



Institutional Economics

Why is it that some countries become rich while others remain poor? Do markets require regulation to function efficiently? If markets offer an efficient way of exchanging goods, why do individuals even create firms? How are economic transactions organized in the absence of a state that could enforce contracts and guarantee property rights? Institutional economics has allowed social scientists to answer many fundamental questions about the organization and functioning of societies. This introduction to institutional economics is concise, yet easy to understand. It not only caters to students of economics but to anybody interested in this topical research area and its specific subfields. Both formal and informal institutions (such as customs, habits, and traditions) are discussed with respect to their causes and consequences, highlighting the important part they play for economic growth and development.

Stefan Voigt is Chair of Economic Analysis of Law at the University of Hamburg and Director of its Institute of Law and Economics. He is also a fellow with CESifo (Munich). Voigt is one of the editors of *Constitutional Political Economy* and a member of various editorial boards, including those of *Public Choice* and the *International Review of Law & Economics*.

Cambridge University Press
978-1-108-47324-8 — Institutional Economics
Stefan Voigt
Frontmatter
[More Information](#)

CAMBRIDGE

Cambridge University Press
978-1-108-47324-8 — Institutional Economics
Stefan Voigt
Frontmatter
[More Information](#)

Institutional Economics An Introduction

Stefan Voigt
University of Hamburg



CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom
One Liberty Plaza, 20th Floor, New York, NY 10006, USA
477 Williamstown Road, Port Melbourne, VIC 3207, Australia
314–321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre,
New Delhi – 110025, India
79 Anson Road, #06–04/06, Singapore 079906

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning, and research at the highest international levels of excellence.

www.cambridge.org

Information on this title: www.cambridge.org/9781108473248

DOI: 10.1017/9781108573719

© Stefan Voigt 2019

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press.

First published 2019

Printed and bound in Great Britain by Clays Ltd, Elcograf S.p.A.

A catalogue record for this publication is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Names: Voigt, Stefan, author.

Title: Institutional economics : an introduction / Stefan Voigt, University of Hamburg.

Description: 1 Edition. | New York : Cambridge University Press, [2018] |

Includes bibliographical references and index.

Identifiers: LCCN 2018030131 | ISBN 9781108473248 (hardback) | ISBN 9781108461085 (pbk.)

Subjects: LCSH: Institutional economics.

Classification: LCC HB99.5 .V65 2018 | DDC 330–dc23

LC record available at <https://lcn.loc.gov/2018030131>

ISBN 978-1-108-47324-8 Hardback

ISBN 978-1-108-46108-5 Paperback

Cambridge University Press has no responsibility for the persistence or accuracy of URLs for external or third-party internet websites referred to in this publication and does not guarantee that any content on such websites is, or will remain, accurate or appropriate.



Brief Contents

List of Figures	xii
List of Tables	xiii
Preface	xv
Introduction	1
1. The Basics	5
2. Simple Transactions	37
3. Repeated and Long-Term Transactions: On the Choice of Governance Structures with Given Institutions	60
4. Institutions and Collective Action	81
5. The Relevance of Institutions for Growth and Development	107
6. Explaining Differences in External Institutions across Societies	158
7. Explaining Change in Internal Institutions	195
8. On the Need for Normative Theory	221
9. Consequences for Economic Policy	237
10. Outlook	255
References	268
Index	289



Detailed Contents

List of Figures xii
List of Tables xiii
Preface xv

Introduction 1

1. The Basics 5

1.1 The Standard Behavioral Model of Economics – and a Few Modifications Made by New Institutional Economics 5
1.1.1 From Perfect to Bounded Rationality 8
1.1.2 Transaction Costs 9
1.2 Institutions: Functions, Types, and Interrelationships 12
1.2.1 Definitions of Institutions 13
1.2.2 Interactions between Internal and External Institutions 19
1.3 Research Questions 20
1.4 The Toolkit of Institutional Economists 22
1.4.1 Game Theory: A Tool for Analyzing Strategic Interaction Situations 23
1.4.2 Comparative Institutional Analysis 27
1.4.3 Experiments in the Laboratory or the Field 28
1.4.4 Case Studies Including Economic History 29
1.4.5 Econometric Tests 30
1.5 NIE's Common Ground with and Differences from Other Research Programs 31
1.6 Open Questions 33
Further Reading 35

2. Simple Transactions 37

2.1 The Relevance of External Institutions for Simple Transactions 38
2.1.1 The Coase Theorem 40
2.2 The Relevance of Internal Institutions for Simple Transactions 45
2.2.1 Example 1: Norms of Cooperation and the Ultimatum Game 45
2.2.2 Example 2: Fairness Notions and Price Formation 47
2.3 The Relevance of Interplay between External and Internal Institutions for Simple Transactions 48
2.3.1 Conflicting External and Internal Institutions 48

- 3.3.2 Complementary External and Internal Institutions 48
- 3.3.3 Substitutive Relationship between External and Internal Institutions 49
- 3.3.4 Empirical Results on the Relationship between External and Internal Institutions 50
- 2.4 On the Estimation of Transaction Costs 54
 - 2.4.1 Estimations of the Size of the Informal Sector 56
- 2.5 Open Questions 57
- Further Reading 58
- 3. Repeated and Long-Term Transactions: On the Choice of Governance Structures with Given Institutions 60**
 - 3.1 Introductory Remarks 60
 - 3.2 From a Black Box to the Firm as a Team 63
 - 3.3 Problems Associated with Asymmetric Information: The Principal–Agent Theory 65
 - 3.4 Transaction Cost Economics 68
 - 3.5 The Firm as a Collection of Assets 72
 - 3.6 The Relevance of Internal Institutions 75
 - 3.6.1 Example 1: Corporate Culture: On the Coordination of Interaction Situations within Firms 75
 - 3.6.2 Example 2: On the Relevance of Reciprocity in Labor Relations 76
 - 3.7 Open Questions 77
 - Further Reading 78
- 4. Institutions and Collective Action 81**
 - 4.1 Introductory Remarks 81
 - 4.2 Explaining Politicians' Behavior Under Given Institutions 83
 - 4.2.1 Preliminary Remarks 83
 - 4.2.2 Example 1: Rent Seeking 84
 - 4.2.3 Example 2: Political Business Cycles 85
 - 4.2.4 The Dilemma of the Strong State 86
 - 4.3 Explaining Collective Action Using Internal Institutions 91
 - 4.3.1 From Non-Repeated to Repeated Games 91
 - 4.3.2 Evidence from the Laboratory 93
 - 4.4 The Interplay between External and Internal Institutions and its Relevance for Collective Action 98
 - 4.5 Open Questions 102
 - Further Reading 104
- 5. The Relevance of Institutions for Growth and Development 107**
 - 5.1 Introductory Remarks 107
 - 5.2 Determinants of Economic Growth: Institutions, Geography, Culture? 109

Detailed Contents

ix

- 5.2.1 Institutions 109
- 5.2.2 Geography 112
- 5.2.3 Culture 119
- 5.3 The Relevance of External Institutions for Economic Growth and Development 122
 - 5.3.1 How to Measure External Institutions 123
 - 5.3.2 Early Attempts to Measure External Institutions 124
 - 5.3.3 One Measurement Attempt in Detail 127
 - 5.3.4 Results of Empirical Studies 139
 - 5.3.5 Institutions or Policies? 141
- 5.4 The Relevance of Internal Institutions for Economic Growth and Development 142
- 5.5 On the Interplay between External and Internal Institutions and its Relevance for Economic Growth and Development 149
- 5.6 Open Questions 150
- Further Reading 151
- Appendix: A Ten-Minute Primer in Econometrics 152
- 6. Explaining Differences in External Institutions across Societies 158**
 - 6.1 Introductory Remarks 158
 - 6.2 Origins and Change of Property Rights: A Traditional View 160
 - 6.3 Origins of and Change in Property Rights and the State: Accounting for Political Economy Factors 165
 - 6.4 Explaining Differences in Institutions 169
 - 6.4.1 Preliminary Remarks 169
 - 6.4.2 Explaining External Institutions Based on Geography 170
 - 6.4.3 Explaining External Institutions Based on Culture or History 171
 - 6.4.4 Explaining External Institutions Based on Social Conflict View 174
 - 6.5 Institutional Change via Institutional Competition? 181
 - 6.6 Elements of a General Theory 184
 - 6.6.1 Preliminary Remarks 184
 - 6.6.2 Satisficing Behavior 186
 - 6.6.3 Collective Action Problems 187
 - 6.6.4 Path Dependency of Institutional Change 188
 - 6.6.5 Political Transaction Costs 189
 - 6.6.6 The Relative Power of the Relevant Actors 190
 - 6.6.7 The Relevance of Internal Institutions 191
 - 6.6.8 A Short Summary 192
 - 6.7 Open Questions 192
 - Further Reading 193
- 7. Explaining Change in Internal Institutions 195**
 - 7.1 Introductory Remarks 195

- 7.2 The Problem in Economic Terms 196
- 7.3 Hypotheses on the Origins of Norms 199
 - 7.3.1 Evolutionary Approaches 199
 - 7.3.2 Repetition or Reputation as Explanatory Factor? 202
 - 7.3.3 An Attempted Synthesis 203
- 7.4 Potential Triggers for Change in Internal Institutions 212
 - 7.4.1 Introductory Remarks 212
 - 7.4.2 Geography Again 213
 - 7.4.3 External Institutions 215
- 7.5 Open Questions 217
- Further Reading 219
- 8. On the Need for Normative Theory 221**
 - 8.1 Introductory Remarks 221
 - 8.2 What is Normative Theory and Why Should We Study It? 222
 - 8.3 Two Competing Normative Concepts 224
 - 8.3.1 The Welfare Theoretical Approach 224
 - 8.3.2 Hypothetical Consent: A Heuristic to Derive Normative Statements 226
 - 8.3.3 Some Critical Comments on the Unanimity Test 231
 - 8.4 Requirements for a Normative Theory from the Perspective of Institutional Economics 232
 - 8.4.1 The Approach of Williamson 232
 - 8.4.2 The Approach of Hayek 233
 - 8.4.3 Consequences of the Two Approaches 234
 - 8.5 Open Questions 235
 - Further Reading 236
- 9. Consequences for Economic Policy 237**
 - 9.1 Introductory Remarks 237
 - 9.2 Policy Recommendations: The Traditional – Naïve – Approach 238
 - 9.3 Activation of Internal Institutions through Government Action? 242
 - 9.3.1 A Specific Example: Voluntary Commitment Declarations 243
 - 9.4 Policy Reforms in Practice: Case Study of New Zealand 247
 - 9.4.1 The Initial Situation in New Zealand 247
 - 9.4.2 Overview of the Most Important Reforms 247
 - 9.4.3 Explaining the Reforms 249
 - 9.5 Open Questions 253
 - Further Reading 254
- 10. Outlook 255**
 - 10.1 Introductory Remarks 255
 - 10.2 Institutions and Mental Models 258
 - 10.3 Institutions and Ideas 260

Detailed Contents

xi

10.4 Institutions and Individuals	261
10.5 Institutions beyond the Nation-State	263
10.6 Institutions and Identification	265
10.7 Where to Turn to Start Your Own Research?	266
Further Reading	266
References	268
Index	289

Figures

- 2.1 Bargaining solution when P is not liable 42
- 4.1 A graphic depiction of the prisoner's dilemma 92
- 5.1 The evolution of income in the USA, the UK, Spain, Brazil, China, India, and Ghana between 1820 and 2000 110
- 5.2 Relationship between latitude (measured as the distance of a country's capital from the Equator) and income per capita in 1995 114
- 5.3 Population density in 1500 and income per capita in 1995 among former European colonies 118
- 5.4 Direct and indirect effects of geography on income 119
- 5.5 The relationship between culture and institutions 120
- 5.6 Overview of the components of the Economic Freedom Index 128
- 5.7 The country ranking of the Index for 2015 133
- 5.8 Economic freedom and per capita income 135
- 5.9 Economic freedom and per capita income growth 135
- 5.10 Economic freedom and the income share of the poorest 10% 136
- 5.11 Economic freedom and the income earned by the poorest 10% 136
- 5.12 Instrumenting culture with historical institutions 149
- 7.1 One value can be a reference point for multiple norms; one norm can represent the application of multiple values 197
- 7.2 Using the concept of interdependent utility functions to explain the existence of costly sanctions 206
- 7.3 The Habsburg Empire in Eastern Europe 217
- 8.1 The interdependence cost calculus 229



Tables

- 1.1 Types of internal and external institutions 17
- 1.2 Identification of research fields 21
- 1.3 Related research programs 33
- 4.1 Internal institutions and individual contribution to collective action 95



Preface

The new institutional economics is an impressive success story. Within just a few decades, this young subdiscipline has attracted some of the brightest scholars around, several Nobel prizewinners among them.

The book is aimed at familiarizing anybody interested in the new institutional economics with its most basic concepts. No prior knowledge in economics is needed. I have attempted to use plain language and avoid economic jargon. As the new institutional economics continues to develop at high speed, it was impossible to do justice to every branch of its research program; instead, this book summarizes the state of the art from a subjective point of view.

A German-language predecessor, *Institutionenökonomik*, was published in 2002 by Wilhelm Fink publishers. A comparison between that edition and the current one reveals how much, and how quickly, new institutional economics has progressed: some chapters had to be completely rewritten to reflect the progress made during the last 15 years.

I was extremely lucky to have a group of very gifted – and highly critical – collaborators. We discussed every single page of this introduction to the field. Thanks to Marek Endrich, Dr. Jerg Gutmann, Dr. Stephan Michel, and Konstantinos Pilpilidis for critically – but also constructively – reading the first draft of this edition. Dr. Sang-Min Park and Mark Pegors helped make my English readable. Many thanks to them, too.

