2 Defining and Measuring Institutions

Institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance. Time as it relates to economic and societal change is the dimension in which the learning process of human beings shapes the way institutions evolve.


The fundamental question regarding the NIE literature and its application to transition economics is also the simplest: What exactly is an “institution?” As Geoffrey Hodgson astutely pointed out, “it is not possible to carry out any empirical or theoretical analysis of how institutions...work without having some adequate conception of what an institution...is” (Hodgson 2006: 1). While there is a well-developed philosophical literature attempting to tackle this issue (North 1990, Hodgson 2006, and Voigt 2009a bracket the debate), for the most part the empirical literature has avoided the question; thus, lack of a precise definition of this central term has led to difficulties econometrically, with the concept of “institutions” being defined by the model and the data, rather than a concrete conception of “institutions” defining the model. Indeed, the current muddled view of “institutions” has led to empirical investigations encompassing all manner of “institutions” across all spheres: as recent research by Stefan Voigt (2009) noted, “in the literature, newspapers, supermarkets, and even phone booths have been described as institutions” (Voigt 2009a: 2).

The earliest definition of institutions as determinants of economic outcomes comes from North (1981: 201–202), who defines institutions as “a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals
in the interests of maximizing the wealth or utility of principals.” Following on this broad definition, North (1990) added another dimension regarding institutional make-up, noting that their constraints are designed to “structure incentives in human exchange, whether political, social, or economic” (North 1990: 3). Focusing on this idea of institutions as constraining bodies, Glaeser et al. (2004) note that institutions must then have “permanency or ‘depth’” and “actually [be] used over time” in order to constrain (rather than being merely transitory, as this would have less of a restraining effect; Glaeser et al. 2004: 7); thus, in a common phrase from the literature, institutions refer to the “rules of the game” (Campos 2000: 2).¹

These broad definitions of what an institution does, however, made little headway in clearly delineating what an institution is, leading some researchers to seize upon North’s reference to “political, social, and economic” exchange. Under this classification, institutions conspire to work in different spheres, with economic institutions “determin[ing] the incentives of and the constraints on economic actors” and political institutions “determin[ing] the constraints on and the incentives of the key actors, but this time in the political sphere” (Acemoglu et al. 2005).

With this horizontal delineation, combined with the aforementioned definition of institutions as constraining yet permanent, it became somewhat easier to define an institution based upon which sphere it was situated in.²

| Institutions are a set of rules, compliance procedures, and legal or social norms designed by individuals, external to an individual, and accepted by a society to either constrain or facilitate the behavior of individuals. |

A difficulty with this consensus definition of institutions comes from the concept of “constraints”: while institutions undoubtedly do restrict human action in some form, there is little discussion on the types of constraints each sphere of institutions utilizes, and whether the constraints in one sphere can help economic outcomes while those in another can harm them. For example, political institutions are meant to constrain baser human actions (e.g. providing legal sanctions against murder and theft), which can increase commerce and facilitate positive economic outcomes. On the other hand, economic institutions that strictly constrain choice (or, as in the case of central planning, constrain incentives for production and consumption) can be incredibly deleterious for economic outcomes. Simply labeling an institution one that “constrains” may work in its broadest form (even the market