



**AMBO UNIVERSITY WOLISO CAMPUS
SCHOOL OF BUSINESS AND ECONOMICS
DEPARTMENT OF AGRICULTURAL ECONOMICS**

INSTITUTIONAL ECONOMICS

Course Code: AgEc 3125

(3/5 Cr.Hrs/ECTS)

Module Writer:

Getahun G. Woldemariam (MSc)

May, 2020

Woliso, Ethiopia

Table of Contents

INSTITUTIONAL ECONOMICS..... 1

COURSE OUT LINE FOR THE COURSE INSTITUTIONAL ECONOMICS4

MATERIAL SYMBOLS 5

COURSE INTRODUCTION 6

COURSE OBJECTIVES 6

UNIT ONE: THE ORIGIN AND CONCEPTS OF INSTITUTIONAL ECONOMICS7

UNIT TWO: DEFINITION AND CONCEPT OF INSTITUTION14

THE ECONOMICS OF IMPERFECT INFORMATION 20

ADVERSE SELECTION AND MORAL HAZARD 21

TRANSACTION COSTS VERSUS TRANSACTION RISKS 24

THE DEFINITION AND NATURE OF INSTITUTIONS25

2.3. INSTITUTIONS AND ORGANIZATIONS 26

LEVELS OF INSTITUTIONS 27

2.4. TYPES OF INSTITUTIONS IN ECONOMICS 30

2.5. ROLES AND FUNCTION OF INSTITUTIONS32

UNIT THREE: TRANSACTION COST ECONOMICS36

3.1. BASIC TERMS37

3.2. ORIGIN OF TRANSACTION COST37

3.3. DEFINITION AND MEASUREMENT OF TRANSACTION COSTS.....40

3.2. WHAT ARE THE EXACT CLEAR DIFFERENCES AND RELATIONSHIPS BETWEEN
RELATIONSHIP BETWEEN TRANSACTION AND TRANSACTION COST ECONOMICS?..... 40

UNIT FOUR: COLLECTIVE ACTION 52

INTRODUCTION 52

SECTION ONE: CONCEPTS OF COLLECTIVE ACTION.....52

- **EXPLAIN THE CONCEPTS AND ROLES OF COLLECTIVE ACTIONS52**

1.2. EXPLAIN THE CONCEPTS AND ROLES OF COLLECTIVE ACTIONS52

**① DEAR LEARNERS, CAN YOU LIST THE DEFINITIONS AND MAJOR ROLES OF COLLECTIVE
ACTIONS?(PLEASE WRITE YOUR RESPONSE ON THE SPACE PROVIDE BELOW).....52**

**② DEAR LEARNERS, CAN YOU LIST THE SUPPORTING INSTITUTIONS THAT GOVERN
COLLECTIVE ACTION?(PLEASE WRITE YOUR RESPONSE ON THE SPACE PROVIDE BELOW).55**

? DEAR LEARNERS, CAN YOU WRITE WHAT ARE THE DEFINITION AND CONCEPTS OF THE STATE?(PLEASE WRITE YOUR RESPONSE ON THE SPACE PROVIDE BELOW)56

1.7. DEFINITION AND CONCEPTS OF COMMON-POOL RESOURCES59

1.8.ANALYZING COLLECTIVE ACTION PROBLEM60

10. COLLECTIVE ACTION AND INSTITUTIONAL CHANGE69

UNIT FIVE. PROPERTY RIGHTS 76

INTRODUCTION..... 76

ANSWER KEY TO SELF CHECK EXERCISES 106

Course out line for the Course Institutional Economics

Program: Agricultural Economics **ECTS Credits (CP):** 5/3
Course Title: Institutional Economics **Course Code:** AgEc 3125
Name of Instructor: Getahun G. **Sem/Year/ Dept:** II/AgEc/ III

Course objectives: After successful completion of this course students will be able to: Differentiate formal and informal institutions, Explain the concepts of property rights, Analyze the role of institutions in economic development, Identify the causes of transaction costs, Evaluate governance structures and Measure transaction costs using different approaches

Week	(Lhrs)	Conceptual Focus	Activities/tasks	Reading
1-2	5	1. Concepts and Roles of Institutions 1.1. Definition of institution 1.2. Informal and formal rules and norms of behavior 1.3. The function of institution 1.4. The interdependence of institutions 1.5. Institutions and development 1.6. Institutions in economics	-Listen to a lecture and take notes on the lesson treated, Take part in reading assignment, Assignment submission and Asking questions	✓ Platteau, Jean-Phillipe, Institutions, Social norms and economic development, Amsterdam;Harwood Academic Publishers, 2000 ✓ Williamson, Oliver E, Transaction cost economics. In handbook of Industrial Organization, edited by R.D willig; Elsevier Science Publishers B.V. 1989
2-4	7	2: Key theoretical and analytical constructs 2.1. Property rights 2.2. Transaction costs 2.3. Contracts 2.4. Judicial decision making 2.5. Markets and firms		✓ Williamson, Oliver E, Transaction cost economics. In handbook of Industrial Organization, edited by R.D willig; Elsevier Science Publishers B.V. 1989
5	2	3: Demand for institutions 3.1. The role of transaction costs 3.2. Interdependence between transaction costs and institutions	Listen to a lecture and take notes on the lesson treated, Take part in reading assignment, Assignment submission and Asking questions	✓ Williamson, Oliver E, Transaction cost economics. In handbook of Industrial Organization, edited by R.D willig; Elsevier Science Publishers B.V. 1989
5-7	8	4: Measurement of transaction costs 4.1. Ordinal and cardinal approaches; 4.2. Two traditions of law (common and continental and property rights) approaches.	Listen to a lecture and take notes on the lesson treated, Take part in reading assignment, Assignment submission and Asking questions	✓ Bromely, Daniel w, Economic interests and institutions; The conceptual foundation of public policy, New York and Oxford; Basil Blackwell,1989 ✓ Sandler, Tood, Collective Action; Theory and Application, University of Michigan Press,1992
7-9	7	5: Governance Structure 5.1 Market governance 5.2 Trilateral governance 5.3. Bilateral governance 5.4. Unified governance 5.5. Efficient governance Vertical integration	Listen to a lecture and take notes on the lesson treated, Take part in reading assignment, Assignment submission and Asking questions	
10-11	5	6. Institutional changes in the process of development. 6.1. Types of institutional changes 6.1.1. Path determinacy 6.1.2. Path dependence, 6.1.3. Path independence 6.2. Interpretation of economic development as a process of institutional evolution	Listen to a lecture and take notes on the lesson treated, Take part in reading assignment, Assignment submission and Asking questions	
		Chapter 7: General framework for collective action		

Material Symbols



Refers to **Objectives**. These appear at the start of the unit and at the start of every section. The objectives help you to focus on the expected outcomes of each lecture. Please read each objective carefully and check on them again and again throughout the module to find out if you are able to do what the module is intended to enable you do.



Refers to **pre-text Question(s)**. These are questions that are interspersed within the text of the module to help you review and master small chunks of knowledge, skills and values. They are helpful for the mastery of your lessons; please respond appropriately to each one of them before you move on.



Refers to **Activity**. The activities are also interspersed throughout the module to encourage group discussions, open-ended learning, project work, et cetera. Please endeavour to carry out all the suggested activities individually and in groups, as required. This will help you to master what you are learning.



Refers to **Summary**. Summaries are included at the end of every chapter of the module to assist to quickly recapitulate what you have just learnt in the module. You will find summaries also useful when making your personal notes as you study, and when preparing for examinations. Study them keenly.



Refers to **Self-assessment Question(s)**. These are tasks set to cover work done in the entire lecture. The set tasks provide summative evaluation of what you have learned in the lecture. If answers to self-assessment questions are provided, do not check on the answers before attempting the questions yourself. Where answers are not provided, check your answers against the relevant portions of the text. Where the text does not provide satisfactory answers to the self-assessment questions, raise these questions in your discussion group and/or during the face-to-face tutorial session.

COURSE INTRODUCTION

Introduction

☛Dear learners, We welcome you to this exciting module for the course of “Institutional economics’ is designed to acquaint learners about the basic concepts of the origin and concepts of institutional economics, the definitions and origin of institutional economics, the definition and concept of institution, transaction cost economics, collective action and property rights. To reach such objective of the course the writers have tried to incorporate different aspects of Institutional economics. In addition to facilitate your understanding of the course writer have put Activity at the end of each lesson and Self Check Exercise and Checklist at the end of each unit of the course.

☛Dear learner, this course is divided into four chapters. Unit one is about the origin and concepts of institutional economics, its purpose is to provide an overview of the origin and introduce you the definitions of institutional economics, the objective of institutional economics and other concepts. The second unit is concerned with transaction cost economics aspects and its focus is on the different types of aspects used during transaction cost economics. Third chapter is about the collective action, the final fourth chapter/unit is about property rights

☛Dear learners, we have put the objective at the beginning of each chapter and lesson, this may help you to know the direction of each chapter and sub-unit respectively. You should read very carefully and understand each lesson of the course and finally you are advised to do the activities after each lesson and the self-check exercise after each chapter by your own. You find checklist at the end of every chapter and required to read seriously so that you can measure whether the different concepts are understood or not. If you are not sure of your understanding, go back and read it again and again. Finally, since you are a distant learner in studying this module, we recommend you to read this material seriously and other related texts. Joyful reading!

Key terms and concepts

- ☒ An institutional economics
- ☒ Contract Agreements
- ☒ Contract enforcement
- ☒ Formal rules
- ☒ Informal rules
- ☒ Institutions
- ☒ New institutional economics (NIE)
- ☒ Privatization
- ☒ Property rights
- ☒ Public goods
- ☒ Private goods
- ☒ Transaction specificity

COURSE OBJECTIVES

At the end of your study on this course, you should able to:

- Define and Explain the origin and of institutional economics,
- Describe the transaction cost economics
- Explain collective action in institutional economics

- Explain property rights institutional economics.

UNIT ONE: THE ORIGIN AND CONCEPTS OF INSTITUTIONAL ECONOMICS

Overview

☛ **Dear Learners!** Different peoples need to understand the concepts of the Origin and concepts of institutional Economics and why we need to study it. In this section, you will get the brief definition of institutional economics. You will also learn the linkages between institutions and economics.

The concept of Institutional economics had been started to flourish in 1970's and 1980's when scholars as Cyert and March (1963) Simon (1972) and Williamson (1975) had published their studies. Those studies had all in common that they challenged basic assumptions of neoclassical economic theory, but at the same time they remained close enough to the main stream that mutual communication was still possible. These developments led to the birth of New Institutional Economics. The markets were not regarded as an autonomous structure but its performance as coordination mechanism could be affected. New Institutional Economics has also developed major intersections with other disciplines such as legal scholars, social scientists and management scientists (Menard 2004).

Perhaps the most difficult problem confronting administrators in developing countries is implementing development programs. Much of the failures can be traced to poor project preparation. Especially from development viewpoint, for most development activities careful preparation in advance of expenditure is essential, if not absolutely, at least the best available means to ensure efficient, economic use of capital funds and to increase the chances of implementation on schedule. Unless projects are carefully prepared in substantial details, inefficient or even wasteful expenditure is almost sure to result – a tragic loss in nations short of capital.

Since 1960's institutional economics has developed into a wide and varied body of literature including many sets of concepts, sometimes including little compatibility with each other. However, institutional economics has maintained its virility and has made considerable progress in developing its methodology. Institutional economics has opened a totally new path for economic analysis of co-operatives. According to neoclassical economics all the transactions should take place in the markets, thus, leaving cooperatives no particular advantages compared to share companies. Institutional Economics is a wide body of literature containing a variety of concepts and ideas of thought. Even the same concept may mean a different thing in writing. This writing is trying to sort out and explain some of the most principal concepts used especially in New Institutional Economics (NIE). This module Unit looks at the development of the concept of institutional Economics and the various ways in which this concept can be defined as well.

☛ **Objectives:**

The main objective of the learning task is to help Learners to understand, analyze and interpret the institutional economics in developed and developing countries. Dear Learners! At the end of this module, you will be describe the subject matter Institutional Economics; explain the historical/evolutionary development of Institutional Economics

After completing this section, you should be able to:

- Define Institutional Economics

- identify interdependence that exist between institution and Institutional economics ;
- identify Definition and Concept of institution ;
- explain the definition and nature of institutions;
- explain institutions and organizations;
- explain the levels of institutions;
- explain types of institutions in economics;
- explain the roles and function of institutions; and
- explain the transaction cost economics

1.1. What is Institutional Economics?

? Dear learner, can you write the meaning of *Institutional Economics*?
(You can use the space left below to write your response.)

Institutional economics is concerned with the social systems, or institutions, that constrain the use and exchange of resources (goods and services) and their consequences for economic performance. Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies. Institutions and the technology employed determine the transaction and transformation costs that add up to the costs of production (North 1993).

1.2. The Original (Old) and New Institutional Economics (NIE)?

? Dear learner, would you write the clear differences and relationships between the Original (Old) and New Institutional Economics (NIE)? (You can use the space left below to write your response.)

It is necessary to distinguish the differences between the Original (Old) and New Institutional Economics (NIE). Institutional economics focuses on understanding the role of the evolutionary process and the role of institutions in shaping economic behaviour. It was known by some as institutionalist political economy, focuses on understanding the role of human-made institutions in shaping economic behavior. In the early twentieth century, it was the main school of economics in the United States, including such famous but diverse economists as Thorstein Veblen, Wesley Mitchell, and John R. Commons. Therefore, its original focus lay in Thorstein Veblen's instinct-oriented dichotomy between technologies on the one hand and the "ceremonial" sphere of society on the other hand. Its name and core

elements trace back to a 1919 American Economic Review article by Walton H. Hamilton. Institutional economics is concerned with the social systems, or "institutions," that constrain the use and exchange of resources (goods and services) and their consequences for economic performance. Thus, for example, the study of law and economics became significant theme since Commons' publication of the Legal Foundation of Capitalism in 1924. Also, following Veblen's critical view of materialistic culture and the tendency of businesses toward production for pure profit rather than to satisfy consumers' needs, institutional economists were typically critical of American social, financial, and business institutions.

Institutional economics emphasizes a broader study of institutions and views markets as a result of the complex interaction of these various institutions (e.g. individuals, firms, states, and social norms). The earlier tradition continues today as a leading heterodox approach to economics. A significant variant is the new institutional economics from the later 20th century, which integrates later developments of neoclassical economics into the analysis. Law and economics has been a major theme since the publication of the Legal Foundations of Capitalism by John R. Commons in 1924. Behavioral economics is another hallmark of institutional economics based on what is known about psychology and cognitive science, rather than simple assumptions of economic behavior.

Institutional economics focuses on learning, bounded rationality, and evolution (rather than assume stable preferences, rationality and equilibrium). It was a central part of American economics in the first part of the 20th century, including such famous but diverse economists as Thorstein Veblen, Wesley Mitchell, and John R. Commons. Some institutionalists see Karl Marx as belonging to the institutionalist tradition, because he described capitalism as a historically-bounded social system; other institutionalist economists disagree with Marx's definition of capitalism, instead seeing defining features such as markets, money and the private ownership of production as indeed evolving over time, but as a result of the purposive actions of individuals.

"Traditional" institutionalism rejects the *reduction* of institutions to simply tastes, technology, and nature. Tastes, along with expectations of the future, habits, and motivations, not only determine the nature of institutions but are limited and shaped by them. If people live and work in institutions on a regular basis, it shapes their world-views. Fundamentally, this traditional institutionalism (and its modern counterpart institutionalist political economy) emphasizes the legal foundations of an economy and the evolutionary, habituated, and volitional processes by which institutions are erected and then changed (see John Dewey, Thorstein Veblen, and Daniel Bromley.)

Behavioral economics is another hallmark of institutional economics. This is based on what is known about psychology and cognitive science, rather than simple assumptions of economic behavior based on economic factors alone. Economic activities take place in the context of the restraints of society, both formal and informal, that encourage and limit the activities of those agents. Institutional economics takes into account these restraints that institutions lay on members of society, and thus hopes to better understand the economic activities that take place therein and in so doing to benefit society. Mainstream economics, as found in the journals, the textbooks, and in the courses taught in economics departments, has become more and more abstract over time, and although it purports otherwise, in fact it is often little concerned with what happens in the real world. Harold Demsetz (1988) has given

an explanation of why this has happened: Economists since Adam Smith have devoted themselves to formalizing his doctrine of the "invisible hand," the coordination of the economic system by the pricing system. It has been an impressive achievement.

However, it has flaws. Adam Smith also pointed out that we should be concerned with the flow of real goods and services over time-and with what determines their variety and magnitude. Economists have studied how supply and demand determines prices but not with the factors that determine which goods and services are traded on markets and therefore are priced. The result unfortunately is that "economists think of themselves as having a box of tools but no subject matter" (Coase 1998). Adam Smith explained that the productivity of the economic system depends on specialization (or division of labor), but specialization is only possible if there is exchange-and the lower the costs of exchange (transaction costs), the more specialization there will be and the greater the productivity of the system. These transaction costs include the negotiations and drawing up of contracts, inspections of products and their methods of production, agreements on the settling of disputes, and so forth (Coase 1991). These costs are not determined by the individuals who do the buying and selling of goods and services but rather by the institutions of the environment in which the transactions take place.

Thus, the costs of exchange depend on the institutions of a country: it's legal system, its political system, its social system, its educational system, its culture, and so on. Institutions are human-made constraints that control and direct social order and cooperation in the behavior of a set of individuals. Institutions are identified with a social purpose and permanence, transcending individual human lives and intentions, and with the making and enforcing of rules governing cooperative human behavior. Institutional constraints exist both in formal organizations of government and public service with strictly defined laws and regulations and in the informal customs and social norms that guide behavior patterns important to a society:

Institutions form the incentive structure of a society and the political and economic institutions, in consequence, are the underlying determinant of economic performance (North 1993). Institutional economics is concerned with these systems that constrain the exchange of resources and the resulting impact on economic phenomena. Institutions essentially govern the performance of an economy, and it is this that gives institutional economics its importance for current and future economists (Coase 1998).

David Hume (1888) found the unity of the three social sciences (economics, jurisprudence, and ethics) in the principle of scarcity and the resulting conflict of interests, as opposed to Adam Smith who isolated economics from the others on assumptions of divine providence, earthly abundance, and the resulting harmony of interests. Institutional economics takes its cue from Hume. Business ethics deals with the rules of conduct arising from conflict of interests, arising, in turn, from scarcity and enforced by the moral sanctions of collective opinion; but economics deals with the same rules of conduct enforced by the collective economic sanctions of profit or loss in case of obedience or disobedience, while jurisprudence deals with the same rules enforced by the organized sanctions of violence.

Institutional economics deals with the relative merits and efficiency of these three types of sanctions. The vacillations of institutions are necessarily a result of the very incentives created by such institutions, and are thus endogenous. Emphatically, traditional institutionalism is in many ways a response to the current economic orthodoxy; its reintroduction in the form of institutionalist political economy is thus an explicit challenge to neoclassical economics, since it is based on the fundamental premise that neoclassicists oppose: that economics cannot be separated from the political and social system within which it is embedded. Some of the authors associated with this school include Robert H. Frank, Warren Samuels, Mark Tool, Geoffrey Hodgson, Daniel Bromley, Jonathan Nitzan, Shimshon Bichler, Elinor Ostrom, Anne Mayhew, John Kenneth Galbraith and Gunnar Myrdal, but even the sociologist C. Wright Mills was highly influenced by the institutionalist approach in his major studies.

Thorstein Veblen (1857–1929) wrote his first and most influential book while he was at the University of Chicago, on *The Theory of the Leisure Class* (1899). In it he analyzed the motivation in capitalism to conspicuously consume their riches as a way of demonstrating success. Conspicuous leisure was another focus of Veblen's critique. The concept of conspicuous consumption was in direct contradiction to the neoclassical view that capitalism was efficient. In *The Theory of Business Enterprise* (1904) Veblen distinguished the motivations of industrial production for people to use things from business motivations that used, or misused, industrial infrastructure for profit, arguing that the former is often hindered because businesses pursue the latter. Output and technological advance are restricted by business practices and the creation of monopolies. Businesses protect their existing capital investments and employ excessive credit, leading to depressions and increasing military expenditure and war through business control of political power. These two books, focusing on criticism first of consumerism, and second of profiteering, did not advocate change. Through the 1920s and after the Wall Street Crash of 1929 Thorstein Veblen's warnings of the tendency for wasteful consumption and the necessity of creating sound financial institutions seemed to ring true. Veblen remains a leading critic, which cautions against the excesses of "the American way". Thorstein Veblen wrote in 1898 an article entitled "Why is Economics Not an Evolutionary Science" and he became the precursor of current evolutionary economics.

John R. Commons (1862–1945) also came from mid-Western America. Underlying his ideas, consolidated in *Institutional Economics* (1934) was the concept that the economy is a web of relationships between people with diverging interests. There are monopolies, large corporations, labour disputes and fluctuating business cycles. They do however have an interest in resolving these disputes. Commons thought that government should be the mediator between the conflicting groups. Commons himself devoted much of his time to advisory and mediation work on government boards and industrial commissions. Wesley Clair Mitchell (August 5, 1874 – October 29, 1948) was an American economist known for his empirical work on business cycles and for guiding the National Bureau of Economic Research in its first decades. Mitchell's teachers included economists Thorstein Veblen and J. L. Laughlin and philosopher John Dewey. Clarence Ayres (May 6, 1891 – July 24, 1972) was the principal thinker of what some has called the Texas school of institutional

economics. Ayres developed on the ideas of Thorstein Veblen with a dichotomy of "technology" and "institutions" to separate the inventive from the inherited aspects of economic structures. He claimed that technology was always one step ahead of the socio-cultural institutions.

It can be argued that Ayres was not an "institutionalist" in any normal sense of the term; since he identified institutions with sentiments and superstition and in consequence institutions only played a kind of residual role in this theory of development which core center was that of technology. Ayres was under strong influence of Hegel and institutions for Ayres had the same function as "Schein" (with the connotation of deception, and illusion) for Hegel. A more appropriate name for Ayres' position would be that of a "techno-behaviorist" rather than an institutionalist.

Adolf A. Berle (1895–1971) was one of the first authors to combine legal and economic analysis, and his work stands as a founding pillar of thought in modern corporate governance. Like Keynes, Berle was at the Paris Peace Conference, 1919, but subsequently resigned from his diplomatic job dissatisfied with the Versailles Treaty terms. In his book with Gardiner C. Means, *The Modern Corporation and Private Property* (1932), he detailed the evolution in the contemporary economy of big business, and argued that those who controlled big firms should be better held to account.

Directors of companies are held to account to the shareholders of companies, or not, by the rules found in company law statutes. This might include rights to elect and fire the management, require for regular general meetings, accounting standards, and so on. In 1930s America, the typical company laws (e.g. in Delaware) did not clearly mandate such rights. Berle argued that the unaccountable directors of companies were therefore apt to funnel the fruits of enterprise profits into their own pockets, as well as manage in their own interests. The ability to do this was supported by the fact that the majority of shareholders in big public companies were single individuals, with scant means of communication, in short, divided and conquered.

Berle served in President Franklin Delano Roosevelt's administration through the depression, and was a key member of the so-called "Brain trust" developing many of the New Deal policies. In 1967, Berle and Means issued a revised edition of their work, in which the preface added a new dimension. It was not only the separation of controllers of companies from the owners as shareholders at stake. They posed the question of what the corporate structure was really meant to achieve. "Stockholders toil not, neither do they spin, to earn dividends and share price increases. They are beneficiaries by position only. Justification for their inheritance... can be founded only upon social grounds... that justification turns on the distribution as well as the existence of wealth. Its force exists only in direct ratio to the number of individuals who hold such wealth. Justification for the stockholder's existence thus depends on increasing distribution within the American population. Ideally the stockholder's position will be impregnable only when every American family has its fragment of that position and of the wealth by which the opportunity to develop individuality becomes fully actualized."

John Kenneth Galbraith (1908–2006) worked in the New Deal administration of Franklin Delano Roosevelt. Although he wrote later, and was more developed than the earlier institutional economists, Galbraith was critical of orthodox economics throughout the late twentieth century. In *The Affluent Society* (1958), Galbraith argues voters reaching a certain material wealth begin to vote against the common good. He coins the term "conventional wisdom" to refer to the orthodox ideas that underpin the resulting conservative consensus. In an age of big business; it is unrealistic to think only of markets of the classical kind. Big businesses set their own terms in the marketplace, and use their combined resources for advertising programmes to support demand for their own products. As a result, individual preferences actually reflect the preferences of entrenched corporations, a "dependence effect", and the economy as a whole is geared to irrational goals.

In *The New Industrial State* Galbraith argues that economic decisions are planned by a private bureaucracy, a technostructure of experts who manipulate marketing and public relations channels. This hierarchy is self-serving, profits are no longer the prime motivator, and even managers are not in control. Because they are the new planners, corporations detest risk, requiring steady economic and stable markets. They recruit governments to serve their interests with fiscal and monetary policy. While the goals of an affluent society and complicit government serve the irrational techno structure, public space is simultaneously impoverished. Galbraith paints the picture of stepping from penthouse villas on to unpaved streets, from landscaped gardens to unkempt public parks. In *Economics and the Public Purpose* (1973) Galbraith advocates a "new socialism" (social democracy) as the solution, with nationalization of military production and public services such as health care, plus disciplined salary and price controls to reduce inequality.

New institutional economics—with the new developments in the economic theory of organizations, information, property rights, and transaction costs, an attempt was made to integrate institutionalism into more recent developments in mainstream economics, under the title economics. The earlier approach was a central element in American economics in the interwar years after 1919 but was marginalized to a relatively minor role as to mainstream economics in the postwar period with the ascendance of neoclassical and Keynesian approaches. It continued, however, as a leading heterodox approach in critiquing neoclassical economics and as an alternative research program in economics, most notably through the work of Ha-Joon Chang and Geoffrey Hodgson. The leading Swedish economist Lars Pålsson Syll is a believer in institutional economics. He is an outspoken opponent to all kinds of social constructivism and postmodern relativism.

Critics of institutionalism have maintained that the concept of "institution" is so central for all social science that it is senseless to use it as a buzzword for a particular theoretical school. And as a consequence the elusive meaning of the concept of "institution" has resulted in a bewildering and never-ending dispute about which scholars are "institutionalists" or not—and a similar confusion about what is supposed to be the core of the theory. In other words, institutional economics have become so popular because it means all things to all people, which in the end of the day is the meaning of nothing.

Indeed, it can be argued that the term "institutionalists" was misplaced from the very beginning, since Veblen, Hamilton and Ayres were preoccupied with the evolutionary (and "objectifying") forces of technology and institutions had a secondary place within their theories. Institutions were almost a kind of "anti-stuff," their key concern was on technology and not on institutions. Rather than being "institutional," Veblen, Hamilton and Ayres position is anti-institutional.

Summary

This section critically looked at the organ and historical development of Institutional Economics. It also discussed the thought possessed by each institutional economist. Though the thoughts and characteristics identified are numerous because scholars are not agreed on the special thoughts or characteristics of the development of institutions, we were able to identify and discuss the main thought of institutional economist. It also looked at the roles played by the institutional economist in discussing the formation and establishment of old and new institutional economists. The unit also identified the different thought and types of institutional economists that can emerge, motivational and non-motivational influences of institutions. Furthermore, the definition and concept of institution will be examined.

Learning Activity 1

Answer the following questions

1. What we mean by institutional economics?

2. Explain the difference between the old and new institutional economics

3. Discuss the basic characteristics of institutional economics

UNIT TWO: DEFINITION AND CONCEPT OF INSTITUTION

OVERVIEW

☛ Dear learner, we know that institutional economics. Before you go through the detail of this Module, you should clearly understand the definition of institution. To this end, the essence of institutional economics will be discussed in detail in this section:

Objectives

the end of your study in this section, you will be able to

- Describe the definition of concept of institutions
- Explain the division and advantages of Economics.
- Describe Institutions and organizations
- Explain the types of institutions
- Explain the Roles and Function of Institutions

2.1. INSTITUTION

? Dear learner, what is the definition of *Institution*? (You can use the space left below to write your response.)

Institutions is defined as “the rules of the game”, rules that provide a framework of incentives that shape economic, political, and social organization. Institutions are composed of formal rules (e.g. laws and constitutions), informal constraints (conventions, codes of conduct, and norms of behavior), and their enforcement. Enforcement is carried out by the third parties (law enforcement, social ostracism), second parties (retaliation), or by the first party (self-imposed codes of conduct). Institutional economics is defined as a branch of economics that focuses on the role of institutions in economics. Economic institutions also defined as formal and informal rules of economic game. Economic institutions are rules that dictate the costs and benefits of action, thus shaping what we do. Formal law is very important in this approach because it shapes costs by making something legal or illegal.

2.2. The division and advantages of Economics

? Dear learner, can you mention the Explain the division and advantages of Economics? (You can use the space left below to write your response.)

Economics is the study of how society manages its scarce resources. It is concerned with the production, distribution and consumption of goods and services. Economics is traditionally divided into two main branches- macroeconomics and microeconomics, where ‘macro’ means big and ‘micro’ means small. Macroeconomics is the branch of economics that studies economic aggregates (grand totals): e.g. the overall level of prices, output and employment in the economy. Macroeconomics is concerned with the economy as a whole. Microeconomics is the branch of economics that studies individual units/parts: e.g. Households, firms and industries. It studies the interrelationships between these units in determining the pattern of production and distribution of goods and services. Organizations are made up of groups of individuals bound together by some common purpose to achieve certain objectives. Organizations include political bodies, economic bodies, social bodies, education bodies.

- ✓ Formal rules are defined as rules that are formally written down and enforced by the state
- ✓ Informal rules are rules that are unwritten and informally sanctioned (norms and conventions)
- ✓ Rules refer to shared prescriptions (must, must not, or may) that are mutually understood and enforced in particular situations in a predictable way by agents responsible for monitoring conduct and for imposing sanctions.
- ✓ Norms are prescriptions that are known and accepted yet involve intrinsic costs and benefits rather than material sanctions or inducements.

Culture is refers to the whole ways of life of the members of a society. It includes what they dress, their marriage customs, their family life, art, Patterns of work, religious ceremonies, etc. Values are shared assumptions, standards by members of the societies as to what is right or wrong, good or bad, important or unimportant, and desirable and undesirable. Norms are rules and regulations governing behavior in a society Conventions are relatively rigid rules governing certain social situations. Laws are rules that are made by those who hold political power and that are enforced through the machinery of the state.

Different schools of economic theory have been developed over the years to interpret economic phenomena, behaviors, and outcomes. It is generally acknowledged that these phenomena, behaviors, and outcomes (decisions, transactions, and welfare impacts) are shaped by formal economic institutions and rules; culture, values, and conventions and social values. An economic institution is defined as a branch of economics that focuses on the role of evolutionary process and the role of institutions in shaping economic behavior. Institutions are rules that dictate the costs and benefits of action, thus shaping what we do.

Formal law is very important in this approach because it shapes costs by making something legal or illegal. The culture is one of the most important aspects in sociology. It refers to the whole ways of life of the members of a society. It includes what they dress, their marriage customs, their family life, art, Patterns of work, religious ceremonies, etc. It also includes the material goods they produce, factories, machines, computers, books, buildings etc. The concept of culture has been defined many times by the sociologists and anthropologists, like Edward Tylor has defined “Culture is the complex which includes convention is a usual or accepted way of behaving, especially in social situations, often following an old way of thinking or a custom in one particular society: knowledge, belief, Art, Law, custom and other capabilities and habit acquired by man as a member of society”. Culture is dynamic, it grows, expands and develops continually, no culture is totally fixed and static, and each individual is born into a group that already possesses values, beliefs, and standards of behavior. These are transmitted through interaction with others.

Social values: Values are shared assumptions, standards by members of the societies as to what is right or wrong, good or bad, important or unimportant, and desirable and undesirable. Values are evaluation and arguments from the stand point of the culture of what ought to be. These broad principles are widely evident in a people’s way of life. Purr personalities develop in relation to the value of our culture; we learn from our families, schools

and religious institutions how to think and act according to cultural standards of value, what personal goals are defined as worthy and how to relate properly to our fellow human beings.

Values are view about what is desirable. Values defer from norms. Values are generally stood that are somewhat independent of specific situations. Values are preference about the way things should be and they are generally derived from beliefs which are convictions about the way things are. Values which are purposes or goals call for the norms and make the norms meaning full expectations with in the cultural content.

Values are continually emerging from the past and present experience of the group members and appear as a consensus of what is good and desirable. Thus there are economic values regarding material adequacy, political values, and educational goals and so on. The institutions embedding the ultimate and core values that the people have in common and are the main agencies for realizing the values.

Social norms: norms are rules and regulations governing behavior in a society. Norm is a social expectation. It is standards to which we are expected to conform whether we actually do so or not. It is the cultural specification that guides our conduct in society; it is way of doing things, the way that is set for us by our society. Social norms are the essential instruments of social control. There is no society and social life without them. Norms are transmitted to each individual through the process of socialization. In short norms are the blue print or designs for living. Without norms social relations among the individuals would be dangerous. It is the norm that gives order and stability to social life. Norms are usually derived from social values because they are reflections of what society's values. Some norms apply to virtually every social situation, for example we expect children to obey their parents consistently following the rules and regulations etc. Norms are classified in two types; mores and folkways.

Mores: The term 'mores' coined by William Grahm Sumner. It is the Latin word used for 'customs' and 'manners'. **Mores** are a special group of norms about which the members of society are extremely conscious and what they regard as absolutely essential for the well being of the growth. Mores differ from the folk ways in the sense moral conduct differs from merely customary conduct. Our society requires us to conform to the mores with out, however, having established a special agency in force conformity. The mores are social rituals in which we all participate unconsciously. In short mores give us discipline and support of routine habit. There are two important kind of mores; conventions and laws
Conventions: conventions are relatively rigid rules governing certain social situations. **Laws:** laws are rules that are made by those who hold political power and that are enforced through the machinery of the state.

Folk ways: The word 'folkways' literally means the ways of the folk the way people have devised for satisfying their needs, for interacting with one another and for conducting their lives. This term was coined by the American sociologist, William Grahm Sumner. Folk ways are norms to which we conform because it is customary to do so in our society.

Conformity to the folk ways is neither requires by law nor enforced by any special agency of the society, in other words folk ways carry punishment for their violation and yet we do obey the folk ways as a matter of custom, as a matter of usage. For example: eating breakfast in the morning, to greet elders to sleep in a bed etc. Works associated with the various schools of theory place differing emphases on these contextual variables and make different assumptions about their relative importance and the degree to which they are endogenous or exogenous to the problems being examined. Thus, for example, the neoclassical tradition places less emphasis on institutions, taking them largely as given, but focuses on the analysis of efficiency, often abstracting from particular institutional contexts.

New institutional economics (NIE) is an interdisciplinary exercise combining economics, law, organization theory, political science, sociology and anthropology to understand the institutions and their behaviour. Positive structures at different levels and examine efficiency and welfare with respect to these structures. Network (and economic) sociology emphasizes assessment of the influence of relational dimensions but are more limited in their analysis of economic efficiency and formal economic institutions.

The focus of this module is on understanding economic institutions to facilitate institutional development that will lead to more efficient economic outcomes in the agricultural sectors of poor rural economies. To this end we use a broad set of approaches that fall in the category of NIE. NIE draws on the theoretical and empirical tools of neoclassical economics in analyses of both the evolution of institutions and their effects on economic behavior and outcomes in different circumstances. NIE also draws on a variety of schools of thought in other social sciences; consequently NIE is not a well-defined school of thought but rather a loose collection of related research interests and methodologies (Heltberg 2002). The main purpose of this chapter is to familiarize the reader with insights from different schools of thought associated with NIE.

Therefore we begin by showing how core NIE approaches have developed by removing some key assumptions that underlie the basic neoclassical model in Section 1.3. Applying and developing neoclassical analysis to address real-life situations where perfectly competitive conditions do not apply has been the dominant project of neoclassical economics from the time of its inception. However the particular focus and contribution of NIE approaches have been their emphasis on (1) the problems that economic actors face as a result of imperfect information in transactions and (2) the role of institutions in addressing (or exacerbating) such problems. Following this exploration of the neoclassical roots of NIE and of different NIE approaches, the next section deals with questions about the definition and nature of institutions; the level of institutions; different types of institutions in economic activity; describes the scope and functions of different types of institutions in economic activity and the determinants of their effectiveness in performing these functions for different actors and stakeholders. political theory using rational choice approach to politics, public choice, social choice, game theory: Williamson, Hayek, Arrow, Veblen, Buchanan, Tullock, Coase, North, Mueller

Institutions and Neoclassical Economics

Assumptions are important tools in scientific enquiry, because they allow analysts to focus on one set of issues at a time. Introductory physics courses often begin with assuming a frictionless plane; but during the course the assumption is lifted to deal with the effects of friction in reality. Similarly, training in neoclassical economics starts with the development of basic theorems of individual behavior and market interactions under controlled conditions in a virtual laboratory provided by the assumptions of perfect competition. A critical feature of the successful development and application of neoclassical economics is therefore an understanding of its basic assumptions and the ability to extend its analysis to situations in which particular assumptions, or sets of assumptions, do not hold. Core assumptions of the perfect competition model are:

1. Profit and utility maximization: These are the dominant objectives motivating producers and consumers, respectively (or these actors behave as though this is the case). The main objective of rational consumer is to maximize their utility with given limited income and available market price of goods and services. The main objective of rational producer is to maximize their profit. Profit maximization is achieved through two ways 1) Maximization of output subject to cost constraints 2) Minimization of cost subject to cost output constraints

2. Perfect information: Economic actors (individuals, households, firms, or government) have complete information about all aspects of business profits and consumption utility, including market opportunities, available technology, costs of production under alternative production arrangements, prices, natural resources, quality of goods produced, and (critically) the intentions of fellow actors.

3. Homogenous products: Goods that are bought and sold in a given market are identical in all respects, including quality.

3. Ease of entry and exit: Firms can enter and withdraw from all markets without cost. There are no initial investment costs and no costs associated with shutting down. The assumption of costless entry and exit provides the necessary discipline to discourage existing firms in a market from colluding to raise the prices of goods sold, as this action would trigger new competition to undercut them.

4. Large numbers of firms and buyers: No buyer or seller is large enough to influence the market price of the good or services being transacted—all economic agents are price takers.

5. No economies of scale or production externalities: This assumption ensures that all production takes place to equate (private and social) marginal cost and marginal benefit with no externalities (including environmental externalities). It also means that large producers do not enjoy any competitive advantage over smaller firms.

6. Complete set of markets: Perfect markets exist for all commodities, including goods to be exchanged in the future and insurance against all risks. Completeness also implies well-defined and well-protected private property rights. Taken together, these assumptions generate a world of market-clearing equilibrium with costless adjustments to shocks; therefore, no risk of loss attached to current investment decisions. Goods are homogenous and exchange is anonymous, based purely on the price being charged for different goods and taking place in spot markets.

In such a world there is no particular role for organizations and management. But this scenario is not the real world in which most economic activity takes place. The major thrust of neoclassical economics has always been the extension of its analysis to address conditions in which some of these assumptions do not hold. Thus, for example, there are extensive literatures, both within and beyond the agricultural sector, on nonprofit objectives of producers and the effects of corporate governance on firms' objectives; consumer behavior; price and production risk and uncertainty; product differentiation and branding; monopoly, oligopoly, and other market structures; public goods, externalities, and related market failures; and household economics. The specific contribution of NIE arises from its recognition that: economic actors face a particular problem as a result of imperfect information about the behavior of other actors in transactions and; institutions play an important role in addressing these problems (with varying benefits for different actors in a transaction and for wider participants in an economy. This recognition demands explicit attention to the ways that actors and societies address problems arising from imperfect information in transactions. However, it also allows NIE to retain the methodological and analytical foundations of neoclassical economics in its consideration of self-seeking individuals who attempt to maximize an objective function subject to constraints.

The NIE focus on imperfect transaction information and its analysis of associated institutional issues (related to non standard behavior of actors, lack of complete markets or well-defined property rights, and high information costs). Several closely related strands of economic literature address these issues: the economics of imperfect information, transaction-costs economics, moral hazard and agency theory, property rights, and incomplete-contracts theory. These are all important developments of the standard economic tools and are sometimes classified as part of the NIE body of thought.

The Economics of Imperfect Information

The literature on the economics of information includes seminal papers by (Arnott, Greenwald, and Stiglitz, 1993). The main argument is that lack of perfect and freely available information leads to risk and uncertainty in transactions. Information is incomplete and asymmetrical in that sellers have more information than do buyers about the availability and characteristics of the supply of products that they are offering for sale, while buyers have more information than sellers about the nature of their demand and their ability and intentions to pay for products that they purchase. Searching for and obtaining information about products and sellers and about demand and buyers is then necessary for buyers and sellers, respectively, to reduce the risks of transaction failure. However, searching and obtaining information is not costless: it is an important source of transaction costs. The dilemma this asymmetry poses for buyers is well illustrated in Akerlof's (1970) paper on the second hand car market in the United States. Akerlof explains how quality guarantees (labels, certificates), reputation, and trust are useful tools to ensure the production of quality goods and project information about them. His analysis also implies that government intervention to increase information flow can make all parties better off. These

relatively simple observations regarding imperfect transactional information have wide-ranging consequences.

First, recognition that imperfect information leads to substantial transaction costs in most forms of economic activity have profound implications for welfare economics and hence economic development and management policy: it is exceptional to find markets that approximate the conditions necessary for efficiency (Stiglitz and Grossman 1980). Transaction costs impede exchange and hence impede competitive markets' ability to reach efficient equilibria even for private goods not normally considered prone to market failure. This complication leads to multiple possible equilibrium in an economy, dependent on institutional arrangements governing different markets in the economy. Modification of institutions to allow more efficient resource allocation and exchange then becomes an important subject of policy, one that has long been recognized implicitly in policy practice but has not generally been given sufficient attention by conventional economic policy analysis. Second, Akerlof's analysis provides insights into the extent and importance of the difficulties posed by imperfect transactional information in different situations.

These difficulties will vary with

- ✓ The nature of the product or service being exchanged;
- ✓ The institutions governing the transaction;
- ✓ The nature and extent of investments in the transaction;
- ✓ The characteristics of transacting parties (for example, their power, wealth, risk aversion, and access to information); and
- ✓ The characteristics of the economy, sector, and society of the transacting parties.

Consideration of these issues then gives rise to different but closely related approaches to analyzing institutional issues in transactions. In the next section, moral hazards and agency theory will be discussed. But TCE and PR will be discussed in chapter 2 and 4 respectively.

Adverse selection and moral hazard

Adverse selection describes a situation in which buyers have more information than sellers prior to purchase. It is especially relevant in the insurance market (and the credit market), where people who take out insurance are more likely to file claims than the individuals used by the insurer to set their rates. The sellers of insurance thus face the risk of selecting buyers with above-average probabilities of making claims. The seller therefore faces information costs in discerning and discriminating between potential good and bad clients. Akerlof (1970) developed the concept of adverse selection in the context of the "market for lemons." People buying used cars do not know whether the cars are "lemons" (bad cars) or "cherries" (good cars), so they are willing to pay a price that lies between the price for lemons and cherries, a willingness based on the probability that a given car is a lemon or a cherry. Sellers respond by offering for sale fewer good cars because the price is too low, but they offer more bad cars, because they get a better price for them. After a while the buyers recognize this trend and no longer want to pay the old price for the used car. Thus prices will drop, reinforcing the tendency for fewer cherries and more lemons being offered for sale.

Moral hazard refers to the risk that results from a change in conduct caused by an expectation of compensation for a negative outcome. A contract can itself change the behavior of one party to that contract to the detriment of the other party. Crop insurance, for example, gives farmers an incentive not to invest in the prevention of crop failure but rather to rely on cash income from the insurance proceeds of the failed crop. Moral Hazard and Agency

The literature on the economics of information initially found an important application to two problems observed in the insurance industry: adverse selection and moral hazard (Akerlof 1970). In addition Stiglitz illustrated the role of imperfect information, adverse selection, and moral hazard on the performance of credit and labor markets, and the behavior of firms.

Agency theory (or principal-agent theory), as developed by Jensen and Meckling (1976), Fama (1980), and Fama and Jensen (1983), is a closely related field that is concerned with the effects of institutions on reducing transaction risks (Section 1.3.3) and costs arising from imperfect transactional information. Agency theory studies the design of ex ante incentive-compatible mechanisms to reduce agency costs in the face of potential moral hazard by agents: it addresses the question of how a principal (for example, an owner of capital or manager of labor) can structure contracts, incentives, and sanctions to encourage, at low cost, agents (users of capital, or laborers) to behave in ways that will lead to the achievement of the principal's goals.

Agency costs are defined by Jensen and Meckling (1976, 308) as the sum of "(1) the monitoring expenditures of the principal, (2) the bonding expenditures by the agent and (3) the residual loss." The residual loss represents the potential gains from trade not realized because principals cannot provide perfect incentives for agents when the agents' actions are unobservable. There are close parallels between agency costs and transaction costs.

The problem of motivating one party to act on behalf of another is known as the principal-agent problem. It arises when a principal compensates an agent for performing certain acts that are useful to the principal and costly to the agent and there are elements of the performance that are costly to observe. This is the case to some extent for all contracts, given that we live in a world of information asymmetry, uncertainty, and risk. Principals do not know enough about whether (or to what extent) a contract is being or has been satisfied.

The solution to this information problem, closely related to the moral hazard problem, is to ensure (as far as possible) the provision of appropriate incentives so that agents act in the way principals wish them to. It involves changing the institutional arrangement (rules of the game) so that the choices that the principal predicts the agent will make coincide with the choices the principal desires.

A large body of literature in this field is about employment contracts, in which it is shown that the challenge is to structure incentives by optimally connecting the

information available about employee performance and the compensation for that performance. The structural details of individual contracts vary widely, however, because of differences in (1) the quantity and quality of information available about the performance of individual employees, (2) the ability of employees to bear risk, and (3) the ability of employees to manipulate evaluation methods. Milgrom and Roberts (1992) identify four basic principles of contract design:

1. **The informativeness principle:** Holmstrom (1979) states that any measure of performance that (on the margin) reveals information about the effort level chosen by the agent should be included in the compensation contract.

2. **The incentive-intensity principle:** An optimal intensity of effort is devoted to solving the principal-agent problem, so it will to some extent always be “not fully resolved,” and thus principal-agent issues are always subject to further experiment and contest in the public and private sectors.

3. **The monitoring intensity principle:** Situations in which the optimal intensity of incentives is high correspond to those in which the optimal level of monitoring is also high.

4. **The equal-compensation principle:** Activities equally valued by the employer should be equally valuable (in terms of compensation, including such nonfinancial aspects as pleasantness) to the employee. This principle relates to the problem that employees may be engaged in several activities, and if some of these are not monitored or are monitored less heavily, they will be neglected, as activities with higher marginal returns to the employee are favored. Targeting certain measurable variables may cause others to suffer. For example, if agricultural extension workers are rewarded by the volume of input packages sold to farmers or the number of loans granted to farmers, they may de-emphasize equally or more important aspects of their role that were not explicitly targeted in their performance contract.

In the agency literature, the firm itself is not the subject of attention. According to Alchian and Demsetz (1972) and Jensen and Meckling (1976), “firm” is simply a convenient label for the collection of contracts between owners and managers, managers and employees, and the firm and its customers and suppliers.

These issues are particularly important in agriculture (especially in the risk-prone, extensive agricultural systems common in many parts of Africa), as the dispersed nature of agriculture and its exposure to multiple sources of risk and uncertainty frequently make the monitoring of inputs and their relationship to outputs problematic. As a result imperfect information and agency theory have been used to explain the emergence of key agrarian institutions, which have been analyzed as substitutes for missing credit or insurance markets in an environment of pervasive risk, information asymmetry, and high transaction costs (Binswanger and Rosenzweig 1986; Bardhan 1989).

These institutions include sharecropping and other forms of interlocked contracts among land, labor, credit, inputs, and outputs. Bardhan (1989), for example, argues that these agrarian institutions may serve a real economic function under a set of informational constraints and missing markets. Such institutions as sharecropping, whose persistence was formerly considered a major development puzzle, can then be seen as an

institutional response to the absence of markets for risk insurance (Stiglitz 1989). This strand of thinking has led to a large literature on sharecropping (for example, Stiglitz 1974; Eswaran and Kotwal 1985). Other applications of such analysis include interlinked contracts in credit and land lease (Braverman and Stiglitz 1982); labor hiring, output sales, and institutions for hedging risk (Zusman 1976; Newberry 1977); interlocking credit, input, and produce transactions (Dorward, Kydd, and Poulton 1998); and cooperative institutions in production and credit (Putterman 1980). Further insights into such institutions can be gained from a more explicit examination of transaction costs.

Transaction costs versus transaction risks

Dorward (2001) and Dorward, Kydd, and Poulton (2005a) consider transaction costs and transaction risks together, as actors are presumed to invest in transaction costs to reduce transaction risks. Thus transaction costs refer to the costs originating from the various actions taken to reduce the risk of transaction failure. Despite these actions (or costs), actors are not able to eliminate transaction risks, so costs are incurred to provide an optimal trade-off where the marginal transaction costs are equal to the marginal utility of risk reduction. Transaction costs therefore involve *(1) the establishment and enforcement of exclusive property rights and/or (2) the definition and enforcement of the attributes of the good or service being exchanged.*

However, transaction risks represent the losses incurred *because of failure to (1) enforce exclusive property rights, (2) enforce required attributes, or (3) complete the transaction.* Problems of enforcing exclusive property rights arise with public goods and externalities. Problems of enforcing the attributes of goods or services or failure to complete the transaction arise when there are difficulties in obtaining information about goods, services, and the actors involved in the exchange (commitment problems) or difficulties relating to enforcing the agreements (opportunism).

Incomplete Contract Theory

Property rights issues are also embedded in incomplete contract theory (ICT). ICT of the firm combines the insights of TCE regarding the importance of bounded rationality and contracting costs with the rigor of agency theory. This theory focuses on the way different organizational structures assign property rights to resolve the issues that arise when contracts are incomplete. It provides a basis for defining different organizational structures by the ownership and control of key assets.

ICT was pioneered by Oliver Hart (Grossman and Hart 1986), building on initial insights from Williamson. Hart departed from the Coasian premise that firms arise when people write incomplete contracts and instead proposed that the allocation of power and control subsequently becomes necessary. Contracts (whether written or unwritten, and whether linked to business or to the use of natural resources) are essentially incomplete because of the bounded rationality of the contracting parties and the non verifiability of relevant variables necessary to make the contract complete. It is

thus accepted that contracts are perpetually renegotiated and redesigned to gain greater efficacy despite the renegotiation cost. These notions of contractual incompleteness and power can be used to understand economic institutions and arrangements. Four aspects are particularly relevant when considering incomplete contracts: ownership, the boundaries of firms, securities, and power distribution (Saussier 2000). The first two refer to property rights and are concerned with why ownership of assets (human and physical) matters. Generally ownership matters because it provides power when contracts are incomplete. In addition, ownership allows residual control (that is, the right to decide about asset use outside of a given contract) and appropriation of residual income (that is, entrepreneurial profit). ICT predicts that asset ownership has an effect on parties' incentives to invest, because it is impossible to write comprehensive contingent contracts for relationship-specific investments and the resulting potential for opportunistic behavior and ex post renegotiation over the trade benefits. This risk of hold-up leads to underinvestment. Changing the allocation of asset ownership between the trading parties may partially solve the hold-up problem.

The Definition and Nature of Institutions

It is hard to make much progress in the study of institutions if scholars define the term to mean almost anything. Williamson (2000b) makes the point that despite enormous progress, "we are still very ignorant about institutions," mainly because institutions are complex, neoclassical economics has been largely dismissive of them, and much institutional theory lacks scientific ambition. The purpose of this section is to provide a thorough understanding of the concept of institutions. The simplest way of defining institutions is as "the rules of the game" (North 1994), rules that provide a framework of incentives that shape economic, political and social organization. Institutions are composed of

- ✓ *Formal rules for example laws and constitutions*
- ✓ *Informal constraints (conventions, codes of conduct, and norms of behavior), and*
- ✓ *Their enforcement. Enforcement is carried out by the third parties (law enforcement, social ostracism), second parties (retaliation), or by the first party (self-imposed codes of conduct).*

Schmid (2004) qualifies this definition by arguing that institutions are more than just the rules of the game providing constraints. They are also enablement to do what the individual cannot do alone. They also affect beliefs and preferences and provide clues to uncalculated action. In her definition of institutions Ostrom (2005a) refers to the rules, norms, and strategies used by humans in repetitive situations.

The early institutionalist understood institutions as essentially "collective action in control of individual action" (Commons 1934). In this tradition institutions are understood to supplement markets where markets cannot function, and in a world of imperfect information institutions carry information about the expected behavior of other agents to better coordinate economic activity. In a market economy with perfect information, such coordination would instead be directed by the price mechanism. Institutions are created by human design through explicit bargaining or by evolution.

In defining the nature of his institutional economics, *Commons (1934) identified some key features that underpin much of the institutional approach:*

- ✓ “Conflict of issues” as opposed to “harmony” is its starting point
- ✓ “Duty and debt” as opposed to “liberty and love” are its foundations
- ✓ “Activity” as opposed to “pleasure and pain” is its focus

2.3. Institutions and organizations

② Dear learner, can you describe the differences Institutions and organizations? (You can use the space left below to write your response.)

2.3. Institutions and organizations

To understand and define institutions it is also important to distinguish between “institutions” and “organizations,” although these terms are often used interchangeably in everyday language. In the context of institutional analysis, however, institutions are complexes of norms and behaviors that persist over time by serving some collectively valued purposes, whereas organizations are structures of recognized and accepted roles, formal or informal. Examples of organizations include trade unions, producer groups, and government agencies. Although there is a great deal of overlap between institutions and organizations, many cultural and market institutions do not have a corresponding organization, and certain organizations may exist “on paper” only and have not been fully institutionalized through the creation of accepted rules.

North (1993b) helps to clarify this link between institutions and organizations. It is the interaction between institutions and organizations that shapes the institutional evolution of an economy. If institutions are the rules of the game, organizations and their entrepreneurs are the players. Organizations are made up of groups of individuals bound together by some common purpose to achieve certain objectives. Organizations include political bodies (political parties, the senate, a city council, regulatory bodies), economic bodies (firms, trade unions, family farms, cooperatives), social bodies (churches, clubs, athletic associations), education bodies (schools, universities). The organizations that come into existence will reflect the opportunities provided by the institutional matrix. That is if the institutional framework rewards piracy then piratical organizations will come into existence; and if the institutional framework rewards productive activities then organizations-firms-will come in to existence to engage in productive activities.

Clearly, institutions can be many things: they can be organizations or sets of rules within organizations; they can be markets or particular rules about the way a market operates; they can refer to the set of property rights and rules governing exchanges in a society; they may be formally written down or unwritten and informally sanctioned. *Institutions can also be defined as “agreed and policed regularity in social behavior for specific recurrent situations,”* “complexes of norms of behavior that persist by serving collectively valued purposes,” “patterned forms of human interaction,” “rules, their

enforcement and norms of behavior for repeated human interaction,” “rights and obligations,” or “constraints on behaviour”.

Following from these definitions, institutions can be considered as the mechanisms used to structure human interactions in the face of uncertainty, and they are formed to reduce uncertainty and risk in human exchange. In the economic exchange of goods and services, then, institutions act as a set of constraints that govern the relations among individuals or groups in the exchange process. Institutions thus help human beings to form expectations of what other people will do. Markets are only one type of social device for settling the terms of transactions. There are, therefore, many concepts that are grouped under the rubric of institutions; as a result the definition of institutions is usually relatively broad. As this generality leads to confusion, it is important to unpack the different aspects of institutions. This can be done by first considering the different levels of institutions, then considering the different types of institutions, and finally considering the functions and scope of institutions.

Levels of Institutions

Institutions operate at both the macro and micro levels. The macro level institutions is defined as a level of institutions that deals with the institutional environment, or the rules of the game, which affect the behavior and performance of economic actors and in which organizational forms and transactions are embedded. Institutional environment describes the set of fundamental political, social, and legal ground rules that establish the basis for production, exchange, and distribution. The micro level institutions (also known as the level of institutional arrangements) deals with the institutions of governance, which is also considered as a subclass of the institutional environment.

These, according to Williamson (1993), refer more to the modes of managing transactions and include market, quasi-market, and hierarchical modes of contracting. The focus here is on the individual transaction, and questions regarding organizational forms (for example, vertical integration versus outsourcing) are analyzed. An institutional arrangement is an arrangement between economic units that governs the ways in which its members can cooperate and/or compete. For Williamson, the institutional arrangement is probably the closest counterpart to the most popular use of the term “institution.” Williamson (1999) later, after conceding the importance of embeddedness, expanded these levels of institutions by considering institutional analysis in a framework with four levels

(Table 1). At the lowest level (level 4), actors operate in existing institutions, making marginal decisions that are amenable to neoclassical microeconomic analyses of performance. These decisions are made in the context of governance structures (level 3)-the institutional arrangements governing rights over resources, goods, and services, and the structure and terms of exchange and access to resources. Governance or institutional arrangements are determined by the institutional environment (level 2), that is, the wider rules of the game set out in formal property rights and laws, for example. This institutional environment is then itself embedded in deeper traditions; norms;

and cultural, religious, and sociopolitical systems (level 1). Level 1 is associated with social theory, level 2 and 3 with NIE, and level 4 with neoclassical economics. Most advances in economics have been made in levels 2-4, and relatively little has been accomplished in level 1. However, for economic development and theory, we need to be aware of the implications of level 1, which may require drawing on other disciplines, such as anthropology and history, which deal with this level in depth. Although level 1 does not strictly fall in the realm of economics but rather in that of social theory, its profound impact on the economic functioning of institutions necessitates that it be considered as integral to a comprehensive understanding of the origins and roles of institutions. It is precisely for this reason that this chapter also addresses the other disciplines associated with level 1.

Table 1. The economics of institutions

Level	Purpose	Theory
<p>Level 1 Embeddedness: social environment (for example, informal institutions, traditions, norms, religion, culture, sociopolitical imperatives)</p>	Protect, preserve, and empower	Social theory
<p>Level 2 Institutional environment: formal rules of the game (for example, property rights, laws, and constitutions)</p>	First-order economizing: create appropriate institutional environment	Economics of property rights; positive political theory
<p>Level 3 Governance: play of the game (aligning governance structures with transactions)</p>	Second-order economizing: create appropriate governance structure	Transaction-cost economics
<p>Level 4 Neoclassical analysis: performance (for example, optimality, prices, quantities, and incentives)</p>	Third-order economizing: appropriate marginal conditions	Neoclassical economics; agency theory

Source: Adapted from Williamson (1999).

Ostrom (2005b) refined the point about different levels of institutions (or rules) by showing that multiple sources of structure are located at diverse analytical levels as well as diverse geographic domains. Besides multiple and nested action arenas at any one level of analysis, nesting of arenas also occurs across several levels of analysis. Ostrom's multiple levels of analysis refer to operational situations, collective choice, and constitutional choice, with sets of rules in the three arenas being nested within one another. For example, decisions made at the constitutional level (or the macro level) affect collective-choice decisions, as these impinge on the operational decisions of individuals.

Thus, decisions made about rules at any one level are usually made within a structure of rules existing at a different level. It is for this reason that institutional studies need to encompass multiple levels of analysis. At any one level of analysis, combinations of prescriptions, attributes of the world, and communities of the individuals involved

work together in a configurative, rather than an additive, manner. *The three basic elements (or pillars) that can be identified as vital ingredients of institutions: **regulative systems, normative systems, and cultural cognitive systems:***

1. The regulatory pillar is legally sanctioned and includes rules, laws, and sanctions. It uses coercion as a mechanism for enforcement and compliance.
2. The normative pillar is morally governed and includes such indicators as certification and accreditation.
3. The cultural-cognitive pillar is culturally supported and has the common beliefs and shared logics of action as indicators. Shared understanding is the basis for compliance. This pillar also corresponds with Clague's (1997) category of institutions as cultural endowments, including the normative behavioral codes of society and the mental models that people use to interpret their experiences. The cultural endowment aspect of institutions links closely to the concepts of social capital and embeddedness of institutions. These three elements of institutions form a continuum moving from the conscious to the unconscious, from the legally enforced to the taken for granted (Scott 2001).

Scott (2001) also reminds us that most scholars underscore the regulatory aspects of institutions that constrain and regularize behavior: "Society's institutions-the rules of the game-largely determine the incentives of the entrepreneurs and thereby guide their actions." Economists are particularly likely to view institutions as resting primarily on the regulatory pillar. North's definition presented earlier, which builds on his Nobel Prize lecture (North 1993b) and has been quoted in virtually every piece on institutional economics since 1994, illustrates the point. Scott (2001) argues that this emphasis may stem in part from the fact that economists are used to focusing attention on the behavior of individuals and firms in competitive situations, where contending interests are more common and, hence, explicit rules and referees are necessary to preserve order. It is perhaps for this reason that private property rights are considered one of the most important institutions.

There has, however, been a greater recognition among economists that cultural aspects, ethical and moral issue (values), and informal constraints (such as conventions, norms, and ideologies) also shape human behavior. Thus the second and third pillars of institutions have increasingly been woven into economists' work about the role of institutions, as Williamson has also explained in his abovementioned four level schema. This approach is stressed in this chapter (and indeed throughout the book) by demonstrations of the relevance of such disciplines as economic sociology, anthropology, and psychology when the standard assumptions of orthodox neoclassical economics are relaxed.

2.4. Types of Institutions in Economics

? Dear learner, can you describe Types of Institutions in Economics? (You can use the space left below to write your response.)

2.4. Types of Institutions in Economics

A common theme in the different analytical frameworks discussed above is the distinction between formal and informal institutions. Although Williamson's framework of four levels of institutional analysis may appear to suggest that formal rules (level 2) are embedded in informal rules (level 1), both formal and informal rules exist in levels 2 and 3, and formal and informal rules are embedded in each other.

Formal institutions

Formal rules (for example, legal environment and property rights) are formally written down and enforced by the state. Of these, the law has received the most attention from economists interested in the economic effects of the legal environment. Economics has been used to study not only the character and effects of law but also the mechanisms by which legal rules change. Contract law and property law is of particular interest to NIE scholars.

The constitutional order is the fundamental set of rules that govern the way societies and states are organized, and within this order institutional arrangements are devised by the collective and individual actions of members. However, the constitutional order changes slowly (except in revolutionary periods), and for that reason it is usually considered as a given. Out of this constitutional order then flow statutes, common law, and various regulations. At various levels of government different laws and by laws shape the way business, natural resources, and social activity are organized. In the case of food products, for example, the rules regarding food safety, grades, and standards are specified in regulations and enforced by government officials.

Furthermore, the formal rules and, by definition, the legal system and its effectiveness also determine the incentive structure in an economy through their influence on the protection of property rights and contract enforcement. Property rights are a key economic institution, but the effectiveness of property rights depends on the nature of the legal system, because these rights are meaningless if not enforced. This argument also extends to contracts, although in that case self-enforcing institutions may apply.

Informal institutions

Informal rules (such as norms and conventions) are unwritten and informally sanctioned. These informal and often tacit rules are as important as formal rules in structuring social conduct. As North (1990) emphasizes: "formal rules... make up a small part of the sum of constraints that shape choices... the governing structure is overwhelmingly defined by codes of conduct, norms of behavior and conventions." Such (informal) rules, once established, form constraints for individual actors. One fundamental component here is cultural endowments. Cultural endowments include the normative behavioral codes of society and the mental models that people use to interpret their experiences. Similar to constitutional order, the cultural endowments of society change slowly. Norms and conventions are different types of informal rules. These are often considered loosely as interchangeable terms, but some authors draw a distinction between them. Conventions are related to such concepts as habits, customs, routines, and standard practices, including honoring queues, access by seniority, and basic ideas of honesty and fair dealing.

Biggart and Beamish (2003) define them as “understandings, often tacit but also conscious, that organize and coordinate action in predictable ways. Conventions are agreed-upon, if flexible, guides for economic interpretation and interaction.” Conventions thus refer to values, rules, and representations that influence economic behavior and include such practices as driving on the right, although this goes beyond a convention, as it is enshrined in formal laws. Customs need to be distinguished from conventions and routines. Individuals adhere to certain customs even if costly because of their emotional commitment and self-identity.

Theorists of conventions see institutions as bundles of conventions that have emerged as pragmatic solutions to economic problems and have become reified as normal. Institutional arrangements may serve elite interests, but theorists also leave open the possibility that arrangements are merely congealed successful solutions to economic problems. Although conventions are used by individuals as they buy, bargain, and sell, conventions do not reside in individuals. Theorists of conventions explain economic order as the product of socially knowledgeable actors working within collective understandings of what is possible, probable, and likely to result in fiscal and social gains and losses. Conventions are shared templates for interpreting situations and planning courses of action in mutually comprehensible ways that involve social accountability; that is, they provide a basis for judging the appropriateness of acts by self and others. Conventions thus are a means of economic coordination among actors that are inherently collective, social, and even moral in nature.

Social conventions, which tend to be embedded in culture (or specific contexts), serve the common welfare and can be interpreted as non cooperative Nash equilibrium solutions to a variety of repeated games (super games) faced by individuals in social settings. These social conventions can assist with important coordination problems in communities. Norms are considered to be shared prescriptions known and accepted by most of the participants themselves. They involve intrinsic costs and benefits rather than material sanctions or inducements. Social norms such as “customary law” can in some cases be superior to administrative or judicial dispute resolution among people with close social ties.

Local disputes are often resolved by appealing to generally accepted social rules, not by bargaining over legal rights. Through repeated interaction, agents tend to converge on strategies of cooperation that improve joint well-being. These strategies replace traditional legal remedies, and in some cases relationships prevail over law. Barbara Harriss-White (2000) identifies what she calls “social institutions of markets” as part of informal institutions or constraints. This definition includes aspects related to class and markets, which have to do with exchange relations, political alignments, habituated collective action, and gender.

2.5. Roles and Function of Institutions

⑦ Dear learner, can you describe roles and function of Institutions? (You can use the space left below to write your response.)

2.5. Roles and Function of Institutions

The function of institutions is to help agents or groups of agents to improve their welfare, but many different institutions can often serve the same function. The type of institution that emerges depends on various factors, including power relations, information structures, the legal environment, and historical accident and path dependence. North (1993) summarizes the main function of institutions as forming the incentive structure of a society; political and economic institutions consequently are the underlying determinants of economic performance. Institutions are, therefore, critical to determining economic performance by influencing the cost of production, which includes input and transaction costs. Hall and Soskice (2001) go to great lengths to show how the institutions of the political economy perform a most important function in shaping the behavior of firms. There are three ways to understand the relationship between the political institutions and behavior:

- 1) Institutions can be considered as socializing agencies that instill a particular set of norms or attitudes in those who operate within them.
- 2) The effects of institutions can be considered as stemming from the power they confer on particular actors.
- 3) Institutions of the political economy can be considered as a matrix of sanctions and incentives to which the relevant actors respond.

In the tradition of NIE, institutions are seen as governance tools. They help individuals cooperate, or they overcome market failures. Many institutions serve a different purpose, however: they manage conflict. Conflict has many causes, for example, a difference of interests, a clash of ideology, identity, honor, or irrational elements in human behavior. However, individuals are not merely constrained and influenced by institutions. As social beings, humans are jointly shaped by the natural environment, biotic inheritance, and institutions. Nevertheless, this notion of institutions must coexist with the equally valid notion that institutions are formed and changed by individuals.



Learning Activity 2

Answer the following questions

PART I. ANSWER THE FOLLOWING QUESTIONS

1. What are the similarity and the difference between institutions and organizations?

2. Give examples for institutions and organizations?

3. Write the type of institutions that do not have a corresponding organization, or that have not been fully institutionalized through the creation of accepted rules?

PART II. FILL IN THE BLANK SPACES

- 1) _____ can also be defined as agreed and policed regularity in social behavior for specific recurrent situations, complexes of norms of behavior that persist by serving collectively valued purposes, patterned forms of human interaction, rules, their enforcement and norms of behavior for repeated human interaction, rights and obligations, or constraints on behavior
- 2) North (1993) helps to clarify the link between institutions and organizations that if institutions are the rules of the game, _____ and _____ are the players.
- 3) _____ are made up of groups of individuals bound together by some common purpose to achieve certain objectives.

PART III. MULTIPLE CHOICE QUESTIONS

1. From the following which organizations is not a political bodies?
A. Political parties B. The senate C. City council D. Regulatory bodies E. Trade unions F. None
- 2) Which of the following is not an economic body of organizations?
A. Firms B. Trade unions C. Family farms D. Cooperatives) E. Churches F. None
- 3) Which of the following may not be social bodies of organizations?
A. Churches B. Clubs C. Athletic associations D. Schools E. None
- 4) Which of the following may not be education bodies of organizations?
A. Schools B. Universities C. ATVET Colleges D. All E. None
- 5) _____ are only one type of social device for settling the terms of transactions.
A. Markets B. Institutions C. Demand D. Supply E. Marketing system F. None
- 6) The level of institutions that deals with the institutional environment, or the rules of the game, which affect the behavior and performance of economic actors and in which organizational forms and transactions are embedded is _____
A. The macro-level institution B. The meso-level institution
C. The micro-level institution D. All E. A and C F. A and B G. None
- 7) Davis and North (1970) describe the institutional environment as the set of fundamental:
A. Political rules B. Social rules C. Legal ground rules D. All E. None
- 8) Which level of institutional arrangements is a subclass of the institutional environment?
A. The macro-level institution B. The meso-level institution
C. The micro-level institution D. All E. None

REFERENCES

- Aoki, M. , 2001. toward a comparative institutional analysis. Cambridge, Mass., U.S.A.: MIT Press.
- ARD, Inc., 2005. Land Tenure and Property Rights (LTPR) Framework and Tools, Burlington, Vermont. Documents may be requested from ard@ardinc.com.
- Ashley, Caroline and Christopher LaFranchi. 1997. Livelihood strategies of rural households in Caprivi: implications for conservancies and natural resource management. DEA Research Discussion Paper 20. Windhoek: DEA.

- Bardhan, P. K. 2001. Institutions, reforms and agricultural performance. In Current and emerging issues for economic analysis and policy research, ed. K. G. Stamoulis. Rome: Economic and Social Department, Food and Agriculture Organization of the United Nations.
- Bromley, Daniel. 2003. The Commons, Common Property, and Environmental Policy. In B. Larson (ed.) Property Rights and Environmental Problems, Volume I. Burlington: Ashgate Publishing Company, pp. 83-99.
- Cavendish, William. 1999. Empirical Regularities in the Poverty-Environment Relationship of African Rural Households, the Centre for the Study of African Economies Working Paper Series, Paper 105.
- Coase, R. H. 1992. The institutional structure of production. *American Economic Review* 82 (4): 713–719.
- Coase, Ronald. 1961. “The problem of social cost.” *Journal of Law and Economics* 3:1-44.
- Coase, Ronald. 1937. “The nature of the firm.” *Economica* 4: 386-405.
- Coase, Ronald. 1988. *The Firm, the Market and the Law*. University of Chicago Press.
- Coase, Ronald. 1992. “Comments on Cheung.” In *Contract Economics*, edited by Lars Werin
- Davis, L. E., and D. C. North. 1971. *Institutional change and American economic growth*. Cambridge: Cambridge University Press.
- Dorward, A. R. 2001. The effects of transaction costs, power and risk on contractual arrangements: A conceptual framework for quantitative analysis. *Journal of Agricultural Economics* 52 (2): 59–74.
- Dorward, A. R., J. G. Kydd, J. A. Morrison, and C. Poulton. 2005. Institutions, markets and economic coordination: inking development policy to theory and praxis. *Development and Change* 36 (1): 1–25.
- Dorward, A. R., J. Kydd, and C. Poulton. 2005a. Coordination risk and cost impacts on economic development in poor rural areas. Paper presented at the Agricultural Economics Society Conference, Nottingham, U.K., April.
- Fernandez-Gimenez, Maria. 2006. Land Use and Land Tenure in Mongolia: A Brief History and Current Issues, USDA Forest Service Proceedings RMRS-P-39 http://www.fs.fed.us/rm/pubs/rmrs_p039/rmrs_p039_030_036.pdf.
- Fischer, Julie E. et al. 1995. Atelier Régional de N’Zérékoré sur la Problématique Foncière et la Gestion des Ressources Naturelles en Guinée Forestière, Workshop Report. Madison, Wisconsin: Land Tenure Center.
- Food and Agriculture Organization. 2002a. *Land Tenure and Rural Development*, FAO Land Tenure Series 3. Rome: FAO.
- Hall, P. A., and D. Soskice, eds. 2001. *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford: Oxford University Press.
- Kinder, D. R., & Sears, D. O. (1985). Public opinion and political action. In G. Lindzey, & E. Aronson (Eds.), *Handbook of Social Psychology* (pp. 659-741). New York: Random House.
- Lawry, Steven W. 1990. Tenure Policy toward Common Property Natural Resources in Sub-Saharan Africa, *Natural Resources Journal* 30 (Spring): 403-422.
- Mathieu, Paul, Philippe Lavigne Delville, Lacinan Pare, Mahamadou Zongo, Hubert Ouedraogo with Julianne Baud, Eric Bologo, Nadine Kone, Karine Triollet. 2003. Making Land Transactions More Secure in the West of Burkina Faso, IIED Drylands Program, Issue Paper No. 117, London: IIED. <http://www.iied.org/pubs/pdf/full/9170IIED.pdf>.
- Meinzen-Dick, Ruth, Rajendra Pradhan, and Monica Di Gregorio 2004. Understanding Property Rights. In Meinzen-Dick, Ruth and Monica Di Gregorio (eds.) *Collective Action and Property Rights for Sustainable Development*, Focus 2020, Brief 3, Washington DC: IFPRI.

- Norfolk, Simon. 2004. Examining Access to Natural Resources and Linkages to Sustainable Livelihoods: A Case Study of Mozambique, Livelihood Support Programme Working Paper 17. Rome: FAO.
- North, D. C. 1990. Institutions, institutional change and economic performance. Cambridge: Cambridge University Press.
- Oliver, P. (1980). Rewards and punishments as selective incentives for collective action: Theoretical investigations. *American Journal of Sociology*, 85,1356-1375
- Olson, M. (1965). The logic of collective action: Public goods and the theory of groups. Cambridge, M A : Harvard University Press.
- Ostrom, E. 1990. 2005b. Understanding institutional diversity. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, E. 1990. Governing the commons: The evolution of institutions for collective action. Cambridge: Cambridge University Press.
- Ostrom, E. 2005a. Doing institutional analysis: Digging deeper than markets and hierarchies. In *Handbook of New Institutional Economics*, ed. C. Ménard and M. Shirley. Dordrecht: Springer.
- Ostrom, E. 2005b. Understanding institutional diversity. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, Elinor. 1999. Private and Common Property Rights. In Boudewijn, Bouckaert and Gerrit De Geest (eds) *Encyclopedia of Law and Economics*, Vol. 1 The History and Methodology of Law and Economics, Edward Elgar and The University of Ghent, pp 332-379. <http://encyclo.findlaw.com/2000book.pdf>
- Safia Aggarwal and Kent Elbow, 2006. Rights in Natural Resource Management, Good Governance And Empowerment of The Rural Poor. United States Agency for International Development, ARD, Inc.159 Bank Street, Suite 300, Burlington, VT 05401 Tel: 802 658-3890, Fax 802 658-4247 www.ardinc.com
- Shackleton, Sheona, Charlie Shackleton and Ben Cousins. 2000. Re-valuing the Communal Lands of Southern Africa: New Understandings of Rural Livelihoods, ODI Natural Resource Perspectives Number 62, November 2000.
- Smon, B. (1998). Individuals, groups, and social change: On the relationship between individual and collective self-interpretations and collective action. In C. Sedikides, J. Schopler, & C. Insko (Eds.), *Intergroup cognition and intergroup behavior* (pp. 257-282). Mahwah, NJ : Lawrence Erlbaum.
- Soloman, Barry. 1999. "New directions in emission trading: the potential contribution of new institutional economics." *Ecological Economics* 30: 371-87.
- Tarrow, S. (1994). *Power in Movement: Social movements, collective action, and politics*. New York: ambridge University press.
- Thomson, Jamie T. 1992. *A Framework for Analyzing Institutional Incentives in Community Forestry*, Rome: FAO.
- Tietenberg, Tom. 2002. "The evolution of emission trading: theoretical foundations and design considerations." Manuscript. Available from www.colby.edu/personal/t/ttieten.
- Toulmin, Camilla. 2005-06. Securing Land and Property Rights in Sub-Saharan Africa: The Role of Local Institutions. http://www.iied.org/Gov/mdgs/documents/mdg3/ch2_28pp.pdf.
- Unruh, Jon, Lisa Cligget and Rod Hay. 2005. Migrant Land Rights Reception and 'Clearing to Claim' in Sub-Saharan Africa: A Deforestation Example from Southern Zambia, *Natural Resources Forum* 29: 190-198.
- Uphoff, N. 1986. *Local institutional development: An analytical source book with cases*. West Hartford, Conn., U.S.A.: Kumarian Press.

Wallis, J. J. and D. C. North, 1986. Measuring the transaction sector in the American economy. In Long-term factors in American economic growth, ed. S. L. Engerman and R. E. Gallmann. Chicago: University of Chicago Press.

Wiber, Melanie G. 2005. The Voracious Appetites of Public versus Private Property: A View of Intellectual Property and Biodiversity from Legal Pluralism, CAPRI Working Paper # 40, July 2005.

Williamson, Oliver .1991. Comparative economic organisation: The analysis of discrete structural alternatives. *Administrative Science Quarterly* 36: 269–296.

Williamson, Oliver. 1996. *The Mechanism of Governance*. New York: Oxford University Press.

Williamson, Oliver. 1998. “Transaction cost economics: how it works; where it is headed.” *De Economist* 146 (1): 23-58.

Williamson, Oliver. 2000. “The New Institutional Economics: taking stock, looking ahead.” *Journal of Economic Literature* 38 (3): 595-613.

UNIT THREE: TRANSACTION COST ECONOMICS

🌀 Overview

Dear learner, this section will introduce transaction cost economics. In the previous first two sections, you have already gained the basic understanding concerning the concept of Institutional Economics, Institutions and organization similarities and differences. Moreover this unit gives you the opportunity to learn more about the transaction cost economics as the Vital component of the Economy. The unit is outlined to cover various topics that are related to the broader subject of transaction cost economics. These topics include definition of transaction cost economics; historical review of Characteristics of transaction cost economics; principle and scope of the Contribution of transaction cost economics to the Economy; and overview of the problems in Ethiopian transaction cost economics situations.

🌀 Objectives

Dear Learners, at the end of your study in this section, you will be able to:

- Explain the Definition of transaction cost economics
- Understand Principles and Scope of transaction cost economics /Control Criteria.
- Explain Characteristics of transaction cost economics
- Identify different Problems and Practice in Ethiopian transaction cost economics
- Explain the advantages and disadvantages of transaction cost economics

② Dear learner, can you write what are the roles of transaction cost economics in societal economic development?

3.1. Basic Terms

Transaction is a transfer of a good or service across technologically separable interfaces. Transaction costs also defined as the “costs of running the economic system. These transaction costs are distinguished as ex-ante and ex-post transaction costs. Ex-ante transaction costs include those of drafting, negotiating, and monitoring an agreement. Ex-post transaction costs is refers to the costs of mal adaption, haggling, setup, and running associated with governance and the bonding costs of securing commitment

Coase defined transaction costs as the “cost of using the price mechanism” or “cost of carrying out a transaction by means of an exchange on the open market”. In the New Institutional Economics (NIE) transaction costs are typically defined as the costs of negotiating, writing, monitoring and enforcing a contract. NIE theorists focus on the intangible costs that require indirect methods of estimation. These costs are the result of limited knowledge and information captured by the terms “bounded rationality” and “information costs.”

Bounded rationality refers to the inability to have perfect information, so that contracts that cover a period of time are inherently incomplete and may require renegotiation should unexpected events arise. Information costs refer to the unobservability of effort in gathering information, such as quality levels and knowledge, so that third parties (a judge, for example) cannot verify whether a buyer and seller have fully complied with their exchange agreements. Uncertainty refers to the inability to anticipate all possible contingencies, increasing the likelihood of renegotiating a contract. Transaction risks represent the losses incurred because of failure to enforce exclusive property rights, enforce required attributes, or complete the transaction. Spot-market transactions are the normal form of transaction in basic neoclassical economics

3.2. Origin of Transaction cost

The general hypothesis of transaction-cost economics (TCE) is that institutions are transaction-cost reducing arrangements that may change and evolve with changes in the nature and sources of transaction costs. Coase (1937) pioneered this work in his article “The Nature of the Firm,” in which he argued that market exchange is not costless. Coase underlined the important role of transaction costs in the organization of firms and other contracts. He explained that firms emerge to economize on the transaction costs of market exchange and that the boundary of a firm or the extent of vertical integration depends on the magnitude of these transaction costs. Coase was not the first to use the term “transaction costs” (the term is attributed to Arrow) but expanded on this concept in his paper “The Problem of Social Cost” (Coase 1960). His insight that the costs of reaching, modifying, and implementing agreements restrain the potential gains from trade provided the foundation for analyzing organizations and governance in terms of

transaction cost. Thus, in a world of transaction costs, the relative merits of different organizational forms depend on a comparison of the costs of transacting under each.

Arrow (1969) defined transaction costs as the “costs of running the economic system.” These transaction costs are distinguished as ex-ante and ex-post transaction costs. Ex-ante transaction costs include those of drafting, negotiating, and monitoring an agreement. Ex-post transaction costs is refers to the costs of mal adaption, haggling, setup, and running associated with governance and the bonding costs of securing commitment (Williamson 1985). Moreover, unlike market price, transaction costs are unique to each agent or firm and are related to the process of exchange itself.

Eggertson (1990) provides perhaps one of the more comprehensive discussions on the reasons for the existence of transaction costs, also emphasizing that information costs and transaction costs are not identical. When information is costly various activities related to the exchange of property rights between individuals give rise to transaction costs. These activities include: Haggling is an attempt to decide on a price or conditions which are acceptable to the person selling the goods and the person buying them, usually by arguing. Example it's traditional that you haggle over/about the price of things in the market

1. The search for information about the distribution of price and quality of commodities and labor inputs, and the search for potential buyers and sellers and for relevant information about their behavior and circumstances; 2. The bargaining that is needed to find the true position of buyers and sellers when prices are endogenous; 3. The making of contracts; 4. The monitoring of contractual partners to see whether they abide by the terms of the contract; 5. The enforcement of a contract and the collection of damages when partners fail to observe their contractual obligations; and 6. The protection of property rights against third party encroachment.

The uncertainty of the behavior of trading partners and the costs of contract negotiation identified by Eggertson are key sources of transaction costs identified in the literature. Schmid (2004), however, adds another two to the list: 1) The uncertainty of future states of the world, particularly the general level of demand and new technology and 2) The inability of the brain to deal with complex decision making (people find it difficult to deal with complexities and therefore rely on routines).

As developed by Williamson (1975, 1985, 1996); Klein, transaction cost economy maintains that the implication of positive transaction costs is that contracts are typically incomplete. Therefore, parties that invest in relationship specific assets expose themselves to the hazard that, if circumstances change, their trading partners may try to expropriate the rents accruing to specific assets (assets that have been committed to a particular transaction), a hazard known as the hold-up problem (Shelanski and Klein 1995). Transactions costs are then costs incurred by parties to protect themselves against the hold-up problem, and institutions are sets of rules, arrangements, and relationships that parties invest in to economize on such costs. Thus institutions are a means to reduce information and transaction costs. Alternatively, to follow Dorward's

(2001) argument, institutions are formed to reduce uncertainty in human exchange (or risk). Markets are only one type of social device for settling the terms of transactions. The focus here is thus on the costs of doing business, specifically, the making, monitoring, and enforcing of contracts. The ease or difficulty of contracting and the types of contract made are determined by the level and nature of transaction costs. These costs are influenced by the extent of imperfect information involved in making a transaction and the risks involved in transaction failure. Williamson (1991) identifies three major determinants of transaction costs and of transaction cost-reducing governance structures: 1) The specificity of assets involved 2) The uncertainties surrounding the transaction, and 3) The frequency of that transaction.

Ménard (2005) notes that these three variables are notoriously difficult to measure, and almost all the empirical literature avoids any attempt at measuring transaction costs directly, using instead reduced-form models in which transaction costs are assumed to be minimized. However, Williamson (1991) argues that transaction costs increase with a higher degree of asset specificity, a higher degree of uncertainty, and lower frequency of transaction. Furthermore, Williamson reasons that increases in these three variables are associated with shifts from spot markets to hybrid to hierarchical forms of governance, the last form involving vertical integration or a variety of alternative governance structures or institutional arrangements of economic organization.

The working hypothesis of TCE is thus that economic organization is an effort to align transactions, which have different attributes, with governance structures, with different costs and competencies, in a cost-economizing way (Williamson 1991). More precisely, it is an effort to maximize profits allowing for trade-offs among risks of contracting; transaction costs required to reduce those risks; and normal production (or transformation) costs, risks, and revenues (Dorward 2001). Conventional analysis of market failures makes use of two attributes to distinguish among four basic types of goods and services: excludability and subtractability (or rivalness) of use. Excludability relates to the difficulty of restricting those who benefit from the provision of a good or a service. Subtractability or rivalness refers to the extent to which one individual's use subtracts from (or rivals) the availability of a good or service for consumption by others. Both of these attributes can range from low to high and can be used as the defining attributes of the following basic types of goods: Private goods have both high excludability (through private property rights) and high subtractability. When a private good (or service) is consumed, there is nothing left for the next consumer. Examples include food, clothing, and consumer goods. Toll goods (sometimes referred to as club goods) have high excludability (people can be excluded through payment of tolls or memberships) and low subtractability. Examples include roads and various services for which fixed costs are high relative to variable costs and use is low relative to capacity. Subtractability generally increases as utilization increases.

Public goods yield non subtractive benefits that can be enjoyed jointly by many people who are hard to exclude from obtaining these benefits. Examples include enjoyment and use of general environmental services, such as clean air, and institutional services, such as law and order. Common pool resources have low excludability, but the use

of such a resource subtracts from that resource. Examples include natural fisheries and common lands used for grazing, hunting, or extraction of other natural resources. Merit goods are those with private good characteristics but that yield further non-excludable positive externalities. Examples include education and health services, which provide immediate excludable and subtractable benefits to individuals, but their use by individuals provides further benefits to society as a whole (by raising the productivity of labor).

Note that increasing population pressure and/or economic growth often cause subtractability or rivalness to increase, whereas technical and institutional changes can lead to changes in exclusion costs. Thus, for example, subtractability in the use of fisheries increases with increasing fishing intensity. With regard to excludability, although digital technology has made the copying of music much easier and hence reduced excludability in the music industry, new electronic surveillance and tracking technologies allow better low-cost control of access to fisheries and toll goods, such as roads. Increases in excludability may also be achieved by changes in institutional arrangements.

3.3. Definition and Measurement of Transaction Costs

Transaction costs are often understood as those costs that are beyond the direct costs (market price times volume) of factor inputs into production but that are incurred in making a trade. Their importance lies in determining the effective price faced by a buyer or seller, where effective price includes both the “sticker” price of a good and the hidden costs that the buyer and seller face to transfer ownership of the good. Transaction costs can lower the effective price a seller receives and raise the effective price a buyer pays. As a result, the same product made with the same materials and labor can have vastly different prices across sectors and regions because of the transaction costs incurred in making the exchange. Firms have several options; they may (1) refrain from using the market, (2) allocate resources differently or (3) create special contractual relationships to avoid or minimize transaction costs.

The term “transaction cost” has a broad range of definitions and empirical approaches. Even within one discipline like economics, various branches of transaction cost analysis exist, each with a separate focus and methodology. Distinctions also exist depending on whether study includes government agency costs or only individual agent costs. We introduce the basic concepts of transaction cost economics with an overview of the two main branches of this literature. The first, the Coasian approach, focuses on the quantification of transaction costs and the impact on volume of trade. The second, the New Institutional Economics (NIE) approach propagated by Oliver Williamson, emphasizes the design of institutions and contracts to minimize unobservable transaction costs that are not directly quantified. These two approaches form a basis for establishing an analytical framework.

3.2. What are the exact clear differences and relationships between Relationship between transaction and transaction cost economics?

3.3.1 Trade-volume approach`

Coase viewed transaction costs as the “cost of using the price mechanism” or “cost of carrying out a transaction by means of an exchange on the open market” (Coase, as quoted in Wang, 2003). The focus is on how transaction costs affect the volume of trade and market participation. In the context of environmental policy, the problem of transaction costs extends to the task of creating a market for negative environmental externalities, which in turn can affect the transaction costs of polluting entities. Negative environmental production externalities are those environmental costs not borne by the buyers or sellers. The regulatory infrastructure that creates and facilitates emissions trading represents the effort to define these externalities and bring them into a system of market trading, thus internalizing them in the emitters’ production decisions.

Coase (1960) observed the problem of an externality and argued that assigning property rights would lead to an optimal level of pollution that balances its benefits and costs because it incorporates the costs and benefits of the externality into the owner’s allocation decisions. Figure 1 illustrates a basic exposition of transaction cost effects on the market for emissions trades. The figure shows the supply and demand for emissions reductions. The demand curve is from the point of view of a buyer: in this case, a developer or investor that seeks to meet an emissions reduction target. The sellers represented by the supply curve are landowners, households, utilities, and others who are able to generate emissions reductions and present them to the market for sale. At a price P_0 a quantity Q_0 of emissions reduction is traded. The effect of a transaction cost ($PT - P_1$) is to increase the price of the reductions from P_0 to PT . Since the demand for reductions is lower at this price, the transaction cost results in a new and higher equilibrium price of PT while reducing the quantity of emissions traded from Q_1 to Q_T . The seller receives a price P_1 while the buyer pays a price PT .

Figure 1. Effect of transaction costs on market for emissions reductions

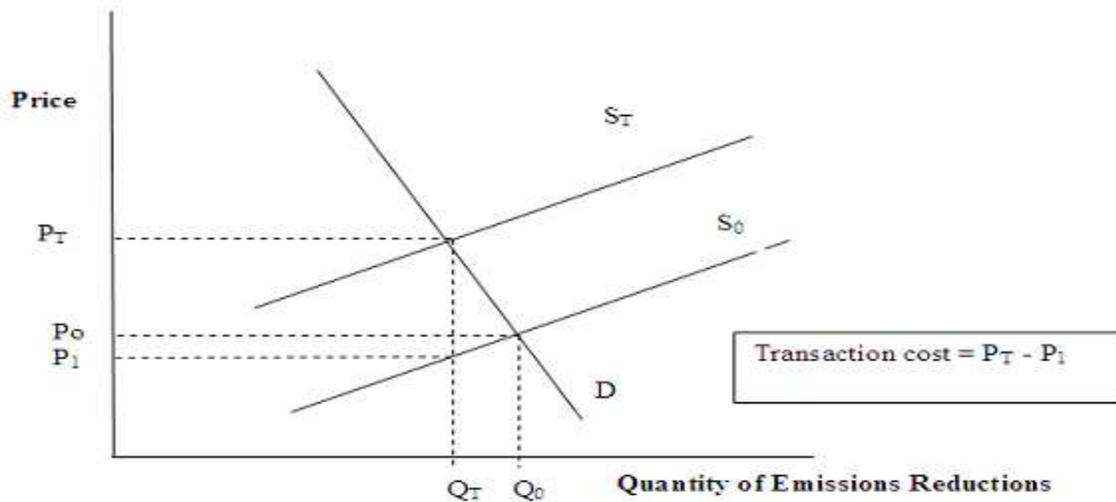


Figure 1 Effect of transaction costs on market for emissions reductions

The supply curve S_T is shown a parallel shift away from S_0 . However, there are variations other than the parallel shift of the supply curve that may affect trade and market participation. The supply curve may shift downward or upward over time in a non-parallel manner or rotate depending on factors generating transaction costs to the “producer.” Stavins (1995) developed a theoretical model illustrating similar effects, where the main results are that transaction costs can significantly reduce the volume traded and that initial allocations (e.g. quotas) matter to those costs and trade volumes.

There has been a great deal of difficulty in measuring transaction costs empirically, partly due to the inconsistency in terminology and partly because production and transaction costs are jointly determined in econometric analysis, making problematic empirical analysis that implies a direction of causality. Therefore, both comparable quantitative definitions of transaction costs and estimation methods that imply causality have few examples in the literature using the Coasian approach. Benham et al. (2004) and Wang (2003) seek a consistent terminology based on Coase’s “cost of exchange” concept where a direct measure of transaction costs is the economic value of total resources (money, time and goods) for an individual with certain characteristics to obtain a good using a given form of exchange in a given institutional setting. Four factors may affect the level of transaction costs: 1. Individual characteristics, such as each person’s or firm’s opportunity costs, experience, skills, personal networks; 2. Characteristics of the good traded; 3. Form of exchange, such as a formal or informal market, or pecuniary 4. Or barter exchange, specific contract clauses and terms for a trade; and 4. Institutional setting, such as country or social and legal environments.

This approach is fundamentally comparative. The value of transaction costs across observations grouped according to the above characteristics should be associated with changes in transaction costs levels, according to these hypotheses. For example, the “transaction” costs of installing a telephone in two weeks range from \$130 in Malaysia to \$6000 in Argentina (Benham and Benham (2001)). If such differences are

significant, it becomes possible to envision strategies to minimize such costs by introducing policies that mitigate the impact of these factors.

Several studies use a form of the above transaction cost definition and compare costs levels against factors that relate to the above list (Colby, 1990; Falconer et al., 2001; Fang et al., 2005; McCann and Easter, December 2000). Colby's (1990) study of water markets defines transaction costs as the cost of searching, ascertaining characteristics of water commodities, negotiation, and legal approval for change in water use. She compares the costs of the latter category, which she terms "policy-induced transaction costs," as they differ across states, and is affected by time delays, frequency of protests to the change, and types of transfers. Kuperan et al.(1998) compares similar categories of costs across alternative institutions for fisheries management in San Salvador, concluding that differences between government management and co-management at a local level are not large and that evidence supports the argument that co-management is less costly. Few studies translate the transaction cost measures into a framework for empirical estimation with econometric techniques. Exceptions are Falconer et al. (2001) and Fang et al., 2005 who emphasize the importance of including public sector costs in assessing policy options.

McCann and Easter (2000) analyze the public sector transaction costs of non-point source pollution abatement in agriculture. Empirical results from regressing transaction costs, measured as planning and administration costs of National Resource Conservation Service field offices, on public and private abatement costs and dummies for region and conservation system reveal that abatement levels increase transaction costs, which were 38 percent of total conservation costs.

Thus, abatement levels will be less than optimal due to transaction costs, unless policy measures can be designed to minimize those costs. Falconer et al., (2001) analyzes transaction costs as the public sector administration costs for an environmental program in England. They link this level of transaction costs with causal factors, including number of participants, acreage, participant experience and geographic location as independent variables in an econometric model using the within-groups estimator. The data suggested the existence of size economies with regard to the numbers of agreements made in any one geographic location, and a significant effect of scheme experience in exerting downward-pressure on administrative costs.

3.3.2. New Institutional Economics (NIE) Approach

In the New Institutional Economics (NIE) literature, transaction costs are typically defined as the costs of negotiating, writing, monitoring and enforcing a contract (Williamson, 1985 and 1991). NIE theorists focus on the intangible costs that require indirect methods of estimation. These costs are the result of limited knowledge and information captured by the terms "bounded rationality" and "information costs." Bounded rationality refers to the inability to have perfect information, so that contracts that cover a period of time are inherently incomplete and may require renegotiation should unexpected events arise. **Information costs** refer to the unobservability of effort in gathering information, such as quality levels and knowledge, so that third parties (a judge, for example) cannot

verify whether a buyer and seller have fully complied with their exchange agreements. Both phenomena lead to opportunistic behavior specifically dubbed in the transaction cost literature as the “hold-up problem.” If quality and effort are unobservable, one side of the trade, the seller for example, can demand a higher price after the other side has invested capital resources in trading with that particular party, making it costly to exit the agreement. NIE theory hypothesizes that firms and individuals assess the probability of this situation and structure their production relationships or contracts to lower their exposure to this “hold-up risk.” Much of the NIE research analyzes how buyers and sellers design their contracts or other forms of exchange to minimize hold-up risk. At this level of analysis, the presence of four main production characteristics is likely to increase transaction costs by increasing exposure to holdup risk:

Asset specificity

Asset specificity arises when an asset has less value with an alternative trading partner. Asset specificity creates bilateral dependency, thereby posing a loss to the asset owner if the other party leaves the agreement. Genetically modified seedlings developed to suit only one trading partner, or modifying cropland for a forest plantation project where alternative buyers are few, represent specific asset investments. A variation of asset specificity is a dedicated asset where someone would not buy an asset needed for production but for the prospect of trading that product. For example, van Kooten, C. et al., (2002) surveyed landowners in Canada to determine the preferred land-use contract for carbon sequestration activities. They found that asset specificity manifested in the form of developed land and investment in cropping equipment - tractors, combines, etc.- may be an impediment to afforestation projects. Therefore, transaction costs were a significant obstacle to conversion of agricultural land to large-block plantation forests.

Solomon (1999) suggests that asset specificity in the emissions trading market consists of the degree of credit fungibility (e.g. if the credit is tradable across regulatory regimes) or geographic restrictions to trade. This would affect a buyer’s choice between internal or external generation of the emissions reduction, or trade in Sweden versus Germany, for example, to reduce overall transaction costs.

Uncertainty refers to the inability to anticipate all possible contingencies, increasing the likelihood of renegotiating a contract. The negotiation that ensues is considered a transaction cost.

Frequency of trade raises transaction costs, when the buyer or seller has to reenter the market frequently, search for new trading partners and arrive at agreements for each trade (Williamson, 1985). This effect is distinguished from situations where the trader gains experience with more trades, thereby lowering transaction costs.

4. Complexity of a production process, as it increases, may require continual adjustments over time and non-verifiable quality and effort levels. Negotiating with engineers external to the firm, for example, over technically complex trades becomes more time consuming and increases transaction costs. Application of a new technology in a climate change project, for example, may incur higher transaction costs than an established system. The empirical strategy to estimate the impact of transaction costs on trade most often involves translating the above four characteristics of trade into categorical variables or

proxies to predict which trade mechanisms buyers and sellers choose. A typical choice is between vertical integration and outside production services contracting. The structure of empirical analysis is then to predict the probability of choosing one form of exchange over another, given the trade characteristics. Therefore, this empirical exercise measures the implications of transaction costs associated with increased risks to contracting parties due to unforeseeable events and unobservable behavior when buyers and sellers have different objectives. This approach does not provide the direct measures of the magnitude of transaction costs but rather their impact, proxied by categorical variables, on economic organization. This method avoids much of the problems of joint determination between costs and production which plague direct estimations of transaction costs and shows how the right institutional choice can minimize transaction costs, as revealed by choices of trading partners who implicitly recognize the differential transaction costs of contracting and given production characteristics and the trading environment.

Institutional economics analysis also encompasses broader environments in which trading takes place. A trading environment or forum can be affected by social values, norms and customs that change only slowly but nevertheless influence modes of exchange, as well as the laws, legal procedures and the regulatory system promulgated by governments which shape and constrain the possibilities for exchange (Williamson, 1998). For those concerned with climate change mitigation, the full range of analytical levels is relevant in the current, emerging stage of offset trades. Governments can consider how to design institutions and motivate use of those institutions, while potential traders can consider how to reduce costs, including risk, through structuring a trade given the nature of the exchange and the options available.

Ⓢ Summary

In this unit, we discussed the Nature of transaction cost economics. We discussed the definition of transaction cost economics. We also discussed the identification of transaction cost economics. We also went ahead to discuss the types of transaction cost economics. And lastly we discussed the advantages and disadvantages of transaction cost economics. Transaction Cost Theory understands that the total cost of production consists of production and transactions costs, transaction costs being great-ly influenced by the institutional structure of the production-transaction sequence. According to Transaction Cost Theory three dimensions of transactions, asset specificity, uncertainty and frequency explain a great deal about transaction costs created in various institutional arrangements. This assumption was supplemented by externalities defining whose costs will be taken into account as transaction costs. Transaction Cost Economics believes in a kind of an evolutionary development of institutions and governance structures. In changing circumstances some institution-al arrangements either get and increasing need for changes of become obsolete and must be abandoned. What exists and survives, must be efficient!



Learning Activity 3

Answer the following questions

Part I. multiple choice questions

1. According to Arrow (1969) _____ cost defined as the costs of running the economic system.
A. Transaction cost B. Transportation cost C. Opportunity cost
D. Sunk cost E. Information cost F. None
2. Arrow (1969) classified transaction costs as _____ and _____ transaction costs.
A. Ex-ante and ex-post B. Transaction and information C. Direct and indirect
D. Economic and Financial cost E. Sunk cost and indirect cost F. None
3. _____ costs includes those of drafting, negotiating, and monitoring an agreement
A. Ex ante transaction cost B. Ex-post transaction costs C. Economic cost
D. Financial cost E. All F. None
4. Unlike market price, transaction costs are unique to each agent or firm and are related to the process of exchange itself a) True b) False
5. Which of the followings are the major determinants of transaction?
A. The specificity of assets involved B. The uncertainties surrounding the transaction
C. The frequency of that transaction D. All E. None
6. Transaction Cost is defined as the costs of doing business, specifically, the making, monitoring, and enforcing of contracts. a) True b) False
7. Which of the following may not be the reasons for the existence of transaction costs?
A. The search for information about the distribution of price and quality of commodities and labor inputs, B. The search for potential buyers and sellers and for relevant information about their behavior and circumstances. C. The bargaining that is needed to find the true position of buyers and sellers when prices are endogenous D. The inability of the brain to deal with complex decision making E. The enforcement of a contract and the collection of damages when partners fail to observe their contractual obligations. F. All G. None
8. Parties that invest in relationship specific assets expose themselves to the hazard that, if circumstances change, their trading partners may try to expropriate the rents accruing to specific assets (assets that have been committed to a particular transaction), a hazard known as A. Hold-up problem B. Moral hazards C. Adverse selection D. Asymmetric information E. All . None
9. _____ relates to the difficulty of restricting those who benefit from the provision of a good or a service. A. Excludability B. Subtract ability or C. rivalness D. All
E. B and C F. None
- 10 _____ refers to the extent to which one individual's use subtracts from the availability of a good or service for consumption by others.
A. Excludability B. Subtractability C. Rivalness D. All E. A and C F. None
11. The two attributes that used to distinguish among four basic types of goods and services in conventional analysis of market failures are:
A. Excludability and subtractability B. Subtractability and rivalness C. Excludability and rivalness D. All E. A and C F. None

12. All of the followings are considered as public goods but: A. Enjoyment and use of general environmental services B. Clean air C. Institutional services D. Law and order E. Food and clothing F. None
13. All but one is considered as common pool resource?
A. Natural fisheries B. Common lands used for grazing. C. Common lands used for hunting, or extraction of other natural resources D. Education and health services E. All F. None
14. A type of good that has private good characteristics but yield further non excludable positive externalities.
A. Privet goods B. Club goods C. Common goods D. Merit goods E. All F. None

Part II. Fill the in the Blank Spaces

- 1 Transactions costs are then costs incurred by parties to protect themselves against the hold-up problem, and _____ are sets of rules, arrangements, and relationships that parties invest in to economize on such costs
2. _____ are only one type of social device for settling the terms of transactions.
3. _____ transactions are the normal form of transaction in basic neoclassical economics
4. _____ goods have both high excludability and high subtractability
- 5 _____ goods sometimes referred to as club goods
6. _____ are often understood as those costs that are beyond the direct costs (market price time's volume) of factor inputs into production but that are incurred in making a trade
7. The two approaches that form a basis for establishing an analytical framework for transaction costs are _____ and _____
8. _____ approach of measuring transaction costs, focuses on the quantification of transaction costs and the impact on volume of trade. 9. _____ approach measuring transaction costs propagated by Oliver Williamson, emphasizes the design of institutions and contracts to minimize unobservable transaction costs that are not directly quantified.
10. Coase viewed transaction costs as the _____ by means of an exchange on the open market



Self check exercise

Part III. Answer the following questions

1. Describe and explain the four factors may affect the level of transaction costs according tp Volume Based Approach?
2. Clearly explain the difference between NIE Approach and Volume Based Approach? 3. Much of the NIE research analyzes how buyers and sellers design their contracts or other forms of exchange to minimize hold-up risk. At this level of analysis, the presence of four main production characteristics is likely to increase transaction costs by increasing exposure to holdup risk. List and explain briefly?
4. What do you mean by asset specificity?

5. Compare and contrast the followings A. Transaction and transaction cost B. Transaction cost and information cost C. Uncertainty and risk D. Transaction and transaction risk E. Bound rationality and information cost

*. Mention Characteristics of transaction cost economics?

REFERENCES

Aoki, M. , 2001. toward a comparative institutional analysis. Cambridge, Mass., U.S.A.: MIT Press.

ARD, Inc., 2005. Land Tenure and Property Rights (LTPR) Framework and Tools, Burlington, Vermont. Documents may be requested from ard@ardinc.com.

Ashley, Caroline and Christopher LaFranchi. 1997. Livelihood strategies of rural households in Caprivi: implications for conservancies and natural resource management. DEA Research Discussion Paper 20. Windhoek: DEA.

Bardhan, P. K. 2001. Institutions, reforms and agricultural performance. In Current and emerging issues for economic analysis and policy research, ed. K. G. Stamoulis. Rome: Economic and Social Department, Food and Agriculture Organization of the United Nations.

Bromley, Daniel. 2003. The Commons, Common Property, and Environmental Policy. In B. Larson (ed.) Property Rights and Environmental Problems, Volume I. Burlington: Ashgate Publishing Company, pp. 83-99.

Cavendish, William. 1999. Empirical Regularities in the Poverty-Environment Relationship of African Rural Households, the Centre for the Study of African Economies Working Paper Series, Paper 105.

Coase, R. H. 1992. The institutional structure of production. American Economic Review 82 (4): 713-719.

Coase, Ronald. 1961. "The problem of social cost." Journal of Law and Economics 3:1-44.

Coase, Ronald. 1937. "The nature of the firm." *Economica* 4: 386-405.

Coase, Ronald. 1988. *The Firm, the Market and the Law*. University of Chicago Press.

Coase, Ronald. 1992. "Comments on Cheung." In *Contract Economics*, edited by Lars Werin Davis, L. E., and D. C. North. 1971. *Institutional change and American economic growth*. Cambridge: Cambridge University Press.

Dorward, A. R. 2001. The effects of transaction costs, power and risk on contractual arrangements: A conceptual framework for quantitative analysis. *Journal of Agricultural Economics* 52 (2): 59-74.

Dorward, A. R., J. G. Kydd, J. A. Morrison, and C. Poulton. 2005. Institutions, markets and economic coordination: inking development policy to theory and praxis. *Development and Change* 36 (1): 1-25.

Dorward, A. R., J. Kydd, and C. Poulton. 2005a. Coordination risk and cost impacts on economic development in poor rural areas. Paper presented at the Agricultural Economics Society Conference, Nottingham, U.K., April.

- Fernandez-Gimenez, Maria. 2006. Land Use and Land Tenure in Mongolia: A Brief History and Current Issues, USDA Forest Service Proceedings RMRS-P-39 http://www.fs.fed.us/rm/pubs/rmrs_p039/rmrs_p039_030_036.pdf.
- Fischer, Julie E. et al. 1995. Atelier Régional de N'Zérékoré sur la Problématique Foncière et la Gestion des Ressources Naturelles en Guinée Forestière, Workshop Report. Madison, Wisconsin: Land Tenure Center.
- Food and Agriculture Organization. 2002a. Land Tenure and Rural Development, FAO Land Tenure Series 3. Rome: FAO.
- Hall, P. A., and D. Soskice, eds. 2001. Varieties of capitalism: The institutional foundations of comparative advantage. Oxford: Oxford University Press.
- Kinder, D. R., & Sears, D. O. (1985). Public opinion and political action. In G. Lindzey, & E. Aronson (Eds.), Handbook of Social Psychology (pp. 659-741). New York: Random House.
- Lawry, Steven W. 1990. Tenure Policy toward Common Property Natural Resources in Sub-Saharan Africa, Natural Resources Journal 30 (Spring): 403-422.
- Mathieu, Paul, Philippe Lavigne Delville, Lacinan Pare, Mahamadou Zongo, Hubert Ouedraogo with Julianne Baud, Eric Bologo, Nadine Kone, Karine Triollet. 2003. Making Land Transactions More Secure in the West of Burkina Faso, IIED Drylands Program, Issue Paper No. 117, London: IIED. <http://www.iied.org/pubs/pdf/full/9170IIED.pdf>.
- Meinzen-Dick, Ruth, Rajendra Pradhan, and Monica Di Gregorio 2004. Understanding Property Rights. In Meinzen-Dick, Ruth and Monica Di Gregorio (eds.) Collective Action and Property Rights for Sustainable Development, Focus 2020, Brief 3, Washington DC: IFPRI.
- Norfolk, Simon. 2004. Examining Access to Natural Resources and Linkages to Sustainable Livelihoods: A Case Study of Mozambique, Livelihood Support Programme Working Paper 17. Rome: FAO.
- North, D. C. 1990. Institutions, institutional change and economic performance. Cambridge: Cambridge University Press.
- Oliver, P. (1980). Rewards and punishments as selective incentives for collective action: Theoretical investigations. American Journal of Sociology, 85,1356-1375
- Olson, M. (1965). The logic of collective action: Public goods and the theory of groups. Cambridge, M A : Harvard University Press.
- Ostrom, E. 1990. 2005b. Understanding institutional diversity. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, E. 1990. Governing the commons: The evolution of institutions for collective action. Cambridge: Cambridge University Press.
- Ostrom, E. 2005a. Doing institutional analysis: Digging deeper than markets and hierarchies. In Handbook of New Institutional Economics, ed. C. Ménard and M. Shirley. Dordrecht: Springer.
- Ostrom, E. 2005b. Understanding institutional diversity. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, Elinor. 1999. Private and Common Property Rights. In Boudewijn, Bouckaert and Gerrit De Geest (eds) Encyclopedia of Law and Economics, Vol. 1 The History

- and Methodology of Law and Economics, Edward Elgar and The University of Ghent, pp 332-379. <http://encyclo.findlaw.com/2000book.pdf>
- Safia Aggarwal and Kent Elbow, 2006. Rights in Natural Resource Management, Good Governance And Empowerment of The Rural Poor. United States Agency for International Development, ARD, Inc.159 Bank Street, Suite 300, Burlington, VT 05401 Tel: 802 658-3890, Fax 802 658-4247 www.ardinc.com
- Shackleton, Sheona, Charlie Shackleton and Ben Cousins. 2000. Re-valuing the Communal Lands of Southern Africa: New Understandings of Rural Livelihoods, ODI Natural Resource Perspectives Number 62, November 2000.
- Smon, B. (1998). Individuals, groups, and social change: On the relationship between individual and collective self-interpretations and collective action. In C. Sedikides, J. Schopler, & C. Insko (Eds.), Intergroup cognition and intergroup behavior (pp. 257-282). Mahwah, N J : Lawrence Erlbaum.
- Soloman, Barry. 1999. "New directions in emission trading: the potential contribution of new institutional economics." *Ecological Economics* 30: 371-87.
- Tarrow, S. (1994). *Power in Movement: Social movements, collective action, and politics*. New York: ambridge University press.
- Thomson, Jamie T. 1992. *A Framework for Analyzing Institutional Incentives in Community Forestry*, Rome: FAO.
- Tietenberg, Tom. 2002. "The evolution of emission trading: theoretical foundations and design considerations." Manuscript. Available from www.colby.edu/personal/t/thtieten.
- Toulmin, Camilla. 2005-06. *Securing Land and Property Rights in Sub-Saharan Africa: The Role of Local Institutions*. http://www.iied.org/Gov/mdgs/documents/mdg3/ch2_28pp.pdf.
- Unruh, Jon, Lisa Cligget and Rod Hay. 2005. Migrant Land Rights Reception and 'Clearing to Claim' in Sub-Saharan Africa: A Deforestation Example from Southern Zambia, *Natural Resources Forum* 29: 190-198.
- Uphoff, N. 1986. *Local institutional development: An analytical source book with cases*. West Hartford, Conn., U.S.A.: Kumarian Press.
- Wallis, J. J. and D. C. North, 1986. Measuring the transaction sector in the American economy. In *Long-term factors in American economic growth*, ed. S. L. Engerman and R. E. Gallmann. Chicago: University of Chicago Press.
- Wiber, Melanie G. 2005. *The Voracious Appetites of Public versus Private Property: A View of Intellectual Property and Biodiversity from Legal Pluralism*, CAPRi Working Paper # 40, July 2005.
- Williamson, O. E. 1985. *The economic institutions of capitalism*. New York: Free Press.
- Williamson, Oliver .1991. Comparative economic organisation: The analysis of discrete structural alternatives. *Administrative Science Quarterly* 36: 269–296.
- Williamson, Oliver. 1975. *Markets and Hierarchies*. New York: Free Press.
- Williamson, Oliver. 1996. *The Mechanism of Governance*. New York: Oxford University Press.
- Williamson, Oliver. 1998. "Transaction cost economics: how it works; where it is headed." *De Economist* 146 (1): 23-58.
- Williamson, Oliver. 1999. *The New Institutional Economics: Taking stock and looking ahead*. Address to the International Society for New Institutional Economics. ISNIE Newsletter 2 (2): 9–20.

Williamson, Oliver. 2000. "The New Institutional Economics: taking stock, looking ahead." *Journal of Economic Literature* 38 (3): 595-613.

UNIT FOUR: COLLECTIVE ACTION

Introduction

Dear learners! In the previous units you have already learned a lot about Entrepreneurship, entrepreneur and management, and the vital role of small business in the economic development as a result it is expected that you have developed basic understanding of these topics. To capitalize on what you have already understood, in this unit you will learn different Forms of Business Ownership such as Sole Proprietorship Option, the Partnership Option and the corporation option will be discussed in this unit.

⊗ Objectives

At the end of this chapter you should able to;

- Describe the major aspects of collective action
- Explain the Roles of Collective Actions
- Explain those Supporting Institutions that govern Collective Action
- Describe the Determinants of Collective Action
- Discuss the various forms of business organization
- Describe the Sole Proprietorship Option of the Business
- Describe The Partnership Option of the Business
- Describe the corporation option of the Business
- Identify some criteria for choosing the ownership form
- Understand some legal considerations

Section One: Concepts of Collective Action

Overview

⊗ Dear learners, this section is about the Concepts of Collective Action involved in institutional economics.

⊗ Objectives:

Dear learner after reading this lesson you can be able to: -

- Explain the Concepts and Roles of Collective Actions

1.2. Explain the Concepts and Roles of Collective Actions

⊗ Dear learners, can you list the definitions and major Roles of Collective Actions?(Please write your response on the space provide below)

Collective action can be understood as an action taken by a group of individuals to achieve common interests. This collective action refers to the collaboration of two or more

individuals in pursuit of a common goal: Collective action ranges all the way from unorganized custom to the many organized going concerns, such as the family, the corporation, the trade association, the trade union, the reserve system, the state. The principle common to all of them is greater or less control, liberation and expansion of individual action by *collective action* (Commons 1931: 650). Economics is based on collective action in the form of transactions that involve the exchange of resources:

Either the state, or a corporation, or a cartel, or a holding company, or a co-operative association, or a trade union, or an employers' association, or a trade association, or a joint trade agreement of two associations, or a stock exchange, or a board of trade, may lay down and enforce the rules which determine for individuals this bundle of correlative and reciprocal economic relationships. Indeed, these collective acts of economic organizations are at times more powerful than the collective action of the political concern, the state (Commons 1931: 650). An institution is "collective action in control, liberation and expansion of individual action" (Commons 1931: 651). Analysis of these collective sanctions provides the correlation of economics, jurisprudence, and ethics which is prerequisite to a theory of institutional economics. An area of considerable interest in NIE literature concerns collective action.

Indeed, Schmid (2000) goes as far as to argue that "the main agenda of institutional economics is collective action." Collective action arises when people collaborate on joint action and decisions to accomplish an outcome that involves their interests or well-being (Sandler 1992). Collective-action problems are typically characterized by interdependency among the participants, so that the contributions or efforts of one individual influence the contributions or efforts of others, no wider benefits are produced, and all are worse off if they each act to maximize their own narrow self-interests.

The economic theory of collective action is concerned with the provision of public goods (and other goods and services that are collectively consumed) through the collaboration of two or more individuals and with the impact of externalities on group behavior. Although there are many instances in which individuals would be better off if they cooperated, collective action often does not emerge. Problems typically arise over imbalances among contributions to the effort and the distribution of benefits from the creation of public or collective goods, known as the free-rider problem. The foundation of this work was Olson's (1965) book *The Logic of Collective Action*. The theory of collective action is a useful tool to analyze how to overcome free-rider problems and fashion cooperative solutions for the management of common resources or the In the analyses of economics and political science, free riders are actors who take more than their fair share of the benefits or do not shoulder their fair share of the costs of their use of a resource, involvement in a project, or the like. The free-rider problem is the question of how to prevent free riding from taking place, or at least limit its effects. provision of public goods. Collective action differs from other coordination mechanisms in that it involves pooled decisions within a group, whereas in hierarchies (such as firms) delegated decisions are made, and individuals operate in terms of independent decisions.

An important field of investigation in the theory and application of collective action concerns the use of common-pool resources, such as water, land, fisheries, and forests. In the past, the solution to the so-called tragedy of the commons was the establishment of enforceable property rights over the resources. However, recent work by Ostrom (2005b) and others has shown that local institutional arrangements, including customs and social conventions designed to induce cooperative solutions, can overcome the difficulties of collective action and help achieve efficiency in the use of such resources (Nabli and Nugent 1989). The key distinction here is between commons (or common-property resources) and open-access resources.

Collective action can be understood as an action taken by a group of individuals to achieve common interests (Marshall 1998). Collective action can be voluntary or obligatory for specific persons, e.g. in water users associations where all land owners in an irrigation scheme are obliged to join an association for collective action. However, we exclude hired labor and forced labor from analysis of collective action, because the incentive structure is very different. A group deciding to hire laborers, and raising the resources to hire them would be considered collective action, but the hired laborers themselves would not necessarily be participating in collective action. Members can act directly on their own or through an organization. In the next sections below, we first consider the circumstances that give rise to collective action and the different types of collective action most relevant to poverty alleviation, and then consider the supporting institutions that govern collective action.

In many communities throughout the world, people work together to provide local goods and services they would not be able to provide as single individuals or that the government is not providing. They build and maintain local parks, religious buildings and community halls, operate volunteer fire control groups, and implement rules for local natural resource management. Sometimes local groups share responsibilities for provision with local or central governments, such as in supporting schools and health services (McCarthy 2004). Collective provision of goods and services is particularly important for the poor, who are often less served by government services, and may even provide a vehicle for poverty reduction programs, such as through community driven development (CDD).

Collective action can also be used to substitute for missing markets. Self-help groups and other mutual insurance mechanisms are examples of substitutes for imperfect credit markets. For example, where people cannot access loans individually (for instance, due to lack of sufficient collateral), groups can form to collectively secure loans. Many micro-finance programs are geared towards small groups that can rely on social sanctions to enforce reciprocal obligations among group members to assure repayment of loans (Wydick 1999). Given asymmetric information, monitoring by group members is generally more cost-effective than monitoring by the lending agency. In such cases, collective action can have the double benefit of substituting for a missing market and also allowing poor people to build assets through access to credit.

Third, collective action can be used by people to increase their access to higher level institutions and as well as their clout in those institutions. For example, people can come together to demand specific government services or insist on enforcement of their property claims. Alternatively, collective action allows groups to increase their bargaining power vis-a-vis local authorities. Finally collective action can enable local groups to benefit from knowledge/resources of other groups through federated structures, e.g. in order to influence policy decisions undertaken at higher levels of government.

Moreover, collective action is often exercised to regulate access, use and maintenance of common pool resources, and often includes undertaking such specific activities as devising rules, monitoring use, devising enforcement mechanisms and implementing sanctions. The role of collective action in natural resource management is probably the well-studied context of collective action. However, collective action can also be exercised to create institutions discussed above, e.g. Parent-teachers associations, burial societies, self-help groups, civic movements, as well as resource management groups.

1.2. the Supporting Institutions that govern Collective Action

② Dear learners, can you list the Supporting Institutions that govern Collective Action?(Please write your response on the space provide below)

Collective action is often considered narrowly in terms of activities undertaken through formal organizations, but many formal organizations exist “on paper” only, and do not foster any real collective action, whereas much collective action occurs informally through social networks or even through people coming together temporarily for specific short-term purposes. Thus, as with property rights, it is essential to look at both formal and informal institutions that govern collective action. The exact role of these governance structures depends on the nature of the collective action or good(s) involved, but in general they play a key role in coordinating the actions and contributions of members. This can include setting of rules, monitoring, and sanctioning, which reduce the incentives for people to break the rules or free ride, and also provides assurance to other members that others will also be contributing. Collective action governance structures do not exist in isolation, but co-exist with and complement other governance structures, such as local and national government agencies and markets. Often, these different governance structures are not exclusive, but they may be overlapping or complementary.

1.3. the Determinants of Collective Action

② Dear learners, can you list the Supporting Institutions that govern Collective Action?(Please write your response on the space provide below)

According to Olson (1971), important determinants of success in collective action include the size, homogeneity, and purpose of the group. Building on this observation, Gaspart and Platteau (2002) argue that the success of collective action depends on two sets of factors: 1) Characteristics of the people concerned: the size of the group, the extent of heterogeneity in the group, and social capital in the group (specifically, the tradition of cooperation in other areas) and 2) Characteristics of the environment that bear on the enforcement costs of a collective scheme: technical characteristics (including the physical attributes of the resource and its location), economic characteristics (especially market conditions), and political characteristics (the role played by state institutions). TCE also provides a useful tool to evaluate collective schemes by assessing monitoring and enforcement costs and aspects of market power. Gaspart and Platteau's (2002) study of collective schemes in the Senegalese fishing industries show how an assessment of the rate of infraction of the rules adopted versus rule abidance can also predict the success or failure of collective action.

1.4. The Definition and concepts of the state

? *Dear learners, can you write what are the definition and concepts of the state?(Please write your response on the space provide below)*

Max Weber (1946) defined the state as “a human community that (successfully) claims the monopoly of the legitimate force within a given territory”. Thus for Weber the essence of “stateness” is ability to enforce. The term “the state” is a useful abstraction for certain kinds of general discussion, but for practical policy analysis it is necessary to focus on particular components of government. Furthermore, the boundaries of the state are fuzzy. For example, is a government-owned firm providing services in a market in which it competes with the private sector part of the state? Another example is provided by supranational organizations (such as COMESA [Common Market for Eastern and Southern Africa]), in which governments have pooled sovereignty in certain areas (such as the collection of border taxes).

The state, an all-encompassing term taking in all layers of government from the local to supranational level, is an important factor in most spheres of economic life and is dominant in some. It is a key source of law and has a legal monopoly over the harsher mechanisms of enforcement, such as arrest, prosecution, fining, and loss of liberty. The rules made and upheld by the state are core features of the institutional environment. But the state is also seen as an indispensable provider of certain services, including law and order, physical infrastructure, education and health, and regulation of the economy, for which it has to raise taxes. There is constant debate about which services the state should provide and the manner of their provision. Economists (both orthodox and those who pursue New Institutional Economics (NIE) find that the concepts of public goods, market failure, merit goods, and redistribution provide useful guidance in this debate, as they focus attention on needs that would not be met adequately, if at all, were provision left solely to the market.

These concepts, although very useful, are far from sufficient. In some of the literature on development policy, they can become part of an unrealistic technocratic discourse that assumes the existence of a rational, development-oriented state, backed by political leaders with similar motivation, and with adequate capacity. Certainly it is helpful to identify and rank the importance of public goods, market failures, and merit goods and to debate the possibilities for asset and income redistribution. But if this effort is done without considering key issues in the wider context, the result will be unbalanced assessments underpinning what could prove to be dysfunctional policy advice. So it is critical to examine sections of the state (that is, state organizations) in their broader social, political, economic, and cultural settings.

This examination includes determining whose interests state organizations serve, for example, those of politicians, different grades and professions of state employees, interest groups in society at large, and foreign aid donors. Related matters are the internal cultures of state organizations: how are staff members motivated and their actions regulated, and what are their accepted norms of behavior? The financial resources available to state organizations and the mechanisms of accountability are also very important.

The rules of the state are central features of the institutional environment and come out of a complex interplay of history (path dependency), culture (or habits of mind), and influences of powerful elements in society (generally, but not exclusively, the richer segments). The rules of the state can be considered as layered from the higher levels (which structure the ways in which politics affects government and property rights are recognized and enforced) to lower levels (which define the rules detailing entitlements to rights and to state services). However, the rules of the state are only one component of the institutional environment.

1.5.. Public goods, market failure, merit goods

? Dear learners, can you list Public goods, market failure, merit goods ? (Please write your response on the space provide below)

Public goods are those that are supplied by the market or are supplied in insufficient quantity. A pure public good has two key properties: (1) it does not cost anything for an additional individual to enjoy its benefits (non subtractability) and (2) it is impossible, or at least difficult, to exclude individuals from enjoyment of its benefits (non excludability). Welfare economics has a fundamental theorem: resource allocations with the property that no one can be made better off without someone else being made worse off are Pareto efficient (or optimal). There are factors that may cause markets to be Pareto inefficient, and these provide rationales for government activity: 1. Competition in the market, or at least the realistic threat of potential competition; 2. Public goods; 3. Externalities (the actions of one individual or firm imposes an uncompensated cost or benefit on other individuals or firms); 4. incomplete markets (private markets fail to provide a good, even though the costs of provision are less than what individuals would be willing to pay; incomplete markets are said to be common in insurance and finance); 5. information

failures (the market may not supply business and consumers with sufficient information); and

6. High unemployment of people and also of machinery. Category 6, which might be called systemic market failure, has been the basis of much controversy in macroeconomics and development economics. Arguments for merit goods are based on the proposition that there are cases when governments should intervene to provide the good, because individuals do not know what is in their own best interests. Thus perhaps consumers are not well informed, or suffer from “bounded rationality” or, even if well informed, still make bad decisions. Government provision of universal and compulsory primary education is often cited as a merit good. The argument is that if primary school attendance were optional, pupils (and their parents) may decide not to go to school, even though this is against their longer run interests. The argument is that Pareto efficiency (optimality) is silent about the distribution of incomes, even though the working of markets, interacting with government, may lead to a distribution of incomes that is ethically unacceptable, particularly if a significant proportion of members of the society have incomes below poverty levels. In these circumstances governments should tax wealthier groups and spend the funds on (1) pro-poor public and merit goods, (2) subsidies to the economic activities of the poor (for example, credit subsidies), and (3) direct income transfers to the poor.

1.6. Dimensions of the state

? Dear learners, can you list the dimensions of the state ? (Please write your response on the space provide below)

Max Weber and Charles Tilly both developed classic definitions of the state. According to Weber (1966), ‘[t]he state is a human community that (successfully) claims the monopoly of the legitimate use of physical force within a given territory. If the state is to exist, the dominated must obey the authority claimed by the powers that be.’ Tilly (1975) argues that ‘an organization which controls the population occupying a defined territory is a state in so far as (1) it is differentiated from other organizations operating in the same territory; (2) it is autonomous; (3) it is centralized; and (4) its divisions are formally coordinated with one another’. Both definitions stress the structural and organizational aspects of the state. They do not mention any state functions (apart from the monopoly of violence in Weber’s definition). However, both focus very much on the importance of some kind of centralized form of authority. For Weber in particular, the ideal type modern state is underpinned by a ‘rational-legal’ bureaucracy. Michael Mann (in Hall 1994) adds another important dimension to the concept of the state in his elaboration on ‘infrastructural’ power. Infrastructural power refers to the actual penetration of societies by state bureaucracies and state-sponsored programmes, such as public education, and the ability to enforce policy throughout the state’s entire territory. A defining characteristic of the ‘modern’ state in the tradition of Weber, Tilly and Mann is that ‘political power becomes progressively depersonalized and formalized’ (Chesterman et al. 2005). A range of typologies is available distinguishing among different aspects and fundamental forms of the state. These tend to characterize the state in terms of a specific dimension – be this political economy or scope, or (internal) strength and capacity –

or of a particular kind of state type (e.g. Failed states, developmental states, etc.). While it is essential to recognize the multidimensionality of the state and avoid assessing it along a linear strong-weak continuum, as will be discussed in greater detail throughout this paper, many states in the developing world, in particular those emerging from conflict or otherwise identified as fragile, often fail to meet many of the basic criteria highlighted by Weber, Tilly and Mann. These kinds of states tend to have only tenuous control of their population beyond the centre, and their infrastructural capacity (presence of state bureaucracy and services) is often minimal, up to the point where the quality of being a state becomes questionable (see Herbst 2000).

The external dimension of the state

The state is characterized not only by the internal dimensions mentioned above but also by an important external dimension. Since the peace of Westphalia (1648), the state has been the central organizational structure in international relations and the concept of 'sovereignty' has underpinned relations among states.

The principles of sovereignty, legal Mann contrasts infrastructural power with 'despotic powers' of the ruler to take decisions arbitrarily or autonomously, and especially decisions about 'life and death'. Pre-modern states – as well as rulers in highly despotic countries in the 1960s and 1970s – were often marked by considerable despotic powers but weak infrastructural powers. International relations theorists have identified the Peace of Westphalia as having several key principles, which explain its significance and impact on the world today: i) the principle of the sovereignty of states and the fundamental right of political self determination; ii) the principle of (legal) equality between states; and iii) the principle of non-intervention of one state in the internal affairs of another state. Equality and non-interventionism were furthermore enshrined in the United Nations (UN) system as it originally emerged after World War II. Since then, a state has been considered sovereign and autonomous at the international level once the UN recognizes it as such, regardless of whether or not it meets any of the criteria laid out by Weber, Mann and others. In a seminal article on quasi-states in the developing world, Robert Jackson (1990) forcefully highlighted the contradiction between the domestic and the external aspects of stateness, pointing to states that possess external judicial statehood but only very limited internal state capacity

1.7. Definition and Concepts of Common-Pool Resources

 Dear learners, can you write what are the definition and concepts of *Common-Pool Resources*?(Please write your response on the space provide below)

Common-pool resources are systems that generate finite quantities of resource units so that one person's use subtracts from the quantity of resource units available to others (E. Ostrom,

Gardner and Walker (1994)]. Irrigation systems are among the most important types of common-pool resources [E. Ostrom (1992a)]. Most common-pool resources are sufficiently large that multiple actors can simultaneously use the resource system and efforts to exclude potential beneficiaries are costly. When the resource units (e.g., water) are highly valued and many actors benefit from appropriating (harvesting) them for consumption, exchange, or as a factor in a production process, the appropriations made by one individual are likely to create negative externalities for others. The "tragedy of the commons" will occur in highly valued, open-access commons where those involved and/or external authorities do not establish an effective governance regime [G. Hardin (1968)]. Governance regimes regulate one or more of the following:

- ✓ Who is allowed to appropriate resource units
- ✓ The timing, quantity, location, and technology of appropriation
- ✓ Who is obligated to contribute resources to provide or maintain the resource system itself

How appropriation and obligation activities are to be monitored and enforced. How conflicts over appropriation and obligation activities are to be resolved; and how the rules affecting the above will be changed over time with changes in the performance of the resource system and the strategies of participants.

A self-governed common-pool resource is one where actors, who are major appropriators of the resource, are involved over time in making and adapting rules within collective-choice arenas regarding the inclusion or exclusion of participants, appropriation strategies, obligations of participants, monitoring and sanctioning, and conflict resolution. Some common-pool resources that are located far from centers of governmental authority are governed entirely by appropriators and are not governed at all by external authorities. In most modern political economies, however, it is rare to find any resource systems - including the treasuries of private for-profit corporations - that are governed entirely by participants without rules made by local, regional, national, or international authorities also affecting key decisions [V. Ostrom (1991, 1997)]. Thus, in a self-governed system, participants make many, but not necessarily all, rules that affect the sustainability of the resource system and its use. In the conventional theory of the commons, participants do not undertake efforts to design their own governance arrangements. Substantial empirical evidence exists, however, that many common-pool resources are self-governed.

1.8. Analyzing collective action problem

 Dear learners, can you write what is analyzing collective action problem ?(Please write your response on the space provide below)

Considerable theoretical turmoil exists related to the underlying “problem” of collective action-how to model social dilemma situations in light of the repeated evidence that early theoretical predictions have not been supported. The most famous social dilemma is the

Prisoner's Dilemma (PD). Traffic jams, residential flight, runs on scarce goods, extending and keeping trust in long-term relations, and the organizing of labor unions, work-teams, demonstrations, or any group seeking common interests-all can and have been modeled as social dilemmas generating collective action problems. Frequently, collective-action problems are modeled as public good games, common-pool resource games, games of trust, the dictator and ultimatum game, as well as a Prisoner's Dilemma game. Collective-action problems occur when individuals choose actions-such as whether to build and maintain irrigation system-in an interdependent situation. If each individual in such situations selects strategies based on a calculus that maximizes short-term benefits to self, individuals will take actions that generate lower joint outcomes than could have been achieved. In other words, a collective action problem can be analyzed as a game where the Nash equilibrium for a single iteration of the game yields less than the socially optimal outcome. The socially optimal outcome could be achieved if those involved "cooperated" by selecting strategies other than those prescribed by the Nash equilibrium. Since the suboptimal joint outcome is an equilibrium, no one is independently motivated to change their choice, given the predicted choices of all others. Thus, the socially desirable outcome is predicted not to occur.

In addition to the assumption regarding the structure of payoffs leading to a deficient equilibrium, further assumptions made in almost all formal models of social dilemmas include:

1. All participants have common knowledge of the exogenously fixed structure of the situation and of the payoffs to be received by all individuals under all combinations of strategies.
2. Decisions about strategies are made independently and simultaneously.
3. No external actor (or central authority) is present to enforce agreements among participants about their choices.

When these assumptions are made for a game that is repeated only once, the theoretical prediction derived from non cooperative game theory is unambiguous- zero cooperation. When uncertainty exists about the time or the number of rounds involved in a repeated game, such as would usually be the case in field settings, two theoretical developments generate more optimistic predictions than backward induction in finitely repeated games. First, Kreps et al. (1982) posited that if some individuals in a game do not follow the prescriptions of full rationality involving the maximization of expected objective outcomes to self, other fully rational players might then adopt cooperative strategies at least in the early stages of a game so as to gain the benefits of engaging in reciprocal cooperation.

Second, Fudenberg and Maskin (1986) posited that it was possible for subjects to eliminate free riding if some players made a firm commitment to follow a "grim trigger strategy." A grim trigger strategy involves a permanent switch from cooperation to defection once anyone fails to cooperate. These theoretical results have held up over the years. Instead of generating a clear and better prediction, however, they have led to an explosion of the number of possible equilibria predicted by non cooperative game theory. Among the predicted equilibria are strategies yielding the suboptimal Nash equilibrium, the optimal outcome, and everything in between (Abreau, 1988).

Thus, while empirical evidence generates some optimism that collective action can be achieved in some settings, the problem of collective action remains: How can participants avoid the temptation of suboptimal equilibria and move closer to optimal outcomes in other words, gain a “cooperators’ dividend” (Lichbach, 1996)? Developing a coherent theory of collective action related to the use of common-pool resources is a real challenge. At the individual level, individuals do take costly actions that effectively take the interests of others into account.

Shivakumar (2005) and Gellar (2005) provide evidence of local and regional groups that are successfully engaging in collective action in Somaliland and in Senegal where little cooperation occurred earlier. On the other hand, individuals may callously ignore or viciously harm others depending on the setting in which they find themselves. Thus, an important task for all social scientists is achieving a more coherent synthesis of theoretical work that posits variables affecting the likelihood of undertaking diverse forms of collective action. We must be able to explain success as well as failure of efforts to achieve collective action. Further, we need to recognize that forms of collective action differ in regard to the distribution of benefits and harms to those in a group and those who are external to it.

In section 4.8.1 the growing and extensive theoretical literature positing a host of structural variables presumed to affect the likelihood of individuals achieving collective action to overcome social dilemmas will be discussed. None of these structural variables, however, should really make any difference in the probability of successful collective action if we continue to treat the model of rationality that has proved successful in explaining behavior and outcomes in competitive market settings as a universal theory of human behavior. Thus, the section 4.8.2 this chapter we will examine how a theory of boundedly rational, norm-based human behavior is a better foundation for explaining collective action than a model of maximizing material payoffs to self. If one posits that individuals can use reciprocity and reputations to build trust in dilemma situations, then one can begin to explain both successful and unsuccessful efforts to overcome social dilemmas through collective action.

1.9. Factors affecting collective action



Dear learners, can you write what are Factors affecting collective action?(Please write your response on the space provide below)

A rich array of theoretical speculations, formal game-theoretic models, and computer models of evolutionary processes have generated a long list of structural variables that are frequently postulated to affect the likelihood that a set of participants will be able to achieve outcomes greater than the deficient Nash equilibrium-or, the cooperators’ dividend (Lichbach, 1996). Let us first focus on structural variables that do not essentially depend on a situation being repeated. These include:1) the number of participants involved; 2)

whether benefits are subtractive or fully shared (i.e., public goods vs common-pool resources); 3) the heterogeneity of participants; and 4) face-to-face communication. Then, we will focus on situations where repetition of the situation makes possible the impact of additional structural variables including: 5) information about past actions; 6) how individuals are linked; and 7) whether individuals can enter or exit voluntarily. Let us turn to a brief discussion of these seven major variables and how they are posited to affect the possibility of collective action and the size of benefits achieved.

Situations where repetition is not relevant

Among the variables that are posited to affect the likelihood of participants overcoming a social dilemma are four variables considered to be important whether or not the situation is repeated: the number of participants, whether benefits are subtractive or fully shared, their heterogeneity, and whether they can communicate

1) The number of participants involved

In his influential book *The Logic of Collective Action*, Mancur Olson (1965) argued that as the size of a group increased, the probability of a group achieving a public good decreased and the extent of non optimality increased-for two reasons. First, as group size increases, the notice ability of any single input to the provision of public good decline. It is then easier for the individual to think that their own free riding will not be noticed and thus it will not affect the likelihood that the good will be provided. Second, coming to an internal agreement about coordinated strategies in larger groups involves higher transaction costs. Thus, a core theoretical hypothesis has been that the number of participants will likely reduce the probability of achieving any form of collective action or at least diminish the amount of joint benefits that could be achieved.

2) Subtractive versus fully shared benefits

Olson originally included all dilemmas where it was difficult to exclude potential beneficiaries, whether or not they had contributed. This analysis confounded situations where the consumption of benefits by one individual subtracted benefits from others with situations where consumption was non subtractive in nature (characterized as having full jointness of supply-see Ostrom and Ostrom, 1999). In a public good environment, increasing the number of participants tends to bring additional resources that could be drawn on to provide a benefit that will be jointly enjoyed by all. It is because of the additional resources available in a larger group and the non subtractability characteristic of public goods that Marwell and Oliver (1993) conclude that when “a good has pure jointness of supply, group size has a positive effect on the probability that it will be provided.”

Goods that are subtractable in nature are better defined as common-pool resources (CPRs) (Ostrom et al., 1992). Social dilemmas related to CPRs share with public good provision the problems of free riding, but they also include the problems of overharvesting and crowding. Important types of CPRs include forests, water systems, and pastures. In a CPR environment, an increase in the number of participants, holding other variables constant, is negatively related to achieving social benefits.

3) The heterogeneity of participants

Participants can be heterogeneous in many ways. Others have speculated that heterogeneity in assets, information, and payoffs are negatively related to gaining a cooperators' dividend due principally to increased transaction costs and the conflict that would exist over the distribution of benefits and costs to be borne. In fact, the literature contains many arguments that point to heterogeneity as a serious deterrent to cooperation (Bardhan, 1993).

4) Face-to-face communication

Given that non cooperative game theory predicts that communication will make no difference in the outcome of social dilemmas, the repeated findings of a strong positive effect that communication has on the outcomes of collective-action experiments is a major theoretical puzzle (Sally, 1995). The result has been replicated so many times, however, that contemporary scholars have to take it seriously.

Adolphs et al., 1996 posited that the brain of one person unconsciously processes information about the emotional state from the facial expressions of another person with whom they are interacting. Frohlich and Oppenheimer (1998) explain the effectiveness of communication in general related to the needs of individuals in such settings to express the desire to each other that they should forego their immediate self-interest for the benefit of the group. In other words, communication is used for "moral suasion." And, being able to look others directly in the eye while discussing such moral issues is substantially better than relying on written communication.

Kerr and Kaufman-Gilliland (1994) conclude that communication in general helps a group gain a sense of "solidarity" and that face-to-face communication enhances the likelihood that individuals will keep their promises to cooperate. In general, the efficacy of communication appears to be related to the increased trust that individuals acquire when promises are made to them in a face-to-face setting. When they are in a repeated situation, they use the opportunity for communication to discuss deviations from promises made in a highly critical and moralistic tone.

Repetition of interactions

With repeated interactions, at least three more structural variables are posited to affect the level of cooperation achieved in social dilemma situations: the level of information generated about past actions, how individuals are linked, and voluntary entry and exit.

1) Information about past actions

The amount of information that an individual can obtain about the earlier actions of others can make a substantial difference when choosing strategy in a repeated situation. In a two-person game where individuals know the structure of the game and learn accurate information about the outcomes achieved, the behavior of the other individual is also known. As soon as more than two individuals are involved, accurate information about outcomes alone is no longer sufficient to inform one player about the actions of others. In families and small farming neighborhoods, where interactions are repeated, reputations can be built over time and group members can build up a level of trust about other participants. Cooperation can grow over time in such settings. In large groups, the disjunction between an individual's actions and reputations is more difficult to overcome. In some

situations, individuals can observe the actions of others and thus know what each individual did in the previous rounds. Various ways of monitoring the actions of participants increase or decrease the availability and accuracy of the information that individuals have concerning the particular actions of known individuals (or types of players) in the past (Janssen, 2006).

2) How individuals are linked

Sociologists and social psychologists have stressed the importance of how individuals may or may not be linked in a network when confronting various types of social dilemmas (Cook and Hardin, 2001). They have posited that individuals who are linked in a network where A contributes resources to B, and B contributes resources to C, and C contributes resources to A—or any similar unidirectional linking—are more likely to contribute to each other's welfare than individuals whose resource contribution goes to a generalized pool from which all individuals obtain benefits. The reason given for this expectation is that individuals in an undifferentiated group setting can expect to free ride for a longer period of time without reducing their own benefits than when contributions have to be delivered to someone in the chain of relationships in order for benefits to eventually come to them. Anyone in the chain who stops contributing faces a higher probability (so the argument goes) of the chain of benefit-enhancing contributions stopping and their losing out on obtaining a positive benefit. Creating a particular type of network may change the structure of the game from an n-person PD to an Assurance Game. The possibility of choosing whether to play or not (entry and exit)

Hauk and Nagel (2001) have argued that when individuals have a choice as to whether to play social dilemma games with others, and they can identify the individuals with whom they have played and have a memory of past history, that individuals will choose partners so as to increase the frequency with which cooperative outcomes are achieved. This gives individuals a third choice in a social dilemma game. Besides deciding whether to cooperate, they can decide whether to “opt out.” If one player opts out, the decision round ends and everyone receives a zero payoff. All players have an effective veto over the entire play of the game.

Janssen (2008) has developed an agent-based model of a two-person, prisoner's dilemma in which individuals can cooperate, defect, or withdraw. Each agent carries symbols that can be identified by others. The symbols are used by participants to gain or lose trust that the other participant will cooperate. Given this capacity to recognize trustworthiness in others and the capacity to withdraw from playing a game at all, cooperation levels rise over time and reach relatively high levels in populations composed of 100 players. With 1,000 players, cooperation levels are lower unless the number of symbols that can be used to recognize trustworthy plays is increased—a somewhat counterintuitive result (see also Hauert et al., 2002).

Toward a more general theory of human behavior

As is by now obvious from the above discussion, the earlier image of individuals stuck inexorably within social dilemmas has slowly been replaced in some theoretical work with a recognition that individuals face the possibility of achieving results that avoid

the worst outcomes and, in some situations, may even approximate optimality. The clear and unambiguous predictions of earlier theories have been replaced with a broad range of predictions including some that are far more optimistic. The theoretical enterprise has, however, become more opaque and confused.

This is a particularly challenging puzzle for scholars who yearn for frameworks and theories of behavior that integrate across the social sciences. To have one theory-rational choice theory-that explains how individuals achieve close to optimal outcomes in markets, but fails to explain why anyone votes or contributes voluntarily to the provision of public goods, is not a satisfactory state of knowledge in the social sciences. Simply assuming that individuals are successfully socialized into seeking better group outcomes does not explain the obvious fact that groups often fail to obtain jointly beneficial outcomes (Dietz et al., 2003). We need to recognize that what has come to be called rational choice theory is instead one model in a family of models useful for conducting formal analyses of human decisions in highly structured settings. It is a rather thin model of a broader theory of rational behavior. When it is used successfully, the rational choice model is largely dependent for its power of explanation on how the structure of the situations involved is modeled. In other words, the context within which individuals face social dilemmas is more important in explaining levels of collective action than relying on a single model of rational behavior as used in classical non cooperative game theory. In highly structured and competitive environments, predictions generated from the combination of a model of the situation and a model of complete rationality are well supported empirically. As Alchian (1950) demonstrated long ago, competitive markets eliminate businesses that do not maximize profits. Further, markets generate limited, but sufficient, statistics needed to maximize profits. The institutional structure of a market rewards individuals who make economically rational decisions and who can then be modeled as if they were determinate, calculating machines.

A broader theory of human behavior views humans as adaptive creatures (Jones, 2001) who attempt to do as well as they can given the constraints of the situations in which they find themselves (or the ones that they seek out) (Simon, 1955, 1957, 1999). Humans learn norms, heuristics, and full analytical strategies from one another, from feedback from the world, and from their own capacity to engage in self-reflection and imagine a differently structured world. They are capable of designing new tools-including institutions-that can change the structure of the worlds they face for good or evil purposes. They adopt both short-term and long-term perspectives dependent on the structure of opportunities they face. Multiple models are consistent with a theory of boundedly rational human behavior, including a model of complete rationality when paired with repetitive, highly competitive situations.

Heuristics and norms

Many situations in life, however, do not generate information about all potential actions that one could take, all outcomes that could be obtained, and all strategies that others could take. One simply assumes this level of information when using a model of

complete rationality. In most everyday situations, individuals tend to use heuristics-rules of thumb- that they have learned over time regarding responses that tend to give them good (but, not necessarily optimal) outcomes in particular kinds of situations. In frequently encountered, repetitive situations, individuals learn better and better heuristics that are tailored to the particular situation. With repetition and sufficiently large stakes, individuals may learn heuristics that approach best-response strategies and thus approach local optima. In addition to learning instrumental heuristics, individuals also learn norms. By norms, we mean that the individual attaches an internal valuation-positive or negative-to taking particular types of action. Analytically, individuals can be thought of as learning norms of behavior that are relatively general and fit a wide diversity of particular situations.

Crawford and Ostrom (2005) refer to this internal valuation as a delta parameter that is added to or subtracted from the objective costs of an action or an outcome.

Andreoni (1989) models individuals who gain a “warm glow” when they contribute resources that help others more than they help themselves in the short term. Knack (1992) refers to negative internal valuations as “duty.” The strength of the commitment (Sen, 1977) made by an individual to take particular types of future actions (telling the truth, keeping promises) is reflected in the size of the delta parameter. After experiencing repeated benefits from their own and from other people’s cooperative actions, individuals may resolve that they should always initiate cooperation in the future. Or, after many experiences of being the “sucker” in such experiences, an individual may resolve never to initiate unilateral cooperation and to punish non cooperators whenever feasible.

James Cox and colleagues posit that individual behavior in a particular setting is affected by an individual’s initial emotional or normative state and then by direct experience with others in a specific setting (Cox, 2004). The underlying norms and direct experience in a particular setting combine to affect orientations toward reciprocity. “Instead of beliefs or type estimates we use emotional states based on actual experience: my attitude towards your payoff depends on my state of mind, e.g., kind or vengeful, and your actual behavior systematically alters my emotional state” (Cox et al., 2007).

Fairness is also one of the norms used by individuals in social dilemma settings. The maximal net return to a group may be obtained in a manner that is perceived to be fair or unfair by those involved-using the general concept that “equals should be treated equally and un equals unequally” (see Isaac et al., 1991). When participants are symmetric in regard to all strategically relevant variables, the only real fairness issue relates to the potential capability of some to free ride on others (Dawes et al.,1986). When participants differ, however, finding an allocation formula perceived by most participants as fair is far more challenging (Rawls, 1971). In both cases, however, theorists have argued that when participants think that a proposal for sharing costs and benefits is fair, they are far more willing to contribute (Isaac et al., 1991).

Since norms are learned, they vary substantially across individuals, and within individuals across the different types of situations they face, and across time within any particular situation. As Brennan and Pettit (2004) stress, however, norms that help to solve social dilemmas need to be shared so that individuals who act contrary to the norm fear the reduction in esteem likely to occur. Once some members of a population acquire norms of behavior, they affect the expectations of others. When interacting with individuals who are known to use retribution against those who are not trustworthy, one is better off by keeping one's commitments.

Contingent strategies and norms of reciprocity

Many theorists posit that one can explain behavior in social dilemmas better if one assumes that boundedly rational individuals enter situations with an initial probability of using reciprocity based either as a calculated strategy that contingent action leads one to be better off or based on a normative belief that this is how one should behave (Panchanathan and Boyd, 2004). In either case, individuals learn to use reciprocity based on their own prior training and experience. The more benefits that they have received in the past from other reciprocators, the higher their own initial inclinations. The more they have faced retribution, the less likely they estimate that free riding is an attractive option. Their trust that others will also be reciprocators is highly correlated with their own norms but is affected by the information they glean about the reputation of other players and their estimate of the risk of extending trust given the structure of a particular situation. By and far the most famous contingent strategy- tit-for-tat-has been the subject of considerable study from an evolutionary perspective. Axelrod and Hamilton (1981) and Axelrod (1984) have shown that when individuals are grouped so that they are more likely to interact with one another than with the general population, and when the expected number of interactions is sufficiently large, reciprocating strategies such as tit-for-tat can successfully invade populations composed of individuals following an all-defect strategy.

Boyd and Richerson (1992) build a two-stage evolutionary model based on Hirshleifer and Rasmusen's (1989) model of a large population from which groups of size $n > 2$ are selected. The first stage is an n person PD where an individual selects cooperates or defect. In the second stage, any individual can punish any other individual at a cost to the punisher and to the punished. The same group continues for the next round dependent on a probability function. Strategies are modeled as if they were inherited. They allow errors to occur in the execution of a cooperative strategy, but all other strategies are executed as intended. After the rounds of interaction are completed, the more successful strategies are reproduced at a higher rate than the less successful strategies.

In the Boyd and Richerson (1992) model, an increase in group size requires an offsetting linear increase in the number of interactions to achieve similar levels of collective action. They also find that moralistic strategies, "which punish defectors, individuals who do not punish non cooperators, and individuals who do not punish non punishers can also overcome the problem of second-order cooperation" (Boyd and Richerson, 1982). When moralistic strategies are common, defectors and cooperators who do not punish are selected against due to the punishment directed at them. "In this way, selection may favor

punishment, even though the cooperation that results is not sufficient to compensate individual punishers for its costs” (ibid.). These moralistic strategies can stabilize any behavior—a result that is similar to the famous “folk theorem” that any equilibrium can be stabilized by such punishing strategies as the grim trigger. Yamagishi and Takahashi (1994) explore in an evolutionary simulation whether linking sanctioning to cooperative actions so that cooperators punish defectors and defectors do not punish other defectors solves the problem of aggressive moralistic strategies or meta norms. When these strategies are linked, they find close to 100% cooperation.

Several of the heuristics or strategies posited to help individuals gain larger cooperators’ dividends depend upon the willingness of participants to use retribution to at least some degree. In tit-for-tat, for example, an individual must be willing to “punish” a player who defected on the last round by defecting on the current round. As mentioned above, the grim trigger is a strategy that cooperates with others until someone defects, and then defects the rest of the rounds. In repeated games where substantial joint benefits are to be gained from mutual cooperation, the threat of the grim trigger is posited to encourage everyone to cooperate. A small error on the part of one player or exogenous noise in the payoff function, however, makes this strategy a very dangerous one to use in large environments where the cooperators’ dividend is substantial.

The core relationships: reputation, trust, and reciprocity as they affect cooperation

In situations where individuals can acquire a reputation for using positive and negative reciprocity and being trustworthy, others can learn to trust those with such a reputation and begin to cooperate—as long as others also cooperate (Fukuyama, 1995). Thus, at the core of an evolving theoretical explanation of successful or unsuccessful collective action are the links between the trust that one participant (P_i) has in the others (P_j, \dots, P_n) involved in a collective-action situation, the investment others make in trustworthy reputations, and the probability of all participants using reciprocity norms (see Fig. 1). When some individuals initiate cooperation in a repeated situation, others learn to trust them and are more willing to adopt reciprocity themselves leading to higher levels of cooperation. And, when more individuals use reciprocity, gaining a reputation for being trustworthy is a good investment as well as an intrinsic value. Thus, reputations for being trustworthy, levels of trust and reciprocity are positively reinforcing. This also means that a decrease in any one of these can generate a downward cascade leading to little or no cooperation.

10. Collective Action and Institutional Change

 Dear learners, can you write the interdependence of collective action and institutional change (Please write your response on the space provide below)

When do People Support Institutional Change? One of the key features of democratic society is that it allows citizens to make concerted efforts to control and replace authorities representing them (Tarrow, 1994). Collective action appears in many different forms, some of which are more or less spontaneous (e.g., strikes, demonstrations, and petitions), while others are more organized and routine events (e.g., elections, public hearings, citizens' juries). Moreover, collective action can be directed at solving small-group problems (e.g., electing a school representative), community problems (e.g., participating in local environmental groups), or larger societal issues (e.g., women and gay right movements). Perhaps the most common and institutionalized form of collective action is voting, for example, in the context of an election or referendum (Kinder & Sears, 1985).

Voting enables individual citizens in society to indicate their preference for the kind of authorities and policies they desire. Voting procedures thus contribute to a dynamic political process, whereby societies and communities can make regular changes in the authorities representing them. When do people decide to collectively vote for change? Why do people want to keep authorities in place, even though they are dissatisfied with the outcomes they receive? What role do concerns about the legitimacy and fairness of authorities play in people's support for change?

Traditionally, collective choice issues have been studied predominantly in political science (Oliver, 1980). These disciplines tend to emphasize the socio-structural and macro-political antecedents of collective action (e.g., social class, race, political structure). In addition, we need a micro-perspective to look at the actual motivations and perceptions of individuals deciding to support change (Simon, 1998). Current thinking about collective action is still dominated by rational-economic theories (Olson, 1965), which regard collective actions, such as voting, as a public good problem. This perspective is limited, however, because it cannot account for the ubiquity of collective actions in modern society. Moreover, it does not say much about the kinds of actions individuals or groups will decide for what direction these actions will take. For example, collective action may be directed towards establishing social and institutional change or towards maintaining the status quo.

Unit summary



Learning Activity 1:

Answer the following questions

1. Mention the types of business ownership and identify the one which is appropriate for an entrepreneurs to start small business?

2. Mention the types of business ownership and identify the one which is appropriate for an entrepreneurs to form the corporation business-----

Part I. Multiple Choice questions

1. _____ arises when people collaborate on joint action and decisions to accomplish an outcome that involves their interests or well-being.
a. Collective action b. Property rights c. Transaction costs d. All e. None
2. Collective-action problems are typically characterized by
a. Interdependency among the participants,
b. The contributions or efforts of one individual influence the contributions or efforts of others, no wider benefits are produced,
c. All are worse off if they each act to maximize their own narrow self-interests
d. All e. None
3. The economic theory of collective action is concerned with the provision of public goods through the collaboration of two or more individuals and with the impact of externalities on group behavior. A. True B. False
4. From the following given alternative which is not a common-pool resources
a. Water b)Land c)Fisheries d)Forests e) All f)None
5. Which of the following may not be considered as the role of collective action? a. Build and maintain local parks b. Religious buildings and community halls c. Operate volunteer fire control groups d. Implement rules for local natural resource management e. All f. None
6. Collective action is often exercised to a) regulate access, use and maintenance of common pool resources, b) undertaking such specific activities as devising rules, c) monitoring use, devising enforcement mechanisms and implementing sanctions d) All e) None
7. There are formal and informal institutions that govern collective action. Then which of the following is not the role of these governance structures a. Coordinating the actions and contributions of members. b. setting of rules, monitoring, and sanctioning, which reduce the incentives for people to break the rules or free ride, c. provides assurance to other members that others will also be contributing d. All e. None
8. Which of the following is not the determinants of success in collective action? a. the size of the group, b. the extent of heterogeneity in the group, and c. social capital in the group d. technical characteristics and economic characteristics e. political characteristics (the role played by state institutions) f. None

Part II. Fill in the Blank spaces

1. The main agenda of institutional economics is _____.
2. Collective action problems typically arise over imbalances among contributions to the effort and the distribution of benefits from the creation of public or collective goods, known as _____.
3. _____ can be understood as an action taken by a group of individuals to achieve common interests
4. As with property rights, it is essential to look at both _____ and _____ institutions that govern collective action.
5. The systems that generate finite quantities of resource units so that one person's use subtracts from the quantity of resource units available to others is known as _____

Part III. Matching Match the correct answer from part "A" to part "B"

Part "A"

1. The most common and institutionalized form of collective action is
2. The foundation of Collective Action problem was
3. Collective action which appears more or less spontaneous
4. Collective action which appears in more organized and routine events

Part “B”

- A. Olson’s (1965)_____
- B. strikes, demonstrations, and petitions_____
- C. elections, public hearings, citizens' juries_____
- D. Voting_____
- E. None_____

Part IV State whether True or False Type

Write “A” if the statements are true and “B” if the statements are false

- _____1. Collective action can be voluntary or obligatory for specific persons
- _____2. Collective action can also be used to substitute for missing markets
- _____3. Collective action can be use by people to increase their access to higher level institutions
- _____4. Collective action can enable local groups to benefit from knowledge/resources of other groups through federated structures, e.g. in order to influence policy decisions undertaken at higher levels of government
- _____5. Collective action is often considered in terms of activities undertaken through formal organizations only
- _____6. Collective action governance structures do not exist in isolation, but co-exist with and complement other governance structures, such as local and national government agencies and markets
- _____7. Institutional change is explained in terms of the responses of powerful groups to changes in relative prices, technologies, and transaction costs



Self-Check Exercise 2

Part III. Give short answer for the following questions

1. What do you mean by Collective action?
2. Why collective action is needed?
3. What are the problems of collective action?
4. Write at least five examples of collective action?
5. Define public goods (and other goods and services that are collectively consumed)
6. What makes collective action differs from other coordination mechanisms for instance hierarchies (such as firms)?
8. Differentiate between common-property resources and open-access resources?
9. Explain the circumstances that give collective action?
10. Explain the role of supporting institutions that govern collective action? 11 Describe the two sets of factors that determine the success of collective action?

REFERENCES

Aoki, M. , 2001. toward a comparative institutional analysis. Cambridge, Mass., U.S.A.: MIT Press.

- ARD, Inc., 2005. Land Tenure and Property Rights (LTPR) Framework and Tools, Burlington, Vermont. Documents may be requested from ard@ardinc.com.
- Ashley, Caroline and Christopher LaFranchi. 1997. Livelihood strategies of rural households in Caprivi: implications for conservancies and natural resource management. DEA Research Discussion Paper 20. Windhoek: DEA.
- Bardhan, P. K. 2001. Institutions, reforms and agricultural performance. In Current and emerging issues for economic analysis and policy research, ed. K. G. Stamoulis. Rome: Economic and Social Department, Food and Agriculture Organization of the United Nations.
- Bromley, Daniel. 2003. The Commons, Common Property, and Environmental Policy. In B. Larson (ed.) Property Rights and Environmental Problems, Volume I. Burlington: Ashgate Publishing Company, pp. 83-99.
- Cavendish, William. 1999. Empirical Regularities in the Poverty-Environment Relationship of African Rural Households, the Centre for the Study of African Economies Working Paper Series, Paper 105.
- Coase, R. H. 1992. The institutional structure of production. *American Economic Review* 82 (4): 713-719.
- Coase, Ronald. 1961. "The problem of social cost." *Journal of Law and Economics* 3:1-44.
- Coase, Ronald. 1937. "The nature of the firm." *Economica* 4: 386-405.
- Coase, Ronald. 1988. *The Firm, the Market and the Law*. University of Chicago Press.
- Coase, Ronald. 1992. "Comments on Cheung." In *Contract Economics*, edited by Lars Werin Davis, L. E., and D. C. North. 1971. Institutional change and American economic growth. Cambridge: Cambridge University Press.
- Dorward, A. R. 2001. The effects of transaction costs, power and risk on contractual arrangements: A conceptual framework for quantitative analysis. *Journal of Agricultural Economics* 52 (2): 59-74.
- Dorward, A. R., J. G. Kydd, J. A. Morrison, and C. Poulton. 2005. Institutions, markets and economic coordination: inking development policy to theory and praxis. *Development and Change* 36 (1): 1-25.
- Dorward, A. R., J. Kydd, and C. Poulton. 2005a. Coordination risk and cost impacts on economic development in poor rural areas. Paper presented at the Agricultural Economics Society Conference, Nottingham, U.K., April.
- Fernandez-Gimenez, Maria. 2006. Land Use and Land Tenure in Mongolia: A Brief History and Current Issues, USDA Forest Service Proceedings RMRS-P-39 http://www.fs.fed.us/rm/pubs/rmrs_p039/rmrs_p039_030_036.pdf.
- Fischer, Julie E. et al. 1995. Atelier Régional de N'Zérékoré sur la Problématique Foncière et la Gestion des Ressources Naturelles en Guinée Forestière, Workshop Report. Madison, Wisconsin: Land Tenure Center.
- Food and Agriculture Organization. 2002a. Land Tenure and Rural Development, FAO Land Tenure Series 3. Rome: FAO.
- Hall, P. A., and D. Soskice, eds. 2001. *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford: Oxford University Press.
- Kinder, D. R., & Sears, D. O. (1985). Public opinion and political action. In G. Lindzey, & E. Aronson (Eds.), *Handbook of Social Psychology* (pp. 659-741). New York: Random House.

- Lawry, Steven W. 1990. Tenure Policy toward Common Property Natural Resources in Sub-Saharan Africa, *Natural Resources Journal* 30 (Spring): 403-422.
- Mathieu, Paul, Philippe Lavigne Delville, Lacinan Pare, Mahamadou Zongo, Hubert Ouedraogo with Julianne Baud, Eric Bologo, Nadine Kone, Karine Triollet. 2003. Making Land Transactions More Secure in the West of Burkina Faso, IIED Drylands Program, Issue Paper No. 117, London: IIED. <http://www.iied.org/pubs/pdf/full/9170IIED.pdf>.
- Meinzen-Dick, Ruth, Rajendra Pradhan, and Monica Di Gregorio 2004. Understanding Property Rights. In Meinzen-Dick, Ruth and Monica Di Gregorio (eds.) *Collective Action and Property Rights for Sustainable Development*, Focus 2020, Brief 3, Washington DC: IFPRI.
- Norfolk, Simon. 2004. Examining Access to Natural Resources and Linkages to Sustainable Livelihoods: A Case Study of Mozambique, *Livelihood Support Programme Working Paper 17*. Rome: FAO.
- North, D. C. 1990. *Institutions, institutional change and economic performance*. Cambridge: Cambridge University Press.
- Oliver, P. (1980). Rewards and punishments as selective incentives for collective action: Theoretical investigations. *American Journal of Sociology*, 85,1356-1375
- Olson, M. (1965). *The logic of collective action: Public goods and the theory of groups*. Cambridge, M A : Harvard University Press.
- Ostrom, E. 1990. 2005b. *Understanding institutional diversity*. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, E. 1990. *Governing the commons: The evolution of institutions for collective action*. Cambridge: Cambridge University Press.
- Ostrom, E. 2005a. Doing institutional analysis: Digging deeper than markets and hierarchies. In *Handbook of New Institutional Economics*, ed. C. Ménard and M. Shirley. Dordrecht: Springer.
- Ostrom, E. 2005b. *Understanding institutional diversity*. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, Elinor. 1999. Private and Common Property Rights. In Boudewijn, Bouckaert and Gerrit De Geest (eds) *Encyclopedia of Law and Economics*, Vol. 1 *The History and Methodology of Law and Economics*, Edward Elgar and The University of Ghent, pp 332-379. <http://encyclo.findlaw.com/2000book.pdf>
- Safia Aggarwal and Kent Elbow, 2006. *Rights in Natural Resource Management, Good Governance And Empowerment of The Rural Poor*. United States Agency for International Development, ARD, Inc.159 Bank Street, Suite 300, Burlington, VT 05401 Tel: 802 658-3890, Fax 802 658-4247 www.ardinc.com
- Shackleton, Sheona, Charlie Shackleton and Ben Cousins. 2000. Re-valuing the Communal Lands of Southern Africa: New Understandings of Rural Livelihoods, *ODI Natural Resource Perspectives Number 62*, November 2000.
- Smon, B. (1998). Individuals, groups, and social change: On the relationship between individual and collective self-interpretations and collective action. In C. Sedikides, J. Schopler, & C. Insko (Eds.), *Intergroup cognition and intergroup behavior* (pp. 257-282). Mahwah, N J : Lawrence Erlbaum.

- Soloman, Barry. 1999. "New directions in emission trading: the potential contribution of new institutional economics." *Ecological Economics* 30: 371-87.
- Tarrow, S. (1994). *Power in Movement: Social movements, collective action, and politics*. New York: ambridge University press.
- Thomson, Jamie T. 1992. *A Framework for Analyzing Institutional Incentives in Community Forestry*, Rome: FAO.
- Tietenberg, Tom. 2002. "The evolution of emission trading: theoretical foundations and design considerations." Manuscript. Available from www.colby.edu/personal/t/thieten.
- Toulmin, Camilla. 2005-06. *Securing Land and Property Rights in Sub-Saharan Africa: The Role of Local Institutions*. http://www.iied.org/Gov/mdgs/documents/mdg3/ch2_28pp.pdf.
- Unruh, Jon, Lisa Cligget and Rod Hay. 2005. *Migrant Land Rights Reception and 'Clearing to Claim' in Sub-Saharan Africa: A Deforestation Example from Southern Zambia*, *Natural Resources Forum* 29: 190-198.
- Uphoff, N. 1986. *Local institutional development: An analytical source book with cases*. West Hartford, Conn., U.S.A.: Kumarian Press.
- Wallis, J. J. and D. C. North, 1986. *Measuring the transaction sector in the American economy*. In *Long-term factors in American economic growth*, ed. S. L. Engerman and R. E. Gallmann. Chicago: University of Chicago Press.
- Wiber, Melanie G. 2005. *The Voracious Appetites of Public versus Private Property: A View of Intellectual Property and Biodiversity from Legal Pluralism*, CAPRI Working Paper # 40, July 2005.
- Williamson, O. E. 1985. *The economic institutions of capitalism*. New York: Free Press.
- Williamson, Oliver .1991. *Comparative economic organisation: The analysis of discrete structural alternatives*. *Administrative Science Quarterly* 36: 269–296.
- Williamson, Oliver. 1975. *Markets and Hierarchies*. New York: Free Press.
- Williamson, Oliver. 1996. *The Mechanism of Governance*. New York: Oxford University Press.
- Williamson, Oliver. 1998. "Transaction cost economics: how it works; where it is headed." *De Economist* 146 (1): 23-58.
- Williamson, Oliver. 1999. *The New Institutional Economics: Taking stock and looking ahead*. Address to the International Society for New Institutional Economics. *ISNIE Newsletter* 2 (2): 9–20.
- Williamson, Oliver. 2000. "The New Institutional Economics: taking stock, looking ahead." *Journal of Economic Literature* 38 (3): 595-613.

UNIT FIVE. PROPERTY RIGHTS

Introduction

☛ Dear learner, welcome to the fifth unit of the course “Institutional Economics”. This unit is deals with concept of Property rights. Property rights are a fundamental institution governing who can do what with resources Management rights are an order higher than use rights, and are intermediate between use and full ownership (including transfer) rights in institutional Economics. Dear learner, to simplify your study, there are included access devises such as in text, questions, learning activities in this unit.

✳ Chapter objectives:

Dear learner, after you complete your study on this unit, you should able to:

- Explain definitions and Origins of Property Rights
- Explain the Role of Property Rights
- Identify the Many Types of Property Rights
- The basic Property Rights Concepts
- Property Rights and Transaction Costs
- Property Rights to Land versus Natural Resources

Section One: Explain definitions and Origins of Property Rights

Overview

☛ Dear learner, before you read this chapter, you should have to identify clearly the following definitions. Property rights are a fundamental institution governing who can do what with resources Management rights are an order higher than use rights, and are intermediate between use and full ownership (including transfer) rights. Extraction rights: the right to capture the benefits from the property through, for example, mining or agriculture

- i) Transfer rights: the right to sell or lease the property to someone else;
- ii) Exclusion rights: the right to exclude someone from the property
- iii) Encumbrance rights: the right to use property as security or for other purposes

✳ Objectives:

After completing this section, you should be able to:

- Explain property rights
- Identify the origin of property rights

1.1. Definitions and Origins of Property Rights

☛ Dear learner, would you explain *definitions and Origins of Property Rights*? (You can use the space left below to write your response.)

Social embeddedness here refers to the social, economic and political relations, and associated institutions within which land and property rights are situated and are constituted. This can be illustrated with the following observations. A bundle of rights comprises a set of rights that may include the right to use a resource, the right to manage it, and the right to transfer (assign or reassign), right to own, management and use right. Management rights are an order higher than use rights, and are intermediate between use and full ownership (including transfer) rights. Management rights consist of the right to organize and assign use rights. Transfer rights refer to the authority to assign or reassign both management and use rights.

Tenure security is characterized by enforceability of property rights, and refers to the degree to which individual or group rights to land and natural resources are recognized and protected. There are two distinct definitions of transaction costs. The 'Neoclassical' definition rests on the costs of trading across a market, while the 'property rights approach to transaction costs' definition centers on the costs of establishing and enforcing property rights. Property rights are therefore defined as the ability to freely exercise a choice over a good or service.

Property rights are a fundamental institution governing who can do what with resources. Property rights may be defined as "the capacity to call upon the collective to stand behind one's claim to a benefit stream" (Bromley 1991), or "the claims, entitlements and related obligations among people regarding the use and disposition of a scarce resource".

Property rights are found in the oldest written laws, and they equate the expectation of use or profit to some payment from the very beginning. Property rights usually also refer to a bundle of rights. These rights include: 1) Use rights (usufruct): controlling the use of the property; 2) Extraction rights: the right to capture the benefits from the property through, for example, mining or agriculture; 3) Transfer rights: the right to sell or lease the property to someone else; 4) Exclusion rights: the right to exclude someone from the property 5)

Encumbrance rights: the right to use property as security or for other purposes. Although exact definitions of these rights vary, there are several key elements. First, property rights are fundamentally a social relation: they are not about the link between a person and a thing (object of property), but rather about the relations between people with regard to a thing, or more particularly, with regard to the benefit stream that is generated. Unless others respect one's property rights, they are meaningless. Thus, all property rights are associated with corresponding duties of others to observe them. They are also frequently associated with specific duties of the rights-holder to do certain things to maintain the right to the resource.

According to Coase (1960), relatively well-defined property rights and institutions for implementing them form a prerequisite for making the transfer of rights possible and the trade-off among arrangements meaningful. Property rights thus affect contractual

hazards and embed transactions into specific institutional environments. If property rights are well established and there are no transaction costs, an externality can be internalized between two private parties through bargaining and negotiations (Coase 1960). This observation is the essence of what has been labeled the Coase Theorem. Coase's argument was used to counter

Arthur Pigou's call for government taxes to curb negative externalities. Coase showed that government involvement is in fact not necessary if property rights are well established. He also showed that, in the absence of transaction costs, the outcome would be efficient and equitable regardless of whom owns the property right. In the presence of transaction costs, however, different systems of property rights may yield different outcomes in terms of efficiency and equity.

The property-rights school (Alchian and Demsetz 1973) hypothesizes that potential collective efficiency gains in adaptation to changes in relative prices are the key determinant factor for changes in property rights. However, this approach does not deal with the distribution of property rights, and it cannot explain why efficient regimes of property rights are the exception rather than the rule (North 1990). Which property rights eventually evolve is a function of their economic consequences, ideology regarding the proper distribution of benefits that accrue from property rights, and the bargaining power of the various interest groups.

1.2. Role of Property Rights

? Dear learner, would you explain the role of property rights? (You can use the space left below to write your response.)

Property rights or "tenure" also refers to control over and access to resources, that is, the way in which people (individually or collectively) hold rights and responsibilities to land and natural resources upon it. Thus, the issue of property rights raises fundamental questions of who claims rights to what resources, who has access to the land and associated natural resources, and who has the responsibility for managing these lands. Of particular interest then is how land and property rights create incentives or disincentives for sustainable management and governance of natural resources such as agricultural lands, forest resources, freshwater and coastal resources, wild species of plants or animals or watersheds. These fundamental property rights questions become even more critical where natural resource markets are concerned, such as markets for timber or non-timber forest products, wildlife, ecotourism, agricultural products, payment for environmental services and other revenue-generating activities. Control or access to land and natural resources is important for sustainable management, good governance and empowerment of the rural poor for several reasons:

1. Land and natural resources are important assets for individuals and households in meeting subsistence needs including food and shelter. To that end, access to land and natural resources (renewable natural resources in particular) is critical for poverty alleviation and food security.
2. Land and natural resources provide important assets for income generation for most rural households. Rural households may generate income through production of cash crops, or from collection and sale of forest, marine or coastal resources. Indeed, households with secure rights to land are typically better off than those with insecure, limited or no land rights (FAO, 2002a).
3. Property rights are a critical tool for promoting self reliance among the poor. Specifically, improved access to arable land can provide incentives for greater investments in time and labor toward enhancing the natural resource base, leading to greater productivity of arable lands and hence greater food security at the household level. To that end, secure access to land and natural resources is essential for lasting solutions to sustainable land and natural resource use and management, as well as poverty alleviation.
4. Secure land and property rights are a critical element of a rights-based approach to development programming.

The rights-based approach serves to ensure that program designers proactively consider women, minorities, indigenous and other marginalized groups in development programs (FAO, 2002a). Underlying each of these concerns is sustainability of the resource base, which is often highly correlated to the level of property rights security characteristic of key natural resource users. Secure property rights are an important element of rural empowerment. Where property rights are weak or nonexistent, rural populations may be displaced or customary access and control over resources may be challenged by outside interest groups. On the other hand, secure property rights that are protected by law can empower rural communities, ensuring participation in critical decision-making processes related to the management of land and natural resources, and other social political processes. Given the importance of property rights in providing critical incentive for sustainable management of land and natural resources, and potential for subsistence livelihoods and income generation as well as rural empowerment, the nature of property rights, what constitutes these rights, and what makes for secure rights needs to be clearly understood. Conversely, a better understanding is needed The rights-based approach to development places human rights at the center of development policy, and includes economic, social and cultural, as well as civil and political rights (Maxwell, 1999). of how insecure, unclear, limited or short-term rights to land and natural resources provide disincentives for sustainable use and management of resources. Indeed, failure to take into consideration land and property rights at the outset of the program may inadvertently eliminate individual or collective property rights, fostering poverty, inequity, social instability, or in some cases, conflict. In other words, failure to grasp the incentive structures inherent in land and property rights arrangements may lead to unsustainable outcomes (FAO, 2002a).

1.3. The Many Types of Property Rights

② Dear learner, would you explain the many Types of Property Rights? (You can use the space left below to write your response.)

Control over and access to land and natural resources may be understood as an individual's or group's claim to a bundle of rights. These rights typically include authority to use, manage, and transfer land and various natural resources on it. People's rights, including property rights, weigh heavily in matters of fairness, equity, and justice, and can be understood and analyzed through a simple and long-standing model that portrays property rights as bundles of rights. This concept of property rights serves to keep the multi-dimensionality, social embeddedness and the institutional breadth and depth at the forefront of development and environmental planning. Social embeddedness here refers to the social, economic and political relations, and associated institutions within which land and property rights are situated and are constituted. This can be illustrated with the following observations. Property rights entail cultural and social meaning; for example, the property rights system is a fundamental element upholding cultural identity in many customary societies. In the political realm, property rights and the ability to manipulate them, confer power. Finally, property rights are intimately related with the distribution of wealth, and thus provide powerful incentives for their protection. The expression of property rights within each of these domains has the potential either to clarify or to strain existing property regimes and the larger socio-political domains of which they form a fundamental part. Henry Maine first conceptualized bundles of rights in his classic book, *Ancient Law*, published in 1861.

1.4. The Basic Property Rights Concepts

② Dear learner, would you explain the Basic Property Rights Concepts? (You can use the space left below to write your response.)

A bundle of rights comprises a set of rights that may include the right to use a resource, the right to manage it, and the right to transfer (assign or reassign), right to own, management and use rights.

The four strands in the bundle right are summarized in Box 1

Various strands in a bundle of rights related to a unit of land and associated natural resources may include:

- Right to use,
- Right to manage,
- Right to transfer (assign or reassign) use and management rights, and
- Right to “own”.

1. Use rights

The most observable types of property rights are use rights, either to non-consumptive use of a resource or withdrawal of the resource such as gathering deadwood in a forest, grazing livestock in a pasture, producing crops on agricultural lands, or fishing in a pond. Use rights are as varied as are uses of a unit of land and the natural resources it contains. For example, use rights to a parcel of land may include the right to farm, to pasture, to plant trees, to cut trees, to build a house, to establish a non-agricultural enterprise, to exploit the land as a quarry, or any combination of such rights. Use rights to trees may include fruit or leaf gathering, honey collection, removal of bark or branches, or removal of the tree itself. Use rights to a body of water may include drinking, bathing, washing clothes, watering livestock, fishing or diversion for irrigation.

2. Management rights

Management rights are an order higher than use rights, and are intermediate between use and full ownership (including transfer) rights. Management rights consist of the right to organize and assign use rights. The manager of a unit of land or a stock of natural resources typically has authority to make land use and production decisions that have implications for the various use rights holders. Just as management rights can be distinct from use rights, Our proposed categorization of property rights to natural resources is inspired by some existing models, such as that presented in Fortmann, Louise. (1988). *The Tree Tenure Factor in Agroforestry with Particular Reference to Africa*, from Fortmann and Bruce, *Whose Trees? Proprietary Dimensions of Forestry*, and that presented in Ostrom (1999) Management rights are also often distinct from transfer (or ownership) rights. For instance, a wetland may be legally owned by the state, but management of the wetland, that is, rules of when and where people can fish or how much fish can be withdrawn may be decided upon by a village council. Typically, in such cases, the village council will manage the wetland within the overarching regulations imposed by the state—as for instance, a state imposition of ban on fishing during specific times of the year. In such cases, the village council does not hold the right to transfer the wetland (ownership or management) to another entity. This authority will rest with the state.

3. Transfer right

Transfer rights exist at a still higher order than use and management rights. Transfer rights refer to the authority to assign or reassign both management and use rights. A transfer of rights may be definitive and absolute, that is, the transfer may include all rights included in the property rights bundle. The ability to definitively transfer the entire property rights bundle is a typical feature of property rights systems predominant in the West, and may be referred to as alienation right. However, a transfer of property rights may also apply to something less than the entire property rights bundle. For example, it is common in non Western societies for a family or a community to transfer management and use rights attached to a specific parcel to a new arrival. The transferred rights include the right to exclude all others, including community members, from certain uses of the transferred parcel such as crop cultivation. Rights granted to the new arrival are often quite secure, and may even be considered permanent. But the right to transfer the use and management rights is typically withheld from a new arrival within a given community.

4. Ownership

In contrast to the rights categories presented above, definition of the term ownership, as applied to land and natural resources, is neither precise nor rigorous. It is a useful term, and unavoidable within a discussion of property rights. The term is used here simply to indicate priority claims to the property rights bundle made on the part of an individual, a private entity or a state. Priority rights can be thought of as a claim of authority to manage and administer the property rights bundle. The concept of ownership may vary depending upon the socio-political context. For example, alienation rights, taken for granted in Western property rights systems, may be entirely absent from the property rights bundle claimed by the customary owners of land and natural resources.

A Westerner tends to think of ownership as a rights bundle that generally involves a relatively concentrated rights bundle involving a nearly exhaustive set of rights strands as illustrated by the equation: ownership = use rights + management rights + transfer rights + alienation rights. A non-Westerner may think of ownership in terms of historically established priority rights to a particular area or set of natural resources on the part of a community or clan. In such a system, assignment of use and management rights is based on the family, clan, religious or ethnic identity of the holder rather than on formal legal precepts.

1.5. The Property Rights Regimes

❓ Dear learner, would you explain the Property Rights Regimes ? (You can use the space left below to write your response.)

Typically, property rights regimes are envisioned in terms of the four broad categories: private property, common property, public property, and Open access (see Box 2). Thus, private property refers to cases where all strands of a property rights bundle associated with a unit of land (or natural resource) may be held by a natural (real individual) or a legal person (e.g., corporation). Where the strands of a private property bundle are shared among members of a defined group such as a community, that property rights regime is designated as common property. In contrast to both private and common property, strands of the property rights bundle may be held and managed by the government, in which case the term public property is applied. Finally, open access refers to land or natural resources that have no specific right holders associate with them. While such a situation is extremely rare, in reality, land and natural resources often experience open access situations where claimed rights are unenforceable in the face of an absence of legitimacy or the means to exclude anyone from use. This situation creates a powerful disincentive for good governance, often leading to a competition to capture resources in a race against other users. For example, in some rural areas of Guinea, households may not transfer agricultural parcels to outsiders without the consent of the customary community authority structure (Fischer et al, 1995). It can also happen that a land “owner” is not authorized to make management decisions regarding his or her property, including such a fundamental decision during which years to cultivate specific parcels,

This concept of ownership is greatly simplified as compared to that detailed by Honoré (1961) cited in Bromley (1989). Honoré’s portrayal of ownership identifies eleven characteristics that are said to be present in full, or liberal, ownership (p.187). Bromley, Daniel W. 1989. Economic Interests and Institutions: The Conceptual Foundations of Public Policy. New York, NY: Basil Blackwell Inc. pp. 187-190.

Box 2. The idealized property rights regimes

Private property occurs when the strands of the property rights bundle are held by a natural or legal person (ARD, Inc., 2005).

Common property exists where property rights strands are shared among members of a community or association.

Public property is established when the strands of the bundle are concentrated, held and managed by the government.

Open access occurs where either no specific rights to land or natural resources have been assigned or claimed by holders.

Titenberg 2003 also defined the four types of property regime. These are private property regime, where the entitlement is associated to individuals. State property regime, where the entitlement is attached to the state, common property resources regime, where the

entitlement is attached commonly rather than individuals and finally res nullius property resources, where there is open access and the resource is used based on first come, first use principle. Keeping these property right regimes in to consideration based on their utilization; we can broadly identify two types of natural resources where there is no direct market value.

These are natural resources which are open-access called common pool resources and natural resources which do not have open access like national parks. The common-pool types of natural resources are characterized by non-exclusivity and divisibility. Non-exclusivity implies that they can be exploited by any one while divisibility means that the capture of part of the resource by one group subtracts it from the amount available to other groups. However, in the absence of scarcity, efficiency cannot be affected by open access (Tietenberg, 2003).

Public good defined in Tietenberg (2003) as by those that exhibit both consumption indivisibility and non-excludability, present a particularly complex category of environmental resources. Non-excludability refers to a circumstance where, once the resource is open for public use, even those who fail to pay for it cannot be excluded from enjoying the benefits it confers. Consumption is said to be indivisible when one person's consumption of a good does not diminish the amount available for others. Several common Tietenberg, T., 2003. Environmental and Natural Resource Economics. Pearson Education, New York City. Environmental resources are public goods, including the charming landscape, national parks, biological diversity and even the air and clean water.

According to Tietenberg (2003) an efficient structure of property right has three main characteristics. These are Exclusivity- all benefits and costs accrued as a result of owning and using the resources should accrue to the owner, and only to the owner, either directly or indirectly by sale to others or other means. Transferability- All property rights should be transferable from one owner to another in a voluntary exchange. Enforceability- Property rights should be secure from involuntary seizure or encroachment by others. Belay (2003) states that completeness indicates the degree of ownership (all benefits accrue to the owner), enforceability of rights is related to the security of the property right and transferability of property right expands time horizons in resource use.

Exclusivity is one of the chief characteristics of an efficient property right structure. However, this characteristic is frequently violated in practice. One of the major violation is when an agent making a decision, does not bear all of the consequences of his or her action. This is particularly true for park related use of resources as the users (residents) might not bear the consequences of their actions. Thus, relying on market in the use of the park resources may lead to market failure that aggravates overexploitation and further degradation. Hence, this calls for government intervention in the management and use of such resources. Open access lands and natural resources, sometimes referred to as "non-property," exemplify lack of specific rights, or unenforceable rights. In contrast to common property regimes, open access resources have no named and

known group that claims them, and no specific institutional arrangements designed to ensure proper governance of the resource.

Also unlike common property, in open access areas by definition no particular individual or group has authority to exclude anyone from using the resource. Open access is common in marine contexts, where access to resources beyond a specified distance from land may be free and unrestricted to all. Open access areas may include rangelands, forests, or wetlands. It is important to note that common property, public property, or private property may at times “slip into” open access status where local institutions, governments, or individuals responsible for governing and maintaining them lack the ability to effectively monitor and enforce rules of resource use. For instance, protected areas legally falling under state jurisdiction often experience open access situations (and are hence characterized as “paper parks”), due to lack of effective mechanisms for monitoring and enforcement (Safia Aggarwal and Kent Elbow, 2006)

In some circumstances “hybrid” property regimes exist. These regimes combine varying elements of the rights regimes of private, public and common property systems. The defining characteristic of hybrid property regimes is that the strands of the property rights bundle are shared among private and public entities. Hybrid property rights regimes include co-managed natural resources or community-based natural resource management, in which use and management rights are shared between government agencies and community-based organizations. As generally perceived, private, public, and common property regimes are idealized forms of property regimes. Even the hybrid models generally ignore many ideological, legal, and social aspects systemically embedded in property rights systems. As a result, the property regime types presented above-private, public, common, and open access has been somewhat dryly referred to as the “big four” (Wiber, 2005).

Nevertheless, if used sensibly, this taxonomy of property rights regimes is a useful tool for analyzing property issues and implications involved in program or project development contexts. In addition, multiple forms of property rights often coexist in any given location (Coward, 2006). In other words, individuals may hold rights to private lands, and at the same time, have rights to resources held in common such as collectively managed fisheries resources in a state-owned wetland. It is important to note also that property rights are impermanent and often change over time. As Coward notes, property rights arrangements are made and remade, particularly when there are shifts in political or economic power.

1.6. Supporting institutions

? Dear learner, would you explain the Supporting institutions? (You can use the space left below to write your response.)

To be effective property rights need recognition and legitimacy. This, in turn, implies the need for governance structures that enforce rights and the corresponding duties of others to respect those rights. The functions of these governance structures include supervision, sanctioning in case of non-compliance, and provision of forums for resolving disputes over property rights. The institutions that provide legitimacy can be diverse. Rights can be backed such coexisting property rights are best illustrated in a “communal” tenure system not unusual in the non-Western context. In a communal tenure, individual property rights are often derived from the property rights of a community, such as a lineage, a village, or another social group (Bruce, 2004). In such a case, rights of individual landholders can be limited by the community from which those rights are derived. by state law, with police and courts at different levels to enforce and sanction. However, customary laws can also provide legitimacy to property rights claims, which may be enforced by village chiefs and local observances by social exclusion, etc. Even religious laws or other normative principles may provide a basis for claiming rights; how effective these claims are depends on the extent to which others recognize those rights, either because of a sense of internalized legitimacy or external enforcement.

The presence of multiple legal orders, which provide the basis for claiming property rights, is referred to as legal pluralism (Griffiths 1986; Merry 1988). However, not all types of law are equal: they depend on the strength of the governance structures that back them up, which varies from place to place and over time. In some cases, customary or religious institutions may be very strong, and state laws have a weak effect, whereas in others, the state institutions hold much stronger sway.

There are three effects of weak property rights institutions that are of particular importance to the poor. First, the inability of the institution to enforce rights means that individuals holding these rights are either prevented from receiving a stream of benefits from a resource to which they might be entitled, or are uncertain about receiving future benefits (e.g. head-enders’ capture of irrigation water that leaves tail-end farmers without water).

Secure rights allow people to plan ahead and, particularly, to invest in a resource with the confidence that they will reap the returns. Similarly, where institutions are weak, the likelihood of disputes and conflicts among different rights-holders (or even non rights-holders!) Increases; e.g. rent-seeking activities such as encroaching on common lands can lead to an eruption of violent conflict. Such rent-seeking may also lead to a change in the institution, as discussed below under outcomes. Third, when there are multiple institutions (legal pluralism), those with claims backed by weak institutions may feel particularly vulnerable to potential changes that alter the capacity of that institution to enforce claims. For instance, many people rely on customary institutions for enforcing claims on common pool resources, but most people also recognize that the state has often claimed *de jure* ownership of the land. Thus, while at the present time, peoples’ rights enable them to enjoy benefits from these resources; they are also faced with the possibility that the state may exert various rights to their detriment in the future.

1.7. Tenure Security and Enforcement of Property Rights

❓ Dear learner, would you explain the Tenure Security and Enforcement of Property Rights? (You can use the space left below to write your response.)

Tenure security is characterized by enforceability of property rights, and refers to the degree to which individual or group rights to land and natural resources are recognized and protected. A lack of security implies insufficient capacity to defend a property right against competing claims, encroachment, or eviction. Insecurity of property rights invites conflict, discourages investment, and in some instances creates disincentives for sustainable land and natural resource stewardship, for instance by instigating land clearing in efforts to legitimize land claims (see Unruh et al. 2005). Numerous factors play a role in determining the level of tenure security. As summarized in Box 2, these include the legitimacy of the property rights, institutions, available to support legitimate property rights (Meinzen-Dick et al., 2004), clarity of rights, and excludability of these rights (Lawry, 1990). Box 2. Elements of tenure security

Tenure security is characterized by:
Legitimacy,
Institutional backing,
Clarity, and
Excludability.

1. Legitimacy

A leading factor in property rights enforceability is the degree of legitimacy of the property rights system in which the claimed rights are anchored. A high degree of legitimacy encourages voluntary compliance on the one hand, and discourages challenges to recognized rights on the other. A high degree of legitimacy reduces the need for repressive responses and elaborate institutions for dispute resolution. Property rights gain legitimacy through laws and associated institutions (see Table 1). A diverse set of laws and institutions may legitimate property rights claims; however, these typically involve customary law enforced by a local governance unit such as village institutions and elected or appointed institutional or village

A good summary of the economic advantages obtained through security of tenure is provided in Place, Roth and Hazell, Land Tenure Security and Agricultural Performance in Africa: Overview of Research Methodology, in Bruce and Migot-Adholla, Searching for Land Tenure Security in Africa, Dubuque, Iowa: Kendall/Hunt Publishing Company, 1994 (sponsored by the World Bank). Authorities.

The statutory system is defined in written laws (de jure) enacted and enforced by a central or regional government. Customary property rights regimes are often referred to as non-formal (de facto) systems. These typically incorporate unwritten rules, often characterized by property rights systems of considerable complexity. Customary property rights systems,

which have evolved along with the societies in which they are rooted, often enjoy a degree of legitimacy in the eyes of local people that far exceeds that of (imposed) statutory laws. Indeed, in many parts of the non-Western world, it is the customary rights that legitimate property rights in rural areas. For instance in West African countries, Toulmin (2005/2006) notes that rights to only

2-3 percent of land may be formally recognized under statutory law. A majority of those parcels are localized in urban or other commercialized areas. Various sets of laws (formal and non formal) may contradict each other resulting in overlapping claims and at times conflict.

Table 2. Support for enforcement of customary property rights to village lands and natural resources: the role of legitimacy

Rights Holder	Type of Rights	Basis for Legitimacy	Challenges to Legitimacy
COMMUNITY	ownership rights	Traditional authority structures of community; shared history and traditions	Government claims to manage reserves, waterways, watersheds, fisheries and as well as otherwise "vacant" lands; development of land markets
COUNCIL OF ELDERS	transfer rights	Traditional authority structures of community	Hereditary posts losing power and a fragmentation of authority as it shifts from community-level toward households and nuclear families
HEADS OF HOUSEHOLDS	management rights	Traditional authority structures of community and households	Household fragmentation and asserted claims to portions of family common land by part of nuclear families
HOUSEHOLD MEMBERS	use rights	Traditional authority structures of household backed up by community	Money economy develops creating incentives for household members beyond farming; encourages land markets)

2. Institutional Backing

Institutions are necessary to enforce the specific legal system that provides legitimacy to a set of property rights. These institutions (associated with each legal system) are responsible for making and modifying rules of the regime; monitoring compliance with those rules; sanctioning persons who infringe rules; mediating any resulting conflicts; disseminating information about results of monitoring; sanctioning; resolving disputes; and mobilizing resources, leaders and staff to conduct all these functions. The effectiveness of the property rights claims depends on the strength of the institution(s) defending the rights, and institutional ability to enforce rights. In customary systems, the recognized authority of village leaders and governing councils provide the basis for mediating conflicts, issuing rulings and imposing penalties where needed. In many cases, people prefer customary governing councils to formal courts since there is a sense that local mediators, if selected by the parties to the dispute, are likely to render more appropriate judgments. The customary governing councils typically have fewer "transaction costs" than do state courts. In other cases, individuals may prefer taking disputes to formal courts as it may allow buying of corrupt decisions and wresting control of land or natural resource

from other local actors. Localized institutions may be at a disadvantage when uses and markets for natural resources begin to exceed village boundaries. Such institutions have often found it difficult to compete with statutory law buttressed by institutions such as networks of judicial courts and land and natural resource agencies.

3. Clarity

Clarity, or shared and widespread understanding, of existing property rights is another factor in securing property rights since it helps to eliminate the gray areas within a property rights system that can lead to ambiguity. Well-functioning property rights are dependent on the degree to which each strand of the property rights bundle is clearly defined, and transparently assigned to one or more rights holders. Insufficient clarity in defining and assigning rights encourages competing claims and warps incentives in use, governance, and management of the resource. Clarity of rights may be challenged by conflicting claims to an identical right rooted in competing property rights regimes, and the tendency for rights to change over time.

It is important to note, however, that customary tenure systems may be considered legitimate by individuals and communities at the local level nevertheless, they may not always be equitable. Powerful groups based on ethnicity, gender, and social status may form rules that exclude certain groups or restrict their rights. Both customary and statutory systems are susceptible to institutional inequity and exclusion (see for instance Fitzpatrick, 2005; Larson, 2004; McAuslan, 1998).

A common example of lack of clarity resulting from competing property regimes is assertion of state property use restrictions on forests, versus customary claims of management and use rights. In other cases, overlapping claims emerge in post-conflict situations where shifting waves of refugees leaving and entering the country at various times have established overlapping claims to land and natural resources. Lack of clarity and gray areas can pose great risks to enforceability since each competing property rights system attempts to uphold conflicting rules regarding access and use of natural resources.

4. Excludability

A use, management or transfer right to a natural resource has meaning only to the extent that the rights holder is capable of excluding non-rights holders from using the claimed right. Lack of capacity to exclude non-rights holders from property held by recognized rights holders moves the property system toward a situation of open access and potential conflict.

1.8. Property Rights to Land versus Natural Resources

? Dear learner, would you explain the Property Rights to Land versus Natural Resources? (You can use the space left below to write your response.)

Access to land and rights to use it are important aspects of rural wealth for the numerous direct and indirect benefits that land provides to rural populations. Property rights to land provide critical assets in terms of meeting subsistence needs and numerous income-generating opportunities, such as cash crop production. In addition to these direct subsistence and commercial benefits that land provides, access to arable land serves also as an important safety net particularly for the rural poor. Basic livelihood needs may be met from this single resource, even where land parcels are small. While control and access to land are important and acknowledged in many rural development strategies, to date, the important role that rights to natural resources play in rural livelihoods is rarely adequately recognized. Emphasis on income-generating activities such as agricultural cash crop production and on formally marketed goods has reduced visibility of renewable natural resource contributions to rural livelihoods. Rural livelihoods often incorporate a diverse portfolio of activities that serve to enhance household income and food security, improve health, and sustain social networks.

Studies show that collecting natural resources daily or occasionally from communal areas serves to meet a variety of needs of a high percentage of rural households in non-Western countries. These natural resources include firewood, charcoal, fodder for livestock, water, and other resources for agricultural production (wood for tools and implements), building materials (wood, fibers, grasses), foods (fruits, nuts, seeds, tubers, honey, bush meat), and medicinal plants. In addition, property rights to livestock enable owners to meet a diverse range of subsistence, commercial, or other needs including food (meat and milk), animal traction in agriculture, transport, and manure; while livestock such as goats and barnyard fowl provide owners stores of value that generate real rates of return with both commercial and subsistence uses. This creates for owners a safety net against misfortune and for use in times of critical cash needs.

Property rights to natural resources in forests, pastures, freshwater, marine and coastal areas (often held in common) are fundamental to these livelihood strategies for the numerous economic and environmental services they provide. Increasingly, studies show the significant role that forest resources play both in household income and subsistence. For instance, in Mozambique 85 percent of energy needs are met from woody biomass (Norfolk, 2004). In addition to subsistence, commercial demand for many natural resources provides additional opportunities to rural communities. For instance, Cavendish's (1999) study in Zimbabwe suggests that wild products harvested from the commons contribute to as much as 40 percent of average household income.

Recent developments in state-community partnerships (co-governance and co-management) in wildlife conservation and occasionally partnerships with private sector are opening new opportunities for rural livelihoods in communal lands. Revenues derived from such partnerships and associated rights may be seen as property. In such instances, property right is not a claim to a specific land parcel or natural resource, but

rather a claim to the natural resource benefits that flow from a commons (Bromley, 2003).

The significance of common property resources particularly for the most vulnerable segments of rural society is increasingly recognized. In many parts of the developing world, communal lands support the majority of the rural population, many of whom live below poverty. Female-headed households, female members of households, and the exceptionally poor or 'marginalized' members of rural communities tend to be particularly reliant on natural resources for their livelihood needs. For these segments of the society in particular, access to natural resources (natural capital) remains a crucial source of livelihood, and often the safety net of final resort.

For instance, in Botswana a study conducted by Kerapeletswe and Lovett (2001) showed that common property resources may provide more than half of the total household income for the poorest 20 percent of population. Property rights reforms which aim at individualization can eliminate property rights to diverse resources, or to associated benefits, or both. In some cases community management of natural resources may outweigh benefits of individual property rights. For instance, customarily in many countries within the Western and non-Western contexts, pastures have been, and continue to be, managed as a common property resource. Pastoralist groups may manage this resource through seasonal movements and a rotational system of use. In order to limit excessive use of a pasture resource, grazing may be regulated to specified areas during specific times. When carrying capacity is reached, grazing is shifted to adjacent parcels. This ensures that no unit of land is overgrazed. The ability to move over large areas reduced, to some degree, herder vulnerability to drought and constraints of land quality of fixed plots (Thomson, 1992). Recent trends in land privatization, however, has reduced mobility of pastoralist groups, confining grazing to relative small land parcels, and as a result significantly reducing productivity and plant species diversity in these pasture areas (Fernandez-Gimenez, 2006).

Key observations to Property rights to land and natural resources:

1. A property rights system and related institutions are nearly always present

Wherever stocks of natural resources exist, some type of property rights system that governs or attempts to govern access, use, management, and transfer of the natural resources nearly always exists. A situation of open access to natural resources occurs where property rights authority systems are inadequately equipped to enforce claimed authority or are excessively challenged; however, governing principles are very rarely absent. Information regarding local property rights rules and their enforcement is usually fairly easy to come by. Posing questions to observed resource users about access and use rules is a good place to start.

2. More than one property rights system may operate at the same site

Often overlapping and perhaps competing property rights systems exist in relation to a given natural resource set. A common occurrence of plural property rights systems involves customary and statutory rules and policies. But property systems may also be defined and applied through vehicles as diverse as religion or development projects. The presence of multiple systems regulating, or claiming authority to regulate, property rights

has significant impact on the contents and coherence of the bundles of rights attached to the natural resources of a particular site.

3. Whatever the orientation of national policies, customary practices remain in effect in many settings. In non-Western countries, customary property rights systems frequently retain de facto authority and institutions that continue to regulate and enforce property rights, although in many cases customary systems are challenged and weakened. Customary systems react to, and may compete with, government policy and changing socioeconomic conditions. Nonetheless, customary property rights systems often retain much more coherence and legitimacy than competing systems and events. Indeed, it is important to understand the property rights situation in terms of de jure versus de facto, and customary versus statutory. Often one finds that initial perceptions of a property rights regime turn out to be only part of a much larger picture.

4. Customary property rights systems are durable

Property rights systems, particularly customary systems, exhibit characteristics of flexibility as they evolve in the face of changing economic, social, and political environments. This flexibility, along with long-standing local legitimacy, makes it difficult to replace a customary system. Also, in many circumstances, it is not necessary to replace customary systems. If the goal is to improve stewardship of natural resources, rather than promoting or facilitating exploitation by outsiders (with the latter arguably leading to further marginalization of already impoverished populations), then states can materially strengthen customary systems particularly those that have demonstrated their utility and robustness simply by according them official recognition. When outsiders challenge the authority of customary rules and institutions, an occasional state intervention underlining state support for customary rules and institutions can enhance their credibility and reinforce their legitimacy. Such rules and institutions gain a new lease on life simply because the state or national government has recognized their existence and utility.

5. Customary property rights are not a panacea

As noted earlier, customary land and property rights are not always equitable. Societal prejudices against particular groups, including women, are often reflected in the associated property rights system. In some cases customary tenure systems may not promote sustainable management of natural resources, and instead engage in exploitative use responding to changing economic incentives. In other cases yet, customary systems may find it difficult to adapt to the rapid pace of changes taking place in the current context (Mathieu et al., 2003). It is useful to note however, that statutory property rights systems are equally susceptible to inequity arising from unfair privileges granted to favored groups. Statutory property rights may also promote unsustainable management of natural resources through unclear, contradictory or poor policies, or through the poor implementation of these policies. Therefore, some combination of the customary and statutory systems could yield positive results.

6. Form often follows function

Established practices often constitute the basis for establishment of the rules that govern property rights systems. This principle is articulated in the well-known maxim: possession is nine-tenths of the law. In many parts of the world, customary land tenure systems have to adapt to demographic pressure and changes in local economy. As a result, agriculture is coming under direct competition against non-agricultural uses of land. As Mathieu et al., (2003) illustrate of Burkina Faso, customary rules and restrictions, such as restrictions regarding alienation of land to outsiders is coming under pressure. As new practices become dominant, rules are often modified to reflect these changing practices. Conversely, regulation of practices through proclamation of new rules can be even more challenging. This is evidenced in the fact that in many countries volumes of land tenure legislation have been produced but they have never been effectively implemented.

7. To be complete, a property rights system needs “sticks”

To enforce rules, a property rights system needs teeth in the form of institutions capable of monitoring compliance with rules, imposing penalties for non-compliance and resolving disputes. Where such institutions are lacking, existing rules governing property rights will not necessarily shape practices. Among the challenges to customary property rights systems is that legitimate authority to enforce rules may not be recognized beyond community boundaries, whereas challenges to local rules are often non-local. As local authority weakens, it may also become more feasible to challenge rules from the inside. However, it is equally important to note that many statutory rules ostensibly governing access to and use of natural resources lack the institutional supports upon which their enforcement depends.

8. To be complete, a property rights system also needs “carrots”

New or expanding market incentives can either pose threats to existing property rights, or create opportunities for achievement of environmental and development goals through a rights-based approach. Market incentives, where carefully managed, can complement and reinforce existing property rights systems. Unmanaged market incentives can destroy existing rights systems and lead to free-for-all competition favoring those with privileged means and access. Where property rights are ignored and not replaced, few constraints or guidelines remain regarding environmental sustainability. Usually the most appropriate approach to skirt this problem is to channel incentives toward traditional and local natural resource users.

9. Duration of tenure has implications for security of tenure and productive investments. Individuals or groups with short-term use rights are unlikely to invest in long-term sustainability of land and natural resources. For instance, five-year use rights are unlikely to provide adequate incentives for investments in planting slow growing trees or in soil and water conservation works as the time period is too brief to permit short-termers to benefit from their investments. Long-term tenure security is fundamental for long-term investments in land and natural resource sustainability (FAO, 2002a).

The system of sanctions and rule enforcement can vary. Sanctions may take the form of imposed fees or penalties for rule violations. However, in many non-Western contexts, parallel or overlapping systems of sanctions may exist, as for instance social sanctions and the fear of social exclusion, or supernatural sanctions based on belief in divine retribution.

1.9. Property Rights and Transaction Costs

② Dear learner, would you explain the Property Rights and Transaction Costs? (You can use the space left below to write your response.)

There are two distinct definitions of transaction costs. The ‘Neoclassical’ definition rests on the costs of trading across a market, while the ‘property rights approach to transaction costs’ definition centers on the costs of establishing and enforcing property rights. The delineation of ownership is as old as human written records. The Mosaic laws as described in the Ten Commandments or the laws on takings in Exodus 22:1-15, as well as the host of other Levitical laws throughout the first five books of the Old Testament, are all attempts to legally define ownership. From the Hammurabi code to the English common law the notion of legal ownership, or legal rights, to property is well defined. In the words of Blackstone: ‘The third absolute right; inherent in every Englishman, is that of property: which consists in the free use, enjoyment and disposal of all his acquisitions, without any control or diminution, save only by the laws of the land’.

Though it is difficult to identify where one idea begins, the modern attempt to go beyond a legal delineation of rights and begin talking about ‘economic rights’ seems to start with Alchian. Alchian’s early work on tenure (1958) and the pursuit of individual utility within the context of regulated firms (Alchian and Kessel, 1962) hinge on the property right structures of the institutions in question. For example, managers and administrators of non-profit firms and universities, he argues, face a lower relative cost of private consumption on the job than their counterparts in the private sector. Because these firms are constrained in their ability to show profit, they are able to survive with higher costs. Alchian’s insight was that the set of rules (the distribution of property rights) determined the level of output of the firm because they determined the incentives of each individual. This theme is manifest throughout Alchian’s work and culminates in his famous article with Demsetz (Alchian and Demsetz, 1972). But perhaps Alchian’s most significant contribution, articulated most clearly in Alchian (1979), is his emphasis on economic rather than legal rights. For Alchian, property rights are ‘the rights of individuals to the use of resources’ (1965) not just under the law, but in reality. He makes clear that these rights are not solely dependent on the existence of the state, but that they depend on custom, reciprocity and voluntary restraints. This notion is now commonplace in the modern property rights literature and is explicitly found in Landa (1994).

Although economic property rights are enhanced by the law, they are ultimately use rights and the greater extent one can exercise these uses and bear the consequences the greater are the property rights, regardless of the law. Property rights are therefore defined as the ability to freely exercise a choice over a good or service. The property rights literature argues there is a monotonic relationship between property rights and wealth. Given that trade is the transfer of property rights, there can be no trade (and hence no gains from trade) in the absence of property rights. Also, when property rights are perfectly defined, the Coase theorem states that the gains from trade are maximized. Assuming there is a continuum between these two extremes, as property rights become better defined, the gains from trade increase (see Anderson and Lueck, 1992). Other things equal, individuals prefer better defined property rights to poorer defined ones because they prefer more wealth to less. Increasing the ability to make choices of one individual can reduce the ability to make choices for others. Generally speaking individuals increase their property rights in three ways. First, the individual may steal the good in question. Second, the individual may privatize a good that was previously in the public domain. Finally, an individual may cooperate with other individuals with an agreement to divide the new wealth in some fashion.

When property rights are perfect, by definition no theft can take place and as a result, no effort is made to protect the rights (Barzel, 1985). However, when property rights are incomplete, individuals attempt to increase their ownership in an effort to increase their wealth. This attempt to capture property rights may be dissipating (as in the case of theft), or may be wealth generating (as in the case of assets brought out of the public domain). When there is an opportunity for theft, there is also an opportunity for protection. Hence, when property rights are incomplete, individuals are always in the process of maintaining their existing property rights and attempting to establish new ones. This leads to the property right definition of transaction costs. Transaction Costs: the costs establishing and maintaining property rights.

This definition is first articulated in Allen (1991). Writers in the property rights literature have seldom defined transaction costs, relying mostly on examples of inspection, enforcing, policing and measurement which all hint at the protection of property rights and implicitly recognize the threat of appropriation or theft. For similar, but informal, definitions, see Cheung (1969, p. 16), McManus (1975, p. 336), Jensen and Meckling (1976, p. 308), Barzel (1985, p. 8), Goldberg (1989, p. 22) and Alchian and Woodward (1988, p. 66).

Transaction costs include any direct costs, as well as any concomitant inefficiencies in production or misallocation that resulted from them. For example, consider the Klein and Leffler (1981) example of a firm investing in a sunk asset as a guarantee of product quality. The firm does this to protect the wealth of its customer and as such it is clearly an attempt to maintain property rights. The transaction costs would include the cost of the investment and any increases in costs of production that it may have caused. The property rights definition of transaction costs respects no boundaries between firms, markets, households, or any

other theoretical constructs. When property rights are protected and maintained in any context, transaction costs exist. By explicitly recognizing this relationship it is clear that statements like ‘if we assume zero transaction costs and complete property rights’ are redundant. To say that a situation has zero transaction costs is to say that property rights are complete, according to this definition. Cheung (1992) agrees with this, stating: ‘the dual specifications of clearly delimited rights and zero transaction costs are redundant. If transaction costs are truly zero, the delineation of rights can be ignored’.

When it is costless to establish and maintain rights they are done so perfectly. If transaction costs are prohibitively high then property rights will neither be established nor maintained and property rights will be zero. The reverse, however, is not necessarily true. If property rights are complete in some situation, there are two possibilities, either transaction costs are zero, or costs may have been incurred to guarantee the property rights simply because the benefits of doing so exceed the costs - in which case transaction costs are positive. Further, when property rights are zero, transaction costs could also be zero. For example, if a property right could never be established, despite the resources devoted towards such a goal, no one would bother making any expenditures towards establishing property rights and the good would remain un owned. For example, there are no property rights over the planet Venus and no efforts have been made to establish any.

20. Transaction Cost Economics Approach to the Property Rights

? Dear learner, would you explain Transaction Cost Economics Approach to the Property Rights? (You can use the space left below to write your response.)

An excellent survey of the property right literature is found in Eggertsson (1990a), while an excellent textbook treatment of this approach is found in Milgrom and Roberts 94 (1992). Essentially the property rights literature is characterized by several features related to the above definition. First, the central question is always ‘what explains the distribution of property rights?, where the ‘distribution of property rights’ has a broad meaning and includes all sets of rules, governance structures and organizations. Hence, families, firms, governments, non-profit institutions, contracts, are all viewed as sets of property rights.

Lawyers forming a partnership to split the residuals, a farmer renting land from a landowner, or a judge deciding on a case, are all examples of different allocations of property rights. Every distribution of property rights has with it a set of production costs and a set of transaction costs. The distribution of property rights that maximizes the gains from trade net of all costs is the optimal distribution. This, in fact, is the grand hypothesis of transaction cost economics under the property rights approach.

A second characterization is the reluctance to infer any policy implications from the analysis and to stress explanation. As stated earlier, this goes back to Coase's original idea that no single allocation mechanism dominates. Notions of 'market failure' lose meaning when there is no reason for prices to allocate everything. One might as well refer to 'government failure' or 'firm failure' in cases where prices do allocate.

This transaction cost approach dominates what is now called the 'New Institutional Economics', so named because it provides a theoretical framework and emphasis of testability to the institutional traditions of Veblen and Commons. Oliver Williamson is considered the founder of this literature, both in terms of vocabulary and content and he is one of the strongest proponents of applying the notion of transaction costs ubiquitously. His notion of a 'governance structure' as a distribution of property rights providing appropriate incentives to govern a relationship is intended to apply within and outside firms. Williamson (1971) is the first to note the role sunk costs can play in causing contracting problems and incentives to vertically integrate. This idea is popularized in Klein, Crawford and Alchian (1978) and in Klein and Leffler (1981).

The role of asset specificity and idiosyncratic capital is so attached to the name of Williamson that for many, transaction costs means little else. Although Williamson's understanding of the relationship between transaction costs and property rights is consistent with what is presented here, he also distinguishes between the 'property rights approach' and the 'transaction cost approach' to organizational problems. For Williamson, a property rights approach deals with grand private environmental rules, while the transaction cost approach deals with private incomplete contracts (see Williamson, 1990).

21. The Neoclassical Approach to Property Rights

? Dear learner, would you explain the Neoclassical Approach to Property Rights? (You can use the space left below to write your response.)

Although, Coase (1937) provides mostly market exchange examples and could be argued as the founder of the neoclassical approach to transaction costs, it could be better argued that this approach begins with Hicks' (1935) publication 'A Suggestion of Simplifying the Theory of Money', which predates Coase by two years. In his paper, Hicks begins what is known as a transaction demand for money, although he never calls it as such. For him, there are frictions in the economy and these apply to buying and selling capital assets yielding positive returns. When the returns were small, at the margin, relative to the costs of trading, individuals rationally hold cash balances yielding no return. In his words: The most obvious sort of friction and undoubtedly one of the most important is the cost of transferring assets from one form to another. This is of exactly the same character as the cost of transfer which acts as a certain impediment to change in all parts of the economic system; it doubtless comprises subjective elements as well as elements directly priced. Thus a person is deterred from investing money for short periods, partly because of brokerage charges and stamp duties, partly because it is not worth the bother.

Since money is used to facilitate exchange and since an exchange that needs 'facilitating' must be subject to transaction costs, it is not surprising that those concerned with money dealt with these costs. Indeed, Baumol (1952) and Tobin (1956) elaborate on the transaction demand for money and again treat transaction costs as the costs of trading. The first explicit statement of transaction costs as the cost of trading comes from Demsetz (1964) where he states that 'Transaction cost may be defined as the cost of exchanging ownership titles' (1988). Although this type of definition refers to property rights, transaction costs only arise when an exchange of property rights takes place. This leads to the neoclassical definition of transaction costs: Transaction Costs: the costs resulting from the transfer of property rights.

This is a shortened version of the definition later given in Niehans (1987). The neoclassical approach to transaction costs dominates in finance and pure theory. The following is a partial list of papers that utilize a neoclassical approach: Stavins (1995). A typical definition of transaction costs found in these papers would be as follows:

In general, transaction costs are ubiquitous in market economies and can arise from the transfer of any property right because parties to exchanges must find one another, communicate and exchange information. There may be a necessity to inspect and measure goods to be transferred, draw up contracts, consult with lawyers or other experts and transfer title. Depending upon who provides these services, transaction costs can take one of two forms, inputs or resources – including time - by a buyer and/or a seller or a margin between the buying and selling price of a commodity in a given market. (Stavins 1995)

In the neoclassical approach, enforcement-type costs within firms are not transaction costs. Transaction costs consist of those costs that occur between firms or individuals from the process of market exchange. Hence, an economy made up of one giant firm, or a state run economy, would be a zero transaction cost economy by this definition. Because these transaction costs are just the cost of exchange, they are modeled in a more recognizable fashion, often in the form of a 'transaction function' (Constantinides, 1979). These functions are similar to other neoclassical production functions and are usually assumed to depend on labor inputs. These functions may have increasing, constant, or decreasing returns to scale. Further, the transaction cost functions may have fixed or variable components. Although the analogy is not complete, in many ways transaction costs play a role very similar to transportation costs and taxes and, according to Niehans: 'transaction costs are analytically analogous to transportation costs' Being analytically similar means that many of the impacts of transaction costs are similar as well. Consider, for example, the impact of transaction costs on the volume of trade. If transaction costs increase with the quantity traded, this has the impact of increasing the relative price of the commodity being purchased. Since this holds for goods, in effect the budget constraint becomes kinked at the endowment point and, as a result, individual demands become less responsive to price changes and the volume of trade falls. These are often called 'proportional transaction costs' in the literature and their effect on multi period investment and consumption has also been examined. (Boyle and Vorst, 1992).

Other similar results follow as well. Like per unit taxes, frictional per unit transaction costs drive a wedge between buying and selling prices, although neoclassical transaction costs are not necessary to explain price spreads. Glosten and Milgrom (1985), based on Copeland and Galai (1983), provide an adverse selection explanation for bid-ask spreads that assumes traders have zero friction costs.

Fixed transaction costs tend to bunch transactions together and provide an explanation for the demand for money (see Edirisinghe, Naik and Uppal, 1993, for an example). Differences in transaction costs across individuals lead to some specializing in the transaction function. Hence brokers and agents are those individuals with low transaction costs. Alchian and Allen (1964) were probably the first to note this (see also Niehans, 1969). Differences in the transaction costs across commodities provides an explanation for why some commodities are used as currencies of exchange (Alchian, 1977).

In these last two cases, the question examined is close to the institutional type of question addressed by the property rights school. Neoclassical transaction costs have also been used to analyze the equity premium. The real average returns on US Treasury Bills is less than 1 percent, while for stocks it is closer to 7 percent. This difference is too large to explain with reasonable Arrow-Debreu models. Mehra and Prescott (1985) began a literature explaining this premium based on neoclassical trading costs. (See Aiyagari and Gertler, 1991) Finally, all discussions of the existence of equilibrium with transaction costs utilize a neoclassical definition (See Bergstrom, 1976; Foley, 1970; Hahn, 1971; Hart and Kuhn, 1975; Heller and Starr, 1976; Kurz, 1974b; McKenzie, 1981; Radner, 1972; and Repullo, 1988).

22. The Interest group approach to property rights

? Dear learner, would you explain the Interest group approach to property rights? (You can use the space left below to write your response.)

The set of interest groups concerned with the enforcement of property rights in any country is vast. For example, consumers will favor the level of property rights enforcement that brings them the most economic gain; land holders care about better titling of their land so that they can expand and make capital improvements to their holdings; labor may see increased employment opportunities through better property rights that bring new investment projects. Yet if we are concerned with those groups that will make political investments to influence political actors preferences over property rights, the key is to understand which groups stand to gain or lose, and which are able or willing to organize over well-enforced property rights.

Many groups would have only minimal gains or losses from changes to property rights enforcement. Because these benefits/losses are not defined ex ante, their minimal nature will be unlikely to induce them to make political investments. Further, certain groups may be too difficult to organize. One of the primary determinants of an interest group's ability to make political investments is their ability to organize. According to Olson (1965), better organized groups of voters or interests are better able to exert pressure on political actors than are less organized and less cohesive groups. I concentrate this analysis on those groups with the most to gain/loss from reform of the level of enforcement of the property rights environment: foreign investors, business elites, and small and medium enterprises (SMEs). The remaining interest groups concerned with property rights enforcement may either be subsumed into one of these groups or will not choose to make political investments over property rights. That business interests hold sway in matters of property rights is not surprising. The difficult issue is how to disaggregate the interests of business to understand not only what they want, but when they will elect to make political investments to exercise their influence.

Business as a general category should be able to influence policy because of their organizational abilities and financial resources. Business or trade groups exist in almost every country in the world and tend to have a powerful influence over government. Of course, to consider business in the aggregate would be a mistake in any policy area. While all firms share an interest in profit maximization, for nearly any economic policy, business interests will differ by industry and sector. Within each of our groups, interests-even those reflecting property rights-will differ by sector in terms of their willingness to make political investments. While only through country- and industry-level case studies could we understand the interests by industry and sector in any country, we can make some generalizations across types of industries.

Summary

In this unit Property Rights are discussed. Definitions and Origins of Property Rights, the Role of Property Rights, The Many Types of Property Rights, The Basic Property Rights Concepts, The Property Rights Regimes, Tenure Security and Enforcement of Property Rights, Property Rights and Transaction Costs and Transaction Cost Economics Approach to the Property Rights are fully and thoroughly discussed

Self check exercise 5

PART I. Fill in the Blank spaces

- 1) _____ may be defined as the capacity to call upon the collective to stand behind one's claim to a benefit stream, or "the claims, entitlements and related obligations among people regarding the use and disposition of a scarce resource"
- 2) _____ usually also refer to a bundle of rights
- 3) _____ refers to the social, economic and political relations, and associated institutions within which property rights are situated and are constituted.
4. _____ comprises a set of rights that may include the right to use a resource, the right to manage it, and the right to transfer (assign or reassign), right to own.

5. _____ refer to the authority to assign or reassign both management and use rights.
6. The ability to definitively transfer the entire property rights bundle is a typical feature of property rights systems predominant in the West, and may be referred to as _____.
7. _____ is a useful term and unavoidable within a discussion of property rights.
8. _____ refers to cases where all strands of a property rights bundle held by a natural (real individual) or a legal person (e.g., corporation).
_____ refers to cases where the strands of a private property bundle are shared among members of a defined group such as a community,
9. A strands of the property rights bundle held and managed by the government is known as _____
10. _____ refers to land or natural resources that have no specific right holders associate with them.
11. Natural resources which are open-access called _____
12. The common-pool types of natural resources are characterized by _____ and _____
13. _____ refers to the degree to which individual or group rights to land and natural resources are recognized and protected
14. Transaction Costs is the costs establishing and maintaining property rights. This leads to the _____ approach definition of transaction costs.

PART II. Matching Type

Match the correct answer from Part “B” to Part “A”

Part A

- _____ 1) Controlling the use of the property
- _____ 2) The right to capture the benefits from the property through, for example, mining or agriculture;
- _____ 3) The right to sell or lease the property to someone else;
- _____ 4) The right to exclude someone from the property
- _____ 5) The right to use property as security or for other purposes
- _____ 6) A rights that consist of the right to organize and assign use rights
- _____ 7) Natural resources which do not have open access like
- _____ 8) Implies that they can be exploited by any one
- _____ 9) Means that the capture of part of the resource by one group subtracts it from the amount available to other groups.
- _____ 10) Charming landscape, national parks, biological diversity and even the air and clean water

Part B

- A. public goods B. Divisibility C. Non-exclusivity D. national parks.
E. Transfer right F. Encumbrance rights G. Exclusion rights H. Use rights (usufruct)
I. Extraction rights J. None

Multiple Choice Questions

1. Which of the following statement is wrong about property rights?
A. Property rights are fundamentally a social relation:
B. They are not about the link between a person and a thing (object of property),
C. Property rights are about the relations between people with regard to a thing,

- D. Property rights are more particularly about the benefit stream that is generated
E. . They are also frequently associated with specific duties of the rights-holder to do certain things to maintain the right to the resource
F. All G. None
2. _____ also refers to control over and access to resources, that is, the way in which people (individually or collectively) hold rights and responsibilities to land and natural resources upon it.
A. . Property rights B. Tenure C. Collective Action D. Transaction costs E. None
3. Control over and access to land and natural resources may be understood as an individual's or group's claim to a bundle of rights. These rights typically include authority to
A. Use land and various natural resources B. Manage land and various natural resources C. transfer land and various natural resources D. All E. None
4. The most observable types of property rights are_____
A. use rights, b) Right manage c) Right to transfer d) Right to own e) All F) None
5. Which of the following activities may not be considered as use right type of property rights?
A. Gathering deadwood in a forest B. Grazing livestock in a pasture C. Producing crops on agricultural lands D. Fishing in a pond E. All F. None
6. Use rights to a parcel of land may include the right to
A. Farm B. pasture C. Plant trees, or cut trees, D. Build a house, or establish a non-agricultural enterprise, E. Exploit the land as a quarry F. None
7. Type of property rights that exist at higher order than use and management rights are_____
A. Use rights b)Right manage c)Right to transfer d)Right to own d)All e)None



Self check exercise 5

Part IV. Answer the following questions

1. Describe and explain the role of property rights?
2. What do you mean by the Many Types of Property Rights?
3. Outline the use right of water and tree?
4. Discuss the Westerner and non-Westerner think of ownership?
5. What do you mean by Priority rights?
6. Discuss the four types of property Rights Regimes?
7. Keeping the property right regimes in to consideration based on their utilization; we can broadly identify two types of natural resources where there is no direct market value. Explain?
8. Explain the three main characteristics of efficient structure of property right.
9. Explain the need of supporting institutions for property right?
10. Explain Incomplete Contract Theory?
11. Outline the elements of tenure security.

12. Describe the key observations to Property rights to land and natural resources?
13. Explain the two distinct definitions of transaction costs.
14. Explain the difference between Neoclassical and 'property rights approach definition to transaction costs'.

REFERENCES

- Aoki, M. , 2001. *Toward a comparative institutional analysis*. Cambridge, Mass., U.S.A.: MIT Press.
- ARD, Inc., 2005. *Land Tenure and Property Rights (LTPR) Framework and Tools*, Burlington, Vermont. Documents may be requested from ard@ardinc.com.
- Ashley, Caroline and Christopher LaFranchi. 1997. *Livelihood strategies of rural households in Caprivi: implications for conservancies and natural resource management*. DEA Research Discussion Paper 20. Windhoek: DEA.
- Bardhan, P. K. 2001. *Institutions, reforms and agricultural performance*. In *Current and emerging issues for economic analysis and policy research*, ed. K. G. Stamoulis. Rome: Economic and Social Department, Food and Agriculture Organization of the United Nations.
- Bromley, Daniel. 2003. *The Commons, Common Property, and Environmental Policy*. In B. Larson (ed.) *Property Rights and Environmental Problems, Volume I*. Burlington: Ashgate Publishing Company, pp. 83-99.
- Cavendish, William. 1999. *Empirical Regularities in the Poverty-Environment Relationship of African Rural Households*, the Centre for the Study of African Economies Working Paper Series, Paper 105.
- Coase, R. H. 1992. *The institutional structure of production*. *American Economic Review* 82 (4): 713–719.
- Coase, Ronald. 1961. "The problem of social cost." *Journal of Law and Economics* 3:1-44.
- Coase, Ronald. 1937. "The nature of the firm." *Economica* 4: 386-405.
- Coase, Ronald. 1988. *The Firm, the Market and the Law*. University of Chicago Press.
- Coase, Ronald. 1992. "Comments on Cheung." In *Contract Economics*, edited by Lars Werin Davis, L. E., and D. C. North. 1971. *Institutional change and American economic growth*. Cambridge: Cambridge University Press.
- Dorward, A. R. 2001. *The effects of transaction costs, power and risk on contractual arrangements: A conceptual framework for quantitative analysis*. *Journal of Agricultural Economics* 52 (2): 59–74.
- Dorward, A. R., J. G. Kydd, J. A. Morrison, and C. Poulton. 2005. *Institutions, markets and economic coordination: inking development policy to theory and praxis*. *Development and Change* 36 (1): 1–25.
- Dorward, A. R., J. Kydd, and C. Poulton. 2005a. *Coordination risk and cost impacts on economic development in poor rural areas*. Paper presented at the Agricultural Economics Society Conference, Nottingham, U.K., April.
- Fernandez-Gimenez, Maria. 2006. *Land Use and Land Tenure in Mongolia: A Brief History and Current Issues*, USDA Forest Service Proceedings RMRS-P-39 http://www.fs.fed.us/rm/pubs/rmrs_p039/rmrs_p039_030_036.pdf.

- Fischer, Julie E. et al. 1995. Atelier Régional de N'Zérékoré sur la Problématique Foncière et la Gestion des Ressources Naturelles en Guinée Forestière, Workshop Report. Madison, Wisconsin: Land Tenure Center.
- Food and Agriculture Organization. 2002a. Land Tenure and Rural Development, FAO Land Tenure Series 3. Rome: FAO.
- Hall, P. A., and D. Soskice, eds. 2001. Varieties of capitalism: The institutional foundations of comparative advantage. Oxford: Oxford University Press.
- Kinder, D. R., & Sears, D. O. (1985). Public opinion and political action. In G. Lindzey, & E. Aronson (Eds.), Handbook of Social Psychology (pp. 659-741). New York: Random House.
- Lawry, Steven W. 1990. Tenure Policy toward Common Property Natural Resources in Sub-Saharan Africa, Natural Resources Journal 30 (Spring): 403-422.
- Mathieu, Paul, Philippe Lavigne Delville, Lacinan Pare, Mahamadou Zongo, Hubert Ouedraogo with Julianne Baud, Eric Bologo, Nadine Kone, Karine Triollet. 2003. Making Land Transactions More Secure in the West of Burkina Faso, IIED Drylands Program, Issue Paper No. 117, London: IIED. <http://www.iied.org/pubs/pdf/full/9170IIED.pdf>.
- Meinzen-Dick, Ruth, Rajendra Pradhan, and Monica Di Gregorio 2004. Understanding Property Rights. In Meinzen-Dick, Ruth and Monica Di Gregorio (eds.) Collective Action and Property Rights for Sustainable Development, Focus 2020, Brief 3, Washington DC: IFPRI.
- Norfolk, Simon. 2004. Examining Access to Natural Resources and Linkages to Sustainable Livelihoods: A Case Study of Mozambique, Livelihood Support Programme Working Paper 17. Rome: FAO.
- North, D. C. 1990. Institutions, institutional change and economic performance. Cambridge: Cambridge University Press.
- Oliver, P. (1980). Rewards and punishments as selective incentives for collective action: Theoretical investigations. American Journal of Sociology, 85,1356-1375
- Olson, M. (1965). The logic of collective action: Public goods and the theory of groups. Cambridge, M A : Harvard University Press.
- Ostrom, E. 1990. 2005b. Understanding institutional diversity. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, E. 1990. Governing the commons: The evolution of institutions for collective action. Cambridge: Cambridge University Press.
- Ostrom, E. 2005a. Doing institutional analysis: Digging deeper than markets and hierarchies. In Handbook of New Institutional Economics, ed. C. Ménard and M. Shirley. Dordrecht: Springer.
- Ostrom, E. 2005b. Understanding institutional diversity. Princeton, N.J., U.S.A.: Princeton University Press.
- Ostrom, Elinor. 1999. Private and Common Property Rights. In Boudewijn, Bouckaert and Gerrit De Geest (eds) Encyclopedia of Law and Economics, Vol. 1 The History and Methodology of Law and Economics, Edward Elgar and The University of Ghent, pp 332-379. <http://encyclo.findlaw.com/2000book.pdf>

- Safia Aggarwal and Kent Elbow, 2006. Rights in Natural Resource Management, Good Governance And Empowerment of The Rural Poor. United States Agency for International Development, ARD, Inc.159 Bank Street, Suite 300, Burlington, VT 05401 Tel: 802 658-3890, Fax 802 658-4247 www.ardinc.com
- Shackleton, Sheona, Charlie Shackleton and Ben Cousins. 2000. Re-valuing the Communal Lands of Southern Africa: New Understandings of Rural Livelihoods, ODI Natural Resource Perspectives Number 62, November 2000.
- Smon, B. (1998). Individuals, groups, and social change: On the relationship between individual and collective self-interpretations and collective action. In C. Sedikides, J. Schopler, & C. Insko (Eds.), *Intergroup cognition and intergroup behavior* (pp. 257-282). Mahwah, N J : Lawrence Erlbaum.
- Soloman, Barry. 1999. "New directions in emission trading: the potential contribution of new institutional economics." *Ecological Economics* 30: 371-87.
- Tarrow, S. (1994). *Power in Movement: Social movements, collective action, and politics*. New York: ambridge University press.
- Thomson, Jamie T. 1992. *A Framework for Analyzing Institutional Incentives in Community Forestry*, Rome: FAO.
- Tietenberg, Tom. 2002. "The evolution of emission trading: theoretical foundations and design considerations." Manuscript. Available from www.colby.edu/personal/t/thtieten.
- Toulmin, Camilla. 2005-06. *Securing Land and Property Rights in Sub-Saharan Africa: The Role of Local Institutions*. http://www.iied.org/Gov/mdgs/documents/mdg3/ch2_28pp.pdf.
- Unruh, Jon, Lisa Cligget and Rod Hay. 2005. Migrant Land Rights Reception and 'Clearing to Claim' in Sub-Saharan Africa: A Deforestation Example from Southern Zambia, *Natural Resources Forum* 29: 190-198.
- Uphoff, N. 1986. *Local institutional development: An analytical source book with cases*. West Hartford, Conn., U.S.A.: Kumarian Press.
- Wallis, J. J. and D. C. North, 1986. Measuring the transaction sector in the American economy. In *Long-term factors in American economic growth*, ed. S. L. Engerman and R. E. Gallmann. Chicago: University of Chicago Press.
- Wiber, Melanie G. 2005. *The Voracious Appetites of Public versus Private Property: A View of Intellectual Property and Biodiversity from Legal Pluralism*, CAPRI Working Paper # 40, July 2005.
- Williamson, O. E. 1985. *The economic institutions of capitalism*. New York: Free Press.
- Williamson, Oliver .1991. Comparative economic organisation: The analysis of discrete structural alternatives. *Administrative Science Quarterly* 36: 269–296.
- Williamson, Oliver. 1975. *Markets and Hierarchies*. New York: Free Press.
- Williamson, Oliver. 1996. *The Mechanism of Governance*. New York: Oxford University Press.
- Williamson, Oliver. 1998. "Transaction cost economics: how it works; where it is headed." *De Economist* 146 (1): 23-58.
- Williamson, Oliver. 1999. *The New Institutional Economics: Taking stock and looking ahead*. Address to the International Society for New Institutional Economics. *ISNIE Newsletter* 2 (2): 9–20.
- Williamson, Oliver. 2000. "The New Institutional Economics: taking stock, looking ahead." *Journal of Economic Literature* 38 (3): 595-613.

Answer Key to Self Check Exercises

Answer Keys to Self Check Exercise 1

1. True
2. False
3. True
4. False
5. False
6. False
7. True
8. True

Answer Keys to Self Check Exercise 2

Part I.

1. Project appraisal is about a method used to select best project from the alternative project ideas
2. Technical, financial, economic, social environmental
3. Shadow price is the price use in economic analysis
4. Financial analysis is focused on individual project owner while economic analysis consider project from the contribution to the communities welfare

Part II.

1. E
2. B
3. D
4. A

Answer Keys to Self Check Exercise 3

Part I.

1. Project cycle is the sequence of events which shows the activities done after the other to realize the project aspect.
2. Experts, entrepreneurs, developmental plan, community
3. To get lesson for future planning, set standard for project evaluation

Part II.

1. True
2. True
3. True
4. False

Answer Keys to Self Check Exercise 4

1. Tax, subsidy, credit transactions
2. Tax reduces income of individual in financial analysis and considered as cost in financial analysis.
3. Increase production, reduce cost, and improve quality
4. Externalities is secondary costs and benefits which realized by community surrounding the project area.

Answer Keys to Self Check Exercise 5

1. Discount and undiscounted interest rate calculation methods
2. Financial ratios tell us the status of the project, whether the project is profitable or not
3. Inventory ratio, income per cost ratio

Ambo University Woliso Campus

Department of Agricultural Economics

Assignment for the course titled institutional Economics (AgEc 3125)

Assignment load- 30%

Name _____ ID.No. _____ Department _____ Year _____

This is an assignment for institutional Economics. You are expected to work all the questions and submit it to Instructor of the course Primarily via MoSHE/AUWC authorized Telegram address if not using edikonjog@gmail.com or Getahun.gebru@mwu.edu.et .

N.B: Try by your own self, copying from other student(s) result in zero mark.

I. Fill in the Blank spaces

1. _____ security of tenure refers to the ability of an individual to appropriate resources on a continuous basis, free from imposition, dispute, or approbation from outside sources, as well as the ability to claim returns from investment in the resource

2. _____ are sets of rules?
3. _____ are the rules of the game in a society, together with their enforcement arrangements?
4. _____ describe the sets of rules and structures governing the allocation and exchange of resources through specific transactions.
5. _____ is a common phenomenon in evolving systems, such as biological systems or ecosystems, and is an important feature in the development of social and political institutions.
6. A _____ is the exclusive authority to determine how a resource is used, whether that resource is owned by government or by individuals
7. Property rights to a good must be defined, their use must be monitored, and possession of rights must be enforced. The costs of defining, monitoring, and enforcing property rights are termed _____
8. _____ refers to as the right to use property as security or for other purposes.

Part II ESSAY TYPE

1. Discuss briefly the causes of institutional change?
2. What are the effects of exogenous shocks and endogenous processes in bringing about change, and which is more important, in the short run and the long run?
3. Explain the process of institutional change?
4. What do you mean by the process of institutional change?
5. Under what circumstances is institutional change deliberate or spontaneous, sudden or gradual, a cooperative venture or an outcome of conflict?
6. What are the sources of inertia which make institutions relatively durable over time?
7. What is the role of politics in the process of institutional change?
8. What is the role of “bounded rationality” in the process of institutional change?
9. How should we think about the interaction between formal and informal rules in the process of institutional change?
10. Briefly explain the outcome of institutional change: and also answer the following questions
 - Under what circumstances will efficient institutions tend to emerge?
 - When there are multiple equilibrium, how are particular equilibrium selected?
 - When, and how much, does history matter?

Check list

Dear learner, below are some of the most important points down from the Unit you have been studying up to know. Please put tick(✓) mark in front of the point you have understood well in the box under “Yes” and in the box under “No” for the points you have not yet understood well. And if the tick marks under “No” are more than those under “Yes”, it means you are left with a lot to understand the Unit and you have not yet achieved the objectives indicated at the beginning of the Unit. This tells you to go back and read the Unit you passed through. This will be very much helpful to you in at least two ways.

- a. It will enable you to master the subject matter this Unit which will be the foundation of many of the concepts in this course, so that the difficulty to study subsequent Units will be highly reduced.
- b. You can easily work on self –check exercise questions that follow the summary of this unit.

I can:	Yes	No
1. Define project		
2. Distinguish between a project and program		
3. Explain what is meant by project analysis		
4. Discuss the advantages and limitations of project analysis		
5. Explain project quality factors		
6. Discuss the main techniques for project planning		

REFERENCES

Bromley, Daniel (2006). Sufficient Reason: Volitional Pragmatism and the Meaning of Economic Institutions, Princeton University Press.

- Dean Lueck (2008). "Property law, economics and," The New Palgrave Dictionary of Economics, 2nd Edition. Abstract.
- Elinor Ostrom (2005). "Doing Institutional Analysis: Digging Deeper than Markets and Hierarchies," Handbook of New Institutional Economics, C. Ménard and M. Shirley, eds. Handbook of New Institutional Economics, pp. 819-848.
- Gudeman, Stephen (2005). Peopled Economies: Conversations With Stephen Gudeman. Staffan Löfving. ISBN 91-974705-6-2.
- Malcolm, Dewey and Reese Rutherford (2008). "Institutionalism, old," The New Palgrave Dictionary of Economics, 2nd Edition, v. 4, pp. 374-81. Abstract.
- M. Klaes (2008). "Transaction costs, history of," The New Palgrave Dictionary of Economics, 2nd Edition. Abstract.
- Warren J. Samuels, (2008). "Institutional economics," The New Palgrave: A Dictionary of Economics. Abstract.