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Introduction

Why do a few hundred million people enjoy a very high income while billions suffer from malnourishment and struggle to survive? Why do certain types of constitutions – ones that have proved very successful elsewhere – often not have their intended results, for instance, high incomes for the populace and a stable political system? Why is it that development programs introduced with the best intentions by the World Bank or the International Monetary Fund (IMF) often do not induce development, but instead sometimes even make the poor worse off? Is there a systematic relationship between individual freedom and per capita income? In the case of formerly socialist societies, is there indeed only a single silver bullet, namely, to privatize as fast and comprehensively as possible?

These are among the many questions that concern institutional economists. Institutional economists do not claim to be able to answer these questions comprehensively, but they do claim that their methods of investigating these questions can lead to more convincing answers than those offered by traditional economists.

The core hypothesis of institutional economics is that *growth and development are decisively shaped by the prevailing institutions*. The willingness as well as the ability not only to specialize, and thereby contribute to a deeper division of labor, but also to make long-term capital investments depends on the security of private property rights. Chapter 1 shows that property rights are an essential component of the institutions we are about to analyze. The form and content of private property rights, as well as possible costs of their enforcement, are crucial determinants in explaining why growth and development unfold – or do not. Douglass North, who was awarded the Nobel prize for his achievements regarding institutional economics, writes that “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” (1990a, 54).

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Another pioneer of institutional economics, Mancur Olson, asks why some nations are rich while others are poor. After having gone through the usual suspects (such as different access to knowledge, different access to capital markets, differences regarding population size in relation to arable land or the abundance of natural resources, differences in human capital, etc.), he concludes that none of them is particularly convincing and continues: "The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and their economic policies" (1996, 19).

To most non-economists, the relevance of institutions might appear so self-evident that it is difficult to understand why a still fairly young research area in economics puts that relevance center stage and even calls it "new." The answer lies in the fact that mainstream economics has long neglected institutions, albeit usually benignly. For many decades, growth theory tried to explain differences in growth across countries without explicitly taking into account the underlying institutions, looking instead at changes in labor and capital goods supply.

Over the last couple of decades, however, an increasing number of economists have become interested in how institutions might influence economic development. Among them are a number of Nobel laureates, including Ronald Coase, Friedrich Hayek, Douglass North, Elinor Ostrom, Herbert Simon, and Oliver Williamson. The new institutional economics is not marginal anymore: it is an amazing success story.

This brief introduction to the new institutional economics is aimed at a wider audience than just economists or students. Economics does not have a happy reputation; indeed, it is often referred to as the "dismal science." Many non-economists view economics as a soulless science completely divorced from real people and real life. Scientists in other disciplines often claim that economists abstract from so much relevant context that their results are meaningless. The new institutional economics takes these criticisms seriously, while still remaining "economic" in nature, taking some comfort from the fact that some have crowned economics as the queen of social sciences. In truth, economists have always inquired into constraints on human behavior when explaining individual choices. Traditionally, the main focus has been on the laws of nature as well as on budgetary constraints.

The new institutional economics takes the less-traveled path of explicitly acknowledging that both proscriptions and prescriptions influence human behavior and, further, that these proscriptions and prescriptions are not only state imposed and enforced (e.g., speed limits) but are also found in the norms of a society (e.g., in many countries, if one wants to board a bus, one must stand in line to do so, with deviations being sometimes quite severely punished by others in the queue).

Indeed, norms, customs, traditions, and mores can channel behavior just as much, sometimes even more, than laws. Whereas laws can be changed radically and swiftly, such is not the case with norms, customs, traditions, and mores. Thus the second core hypothesis of new institutional economics is that *the possibility of implementing institutions conducive to growth and development is constrained by the cultural imprint of the respective society*. Or, as Douglass North puts it: "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" (1990a, 6).

If it is true that growth and development are determined by both formal and informal rules, the interdependencies between them must be explicitly taken into account. A general hypothesis is that the enforceability of formal rules ultimately depends on their compatibility with informal ones (Weingast, 1995; Voigt, 1999a, ch. 5). This is not especially good news for politicians and their advisors whose carefully designed programs optimistically intend to turn entire countries around within just a hundred days and set them on a path to growth and prosperity. Institutional economists view such optimism skeptically and more cautiously hope for a sequence of incremental improvements.

Conventional textbooks usually present the (more or less) solid knowledge of the respective field in a didactically sophisticated fashion. I have opted for a different approach in this book. I frequently point out that our knowledge regarding the effects of specific institutions is quite limited (yet). Every chapter ends with a section entitled "Open Questions." My hope is that these questions will inspire curiosity in readers, even leading some to become researchers themselves. If this book manages to make institutional economics seem exciting and valuable, it will have achieved its goal.

Just a word on my use of references. In each chapter, I quote from or cite those publications that have been seminal contributions to a particular topic. However, I realize that such references might be somewhat daunting to a reader just beginning to become acquainted with the topic. Therefore, the further reading recommendations at the end of the chapters were selected to be more accessible; surveys – either in the form of papers or books – were given priority.