Institutional Economics: A Crucial Tool for Understanding Economic Development

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1. Bratislava Workshop on Institutional Analysis and Bratislava Open Lecture Series

From May 10 until May 15, 2009 the University of Economics in Bratislava hosted a Workshop on Institutional Analysis organized by the Ronald Coase Institute. The event was co-organized by Virtual Scientific Laboratories and supported by the Tatra Banka Foundation. The workshop attracted to Bratislava twelve faculty members from renowned universities and research institutes in the United States, England, New Zealand, Bulgaria, and Russia.

Twenty-five participants – young scholars and advanced graduate students in economics, law, and political science -- were competitively selected based on the quality of their current research. During the lectures they were able to learn about the analysis of formal and informal institutions, such as laws, rules, regulations, norms, and customs. The lectures were often illustrated by faculty's own research. The workshop program also focused on strategies concerning how to formulate research questions, design projects, draw important and practical conclusions, and how to effectively communicate the findings to the community of researchers and the wider public. The participants presented their research projects twice and received comments from established scholars and from their peers.

Parallel to the workshop, two additional public lectures were organized as part of the Bratislava Open Lecture Series. The main idea behind this series is to familiarize Slovak students with the current trends in the area of economic and behavioral sciences. On average, twice a year renowned academics are invited to present frontier economic research to students and faculty. On May 13, 2009 Robert Aliber, Professor Emeritus of the Graduate School of Business (currently Booth School of Business) at the University of Chicago gave a talk titled "Four Financial Crises in the Last 25 Years: A New World Record" in which he talked about the crises that hit the financial

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world since the eighties. According to Professor Aliber, who is known for his in-depth understanding of financial markets and timely predictions and insights, each wave of crises was preceded by a wave of credit bubbles. In each case the rate of growth of credit was much too high to be sustainable.

On May 18, 2009 four other workshop faculty members – Alexandra Benham (a founder and the Secretary of the Ronald Coase Institute), Lee Benham (a founder of the Ronald Coase Institute and Professor of Economics at Washington University in St. Louis), John Nye (Professor of Economics who also holds the Frederic Bastiat Chair in Political Economy at George Mason University), and Mary M. Shirley (a founder and the President of the Ronald Coase Institute and former research manager in the Development Economics Department of the World Bank) gave public lectures pertaining to Institutional Economics and the role of the Ronald Coase Institute. We present the summary of their presentations below. Sponsorship for both lectures was provided by the U.S. Embassy in the Slovak Republic.

2. Institutional Economics and the Ronald Coase Institute

2.1. What is New Institutional Economics?

New institutional economics concerns itself with the study of institutions. By institutions, we mean the rules of the game. These include the written regulations, rules, and agreements that govern contractual relations between firms and governance within firms; the constitutions, laws, and written rules that govern politics, bureaucracies, and societies in general; and the unwritten norms of behavior and codes of conduct that govern human economic and political activities. Institutional economics encompasses two broad and complementary areas of study. One of these focuses on property rights and the role of firms and other organizational arrangements in reducing transaction costs, following on the pioneering work of Ronald Coase and further developments by Oliver Williamson. The other emphasizes the role of the state in creating order and controlling violence, and the role of institutions in constraining the state from using its powers over violence to expropriate property and exploit individuals. This area is epitomized by the work of Douglass North.

Institutional economics is like standard neoclassical economics in its emphasis on the importance of scarcity, markets, and competition. But unlike neoclassical economics, institutional economics assumes that humans have imperfect information and limited mental capacity and face uncertainties and risks in their transactions with one another. To reduce risks and costs, humans devise rules, contracts, and norms to constrain behavior and make transactions more predictable. Such rules, contracts, norms, and habits significantly affect the performance of markets. This contrasts with the view of neoclassical economics which assumes that market performance largely depends on resource endowment, macroeconomic policy, and technological change. Institutional economics argues that the incentives and transaction costs created by institutions largely determine how resources are used, which policies are chosen, and whether technological innovations are utilized. Institutional economics shifts the focus to institutions and away from macroeconomic aggregates, which are viewed as measures, not as fundamental drivers of the economy.

Although institutions are viewed as fundamental economic drivers, they are still not well understood. More research is needed to understand how institutions function in specific societies, when beliefs matter, and how deviations from rational behavior affect performance. With better understanding of institutions we can better answer this fundamental question: why are some countries rich and some are poor?

2.2. How do institutions matter for development?

Institutional economics may not yet provide a definitive answer to the question why countries are rich or poor, but it offers many fundamental insights into development. One important insight is that in order to develop, countries need institutions that encourage and support low transaction costs. Where such market-supportive institutions are weak or absent, transaction costs are much higher, sometimes so high that some markets may develop weakly or be entirely absent. As Ronald Coase wrote in "The Economic Structure of Production" (AER, 1992): "If the costs of making an exchange are greater than the gains which that exchange will bring, that exchange will not take place."

As institutions vary widely across countries, so do transaction costs. For example, consider the turnaround cost of buying/selling a house in different countries. In Russia and Bulgaria, transaction costs consume 25% of the value of the house; in the UK only 5%, and in Slovakia only 3.1%. Many more housing transactions will take place where these turnover costs are lower.

Well-functioning markets depend fundamentally on institutions that keep transaction costs low. These include informal codes of conduct, reputation, and trust, as well as formal laws, codes, and contracts enforced by the state. The state is critical here, but it is also problematic. A fundamental insight of Douglass North is that, while a market is voluntary, a market needs a state powerful enough to enforce the rules. But any powerful state faces this decision constantly: to make or to take? To support production or to expropriate its returns? In order to constrain state power, countries embody citizens' rights in constitutions, separate powers across assemblies and courts and regional and local governments, develop norms of civic engagement, and use elections to control or remove politicians who abuse their powers. Many countries today have adopted constitutions and other formal rules that purport to constrain the power of the state. However, economies will only flourish if these institutions are credible to potential investors. Investors will not be convinced by formalities imported whole cloth from other countries into societies whose histories, local norms, and beliefs do not support their adoption.

Norms and beliefs are slow to change, which helps explain why institutions tend to endure over time. Institutions also endure because powerful people who derive their power from the status quo institutions have strong incentives to preserve them. This presents a challenge to reformers, who have to persuade the powerful that some change are in their best interest. This challenge confronts the foreign aid community as well.

2.3. Institutions and foreign aid

Can foreign aid promote the institutions that reduce transaction costs and constrain the state? The aid track record is not encouraging. There is no consistent statistical evidence that foreign aid promotes growth, and some evidence suggests that aid may even harm institutions by promoting corruption and making governments less responsive to taxpayers. In 2005 the World Bank's own evaluation department judged its projects aiming to improve governance, legal systems, and other institutions as "largely ineffective."

Aid is not more effective in promoting development because the characteristics of aid conflict with the characteristics of market-supportive institutions. For one thing, institutions tend to be durable, while aid focuses on short-run projects and more superficial changes in policies or organizations. Aid staff may not even be aware of some of the more deeply rooted norms of a country, since they are outsiders and are rotated every 3-5 years before they have a chance to understand local norms. Nor are aid staff rewarded for institutional change, which is hard to measure or affect. Rather, rewards are geared to new projects. Aid staff have little incentive to push reluctant governments to enact difficult institutional change because they need the support of the powerful elites who usually oppose such change. In those rare cases when institutional changes do occur they are usually idiosyncratic and very different from the Western best practice model that aid agencies promote.

2.4 What does promote institutional change?

Most efforts to change the rules fail. An example of this is communism, probably the biggest experiment in changing institutions in the 20th century. Often the lessons of failure are ignored while the rare successes are overlooked or misunderstood. This deprives us of the knowledge we need to understand and support institutional change.

While there is much to be learned about institutional change, we do know from the history of the European enlightenment and from the recent changes in countries like Chile, China, and Slovakia that ideas and learning are powerful forces for institutional change. Good scholarship on institutions can make a difference in people's lives. Our studies of successful institutional experiments found that scholars played a critical role there, sometimes by advising policy makers, sometimes by taking leadership positions, and always through their research and ideas.

2.5 What does the Ronald Coase Institute do to support such scholarship?

The Ronald Coase Institute aims to encourage the scholarship that underpins successful institutional change. The Institute invests systematically in developing and encouraging the institutional research of young scholars worldwide. We do that by:

1. building young scholars' capacity to analyze institutions through our workshops such as the one just completed at the University of Economics in Bratislava,
2. supporting and encourage the research of our young scholars through time by mentoring and very occasionally by giving small grants,
3. involving these scholars in a long-lasting scholarly community that we founded and continue to nurture. We have held 14 workshops since 2001 and now have 289 alumni in 58 countries in our community, as well as many excellent senior faculty teaching institutional economics around the world.

The Ronald Coase Institute was founded in the year 2000 by a group of individuals who earlier founded the International Society for New Institutional Economics. Three Nobel laureates in economics participate directly in the Institute's work. Ronald Coase is our research adviser. Kenneth Arrow and Douglass North are on our Board of Directors. Douglass North also lectures frequently at our workshops.

Our alumni are doing well. They are teaching in excellent universities where their ideas influence others. They are organizing conferences and editing journals, writing opinion pieces and policy papers, and publishing scholarly pieces in prestigious journals. Several have won prizes in worldwide competitions. They have made real progress toward our goal: to better understand how real economic systems work, so that individuals and societies have greater opportunities to improve their well-being.