

Types of institutions:

We can distinguish between the following types of institutions

(1) Economic institutions: determine the “economic rules of the game”—in particular, the degree of property rights enforcement, the set of contracts that can be written and enforced, and some of the rules and regulations that determine the economic opportunities open to agents. Common examples of economic institutions would therefore include individual property rights, commercial law, contract law, patent law, the type of credit arrangements, etc.

(2) Political institutions: The political institutions regulate the limits of political power and determine how political power changes hands. Common examples of political institutions would include the constitution, judiciary, electoral rules, constraints imposed on the power of the executive by other branches of the government, etc.

This distinction is useful, but there is considerable uncertainty about the role of these different institutions and their effects on economic outcomes. We perhaps don't know exactly what these different “institutions” do in practice.

The difference between political power and political institutions also needs to be clarified. Why is there a need for political institutions at all? Why is there anything more than current political power? The answer to these questions lies in the fact that in these types of social interactions that are important commitment problems. In particular, there are two types of commitment problems that political institutions might be useful in mitigating:

(i) A ruler (head of the state/ruling party) today can fail to oblige not to expropriate assets or returns from investments tomorrow. In this case, political institutions that take away the ruler's power of expropriation may be socially useful. Moreover, introducing such institutions might even be in the interests of the ruler in order to encourage investment. Therefore political institutions might emerge as a credible commitment by the ruler not to expropriate the citizens in the future.

(ii) The party who is in power today may not be in power tomorrow, and they may be afraid of the redistribution policies that those who come to power in the future may undertake. In this case, those in power today may introduce political institutions in order to constrain others who will come to power in the future. Therefore one way of thinking of political institutions is as a way of restricting the future use/misuse or allocation of political power, hence providing some commitment value.