirect” TC)

2 Property rights theory: The Coase Theorem

Transaction costs

- Coordinating: Communicating and transacting is not cost free
- Arrow (1969): The costs of running the economic system
- Dahlman (1979): Costs of information gathering, contracting and controlling contracts
- We could even expand the definition beyond the economic system, that of contracting and include costs of communicating -where a cost may even become a benefit …
- Cost of production= Cost of transformation + Costs of transacting
- Transaction costs make up a very large proportion of total economic costs, particularly in advanced economies d(TC/Y)/dY>0
    - This is because of the nature of production In developing countries, potential TC is very high → rather stick to simpler production tasks with lower TC
- Contracts, property rights and transaction costs: Defining, measuring, monitoring, enforcing, protecting and solving disputes about unclarities
- Neoclassical economics and the ignoring of TC

2 Property rights theory: The Coase Theorem

Transaction costs: Costs caused by:

- The **establishment** of an institution or organisation
- The **use** of the institution or organisation
- *For example, transaction costs for using **markets**:*
- Costs of obtaining and processing information on potential contract partners and their preferences
- Costs of preparing and formulating the contract
- Costs of negotiating the terms of the contract
- Costs of monitoring the fulfilment of the contract
- Costs of enforcement of the contract
- Costs of adjusting the contract to new conditions
- ***Relationship between transaction costs and institutional choice***: people will choose institutions that minimise transaction costs (<u>but this is not the only theory on institutional change</u>)

2 Property rights theory: The Coase Theorem

Categories of Transaction Costs

- **Sunk and running transaction costs**
  - Sunk: lost inputs, no opportunity costs
  - Running: inputs for which opportunity costs exist
- **Fixed and variable transaction costs**
  - Fixed – not depending on the size and the frequency of transaction
  - Variable - depending on the size and the frequency of transaction
- **Ex-ante and ex-post transaction costs**
  - Ex-ante costs: before the contract has been made
  - Ex-post costs: after the contract has been made

2 Property rights theory: The Coase Theorem

Categories of Transaction Costs

- **Market transaction costs**
  - Costs of market organisation
  - Searching, preparation, agreement, supervision, monitoring, controlling, enforcement, adjustment

  Transaction costs in firms
  - Costs of firm organisation
  - Instruction, controlling, enforcement, adjustment
- **Political transaction costs**
  - Costs of the establishment and maintanance of a political order
  - Decision making, implementation, administration, enforcement

3 The economic role of property rights

- Question
  - How can well-defined property rights stimulate economic growth?
- Answers
  - The more certain property rights are, the more capital accumulation there will be
  - The more certain are property rights, the more entrepreneurship there will be
- The "Institutional" View
- The "West" experience growth because countries developed secure private property rights (North and Thomas 1973)

1. Property rights basic concepts
2. Property rights theory
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3 The economic role of property rights- Empirical evidence

- Thinkers in the last two decades have focused on the role of institutions in long-term economic growth, and among them, property rights (for example, Acemoglu et al 2001, 2002, 2004, 2005; Mauro 1995; Knack and Keefer 1995; Barro 1996; Aron 2000; Easterly and Levine 2003; Dawson 2003; Rodrik 2004)
- A particular focus on the role of property rights emerged with papers from Acemoglu et al (ibid) singling out the security of property rights as a predominant determinant of income level differences

3 The economic role of property rights

Empirical evidence

- Focusing on growth over the period 1974-1989, and using the ICRG composite index and adding it to a Barro-type growth regression, Acemoglu et al (2001, 2002, 2005) who use a base sample of 64 countries colonised between the 15th and 19th centuries, running simple and more complex least squares regressions of GDP per capita in 1995 on the average protection against expropriation risk (of private property) through institutions (measured via ICRG – average over 1985-1995)
    - On the basis of a 2SLS regression, the authors found a highly significant impact of (property rights) institutions on the level of income per capita
- This analysis was repeated with the **"natural experiment"** of the separation of North and South Korea, countries with shared historical and cultural roots, and similar geography but which established very different types of property rights regimes after their separation
- The authors noted that by 2000, the level of income per capita in South Korea was **US$16,100** while in North Korea it was only **US$1,00**0, about the same as a typical sub-Saharan African country (Acemoglu et al 2005)

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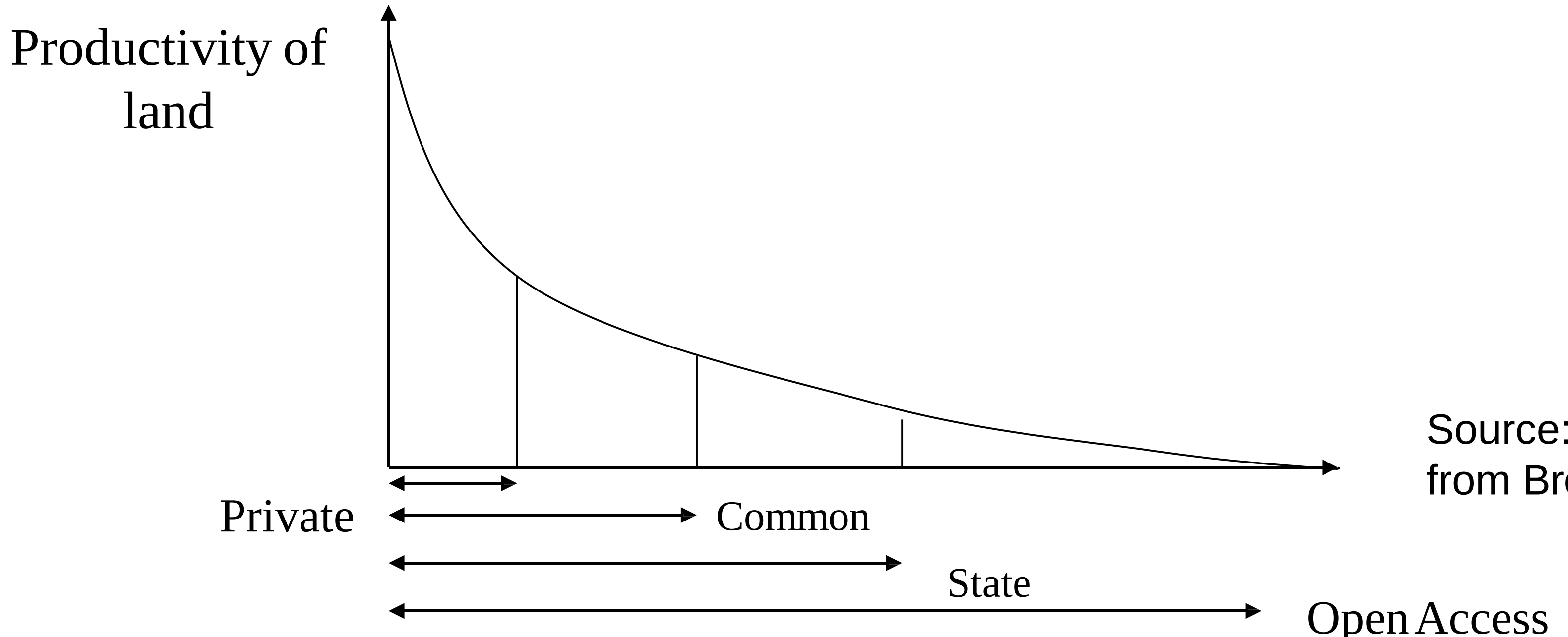
3 The economic role of property rights

Property regimes and productivity

- Gain from exclusion depends on productivity of resource =>private property only viable for most productive resources!
- Establishment of private property = efficiency, but not of worth establishing – TC depend on property regime



Source: Vatn, 2005, adjusted from Bromley, 1991

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3 The economic role of property rights

Hoskins and Eiras(2002),

- Armen Alchian, Ronald Coase, and Harold Demsetz founded the modern property rights school of economics
- They sought not only to delineate the importance of a system of private property rights to the effective functioning of an economy but to identify the circumstances that lead to the assignment and formation of property rights
- The property rights system in a society defines the permissible forms of competition

3 The economic role of property rights

- A private property system gives the exclusive right to individuals to use their resources as they see fit and to voluntarily transfer them
- Such a system prohibits force and encourages cooperation. Indeed, economic competition is a system of social cooperation
- The broader and stronger the protection of private property rights, the more effective prices are at allocating resources, and the more effectively resources are allocated, the greater the wealth creation

3 The economic role of property rights

Hoskins and Eiras(2002)

- The relationship between protection of property—defined in terms of the transparency, independence, and efficiency of the judicial system—and wealth, measured in GDP per capita for 150 countries around the world, makes the point
- On average, GDP per capita, measured in terms of purchasing power parity, is **twice as high** in nations with the strongest protection of property ($23,769) than in those providing only fairly good pro- tection ($13,027)

3 The economic role of property rights

Locke (2013)

- Since the 1990s, authors such as Rodrik (2000b, 2003, 2004b, 2007) have found that institutions are powerful determinants of growth, and that property rights represent one category of economic institutions

- More recently, greater importance has been attributed to the role of property rights as a mainstay among institutions of promoting growth (Besley and Ghatak 2009) and the role of the state in formalising and protecting such rights (Acemoglu and Johnson 2000, 2004)

3 The economic role of property rights

Why private property rights matter for growth — a theory of change?

- The economic case for secure property rights is that growth depends on investment; however, investors do not invest if there is a risk of government or private expropriation (Everest- Phillips 2008; Besley and Ghatak 2009; Acemoglu et al 2004)
- In this context, property rights are equated with private property rights whereby property owners can legally exclude others from using a good or asset

3 The economic role of property rights

- Besley and Ghatak (2009; 2011) identify four main channels through which secure property rights influence economic activity and resource allocation:

- **Security channel,** whereby investment is expected to lead to a flow of income, which needs to be protected against expropriation through secure, well- defined property rights. Such protection provides incentive to invest; by implication, insecure property rights could mean that firms or individuals *may fail to realise the fruits of their investment and efforts*

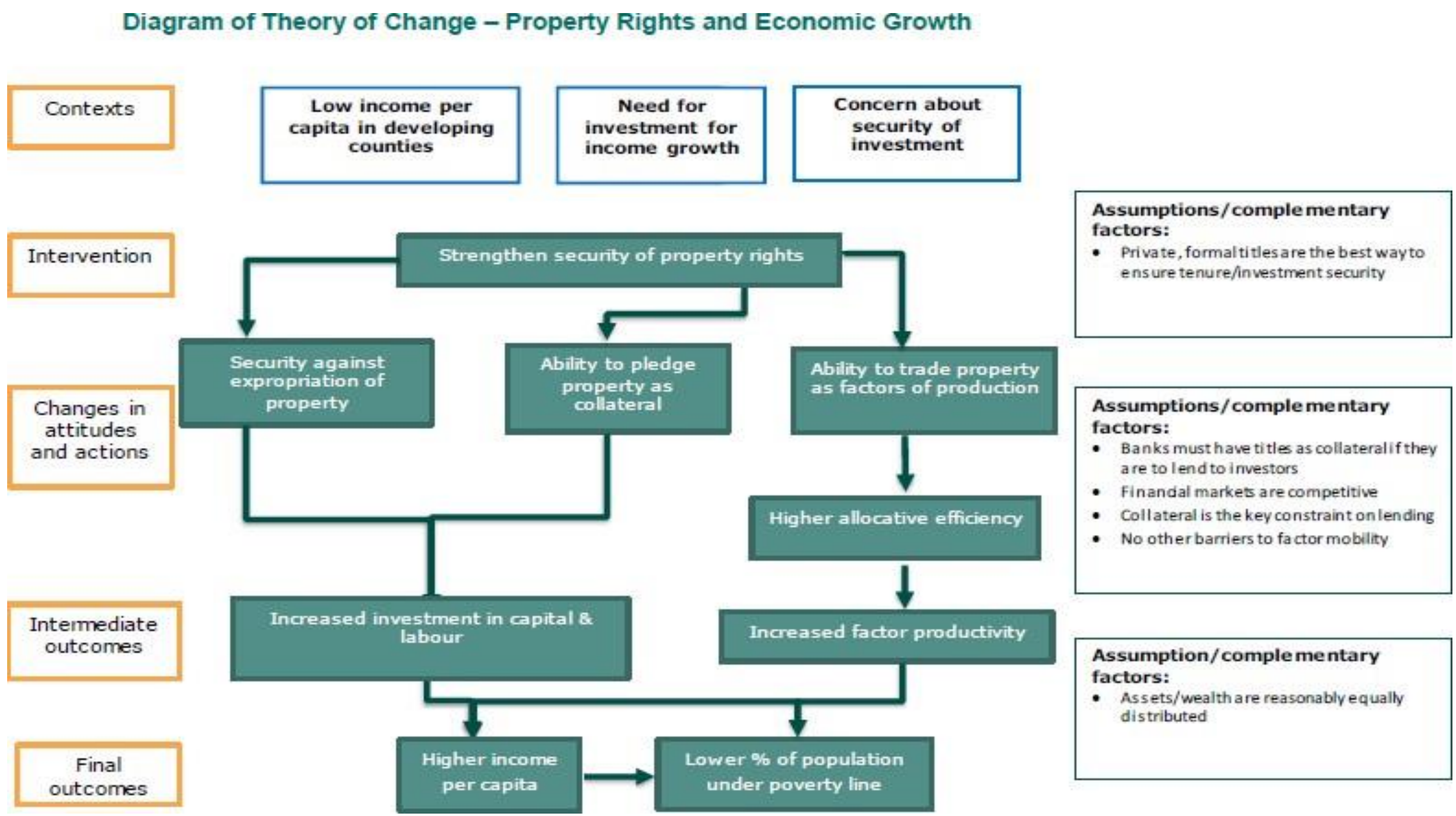
- **Efficiency channel,** enhancing the mobility of assets through transactions such that assets are transferred to those who can use them most productively

3 The economic role of property rights

- **Reduced protection costs** – secure property rights mean that individuals can devote fewer resources to protecting their property (an unproductive use of resources) and these resources can go to productive uses

- **Transactions facilitation** – formally defined property rights allow for the use of property in supporting other transactions by using it as collateral to raise resources on the financial market This may increase productivity along the lines delineated by De Soto (De Soto, 2000)

3 The economic role of property rights



3 The economic role of property rights

Ownership and incentives

- Private ownership create incentives for investments, innovations, and work efforts since it protects against expropriation by others
- Transferable ownership of productive resources lead to investments that maximizes the current value of the resource
- Transferability of ownership disconnect the investment from the time horizon of the investor
- Example of the effects of limited transferability: labor managed firms in Yugoslavia

3 The economic role of property rights

Property rights and externalities

- External effect: The utility of one person is affected by the production or consumption activities of another person (positive or negative)
- Conflicts emerge always if the property rights are not well defined or if the transfer of property rights is very costly
- „If A beliefs he has a right to smoke and B beliefs he has a right to clean air, we have difficulties *The practical problems with externalities generally arise because of poorly defined property rights* “ (Varian, 1987)

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3 The economic role of property rights

Property regimes, externalities and transaction costs

- All imply externalities or “interactions”
- Costs of exclusion : “costs of keeping agents and their uses apart”
- Compare gains from demarcating with costs, from demarcating depend on property regime and character of the good/resource

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Property regimes and transacion costs

- To avoid tragedy of open access: common property => moderate exclusion + coordination costs
- Common property about striking a balance between exclusion costs of non-members and coordination costs of members
- Trade-off for technical aspects, but natural systems contain complex interrelationships
- => always partial or very costly

3 The economic role of property rights

Private property

- Private property create strong incentives for investments, innovation and efforts

but

- Costs of specification and exclusion (distributional conflicts)
- Costs of monitoring and enforcement
- Costs of transferring private rights

3 The economic role of property rights

Common property

•Lower exclusion and specification costs

But

- Reduced incentives for investments, innovations and efforts
- Costs of designing and managing use rights
- Costs for monitoring and enforcement

3 The economic role of property rights

State property

- Low specification and exclusion costs

but

- Low incentives for investments, innovation and work efforts
- Cost for designing and managing use rights
- Cost of monitoring and enforcement

3 The economic role of property rights

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- No specification and exclusion costs
- No monitoring and enforcement costs

but

- No incentives for investments, innovation and work efforts
- Losses due to resource overuse or destruction

3 The economic role of property rights

……and why they might not

- However, not everyone supports the view that institutions, and secure property rights specifically, are the main ingredient for growth (Glaeser et al 2004; Fogel 2004; McArthur and Sachs 2001; Schmid 2006), and some question that private, individual property rights are the most appropriate form for spurring growth
- Even where the role of private property rights in promoting growth is broadly supported, questions are raised about other factors that influence growth and that may be equally or more important than property rights themselves, such as the existing distribution of wealth or the degree of competition in financial markets (Besley and Ghatak, 2011)

3 The economic role of property rights

- Schmid (2006) suggests that a certain degree of insecurity of rights (in the form of uncompensated change in economic opportunities) is actually essential for economic growth and development Drawing on the experience of US frontier history in milldams, canals and railroads, he argues that entrepreneurs can tolerate some change in rights that is not completely compensated, which provides for innovation, whereas excessively secure property rights could **undermine innovation if entrepreneurs must fully compensate those affected**

- Two key arguments advanced against securing rights through private titling are that this process **can generate conflict and can increase the level of inequality** in society, both of which can retard growth, particularly pro-poor growth (Easterly 2001; Acemoglu et al 2005) The rise of the *rentier* society in Latin America is a case in point (Engelmann and Sokoloff 2000; Hoff 2003)

  - Others point to the great expense associated with constructing a formal property rights system and suggest that resources could be best placed improving more simplified forms of rights (eg, starter rights)10 or focusing on other issues that could be more important for growth (Everest-Phillips, 2008)

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