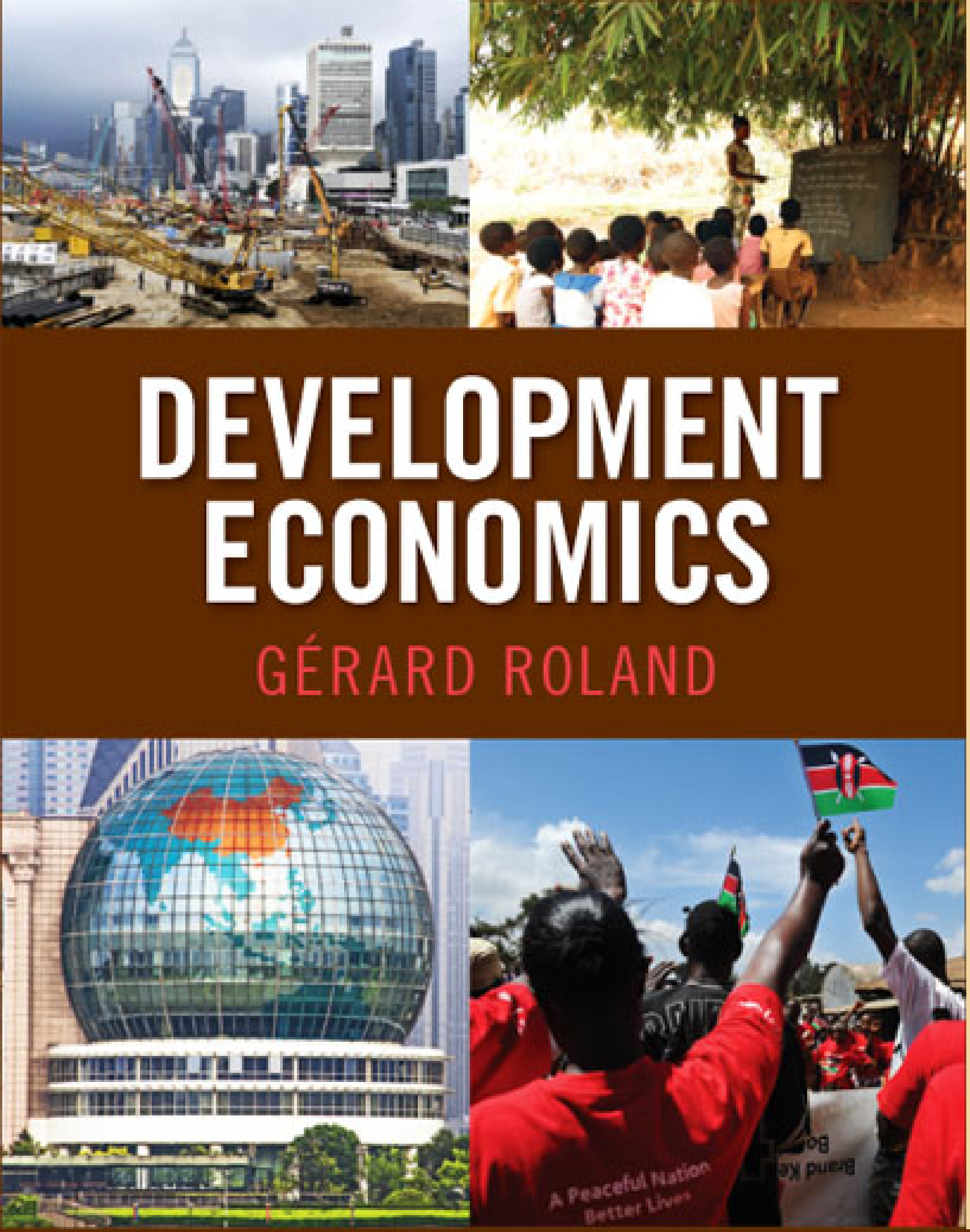

Chapter 7

Institutions and Economic Development

WHAT ARE INSTITUTIONS?

There are two types of institutions:

- *Formal institutions:* codified in writing and more precise than unwritten rules.
  - *Political institutions* set rules for major political figures, bodies, parties, etc.
  - *Legal institutions* allocated among religious law, common law and civil law.
- *Informal institutions:* are not legally codified, based on *social norms*, conventions, social values, and culture.
  - *Enforced informally (e.g., peer pressure, moral obligations)*
  - *Religion also plays a role in shaping social norms and values.*

Institutions underlie *well-functioning markets*:

- Without *quality institutions* transaction costs will be higher and thus less economic development is likely to take place.
- The more *complex products and markets*, the greater the importance of institutions. Since complexity increases with development, institutions become *more important over time.*

WHAT ARE INSTITUTIONS?

Interactions Between Institutions

- Formal institutions (laws) *evolve with* informal institutions (culture and social norms - e.g., capital punishment).
- Difficult to establish formal laws which *conflict* with social norms (e.g., border versus ethnic division in Africa)
- Formal institutions can *strengthen* informal institutions and vice versa. They are *complementary*.

What Do Institutions Do?

There are *five important problems* that institutions can solve:

- Informational problems
- Hold-up problems
- Commitment problems
- Cooperation problems
- Coordination problems

WHAT DO INSTITUTIONS DO?

Informational Problems

- *Asymmetric information* occurs when one party has more information about a product's quality than the other party does.
  - If a creditor does not know the *creditworthiness* of a borrower, a loan transaction may not take place.
- *Adverse selection* may lead to dominance by disreputable players and uneconomic trades and eventual market collapse.
- Information asymmetries and adverse selection are common in credit markets. Without information on borrowers, creditors cannot rely on the market and instead *ration credit via* other means (contacts, reputation, repeat customers, etc.).
- *Moral hazard:* the possibility that one party takes *unobservable actions (often risky)* that hurt the other party's interests. Common problem with insurance contracts

WHAT DO INSTITUTIONS DO?

George Akerlof's *Market for Lemons* (used cars):

50% Good Cars -- Seller cost: $10K, Buyer Value: $12K

50% Bad Cars -- Seller cost: $ 5K, Buyer Value: $ 4K

A *risk neutral* individual considers *expected payoff:*

$$(.5 \times \$12K) + (.5 \times \$4K) = \$8K$$

A *risk-averse* individual might not even buy a car at $4K.

Without information confirming a car's condition, no one will be willing to pay $12K for an alleged good car.

A seller of the bad car can make a profit at $8K, but not the seller of a good car. Only bad cars make it to market, and eventually the *market disappears.*

WHAT DO INSTITUTIONS DO?

Institutional Solutions to Informational Problems

- *Disclosure rules* are obligations to disclose relevant information about a transaction (common for houses, etc.).
- *Regulation of access or entry* rules to govern entry into a profession (e.g. diplomas, certificates, licenses).
- *Warranties* and *return policies* guarantee quality of a product.
- *Signaling* provides credible information (brand names, franchising).
- Chain stores are *informational intermediaries* which gather information about the products they sell.
- *Rating agencies* also serve as informational intermediaries (Cars.com, eBay feedback). Watch *incentives* (Moody's, S&P)
- These solutions usually work well *only if there are effective formal institutions* (legal system) to enforce contracts.
- Informal institutions help solve informational problems: *repeated interaction, reputation, relational contracting,* etc.

WHAT DO INSTITUTIONS DO?

The Hold-Up Problem

- Situation in which a business partnership requires an *initial investment for one party*. When the investment is *sunk*, the second party moves to renegotiate the original bargain.
- *Sunk costs* have been incurred and cannot be recovered.
- Without remediation, the hold-up problem causes underinvestment.
- The hold-up problem is more acute the more *relationship-specific* the investment is. *Asset specificity,* for example, means an investment only has value for the specific transaction.
- The primary formal solution is *binding and legally enforceable contracts*. Sometimes contracts have to be very detailed, however, and legal systems must be sophisticated.
- *Vertical firm integration* (ownership along the supply chain) is a common informal solution to the hold-up problem.

WHAT DO INSTITUTIONS DO?

The Commitment Problem

- Occurs when a party *doesn’t honor prior commitments* made to another party
- Occurs most often in *sequential transactions* (e.g., payment precedes service or vice versa)
- Often results from *time inconsistency,* when optimal decisions for one or both parties changes at different transaction stages
- *Visible and repetitive lack of commitment* reduces bargaining power (negotiation with kidnappers) and credibility.
- *Credibility* is especially important for monetary and fiscal policy.
- *Formal contracts* are the best solution. Contracts can be *flexible* to deal with time inconsistency.
- Informal approaches include *witnesses* and severed fingers. These tend to be less effective in modern economies.

WHAT DO INSTITUTIONS DO?

The Cooperation Problem

- Occurs when individual *self-interested decisions* results in *suboptimal outcomes* across all parties
- *The prisoner's dilemma (Table 71.)* illustrates how the total payoff from individual decisions depends on the decisions of others.
- A *Nash equilibrium (N.E.)* occurs if one agent will not deviate from his strategy regardless of the action of the other party.
- In this case from an individual's point of view, it is always optimal to confess: the *dominant strategy.*
- Note that the outcome is *suboptimal* from the case of neither confessing: both would be better off than the N.E.
- Cooperation would create the *"socially" optimal* outcome, but there is an inherent commitment problem to be addressed.
- The *inefficiency of pure self-interest maximization:* Is pursuing self interest always the most beneficial to society as a whole?

WHAT DO INSTITUTIONS DO?

Table 7.1. The Prisoner's Dilemma.

	B stays silent.	B confesses.
A stays silent.	Both serve 6 months.	Prisoner A serves 10 years. Prisoner B goes free.
A confesses.	Prisoner A goes free. Prisoner B serves 10 years.	Both serve 2 years.

Prisoners A and B decide individually whether to confess to a crime. It would be in their joint interest for both to stay silent, but if they follow their self-interest, they will both choose to confess ... and end up staying in jail longer.

WHAT DO INSTITUTIONS DO?

- The *collective-action problem* is when people fail to undertake collective actions, even if it is in their joint interest to do so.
- An individual or subgroup gets a *free ride* when it benefits from the actions taken by others without incurring any of the costs.
- Solving, or not solving, collective action problems are *fundamental to human societies.*
- Various institutions have *evolved* to establish cooperation across individuals: nations, labor unions, professional organizations, political parties, international bodies.
- As opposed to *dictatorships, democracy* encourages the associations to overcome the collective action problem.
- Spontaneous strikes or riots are *informal solutions* to collective action problems.
- Recently, the *ease of communication* has reduced costs of spontaneous forms of collaboration.

WHAT DO INSTITUTIONS DO?

The Coordination Problem

- Agents coordinate on a specific situation, and the optimal action of an individual *depends* on what others do.
- Raises possibility of *multiple equilibria* where only some are optimal (*efficient*) solutions to coordination problems
- In many developing countries the *prevalence of sub-optimal equilibriums* (e.g., lack of law abidance, tax evasion, corruption) have evolved to become social norms.
- These can be difficult to understand and reverse. Reform usually requires collective effort: "*Big Push*" strategies.
- Formal laws and *standards* help in reaching one coordination equilibrium over another (traffic standards).
- *Conventions,* informally enforced, also help solve the coordination problem (gestures, virtues).

PERSISTENCE OF INEFFICIENT INSTITUTIONS

- The lack of effective formal institutions hinders economic growth by *raising transaction costs* and slowing the flow of capital.
- *Reforming* institutions requires overcoming collective-action problems, which often is difficult in developing countries.

The Functionalist Fallacy

- Institutions do not necessarily arise to address a specific problem. Therefore, many institutions can be *inefficient yet persistent.*
- In some cases, given vested interests and uneven distribution of influence, institutions can prevent or punish collective movements and mobilization.
- Overall, groups that have a minimal stake in public action suffer more from collective-action problems than small groups with large stakes in public action.