

Institutions and Institutional Change

The purpose of the lecture: to explain the reasons and sources of institutional change

Stability of the institutional structure

- ▶ Stability is accomplished by a complex set of constraints that include formal rules nested in a hierarchy, where each level is more costly to change than the previous one.
- ▶ Informal constraints are even more persistent and harder to change than formal rules.

D.North



Institutional change concept

Institutional change – a change in one or more components of an institution


Causes and sources of institutional change

T. Veblen:

- ▶ Veblen argues that: 'the evolution of social structure has been a process of natural selection of institutions'
- ▶ Human behaviour is the determinants of institutional evolution. Veblen asserts that: The changes that take place in the mechanical contrivances are an expression of changes in the human factor. It is in the human material that the continuity of development is to be looked for.

Causes and sources of institutional change

Joseph Schumpeter:

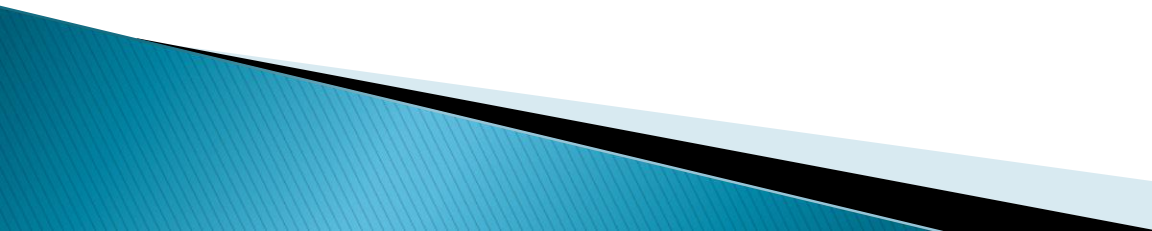
- ▶ innovative activities of entrepreneurs and other active members of society, as well as technological progress. Their actions are creative and full of risk, and they are the reason for the creation of the new and the destruction of the old.
 - ▶ Schumpeter stated that entrepreneurial creativity and exploration are continually replacing the old equilibria and producing new ones, thereby making greater standards of life attainable.
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Causes and sources of institutional change

Libecap G. D., Ostrom E.

- ▶ Institutional change is a centralized, collective-choice process in which rules are explicitly specified by a collective political entity, such as the community or the state, and individuals and organizations engage in collective action, conflict and bargaining to try to change these rules for their own benefit.
- ▶ <https://www.amherst.edu/media/view/69391/original/Comparing.pdf>

Causes and sources of institutional change

- ▶ *External shocks* from the working environment, such as radical changes in economy or technology: for example, new networking technologies not only provide new capabilities and opportunities for public sector institutions, but their use is so taken for granted by other sectors and the public that they cannot but be deployed, fundamentally altering information and communication flows.
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Causes and sources of institutional change

D.North


The sources of change are

- Changes in relative prices
- Changes in tastes and preferences

Changes in relative prices

- ▶ The Black Death in 1347–1351 was the largest demographic shock in European history.
- ▶ Prior to the Black Death, the European economy was land and capital scarce whereas labor was relatively abundant. As such, wages were low, whereas the rental value of land and interest rates were high. The fall in population resulting from the Black Death thus had positive effects on real wages and incomes. Land prices, interest rates, and inequality fell. The Black Death made more land available to a diminished number of farmers.
- ▶ The economic impact of the Black Death is that it raised real wages relative to payments to land or capital.

Changes in relative prices

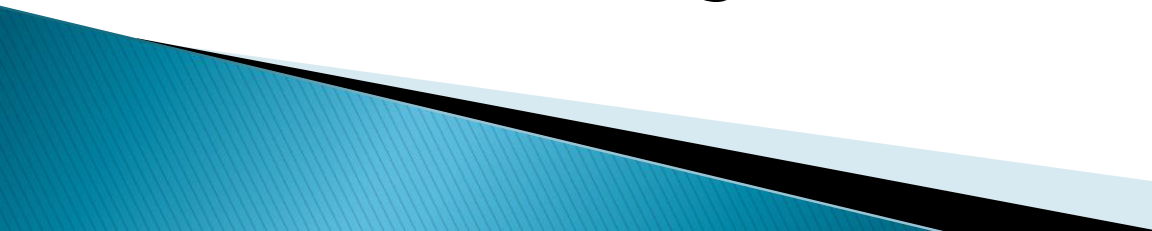
- ▶ As a result, the bargaining power of the feudal lords decreased, and the bargaining power of the peasants increased, which led to changes in property rights. Competition between feudal lords for labor power led to the fact that the feudal lords reduced rent and facilitated feudal duties. Gradually, land lease contracts began to be concluded for a longer period and soon the lease became life-long, and the custom of transferring the allotment by inheritance arose. The population remained low for several generations, and gradually the right to inherit land parcels became common.
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Changes in tastes and preferences

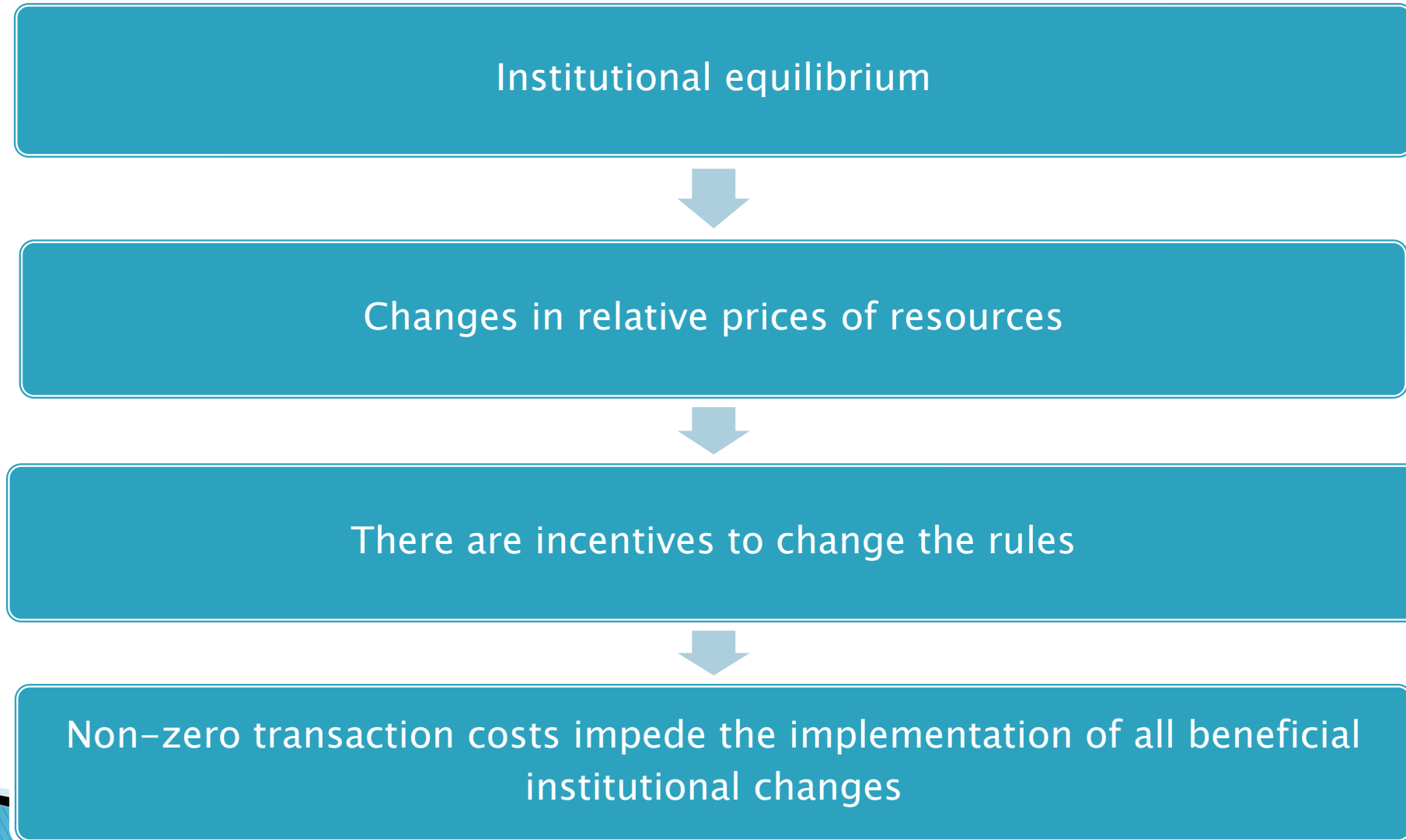
Classic case: abolition of slavery in the USA.

Slavery was still profitable at the time of the Civil War (mid 19th century). At the same time, in the Civil War, European politicians were on the side of the Confederate southerners. That is, the abolition of slavery was both economically and geopolitically inexpedient.

But tastes and preferences changed: if at the beginning of the 19th century slavery was quite normal, then later other ideas arose. These ideas were the consequence of the growing abhorrence on the part of civilized human beings of one person owning another and therefore the rise of the antislavery movement throughout the world.

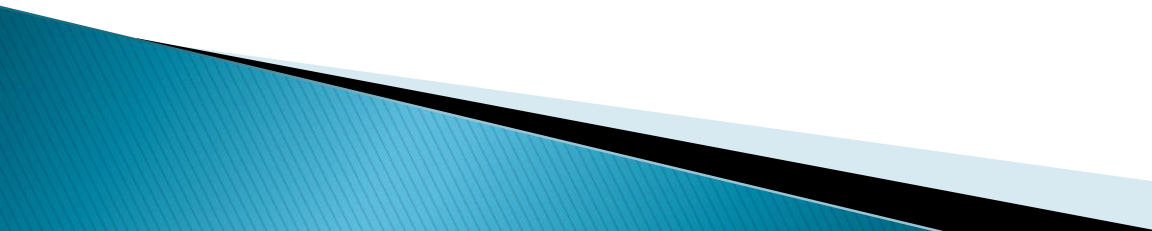


Scheme of institutional change (D.North)



D.North

“Institutional equilibrium would be a situation where given the bargaining strength of the players and the set of contractual bargains that made up total economic exchange, none of the players would find it advantageous to devote resources into restructuring the agreements. Note that such a situation does not imply that everyone is happy with the existing rules and contracts, but only that the relative costs and benefits of altering the game among the contracting parties does not make it worthwhile to do so. The existing institutional constraints defined and created the equilibrium”.



Types of institutional change

Incremental

Gradual changes based on endogenous developments

Discontinuous

Radical change in the formal rules, usually as a result of conquest or revolution

Types of institutional change

Incremental

- Informal rules


Discontinuous

- Formal rules

D. North about Institutional change

- Institutional change is a complicated process because the changes at the margin can be a consequence of changes in rules, in informal constraints, and in kinds and effectiveness of enforcement. Moreover, institutions typically change incrementally rather than in discontinuous fashion. How and why they change incrementally and why even discontinuous changes (such as revolution and conquest) are never completely discontinuous are a result of the imbedded ness of informal constraints in societies. Although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies. These cultural constraints not only connect the past with the present and future, but provide us with a key to explaining the path of historical change.

D. North about Institutional change

- ▶ Most important point about institutional change is that institutional change is overwhelmingly incremental.
 - ▶ Discontinuous change means a radical change in the formal rules, usually as a result of conquest or revolution.
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How institutions change over time

1. *The evolutionary theory* justifies the conclusion that over time inefficient institutions are weeded out, efficient ones survive, and thus there is a gradual evolution of more efficient forms of economic, political, and social organization. In economic science, this theory is developed by A. Alchian.

2. Inefficient institutions and economic systems can be sustainable.


Economies with persistently poor performance can survive over long periods of time.

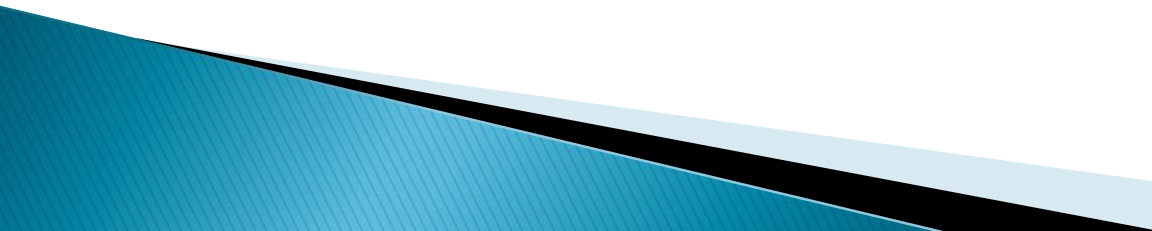


Armen A. Alchian “Uncertainty, Evolution, and Economic Theory” (1950)

In this article, Alchian delineates an evolutionary approach to describe firms' behavior. His theory embodies principles of biological evolution and natural selection.

The evolutionary approach to firm survival and behavior proposes that firms do not have to consciously strive to maximize profits and that is because scarcity and competition will ensure the firms' survival and will behave as if they are maximizing profits.



- ▶ Proponents of the second approach draw attention to those phenomena that contradict the thesis that only the most effective institutional structures and organizational forms survive.
 - ▶ D. North “Institutions, Institutional Change and Economic Performance” (1990)
 - ▶ Paul David “Clio and the Economics of QWERTY” (1985)
 - ▶ W. Brian Arthur “Self-Reinforcing Mechanisms in Economics” (1988)
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**Are new institutions
always more effective?**

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graph TD; A[Are new institutions always more effective?] --- B[Path dependence]; A --- C[Lock-in]
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**Path
dependence**

Lock-in

Path dependence

- ▶ Path dependence means that history matters. We cannot understand today's choices (and define them in the modeling of economic performance) without tracing the incremental evolution of institutions.
 - ▶ Past events influence possible future actions
 - ▶ Path dependence is a way to narrow conceptually the choice set and link decision making through time.
 - ▶ Once a development path is set on a particular course, the network externalities, the learning process of organizations, and the historically derived subjective modeling of the issues reinforce the course.
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Path dependence

Paul David and W. Brian Arthur

Economics of QWERTY


- Random selection
- Increasing returns to scale
- Prohibitively high switching costs



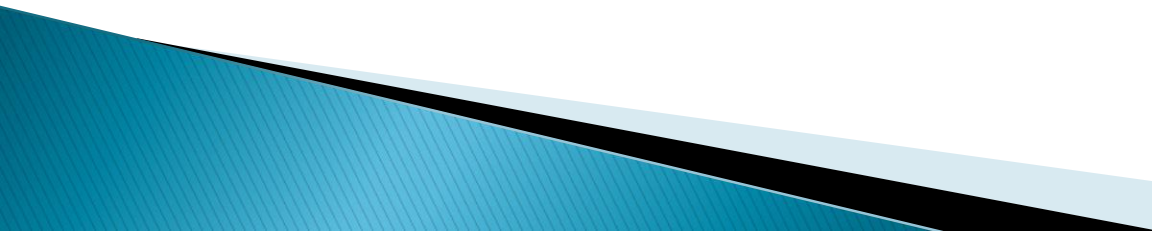
Other examples of the QWERTY effect



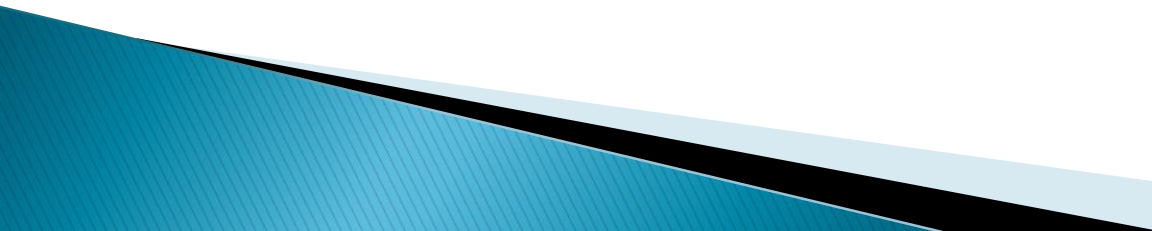
D. North: The Case of England and Spain

- ▶ By the 16th century, these countries were on absolutely equal starting positions. Both were approximately equal in terms of population and employment structure, and both carried out foreign policy expansion.
 - ▶ But already in the 19th century, England was the main world power, and Spain was one of the most backward countries in Europe. What's the matter?
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D. North: The Example of England and Spain

- ▶ North testified that it was an accident.
 - ▶ It just so happened that in the XVI century in England the question of the distribution of taxes fell within the competence of the parliament, and in Spain—the king.
 - ▶ In England royal prerogatives were curtailed, Parliament had a dominant role in the area of taxation; the protection of property rights were reaffirmed and strengthened.
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D. North: The Example of England and Spain

- ▶ As a result, Spain, which took out much more wealth from the colonies than England, very quickly squandered its treasures – because kings love wars and leaky budgets. There is no point in investing in the economy if the king can confiscate these investments at any time.
 - ▶ In England, the conditions for accumulation and investment have developed.
 - ▶ According to North, the root cause of Spain's relative decline and the ensuing three centuries of stagnation were caused by a centralized bureaucracy that hopelessly tried to control every aspect of the economy through an inordinate number of decrees and regulations.
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Lock-in

- ▶ Lock-in – once reached, a solution is difficult to exit from.
- ▶ In terms of neoinstitutional theory, " an institutional trap is an inefficient stable norm (an inefficient institution) that has a self-sustaining character."

Lock-in

- ▶ The potential for blocking potentially effective institutional changes is particularly great in cases where the beneficiaries of the existing rules are not private organizations, but the state as a whole or in the person of its individual representatives with authority.

Literature:

- ▶ North D. Institutions, Institutional Change and Economic Performance. Cambridge University Press, 1990. – Ch. 9, 10, 11
 - ▶ Douglass C. North. Institutions and Economic Growth
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