ECON 272: Economic History of North America to 1913

Governance, Institutions and Public Choice Theory

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Winter 2019

Outline

1. The role of institutions
   - What purpose is served by institutions?
   - The rules of the game
   - Transaction costs
2. Humanly devised institutions
   - Institutions can be formal or informal
3. Not necessarily efficient
   - Public Choice
   - Distribution matters
4. Conclusion

Rules of the Game

- If our aim is to seek understanding of divergence/convergence and the course of living standards, we must discuss institutions:
- "The rules of the game in a society (...) the humanly devised constraints that shape social interaction, reducing uncertainty by providing a stable (but not necessarily efficient) structure to human interaction" - Douglass North
- Let us divide this sentence: a) rules of the game for a stable environment; b) humanely devised; c) not necessarily efficient.

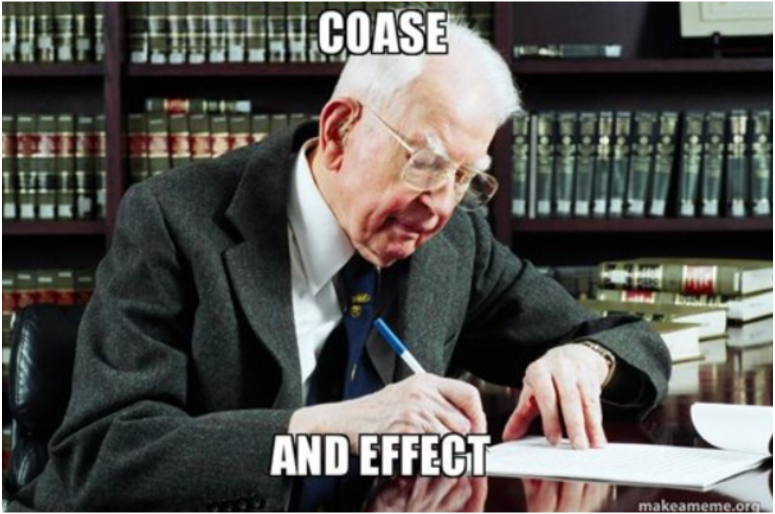
Rules of the game

- Imagine the last centuries of the Roman empire : barbarians are roving throughout the Empire for loot. They sack Rome in 410 (and do it again a little later). The end of the Roman Empire in the West marks the high point of a dark period in western civilization (Dudley, 1990)
- Recovery from that low point occurs from 7th to 9th centuries (Pirenne, 1927) as certain kings consolidate power and manage violence better (Young, 2018; Salter and Young, 2018) (e.g. Germanic kingdoms etc.)
- Think about this world in terms of bandits. There are "roving bandits" and "stationary bandits". (Olson, 1993)
- Roving bandit is looting barbarbian; stationary bandit is the king who taxes you regularly but protects you from the roving bandit. Which one gives you the greatest incentive to make productive investments/decisions?
- The stationary bandit! (Problem: we will see below that there are some derivate questions from this assertion).

Transaction costs

- The key answer is that institutions are meant to deal with transaction costs (Coase, 1960)
- We face barriers to exchange (uncertainty, opportunistic behavior, incompleteness of contracts, adjudication costs, cost of information etc.) - these are transaction costs!
- The "instinctive answer" to *any* question regarding institutions is *always intimately* linked with transaction costs.
- This is because institutions are solutions to deal with transaction costs and they will unlock a greater realm of exchange.
- Think again about the roving/stationary bandit example. The security provided by the latter bandit reduces the uncertainty of production = ability to make forward-looking (and production-increasing) decisions. The stationary bandit is a transaction-cost reducer.

Transaction costs

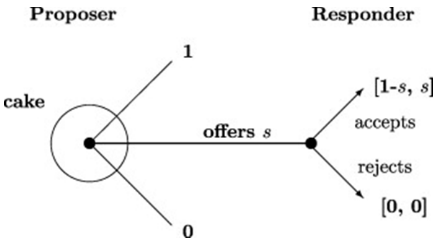


Informal (non-state)

- *Spontaneous orders are the products of human action but not human design* - Adam Ferguson

Informal (non-state)

- Non-state institutions can rely on a host of mechanisms to deal with transaction costs.
- Some are very simple and rely on the "discipline of continuous dealings" (i.e. because there is a stream of continuous exchanges, acting poorly means loosing the stream which forces the "honest" behavior as an equilibrium outcome) (Axelrod, 1984)



Informal (non-state)

- Non-state institutions can rely on a host of mechanisms to minimize transaction costs.
- Some are very simple because they reinforce the discipline of continuous dealings with "warm glows" (reputation) (Ostrom and Schwab, 2007)

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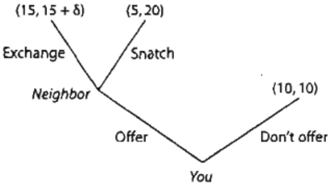


Figure 10.2. Game of Snatch with "Warm Glow"

Informal (non-state)

- They can be more sophisticated because the discipline of continuous dealings is weaker in large heterogeneous groups (Leeson, 2014):
  - Social distance reducers (Leeson, 2009) (e.g. middlemen minorities)
  - Supertistions (Leeson, 2013) (e.g. think about the ordeals paper from last class).
- They can have a sophisticated legal form (and be strange-looking) as long as there is a residual claimant, have features that deal with the exclusion of free-riders
  - Homeowner associations
  - Social clubs with constitutions (Stringham, 2015; Anderson and Hill, 2004) (e.g. the "Not so *wild* Wild West" which we will discuss in the later portions of the semester).
  - Business improvement districts (Cook and MacDonald, 2011)
  - Multilateral adjudication mechanisms (trading networks) (Stringham, 2015; Greif, 1993) (e.g. Maghrebi traders example).

Informal (non-state): a weird example

Figure: Example from Cheung (1983)

As examples of the gain from collaboration and the difficulty of delineating contributions, Alchian and Demsetz[13] cite the examples of loading and of fishing. My own favorite example is riverboat pulling in China before the communist regime, when a large group of workers marched along the shore towing a good-sized wooden boat. The unique interest of this example is that the collaborators actually agreed to the hiring of a monitor to whip them. The point here is that even if every puller were perfectly "honest," it would still be too costly to measure the effort each has contributed to the movement of the boat, but to choose a different measurement agreeable to all would be so difficult that the arbitration of an agent is essential.

Informal (non-state)

- The downsides of "private ordering" (Djankov et al., 2003)
  - Some things are harder to do without a monopoly on violence (certain goods are public goods and there will be free riders).
  - Externalities do exist
- There is a commitment problem: if I can be a stationary bandit (e.g. a private police force protecting you), I can also abuse you to some extent as long as you find the rebellion not worthwhile (Acemoglu, 2003).
- There is still some *returns* to marginally being a roving bandit. Thus you can see a *part* of the "not necessarily efficient" portion of North's opening remark.
- Thus, there *must* be some trade-off - see figure from (Djankov et al., 2003) on the next slide and Clark and Powell (2017).

Formal

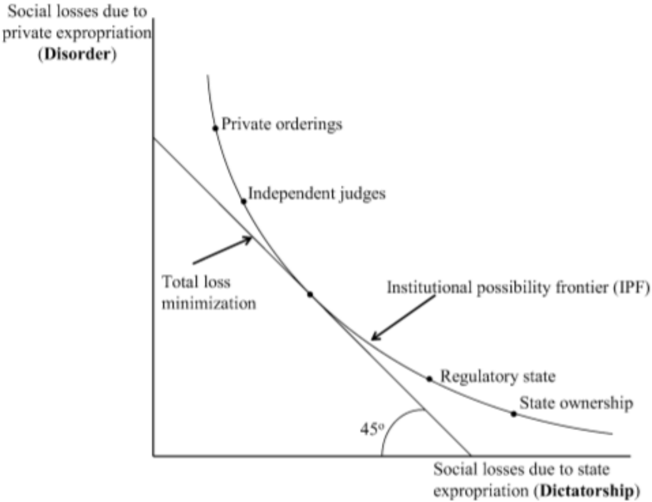


Fig. 1. Institutional possibilities.

Formal (state)

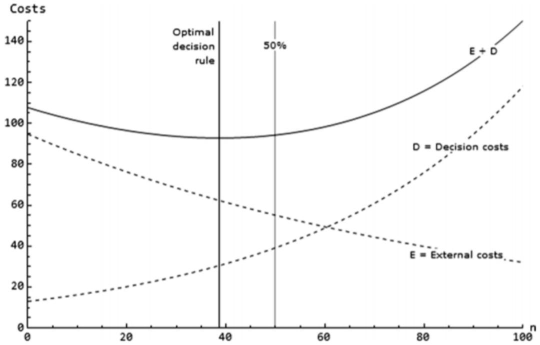
- To some extent private and public orderings are complements which makes the figure in the slide before somewhat inaccurate (but not necessarily wrong) - see Rosser and Rosser (2008) and Hayek (1988).
- Thus, there are formal institutions (i.e. state capacity) which can be supportive of economic growth (Dincecco and Katz, 2014; Dincecco, 2017; Johnson and Koyama, 2017). In other words, there are margins where the state can do better.
- But this spawns a tougher set of questions: what are good formal institutions, how do they emerge and how are they maintained?

Formal (state)

- Those questions are tough. Very! But they can be subjected to economic theory and this is known as public choice theory and constitutional political economy (in other words: the economics of politics) (Buchanan and Tullock, 1962).
- Political actors are just like all other actors: they are utility maximizers with their constraints and preferences and are not imbued with superior/inferior morality than others. They too respond to incentives.

Optimal rules

- First, there are optimal decision rules. Unanimity would be ideal (because there are no external costs and with unanimity you can assume the same outcomes as under voluntary system) (Buchanan and Tullock, 1962). However, unanimity is costly to achieve and the external costs have to be weighted against the decision costs.



Rent-Seeking and Distributional Coalitions

- Second, whatever is, is not necessarily efficient because certain groups can mobilize easier for concentrated benefits with diffuse costs (rent-seeking).
- Rulers can barter with certain groups in ways that preserve their power or increase their rent-extraction. The exchange is between two parties who are mutually gaining but they are shifting the costs onto others (regardless of whether or not that exchange constitutes an overall reduction in welfare).
- Even more problematic is that this process of rent-seeking can actually serve to build the basic functions of state institutions in places where they are clearly superior to most other state institutions (Salter, 2015; Salter and Young, 2018).

Rent-Seeking and Distributional Coalitions

- Thus, in a weird way, the question is not why X or Y political actor will behave correctly. The question is what institutions will incentivize even the bad one to do the right thing.
- What were the constraints of rulers (Leeson and Suarez, 2016)? What were the incentives facing them? What were the costs and benefits? **How did they diverge from acting in the socially desirable way** (see my example about the bias against presidential restraint (Garmon Jr et al., 2019).)

Conclusion

- The boldened passage in the previous slide is the one that we care about! All the tools mentioned here are about helping size the gap between what is occurring and what constitutes a pareto-improvement.
- The reason why is that there is a difference between productive efficiency and economic (or allocative) efficiency.
    - Productive efficiency (...) asks the question, are we producing as much as possible, given the scarcity of the factors of production?
    - Allocative efficiency (...) asks the question, are we producing the mix of goods and services that people value most, and are they going to those who value them most, given people's existing preferences?
- When we speak about institutions, we are concerned about the latter questioN!

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