THE FOUNDATIONS OF NEW INSTITUTIONAL ECONOMICS

Dr. Douglass C. North

Winner of the 1993 Nobel Prize in Economics

CIPE is an affiliate of the U.S. Chamber of Commerce and one of the four core institutes of the National Endowment for Democracy

Improving the performance of economies

- Background on the nature of institutions
- Need for the theory of institutional analysis
- The need to go beyond existing economic theories to improve performance

What do we know about good economic performance?

- Statistical evidence about economic performance is available for countries around the world
- Economic growth and development are a function of an economy’s productivity
- Higher productivity requires better institutions

Institutions necessary for productivity and economic growth

- Well-defined property rights
- Political institutions defining legal rules
- Judiciary serving as a third-party enforcer of contracts and agreements
- Level playing field of equal rights and legal protection for everyone

BUT knowing the kind of institutions that need to be put in place to realize economic growth does not tell us how to acquire them in the first place

Why do we need the theory of institutional analysis?

- Neoclassical economic theory does not address how to *create* efficient markets
  - Focuses on already developed markets
  - Does not explain the role of political markets
- Problems with the neoclassical theory assumptions
  - Frictionless markets (they "just work" without governments or institutions)
  - Static policy implications (not accounting for time, history, or the way humans learn)
  - Ergodic worldview (world with a constant underlying structure of the economy, like in natural sciences)

We live in an evolving, complex, and non-ergodic world

- The world is dynamic, in continuous change
- From the perspective of economic history, we are constantly creating new and novel worlds
- The types of problems humans faced in the past are not the same we face today

Many elements of the neoclassical theory (e.g., price theory) remain useful, but the assumptions that economics is frictionless, static, and ergodic are simply wrong; the real world does not work like that.

How do we overcome the limitations of the neoclassical theory?

We need to continually modify our economic theory as we improve our understanding of the contemporary world.

- Modify neoclassical theory assumptions
  - Frictionless – Recognize the role of institutions
  - Static – Consider time and how humans learn over time
  - Ergodic – Understand fundamental change over time
- BUT avoid over-reliance on the evolutionary theory to explain the dynamics of economic development
  - Societies, unlike species, do not develop through mutation of traits
  - Evolutionary change is blind; human actions are intentional

Intentionality and institutional change

- Institutional change involves purposeful and calculated human efforts
  - Underperforming institutions do not just disappear the way undesirable genetic traits do in evolutionary survival
  - Whoever is pursuing an institutional change in a society, wants the results favorable to the well-being of that person or social group

Understanding human intentionality is at the very heart of improving institutional performance in a society.

What are institutions?

- Institutions are incentive systems that guide human behavior
  - Economic growth requires institutions that reward productivity and creativity
- Institutions consist of:
  - Formal rules (constitutions, laws, rules and regulations put in place by the government)
  - Informal constraints (norms of behavior, conventions, codes of conduct)
  - Enforcement mechanisms

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Football / soccer analogy

- Formal rules define what players can and can't do
- Informal norms guide acceptable behavior
- Umpires and referees are the enforcers
- The way the game is actually played is very different than the formal structure that we set up

Institutions are the best game in town, but they are imperfect with respect to the way in which they produce the outcomes we want.

Institutional reform: Understanding the local context

- Successful reformers must understand
  - how formal rules, informal norms, and enforcement work in specific markets
  - what makes these existing institutions work the way they do and what makes them work differently from their intention

The first step to designing successful institutional reforms is to conduct empirical research on how institutions work in particular markets and why they work the way they do.

Institutional reform: Overcoming the static limitations

- Laws, rules, norms, and beliefs inherited from the past constrain the introduction of new institutions
- Various groups have vested interests in the old rules
- The inherited institutions
  - tend to be very conservative (path dependent)
  - provide built-in protection for the existing structure
- Improving institutional performance requires understanding a particular cultural heritage
- Improvements happen on the margins by modifying the institutional “rules of the game”

You need to understand where you've been in order to know where you are going.

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Institutional reform:
Accounting for human intentionality

- Economics is the theory of choice
- Modifying human behavior requires understanding how people make choices
- Standard economics assumes that people
  - are perfectly informed (know all of the alternatives)
  - act on the basis of pure logical calculus
- BUT human actions are also influenced by the belief system that determines the incentive structure

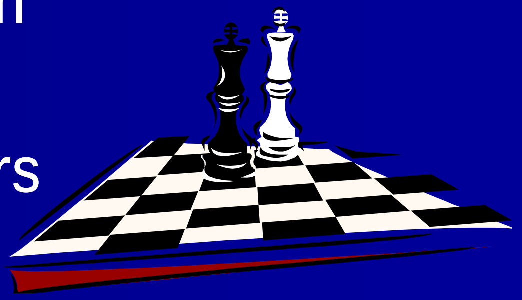
How does Latin America's heritage of personal exchange fit into institutional analysis?

- Personal exchange is a natural human tendency to interact directly within small groups
- BUT in the contemporary world, specialization, division of labor, and the size of the market are the keys to the wealth of nations (Adam Smith)
  - This necessitates moving from personal to impersonal exchange and developing structures for exchanges over long periods of time with people you don't know
  - **Impersonal exchange** requires mechanisms for ensuring honesty and cooperation without personal ties

Game theory analogy

In the world under personal exchange conditions:

- It pays to cooperate with the other players when
  - you have repeated dealings with them
  - you have a small number of players
  - you know a lot about the other players



- You as a player will defect when
  - you have no more dealings with somebody or you deal with them only once
  - you have large numbers of players
  - you don't know the other players

The movement from personal exchange to impersonal exchange is the most fundamental dilemma of economic development.

A world of impersonal exchange

It took the Western world five or six centuries to gradually evolve institutions that made possible a world of impersonal exchange.

Capital markets
Long-distance trade
Worldwide exchange

- The ability to conduct personal exchanges is genetically inherited, but impersonal exchange requires that
  - we fundamentally alter the way the game is played
  - there is a political system that puts in place rules and mechanisms to enforce contracts across time and space

Why has the Washington Consensus failed to produce effective markets?

Creating efficient political and economic markets that are built on impersonal exchange is at the very heart of the problems that Latin American and other developing countries must confront.

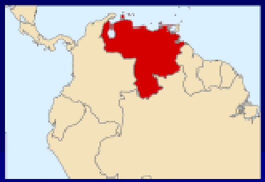
- The theory used to develop the Washington Consensus policies was incomplete
  - Assumed a neoclassical model of the world, in which people had perfect information and necessary market institutions already existed
  - Recommended that “all you have to do is get the prices right” – if only you eliminated price controls, exchange controls, and rent controls, the market would just work

The advantage of institutional analysis theory

- Concerned with the kind of institutions and belief systems that need to be confronted and understood for market reforms to succeed
- Postulates that the reforming country must undergo a fundamental transformation
- Recognizes the need to measure transaction costs (costs of human interaction) and the challenges posed by high transaction costs

Measuring transaction costs helps us understand how a given economy works and what is causing it to have imperfect, imprecise, and inefficient institutions.

The example of Venezuela



- Dr. North was invited by the then-President Rafael Caldera to Venezuela in the early 1990s to advise on the difficulties his government encountered in selling its assets
- The problem was various encumbrances that came with the assets (e.g., excessive severance pay in state-owned enterprises)
- Dr. North's advice: the value of an asset is not only what you can get from it directly; the encumbrances that come with that asset diminish its value

How to go about institutional reforms?

- Successful improvements in performance require good understanding of:
  - existing impediments in the structure of the economy and transaction costs
  - cultural heritage (history, background, values)
  - feasible incremental margins of change needed to make the system work better

Issues to address in designing successful institutional reforms:

How does a particular economy work?
What is its history and background?
What are path-dependent limits to reform?

What are the reform priorities in developing countries?

- Modify the market structure to improve the situation of people who don't have an equal opportunity to participate
- Raise the knowledge and skill level of the poor through investments in education and skills, increasing productivity
- Identify social groups with vested interests that are opposed to reform and work with them through the political process

The essence of institutional reforms:

You must understand the structure of the existing economy and learn about the way local institutions work. Then you can modify the formal rules, informal norms of behavior, and enforcement mechanisms to make them work more effectively.

Center for International Private Enterprise

1155 Fifteenth Street NW • Suite 700 • Washington, DC 20005 • USA

ph: (202) 721-9200 • www.cipe.org • e-mail: education@cipe.org