CIPE

Development Institute

LESSON PLAN

The Foundations of New Institutional Economics

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

I. Message

The 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 North and, as The Ronald Coase Institute puts it, "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 what the limitations inherent in a given political, economic, and social system are – 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 the 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 county 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
- 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:

- North, Douglas C., "Institutional Change: A Framework of Analysis," 1994, available at RePec Economics Papers 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
- 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
- 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
- Williamson, Oliver E., "The New Institutional Economics: Taking Stock, Looking Ahead," *Journal of Economic Literature*, Vol. XXXVIII (September 2000) pp. 595-613
- 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, pp. 367-375, 2000, http://www.cipe.org/programs/informalsector/articles/measuring.php
- Shirley, Mary M., "Institutions and development" in: *The Handbook of New Institutional Economics*, ed. Claude Ménard and Mary Shirley, The Netherlands: Springer, 2005

V. Lesson plan

Speaker's background

- Introducing Douglass North and New Institutional Economics (NIE)

The significance of North's ideas

- 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 and disadvantaged to participate in the market

  → Discuss specific implications in your country or region

<u>VI. Test questions</u>

1. **In the understanding of NIE, institutions are**
    a. Buildings housing government and public administration
    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. The costs of market exchanges
    c. Facilitation payments to public officials

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. **Why did the Washington Consensus reforms largely failed 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