

Different Views on Evolution of Institutions:

Generally, institutions provide guidelines for members of the society to control their behaviour and simply it says what to do and what not to do. In the real world, the institutions resulted from the process of evolution or creation. In the process of evolution of institutions, economic benefits for its members have been increased. It means that people selected the efficient combination of choices under the given set of constraints (institutions) in the way which increases economic benefit to the people. This process is dynamic and eventually, it leads people to a better economic position. It is important to understand that there is a link between development of institutions and the economic development of a country. Historically the economic and political institutions have evolved or changed with the changes in the basic economic relations within the society. Groups with conflicting interests do not agree on the set of economic institutions that maximize aggregate growth. Groups with political power want to change political institutions in their favour.

Probably the first question we should address is whether, and how well, institutions adapt to the economic requirements of the society. To understand what institutions is it would be more applicable to discuss and distinguish between the following different views of institutions.

(1) Efficient institutions view: According to this view, societies choose the institutions that maximize their total surplus. How this surplus will be distributed among different groups or agents does not affect the choice of institutions. To put simply those institutions thrive, which contribute to larger output irrespective of how equitable or inequitable the distribution of the production is. The underlying reasoning of this view comes from the Coase Theorem. Ronald Coase argued that when different economic parties could negotiate freely, they will be able to bargain to internalize potential externalities. The farmer, who suffers from the pollution created by the nearby factory, can pay the factory owner to reduce pollution. The same reasoning can be applied to political situations. If the current laws or institutions benefit a certain group while creating a disproportionate cost for another, these two groups can negotiate to change the institutions. By doing so they will increase the size of the total surplus (“the pie” that they have to divide between themselves), and they can then bargain over the distribution of this additional surplus.

(2) Incidental institutions view: While the efficient institutions view is explicitly based on economic reasoning and choices of a society Incidental institutions view emphasizes that institutions developed as a by-product of many complicated social interactions. This outlook, which is more popular among many political scientists and

sociologists, states the set of political and economic institutions emerge not as a choice of economic actors, but are an incidental consequence of other actions. An interesting example of this the theory of the formation of modern states argues that modern state institutions such as fiscal systems, bureaucracy and parliaments are closely related to the need to raise resources to fight wars and thus arose in places with continual inter-state competition.

(3) Rent-seeking institutions view: An alternative is that institutions emerge as a result of economic agents' choices, but are not necessarily efficient or they do not maximize output. But why isn't a set of institutions that maximize output chosen? Because according to this view, institutions are not always chosen by the whole society (and not for the benefit of the whole society), but by the groups that control political power at the time. These groups will choose the institutions that maximize their own rents, and the institutions that result may not coincide with those that maximize total surplus. In all societies there is a "persistent tension between the ownership structure which maximizes the rents to the ruler (and his group) and an efficient system that reduces transaction costs and encourages economic growth". Therefore, equilibrium institutions will not be those that maximize the size of the overall pie, but the ones that maximize slice of the pie taken by the powerful groups.

(4) Costly institutions view: this approach combines elements of the first and the third approaches. Institutions are constructed in order to solve economic problems, such as reducing transaction costs, enforcing contracts etc., and there is a tendency towards efficient institutions. However, this approach, differently from the efficient institutions view, recognizes that it might be costly to design institutions, so depending on these costs, the right set of institutions may not emerge in a society. The general implications of this view are very similar to the efficient institutions view, but it allows for the presence of differences in institutions across societies that might have important economic consequences. Such differences would emerge because the costs of designing the right set of institutions may vary across societies.