



## LESSON PLAN

### The Foundations of New Institutional Economics

*Prerequisite: CIPE Development Institute video presentation by Dr. Douglass C. North*

#### **I. Message**

New Institutional Economics (NIE) is a combination of economics, economic history, political science, and area studies, which incorporates institutions into thinking about those disciplines. This analytical approach was developed by Nobel Laureates Ronald Coase and Douglass C. North, and, according to The Ronald Coase Institute, “unites theoretical and empirical research examining the role of institutions in furthering or preventing economic growth.” Good understanding of NIE is crucial in analyzing the reasons for successes and shortcomings of economic reforms in different countries, since this approach explains why and how reforms are affected by pre-existing institutional environments. In order to pursue successful reforms, one must first understand the limitations inherent in a given political, economic, and social system – and how they can be overcome within that particular context.

#### **II. Objectives**

1. Understand what institutions are and why they matter for economic growth.
2. Discuss how NIE differs from classical economic theory.
3. Discuss and understand what important insights NIE offers on the nature and challenges of institutional reforms.
4. Discuss ways to pursue effective institutional reforms.

#### **III. Discussion questions**

1. What is New Institutional Economics (NIE)?
2. What are institutions in the understanding of NIE?
3. Why do institutions matter in economic performance?
4. Do laws on the books always reflect institutions on the ground? If not, why?
5. What are some examples of formal rules, informal norms, and enforcement?
6. Can you think of examples of economic reforms in your country that failed because they lacked the proper consideration for institutional incentives?
7. How could more effective reforms be structured?



#### **IV. Reading list**

##### Required readings:

- North, Douglas C., *Institutions, Institutional Change and Economic Performance*. Cambridge University Press, 1990.
- North, Douglass C., “Economic Performance through Time,” Nobel Prize Lecture, December 9, 1993, [http://www.uni-saarland.de/fak1/fr12/richter/institut/the\\_new\\_institutional\\_economics.pdf](http://www.uni-saarland.de/fak1/fr12/richter/institut/the_new_institutional_economics.pdf).
- World Development Report 2002, *Building Institutions for Markets*, World Bank. Chapter 1, “Building Institutions,” <http://www.worldbank.org/wdr/2001/fulltext/fulltext2002.htm>.

##### Optional readings:

- Azfar, Omar, “The NIE Approach to Economic Development: An Analytic Primer,” 2002, [http://www.iris.umd.edu/Reader.aspx?TYPE=FORMAL\\_PUBLICATION&ID=70843195-11ce-426b-b8ff-bb0076128693](http://www.iris.umd.edu/Reader.aspx?TYPE=FORMAL_PUBLICATION&ID=70843195-11ce-426b-b8ff-bb0076128693).
- Benham, Alexandra and Lee Benham, “Measuring the Costs of Exchange” in: *Institutions, Contracts and Organizations: Perspectives from New Institutional Economics*, ed. Claude Ménard. Cheltenham, UK: Edward Elgar, 2000, 367-375, <http://www.cipe.org/programs/informalsector/articles/measuring.php>.
- North, Douglas C., “Institutional Change: A Framework of Analysis,” 1994, <http://129.3.20.41/eps/eh/papers/9412/9412001.pdf>.
- North, Douglass C., John Joseph Wallis, and Barry R. Weingast, “The Natural State: The Political-Economy of Non-Development,” March 2005, <http://www.international.ucla.edu/cms/files/PERG.North.pdf>.
- Richter, Rudolf, “The New Institutional Economics: Its Start, Its Meaning, Its Prospects,” *European Business Organization Law Review*, Vol. 6 No. 2, 2005, [http://www.uni-saarland.de/fak1/fr12/richter/institut/the\\_new\\_institutional\\_economics.pdf](http://www.uni-saarland.de/fak1/fr12/richter/institut/the_new_institutional_economics.pdf).
- Shirley, Mary M., “Institutions and development,” *The Handbook of New Institutional Economics*, ed. Claude Ménard and Mary Shirley, The Netherlands: Springer, 2005.
- Williamson, Oliver E., “The New Institutional Economics: Taking Stock, Looking Ahead,” *Journal of Economic Literature*, Vol. XXXVIII (September 2000), 595-613.



## **V. Lesson plan**

### **Speaker's background and the significance of North's ideas**

- Introducing Douglass C. North and New Institutional Economics (NIE)
- How NIE influenced the field of economics
- How NIE applies to real-world economies and economic reform efforts

### **Improving the performance of economies**

- Greater productivity as a key element of economic growth
- Growth (or lack thereof) as a corollary of existing institutions
- The role of history, culture, and local traditions in shaping institutions

### **Neoclassical economics vs. NIE**

- Neoclassical theory → how free markets operate
  - Deficiencies: sees the world as frictionless, static, ergodic
- NIE → what institutions are necessary for functioning markets
  - Advantages: accounts for incentives and human intentionality

### **Institutions necessary for good economic performance**

- Secure property rights
- Political system creating responsible laws and regulations
- Democratic institutions of transparency and accountability
- Effective legal system and third-party enforcement mechanisms

### **Challenges to institutional reform**

- Different belief systems and incentives (not always rational)
- The legacy of economic systems based on personal exchange
- Path dependency of existing institutions and rules of the game
- Vested anti-reform interests benefiting from the status quo

### **How to overcome challenges to institutional reform**

- Frictionless: account for existing institutions and transaction costs
- Static: consider time and human learning over time
- Ergodic: understand fundamental change over time

### **Implications of NIE**

- The need to understand the shortcomings of the Washington Consensus approach
- The need to understand cultural/historical heritage determining where changes can be made at the margin
- The need to create institutions allowing the poor to participate in the market
  - Discuss specific implications in your country or region



## **VI. Sample test questions**

- 1. In the understanding of NIE, institutions are**
  - a. Governmental ministries and public administration offices
  - b. Organizations such as the World Bank or the United Nations
  - c. Incentive systems that guide human behavior
  
- 2. Institutions consist of**
  - a. Formal laws and regulations
  - b. Informal societal norms
  - c. Formal and informal enforcement mechanisms
  - d. All of the above
  
- 3. Transaction costs are**
  - a. Government taxes on sales (e.g., VAT)
  - b. All costs associated with economic exchanges
  - c. Facilitation payments to public officials in business deals
  
- 4. The economic system of impersonal exchange implies**
  - a. Trading with people you don't know
  - b. Repeated dealings with the same trading partner
  - c. Doing business face-to-face
  
- 5. Well-functioning market institutions**
  - a. Create the informal sector
  - b. Encourage and reward productive economic activities
  - c. Eliminate oversight of business transactions
  
- 6. Why did the Washington Consensus reforms largely fail to improve economic performance in Latin America and other regions?**
  - a. They were limited to informal norms of behavior.
  - b. They were not supported by sufficient foreign aid flows.
  - c. They assumed the existence of functioning market institutions.



*The views expressed by the author are their own and do not necessarily represent the views of the Center for International Private Enterprise (CIPE). The Center for International Private Enterprise grants permission to reprint, translate, and/or use in the classroom the materials available through the CIPE Development Institute website provided that (1) proper attribution is given to the original author and to CIPE and (2) CIPE is notified how and where these materials are used.*

*Center for International Private Enterprise  
1155 Fifteenth Street NW • Suite 700 • Washington, DC 20005 • USA  
ph: (202) 721-9200 • [www.cipe.org](http://www.cipe.org) • e-mail: [education@cipe.org](mailto:education@cipe.org)*