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26. January 2011

Online at <http://mpra.ub.uni-muenchen.de/28427/>

MPRA Paper No. 28427, posted 04. February 2011 / 01:24

# AN OVERVIEW ON INSTITUTIONALISM AND DECENTRALIZED DECISION-MAKING

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## **Abstract**

*Human actions, interactions and decisions should have a certain degree of predictability that can be obtained by establishing rules. Institutions, in general, are defined by sets of rules known by the public and applicable for the community. Their existence is essential for the economic activity, as it cannot develop in a vacuum. At the same time, the type and the quality of institutions make the difference in implementing economic aspirations of individuals and in supporting economic overall growth.*

*Institutions provide a minimum of regulations that in conjunction with the particularities and the interests of individuals and communities become the foundation for economic, political and social decision-making processes.*

**Key words:** institutions, institutionalism, decision-making, decentralization

**JEL Classifications:** B25, D23, D73

## **Institutionalism – old and new at the same time**

The setup for institutional economy, so popular in the last decades, can be defined by linking decision processes to institutions and emphasizing their economic implications. The main idea of institutionalism, as a economic theory, is that the modern economy is a complex and evolving system, whose effectiveness in meeting the heterogeneous interests of the people depends on a system of rules that must coordinate the human behavior, naturally inclined to be opportunistic.

In theory, this set of rules is represented by institutions, which by governing the human interactions, have a decisive impact on economic growth directly correlated with the existence and proper functioning of institutions and values. The institutionalist approach on economy differs significantly from the neoclassical one, based on rationality and knowledge, defining institutions as external factors, independently created and developed.

Institutionalism has a close interdependence with legal and political sciences, sociology, anthropology, history, organizational science, management, philosophy and tries to demonstrate its impact on economic behavior.

The basic idea of institutionalism is that institutions play an extremely important role that shifts the economic perspective from specific processes and outcomes to abstract, general rules. This idea is supported by Friedrich von Hayek's approach and by other members of the Austrian School. In his paper *Rule of law, Legislation and Freedom*, Hayek acknowledges the need for certain rules that will be respected by the individuals of a community for ensuring order and effectiveness. He represents the so-called *old institutionalism*, built on Charles Sanders Peirce's pragmatic philosophy, which rejected the Cartesian idea of a rational and calculated individual and replaced it with the idea of a organization led by traditions and daily behaviors.

At the same time, economists such as *Veblen, Commons and Mitchell* have rejected the neoclassical theory of a rational and calculated individual and they emphasized on reaction rather than action, on habit and traditions.

The next approach was the *new institutionalism*, supported by *Ronald Coase* in his paper *The Nature of the Firm (1939)*. He identifies two institutions with vital impact on human activity in general and specially on economic decisions: the firm and private property. *Douglas North* and in the *The Rise of the Western World* adds the free market as being the most effective institution for allocating resources. Together with the already mentioned ones, *James Buchanan*, representing the "public choice" theory, and the economist *William Vickery*, presenting the consequences of limited and asymmetric knowledge, have also contributed in developing institutionalism as an economic theory.

These studies on institutionalism are still very up to date, especially since the authors have obtained the Nobel Prize for Economics: Hayek (1974), Buchannan (1986), Coase (1991), North (1994), Vickery (1996), Williamson (2009).

### **Defining institutions and their characteristics**

Institutions are rules of conduct, meant to coordinate the actions of individuals. They forbid certain actions and impose restrictions on the possible reactions, bringing more predictability. Usually, institutions use the past successful experience and set the way people should act/interact/react in order to reach their objectives. They offer knowledge and confidence that individuals' decisions will develop as expected.

Representing the *old institutionalism*, Veblen made special efforts to analyze the social realities from an institutional point of view. In his opinion the most important institution propriety, which is representative for the way Veblen characterizes an institution: to be based on collective action rather than individual, to develop in time, to consider the informal issues and the role of the community, to define itself at the conceptual level. Thus, Veblen sees

institutions as mental structures, rather than tangible manifestations, resulting from habits and traditions transmitted from generation to generation.

The *new institutionalism* gives a somewhat different meaning to the notion of institution. It doesn't focus on social institutions, but analyses to the whole institutional environment, defined by political, social, economic rules facilitating production and commerce. Institutions are defined as a set of rules that rationalize social interactions and are shared by the entire community (Knight, 1992).

There are reasons for which defining and analyzing institutions are important: institutions are independent political players, having their own goals and interests, institutions include restrictions that help individuals to avoid the negative effects of collective actions and last but not least, institutions support social players in working together for reaching their common goals.

On the other hand, Douglas North argues that institutions are the result of historical evolution, offering rational support in decision-making. He sees institutions as tri-dimensional concepts, made of formal rules, informal restrictions and mechanisms making the former two work. Thus, institutions are at the same time pre-set game rules for society and also individual self-imposed restrictions, meant to mediate social relations and to support exchange processes between different levels. For North the main function of institutions is to reduce uncertainty, offering a stable and effective environment for economic exchanges.

Unlike neo-classical theory, that sees institutions as exogenous from the economic players, institutionalism identifies two types of institutions: *internal*, as rules developed within a group as a result of past experience and *external*, designed and imposed on society through political decisions. Internal institutions can be classified according to how compliance/non-compliance is monitored/punished:

- *Conventions* – rules that provide clear and immediate benefits for those who respect them and also affecting their own interest if they don't respect them;
- *Internalized rules* – rules that individuals have learned through habit, education or experience, spontaneously and by reflex respecting them, dealing with their own consciousness if they don't;
- *Habits and manners* – their breach is informally sanctioned by the community, for example by exclusion;
- *Formalized internal rules* – rules that have evolved from experience and that are now formally monitored, through mechanisms established by the group/community.

External institutions are very much different from the internal ones, being created and imposed to the community through legitimate political will and the power of coercion. They always involve a hierarchical structure, unlike the internal ones and if not respected, the sanctions are formal and possibly applied using force. There are three types of external

rules: external rules of conduct, specific directives, and procedural rules. Authors on institutionalism have emphasized on the importance of external rules for many reasons:

- habits and conventions are ambiguous;
- internal rules might lead to inequities;
- informal sanctions do not have the desired impact;
- external institutions govern contract-based relationships;
- external institutions ensure rationalization of scarce resources;
- internal institutions bring the risk of discrimination and exclusion.

A dilemma appears in identifying the perfect combination internal – external institutions, in order to avoid creating artificial institutions, against the established order and to avoid restrictions on the freedom of deciding on reaching the interest of the community/individual. This is the point where the issue of decentralized decision-making must be addressed. Although a borrowed concept from the administrative sciences, decentralization is important in both public and private sectors.

### **Decentralization and decentralized decision-making**

Decentralization is a complex concept, having different interpretations. It is defined as transferring authority and responsibility from central authorities towards subordinate or quasi-independent governmental structures or towards private sector organizations. In order to ensure efficiency, equity and economic stability through decentralization there are two essential principles that must be respected: providing funding for fulfilling the tasks and a coherent and consistent decision-making process.

Decentralization has different characteristics, political and social implications and specific success factors, which define particular types of decentralization: political, administrative, fiscal, market-based decentralization. Identifying the differences between these types is useful for emphasizing the need for coordination between them in order to ensure the success of decentralization strategies.

*Political decentralization* aims to offer citizens or their representatives more power in decision-making. It is commonly associated with political pluralism and government and applied for policy formulation and implementation. Advocates of political decentralization march on the premise that decisions taken with greater local participation will better reflect the interests of society/community, rather than those taken exclusively by central authorities and implemented at inferior levels.

*Administrative decentralization* seeks sharing authority, responsibility and financial resources for providing public services on different administrative levels. It involves transferring responsibility for planning, financing and management of public services from central level towards territorial agencies and authorities. There are three forms of administrative decentralization:

- Deconcentration – considered the weakest form of decentralization, but the most frequently used in unitary states. It involves transferring decision-making between different administrative levels;
- Delegation – is a more extensive form of decentralization. The central authorities/government transfer responsibility for decisions and for the management of public services toward semi-autonomous structures. These are fully liable, however, they are often exempted from administrative rule of law;
- Devolution – involves transfer of authority, finance and management to autonomous structures of local government, led by elected managers and strongly connected to political decentralization.

*Fiscal decentralization* is a central component of overall decentralization. To achieve other forms of decentralization is essential that necessary financial resources be transferred to lower tiers. It can take many forms: self-financing, co-extension of local taxes, municipal loans.

*Market-decentralization* is the most complex form of decentralization, consisting of privatization or deregulation and transferring responsibility from the public sector to the private one. Privatization and deregulation are often accompanied by policies of economic liberalization and market development. Functions that were exclusively governmental are carried out by companies, community associations, voluntary associations, NGOs. Privatization can vary from complete transfer of goods on the free market to public-private partnership in which public and private sectors work together. Deregulation involves reducing the legal constraints on private sector participation in delivering public services, or encouraging competition in sectors which were state monopolies.

All these forms of decentralization have an important role in expanding participation in political, economic and social activities and can lead to more creative innovative and efficient solutions through local experimentation.

## **Conclusions**

In this context, the institutionalist approach is important in the processes of decision-making, especially in decentralized decision-making. Even in decentralization institutions are rules set to control any opportunistic behavior on all levels of authority and they assume different forms: habits/traditions, manners, economic and financial arrangements designed and implemented in order to facilitate economic exchange. These have an informal content, emerging without express regulation, but are enforced through the consent of the group/community. But even if a large part of the economic interactions included in the beginning such internal institutions, complex societies and economies have found it necessary to define external, formally organized institutions. They are most often based on informal institutions, but once their social and economic role increased the need for

formalization has appeared. This includes an enforcement of coercion and sanctions from outside structures, because as Hayek wrote in his paper *Political Order of a Free People*, the obedience to learnt rules has become necessary to restrain those natural instincts which do not fit into the order of an open society.

Institutions are used to reduce the costs of coordination in complex systems, to limit and even to resolve conflicts between people, but also to protect the freedom of individuals. Consequently, institutions, internal-external, formal-informal, should not limit decision-making, but provide a support mechanism for decision-making, based on:

- safety/certainty;
- general applicability;
- openness/universality

*This work was supported by the the European Social Fund in Romania, under the responsibility of the Managing Authority for the Sectoral Operational Programme for Human Resources Development 2007-2013 [grant POSDRU/88/1.5/S/47646].*

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