

THE SIGNIFICANCE OF INSTITUTIONS: CONCEPTUAL DELIMITATIONS AND TYPOLOGY

Abstract

The specific achievements of recent economic theory in the analysis of institutions and alternative institutional structures implications on economic performance have created the possibility of building a core of institutional aspects for the economic research.

Integrating research institutions in general economic horizon creates the possibility of reassessing disciplinary boundaries between social sciences. Also, we can expect reconciliation of the economic theory "imperialism" with the same trends, no less important, from other disciplines and fields of social analysis. Ultimately, social science analytical concern has its source, in fact, in the same framework of human action analysis and social phenomena resulting from its manifestation.

Understanding human behavior and institutions mutuality, the economic and political implications of this interdependence, increased the importance of institutions and institutional analysis in economic theory

Key words: *economic theory, analysis of institutions, economic performance, social analysis.*

When asked "What institutions are?" , literature does not provide a widely recognized view, much less a uniform analytical technique and the most appropriate response depends primarily on how the notion of institution is used.

North shows that "institutions reduce uncertainty by providing a stable daily life."² In this sense, institutions serve as a guiding role to human interaction, an approach convergent with austrian meaning of institutions as „orientation point" for coordination of individual plans and improvement of the cognitive limits of human nature.

Convergence strengthens on the belief that institutions arise and evolve through human action and the theory that explains this process must be based necessarily on the principle of methodological individualism. However, common elements of these approaches seem to have a weak foundation because of different views³ in the application and validation "criterion of efficiency."

In terms of subjective perceptions of reality, people develop institutions or "rules of the game" to reduce uncertainty arising from repetitive human interactions.⁴

It is widely recognized that, especially in the Austrian approach, institutions have a role in explaining the market process, as a distinct class of phenomena described by Adam Ferguson (which become defining for the Hayek paradigm): *human action, but not human designed.*

Moreover, this definition of social institution has his roots in the tradition of Austrian economics, where institutions represent the social crystallization of human behavior in accordance with the rules.

A criterion for the classification of institutions proposed by O. Williamson⁵, is hierarchical one presented in Table 1.:

¹ Associate-professor,

An. Inst.Cerc.Ec.,Gh. Zane”, t. 20, i.II, Iași, 2011, p.165-170

²Douglass North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990, pag.3

³ Svetozar Pejovich, *Economic Analysis of Institutions and Systems*, Kluwer Academic Publishers, 1995, p. 29.

⁴ Ibidem

⁵ Williamson, O.E. *The New Institutional Economics: Taking Stock, Looking Ahead*, în “The Journal of Economic Literature”, Vol. 38, No. 3, pp. 595-613,2000.

Table 1

Hierarchical classification of institutions

Hierarchical level	Examples	Efects	Frequency of change
Level 1 institutions associated with the social structure of society	Mostly informal institutions - traditions, habits.	Define the way in which society self-regulates.	Resistance over time (changes in over 100-1000 years, although rapid changes can occur in conditions of profound shocks and crises))
Level 2 institutions associated with the "rules of the game"	Most formal institutions which define property rights and legal system.	Defining all the institutional environment	Relatively long horizon of action (10-100 years)
Level 3 behavior associated institutions needed for the "game"	Rules that define the governance and contractual relationships	Contribuie la formarea organizațiilor	Medium term action (1-10 years)
Level 4 institutions associated to the resource allocation mechanism	Rules that control of the capital flows, trade regimes, social security etc..	Helping to regulate the prices and production.	Short and very short-horizon of action

Source : Williamson, O.E. *The New Institutional Economics: Taking Stock, Looking Ahead, The Journal of Economic Literature*, Vol. 38, No. 3, 2000. pp. 595-613.

The groups of institutions listed in the table are not fixed. Depending on the institutional framework, they can pass from one group to another.

Being relatively stable as structure of statuses and roles, formal and informal institutions are meant to lead to the satisfaction of certain needs of people in society.

The diversity of needs or social functions is associated with the diversity of institutions. The history of human society is a history of diversifying institutions, T. Parsons naming this process *institutional differentiation*.

In addition to institutional differentiation based on functional specialization, occurs a process of institutional sectoralisation, the ordering of institutions specialized in performing certain functions in various areas of social life. A particular area or social sector, for example, the productive sector, is not associated with one institution, but with a set of related institutions. Productive sector requires institutions aimed at producing goods and services, organization of work and labor relations, the introduction of innovations etc..

Furthermore the manufacturing sector is and must be correlated with the distribution and consumption, which correspond to other institutions, all together constituting economic institutions of society.

Thus, another criterion for the classification of institutions proposed by J. Jütting⁶, is taking into account the area of specialization or analysis. According to this criterion, we distinguish the following institutions (Table 2.)

Table 2

Classification of institutions as area of analysis

	Formal	Informal
Economic institutions	Rules that govern the allocation of economic resources, production and distribution of economic goods and services	Traditions in the consumption of certain goods (The interdiction in the Muslim consumption of pork and beef to Hindus), predilection for certain economic activities (trade for Hebrew, banking for Swiss, design for Italians)
Political institutions	Constitutional, legislative political and administrative rules operating and changing the political system	Habits characterized by bureaucracy favoritism, nepotism, etc.
Legal institutions	Legal system, the definition and exert of property rights	Anglo-saxon natural law
Social institutions	Rules that ensure social protection and human development	Individualistic or collectivist tradition, obedience or self-development.

Source : Jütting, J. *Institutions and development: a critical review*, Working Paper No. 210, OECD Development Center, 2003, p. 11.

⁶ Jütting, J. *Institutions and development: a critical review*, Working Paper No. 210, OECD Development Center, 2003, pag. 11

However, for defining institutions probably the first question would be "How well and quickly they can adapt to the requirements of economic institutions of society."

More relevant in the present discussion would be how Acemoglu, Johnson and Robinson (2005) distinguish between different views of the institutions⁷:

- **The opinion efficient institutions:** institutions matter for economic performance, and companies will choose only the institutions that maximize surplus. This opinion converges with the North and Demetz's theory of institutions. Both say that in a world where institutions matter, businesses can negotiate the possible internalization of externalities. Eg. a farmer who suffer from pollution created by a close factory will pay the manager to reduce pollution. The same reasoning can be applied to political institutions. If current laws favoring one group creating a disproportionate cost for the other, these two groups will negotiate to change institutions. The opinion of efficient institutions also suggests that institutions are different because countries have certain characteristics that make economically efficient institutions. Eg. We have insecure property rights in Mali, but because much of this country is in the Sahara and the promulgation and implementation costs better laws will result in higher costs than benefits.

- **The opinion of social conflicts** - according to this view institutions are not elected by the whole society (and not the benefit of society), but by groups of interests that control the power at a time. These groups will choose institutions that maximize results and not always maximize the overall society results. North also adheres to this idea, arguing that in all societies there is "a permanent tension between governing bodies seeking to achieve their own interests and an effective system that reduces transaction costs and encourage economic growth."

- **The opinion of beliefs and ideologies** - according to this school of thought institutions differ because we have different beliefs and views on what is good for society. Some companies may implement correct institutions others do not, hence the difference in prosperity. It is certainly possible for those who want a society organized on non-economic criteria, but will have to be prepared to sacrifice the results to have a better set of institutions.

- **The opinion of incidental institutions** - contrary to economic approach this view minimizes economic choices and emphasizes the development of institutions as a product of social interaction. Economic and political institutions does not appear that the choice of economic agents, but they are incidental consequences of other social activities. An interesting example in this area is the work of Richard Tilly⁸ according to which institutions from modern states: such as tax systems, bureaucracy parliaments, are closely related to the idea of gathering as many resources to wage war, and this occurs in places with a continue interstate competition (eg Africa, where we deal with countries that cannot provide public goods and the internal order).

The first two views are closer to economic research in general and therefore I will address in more detail in this work. According to **social conflicts opinion**, the conflict between social groups is essential for institutions and the differences in the nature of this conflict will lead to a different set of institutions. By contrast, in the **opinion of efficient institutions**, the conflict between groups or agents is not important, and institutional differences are due to differences in the economic environment or the costs of creating institutions.

According to of social conflict approach can distinguish between the following types of institutions:

⁷ Daron Acemoglu, Simon Johnson, James Robinson, *Institutions as the Fundamental Cause of Long-Run Growth*, in Handbook of Economic Growth, Edited by Philippe Aghion and Stephen Durlauf, Elsevier, North Holland, 2005, pag. 35-39

⁸ Richard Sylla, Richard Tilly, and Gabriel Tortella, editors. *The State, the Financial System and Economic Modernization*. New York: Cambridge University Press. 1999.

- Economic institutions - or economic determinants of game rules - in particular, private property, contracts, commercial law, laws on patents etc.

- Political institutions - or political determinants of the game rules - they help to establish the limits of political power and change it. Common examples are the, electoral rules, the number of actors with veto power.

Another criterion for the classification of institutions (how they are created and imposed on the community by a third party with coercive power or a certain political authority) allows their separation of domestic institutions and external institutions.

Another view for the classification of institutions, sensitively close to the former, takes into consideration the degree of formalization (encoding) of behavioral rules (social), which allows distinguishing between informal and formal institutions.

The common elements of these typologies come from external institutions that, necessarily, have a formal component, while domestic institutions are not necessarily informal institutions which mean that distinctions internal / external and informal institutions / formats do not always coincide. The determining factor in this distinction is the binding nature of constraints that institutions have on human action.

Domestic institutions, whose existence is crucial for successful human interaction at a higher level of integration, are not imposed by an external authority and, in general, not necessarily the result of human will. They evolve from human experience and incorporate those institutional arrangements (solutions) have served to their best the purposes of community members.

Adequate examples of domestic institutions are customs, language, the ethical norms and good manners, business conventions. Violation of domestic institutions is sanctioned informally by possible hostile attitude from the other members of the community.

External institutions always involve a hierarchical structure, unlike the internal rules whose expression is horizontal, between equals. The sanctions for violation of external institutions are always formal and are often implemented through the use of force. Examples of external institutions, depending on the content and their purpose may be the prohibitive list of behavior rules that are codified and incorporated into civil, commercial, criminal codes etc.. For Pejovich⁹, the formal external rules are legislative / constitutional arrangements that structure the political system (hierarchical structure of power, civil rights) and economic system (property rights, contracts) and other government regulations.

The institutional arrangement prevailing in any society is a mix of internal and external rules, informal and formal institutions. The modern economic thinking view the economic life as ordered by the laws of formal and property rights, but these, even in the most developed market systems, form only a part of all constraints and incentives that shape the actual choices of individuals. The nature of external / formal and the internal / informal must be considered both in itself and in some relationships with each other, as an indication of compatibility and complementarities. In any society, internal constraints / informal are important in themselves, and formal rules are not just an attribute of informal institutions.

North¹⁰ shows that the adoption by the various societies of the same institutional arrangements / formal constitutional produced significantly different effects in relation to the more or less favorable internal institutional arrangements / informal.

According to the Austrian school perspective of defining institutions, we emphasize the need for a critical distinction between designed institutions (pragmatic, in Menger's terms) that are intentionally designed and implemented by authorized actors (governments, parliaments, spiritual leaders or heads of the church) and organic institutions.

⁹ Svetozar Pejovich *Economic Analysis of Institutions and Systems*, Kluwer Academic Publishers, 1995, p. 31.

¹⁰ Douglass North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990, pag.36

The latter arise spontaneously and evolve over time as a result of human action but not of human intention, as Hayek argues.

This definition of institutions does not mean necessarily that all institutions are accompanied by appropriate sanctions for ignoring them, on the contrary. But the existence of penalties increases predictability of human behavior, creating coordination of individual actions and social order. In consequence-institutions incorporates and structure the incentives of human exchanges, whether political, social or economic. Establishment and functioning of institutions mean the shift from anarchy to order through the introduction and compliance with the rules or norms that guide economic and social life. Institutions are thus the prerequisite and product of the economic order and social life.

Any institutional analysis starts from the recognition of certain fundamental properties of the institutions.

The first criterion for assessing the quality of certain social rules is the degree of universality. Universality of an institution reflects the general and abstract nature of a social rule (Hayek, 1980)¹¹ and also openness, for the purposes of applying the same rules to large a number of cases.

The rules that are not universal are intended for specific purposes, which draw their failure in meeting their normative and coordinating function because, by their nature, the necessary precondition of non-conflicting social order is eliminated.

The second criterion derives from the very major function of the "rules of the game", that of human interactions to reduce costs by increasing the predictability of actors behavior. In this regard, institutions should be characterized through *credibility, stability, to be transparent and easily cognitive*.

Thirdly, we emphasize the need for universal *ethical criterion* to assess the quality of institutional arrangements. Richard Epstein shows that simple rules tend to be more easily known and understood than the complex, which attracts greater possibilities to fulfill the functions associated with them.

The advantages of a set of fair, stable and reliable rules are giving individuals incentives to exploit available opportunities to win regardless of their temporal horizon. A comparison to a football game is sufficiently relevant in this case. Players know the rules and the audience appreciates the game because its rules are respected. If the coach of a team is able to obtain an unjustified advantage from the referee in the short term, this discretionary change of rules may influence the further evolution of matches. Spectators will not appreciate the game as before and the clubs will look for coaches more skilled in the change of rules instead of player's training.

Following this example, analysis of institutions supposes a clear conceptual delimitation between "institution" and the "organization". In everyday language, the meaning of the concept of "institution" has deviated strongly from its original meaning, explained in this approach.

In everyday use, the term "institution" is applied in almost all cases as a synonym of 'organization', whether economic or political.

For example, in the terms of institutional economy, European Central Bank is an organization, while the Maastricht Treaty or antitrust laws are institutions. Also, the term "institutionalized" is not the attribute of those taken in care of a hospital or charitable organization.

According to the conceptual boundaries of North's¹² approach, institutions are rules, organizations are the players.

¹¹ Hayek, F.A. [1946], *Individualism and Economic Order*, The University of Chicago Press, pag. 1-32., 1980

¹² Douglass North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990, pag.4

Political organizations, economic or social represent groups of individuals that are united by common means to achieve their goals, more or less different. The institutions determine the set of incentives and opportunities in society and organizations arise to take advantage of these opportunities. The question of the existence of organizations and their specific mode of evolution depend on the structure of incentives and constraints provided by the institutions. The need of the distinction between "institutions" and "organization" does not exclude that some institutions (mainly formal) need and have a specific organizational component, so institutions can be incorporated into organizations. Examples of this are family, church, state, as organizations designed to serve the goals of its members and incorporating certain rules (of conduct and administrative) governing their operation. However, the nature of this institutional analysis stems from modeling institutions as inter-organizational rules, not intra-organizational, recognizing the predetermined hierarchical nature of the latter.

Taking into account relevant differences between institutions and organizations, we want to note the importance of mutuality between the actions of organizations and development institutions. This approach allows the unification of institutions as rules of the game by approaching institutions as rules of conduct, which means that the strategies of organizations influence the rules of the game.

Consequently, institutions arise endogenously in the course of social and organizational interactions and are thus a result of dynamic (dis) equilibrium.

Acknowledgement

„This work was supported by the project "Post-Doctoral Studies in Economics: training program for elite researchers - SPODE" co-funded from the European Social Fund through the Development of Human Resources Operational Programme 2007-2013, contract no. POSDRU/89/1.5/S/61755.)".

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