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# Economic Institutions

## Introduction

Economic institutions have re-emerged at the centre of attention in development economics after a long period when their existence and smooth functioning was assumed in the hypotheses of neo-classical economics.[1] Recent analyses using cross-country regressions – see, for example, Rodrik, Subramanian & Trebbi 2002 – suggest that it is the quality of institutions that is the single most important difference between those economies in the developing world that have grown strongly and those that have not.

However, these insights have not necessarily produced useful guides for policy-makers. It is one thing to recognise the importance of institutional quality, but quite another to specify what makes for quality and to suggest how it may be improved. As a first step towards understanding more about institutions and their quality, three questions arise: how are economic institutions created, how do they function, and with what effects? To begin to answer these questions, we need a working definition of economic institutions and an associated set of concepts.

## Defining institutions

Definitions of institutions vary – see Box A; most would accept the idea that institutions comprise norms, regulations and laws that establish the 'rules of the game' – that is, that they condition and modify the behaviour of individuals and groups so that their actions become more predictable to others. They do so through both formal rules that include laws and contracts and, as well as through informal means such as social norms and conventions that evolve over time. This use of 'institution' is quite different to that where it is taken as synonymous with 'organisation'.

### Box A: Definitions of economic institutions

'Essentially, institutions are durable systems of established and embedded social rules and conventions that structure social interactions' (Hodgson 2001 p.295)

'A social institution is a regularity in social behaviour that is agreed to by all members of society, specifies behaviour in specific recurrent situations, and is either self-policed or policed by some external authority.' (Schotter 1981, quoted in Langlois 1986 p.11)

'Institutions are rules, enforcement characteristics of rules, and norms of behaviour that structure repeated human interaction.' (North 1989)

'Institutions are 'repetitive patterns of interaction through which society undertakes certain functions.' (King 1976)

'Wide sense: persistent groups of norms of behaviour which serve collectively valued purposes; or in narrow sense of , a set of rules to facilitate co-ordination via allowing expectations to form.' (Nabli & Nugent 1989)

1. 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 behaviour that does not conform to economic notions of the 'rational individual' is left to other disciplines such as politics and sociology. 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.

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## Box B: Institutions and policies

All policy changes can be seen as changing the rules of the game. If a tariff level is reduced from 20% to 10%, for example, the conditions – and perhaps thus the 'rules' – governing imports have changed. Is this, then, an institutional change? And if so, are all economic policies effectively institutions?

Institutions are defined as helping form stable expectations, hence institutions can only be changed infrequently if they are to fulfil this function. Institutions operate at a deeper level and are, in effect, *constitutional*; they establish the framework of rules within which more routine decisions take place.

In the case of the import tariff, for example, the institution is that which empowers the state to set such tariffs. Thus, continuing the example, a country that binds its tariffs in accordance with the rules of the World Trade Organisation (WTO) could be seen as changing an institution. This in turn modifies the expectations of those engaged in international trade: the WTO norms set limits to tariffs and discourage quantitative controls on trade.

Institutions can also be seen as constitutional, they set the rules by which the game is played; it is this that distinguishes them from the wider set of economic policies – see Box B.

By narrowing the definition to economic institutions, those institutions that perform economic functions are covered; of these, three sets can be identified:

- establishing and protecting property rights;
- facilitating transactions; and,
- permitting economic co-operation and organisation.

Table 1 presents examples of the institutions that perform these functions, together with the agencies both formal and informal that regulate such functions. It will be noted that some of the institutions that have economic functions may not exist primarily for economic reasons – for example, councils of elders.

The definition of economic institutions can be expanded and discussed by asking three key questions about institutions, namely:

- How are institutions, which affect economic growth and its distribution established, sustained and changed?
- What determines their effective functioning? How is this related to the social, cultural and political matrix from which they arise and in which they operate? How much do they depend upon formal endorsement by the state?
- How do institutional interactions influence economic growth, the pattern of growth and, specifically, the possibilities for pro-poor growth?

## How are economic institutions formed?

Institutions emerge in two ways: either informally through repeated interactions between individuals or organisations that establish expected norms of behaviour; or else formally through deliberate design. In the latter case, it may be government that establishes the institution, or it might be an initiative from private enterprise or civil society. In both cases, it can be argued that institutions are created and evolve in response to the uncertainty, risk and information costs associated with living and transacting in an imperfect world. Institutions are thus rational mechanisms designed to cope with the imperfections of markets, including the asymmetry of information held by different actors, the problems that principals have in ensuring that their agents pursue the same goals, etc. This explains why seemingly 'irrational' and inefficient institutions such as share-cropping have persisted as ways to solve such imperfections.

Whatever the origin of the institution, the more widely it is recognised the better it will function and such recognition reaches its maximum expression when the norm is endorsed by the state as legally binding. Not all institutions require the support of governments, but some do in order to remove ambiguity and to provide legal backing for the norms in question. Institutions may be seen as public goods in that their benefits (and costs) are shared by all in the economy, no matter who took the trouble to establish them.[2] This suggests that many institutions will require action by governments to create and implement the norm.

Most institutions are not lightly changed, even when clearly imperfect or outdated. Institutions are valued for the predictability that they bring to the system; frequent change and experimentation to established norms is thus not usually encouraged. Moreover, particular institutions can confer rights and advantages to particular groups in society who will use their power to prevent changes that undermine their advantages. There is thus the possibility of path dependency in that once certain institutions are in place, then other norms and behaviours ensue, thus reinforcing patterns of development and restricting the range of options for policy.

Discussion of new institutions or changes to institutions is often intense, parties recognise the implications of creating new 'rules' for the game or of changing them and each will fight for their own interests. The political economy of institutional change is therefore important in that they may evolve to confer privileges on particular groups, whether or not the institutions are efficient and effective for society as a whole, and once in place may be difficult to change. An additional consideration is that those administrating the rules may also resist change simply owing to the thereof.

## How do economic institutions function?

An important point is that the functioning of an institution is not necessarily to be inferred from its

2. Not all institutions, of course, necessarily confer benefits on all in society. Far from it. For example, formal limitations on the property rights or rights to carry out certain sorts of business, that may apply to specific ethnic groups, or women – not to mention institutions such as slavery – are all real-world examples of institutions that confer benefits for some, but impose high costs on others.

## Table 1: A classification of economic institutions

| Function | Examples | Typical formal regulating agency | Informal regulating agency |
|---|---|---|---|
| Property rights<br>Establish rights; decide between competing claims; inform non-owners & police | Land tenure<br>Inheritance law<br>Intellectual property rights: patents, copyright | Land registries<br>Probate registry<br>Patent offices | Oral history, chiefs & other local political authorities<br>Custom |
| Reciprocracy: facilitating transactions<br>Establish rules of exchange, respect for contracts<br>Provide information<br>Reduce or re-allocate risk | Weights, measures, standards<br>Contract law; dispute arbitration<br>Public information on markets<br>Physical provision & organisation of markets (e.g. auction rings, stock exchanges, futures markets)<br>Banking conventions, instruments (letters of credit, etc.)<br>Auditing & accounting conventions<br>Insurance companies | Standards bureaux<br>Civil courts; arbitration councils<br>Market information agencies<br>Local authorities; stock exchanges/ bourses<br>Bank regulatory agencies<br>Professional associations<br>Professional associations | Elders, religious courts<br>Customary points for exchange (crossroads, etc.)<br>Market hierarchies (Market mammies/ queens/etc.)<br>Haveli systems |
| Co-operation & Organisation:<br>Allow<br>• Interactions within organisations<br>• Collective action & co-operation (in labour, price negotiation)<br>• Realising economies of scale and managing diseconomies of scale | Laws on limited liability & bankruptcy<br>Competition policy<br>Regulations on co-operatives, charities, civil associations<br>Auditing & accounting conventions<br>Employment regulations | Register of companies<br>Commissions on monopolies & mergers<br>Co-operatives ministries, bureaux<br>Professional associations<br>Min labour, employment tribunals | Social norms of co-operation<br>Custom |

form. For example, very similar institutions exist in many countries that govern the collection of bad debts, but how long it may take to recover such debts can vary greatly, depending on the details of administrative requirements and the efficacy of the legal system. Similarly, there are often significant differences in the extent to which property owners feel secure in their rights, even when the form of entitlement may be the same. The study of institutions thus requires detailed investigation of actual functioning, rather than merely recording the apparent form.

Functioning may be determined by deeper underlying norms in society on matters such as the extent of generalised trust, and individual freedom versus obligations to wider collectives. More generally, then, institutions are often embedded in social and cultural characteristics of the particular context.

## How do institutions affect economic growth and poverty reduction?

The functioning of institutions potentially affects three factors that help determine economic growth, thus:[3]

- **Investment**: when property rights are secure, owners of capital are more likely to invest, all other things being equal. If it is easy to trade, obtain credit, retain a reasonable share of the profits (that is, without excessive taxation) and to insure against risks, investment is again encouraged. Investment may also be stimulated when establishing companies or more informal economic groups, (and the organization of their

3. There is a fourth factor, widely recognised in the literature – human capital. It is not obvious that economic institutions affect this directly – although it might be argued htat when economic institutions function well, and economic growth accelerates, there is greater incentive for governments and individuals to invest in human capital.

functioning) is relatively straightforward.

- **Technical innovation**: again, secure intellectual property rights are likely to promote private investment in research and development of innovations.
- **Economic organisation:** is likely to be more effective and efficient, delivering the benefits of specialisation and economies of scale where they apply, when institutions facilitate transactions and co-operation between individuals, whether in formal companies or less formal co-operatives.

It is easy to imagine that there will be reinforcing interactions between the factors. For example, economies that generate technical innovations readily and where economic organization is efficient are likely to be seen as having a good business environment and consequently likely to attract investment, thus it may well be that sets of institutions function in synergy to generate growth.

Institutions are also likely to have a profound influence on the pattern of economic growth and the distribution of rewards within economies and societies – and thereby affect levels of poverty. Property rights will clearly be important, since they assign entitlements to factors of production and may also affect the bargaining power of different groups in society. More subtle are the ways in which institutions governing transactions and economic co-operation allow those without immediate access to factors of production to obtain credit, rent land, trade and to form small companies or co-operatives, and thereby earn their livelihoods.

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