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Institutional changes: Alternative theories and consequences for institutional design

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ABSTRACT

This paper surveys alternative approaches to the emergence and evolution of institutions. The challenge is to develop frameworks capable of capturing both stability and change. We follow a "descaling" approach to show how founding assumptions about economics—namely, alternative assumptions about individual rationality and the role of social efficiency—influence our understanding of the drivers of institutional evolution. We then contrast two families of institutional theory. In the first, institutions are viewed as rules imposed on individuals and the focus is on the strategic games among coalitions that aim to promote or block new rules. In the second, institutions are viewed as shared beliefs; here the idea is to analyze how equilibria that are self-enforcing (in terms of mutual expectations about others' behaviors) can collapse and so induce switching to another equilibrium. Finally, we discuss the political economy literature that examines institutional transitions to a market economy, and we identify long-term drivers as well as short-term political barriers to institutional reforms.

1. Introduction

The analysis of institutions is a trendy field in economics, as evidenced by the recent wave of books dedicated to this issue that are authored by prominent scholars.[1] The production of books, rather than articles, suggests that the field has reached a certain level of maturity. However, Dixit (2009) argues that understanding the process of institutional change is still undertheorized, even though policy making today is dominated by the idea that most policies consist of designing institutions. In the context of transition or development—and also of reforms in all kind of policy domains (finance, labor, innovation, competition, etc.) within developed countries—many economists have been involved in processes of institutional design. Yet the implementation of institutional reforms and the control of institutional evolution remain underanalyzed. On what basis do economists advise policy makers? Are there any empirical results to support their recommendations? If growth-enhancing institutions have been identified in a specific country, can other countries learn from and transplant

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[1] Examples include Acemoglu and Johnson (2005), Aoki (2001), Barzel (2002), Bowles (2004), Dixit (2004), Eggertson (2005), Greif (2006), North (2005), North et al. (2009), and Ostrom (2005).

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them? Should we change institutional bundles in an incremental way, or should we favor a "big bang" approach? Can institutional change be easily managed?

On the basis of the current state of the literature, we attempt to present the essential challenges contemplated by scholars involved in the economics of institutional change while providing a context for the papers in this special issue. The puzzle is often how to use the same framework to explain both the persistence and evolution of institutions. Alternative frameworks propose different conceptions of institutions that feature contrasting processes of emergence and varying susceptibility to being manipulated by economic agents.

Our paper proposes a "descaling" approach to the literature by examining those contributions that are wider in scope before considering more focused questions. In Section 2 we show how founding assumptions and fundamental conceptions about economics influence analysis of the nature and evolution of institutions. In particular, we focus on alternative conceptions of individual rationality and on the purpose (if any) of social organization. In Section 3, we review and contrast two families of contributions that are specifically dedicated to the analysis of institutions and institutional change. Some scholars envisage institutions as *endogenous and evolving beliefs* (about the behavior of others) that are embodied in individual mental models. This vision is in clear contrast to the other family of works, which views institutions as *exogenous and binding rules* that constrain individual actions. In the latter approach the design of rules is clearly strategic, and attention is paid to the tactics used by various agents or coalitions to manipulate (or at least influence) the "rules of the game". This later vision leads to the realm of literature reviewed in Section 4, which considers how interactions among groups—especially between rulers and the governed—influence the process of institutional evolution.

2. Fundamental assumptions and their consequences for institutional change

There is an unambiguous consensus that human beings create institutions. However, controversies remain concerning the relationships between individuals' behaviors and institutions as well as what these relationships imply for how institutions are defined and how their evolution is analyzed. Some scholars defend the idea that rational individuals voluntarily and purposely create institutions, whereas others argue that institutions emerge spontaneously—*i.e.* result of human action but not of human design (Hayek, 1988). Still others combine these views by considering how the drivers of institutional evolution depend on the type of institution under scrutiny. For instance, it is often suggested that formal rules are designed whereas informal rules are spontaneous. These differences are linked with fundamental assumptions about economics. We focus on two such assumptions. In Section 2.1, we explore the conception of individuals' preferences and cognitive capacities; in Section 2.2, we examine the extent to which the design and evolution of social systems are a function of their socioeconomic outcomes.

2.1. Conception of individuals' preferences and cognitive capacities

The conception one has about individual motivation and ability is one of the most fundamental assumptions for the analysis of economic and social systems. In institutional analysis, the relevant contrast is between analytical approaches based on self-interested behavior (Section 2.1.1) and those that accept the possibility of prosocial behavior (Section 2.1.2). In addition, regardless of which approach is taken, assumptions about the nature of human rationality also lead to contrasting views of the drivers of institutional evolutions.

2.1.1. Equilibria among selfish individuals

When individuals are presumed to be *self-interested optimizers*, institutions defined in terms of social rules can be rationalized as the equilibrium outcome of strategic interactions.[2] In this approach, only an exogenous shock to the set of strategies or their associated payoffs can induce a change of rules. When the equilibrium resulting from individuals' decisions is socially bad, as in the one-shot Prisoners' Dilemma, no player has an incentive to deviate from the Nash equilibrium. In this case, the only way to alter the equilibrium is by introducing a third party (a legislator, judge, or other authority) and granting her the power to change the rules of the game. Any change in institutions is therefore exogenous and cannot occur solely by players' choices.

If one assumes *bounded rationality*—in other words, that individuals have self-regarding preferences but are unable to optimize—then institutions are viewed as devices for enabling coordination of behaviors among individuals who follow routines to economize on decision making. The question is: How do these individuals converge toward compatible behaviors? Peyton Young's (1996, 1998) seminal contributions rely on evolutionary arguments to explain how regularities of behavior emerge within a population of boundedly rational agents, and characterize some properties of that evolution. In his framework, perturbations can arise endogenously in a given social equilibrium. Change is possible if individuals: (1) can play something other than their best response (by mistake and/or to experiment); (2) are unable to remember all the past plays; and (3) do not consider the entire population playing the game, but rather a subset of it (e.g., their "neighbors"), as the reference for their decision. In these circumstances, Young's results show that the evolution of social institutions is

[2] As MacAdams and Rasmusen (2007) sum up: "after discussing such diverse convention models as signaling, repeated prisoner's dilemmas, and cascades, we see that much of human behavior that seems to be driven by moral beliefs is actually driven by utility maximization."