

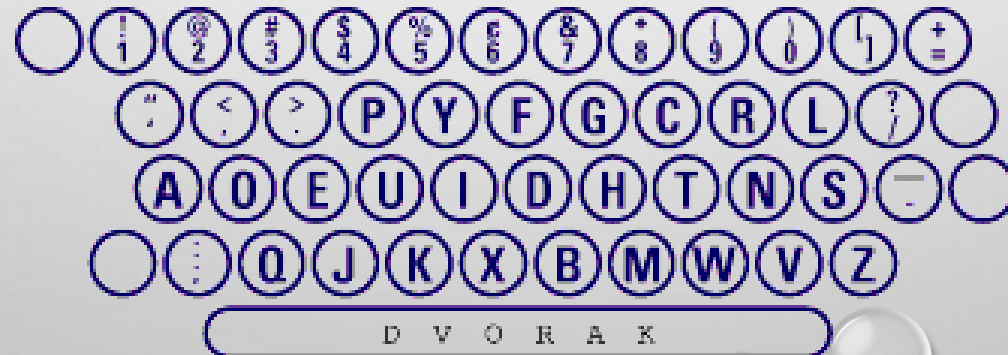
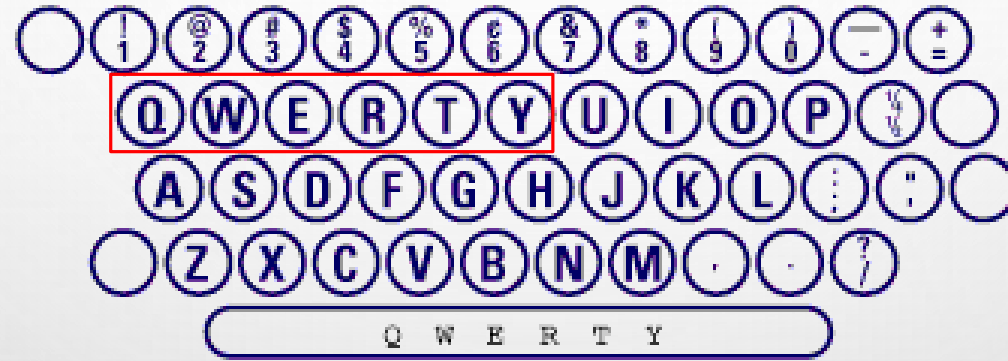
WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]



- Similarly, societies create **informal rules** that deliberately restrict people's freedom of choice so that they don't have to make fresh choices constantly.
 - a convention for queuing so that people do not have to constantly calculate and recalculate their positions at a crowded bus stop in order to ensure that they get on the next bus

PEOPLE ARE NOT RATIONAL?

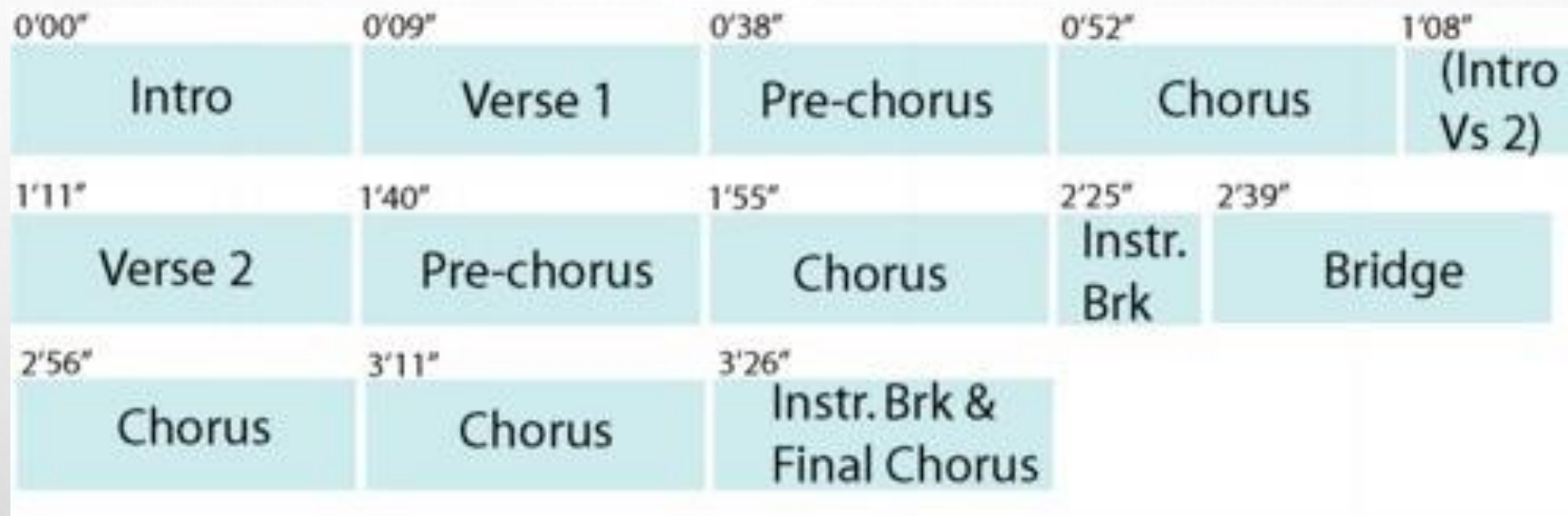
- Numerous examples of "inferior" technologies winning in the market



WHY?

- The concept of '**path dependence**' is used to explain.
- **Path dependence** is the idea that
 - Decisions we are faced with depend on past knowledge trajectory and decisions made, and are thus limited by the current competence base.
 - In other words, ***history matters for current decision-making situations*** and has a strong influence on strategic planning.
- People get "**locked-in**" to the inferior standard.

History matters for current decision-making situations?



Song writing rule

History matters for current decision-making situations?

Cheerleaders
in Thailand



Cheerleaders
in USA



Graduation
Ceremony in
Thailand



Graduation
Ceremony in
Japan



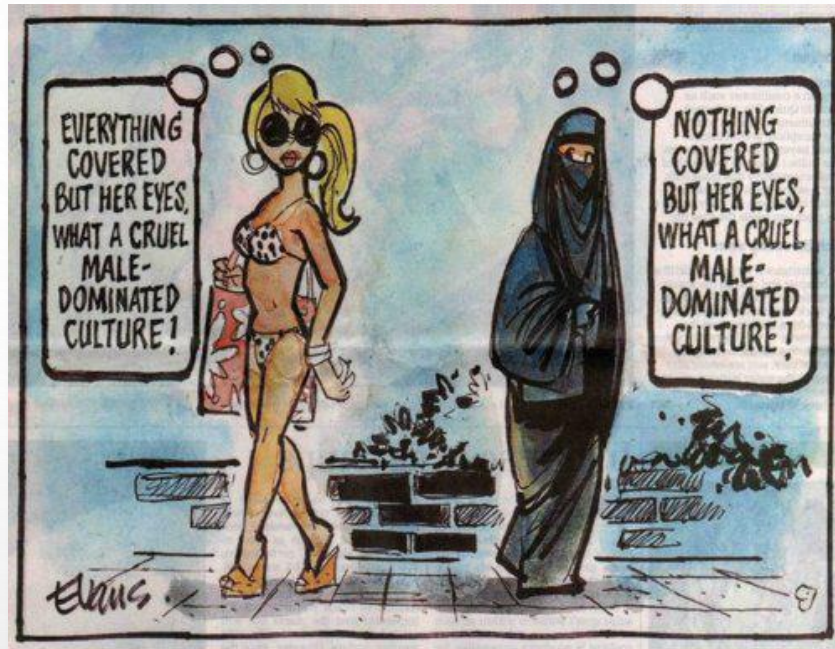
Culture and Norms






Culture and Norms








Culture and Norms



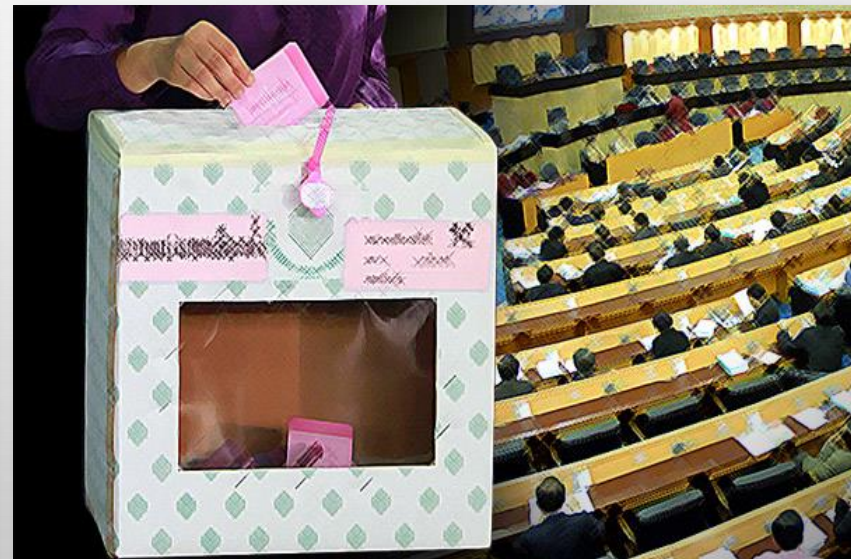
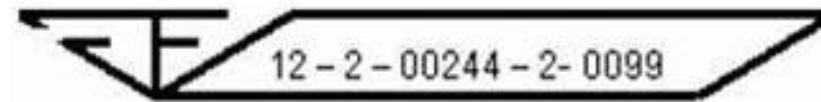
 **Miley Ray Cyrus** 
@MileyCyrus 

It's not about getting your titties out. It's about equality.

 Reply  Retweet  Favorite  More

14,366 RETWEETS 17,820 FAVORITES 

Laws and constitutions



NATION
PHOTO

Laws and constitutions

WORK EMAIL BAN

- ▶ COMPANIES WITH 50 OR MORE EMPLOYEES
- ▶ NO EMAILS ON WEEKENDS OR HOLIDAYS

SOURCE: HUFFINGTON POST

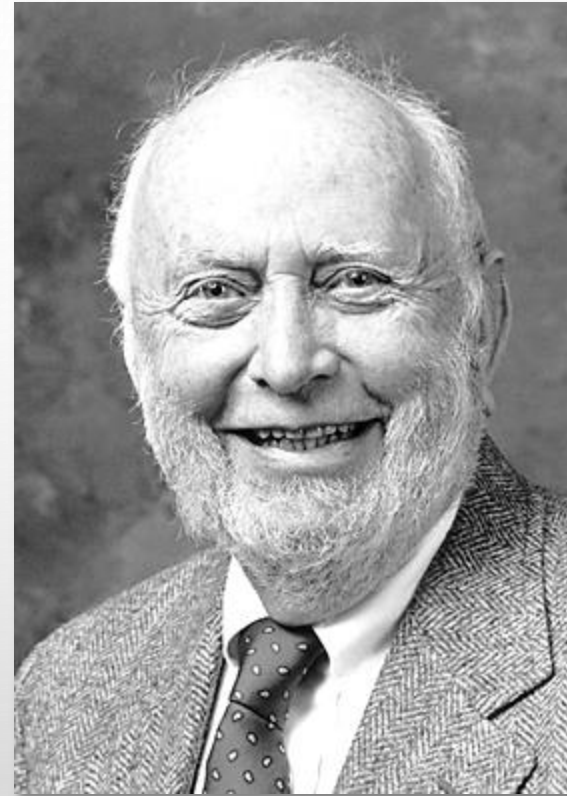


INSTITUTIONS

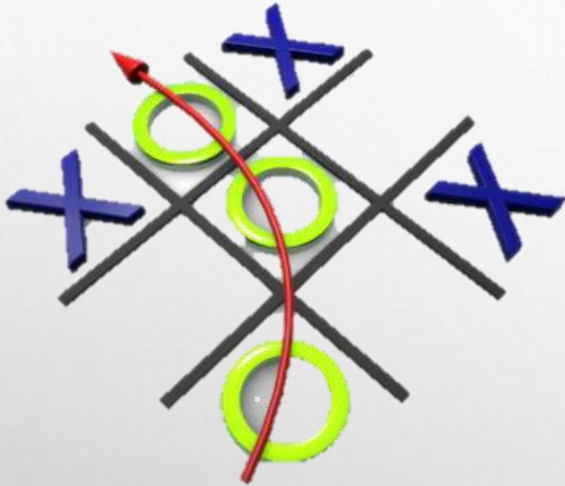
Douglass North

Nobel Memorial Prize in Economic Sciences (1993)

"for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change."



INSTITUTIONS



- Institutions are **the rules of the game**
- They structure incentives in human exchange, whether political, social, or economic.
- Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change

INSTITUTIONS



- Institutional change affects the choice set at a moment of time
- Institutional constraints include both what individuals are prohibited from doing and, sometimes, under what conditions some individuals are permitted to undertake certain activities
- Institutions **reduce uncertainty** by providing a structure to everyday life by establishing a stable (but not necessarily efficient) structure to human interaction

WELCOME TO AMERICA
WHERE ONE NIGHT A YEAR
ALL CRIME IS LEGAL
#SURVIVETHE NIGHT

THE PURGE: ANARCHY

DIGITAL



INSTITUTIONS



Formal constraints - such as rules that human beings devise

Informal constraints - such as conventions and codes of behavior

Enforcement: The functioning of institutions is the costliness of ascertaining violations and the severity of punishment

INSTITUTIONS



- A competitive team sport
 - 1) **Rules:** the purpose of the rules is to define the way the game is played
 - Formal written rules
 - Unwritten codes of conduct that underlie and supplement formal rules, such as not deliberately injuring a key player on the opposing team
 - 2) **Enforcement**
 - Punishment for violation?

Types of institutions (Ellickson 1991)

Rules	Enforcement mechanism	Example
1. Convention	Self enforcement	Language
2. Ethics	Imperative self binding	Being a veterinarian
3. Norms	Social enforcement	Social codes of conduct
4. Formal private rules	Organized private enforcement	Self imposed rules inside organisations
5. Law	Organized state enforcement	Business Law

Institutions

Examples for formal institutions:

Constitution of Germany, the US, and other “basic” laws

Inheritance laws of a country

Voting rights

Institution of the market

Health care system

Institutions for regulating common pool resources

System of rules for getting a Ph.D. or, in general, a doctorate



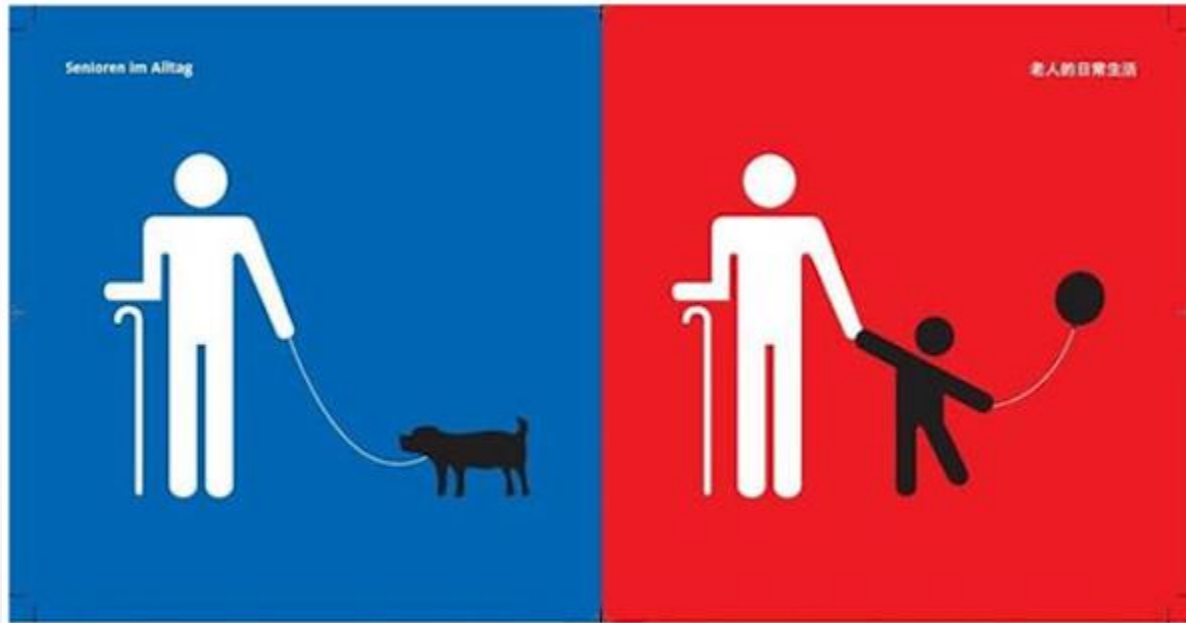
The Possible Effects of Institutions

Institutions may have **effects on:**

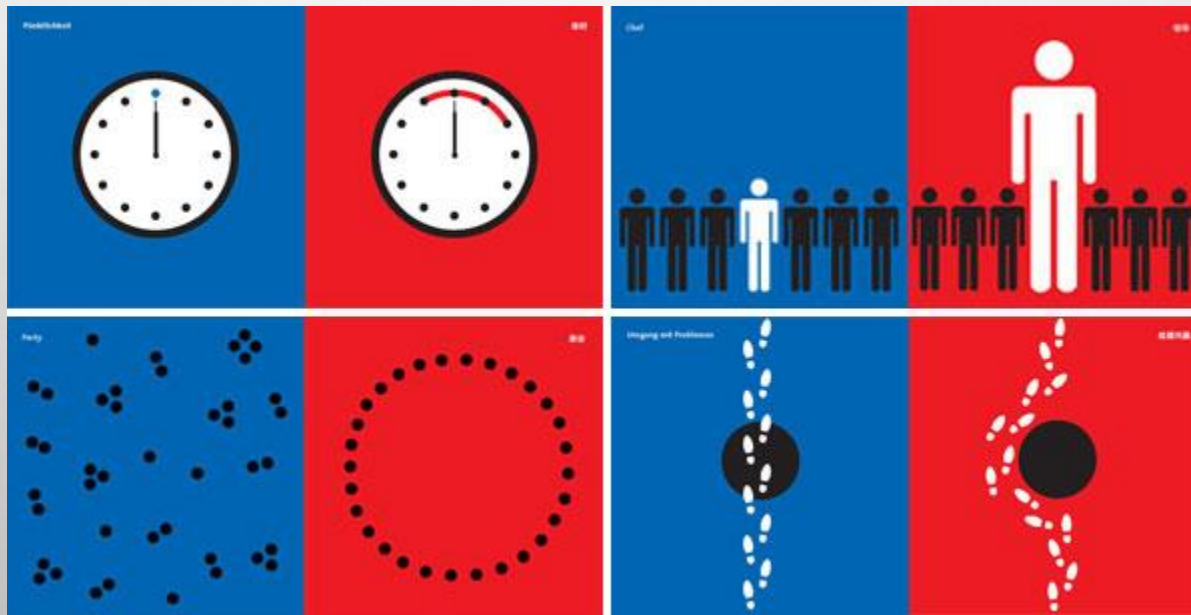
- **Behavior**
 - Conformity to or violation of the norm
 - Side effects (e.g. Discriminatory effects of anti-discrimination laws – e.g. Dismissal of handicapped);
- **Preferences or attitudes** (e.g. Toward the regulated behavior or toward the norm makers);
- **Cognitive beliefs** (e.g. Expectations about the regularity of the demanded or prohibited behavior);
- **Other norms/institutions** (path dependence – see Constitution);
- **Change of the respective norm itself at a later time** (feedback effects – e.g. If a norm does not work it may be changed).

Institutions

- Some basic facts about institutions :
 - Institutions change over time
 - Institutions may be created, or they may simply *evolve* over time.
 - Institutions differ across societies and cultures
 - *Institutions differ* if we were to try to make the same transactions in a different country



Elderly in day to day life





- No gum is allowed to be bought or sold inside Singapore and there is a \$700 fine for spitting out gum on the streets
- Grown children in China must visit their parents or potentially face fines or jail
- ‘*Dowry*’ or bride price culture in Thailand

INSTITUTIONAL EXISTENCE

- Both the formal and the informal institutional constraints result in particular exchange organizations that have come into existence
- Because of the **incentives** embodied in the framework and therefore depend on it for the profitability of the activities that they undertake.

INSTITUTIONAL EXISTENCE

- The actors frequently must act on **incomplete information** and **process the information** that they do receive through mental constructs that can result in persistently inefficient paths
- **Transaction costs** in political and economic markets make for inefficient property rights
- But the imperfect subjective models of the players as they attempt to understand the complexities of the problems they confront can lead to the persistence of such property rights

INSTITUTIONAL CHANGES



Continuous changes

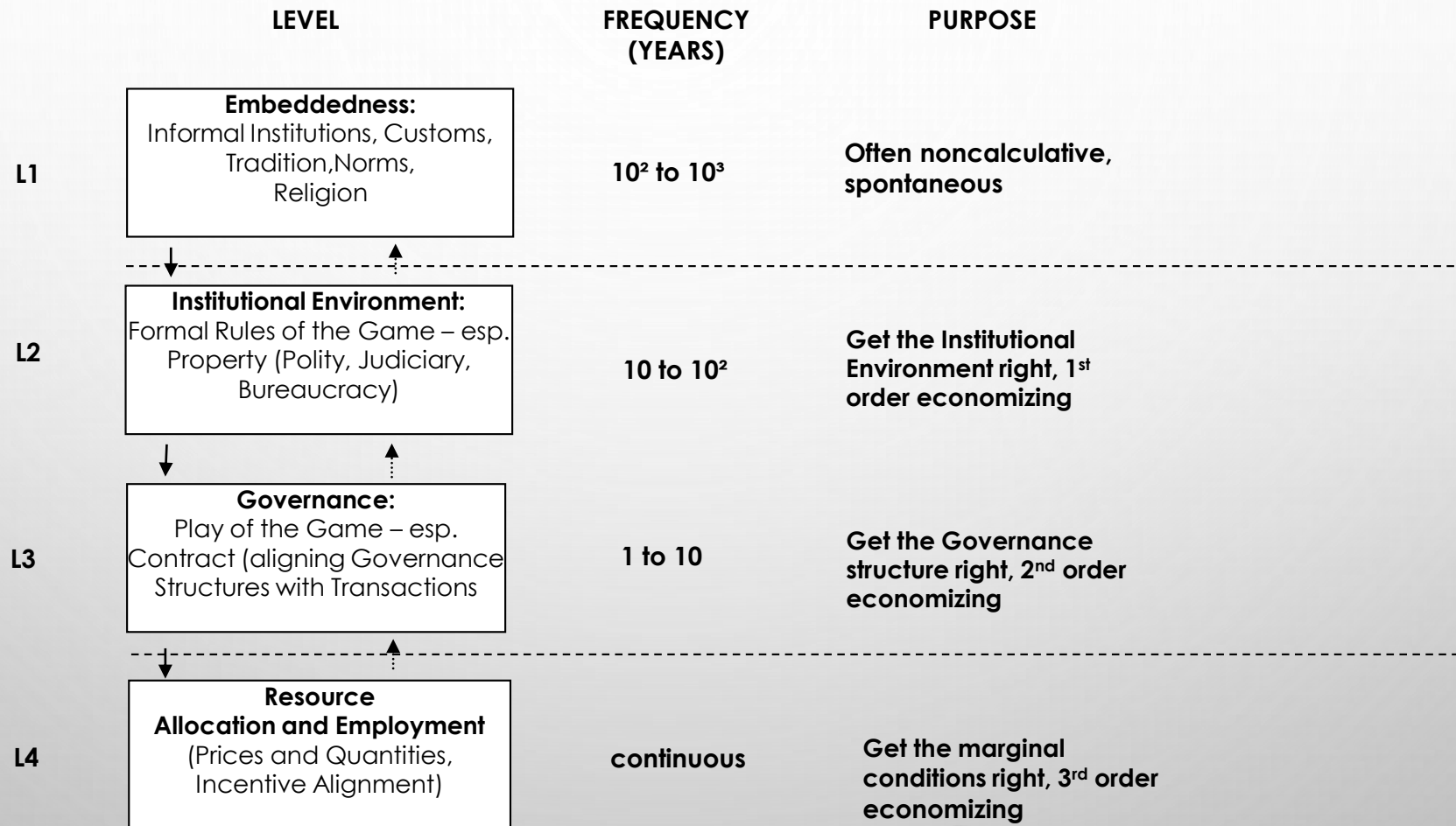
- The changes at the margin may be so slow and glacial in character that we have to stand back as historians to perceive them

Discontinuous changes

- Formal rules may change overnight as the result of political or judicial decisions
- However, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies.



ANALYTICAL LEVELS OF INSTITUTIONS

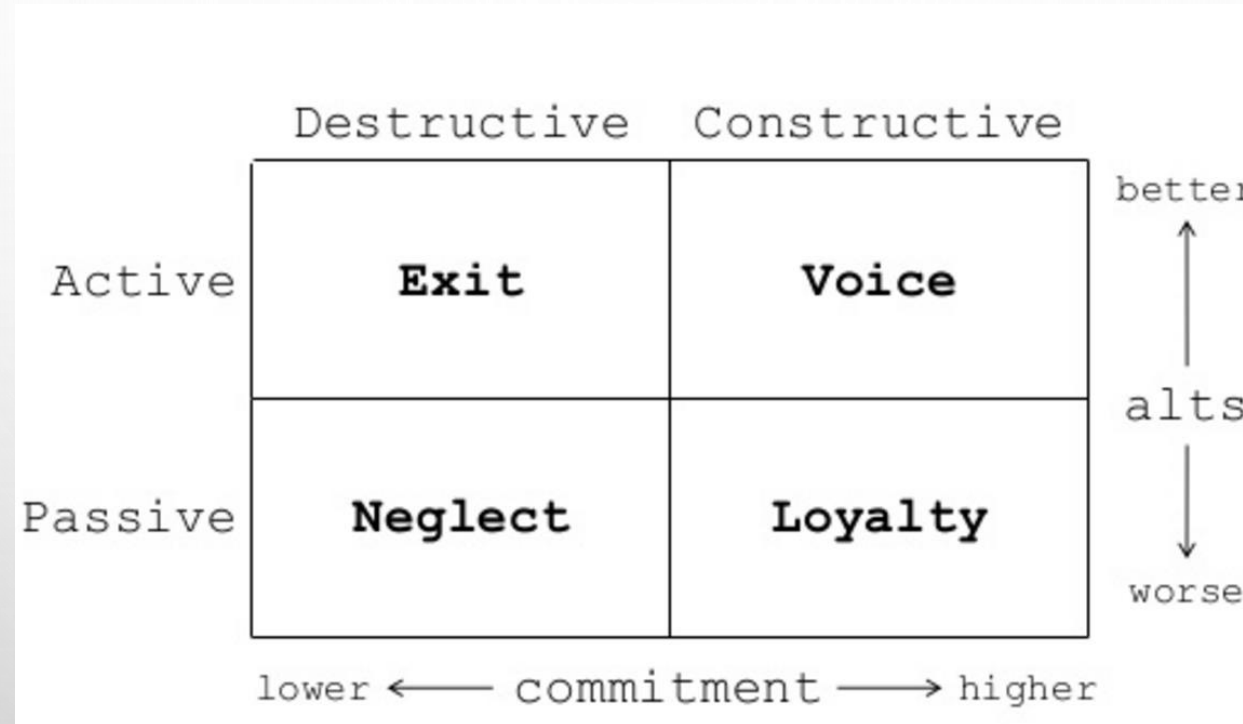


Williamson (1998)

INSTITUTIONAL CHANGES

- The resultant path of institutional change is shaped by
 - (I) The **lock-in** that comes from the symbiotic relationship between **institutions** and the **organizations** that have evolved as a consequence of the incentive structure provided by those institutions
 - (II) The **feedback process** by which human beings perceive and react to changes in the opportunity set.

FEEDBACKS TO EXISTING INSTITUTIONS



FEEDBACKS TO EXISTING INSTITUTIONS



นิสิตนเรศวรลุกฮือ!ปิดรั้ว ค้าน'นโยบายสีเขียว'

นิสิต ม.นเรศวร นับพันคน รวมตัวบุกล้อมตึกอธิการฯประท้วง พร้อมปิดรั้วมหาวิทยาลัย ค้านนโยบายสีเขียวห้ามใช้รถจักรยานยนต์ทำเตีอดร้อนหนัก แห่ขอให้ยกเลิกโครงการ

Revealed: Thailand's most senior human trafficking investigator to seek political asylum in Australia

Major General Paween Pongsirin says his investigations into human trafficking implicated senior figures in police and military and he now fears for his life



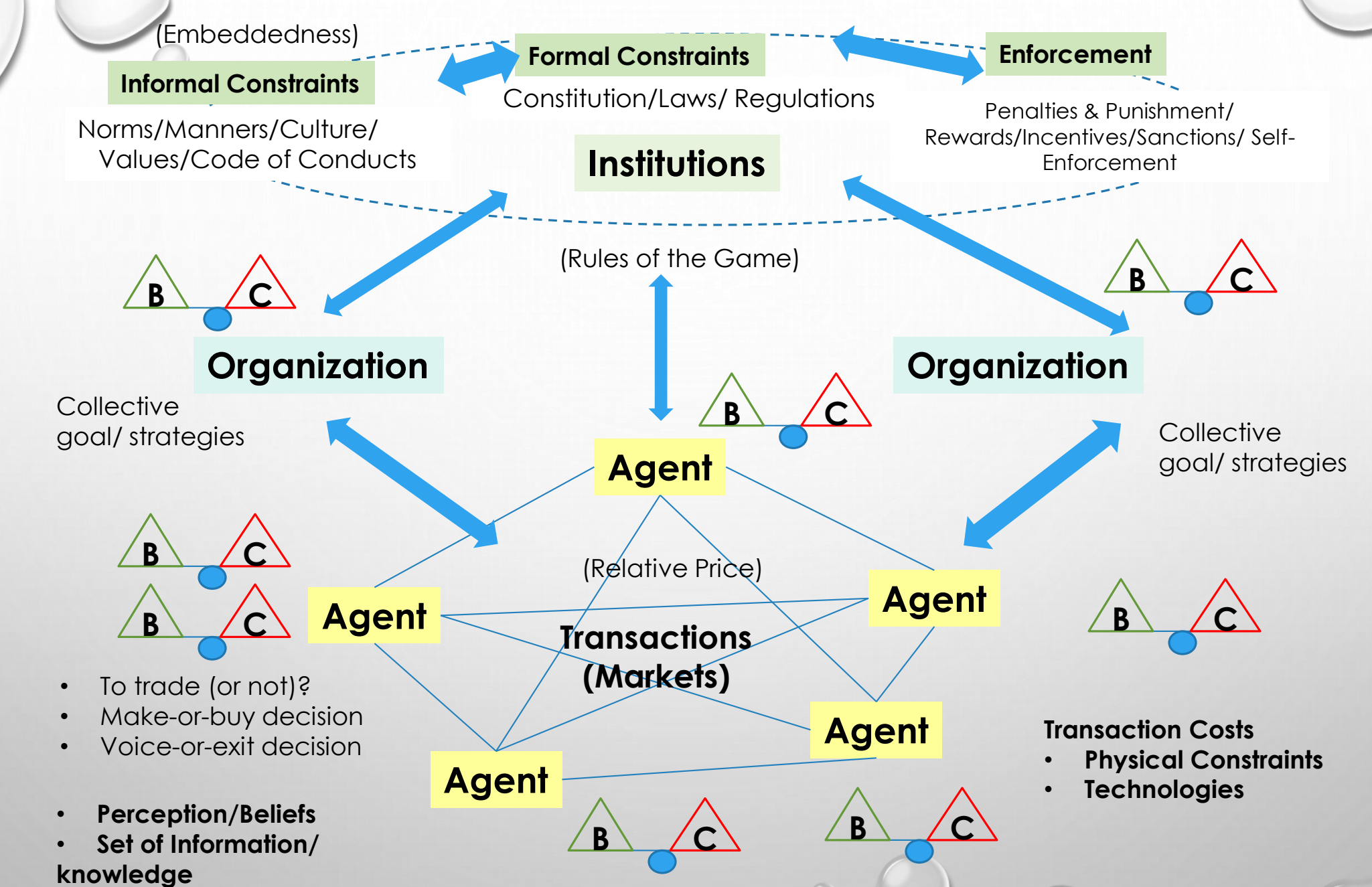
Major General Paween Pongsirin in Melbourne. He was appointed to lead an investigation into the discovery of more than 30 mass graves that was later stopped by influential people, he says. Photograph: Meredith O'Shea for the Guardian

FEEDBACKS TO EXISTING INSTITUTIONS



INSTITUTIONAL CHANGES

- We made institutions the determinant of economic performance and relative price changes the source of institutional change
- Changes in **relative prices** create incentives to construct more efficient institutions
- Institutions, together with the standard constraints of economic theory, determine the opportunities in a society
- **Organizations** are created to take advantage of those opportunities, and, as the organizations evolve, they alter the institutions



- To trade (or not)?
- Make-or-buy decision
- Voice-or-exit decision

- Perception/Beliefs
- Set of Information/
knowledge

Economic/Political/Social **Structure** → **Conduct** → **Performance**

INSTITUTIONAL CHANGES

- Incremental change comes from the perceptions of the entrepreneurs in political and economic organizations that they could do better by altering the existing institutional framework at some margin
- The perceptions crucially depend on both the **information** that the entrepreneurs receive and the way they process that information.
- If **political and economic markets** were efficient (i.e., There were zero transaction costs) then the choices made would always be efficient

INSTITUTIONS

- Institutions affect the **performance of the economy** by their effect on the costs of exchange and production
- Institutions (+technologies) determine the **transaction and transformation (production) costs** that make up total costs

INSTITUTION AND ECONOMIC DEVELOPMENT

- We all descended from primitive hunting and gathering bands.
- The gap between rich and poor nations, between developed and undeveloped nations, is as wide today as it ever was and perhaps a great deal wider than ever before
- How have societies diverged? What accounts for their widely disparate performance characteristics?
- What accounts for societies experiencing long-run stagnation or an absolute decline in economic well-being?

INSTITUTION AND ECONOMIC DEVELOPMENT

- Adam Smith said that productivity growth comes from specialization and the division of labour
- We rely on somebody else to provide us with food and clothing and housing. It sounds simple and easy.
- It is not, because when you get specialization of knowledge, how do you integrate that knowledge?:
- **ANS: Price mechanism? → First Dilemma**

INSTITUTION AND ECONOMIC DEVELOPMENT

- **Second Dilemma → Transaction Cost**

- Indeed what you have is a world in which you must integrate at low cost specialized knowledge by building **connections**.
- You have to make those connections, and that requires institutions and organizations that deliberately lower the transaction costs of integrating knowledge in a society.
- Effective price system gets you part way, but beyond that, then you need to develop a variety of organizations and institutions that will bridge at low cost, and integrate at low cost

INSTITUTION AND ECONOMIC DEVELOPMENT

- If you are a good chemist you do much better staying in the united states, in Switzerland or in Germany than you would in Bangladesh.
- The economic gains come when you can integrate your knowledge with that of a half a thousand other kinds of people.
- In the developed countries we have evolved all different kinds of specializations on various dimensions. → **Low transaction cost!**
- But supposing you are a third world country and are trying to compete with already developed countries. You face a big disadvantage

INSTITUTION AND ECONOMIC DEVELOPMENT

- **Third Dilemma: Rules of the Game**

- Efficient Market. Any Market that works well, whether it is a product market or a factor market, does so because it is structured in such a way that the players compete at those margins, and those margins alone, that ensure that people pursuing their self-interest also improve the well-being of society.
- **But in reality:** almost any market that is structured that way is going to have a mixture of **property rights** and **formal rules** underlying it.
- Additionally, it will have constraints that are usually rules and regulations that go beyond the very general rules and that specify particular margins of particular kinds of economic activity.

INSTITUTIONAL CHANGES

- As **economic organizations** evolved to take advantage of these opportunities, they not only became more efficient), but also gradually altered the institutional framework (political and judicial framework, property rights, norms, behaviors, attitudes (toward slavery, the role of women, and temperance, etc.)
- Both the **political and the economic transaction costs** and the subjective perceptions of the actors resulted in choices that were certainly not always optimal or unidirectional toward increased productivity or improved economic welfare

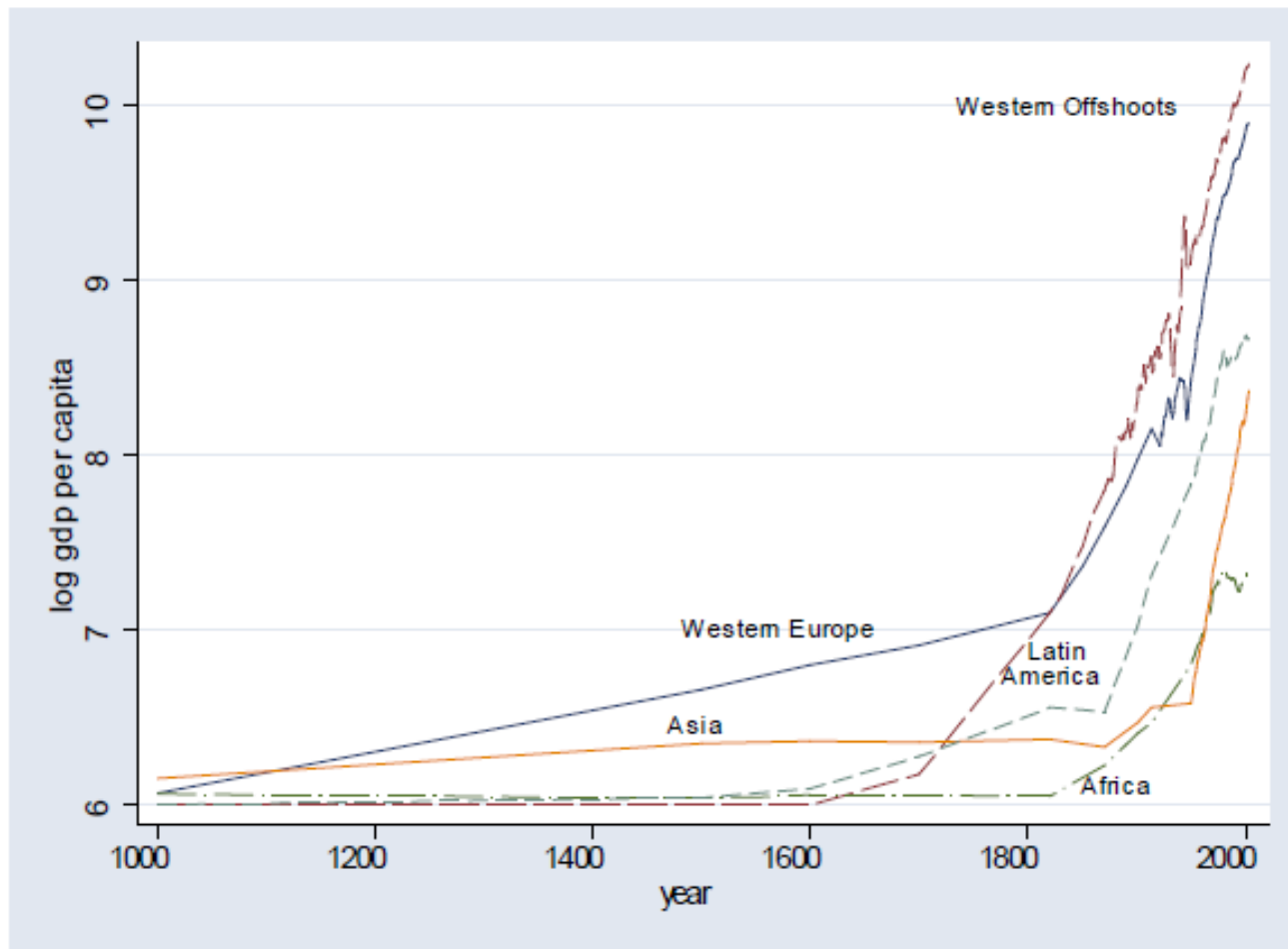
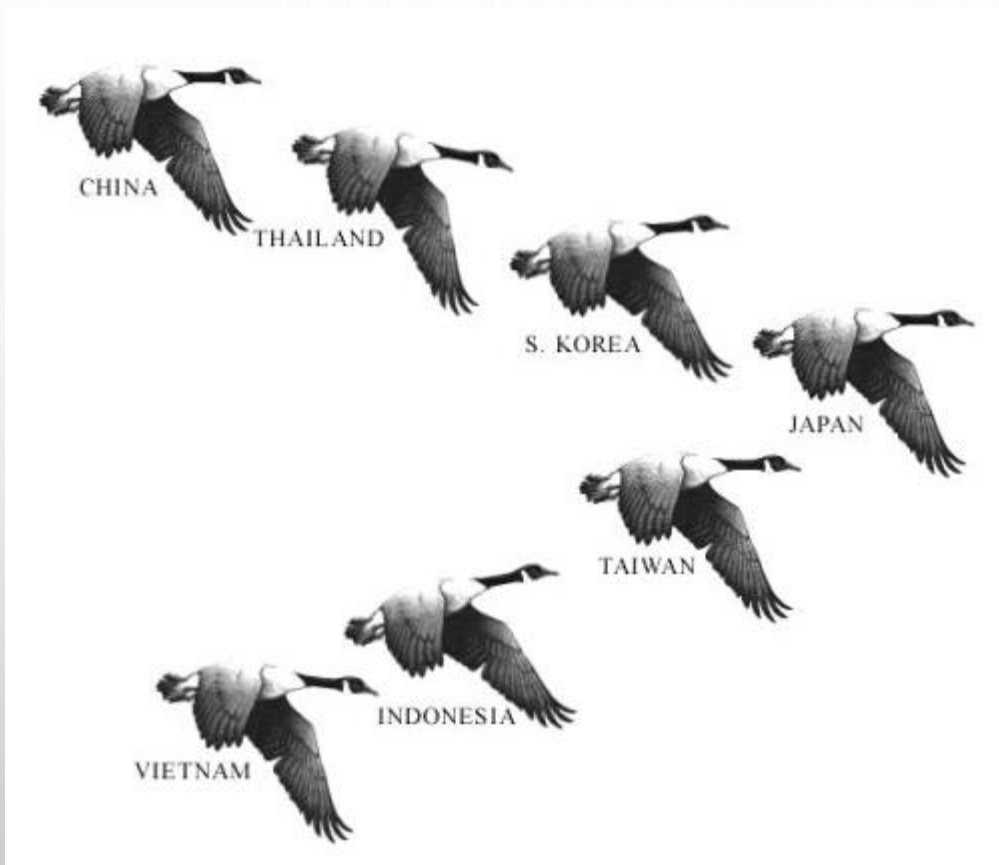
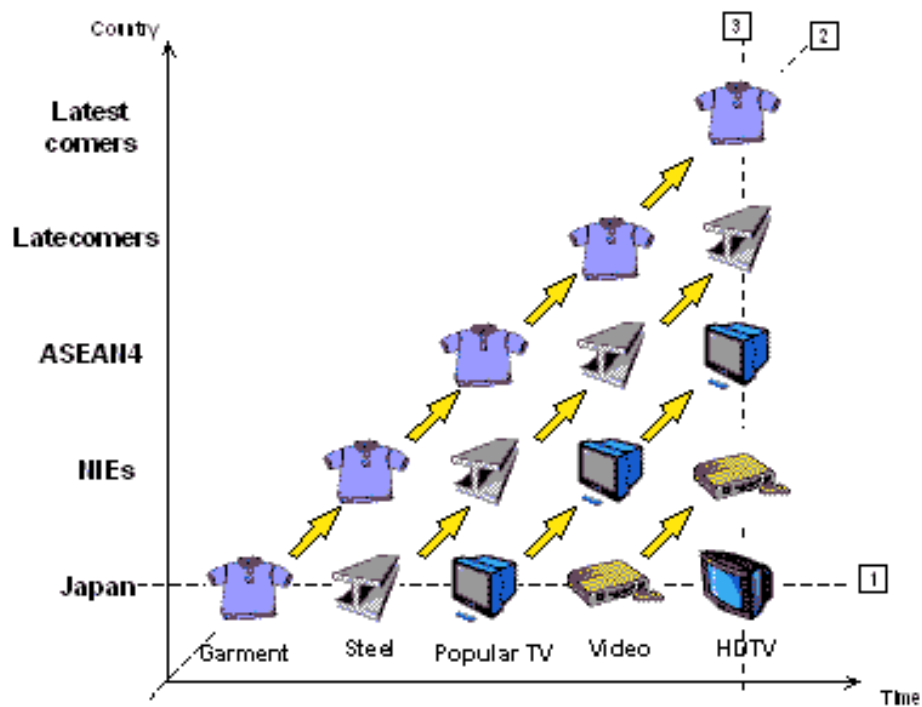


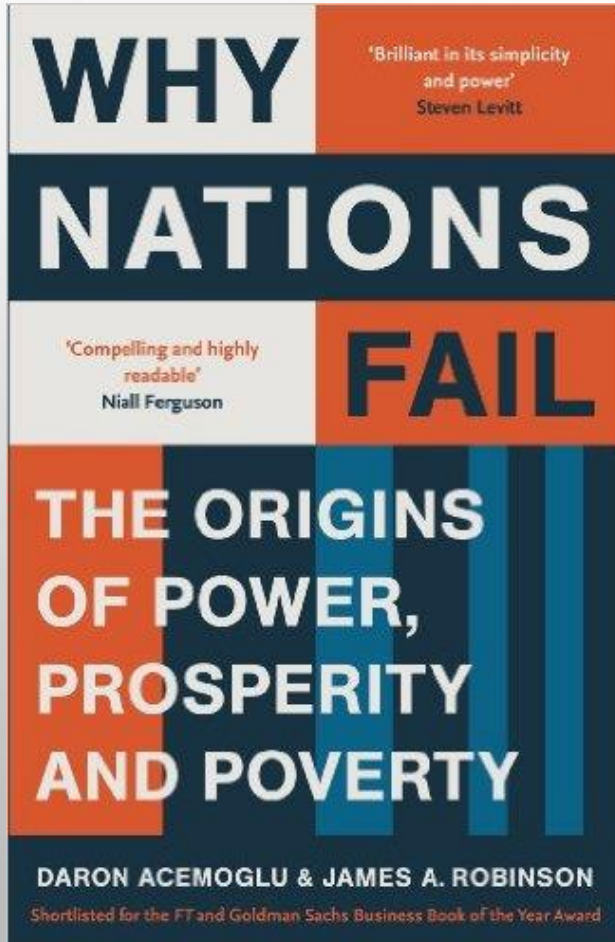
Figure: The evolution of average GDP per capita in Western Offshoots, Western Europe, Latin America, Asia and Africa, 1000-2000.



Structural Transformation in East Asia



WHY IS ONE RICH AND ONE POOR?



Many economists tried to explain why nations fail
Three main hypotheses are used to explain

1. The Geography Hypothesis
Climate affects agricultural productivity and there exists diseases that only occur in hot climate.
2. The Culture Hypothesis
The specific culture that has an impact on how economy develops. For example, “Mañana” culture in Latin America
3. The Ignorance Hypothesis
Simply because rulers **DO NOT KNOW** how to make poor countries rich

WHY IS ONE RICH AND ONE POOR?



Picture source: <http://willseberger.photoshelter.com/image/I0000JoADd5oFj5c>

- Nogales, Arizona (USA) and Nogales, Sonora (Mexico)
- A city divided by a border
- Same people, Same culture, Same location
- The part in the US has about three times higher household income than that in Mexico

THEORIES THAT WON'T WORK

However, these theories do not always work

1. The Geography Hypothesis

Nogales, Arizona and Nogales, Sonora are basically in the same place and therefore same geography.

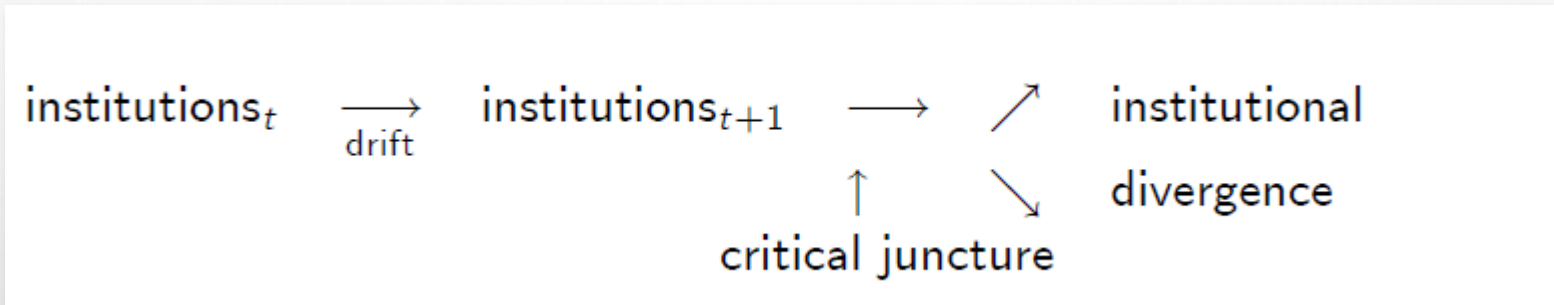
2. The Culture Hypothesis

Nogales has same group of people from the same root and hence same culture.

3. The Ignorance Hypothesis

In the case of breakout of poverty, it is not because the ruler suddenly becomes less ignorant or better informed. For example, Chinese Communist Party did not suddenly realized that collective ownership created terrible economic incentives.

THEORIES THAT WON'T WORK



HOW POLITICS DETERMINES WHAT INSTITUTIONS A NATION HAS

- Extractive and Inclusive Economic Institutions
 - Incentives play a large role of how the economy works
 - Example: North Korea and South Korea
 - Inclusive economic institutions incentivized people to work hard and be innovative as they have a chance to live a better life and make the choices they wished.
 - Extractive economic institutions caused people to become ignorant in their improvement as they cannot do anything to improve their lives.

HOW POLITICS DETERMINES WHAT INSTITUTIONS A NATION HAS

- when you go to a third world country and try to improve performance, there is only one of the three elements of institutions that you can alter and that is the formal rules of the game.
- But, of course, performance is the result of all three: the formal rules, informal norms and their enforcement characteristics.

ASSIGNMENT

- WATCH A MOVIE: **CITY OF GOD (2002)**
- DISCUSS: How what are the nature of **'institutions'** in Rio De Janeiro and how they influenced behaviors of people and social/economic performance.
- Suggest how changing institutions(three components) could be brought for development.

