CHARACTERISTICS OF INSTITUTIONS

Prof. Douglas C. North defines institutions as "the rules of the game, more formally, the humanly devised constraints that shape human interaction". Thus, according to him, institutions have broadly the following features:

1. Institutions are the rules that help in interaction among individuals in several spheres of life, such as, social, economic and political. They include the social norms of behaviour, customs, codes of conduct in the society, rules made by the government for governing the people and for the smooth conduct of the economy. These rules are constitution of the state and various policies and laws enacted by various agencies of the government.
2. Institutions are the constraints that shape human behavior. That means every agent concerned abide by these rules while making his decisions. He or she or the group is not expected to go beyond it or violate it.
3. Institutions are man-made.
4. Institutions form the basis of human interaction. In economics interaction take place in the market when people make decision for exchange.

North distinguishes two types of institutions: formal and informal. Formal institutions are the rules and laws made by statutory authority like government. Constitution and economic policies are the examples of formal institutions. Informal institutions are formulated within the society to influence social behavior.

Institutions have huge impacts on economic development of a country. According to North, institutions create incentives. This is done through enforcing property rights, minimizing transaction costs and enforcing contracts. Good institutions reduce the possibility of occurrence of the problems of asymmetric information, principal-agent problem and moral hazard. Thus, it causes the markets to function efficiently.

The basic problem of an economy is efficient allocation of resources. The allocation of resources is done by the market mechanism. Classical economists believe that under the laissez faire condition a competitive market performs best in allocation of resources. Market becomes competitive under the following conditions:

1. There must be perfect circulation of information. That is to say there is absence of information asymmetry among the parties involved in the exchange.
2. There must be perfect mobility of factors of production. This obliquely means that the property rights are clearly defined and enforced among the factor owners. Secondly, contracts are properly enforced in the factor market.

3. Transaction costs must be absent in the market. This implies that the cost of transaction or exchange should be zero.

Perfect competition is an ideal market hardly found. In the real world conditions, any or all of the above three conditions may be absent and thus there is always a divergence from perfectly competitive conditions in the market. This leads to inefficiency in exchange. Institutions play important role in allocation of resources by strengthening markets. There are various types of markets, such as, markets for goods, labour market, land market, housing market, financial market that deals with credit or the flow of finance for investment, etc. Besides, classification is done on the basis of their occurrences, such as rural markets and urban markets. Often we observe inter-linkage between markets. To strengthen markets, institutions are needed to remove information asymmetry, to enforce property rights, to minimize transaction costs and to enforce contract. This will lead to efficient allocation of resources.

The role of institutions is important for economic development of a country. But, what is more important is the quality of institutions. Economists distinguish good and bad institutions. Good institutions create incentives and hence contribute to economic development through efficient allocation of resources, proper distribution of income and economic stability with a satisfactory level of growth. Acemoglu and Robinson distinguish between extractive and inclusive institution caused by different economic system. Extractive institutions do not enforce property rights. On the other hand inclusive institutions enforce property rights. Inclusive institutions create a level playing field for the growth of an economy. The 'East Asian Miracle' is the outcome of the inclusive institutions.

The basic and fundamental characteristics of institutions are as follows:

1. Institutions serve some pre-defined purposes. Such pre-defined purposes are directed towards promoting social welfare.
2. Institutions evolve over time.
3. Institutions are relatively permanent. However, formal institutions change easily though it takes a long time for change of informal institutions.
4. Institutions tend to become traditions and established code of conduct. They are endured by the people in course of time.
5. Institutions are value based.
6. Each institution emerges within the society.
7. Institutions are created by men.
8. Institutions create incentives and provide the level playing field for the economy. They also provide explanations for the functioning of the markets.

An institution is good or bad depends upon the nature of economic system. Thus, whether institutions prove good or bad is contextual.