INSTITUTIONAL ECONOMICS

For 3rd year Agricultural Economics Students

Welcome

By: Bewuketu Minwuye (MSc)

Chapter 1:
Concepts and Roles of Institutions

- Dear students, there is vast differences in prosperity across countries today.
- *Where did these differences arise from?*
- Standard economic answers may be:
  - Physical capital differences (poor countries don't save enough)
  - Human capital differences (poor countries don't invest enough in education and skills)
  - Technology differences (poor countries don't invest enough in R&D (Research&Developmnent) and technology adoption, and don't organize their production efficiently)

- These are, however, *proximate* causes of differences in prosperity.
  - Why do some countries invest less in physical and human capital?
  - Why do some countries fail to adopt new technologies and to organize production efficiency?
- The answer to these questions is related to the ***fundamental* causes** of differences in prosperity.
- Potential fundamental causes:
  - Institutions (humanly-devised rules shaping incentives)
  - Geography (exogenous differences of environment)
  - Culture (differences in beliefs, attitudes and preferences)
- Thus, **institutions matter**. It is necessary to understand rules of the game.
- Countries with "better" institutions prosper, while those with "bad" institutions stagnate or decline.
- **Good institutions** to be those that encourage investment in physical, human capital, and in technology, and bad institutions in the opposite.

1.1. Definition of institution

- What are institutions?

- **Institutions** are the humanly devised constraints that structure/shape human interaction (Douglas North, 1990).
- Institutions are the rules of the game in economic, political and social interactions.
  - Institutions determine "social organization"
- Simply institution is "the rules of the game" in a society or, more formally, are the "humanly devised constraints that shape human interaction."
- They are made up of formal constraints, informal constraints and their enforcement characteristics.
- Together they define the incentive structure of societies and specifically economies.
- They consists of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)
  - **Formal constraints:** rules, laws, constitutions.
  - **Informal constraints:** norms, behavior, conventions.

- Institutions are the written and unwritten rules, norms and constraints that humans devise to reduce uncertainty and control their environment.
- These include:
  - ✓ written rules and agreements that govern contractual relations and corporate governance,
  - ✓ constitutions, laws and rules that govern politics, government, finance, and society more broadly, and
  - ✓ unwritten codes of conduct, norms of behavior, and beliefs.
- Key point: institutions;
  - √are humanly devised
  - √set constraints
  - √shape incentives
  - √Should have enforcements!!!
  - √**Economics began as institutional economics.**

- Organizational arrangements are the different modes of governance that agents implement to support production and exchange.
- These include:
  - ✓ markets, firms, and the various combinations of forms that economic actors develop to facilitate transactions
  - ✓ contractual agreements that provide a framework for organizing activities, and
  - ✓ the behavioral traits that underlie the arrangements chosen.
- Institutions "structure incentives in human exchange, whether political, social or economic".
- **Predatory (bad) institutions:** as institutions that do not encourage investment and economic development.
- **Developmental (good) institutions:** institutions that permit or encourage investment and growth.

- Institutions have a broad cluster including many sub levels:

  - **Economic institutions:**

- Determining the "economic rules of the game"
- In particular, the degree of property rights enforcement, the set of contracts that can be written and enforced, and some of the rules and regulations that determine the economic opportunities open to agents.
- Examples:
  - ✓ individual property rights
  - ✓ commercial law
  - ✓ contract law
  - ✓ patent law
  - ✓ the type of credit arrangements, etc.
- shape economic incentives, contracting possibilities, distribution.

- Economic growth brought forth by:
- **Inclusive economic institutions:** Secure property rights, law and order, markets and state support (public services and regulation) for markets; open to relatively free entry of new businesses; uphold contracts; access to education and opportunity for the great majority of citizens,
- That is it creates incentives for investment and innovation and a **level playing field**.
- But most societies throughout history and today ruled by **Extractive economic institutions:** Designed by the politically powerful elites to extract resources from the rest of society.
- Inclusive and extractive economic institutions do not exist in a vacuum, but are supported by certain political institutions.
- They exist following the type of political institution that exist.

Political institutions:

- determine the "rules of the political game."
- help to regulate the limits of political power and determine how political power changes hands.
- form of government, constraints on politicians and elites, separation of powers, etc.
- Examples:
  - ✓ the constitution
  - ✓ electoral rules
  - ✓ constraints imposed on the power of the executive by other branches of the government
  - ✓ the number of veto players
  - ✓ the extent of checks and balances etc.
- shape political incentives and distribution of political power.

- Big differences in economic and political institutions across countries.
  - ✓Enforcement of property rights.
  - ✓Democracy vs dictatorship.
  - ✓Constraints on politicians and political elites.
  - ✓Electoral rules in democracy.
  - ✓Entry barriers.
  - Corruption.
  - ✓ Legal systems.
- **Extractive political institutions:** in the limit "**absolutism**":
- Political institutions concentrating **power in the hands of a few**, **without constraints, checks and balances** or **"rule of law".**
- **Inclusive political institutions:** Political institutions **allowing broad participation**-**pluralism**- and placing constraints and checks on politicians; rule of law (closely related to pluralism).
- **There is synergy between political and economic instns.**

Institutions and organisations

- Institutions = rules of the game
- Organisations = players of the game
  - "groups of individuals bound together by some common purpose to achieve certain objectives" (North 1993)
  - Examples: political parties, regulatory bodies, firms, family farms, cooperatives, churches, schools
- Institutions within organisations
- Dynamic interaction between institutions and organisations
  - Institutional environment influences which organisations appear/exist
  - Organisations create new institutional arrangements and lobby for changes in institutional environment

❑ North (1990) stresses the distinction between **institutions** (the rules) and **organizations** (the players (Political (city council, parliament)Economic (firms, cooperatives, family farms) Social (clubs, athletic associations) Educational (schools, universities)))

1.2. Informal and formal rules and norms of behavior

- *Institutions are made up of formal constraints (such as rules, laws, constitutions) and informal constraints (such as norms of behavior, conventions, self-imposed codes of conduct)"*

1. **Formal institutions:** Codified rules. e.g. in the constitution.
2. **Informal institutions:** Related to how formal institutions are used, to distribution of power, social norms, and equilibrium.
   - Constitutions in U.S. and many Latin American countries similar, but the practice of politics, and constraints on presidents and elites very different.
   - Why? Because distribution of *political power* can be very different even when formal institutions are similar.

- **Formal constraints:**
- whether the country in question has a Supreme Court, separation of power, parliamentary system etc.
  - **Public:** laws and constitutions
  - **Private:** rules (e.g. sports games and club membership)
- **Informal constraints:**
- which determine how a given set of formal rules and informal institutions function in practice.
  - Traditions, customs, norms, codes of conduct
  - Institutions are everywhere, but may differ a lot from place to place.
  - Institutions change over time
- In general, informal institutions change more slowly than formal.
- Exception: constitution

1.3. The function of institution

- Institutions (What do institutions do?)
  - Define property rights
  - Define rules of exchange
  - Define incentives and constraints for individual decision makers
  - Influence transaction costs
  - Influence perceptions, interests and values
  - Influence rationality
- **Effective institutions** of economic exchange play the following role: coordinate exchange, facilitate low cost exchange (transaction costs) and provide the necessary incentives for agents.

- **The three key roles of institutions in economics:**

1. **Coordination roles:** institutions coordinate exchange at several levels. At its most basic level, coordinated exchange involves the reliable bringing together of buyers and sellers.

2. **Facilitative roles:** institutions facilitate efficient exchange by reducing information problems and by limiting opportunistic actions. The idea is **as transaction costs increases**, the potential **gains from economic exchanges declines** and hence economic activities decline.

3. **Allocative roles:** institutions providing the incentive structure affect the pattern of allocation of economic resources. If the institutions provide incentive to piracy, more resources will be devoted to capture the economic gains from piracy. If on the other hand institutions make production a profitable activity, then it provides agents to invest their resources on productive activities. If institution (the rules system, the belief, culture, etc.) enforce and protect private property rights, then agents will have the incentive to accumulate private property which affects the extent of economic activity, **saving, investment** and so many other economic variables.

- Institutions emerge to minimize transaction costs and to facilitate market exchange.
- Every set of institutions creates different losers and beneficiaries.
- Certain groups obtain high incomes, rents and privileges.
- Efficient institutions require either the losers to be compensated or the beneficiaries to impose their choice.
- Thus “distributional” implications from institutional choices.
- Economic institutions which shape incentives and determine distribution of resources.
- Preferences over institutions determined by their distributional implications.
- Institutions chosen for their economic consequences.

Features of institutions:

- ✓ Institutions are a structural feature of the society or polity. They are created with the only reason: decrease uncertainty.
- ✓ Stable over time.
- ✓ They must pose constraints and affect individual behavior of its members.
- ❑ Perhaps the following key features of institutions help you to understand what institutions are:
- ✓ All institutions involve the interaction of agents, with crucial information feedbacks.
- ✓ All institutions have a number of characteristic and common conceptions and routines.

- Institutions sustain, and are sustained by, shared conceptions and expectations.
- Institutions have distinct social boundaries in which they effectively work.
- **Unenforced rules are not component of institutions.**
- Institutions generally are thought to serve collectively valued purposes but sometimes institutions may exist without collective intentionality e.g. merely by virtue of shared conventions and habits or by virtue of sustained enforcement by certain groups;
- Although they are neither immutable nor immortal, institutions have relatively durable, self-reinforcing, and persistent qualities.
- Institutions incorporate values, and processes of normative evaluation. In particular, institutions reinforce their own moral legitimation: that which endures is often-rightly or wrongly-seen as morally just.

1.4. The interdependence of institutions

- ✓Reading Assignment

1.5. Institutions and development

- There is a strong support for the overwhelming importance of institutions in predicting the level of development in countries around the world.
- Protection of property rights, effective law enforcement, and efficient bureaucracies, together with a broad range of norms and civic mores, are found to be strongly correlated to better economic performance over time.
- Institutions support economic development through four broad channels:

1. determining the costs of economic transactions,
2. determining the degree of appropriability of return to investment,
3. determining the level for oppression and expropriation, and
4. determining the degree to which the environment is conducive to cooperation and increased social capital.

- Institutions as underlying determinants of long-run performance of economies.
- Developing countries remained poor as institutional constraints do not encourage productive activity; there is a need to redirect incentives to productivity –increasing paths (North, 1990, 1994)
- *Economics Institutions*: encouraging investment through incentives, human capital, entrepreneurship, innovation, occupational choice, land ownership.

i). Institutions that protect individual property rights – e.g. defend against expropriation of resources.

ii). Institutions related to democratic political rights (Sen)

iii). Institutions correcting co-ordination failure - efficiency of government for example in implementing policy (e.g. South Korea).

- Institutional determinants "trump" all geography and integration (trade) in determining the differences in incomes between the world's most developed countries and the poorest ones.
- It is not a new intuition that for the prospering of economic activity institutions matter.
- Adam Smith had already noted this is surprising detail, referring to the importance of a justice system, private property rights, and the rule of law (The Wealth of Nations).

- **why institutions appear so important to economic development?**

- Economic institutions influence growth because they shape incentives and affect investment in physical and human capital.

✓ Costs

1. Institutions conducive to economic development reduce the costs of economic activity.

- The costs include transaction costs such as search and information costs, bargaining and decision costs, policing and enforcement costs (Coase, 1992, Dahlman, 1979).

- They lower transaction costs by providing common legal frameworks (e.g. contracts and contract enforcement, commercial norms and rules), and they encourage trust by providing policing and justice systems for the adherence to common laws and regulations.
- Communities in LDCs typically rely on kinship or ethnic and religious ties for trade.
- Norms and networks of common language and religion may be enough to ensure compliance with agreements on economic exchange; collective punishment and social reputation may be enough to ensure the enforcement of (often informal) contracts even in the absence of a third party.

- To take advantage of opportunities for trade with different groups and increase the size of economic transactions, however, cultural ties are not enough.
- There is need for greater information about trading partners, and for institutions which ensure agreements on the details of exchange and compliance to the agreed conditions.
- These take the form of contracts, codes of conduct, standardized weights and measures, disclosure agreements, and enforcement through courts and policing.
- Where transaction costs are small, the private enforcement of contracts may still be preferred.
- But as economic relations develop and become increasingly impersonal, the role of a third party to enforce compliance to rules is increasingly necessary.

- **Property Rights and the Return to Investment**
- Such institutions increase the security that the risk of incurring in an economic transaction is matched by the full appropriation of its eventual benefits.
- This includes the presence of individual private property rights.
- **If property is protected** individuals are more **willing to invest** and **to incur sunk costs**.
- where individual perception of security of land tenure is low, investment in the land is significantly reduced, and output consequently drops (except when land is obtained through commercial transactions).
- Property right increases output and thus is conducive to economic development.
- The protection of property rights requires an expanded role for state authority.

- However, there is a risk that states which have the power to enforce property rights may use that power to expropriate property too.
- Thus property rights are by no means sufficient to spur economic growth, and must be balanced by institutions which limit the extractive capacity of state power.
- These typically involve **independent parliaments** and **judiciaries**.
- Democratic institutions of political representation strongly contribute to this process.

✓ **Power of Expropriation**

3. Thus institutions determine the extent to which those in power are able to expropriate the economy's resources to their private advantage.

- **Unequal institutions** strongly **limit development** by reducing the capacity of individuals to **access resources**, expand production and increase their incomes.
- A comparative analysis of development trajectories of countries indicates that **institutions which benefit elites and allow their appropriation of resources and products have perpetuated underdevelopment**.

- Countries which have undergone colonial domination tend to be plagued by such extractive institutions.
- These have outlived the gaining of independence on behalf of these countries, and their control has largely been taken over by local elites.
- There is evidence that it limits the development of greater rural employment and higher rural incomes.
- Greater equality and functional economic institutions are also seen as the cause for the successful development, where high inequality has concentrated power in the hands of a restricted elite, and governments have failed to adequately invest in infrastructure and public welfare.

- **Cooperation and Social Capital**

4. Institutions which are conducive to development ensure greater self-expression, allow the free flow of information and encourage the formation of associations and clubs.

- These form prosperous social relationships, which are conducive to greater economic interaction by increasing levels of trust and wider availability of information.
- Institutions conducive to development pool resources to provide the investments in education, health and infrastructure which lie at the basis of economic interaction and are necessary and complementary to private investment.
- Informal institutions lie at the basis of an economy.
- They include public agencies, trade unions, community structures and professional associations.

- **NB: Social capital** refers to features of social organization (in particular, horizontal associations) such as networks, norms and social trust that facilitate coordination and cooperation for mutual benefit."
- It is defined as the norms and social relations embedded in the social structures of societies that enable people to coordinate action to achieve desired goals.

1.6. Institutions in economics

- Economics is found as an institutional economics when it was first emerged.
- But latter, since economists believe that it is impossible to solve economic problems theoretical, the concern of professionals focus only quantitative economics.
- Latter again, economist found that it is difficult to solve all economic problems quantitatively.
- This days, the institutional view of economic problems is an essential component of economic and a thematic area for research.

Why institutions matter in economics?

- Adam Smith said that the productivity of an economic system depends on **specialization**.
- Specialization will be useful only if there is an **exchange,** and the **lower the costs of exchange** (transaction costs) the more specialization there will be and the **higher economic productivity** will be.
- Level of transaction costs however depend on **institutions**, its legal system, its political system, its culture etc.

- Institutions have three key roles in economics**: allocative, facilitative** and **coordination** roles.
- The performance of an economy as a whole or a given activity then depend on the efficiency of institutions to perform these roles.

❑ Four levels of institutional analysis

Williamson's framework: 4 level of social analysis

THE ECONOMICS OF INSTITUTIONS

	Level	Purpose	Theory
1	**Embeddedness:** (Informal institutions, traditions, norms, religion, culture, socio-political imperatives, etc.)	Protection, preservation, power	Social theory
2	**Institutional environment:** Formal rules of game: (property rights, laws, constitutions, etc.)	First order economising: Get the institutional environment right	Economics of property rights Positive political theory
3	**Governance:** Play of the game: (Aligning governance structures with transactions)	Second order economising: Get the governance structure right	Transaction cost economics
4	**Neoclassical analysis:** Performance (Optimality, prices, quantities, incentives, etc.)	Third order economising: Get the marginal conditions right	Neoclassical economics Agency theory

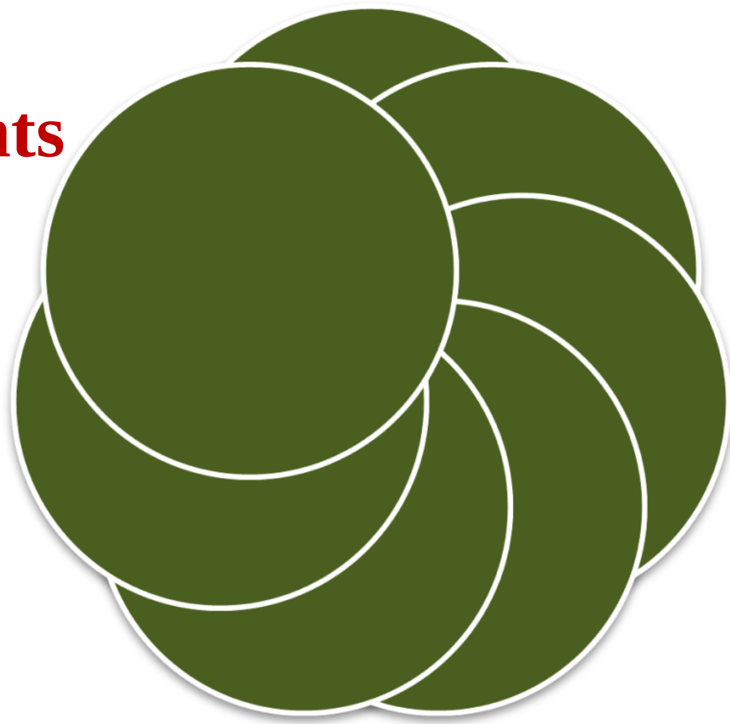
Adapted from Williamson 1999

- ® The confession is that we are still very ignorant about institutions.
- ® Chief among the causes of ignorance is that institutions are very complex.

❑ Challenges for institutional analysis

- ✓ Confusion with definition
- ✓ Institutions are invisible
- ✓ Multiple inputs from different disciplines are needed
- ✓ Given multiple disciplines and concepts a coherent institutional framework is needed.
- ✓ Multiple level of analysis
- ✓ Configural analysis rather that additive

CHAPTER TWO



Property rights

Contracts

Markets and firms

Transaction costs

Judicial Decision making

Chapter 2: Key theoretical and analytical constructs

- The new institutional economics has the following branches/ School of thoughts.

1. Transaction Cost Economics (Coase, Williamson, North)
2. Property Rights Theory (Alchian, Demsetz, Furubotn, Bromley, Barzel)
3. Theory of collective action (Ostrom, Olson, Hardin)
4. Contract Theory
   - Principal Agent Theory (Stiglitz, Tirole)
   - Incomplete Contract Theory (Hart, Moore)
5. Public choice and Political Economy (Buchanan, Tullock, Olson, Bates)
6. Social Capital (Putnam, Coleman)
7. Law and Economics (Posner)

2.1. Property rights

- **Property** is considered as a "benefit (or income) stream" in that the owner controls this benefit stream (Bromley 1991).

- A **right** may be a 'set of actions and behaviors that possessor of a property may not be prevented from undertaking, or a duty on all others to refrain from preventing those actions or behaviors'.

- Therefore, **rights** are not relationships between the right holder and an object/property, but rather are relations between the right holder and other people with respect to the object (Bromley 1991:15).

- What are "**property rights**"?
  - The right to:
    - √Use the asset
    - √Appropriate returns/benefits from the asset
    - √Change its form, substance, location
- A single "asset" may have multiple dimensions of property rights
- Property rights may be partitioned and exchanged in part, or in whole.
- Private property rights:
  - √Include ability to exclude others from using asset
  - √May be attenuated by institutional constraints
- For property rights **to have value**:
  - √Must be well-defined
  - √Must be enforced

- ***property right*** *is defined as "the capacity to call upon* the collective to stand behind one's claim to benefit stream" from an asset of economic importance (Bromley 1991).

- Property rights over assets consists of the **rights**, or the **powers**, to consume, obtain income from, and alienate these assets" Barzel (1989:2).

- "**Bundles of rights**" including access and withdrawal, exclusion, management and alienation rights (Schlager and Ostrom 1992)
- The claims, entitlements and related obligations among people regarding the use and disposition of a scarce resource" (Furubotn and Pejovich 1972).
- Furubotn and Richter (2005) review and classify property rights as **"absolute"** and **"relative"**, the former involving assignment of exclusive individual property rights to physical objects, whereas "relative" property rights include all rights related to contractual obligations and agreements.

Property rights regimes

1. Private property:

- It is any property that is not public property. Private property may be under the control of a single individual or by a group of individuals collectively.
- Private ownerships as the most efficient property rights arrangement.
- A set of ordered institutional arrangements in which the state protects the rights of certain individuals to access, control and manipulate resource benefit steams. Others have a right to expect that only socially-acceptable uses will occur, and a duty to refrain from preventing those uses.
- What are the advantages of private property? Some agree on its role in the efficient allocation of resources and investment in resource improvements

2. Common Property:

- distinction of “**common-pool**” and “**common** property”.

- A **common-pool resource** (CPR) is a particular type of good consisting of a natural or human-made resource system, the size or characteristics of which makes it costly, but not impossible, to exclude potential beneficiaries from obtaining benefits from its use.

- **Common Property** is the private property of a group of co-owners.

- “**Common property regime**" refers to a particular social arrangement regulating the preservation, maintenance, and consumption of a common-pool resource.

- **Common-pool resources** are not necessarily governed by common property regimes, they may be owned by national, regional or local governments as public goods, by communal groups as Common property resources or by private individuals or resources, corporations as private goods.

- Property rights in productive resources-land itself, trees, pasture, many water sources, fish, etc. often characterized by non-private property rights structures.
- Substantial part of income generation, especially in SSA
- Poor, and reliance on non-private resources as safety net
- Almost all "**big**" environmental problems are a function of resources under non-private, non-market property rights (desertification, forest management, soil erosion, pollution, over-fishing, overgrazing)

- Examples of **common-pool resources** include irrigation systems, fishing grounds, pastures, and forests
- **Common-pool resources** are generally subject to the problems of congestion, overuse, pollution, and potential destruction unless harvesting or use limits are devised and enforced, which could lead to the deterioration of livelihoods.
- In a common property regime, a common-pool resource has the appearance of a **private good** from the **outside** and that of a **common good** from the point of view of an **insider**.
- The resource units withdrawn from the system are typically owned individually by the appropriators.
- A common property good is rivaled in consumption.

3. State Property:

- **Resources** are **nationalized** and **citizens may have use rights**, while the **state has all forms of rights** to the resources in question.

- A **state property regime** is a set of institutional arrangements in which the state retains direct control of the benefits derived from a resource by determining access and use rules for individuals (Bromely, 1989, 1991).

- In many socialist countries, individuals are entitled to use resources but not to transfer rights to the resources without the interference of the state.

- However, such **state property regimes fail due to:**
- ✓ rigidity of the state agencies in their application of rules;
- ✓ state agencies usually ignore, or even attempt to undermine, indigenous political structures and institutions;
- ✓ state agencies often lack the power, authority and/or will to implement rules prescribed at regional or national levels; and,
- ✓ state employees who are responsible for the enforcement of resources use rules are often remunerated, legally or illegally, through the collection of fines. (e.g. corruption and bribes)

4. Open access:

- When resources are owned by no one or are used by all without any restriction, they exhibit **open access resources.**
- Such lack of property regime leads to resource destruction and increases behavioral uncertainty.
- Often termed as "tragedy of open access" or formerly coined as "the tragedy of the commons" (G. Hardin 1968)

Bundles of rights

- Note: we do not find very much distinction in property rights as such, rather a bundle of rights approach is important.
- The **bundle of rights** is a common way to explain the complexities and interdependence of rights to resources among actors having different positions

Bundles or rights

Bundles of rights associated with positions					
	Full owner	Proprietor	Authorized Claimant	Authorized User	Authorized entrant
Access	√	√	√	√	√
Withdrawal	√	√	√	√	
Management	√	√	√		
Exclusion	√	√			
Alienation	√				

- *Source: Ostrom and Sclager, 1996:133*

Forces of change in property rights

1. Equity versus efficiency

- There is **tradeoff** in achieving **economic efficiency** and attaining **equity** (distribution); one is satisfied at the expense of the other, i.e. efficiency cannot be materialized when distributional inequality is at stake (Wang, 2001).

- The ***distribution view*** *recognizes that the forces of change* in property rights are the inherent **dissatisfactions by certain groups** or individuals from the existing property rights structure. The existing distribution of property rights may **benefit some but harms others**.

- In such contexts, change is determined by the **capacity of actors** to 'contract' for property rights change or persistence of existing ones (Libecap 1989).

- The ***economic efficiency view*** - *property rights change* results from **opening of new markets, change in relative prices of factors** of production, demographic shift and technological innovation.
- Change in these factors in an economy creates a pressure for change in property rights (Demsetz 1967; Boserup 1965; North 1981; Bromley 1991; Ensminger 1997).
- They argue that **efficiency of land use increases** when property rights change from a purely **open access** (no property rights) **to common** and then **to private** due to population growth and resource scarcity leading to more commercialization.
- Though transaction costs of enforcing rights are increasing at each stage, the return from improved efficiency largely outweighs the costs (Bromley 1991)

2. The ‘ cost-benefit’ versus ‘scarcity-incursion’ analysis

a. Cost-benefit argument

- Property rights emerge when the **benefits** obtained from controlling access to resources **exceed** the **transaction costs** of defending the resource from others, i.e. the ‘social cost-benefit’ comparisons or ‘internalization of externalities’ from introducing new property rights.
- **Gains** from internalization of externalities must **exceed** the **costs** to cause alteration of property rights regime.
- Those economic forces fetching new opportunities (e.g. emergence of markets or newly introduced technology) should ensure cost-effective way of internalizing external effects (Demsetzg, 1967) (eg. controlling of hunting areas as a result of the rise of *fur* industry)

b. *The scarcity-incursion analysis* *- a counterargument challenging Demsetz's* view and that of his proponents (Field 1989).

- This is particularly the case in terms of predicting the **direction of change in property rights** when the **value of a resource rises**.
- An increase in resource value would rather lead to less exclusive property rights since the more valuable resource will attract greater incursion (Field 1989).
- According to Field, a higher resource value will cause pressure from outsiders intending to use the resource.
- This will cause the exclusion cost to rise much more than the benefits obtained from excluding others.

- An increase in the number of these commons (from a single large commons to completely divided parcels for individuals) will lead to a decline in the marginal governance cost because of reduced cost in organizing collective action.
- However, such an increase in the number of commons will lead to a rise in the marginal cost of exclusion (boundary management), where an increasing exclusion costs saves transaction costs.
- A point where **marginal governance costs** and **marginal exclusion costs** intersect, one may find an **optimal number of parcels** for the commons and **size of users**.

- An increase in resource value and an introduction of new technology of exclusion will again affect the optimality, where both having the opposite effect, but again maintaining the optimal point.
- Field's model does not completely deny the influence of population and economic growth as determining factors for private property to emerge.

❑State, Property rights and legal pluralism

- **State (or statutory) law:** as made by legislatures and enforced by the government;
- **Religious law**: including both law based on written doctrines and accepted religious practice;
- **Customary law**: which may be formal written custom or living interpretations of custom;
- **Project (or donor) law**: including regulations associated with particular projects or programs, such as an irrigation project;
- **Organizational law**: such as rules made by user groups; and a range of local norms, which may incorporate elements of other laws.
- Thus, **legal pluralism** can be a possible source of conflict and uncertainty

- *Where do we focus (the role of the state or the primacy of market)?*
- **Two perspectives** in explaining the **role of the state**:

a. Neoclassical view

- **State** (rulers) in the development and enforcement of constitution which further specifies the structure of property rights (North, 1981);
- Property rights specification by the state permits it to maximize monopoly rents in which case principal-agent model arises (as in tax collecting process by the state agents);
- Rulers maximizing their revenue to meet personal objectives subject to the degree of competition with their rivals (Levi, 1988).

b. Neo-institutionalist view

- **Principal-agent** relationship between **voters and politicians** and political exchange between interest groups;
- Institutional arrangements having impact on the ability of agents (law makers, government agents, bureaucrats) to make political commitments credible;
- Ex-post opportunism of the state is constrained by political institutions , one of which could be a limited terms of office; nationally inherited ethical habit may undermine opportunism.
- State playing a role in safeguarding and enforcing international agreements (e.g. hostages for exchanges, tit-for-tat for cooperation) (Furubotn and Richter, 2005)

- Political institutions of the state playing a role in correcting for market failures associated with production externalities and facilitating provision of public good (Bates, 1995);
- These institutions providing credible commitments in safeguarding investments (refraining from policies of predation) even in the absence of market mechanisms (Soskice et al,. 1992);
- They help in overcoming misallocation of resources over **time**, **corruption** and **rent-seeking** (Bates, 1995);
- Question : *Describe the characteristics of state political institutions in our country.*

2.2. Transaction costs

- **What is transaction?**
- A (voluntary) reallocation of property rights.
- **Transactions** are **not** about exchanging goods and services per se, but about **exchanging property rights to the valuable attributes** embodied in those items.
- A transaction occurs when a good or service is transferred across a technological separable interface. One stage of activity terminates and another begins(Williamson, 1985).
- A transaction is an elementary coordination problem connected with the question how to solve this problem institutionally (and technically).
- A transaction is the "**alienation** and **acquisition** between individuals of the rights of future ownership of physical things." (Commons, 1935)
- **A transaction is a transfer of property rights.**

❑ What is transaction cost?

- The term coined by Marschak, 1950 (search, information, measurement, bargaining, decision-making, control, insurance, legal procedures, etc)
- The costs of engaging in an exchange transaction:
  1. Search costs
  2. Negotiation costs
  3. Contracting costs
  4. Monitoring costs
  5. Enforcement costs
  - Most of all have to do with information costs of some sort.
- Costs of running the economic system (Arrow 1969).
- "Cost of establishing, using, maintaining and changing institutions." (Richter und Furubotn 1996).

- **Resources spend** on initiating, negotiating, safeguarding, monitoring, enforcing and adjusting transactions.
- **Utility losses** due to imprecise arrangements, inefficient safeguarding, monitoring, enforcement or adjustment.

Types of Transaction Costs

- Search and information costs
  - √Cost of searching for suppliers, customers, products, technologies, etc.
  - √Information about qualities, prices, etc.
  - Function of the distribution of information and the information and communication technology
- Negotiation and decision making costs
  - √Negotiation, balancing diverse interests
  - √Decision making costs, time and resources spend on decision making, cost of wrong decisions (bounded rationality)
  - Function of differences in preferences, number of people involved and the decision making rule

- Monitoring and Enforcement Costs
  - √Costs of monitoring, identification of non-compliance with the rules
  - √Costs of enforcement, sanctioning non-compliance
  - ➲Function of the measurability and verifiability of activities and the monitoring and enforcement technology
- Adjustment costs
  - √Costs of adjusting the rules to changing environmental circumstances
  - √Costs of maladaptation
  - ➲Function of the environmental uncertainty and the flexibility of rules

- **Categories of Transaction Costs**

- **Sunk and running transaction costs**
  - √Sunk: lost inputs, no opportunity costs
  - √Running: inputs for which opportunity costs exist
- **Fixed and variable transaction costs**
  - √Fixed - not depending on the size and the frequency of transaction
  - √Variable - depending on the size and the frequency of transaction
- **Ex-ante and ex-post transaction costs**
  - √Ex-ante costs: before the contract has been made
  - √Ex-post costs: after the contract has been made

- **Market transaction costs**
  - √Costs of market organization
  - √Searching, preparation, agreement, supervision, monitoring, controlling, enforcement, adjustment
- **Transaction costs in firms**
  - √Costs of firm organization
  - √Instruction, controlling, enforcement, adjustment
- **Political transaction costs**
  - √Costs of the establishment and maintenance of a political order
  - √Decision making, implementation, administration, enforcement
- The Coase Theorem: "In the absence of transaction costs, bargaining will lead to an efficient outcome regardless of the initial allocation of property rights"

Determinants of transaction costs

- Five dimensions affecting transaction costs:

1. ***Specificity***- *transactions requiring specific investments create high TC* as contractors anticipate the problem of ‘hold-up’ once investment is made (e.g. a contractual relation between output supplier and a processer investing in processing equipment);
2. ***Uncertainty and complexity***-*uncertainty increases the costs of* establishing how participants should behave as transactional variables (clients, technology and supply) change;
3. ***Frequency and duration-*** *high frequency entails low average transaction* cost as marginal transaction costs are decreasing; the longer the duration, the higher the transaction cost will be since longer terms involve a detailed negotiation.

4. ***Measurement or search cost***- *the extent to which we measure* transactions determine the cost (e.g. a tractor owner cultivating land and a lawyer negotiating a case where the latter involves higher degree of opportunism)

5. ***Connectedness***- *interdependent transactions are more costly than* independent ones as the former involves greater efforts in coordination of detailed relationships; however, perfectly connected activities could reduce transaction costs (e.g. a building project for a warehouse)

- **Question:** ***Do you expect possible interaction among these five determinants of transaction costs?***

2.3. Contracts

- **An agreement between one or more farmer(s)** and **a contractor for the production and supply of agricultural products under forward agreements**, frequently at predetermined prices (FAO, 2001)
- A **contract** is an agreement between a buyer and a supplier in which the terms of exchange are defined by a triple: **price**, **asset specificity** and **safeguards**, where quality, quantity and duration are specified (Williamson, 1996).
- **Long terms contracts** are complex and incomplete and their enforcement cost could be higher,
- The source of incompleteness being ‘bounded rationality’, where we find limited cognitive competence to store and process information.

- "**Contractual incompleteness** poses added problems when paired with the condition of **opportunism -**which manifests itself as:
  - adverse selection,
  - moral hazard,
  - shirking and other forms of strategic behavior" (Williamson, 2000).
- The basis for opportunism is **information asymmetry** where self-interested individuals will not readily disclose information about their preferences

- *In which form of contract is opportunism a problem?*

- ***Markets*** - ***short term contracts*** *(instantaneous) where* ***identity is irrelevant*** since a transacting party can go its own way at negligible cost to the other.

- ***Hierarchy*** **-** ***Transactions that are placed under unified ownership*** (*buyer* and supplier are in the same enterprise) and **subject to administrative controls** (an authority relation, to include fiat) are managed by hierarchy.
- The contract law of hierarchy is that of forbearance, according to which internal organization is its own court of ultimate appeal.
- ***Hybrid*** **-** ***Long-term contractual relations that preserve autonomy*** *but* provide added transaction-specific *safeguards*, *compared with the market.*
- ***Hybrid contracts*** *and* ***hierarchy*** *emerge as* ***asset specificity builds up*** *and* identity matters.

Factors affecting effectiveness of contracts

- ***Asset specificity**: A specialized investment that cannot be redeployed to alternative uses* or by alternative users except at a loss of productive value.
- Asset specificity can take several forms, of which human, physical, site, and dedicated assets are the most common.
- Specific assets give rise **to *bilateral dependency***, *which complicates contractual relations.*
- ***Safeguard** : The added security features, if any, that are introduced into a* contract in order to reduce hazards (due mainly to asset specificity) and to create confidence.
- Safeguards can take the form of penalties, a reduction in *incentive intensity, and/ or more fully developed private-ordering apparatus* to deal with contingencies.

- ***Extent of Using Private ordering:*** *The* ***self-created mechanisms*** *to* accomplish adaptive, sequential decision making between autonomous parties to a contract, including information disclosure, dispute settlement, and distributional mechanisms to deal with gaps, errors, omissions, and inequities.

Contract farming

- *Contract farming* - an agreement between a buyer and farmers establishing conditions for the **production** and **marketing** of a farm product or products;
- A farmer agrees to provide established quantities of a specific product, meeting the quality standards and delivery schedule set by the purchaser.
- In turn, the buyer commits to purchase the product, often at a predetermined price.
- The buyer could also commit to support production through supplying farm inputs, land preparation, providing technical advice and arranging transport of produce to the buyer's premises.

- Contract farming as a way to **cut transaction costs** and include small farmers in **high-value markets**
- *Some case studies indicate that:*
- ✓ Contracts could increase return to capital;
- ✓ Farm size, education and participation in farm groups as determinants of the effectiveness of contracts;

2.4. Judicial decision making

- The art of judicial decision-making is the cornerstone of justice system.
- Dear students, as you all know, there are three organs of the government.
  1. The legislative (make laws)
  2. The executive (execute laws), and
  3. The judicial (interpret laws) body
- There is division of power between the executive, the legislature and the judiciary
- It is the constitution that effectively guides the functions and powers these bodies.
- NB: The **constitution** of state is a plan for organizing the operation of government.

- It establishes the foundation for governments in the sense that it defines the very structures of government bodies.
- It defines the responsibilities of organs of government by which their actions and decisions are to be undertaken according to the provisions of the constitution.
- All the powers vested to the legislature, the executive, and the judicial organ is emanated from the people.
- Accordingly, **democracy** grants sovereign and ultimate power to citizens and all powers and offices of the government drives from the people.

- **Rule of law** protects the rights of citizens, maintains order, and limits the power the government.
- The principle of the **rule of law** means that **both** government and the governed are, and must be, **subject to the laws of country.**
- Government **decisions and actions** shall be made according to the established laws of the country rather than by arbitrary action.
- **There should be an independent judiciary.**
- The courts may declare on the acts or the legislature invalid if the law conflict with the constitution.
- The greatest defenders of the individual rights are courts and it is possible if judges have life tenure and can focus on legal issues without the destruction or imposition of politics.

- There must be a body that has the authority to determine what the constitution says and when different branches of the government exceeded their power.
- The only that should dictate the function of the court is the law and facts of the case.
- The **decisions of the court** must be free from the influence of the other organs and the higher official of the government.
- **A decision has to pass using an independent Judiciary.**
- While **rule of law** has become a broad solution to the problems of development, it has particularly found favor among lawyers as a method with the perceived potential to tackle problems ranging from **poverty** to **conflict** to **corruption** to **lack of human rights.**

- Thomas Carothers defines the **rule of law** as a system where there is broad and deep knowledge of legal rules, where political and civil rights are embedded in those rules and where the government itself is accountable to the law.

- He conceives **three types of rule of law reforms**:
  - ✓ the reform of the actual laws.
  - ✓ development of stronger legal institutions.
  - ✓ the development of norms within government institutions that compel adherence to the law.

- **The judiciary** must enforce internationally recognized **human rights**, provide fair and equal access to all persons, as well as hold the police accountable for violations of basic and fair procedures

- **Judicial reform** is required for promotion rule of law.

- This may include:
- ✓ establishing legal frameworks for judicial independence,
- ✓ building judicial associations,
- ✓ promoting education and training of judges,
- ✓ strengthening court administration,
- ✓ Improving judicial ethics and accountability, and
- ✓ increasing public outreach and media skills.

- As the judiciary is the final authority to determine whether **legislative acts are constitutional**, it has to has the power to review administrative actions, to order the executive to act and the appellate process to reverse lower court decisions.

- Realists stipulate that judges determine the outcome of a lawsuit *before deciding whether the* conclusion is, in fact, based on an established legal principle.
- In other words, a judge reviews the facts presented and decides how he or she will rule without first analyzing precedent and statutory law.
- Once the judge has reached a conclusion, he or she will then look for existing principles in case law or statutory regulations that support the conclusion.
- Only in unique circumstances where such a premise cannot be found will the judge change his or her conclusion to one which can be justifiably maintained.
- It reject the idea that "a judge begins with some rule or principle of law as his premise, applies this premise to the facts, and thus arrives at his decision.

- **The four competing types of judicial decision-making models** that are popular in political science.

1. *The Legal Model/*Professional Model

- Judges decide cases **based on the facts and the law.**
- Judges' decision-making process is shaped by their legal training, which includes traditional principles of logic, constitutional and statutory interpretation, and so on.
- The model focuses on **all judges**, and emphasizes the differing roles and responsibilities of judges at each stage of the judicial process.
- The model envisions the **court system as a funnel**, with trial judges serving as the "first responders" and the "primary care" providers.
- The legal model posits that judicial decisions are based on the facts of the case and the rule of law.
- The plain meaning of constitutional clauses, the intent of the Framers, and precedent.

- A judge will apply his legal training and knowledge to the facts at hand and decide in an objective legal manner.
- **Precedent** plays an important role in the legal model.

2. Attitudinal Models

- **Judges decide** cases to reach the outcome they prefer based on their **ideological attitudes** and **biases**.
- A judge's attitudes and biases are shaped partly by the prevailing views of the judge's peer group and individual background.
- The model focuses attention on U.S. Supreme Court Justices, and, to a lesser extent, other appellate judges.
- The model often studies high-profile, controversial cases.

- The model envisions the **court system as a pyramid.**
- The best way to understand judicial decision-making is to focus on the policy preferences of the justices.
- Court opinions are merely defenses of those preferences.
- Justices will vote according to how well they can advance their preferences.

- This should come to no surprise to anyone with an understanding of economic theory or social choice theory.
- When making a choice from a set of alternatives, individuals choose the one they prefer most.
- That is, they rank alternatives in an ordinal manner and select their first choice.

3. Institutional Models

- The **tradition of precedent does matter.**
- Economists view such traditions as **institutions,** political scientists are more apt to consider other, more visible institutions in their analyses.
- This is the case with the rational choice institutional models of judicial decision-making.
- These rational choice models pit the Court's interests against the interests of Congress.

4. Strategic Models:

- Marks' separation-of-powers model highlights the strategic relationship between the Court and the other branches of government.
- Perry argues that strategic relationships exist within the Court as a relationship between justices characterized by bargaining and strategy.

- Perry emphasizes that votes on certiorari fall within two categories, which determine the type and level of strategy involved by the justices.
- His decision model posits an initial step that determines the basic logic by which a justice will decide to grant certiorari.
- The steps in the process suggest a great deal of strategy.
- Charles G. Haines remarked that "judicial decisions are affected by the **judge's view of public policy** and by the **personality** of the particular judge rendering the decision."
- Specifically, social, political, economic and cultural movements, coupled with the judge's individual temperament, personal impulses, and lifelong experiences, create a predisposition whereby certain judges are inclined to arrive at certain decisions.

- To Haines, **the factors most likely to influence judicial decisions** are:

1. direct influences which include:

a) legal and political experiences;

b) political affiliations and opinions; and

c) intellectual and temperamental traits; and

2. indirect and remote influences which include:

a) legal and general education; and

b) family and personal associations, including wealth and social status.

- Significantly, Haines excludes formal rules of logic, established legal principles and precedent as critical factors in the judicial decision-making process.

2.5. Markets and firms

- Market as "an organization", is understood as:

1. social arrangement to facilitate repeated exchange among parties,
2. social network consisting a set of actors with customer relationships, a legitimate order (or governance structure) controlling transactions between market actors (Furubotn and Richter, 2005);

- Market competition does not only lead to resource allocation (as in neoclassical view) but also becomes a source new knowledge, learning and creativity for economic agents; hence market evolves given the institutional constraints (Mantzavinos, 2001)

- Considering technologies and coordination important components while explaining markets from an evolutionary perspective.
- Thus, **market** is not something out there but should be **formed** and **produced by the market actors**;
- **Firm** (hierarchy, vertical integration) is in the center of analysis.
- Main choice: **firms versus markets** instead of firms versus the state; the school deals with hierarchies rather than markets, and with institutional arrangements rather than institutional environments.
- **A precondition for a market** is the presence of legal mechanism to enforce property rights, after which individuals get engaged in mutually beneficial exchanges (Rubin, 2005)

Chapter 3: Demand for institutions

3.1. The role of transaction costs

- The concept of transaction costs is the foundation of **New Institutional Economics.**
- Coase (1937) in "The Nature of the Firm": There is a cost to using the price system for **coordinating** supply and demand: **transaction costs.**
- A firm will exist as long as it can perform a coordinating function that is lower than the market or lower than another firm.
- Basic premise: Institutions matter for economic performance.
- The purpose of NIE is to **explain** the determinants of institutions and their evolution over time, and to evaluate their impact on economic performance, efficiency and distribution.
- No commonly agreed upon definition.

- What are Institutions? A set of formal and informal rules of conduct that facilitate coordination or govern relationships between individuals.
- Why is it called “New”?
- ✓ To distinguish it from the “old” institutionalist school (Veblen, Commons)
- ✓ **NIE** operates within the framework of neo-classical economics, but it relaxes some of its assumptions and incorporates institutions as an additional constraint.
- ✓ Economic activities are embedded in a framework of institutions, formal & informal.
- NIE is a useful tool to address policy issues in developing countries because:
- ✓ Frequent occurrence of market failure & incomplete or imperfect markets,

- Many of the formal rules of behavior that are taken for granted in developed economies do not exist in developing countries.

Transaction cost economics:

- Defining transaction costs: Cost of screening and selecting a buyer or seller, Cost of obtaining information on the good or service, Cost of bargaining & negotiating a contract, Cost of monitoring & enforcing the contract.

- Coase (1937): Market exchange is not costless. Firms emerge to economize on transaction costs.
- Boundary of the firm determined by nature and extent of transaction costs.

- Williamson (1996, 2000): Combines the concepts of bounded rationality & opportunistic behavior to explain contracts & ownership structure of firms.
- Continuum of organizational form (from vertical integration to cash markets) that depends largely on the magnitude of transaction costs.

- North (1986, 1989, 1994): Institutions that evolve to reduce transaction costs are key to the performance of economies.
- Not all institutions that emerge are efficient. **Role of government** is crucial in specifying property rights and enforcing contracts.
- North (1990): "The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical **stagnation and contemporary underdevelopment** in the third world."

❑ How is transaction cost economics relevant?

- Globalization & industrialization of world agriculture
- Market liberalization & government devolution

- Increasing reliance on vertical linkages, long-term contracts, and coordinated relationships.

- Characteristics of rural agricultural-economy in developing countries:
- Small farmers and traders face high transaction costs resulting in thin markets.

- Market failure in the provision of credit, inputs, and services in remote areas
- Incomplete or imperfect land and labor markets.

- **The transaction costs literature will be important in:**
  - √ Explaining the choice of contracts between different market participants
  - √ Analyzing the type of institutional innovation needed to integrate small farmers and the poor in the new agricultural economy.
  - √ Understanding the role of the government and the private sector in supporting the development of these institutions.
- Example 1:
  - ➢ Contract farming: Contract farming as a way to cut transaction costs and include small farmers in high-value markets (Minot 1986, Delgado 1999).
  - What are the conditions that make contract farming sustainable and beneficial to small and poor farmers?
  - What is the role of the government in improving those conditions?

- Example 2:
  - Grades & standards: Increasing demand for safe, healthy, and high-quality food in the industrialized countries are changing the nature of international grades & standards (Kherallah, 2000).
- How can developing countries respond?
- Do grades and standards act as a barrier to trade to small farmers or do they create an opportunity to enter high-value produce markets?
- Example 3:
  - Transaction costs and traders behavior: How do traders respond to high transaction costs in terms of screening for trust-worthy partners, obtaining information, and enforcing contracts? (Gabre-Madhin, 1998).
  - Is the institutional response of traders efficient?
  - What is the role of the government to cut down on transaction costs and decrease the riskiness of market exchange?

- **Weaknesses & limitations of transaction cost economics:**
- ☑ Better at describing behavior & providing diagnosis than at predicting outcomes or prescribing cures.
- ☑ Measuring transaction costs is difficult
- ☑ Poor modeling of risk & uncertainty
- ☑ No unified framework or theory
- ☑ Still very ignorant about institutions

- **Social Capital:**
- Isn't "standard" economics enough?
- What is social capital? How does it operate?
- A need to extend the models economists use and to incorporate findings from other fields in fact already exist many examples.
- **Social Capital definition**: " Social capital refers to features of social organization (in particular, horizontal associations) such as networks, norms and social trust that facilitate coordination and cooperation for mutual benefit." Putnam (1995).
- "A variety of different entities, with two elements in common: they all consist of some aspect of social structure, and they facilitate certain actions of actors within the structure" Coleman (1988).

- “includes the social and political environment that enables norms to develop and shapes social structure.
- Includes the more formalized institutional relationships and structures, such as government, the political regime, the rule of law, the court system and civil an political liberties” Grootaert (1998).
- “Social capital is defined as the norms and social relations embedded in the social structures of societies that enable people to coordinate action to achieve desired goals.” The World Bank (2000).
- Norms, Networks, Trust, Coordination and cooperation, Individual/Household, Local/Community, National, International, Private versus Public good.

- **How is social capital hypothesized to work?**
- It lowers transactions costs of exchange,
- Improved diffusion of information and innovations,
- Strengthens informal insurance mechanisms,
- Increases the probability of trust-sensitive exchanges being made,
- Improves local authority performance by drawing them into networks.

- Social? Capital?
  - **Is it Social?** Social in sense of society. But this does not necessarily mean public good.
  - **Is it Capital?** Analogy to other forms of capital useful. Don’t push too hard on this, especially distinction between stocks and flows.
- How is social capital quantified (at “micro” level)?
  - ✓ Contacts & other network measures,
  - ✓ Group membership (and characteristics),
  - ✓ Degree of civic engagement and/or responsibility,
  - ✓ Strength of family networks, Trust measures, (Absence of Violence.

- **Social capital:** problems to bear in mind:
- ✓ Exclusionary aspects, If it's who you know, how did you get to know them? May be particularly true for the poor,
- ✓ Endogeneity,
- ✓ Measurement is difficult,
- ✓ It can have negative externality effects.

3.2. Interdependence between transaction costs and institutions

- The concept of transaction costs is the foundation of New Institutional Economics.
- The idea is **costs of transactions** determines what goods and services are produced and the capacity of any economy to take advantage of the **division of labor and specialization-** the two key concepts of economic theory since Adam Smith.
- Thus, transaction costs profoundly influence not just individual firms but the *size and activities of the entire economy.*
- *But in addition to the concept of transaction costs, two other concepts are also central to NIE: the concepts of property rights and contracts.*
- Presence of transaction cost is in fact the foundation of institution al economics.

- The institutions and rules which govern how markets work (the "rules of the game", in the terminology of Douglass North) may also be adapted and refined so as to reduce transaction costs.
- Transaction cost theory derives from the "New Institutional Economics" approach and focuses on institutions of governance.
- **Institutions of governance** refer to **modes of managing transactions** and include market, quasi-market, and hierarchical modes of contracting.
- It is based on the premise that **institutions are transaction cost-minimizing arrangements**, which may change and evolve with changes in the nature and sources of transaction costs (Coase, 1937;Williamson, 1985).

- The most obvious example of this is the introduction of standard weights and measures and quality standards which make it easier for products to be directly compared.
- The creation of “market-places” in which buyers and sellers of specific products assemble at known times and places is another obvious institutional mechanism for reducing search costs.
- There are also more complex informal rules and codes of conduct which govern how negotiations may be closed and contracts enforced within particular types of markets or amongst specific societies or groups of people.
- Specifically, where established codes of conduct serve to create increased trust, transaction costs are seen to fall considerably and this may be a key explanatory factor for why markets grow faster within certain societies and locations.

- Efficient institutions are the ones that diminish uncertainty in inter-human relations or, in the terms of neo-institutional analysis, they diminish transaction costs.

Chapter 4: Measurement of transaction costs

- Fundamental issues
  - There are a number of fundamental issues relating to transaction cost measurement, which underlie the subsequent discussions of typology, chronology, and measurement methodologies.
  - These can be grouped as:

    (1) integrating transaction costs in policy analysis;

    (2) defining transaction costs;

    (3) the effect of time on transaction costs; and

    (4) the tradeoff between precision and measurement cost.

4.1. Integrating transaction costs in policy analysis:

- Transaction costs need to be measured within a larger framework of the overall costs and benefits of a proposed policy.
- Many transaction cost measurement studies have implicitly or explicitly assumed that the benefits provided by different policies are similar so that a cost-effectiveness framework is sufficient.
- This may not always be the case. For some policies, there is a much broader range of benefits than the other policies examined.
- It is rarely the case that the types and levels of benefits are the same for all the options, so a full cost–benefit analysis is desirable.

- It is essential to make a distinction between decreasing transaction costs and increasing efficiency for a number of reasons.
- A **policy** should not be **rejected** due to high transaction costs alone since there may be tradeoffs between transaction costs and other types of costs.
- Some policies with low abatement costs may have higher transaction costs.
- Transaction costs also need to be viewed in the context of what costs would be incurred in the absence of the policy being evaluated.
- For example, a policy to reduce catch in a declining fishery may be costly but the alternative may be the eventual loss of an industry or the extinction of a species.

4.2. Defining transaction costs

- Measurement of transaction costs forces examination of what is and is not a transaction cost.
- Transaction cost measurement also requires researchers to look at the reality of how policy is made and implemented.
- Kuperan et al. (1998) demonstrate the importance of detailed knowledge of the political and natural resource system to ensure that all costs are accounted for.
- Such knowledge allowed them to recognize that the government is involved at many different stages with respect to both central management and comanagement of a fishery.
- There are numerous definitions of transaction costs and inconsistencies among them that confound the development of consistent transaction cost measures.

- A very narrow definition was used by Demsetz (1968), Transaction cost may be defined as the cost of exchanging ownership titles, while Barzel (1985) used the somewhat broader costs of effecting exchange.
- Gordon (1994) defines transaction costs as the expenses of organizing and participating in a market or implementing a government policy.
- Coase (1960) uses the phrase the cost of carrying out market transactions to refer to interactions between firms or between individuals and firms.
- Coase refers to administrative costs when the resolution of the externality comes about within a firm or by government regulation.
- Some authors treat transaction costs and administrative costs as essentially interchangeable terms (Stiglitz, 1986).
- we define the term transaction costs as including administrative costs.

- Allen (1991) presents a definition that, while designed to be generally applicable, is particularly well suited to environmental and natural resource policies since many market failure issues stem from incomplete property rights:
- **Transaction costs are the resources used to establish and maintain property rights.**
- They include the resources used to protect and capture (appropriate without permission) property rights, plus any deadweight costs that result from potential or real protecting and capturing.
- Some of these costs may represent lost opportunities for productive innovations since human competence is scarce (Eliasson, 1996).
- North (1984) indicates that measuring valued attributes embodied in a good, such as an orange, is costly.
- Therefore, a broader definition is used in this paper: transaction costs are the resources used to define, establish, maintain, and transfer property rights.

- There are a number of issues that relate to the boundaries of transaction costs and their measurement, which are illustrated in the following fig.

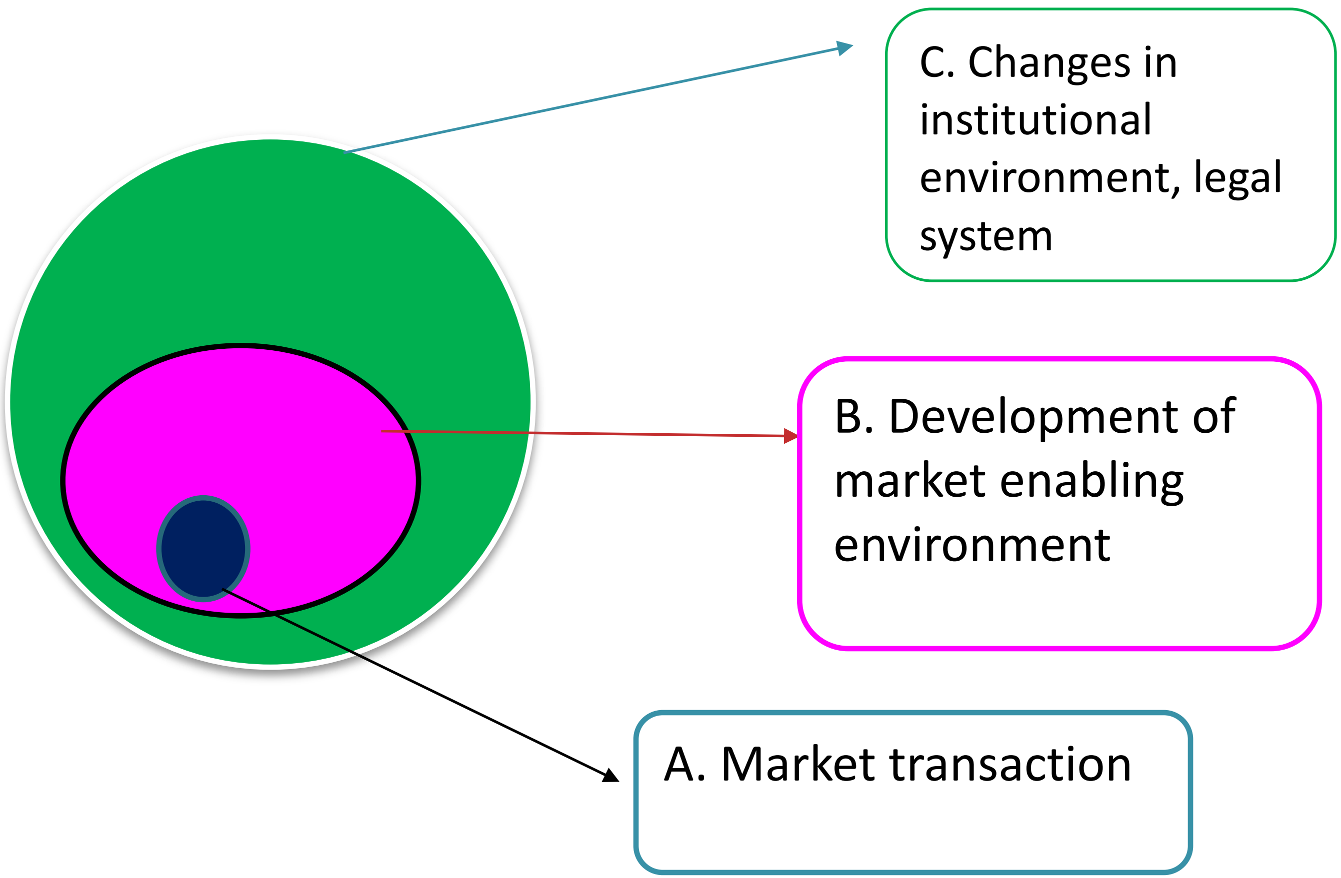


Fig: Boundary issues relating to transaction costs

4.3. The effect of time on transaction costs

- Transaction costs consist of both ex-ante and ex-post costs- those occurring before and after the actual transaction.
- The transaction could be thought of as the enactment of legislation or a court ruling. However, there may be a number of transactions prior to and subsequent to the primary one.
- For instance, a policy that establishes tradable permits will entail transactions for years after the policy is established.
- Falconer et al. (2001) have pointed out that transaction costs vary over the life cycle of a program.
- They may decrease with time due to learning, similar to the literature on learning by doing in manufacturing (Arrow, 1962), and to the presence of fixed or sunk costs, which are incurred primarily at the beginning of a program.

- Existing institutional arrangements and policies may lower the costs of one program relative to another (OECD, 2001).
- History matters, in that an efficient new policy may appear to be more costly than a less efficient program that was set up long ago.
- In another setting, where there is no existing policy, it may be less costly to adopt the more efficient policy.
- There are tradeoffs among costs over time.
- Therefore, the time period covered by the analysis and the discount rate used become important.
- For instance, a policy/program might incur high initial transaction costs as part of a broad stakeholder outreach and consensus-building process and have lower litigation and noncompliance costs later (Egdell, 1998; Colby and Pearson d'Estree, 2000a,b).

4.4. Precision versus measurement cost

- For the differing purposes of transaction cost measurement, how precise do our estimates need to be?
- As an initial screening across policy instruments, rough borders of magnitude may be good enough and would represent an improvement over current practice.
- If these types of costs are to be used as evidence in court, as with nonmarket valuations of natural resource damages, a much higher standard will be required. However, collecting detailed data on transaction costs is difficult and costly.
- Different methodologies may be required for these different uses.
- For example, if researchers only measured types of costs for which there is abundant, reliable data and ignored other types of costs, the measured values would be biased.

- The notion of "transaction costs" is taken from the field of transaction cost economics, a theoretical development first pioneered by Ronald Coase in 1937 in the "The Nature of the Firm" and subsequently developed by Oliver Williamson, and by others working within the new institutional economics tradition, such as David Teece.
- **Transaction costs economics** place ***transaction*** *in the centre of economic production and* exchange activities.
- Transaction costs are defined as '**the costs which allow an economic transaction to take place but which add nothing to the value of the transaction**'.
- These costs arise due to the frictions involved in the exchange process as it entails transfer and enforcement of property rights.
- At microeconomic level, transaction costs are considered a **waste in economy.**

- Transaction costs represent "the difference between what a consumer pays and what a seller gets", a difference which is always positive.
- **Existence of transaction costs:**
- **TC** are the costs that an actor bears in order to engage in exchange (political, economic, social etc.).
- **TC** exist because information is costly to obtain as well as due to "**bound rationality**", cognitive limits and the **opportunism** (self-interested individuals will not readily disclose the information about their preferences).
- **They** are distinguished from the "production costs" which are essential for the creation of a product or the provision of a service.
- They may be broken down into "**search costs**", "**bargaining and decision costs**" and "**policing and enforcement costs**".

Search Costs	☐ **The costs necessary for potential buyers and sellers to identify the possibility of a mutually beneficial contract being established – essentially the costs of market research.**
Bargaining & Decision Costs	☐ The costs which need to be incurred in order to define a contract: specifically the cost of negotiating mutually satisfactory terms and conditions.
Policing & Enforcement Costs	☐ The costs which must be incurred in order for a contract to be enforced: the cost of supervising the fulfillment of a contract and of seeking legal redress in the case of non-fulfillment.

4.1. Ordinal and cardinal approaches:

- The notion of '**transaction costs**' is best considered as a **metaphor**, rather than as a precise measureable concept.
- Although **transaction costs** represent a real concept of demonstrable importance to the structuring of markets and organizations and to the efficiency of operations, this is **not** a concept which lends itself to **easy measurement**.
- This is in large part because investments in 'transaction activities' may generate benefits as well as costs.
- In principle, one may identify an inflection point in the 'transaction cost curve' where investments begin to generate only net costs but identifying this point would in practice be **virtually impossible**.
- For this and other practical reasons, any serious attempt to measure the transaction costs is likely to be expensive but ultimately futile, and is not recommended.

- Unfortunately, it is rarely possible to measure the costs of internal organization *and the costs of market contracting directly.*
- *As a result, we cannot* estimate the parameters of the any structural model directly.
- We do not typically have good **cardinal measures** of the transactional attributes.
- *Instead, researchers frequently must rely on* ***ordinal*** **proxy variables** to measure variations in the elements of *transaction cost attributes.*
- *So, empirical* studies often rely on observations indicating whether or not a relationship is governed by internal organization or market contract using various proxies for variations in transaction related variables that are elements of *transaction costs such as asset specificity, complexity,* uncertainty, and frequency of transactions or repeated interaction.

- Measuring variations in the importance of specific investments to support cost minimizing exchange is difficult.
- In a number of cases survey data have been used to characterize the importance of specific investments in supporting different groups of transactions within the set that is being studied.
- In other cases efforts are made to develop ordinal characterizations of the different types of asset specificity associated with specific sets of transactions within the groups.
- Ideally, it would be desirable to identify attributes of the firms in the sample that are expected to affect the costs of internal organization as well.
- Then the comparative costs of alternative governance arrangements could be captured directly.

- Variables that affect the costs of market contracting are orthogonal to the variables that affect the costs of internal organization.
- More important, since these measurements are based on ordinal rankings, it is hard to compare them from industry to industry.
- What is ranked as a relatively specialized asset in one firm may be rated differently in another firm or industry.
- Similarly, what one firm considers a comparatively uncertain production process may be the standard operating environment in another.

4.2. Two Traditions of Law

- **Common law**

- The common law developed differently in its two main historical places: England and in the United States.
- It is the part of English law that is derived from **custom and judicial precedent/models/examples** rather that statutes.
- It is the body of law derived from judicial decisions of courts and similar tribunals.
- It is the British legal system, and is now used in former British colonies, including the U.S.
- It is sometimes referred to a "judge made law" since the law itself is not written down anywhere, but is the product of judicial decisions, and in particular the decision of appellate courts in resolving actual disputes between individuals, or between individuals and the state.

- In common law countries one has to be aware that the courts have much more independent power than in countries with the civil law system.
- The law was decided by the courts and it depended on the tradition and the precedents of the specific courts.
- Thus law was not a unit, but it was linked to the court that had the jurisdiction to decide on the specific writ.
- According to the concept of common law, a right or obligation can only be created by the judge and a sentence of the court.
- In common law countries the courts empowered by the basic procedural rights will implement justice even though substantial rights may not be given constitutional priority.

- In a common law country one has in addition to discern also the jurisdiction of the courts and in particular to decide how conflicts among different court jurisdictions have to be solved.
- As in common law countries the courts are also law-makers, this distribution of court jurisdiction is of central interest.
- *Habeas corpus is considered to be the core of human rights in common law countries.*

- Common law is somewhat less restrictive than code law; that is, it generates less state power.
- In contrast, legal codes are passed by legislatures and interpreted by judges.
- Thus, in code countries judges are said to interpret the law, but not make it.
- The major difference is in the amount of deference/respect given to the state.
- **A basic question for law and economics is the efficiency of law.**
- Friedrich Hayek (1960, 1973), argued that **common** or judge made law **was superior to statute law.**
- The argument was that common law was "bottom up" law, which began with judges and individuals, while code law was "top down" and so paid more attention to the state and gave more power to the state.

- The common law existed independently of the legislature or the sovereign.
- Hayek argued that common law provides more protection against predation by the state and leads to more freedom than code or civil law.
- Paul Mahoney (2001) indicates that common law judges have more autonomy, and that government officials in code law countries are less subject to legal controls than in common law countries.
- **Common law** makes no distinction between private and public law. The same legal principles apply to actions of government officials and private persons.
- More recently, Posner (1973/2003) has of course argued often and forcefully that the common law is efficient.

- The difficulty of this method is that often the conclusion regarding the efficiency of a particular rule depends on unmeasured transactions costs of various sorts.
- His argument depended on utility maximization by judges.
- The argument is that judges are so insulated from personal factors and from interest group and other pressures that the only remaining **decision factor is efficiency**.
- The only other candidate is income redistribution, and judges lack the tools needed for such redistribution.
- Since this argument was unsatisfactory, scholars turned to evolutionary models to try to explain efficiency.
- The evolutionary models are attempts to explain the form of legal rules without resort to utility functions.
- Initially, these models aimed at explaining Posner's observation that the common law was efficient.

- However, inefficient laws can sometimes create asymmetric stakes because the inefficiency means that there are deadweight losses than cannot be bargained away in the settlement process.
- That is, an inefficient rule creates a loss to one party that is greater than the gain to the other because of future stakes in similar type cases.
- Michael Crew and Charlotte Twight (1990) expanded on this point and found common lawless subject to rent seeking than statute law.
- Charles Rowley and Wayne Brough (1987) find that contract and property might be expected to be efficient, but not tort.

- There is less evidence on the efficiency of the common law relative to code law then of the overall efficiency of a rule of law.
- Nonetheless, Scully (1992) finds a significant relationship between protection of individual liberties and the common law than in countries with a codified legal tradition.
- **Common law origin legal systems lead to significantly increased economic growth because they provide more stable property rights and better contract enforcement.**

Continental Law

- The Continental system started with the French Revolution.
- Continental law system is the French and German concepts, which with regard to administrative law and constitutional review have developed somehow different administrative law principles.
- **Constitutions** are not only conceived as instruments to **limit governmental power**, but they are also seen as the tools to set up, organize and **empower the governmental branches** in order to establish the liberal state
- In the continent the main holder of sovereignty is the **legislature as the only law maker**.
- The **court** is only the body that **applies the law.**
- The power to make the law has totally shifted from the court to the legislature.

- Courts, which according to the continental law system can only quash decisions, have no possibility to prohibit torture.
- In **continental legal** systems, **federalism** is mainly designed along the legislature, while in the **common law** system federalism has to take into account the division of sovereignty of the three traditional branches of government.
- The continental view, that already statutes contain rights and obligations, is not familiar to the common law tradition.
- Thus a human right may be a directive for the court in order to respect it within its decision.
- However, it only an enforceable right if it has been decided by the court.
- According to **continental law**, the statute not only **limits the power of the administration**, it also **empowers the administration**.

- As a result, absolutist **Continental kings** enjoyed **unchecked power** and **interfered with relative ease with private property rights**, thus **hampering the development of market relations** **b**ased on secure private property (North and Thomas, 1988).
- It has been claimed that both the lack of practice and doctrinal influences made Continental judges more **resistant to capitalist wealth accumulation** and hindered their understanding of market transactions.
- Market relationships, with their considerable exposure to risk and striving for profit, were hardly understood by a judiciary which derived most of its income and status from risk-free rents (Taylor, 1967).

- **Judicial respect for property rights also probably suffered** because judgeships were often **expropriated by kings** who were free to sell new judicial offices (Doyle, 1996; Swart, 1980).
- Thus, the judiciary on the Continent did not gradually erode the constraints of the Ancient Regime.
- Because of both institutional constraints and judicial training, civil law judges ended up constituting a barrier to the development of new market relationships.
- Moreover, one has to be aware that comparative analyses among different countries within the respective system may be very different.
- Countries which adopted the continental system have established their own specific statutes and laws which differ considerably from territory to territory.

- In conclusion, the **common law** tradition sees law as an instrument only to limit state government, whereas according to the **Continental tradition**, it limits but also empowers state government.
- If the constitution is seen as an instrument not only to limit state power but also to empower state agencies to change the society, it will have a different position with regard to development and to a peace process.

Chapter 5: Governance Structure

- What is **governance**? It is understood as:

1. The process of deciding what the collective will do and how it will do in such a way that institutions are created through the process of governance to provide order to the relations among members of the collective (Bromley 1989).
2. The exercise of legitimate authority in transacting affairs, broadly understood to refer to the maintenance of social order through endogenously evolved sets of rules or authority structures, or some combination of locally evolved and externally imposed rules sets (Mearns, 1996).

- ***Government*** - the "exercise of influence and control, through law and coercion, over a political community, constituted into a state within a defined territory" (Mearns, 1996)
- Government need information for governance, how to get it is often problematic.
- Information gap on resource conditions undermines the effectiveness of policies in shaping resource governance
- Therefore, governments should establish **governance structures** (refer to **institutional arrangements** through which **rules are created and enforced**, the structures performing the sanctioning of compliance with rules)
- Hence, the **sources of information** for governments are the ultimate rule enforcers and those abide by rules.

- Espino (1999) defines **governance structure** as an organization's internal rules devised to guide its daily transactions. That is the interactions among individuals within the organization and its relations with other organizations.
- **Governance structure:** refer to the institutional framework within which the integrity of a transaction is decided (Williamson, 1979). Markets and hierarchies are two of the main alternatives.
- They are the institutional matrix within which transactions are negotiated and executed and vary with the nature of the transaction.
- Governance structures which attenuate opportunism and otherwise infuse confidence are evidently needed.

- Governance structures, however, are properly regarded as part of the optimization problem.
- Williamson (1996) associates the concept of institutions with that of governance for micro analyses of the individual transaction.
- The institutional environment (rules of the game) is taken as granted, and the economic players willfully align transactions with governance structures to optimize revenues.
- Thus, institutions are governance mechanisms and their study is directly related with the optimum decision regarding lower transaction costs.
- Arrow (*as Williamson*, 1996,) defines **transaction costs** as "costs of running the economic system".
- Based on this concept, Williamson states that the **choice of governance mode** is made through a comparison of the costs of one governance mode with those of others.

- In this sense, *the **study of governance** is concerned with the identification, explanation, and mitigation of all forms of contractual hazards (Williamson, 1996).*

- Three broad types of **governance structures** will be considered:

1. non-transaction-specific,
2. semi-specific, and
3. highly specific.

- The **market** is the classic non-specific governance structure within which "faceless buyers and sellers meet for an instant to exchange standardized goods".

- The **contractual issue** is at the core of the debate on the costs of running a transaction (Coase, 1972).

- Such issue contributes toward the progress of the Theory of the Firm, inasmuch as it points out other relevant determinants of the firm's productive efficiency.

- For Williamson, the contract is a complex institutional arrangement involving the different aspects of an economic transaction (basic unit of an economic relation), such as planning, promises, competition and governance (Williamson, 1985).
- The existence of distinct dynamics within the internal logic of the transactions translates into a complex puzzle of theoretical and empirical knowledge.
- These internal divergences of the transaction are understood through the attributes that lead the economic agents to negotiate.
- Based on the TCE, Zylbersztajn (1995) infers that "*the prevailing **governance structures** are the **optimizing** result of the alignment of **characteristics of the transactions** and of the **institutional environment**. Thus **optimization** is seen in the neoclassical style, meaning **search for efficiency**".*

- Therefore, it is possible to make a Darwinian assumption that an efficient governance structure should prevail as a winning structure.
- And it is a fact that there is a process of expelling inefficient structures – which may last until the result is achieved.
- The path dependence may allow for the persistence of inefficient structures.
- The necessary time for the most efficient structure to win would depend on a series of factors, among which is asymmetric or incomplete information or even institutional rules - formal or informal - that prioritize certain structures.
- It can be verified that the governance structures are distributed in **three different ways**, two extreme ones, hierarchy and market, and an intermediary one, the hybrid mode.

- The higher the asset specificity involved, the higher the cost of its market monitoring.
- The hierarchy is characterized by internal organization (vertical integration).
- The governance structure characterized by vertical integration is mainly determined by the characteristics of the specific assets used in the chain.
- The higher the asset specificity, the larger the prizes given by the adoption of the hierarchy as a governance mode.
- North (2005) points out that the persistence of heterogeneous governance structures may be a result of factors such as institutional path dependency.
- Despite the same degree of asset specificity among the firms, the **coexistence of different governance structures is possible** and occurs as a result of the firms' strategies concerning target markets.

- Thus it is possible to have the same production system meeting different demands, which makes the existence of more than one type of efficient structure possible.
- However, it can be observed that besides the assets, the same chain can have different strategic directions, which makes different governance structures viable.
- Instead of analyzing only the asset specificity to evaluate the trend to obtain a **high governance cost** and a more hierarchic structure, it is necessary, based on the argumentation developed, to bear in mind: the markets the firms serve (size, level of information necessary, type of product, quantity of competitors and consumers); inter-relationship among the markets (dependence on the different markets served with the same production technology); degrees of uncertainty.

- The governance system ensuring transparency and accountability in the titling, registration and transfer of property rights (the court system).

5.1 Market governance:

- **Market governance** is the main governance structure for non-specific transactions of both occasional and recurrent contracting.
- Markets are especially efficacious when recurrent transactions are contemplated, since both parties need only consult their own experience in deciding to continue a trading relationship or, at little transitional expense, turn elsewhere.
- Being standardized, alternative purchase and supply arrangements are presumably easy to work out.
- Non-specific but occasional transactions are ones for which buyers (and sellers) are less able to rely on direct experience to safeguard transactions against opportunism.
- Often, however, rating services or the experience of other buyers of the same good can be consulted.

- Given that the good or service is of a standardized kind, such experience rating, by formal and informal means, will provide incentives for parties to behave responsibly.
- To be sure, such transactions take place within and benefit from a legal framework. But such dependence is not great.
- As S. Todd Lowry puts it, "the traditional economic analysis of exchange in a market setting properly corresponds to the legal concept of **sale** (rather **than contract**), since sale presumes arrangements in a market context and requires legal support primarily in enforcing transfers of title" (1976).
- He would thus reserve the concept of contract for exchanges where, in the absence of standardized market alternatives, the parties have designed' 'patterns of future relations on which they could rely" (1976).

- The assumptions of the discrete contracting paradigm are rather well satisfied for transactions where markets serve as a main governance mode.
- Thus the specific identity of the parties is of negligible importance; substantive content is determined by reference to formal terms of the contract; and legal rules apply.
- Market alternatives are mainly what protect each party against opportunism by his opposite.
- Litigation is strictly for settling claims; concentrated efforts to sustain the relation are not made, because the relation is not independently valued.

5.2 Trilateral governance

- The two types of transactions for which **trilateral governance** is needed are occasional transactions of the mixed and highly specific kinds.
- Once the **principals to such transactions have entered into a contract**, there are strong incentives to see the contract through to completion.
- Not only have specialized investments been put in place, the opportunity cost of which is much lower in alternative uses, but the transfer of those assets to a successor supplier would pose inordinate difficulties in asset valuation.
- The interests of the principals in sustaining the relation are especially great for highly **idiosyncratic/distinctive transactions**.

- Market relief is thus unsatisfactory.
- Often the setup costs of a transaction-specific governance structure cannot be recovered for occasional transactions.
- Given the limits of classical contract law for sustaining such transactions, on the one hand, and the prohibitive cost of transaction-specific (bilateral) governance, on the other, an intermediate institutional form is evidently needed.
- Neoclassical contract law has many of the sought-after qualities.
- Thus rather than resorting immediately to court-ordered litigation-with its transaction-rupturing features-**third-party assistance (arbitration) in resolving disputes and evaluating performance is employed instead**.
- The use of the architect as a relatively independent expert to determine the content of form construction contracts is an example (Macneil, 1978)

- Also, the expansion of the specific performance remedy in past decades is consistent with continuity purposes-though Macneil declines to characterize specific performance as the "primary neoclassical contract remedy" (1978).
- The section of the Uniform Commercial Code that permits the "seller aggrieved by a buyer's breach unilaterally to maintain the relation" is yet another example.

5.3. Bilateral governance

- The two types of transactions for which specialized governance structure are commonly devised are **recurring transactions** supported by investments of the **mixed and highly specific** kinds.
- The fundamental transformation applies because of the non-standardized nature of the transactions.
- **Continuity of the trading relation is thus valued.**
- The transactions' recurrent nature potentially permits the cost of specialized governance structures to be recovered.
- Two types of **transaction-specific governance structures** for **intermediate product market transactions** can be distinguished: **bilateral structures**, where the autonomy of the parties is maintained, and **unified structures**, where the transaction is removed from the market and organized within the firm subject to an authority relation (vertical integration).

- Bilateral structures have only recently received the attention they deserve, and their operation is least well understood.
- Highly idiosyncratic transactions are ones where the human and physical assets required for production are extensively specialized, so there are no obvious scale economies to be realized through inter-firm trading that the buyer (or seller) is unable to realize himself (through vertical integration).
- In the case, however, of mixed transactions, the degree of asset specialization is less complete.
- Accordingly, outside procurement for those components may be favored by scale economy considerations.
- As compared with vertical integration, outside procurement also maintains high-powered incentives and limits bureaucratic distortions

5.4. Unified governance

- Incentives for trading weaken as transactions become progressively more idiosyncratic.
- The reason is that as human and physical assets become more specialized to a single use, and hence less transferable to other uses, economies of scale can be as fully realized by the buyer as by an outside supplier.
- The choice of organizing mode then turns entirely on which mode has superior adaptive properties.
- **Vertical integration** will ordinarily appear in such circumstances.
- The advantage of vertical integration is that adaptations can be made in a sequential way without the need to consult, complete, or revise inter-firm agreements.

- Where a single ownership entity spans/covers both sides of the transaction, a presumption of joint profit maximization is warranted.
- Thus price adjustments in vertically integrated enterprises will be more complete than in inter-firm trading.
- And, assuming that internal incentives are not misaligned, quantity adjustments will be implemented at whatever frequency serves to maximize the joint gain to the transaction.
- Unchanging identity at the interface coupled with extensive adaptability in both price and quantity is thus characteristic of highly idiosyncratic transactions.
- **Market contracting** gives way to **bilateral contracting**, which in turn is supplanted by **unified contracting** (internal organization) as asset specificity progressively deepens.
- The efficient match of governance structures with transactions that results from the foregoing is shown below.

		Investment characteristics		
		Nonspecific	Mixed	Idiosyncratic
Frequency	Occasional	Market governance (classical contracting)	Trilateral governance (neoclassical contracting)	
	Recurrent		Bilateral governance (relational	Unified governance contracting)

		Investment Characteristics		
		Nonspecific	Mixed	Idiosyncratic
Frequency	Occasional	Purchasing Standard Equipment	Purchasing Customized Equipment	Constructing a Plant
	Recurrent	Purchasing Standard Material	Purchasing Customized Material	Site-Specific Transfer of Intermediate Product Across Successive Stages

5.5. Efficient governance (Vertical integration)

- As transaction costs increases, governance structure moves from spot markets to hybrid to hierarchical forms of governance, the last form involving vertical integration or a variety of alternative governance structures or institutional arrangements of economic organization.
- **Vertical integration** represents an alternative governance structure to bilateral contracts for mediating the supply of a product that requires specific investments to support cost minimizing exchange.
- Rather than fiddling with contractual protections to mitigate the inherent conflicts of interest that may arise between independent buyers and sellers in the presence of specific investments, and dealing with other distortions and rigidities that such contracts may entail, the buyer may choose instead to integrate backward (or the seller integrate forward) into the supply of the input at issue (or sale of the downstream good).

- As assets become more specific and more appropriable, *quasi-rents are created and therefore the possible gains from* opportunistic behavior increase.
- The costs of contracting will generally increase more than the costs of vertical integration.
- Hence, *ceteris paribus*, *we are more likely to observe vertical* integration.
- The solution that neo-institutionalists find to the problem of asset specificity that generate opportunistic behavior and high transaction costs is the organization of activities inside the firm by adopting forms of vertical integration, with a view **to save on transaction costs**.
- **Vertical integration** is favored when the benefits of mitigating opportunism problems by moving the transactions inside the firm, by reducing ex-ante investment and ex-post performance inefficiencies, are greater than other sources of static and dynamic inefficiency associated with resource allocation within bureaucratic organizations.

- Continuum of organizational form (from vertical integration to cash markets) that depends largely on the magnitude of transaction costs.

Chapter 6: Institutional changes in the process of development.

- “Institutions matter" is crucial to implement institutional policies.
- Institutions are path-dependent and country specific.
- Hence, the problem is to implement appropriate institutions that bring about economic development.
- **Development** is defined by institutional economists as a process of "institutional change and economic growth" (Toye 1995).
- However, since institutions are "standardized behavior patterns" then in order **to change institutions** those **behavioral models must change**, **breaking off old rules, social norms and routines** that impeded a development process before (Kuznets, 1965)

- **Kuznets says:**

"*The transformation of an underdeveloped in developed country is not merely the mechanical addition of a stock physical capital. It is a thoroughgoing revolution in the patterns of life and a cardinal change in the relative powers and position of various groups in the population. The growth must overcome the resistance of a whole and complex of established interest and values*" (1965).

- In a nut shell, there is no short cut to get institutions right.
- But the good news is, once institutional change begins, the change is then incremental.

6.1. Types of institutional changes

- **Path dependence**
  - when the institutional framework poses certain constraints for the downstream institutional choices and therefore influence the whole process of institutional change.

- **Power**
  - institutional change is the result of the power circles action in their own interest.

- Institutional change can also be:

a) **Elite-driven versus conflict-driven**:

- **Elite-driven:** when the politically powerful elite wish to change institutions in order to increase its rents/utility.
- **Conflict-driven:** when institutional change forced from the non-elites.

b) **Internal versus external:**

- **Internal:** because of internal shocks or dynamics.
- **External:** because of external imposition, shocks, or external incentives.

- **Institutional change** implies the creation of a new set of institutions which provide the basis for a new economic and social order.
- New patterns of correlated behavior underlying development must be conceptualized before they can emerge.
- Although these new patterns can originate in the mind of an individual or group of individuals, any new structure will arise from some conjoint (often legal or legislative) mechanism.
- One can conceptualize **three paths of institutional change**:

1. path-independent,
2. path-dependent, and
3. path-determinant.

6.1.1. Path determinacy

- Differences among countries in their pace of economic development is largely attributed to their path of institutional change (**path dependence**).
- **Path-determinant change** implies significant discretionary/free ability/ intervention, where design is fairly open, but also referenced to the existing past.
- New ideas arise from a causal understanding of historical patterns and relationships with ideational influences.
- Yet the approach is not contained/restricted by the past, but builds upon and is an instrument of transformation.
- The path-determinant approach is aimed at not only understanding what is transpiring/happen, but what could transpire.
- **Cognition**/process of knowing/ is both expansive and continuous.

- Institutions transform and are transformed by the elements of the matrix in a continuous fashion.
- Change is both **discretionary** and **referenced to past and present institutions**.

6.1.2. Path dependence

- The **path-dependent change** - opposite view- has a minimal element of discretion and is heavily informed by existing arrangements.
- There is room for only moderate change which largely reflects prior correlations.
- New knowledge or approaches that are introduced are largely ceremonial-the status quo (existing state of affairs) defines any adjustment.

- ✓ If institutional changes are incremental, why then some countries stagnated?
- ✓ The direction of change is determined by path dependence.
- ✓ **Path dependence means the past situation determine the future path.**
- ✓ Stagnation perpetuate stagnation, decline produce decline and increment induce increment.
- ✓ Path dependence is produced by existing organizations: political, economic, social, and religious organizations.
- ✓ **Institutional path dependence** is then defined as the fact that "the process by which we arrive at today's institutions is relevant and constrains future choices" or "a way to narrow conceptually the choice set and link decision making through time; it is not a story of inevitability in which the past neatly predicts the future".

- We will adopt an encompassing definition of path dependence, considering that "**history matters**" because of legacies and also because of strategic path shaping actions that influence the process of institutional change.
- Organizations favor policy changes that favor their interest.
- In addition, the mental models of the actors-the entrepreneurs-produce ideologies that "rationalize" the existing institutional matrix and therefore bias the perception of the actors in favor of policies conceived to be in the interests of existing organizations.
- **Path dependence** is (when the institutional framework poses certain constraints for the downstream institutional choices and therefore influence the whole process of institutional change).

- Liebovitz and Margolis (1995), distinguish among **three forms of path dependence**.

1. The **first-degree path dependence** is a situation whereby the influence of some initial events on the final outcome does not create any inefficiency in the economy.
2. The **second-degree path dependence** is characterized by the scarcity of information in the initial phases of decisional process, which leads to regrettable outcomes that are not remediable.
3. Finally, the **third-degree path dependence** refers to situations in which an inefficient outcome could have been avoided because of the existing better alternatives.

6.1.3. Path independence

- **Path-independent change-** arises deductively from a logical set of propositions and is independent of any locally generated pattern of culture, ideation, or behavioral regularity.
- Inspired by the neoclassical vision, the approach has dominated reform in Africa.

6.2. Theories of Institutional Change

6.2.1. Theory of Induced Institutional Innovation

- The driving forces for institutional change is the technical progress and change in relative factor prices (Hayami and Ruttan 1985).
- Institutional change is the product of the interaction between demand and supply, basically influenced by the neoclassical equilibrium model.
- Market forces create a demand for institutional change.

6.2.2 Transaction costs theory

- Existing institutions are inefficient in terms of reducing transaction costs.
- Hence, new institutions that could reduce transaction costs are required.

6.2. 3 Distributive bargaining theory

- The driving forces for institutional change is distributional conflict over resources of significant economic importance (Libecap, 1989: Knight 1992, 1997).
- In this theory, institutions are the by-products of social conflict.
- Institutional change is a response to conflict to correct for distributional imbalances.
- Take an example of property rights change
- To apply bargaining theory, one needs to allow for the possibility that some social actors are more powerful than others and investigates the effect of those differences (Knight 1992:127).
- The success of an actor in bargaining is directly related to the ability of an actor to produce strategic commitments (or threats), i.e. compliance or noncompliance to the rules of the game.

- The theory can be applied where there is conflict over resource uses between groups or individuals.

6.2.4. Political-Economy Theory

a) Interest Groups

- There is a political exchange between interest groups (Olson 1982)
- **"Politicians hear nothing from many, but a lot from few";**
- **Dedicated group of voters influence processes of institutional change in return for their political support.**
- Emergence of rent-seekers in the process, having access to public fund in a very unnoticeable way to the public (e.g. money spent on lobbying to manipulate rules of the game)

b) Public choice theory

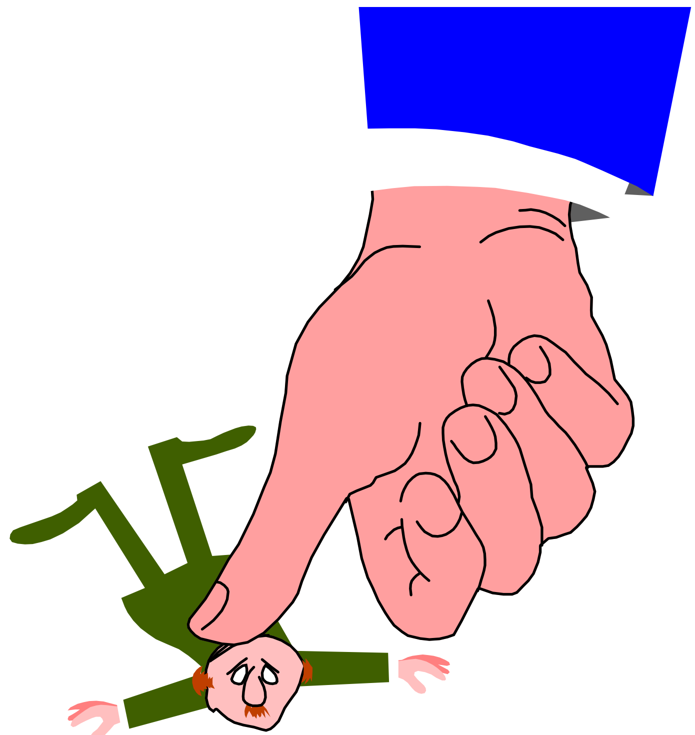
- James Buchanan came up with public choice theory
- the principal-agent relationship between the voters and politicians (Tullock 1987).

- Thus, institutional change arises from the influence of the principals (constituents) on their agents who are expected to maintain their promises or commitments (**political market**)

6.2.5 Evolutionary theory

- Building upon an evolutionary perspective, the concept of **'convention'** was developed based on the works of Sugden (1989), Harsanyi and Selten (1988) and Hayek (1979).
- It refers to unintended consequences of human interaction, driven by 'group' other than 'individual' interests.
- A useful point in this theoretical argument is that though conventions can in a stronger sense be converted to rules, they are not the result of any collective choice and do not originate from abstract rational analysis (Sugden 1989:97).
- It includes rules that have never been consciously designed but are in the interest of everyone to keep (North 1990).

- Rules evolve in unintended way rather being designed on calculative basis contrary to the rational choice.



Chapter 7: General framework for collective action

7.1. Basic Concepts

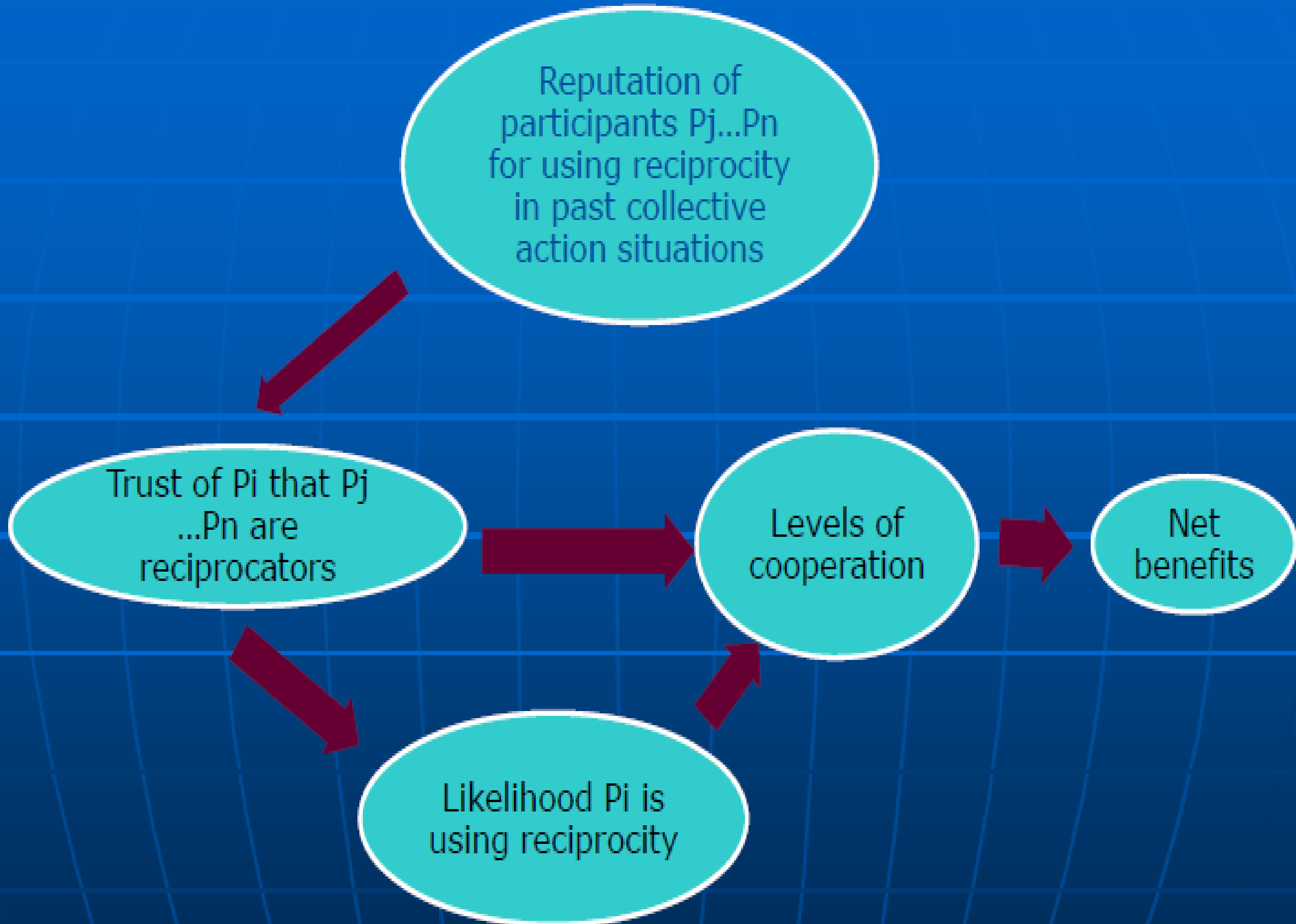
- Conceptualizing collective action has come after the work of pioneer contributors to the field such as Mancur Olson (1965)
- Problems of collective action in the provision of public goods (problem of exclusion of free-riders)
- R. Hardin (1982) criticizes Olson as he considers economic incentives as the main drivers by ignoring non-economic reasons.
- Common to both authors is that collective action is organized when the efforts of two or more individuals are needed to accomplish specific outcome (Sandler 1992)

- Collective action is organized when greater benefits are expected through joining a group rather than acting individually.
- The incentive to organize it is dictated by limited capacity of an individual to provide a good from which he or she generates private benefit (Meinzen-Dick et al. 2004).
- **collective action** is defined as "***an action taken by a group*** *(either directly or on its behalf through an organization)* ***in pursuit of members' perceived shared interests*** *" (Marshall 1998).*
- It can also be defined as "***a coordinated behavior of groups toward a common interest or purpose*** *" (Vermillion 1999: 184).*

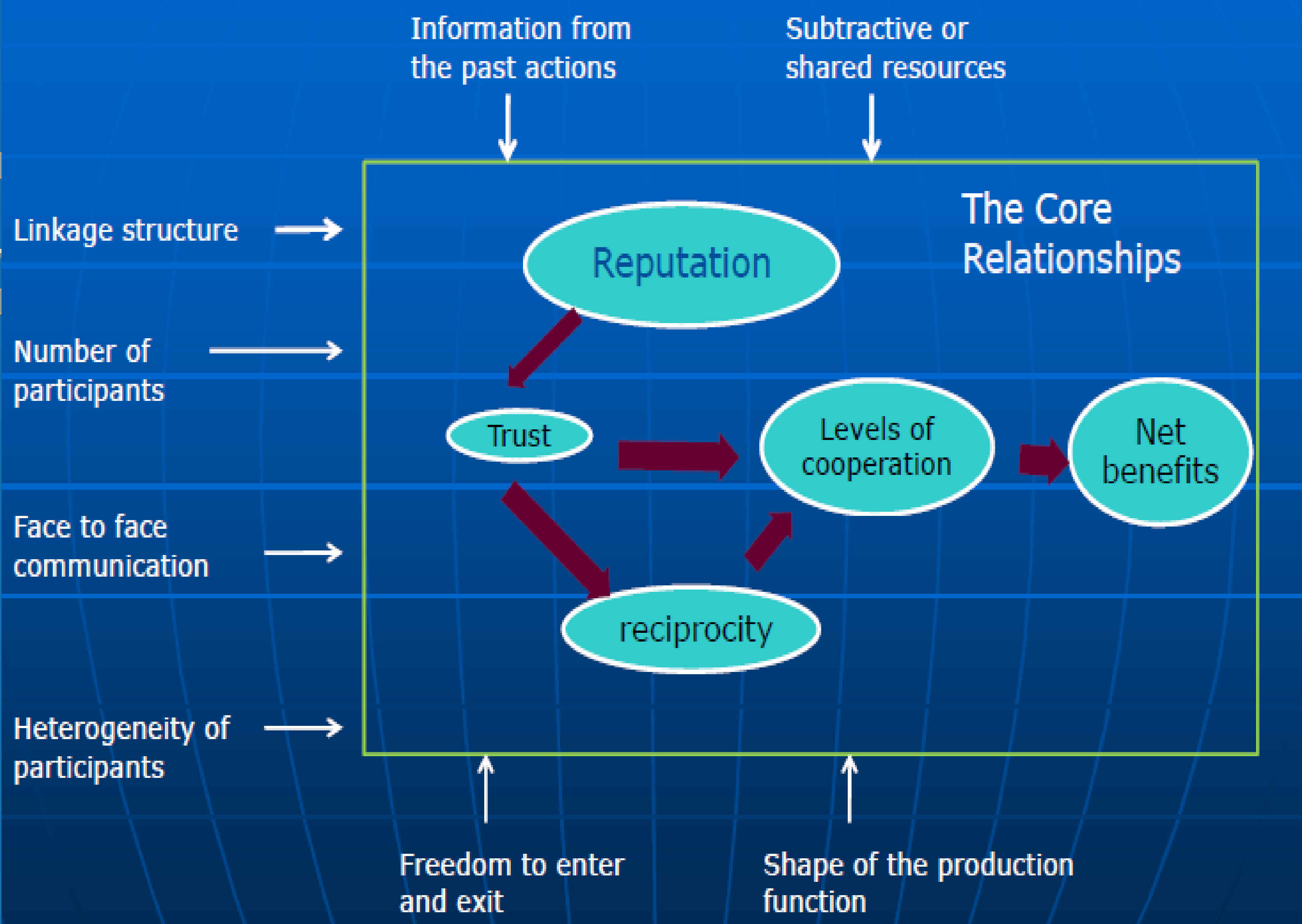
7.2. The Theory of Collective Action

- The most important challenge in collective action is how to find individuals acting collectively in an environment where they face a dilemma about one another's action (Hardin 1982).
- As a result, studies on collective action tend to examine factors motivating individuals to coordinate their activities to improve their collective well-being (Sandler 1992:19).
- **Trust**, **reciprocity** and **reputation** are the three core individual level variables determining individual cooperative behavior in collective action (Ostrom 1998)

- Individuals gain reputation for being trustworthy (or keeping promises) and showing higher levels of cooperation.
- **Trust** shows the expectations that individuals have about others' behavior.
- Some degree of trust about others' action in accordance with the established norm is a precondition for individuals to cooperate.
- When others also cooperate, the reciprocal relationship is attained and this tends to continue as predictions from the theory of repeated games inform us (Sobel 2002).



- cooperation in a social dilemma (Source: Ostrom, 2005)



- A framework linking the structural variables to the core relationships (Ostrom, 2005)

7.3. Fairness, trust, reciprocity and cooperation

- **Fairness**, **trust** and **reciprocity** - important factors affecting cooperative behavior in collective action;
- **Reciprocity:** A norm that generally reflects an attribute that an individual is inclined **to react positively to the positive actions of others and vice versa** (Fehr and Gächter 2000; Bolton and Ockenfels 2000; Fehr and Schmidt, 2004);
- It is governed by moral rules; a benefit granted to one party only upon an implicit condition that it will be returned some other time in the future;
- Self-enforcing agreements could emerge and mutual reinforcement of behavior will take place in a repeated interaction setting;

- First movers trusted second movers to reciprocate even in condition where there is no possibility of punishment (experimental games) (Berg et al. 1995; Hoffman, McCabe and Smith 1998);
- Positive and negative reciprocity – based on the responses of the first mover (involving retaliatory actions);

- **Altruism:** A characteristic in which an agent continues to cooperate while the opponent fails to reciprocate; a behavior which slightly differs from that of conditional cooperators.
- **Inequity aversion:** An individual with an **aversion to income inequality** would **sacrifice own income** to increase or decrease others' income so as to achieve a more equal allocation (Fehr and Schmidt, 1999; Ahn et al., 2003).
- **Self-interested:** An individual is poorly motivated by private benefits to be consistent irrespective of that of others.

7.4 Determinants of Collective Action

- Some of the **factors that determine participation in collective action** include:

1. Heterogeneity (economic, socio-cultural)
2. Mutual vulnerability of group members,
3. Rule enforcement capacity,
4. Established selective incentives (punishments, rewards)
5. Effectiveness of leadership
6. The nature of property rights
7. Attributes of resources (size, predictability)

- Social capital plays a great role in collective action.
- <u>NB</u> : "Social capital refers to features of social organization (in particular, horizontal associations) such as networks, norms and social trust that facilitate coordination and cooperation for mutual benefit." Putnam (1995).
- "A variety of different entities, with two elements in common: they all consist of some aspect of social structure, and they facilitate certain actions of actors within the structure" Coleman (1988).
- Coleman makes distinction between types of social capital as "**bonding social capital**" (within a group) and "bridging social capital" (Coleman1988).

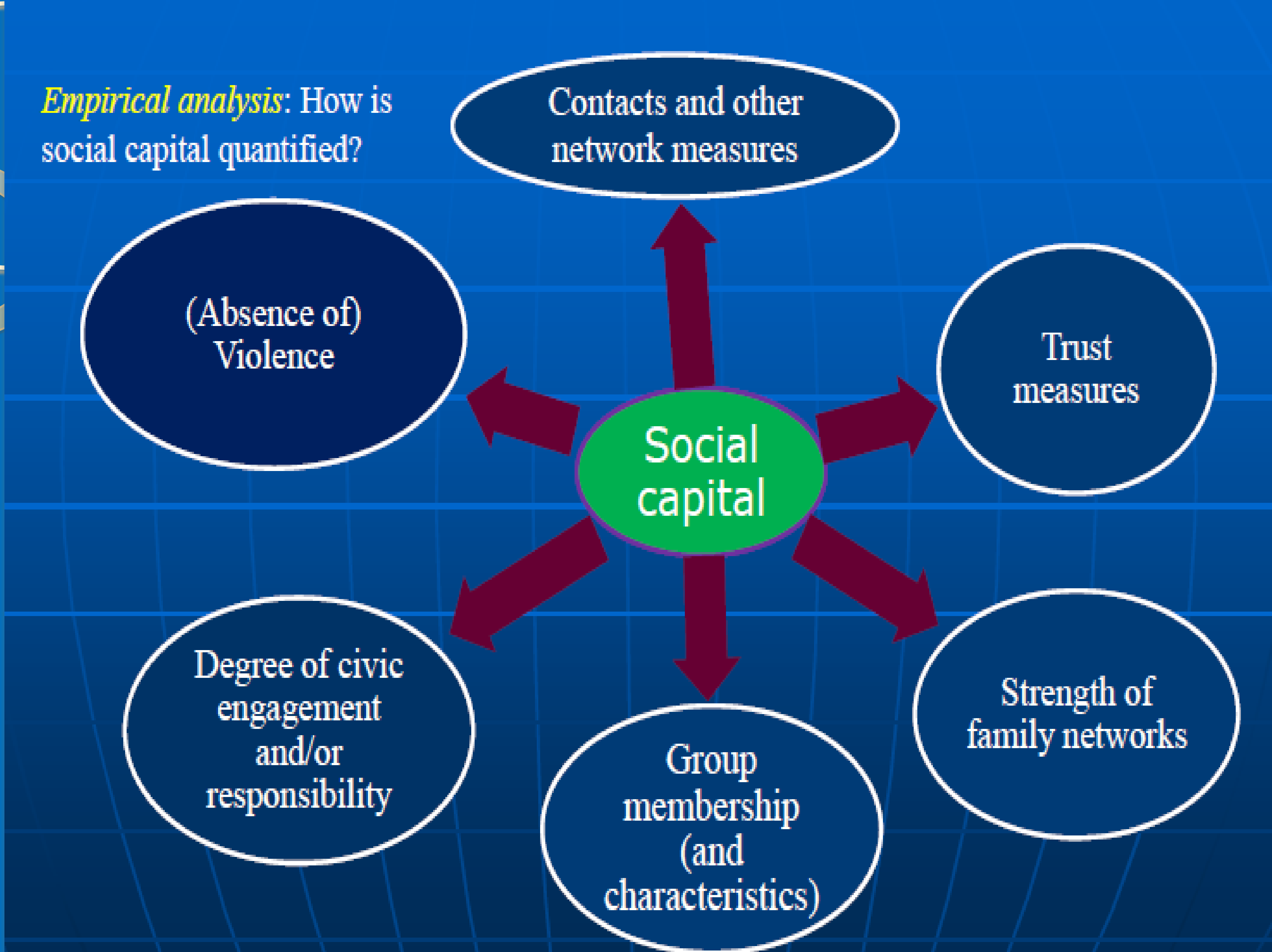
❑Forms and level of analysis

Forms	Levels of analysis
▪ Norms ▪ Networks ▪ Trust ➔ Essential in Coordination and cooperation	▪ Individual/Household ▪ Local/Community ▪ National ▪ International

NB:

- Social capital:

1. lowers transactions costs of exchange
2. Reduces cost of enforcing rules in the provision and appropriation
3. strengthens informal insurance
4. improves local authority performance by drawing them into networks

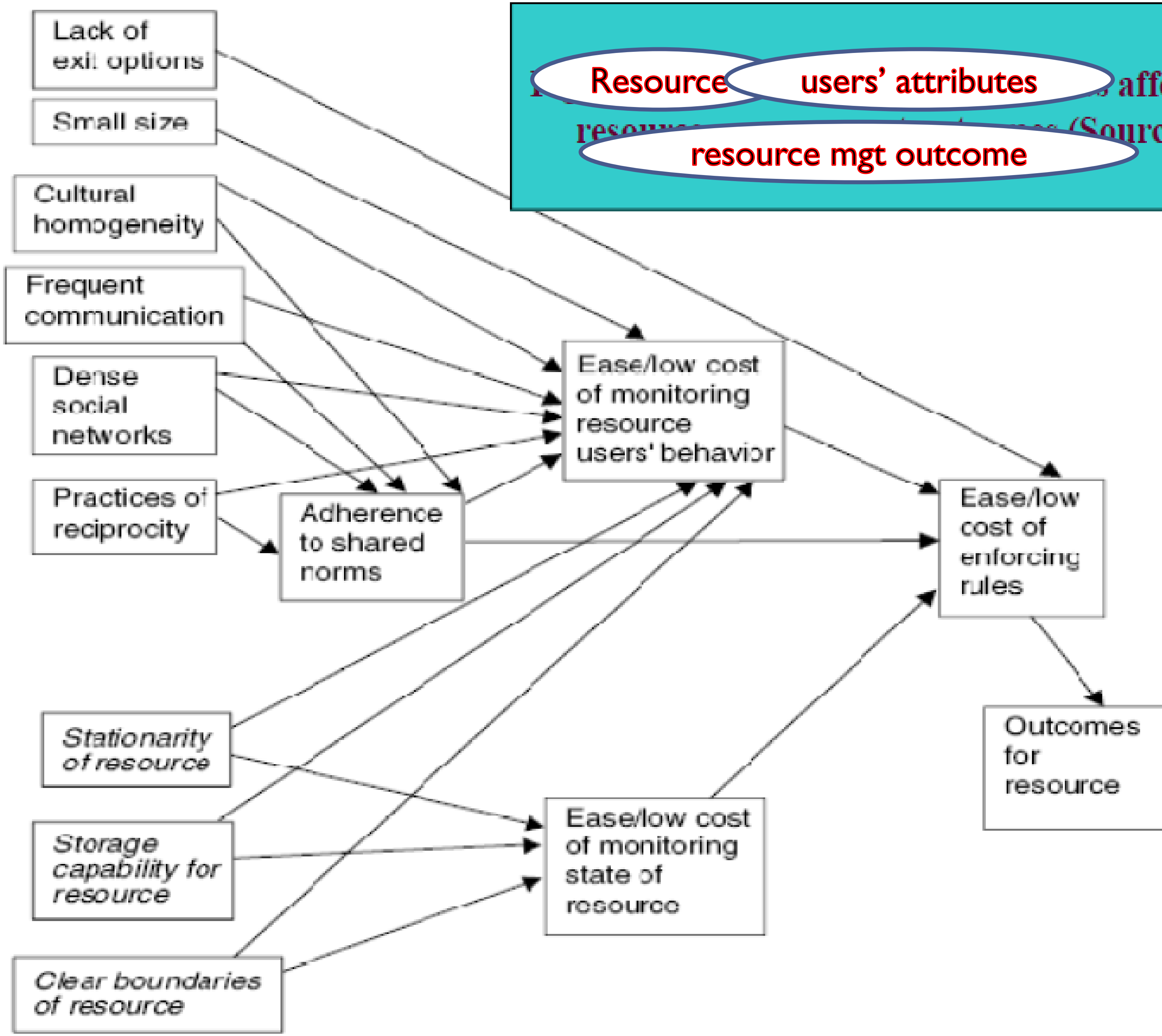


- But measurement is difficult and is often indirect using some proxies!

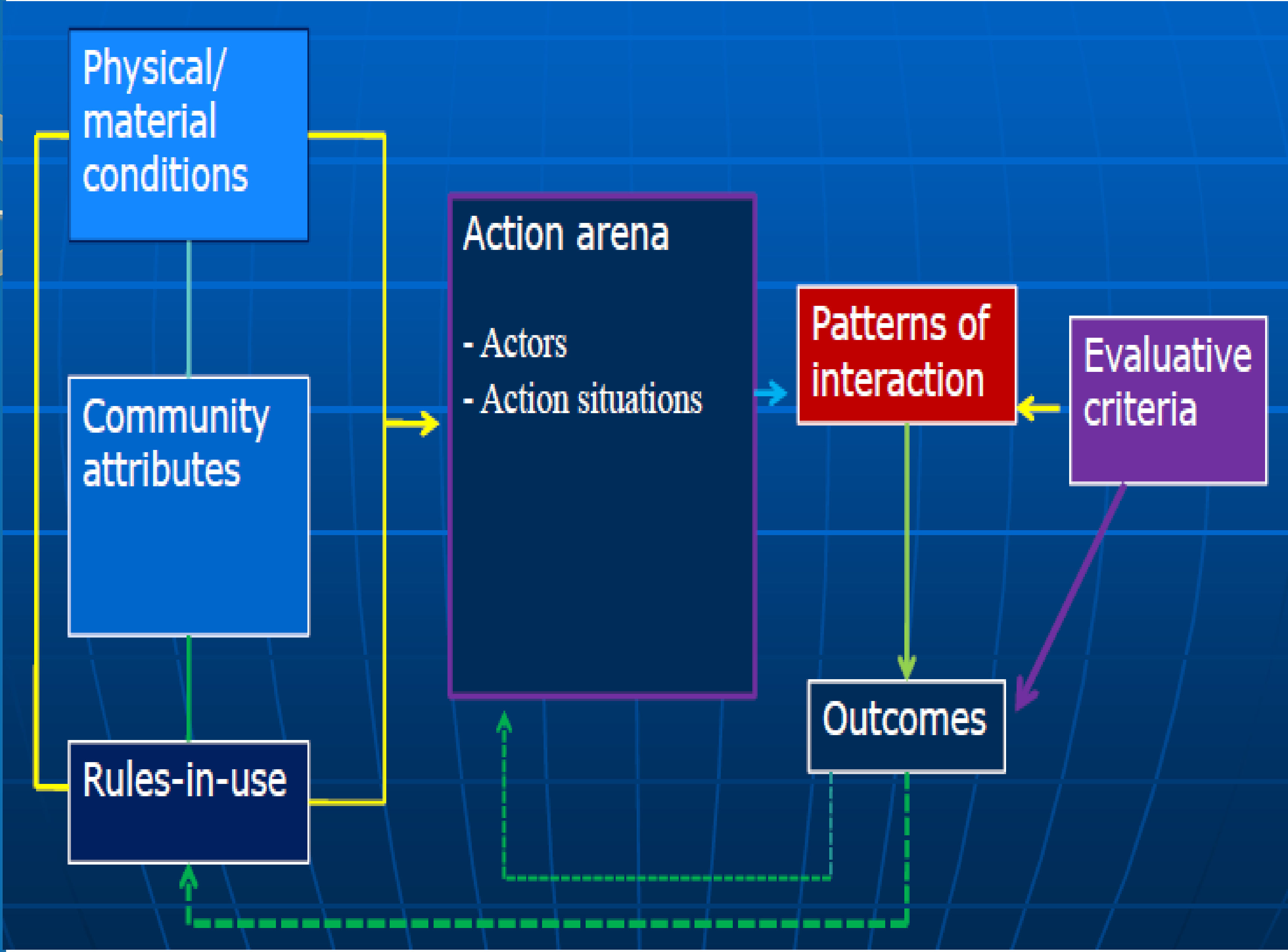
- As a stream of the New Institutional Economics, **collective action is applied in:**

1. Agro-biodiversity management
2. Soil and water conservation
3. Watershed management /management of irrigation systems
4. Marketing of agricultural products (cooperatives, improving access to services)
5. Improving the supply of public goods (provision and maintenance of infrastructures)

Resource users' attributes affecting resource mgt outcome (Source:

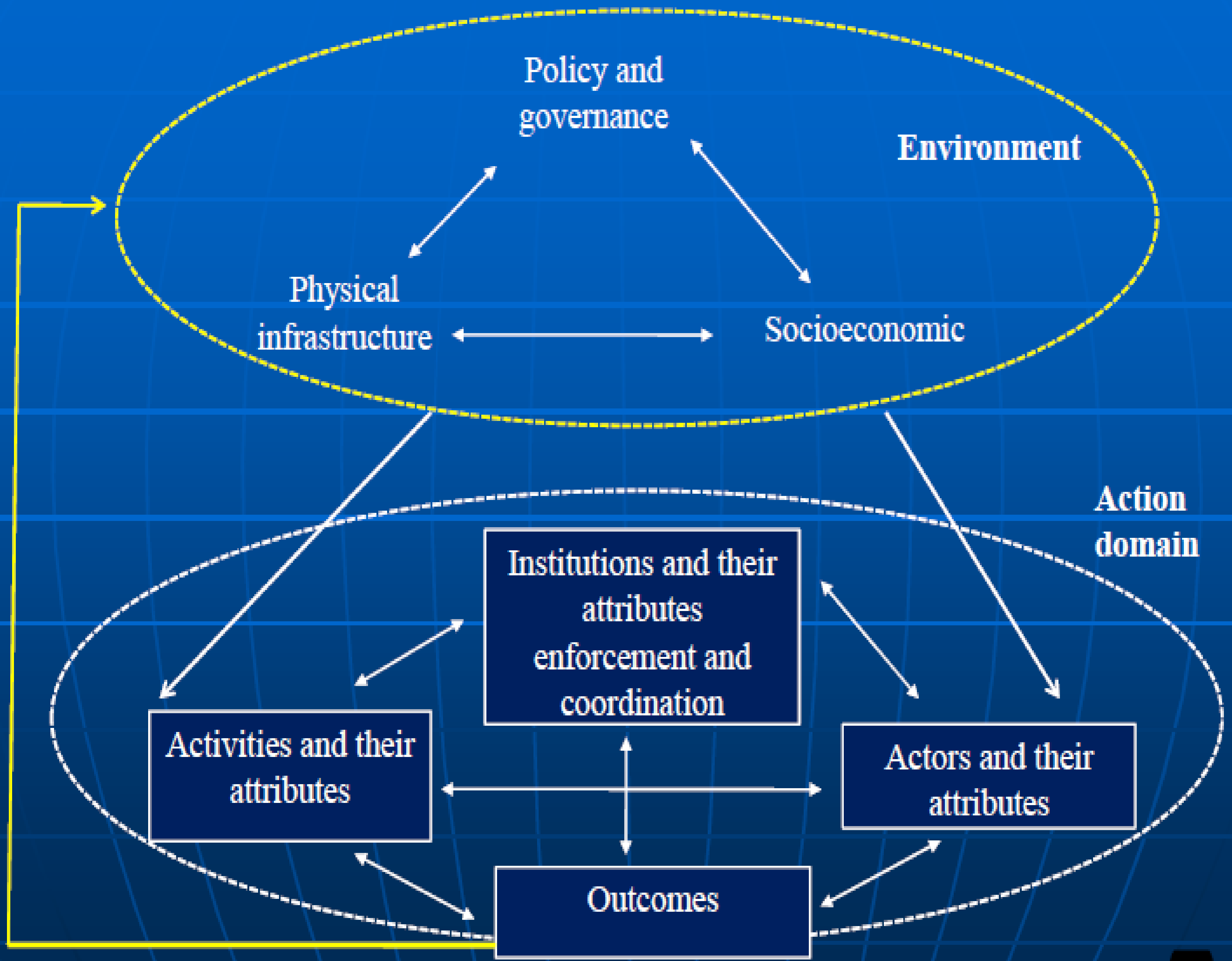


A Framework for Institutional Analysis (IAD)



Source: Ostrom, Gardner and Walker (1994)

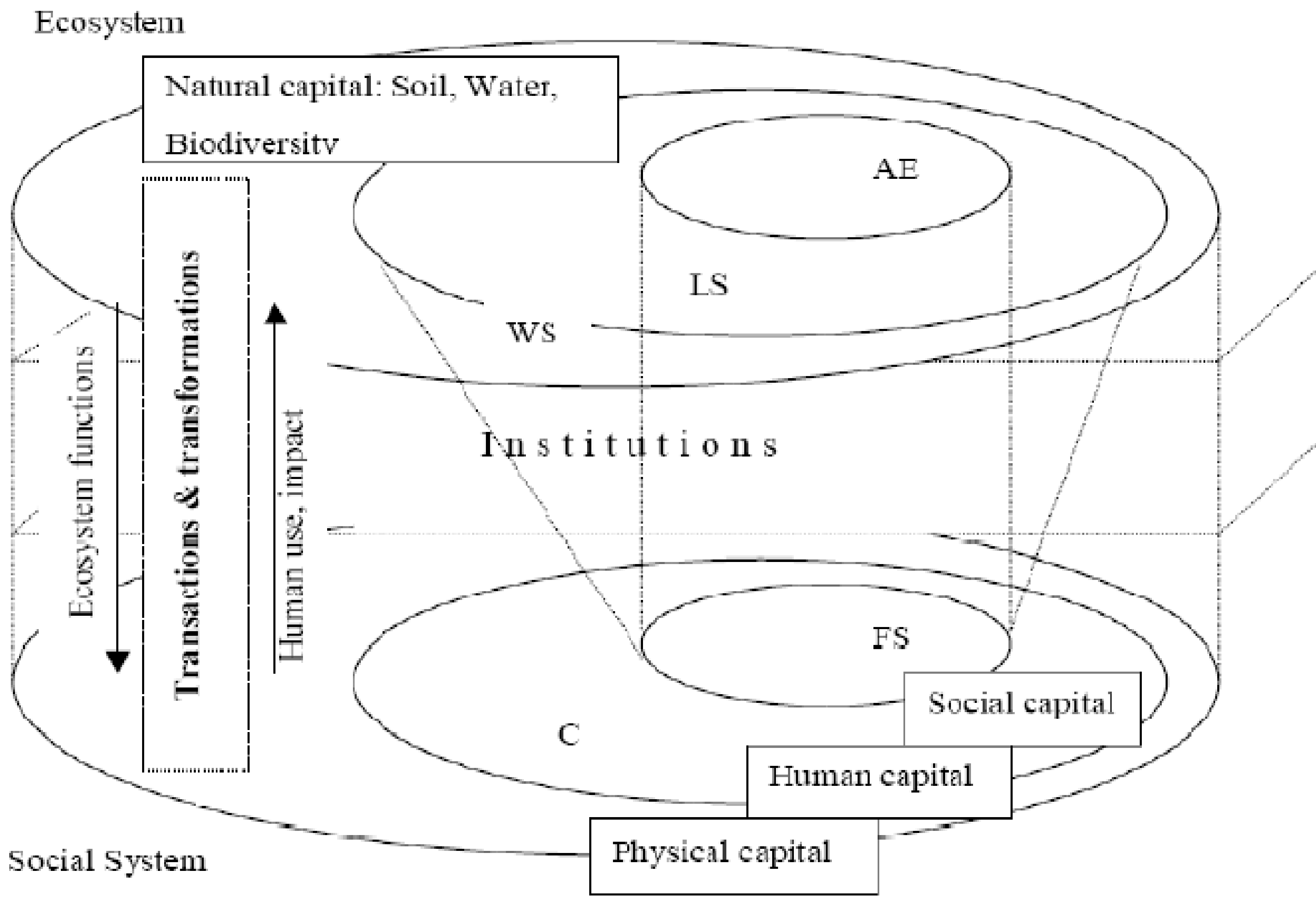
- In the IAD framework, the initial context affects the action situations in the action arena;
- In the action arena, actors would interact (fight, negotiate, influence one another, collaborate) where this is influenced by their action resources;
- Through certain patterns of interactions, actions would lead to outcomes;
- Actors have different evaluative criteria for outcomes;
- Unfavorable outcomes lead to change in the rules-in-use while favorable ones would reinforce the actions in the action arena to generate the outcomes;
- Hence, the framework is iterative in nature;
- Analysis could focus on some parts of the framework as one may not capture all elements of the framework in one particular study;



Source: Dorward and Omamo, 2009:79

- Dorward and Omamo (2009) refine IAD and focus on **initial context** (**the environment**- policy, physical infrastructure and socioeconomic) and the **action arena** (**action domain**- actors, institutions, activities, and outcomes) and then **how the environment influences the action domain;**
- The **environment** as a set of exogenous variables affects actors behavior through institutions;
- Interactions among institutions **actors** and **activities** involve action **leading to outcomes**;
- The **outcomes** of the actions may change or reinforce the environment, institutions activities and actors;

Institutions of Sustainability Framework

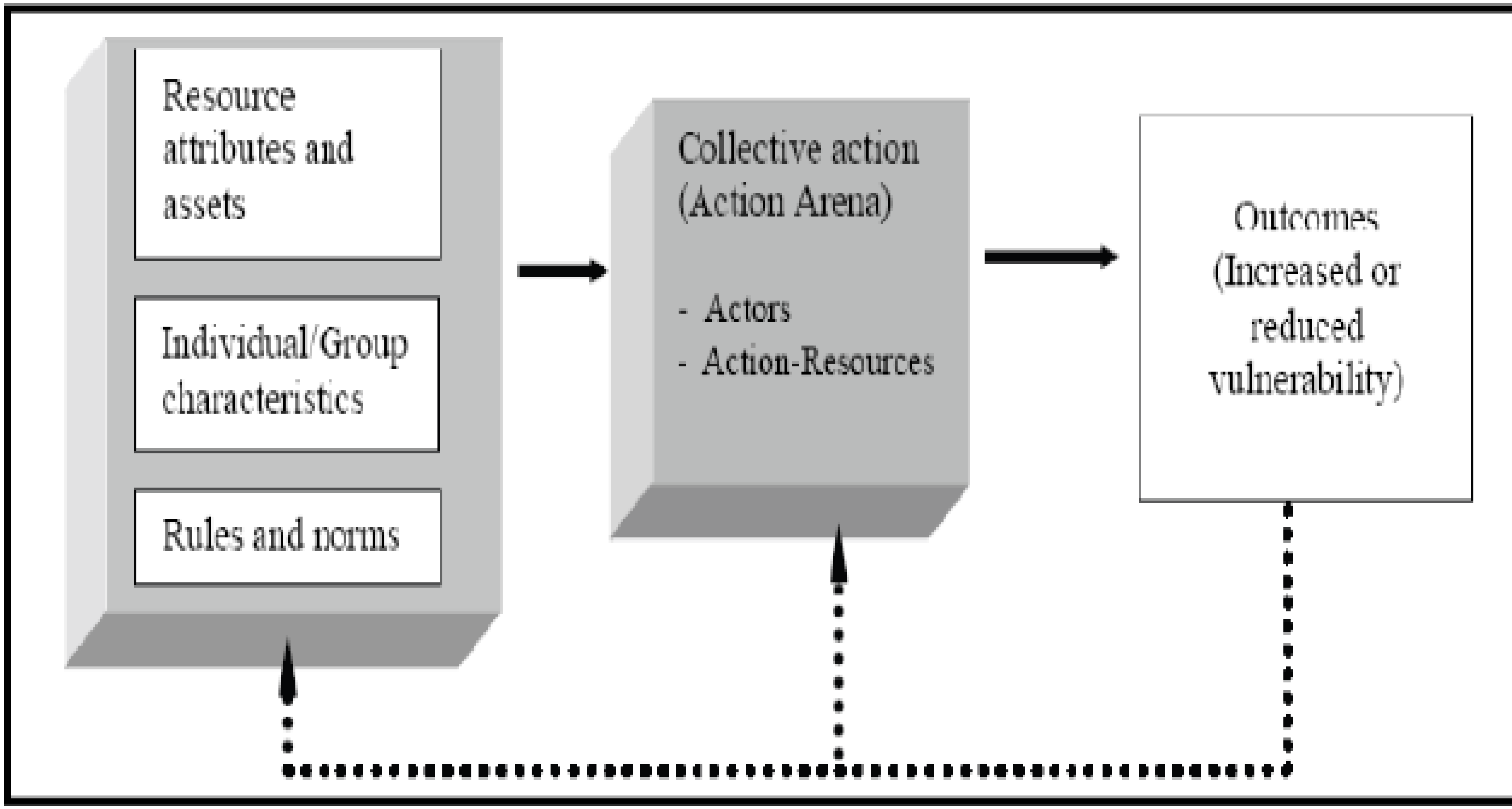


Legend:

AE = Agro-ecosystem
LS = Landscape
WS = Watershed
FS = Farming System
C = Community
S = Society

- Empirical example: A framework used for a case study in Somali Region of Ethiopia

Figure 1. Analytical framework



Source: OSTROM et al., 1994

- Source: Beyene, F. (2008)

THANK YOU FOR YOUR ATTENTION!

I WISH YOU ALL THE BEST!