

New Institutional Economics: A State-of-the-Art Review for Economic Sociologists

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Introduction

According to a widely accepted definition by Douglas North, institutions are “rules of the game” in the society and economy which reduce uncertainty and structure behavior and interactions of economic agents. The notion of institutions is perhaps one of the most “sociological” among economic concepts, as it applies to agents’ dealing with each other (there could be no institutions in a Robinson Crusoe economy), and incorporates a number of inherently sociological categories, such as networks, norms, customs, etc. It should therefore come as no surprise that the work of first institutionalists, such as Veblen and Commons, had a distinct sociological flavor. It took another several decades for mainstream economists to fully appreciate the key role of institutions – not just economic, but also legal, political, etc, for economic performance and development. This understanding heralded the advent of what is now known as the New Institutional Economics (NIE).

Unlike the early institutionalism, NIE is a deductive and empirically grounded discipline, which shares the key tenets and premises of the economic way of thinking, such as allocation of scarce resources, individual incentives and rationality, competition and market exchanges. However NIE is a major departure from the “institution-blind” neo-classical approach in that it recognizes transaction costs as a fundamental feature of economic exchanges. In the presence of transaction costs efficiency of market equilibria can no longer be assured, and institutions as devices for transaction cost management are highly relevant for social and economic outcomes. NIE maintains and expands the conceptual links of the early institutionalism to sociology, law, political science, anthropology and history, and provides a natural basis for the integration of economics with the rest of social science and humanities.

The thematic scope of NIE is vast, imprecisely defined, and evolving, which makes it difficult to produce a comprehensive state-of-the-art survey. In deciding which subject areas to include in this survey, the authors were guided, in the decreasing order of importance, by the following considerations: (i) their understanding, likely imprecise, of which NIE topics would be most interesting for economic sociologists; (ii) their perception of the saliency of particular fields; and (iii) their own professional interests and areas of expertise.

Our coverage also reflects the agenda of the latest annual conference of the International Society of New Institutional Economics (<http://www.isnie.org/isnie2011.html>) held at Stanford University on June 16-18, 2011, which provided a good snapshot of the state of the discipline.

Micro and macro perspectives

NIE operates at the micro and macro and levels. Micro analysis covers the impact of institutions on economic transactions and behavior, organization of economic activities, contracts, allocation of property rights, etc. The focus of macro analysis is the link between institutions and economic development, social welfare, and public sector governance. Sometimes NIE combines micro and macro perspective; i.e. property rights are essential both at the micro and macro levels. Another example are informal institutions, such as behavioral norms – being essentially a micro phenomenon, they are highly relevant for macroeconomic development, and in their turn depend on development patterns, trends, and outcomes (Lipset, 1960; Tabellini, 2008).

Institutional dichotomy

Institutions are expected to have the nature of public goods (or public production inputs) facilitating production and exchange. According to the classical view of institutional change, institutions emerge spontaneously in response to grassroots demand at a time when their benefits exceed the associated costs (Demsetz, 1967; Eggertson, 2001). The modern views are less sanguine, distinguishing between socially productive and unproductive activities;

both are individually rational and hence worth pursuing, but the former contribute to economic growth and social welfare, whereas the latter are 'negative-sum' games. Socially productive activities require level playfield and secured property rights, and hence the institutions that support such activities are known under the generic name of *property rights institutions* (Acemoglu et al., 2001). Synonym for unproductive activities is rent-seeking, and the institutions that favor such activities are known as *institutions for rent extraction*.

Large theoretical and empirical literature attests to critical significance of secured property rights for economic development; an equally impressive body of evidence points out to the detrimental effect of rent-seeking for growth. While secure property rights facilitate deployment of economic resources, first and foremost economic and human capital, for productive purposes, rent-seeking reduces payoffs to productive investments and attracts resources into socially unproductive usages (Murphy, Shleifer, Vishny, 1993). Unchecked rent-seeking is particularly harmful for the allocation of talent and entrepreneurship in the society (Baumol, 1990, Murphy, Shleifer, Vishny, 1991), dragging creative entrepreneurs and gifted individuals from conventional innovations a la Schumpeter and wealth creation more generally into socially wasteful re-distribution of wealth.

Although institutions for rent extraction are detrimental for the society at large, they could be beneficial for privileged elites, in which case the latter use their leverage to establish and sustain such institutions. This public choice perspective explains the emergence and persistence of limited access order (North et al., 2009), when collected rent is used to stabilize the society and control violence. Such arrangements are common in the modern world and prevailed throughout the recorded human history. Its inner stability notwithstanding, *limited access order* offers lower living standard and suppresses economic development; furthermore it restricts entry into the polity to the privileged class. Open access order, while being much less common, is conducive for growth and development: it maintains social order through political and economic competition, rather than rent creation and re-distribution, and is characterized by free entry into political and economic organizations.

Mechanisms and driving forces of the transition from limited to open access order continue to be debated in the NIE literature. One strand of research (Acemoglu, Robinson, 2006a) maintains that at certain times ruling elites'

positions become less solid, and to prevent violent regime change, the elites share political power and economic resources with the masses. An alternative theory (Lizzeri, Persico, 2004) maintains that democratization could be appealing to elites since it improves the quality of institutions and public policies and hence offers an 'insurance' to various elite groups in the event they lose out in the inter-elite competition.

Institutions and development

An important and vibrant area of the NIE is the relation between institutions and economic development. Up until mid-XXth century economic development was perceived as primarily a resource accumulation problem. While modern development views do not reject the prima facie view of financial, physical and human capital as necessities for economic growth and social welfare, they consider accumulation of such resources endogenous to institutions that could either facilitate or suppress private investments.

Of particular significance among such institutions are secured property rights and contract enforcement; other plausible institutional determinants of economic growth are the strength of the rule of law, quality of economic regulation and public sector governance, and the protection of political rights and freedoms. While the importance of property rights and effective and impartial 'administration of justice' for investments and commerce were recognized at least since Adam Smith, it was not until mid-1990s that this conjecture was put to an empirical test. Such testing was made possible by a proliferation of various measures of institutional quality (Kaufman, 2010) which could be related to the rates of economic growth and other key economic outcomes.

The available data reveal strong correlation between the quality of institutions and economic development; this lends support to the *institutional hypothesis* which maintains that 'institutions cause growth'. More sophisticated econometric tests are used to confirm that causality indeed goes from institutions to development and to rule out the omitted variable bias. Usually such tests involve so-called instrumental variables – exogenous factors that affect institutions and hence economic outcomes, but have no immediate impact on economic development and welfare which is not mediated by institutions. Usually such instruments are found in history and/or geography (see the "History and Institutional Origins" section below) and indeed

confirm that “institutions rule”, being the most salient and powerful development driver over all other potential causes of economic growth.

Such evidence notwithstanding, a contrarian *development hypothesis*, which puts the causality in reverse and maintains that good institutions are not a cause but an outcome of economic development, also finds support in data (Glaeser et al., 2004). This hypothesis originates in sociology (Lipset, 1960) and reflects the development model whereby the accumulation of wealth and especially human capital makes the society more prone to consensus-building and improves its capacity to agree upon and jointly implement mutually beneficial policies leading to the establishment and upholding of efficiency-enhancing institutions. Supporters of this hypothesis point out that the mere enactment of formal institutions of democracy and market economy does not in and of itself ensure the desired outcomes, and that real allocation of power and resources often remains invariant to such changes (Acemoglu, Robinson, 2006b). In particular, democratic reforms when implemented in immature societies could frustrate their purpose and be easily subverted, if not reversed, by dominant elites. In such cases an authoritarian regime could present an appealing alternative, providing that such regime has the incentive to advance economic development, and not just to enrich itself.

NIE and political economy

The ‘grand debate’ between the institutional and development hypotheses illustrates the political economy dimension of the NIE. The centerpiece of such analysis is the impact of political institutions on the incentives of economic and political elites that control policy decisions. Inspired by Adam Smith’s famous metaphor, McGuire and Olson (1996) proposed the concept of the ‘invisible political hand’ that improves economic decisions of an authoritarian ruler, bringing them closer to the public sector needs even in the absence of democratic accountability. The basis for such affinity is the ruler’s concern about preserving his tax base, which requires adequate provision of public production inputs and moderation in setting tax rates. There are two important pre-conditions for the ‘invisible political hand’ to work: first, ruler’s interests must be ‘encompassing’, i.e. covering all of the economy, and second, the regime’s duration should be sufficiently long, to allow investments in the physical and institutional infrastructure

to recoup and make them more attractive than grab-and-run-type behavior (Shleifer, Vishny, 2002).

The importance of the ‘encompassing’ condition is illustrated by the ‘institutional resource curse’ – vast natural resource endowments are shown to adversely affect the quality of institutions in less-than-perfect democracies (Karl, 1997). An explanation of this phenomenon is as follows: in resource-rich countries economic interests of the elites are usually in the resource sectors, which also generate a bulk of budget revenues. This weakens the taxation-representation mechanisms which are pivotal for well-functioning democracy; furthermore, elites’ incentives to supply general-purpose institutions and public production inputs serving the interests of the private sector at large get weaker, since resource industries are less dependent on such institutions and the latter are thus neglected by the elites as having lower priority. Furthermore, institutional distortions caused by the predominance of resource industries reallocate human resources away from productive activities towards rent-seeking (Mehlum, Moene, Torvik, 2006).

Encompassing interests could narrow the gap between the social needs and those of the ruling regime, but do not eliminate it completely. An important cause of the remaining discrepancy is the political risks of efficiency-enhancing modernization and institutional reforms (Acemoglu, Robinson, 2005). Such reforms often enhance economic rights and freedoms, improve access to markets, advance competition and social and economic mobility and hence destabilize the status quo ante and might cause a regime change. Therefore ruling elites could block progressive institutional changes even if those make the economy, including the part controlled by the elites, bigger, because the appropriation of such gains, and for that matter even the preservation of the status quo, could no longer be assured. Bargains between the ruling class and the rest of society, in the spirit of the Coase theorem (see below) could not unlock the stalemate, since such bargains would not be enforceable after a regime change (Acemoglu, 2003).

Endogenous property rights

Market-augmenting institutions, such as secured property rights, could be firmly grounded in political tradition and culture, and protected by elites and society alike. Without such firm foundations of the rule of law (more on this below in the survey) property rights protection becomes a

decision variable of the ruling class and are thus endogenous. NIE studies the political and economic incentives that could sustain or undermine endogenous property rights. Without such incentives, declared commitment to secured property rights (and more generally a promise to maintain enabling conditions for private enterprise) could suffer from dynamic inconsistency and is likely to be discarded by investors as 'cheap talk' lacking credibility.

According to the preceding section of this survey, long tenure of the ruling regime could favor the provision of endogenous property rights as an institution that enhances the regime's tax base. Property rights are upheld as an equilibrium in a 'repeated prisoners' dilemma' (Besley, Ghatak, 2010): by honoring property rights and refraining from expropriation the regime maintains its reputation and avoids sanctions of private investors who would respond to violation of their rights by ceasing to invest further.

However such trigger strategy alone could not be sufficient to discipline a ruler who is not politically accountable to the society and private sector. The power of such incentives could depend *inter alia* on economic trends (Polishchuk, 2011): the threat of investors' boycott could be a strong argument in a rapidly growing economy, but is unlikely to make an impression against the backdrop of an investment slump.

Another factor that could uphold endogenous property rights is a degree of political competition, even if in indirect or surrogate form. This can be illustrated by the concept of market-preserving federalism (Weingast, 1995): when subnational units have to compete for mobile investments, they are compelled to offer better investment climate and in particular higher security of property rights. Such competition increases the costs of anti-market institutions and policies, even the latter serve the ruling regime's immediate self-interest, and this could tilt the cost-benefit calculus in favor of endogenous property rights.

Competition between elite groups, even if not of conventional democratic kind (when various political forces vie for voters' support), could still also improve endogenous property rights. Indeed, recent studies (and dramatic development in the Middle East) indicate that long tenure of authoritarian regimes does not necessarily improve the quality of institutions and economic policies (Polishchuk, Syunayev, 2011). One reason is that the real prospect of losing power makes the present regime more interested in preserving the rule of law, competition, and property rights

protection, even if this restricts today's opportunities for plundering the private sector, since those in power today could be ousted tomorrow and need the above institutions as a protection from the predation of the new powers-that-be.

Formal and informal institutions

Coordination of economic activities which is the main task of institutions can be accomplished by both formal and informal means. Formal institutions, such as laws, regulations, courts, government programs and agencies, are supplied by the state. Informal institutions serve similar purposes, and from this viewpoint formal and informal institutions are substitutes for each other. This is the essence of the famous Coase theorem (Coase, 1960) considered as one of NIE's cornerstone. According to the theorem, interested parties could prevent a market failure and achieve Pareto optimality by agreeing to coordinate their actions and share the accruing gains. This alternative to government regulation is feasible only if the transaction costs necessary to achieve and implement such agreements are low and do not excessively reduce, let alone exceed, the gains from collaboration.

Informal institutions which reduce transaction costs are those that facilitate collective action (Olson, 1965) and include norms of behavior, trust, and social networks, collectively known as social capital (Woolcock, 1998). The main purpose of social capital is to assist economic agents in attaining superior outcomes (over those that can be achieved unilaterally) through a concerted effort. Such ability indeed reduces demand for government coordination and hence could serve as a substitute for publicly provided formal institutions.

However, the relation between formal and informal institutions cannot be reduced to substitution alone. Proper performance of formal institutions is not guaranteed simply by their enactment (Acemoglu et al., 2008) and on many occasions *de facto* allocation of power, resources and economic roles remains unaffected by institutional reform, no matter how profound and far-reaching such reform could be *de jure* (Acemoglu, Robinson, 2006c). It is often incumbent on an institution's beneficiaries and users to ensure its proper performance and prevent manipulation and misuse of the institution (Polishchuk, 2008). Upholding and protecting formal institutions poses another collective action problem which also requires social capital to be

resolved. Thus functional democracy and the rule of law are contingent upon broadly shared values and beliefs known as civic culture (Almond, Verba, 1963; Weingast, 1997), and hence social capital-like informal institutions are required for proper performance of formal ones, such as democratic governance. Therefore formal and informal institutions could also be complements to each other.

The ambivalence of the relation between formal and informal institutions explains the “paradox of social capital” (see e.g. Putnam, 1993; Aghion et al. 2010): in societies with low stock of trust and other social capital ingredients there is strong grassroots demand for greater government control and regulation (due to the inability to ensure pro-social behavior at the grassroots), and yet the very same societies often display low esteem or even contempt of government due to its poor performance and abuse of power which the society is unable to prevent. Outcomes of various combinations of formal and informal institutions can be measured by the ‘costs of disorder’ which accrue due to insufficient coordination and regulation, and ‘costs of dictatorship’ caused by government control, suppression of economic freedom, distorted incentives, and abuse of power (Djankov et al., 2003b). The institutional possibility frontier in these two axes characterizes the (in)ability of society to manage these costs and find an acceptable tradeoff between the two. Configuration of such frontier and its distance from the origin (where both costs are nil) depends on the social capital stock: high social capital reduces the need in government intervention (and hence the costs of disorder) and keeps the government accountable, thus reducing the cost of dictatorship.

Relevance of property rights allocation

Simplistic reading of the Coase theorem could lead to the conclusion that allocation of property rights is immaterial for economic efficiency. Indeed, even if such rights are initially assigned wrongly so that asset owners cannot put their assets in the best possible use, the subsequent trade agreed upon as a part of a Coasean bargain would correct such misallocation. NIE provides both theoretical and empirical evidence that initial property rights allocations matter and the ability of markets to fix a biased ownership structure could be severely restricted.

In their seminal paper Grossman and Hart (1986) point out to incomplete contracts as a reason of property rights relevance. If investments into privately owned assets can-

not be made parts of a contract (e.g. because such investments are non-verifiable and hence non-contractible), then ex post re-negotiation would not be sufficient to fully compensate for assets misallocation. This observation proved to be instrumental in explaining boundaries of the firm, and in particular mergers and breakups. Another application of this reasoning is a theory of the outsourcing of government services to private sector firms (Hart et al., 1997). The advantages of such outsourcing are stronger performance incentives of private firms that could deliver better value for money, whereas the flipside of this advantage is the risk of cutting costs at the expense of lower quality of provided services. The criterion of privatization of government services implied by the Grossman-Hart theory of property rights is whether the quality of such services is satisfactorily verifiable or not – in the former case outsourcing is a good idea, but in the latter it could be counterproductive.

Privatization of formerly state-owned enterprises is another example of the importance of the initial allocation of property rights. In Russia in the early 1990s it was maintained that the main objective of privatization was to make market reform irreversible and create a solid political base for the new economic order (Boycko, Shleifer, Vishny, 1995). Accordingly a bulk of the national economy was transferred into private hands in a matter of several years in an often chaotic and non-transparent manner. An efficient capital market and fully secured property rights did not ensue however due to excessive concentration of production assets in the hands of ‘robber barons’ known as the *oligarchs*. The oligarchs used their clout to prevent the completion of institutional reforms (Hellman, 1998, Polishchuk, Savateev, 2004), and the failure to obtain an efficient property rights regime was in agreement with recent development of NIE (Williamson, 2000).

History and institutional origins

Having firmly established the strong link between institutions and development, NIE moved to explaining vast cross-country institutional differences, it turned to history in the search for institutional origins. A good illustration of this strand of literature is the inquiry into the legal origins. The divergence of legal families between the common (Anglo-Saxon) and civil (continental) laws is attributed to differences in allocation of power in pre-medieval England and France (Glaeser, Shleifer, 2002). Once established and

sustained, these systems have had distinctly different impact on economic development.

Existing studies indicate that in Europe early institutional framework already favored development. North and Weingast (1989) find that English institutions for many centuries established checks on sovereign government, and such limited government was conducive for institutional development. To explain how Europe came to develop growth-promoting institutions one needs a comparative perspective going beyond Europe alone. Blaydes and Chaney (2011) compare European and Muslim worlds and in particular the patterns of military recruitments to explore the roots of institutional divergence. In 1000 CE the Islamic world was more economically advanced than Western Europe, but failed to develop the rule of law or parliamentary institutions (see also Kuran, 2008). In Europe wealthy individuals served as mounted military elite and were compensated for their service to the king by land grants, whereas Muslim rulers relied on the mamluks - elite military slaves characterized by cultural dissociation and personal dependence on the sultan. They were unable to transform themselves into a landed aristocracy, because the mamluk status did not pass on to descendants. This appeared to be a critically important distinction that prevented the formation in the Muslim world of the civil society serving as a check on monarchs.

Establishment of the property rights institutions (or transition to the open access order) requires suppression of 'political losers' that benefit from rent-extraction institutions, or means to co-opt them in a new institutional regime. Institutional change which is an outcome of such 'elite pacts' and other similar arrangements could facilitate reaching an efficiency-enhancing institutional consensus. Financial innovations could serve as a case in point (Jha, 2010): the issuance of shares in joint stock companies aligned the interests of disparate groups in England and facilitated the nation's transition from monarchy to representative government in the XVIIth century; similarly the introduction of shares in overseas companies helped generate a broad coalition that successfully challenged executive control and implemented public investments that were crucial for growth. The new financial and corporate governance institutions thus played an important consolidating role creating a shared interest in protecting property rights.

Norms and their origins

NIE combines the economic and sociological perspectives of behavior. Economists believe that behavior is driven by incentives, whereas sociologists emphasize the importance of norms. The two approaches are blended in more sophisticated models of behavior whereby individual preferences reflect not just 'ends' (consumption bundles, income, social and economic status etc.) but also 'means' (i.e. actions) leading to such outcomes. Internalized norms wired in preferences cause anguish if behavior is inconsistent with a person's identity (Akerlof, Kranton, 2000), and decrease the utility from material consumption. Such preferences make pro-social behavior individually rational even if the behavior is sub-optimal on purely materialistic grounds. Sometimes identity is not fully known to an individual and/or to those surrounding him or her; in that case identity could be 'managed' and its (self) perception updated based on actions; this creates additional incentives to behave pro-socially (Tirole, Benabou, 2011).

Norms exhibit significant stability across generations, in large part because of their transmission in the family from parents to children (Bisin, Verdier, 2001). Thus, studying trust levels of USA citizens, Algan and Cahuc (2010) showed that inherited trust of descendants of US-immigrants is significantly influenced by the country of origin of their forbears. According to Nunn and Wantchekon (2009), slave trade is responsible for differences in trust level across African countries. Fisman and Miguel (2007) studied the driving patterns of U.N. diplomats in New York. Because of immunity, only cultural norms would force representatives of different countries to follow parking rules. The number of parking tickets of diplomat is shown to be strongly correlated with corruption in their home countries.

Education is a powerful creator of social capital (Helliwell, Putnam, 2007; Natkhov, 2011). Tabellini (2010) uses literacy rates at the end of the XIXth century and historical political institutions to explain the differences in civic values and trust today. Better educated and more intelligent people are shown to be much more cooperative and civic-minded, consistently with Lipset's (1960) views. Recent studies show that teaching techniques may be relevant as well: working in student groups accumulates trust and cooperative attitude (Algan et al., 2010), whereas a purely 'tutorial' format erodes trust and cooperative attitudes.

Historical upheavals and dislocation could adversely affect pro-social norms, as illustrated by the above mentioned lasting impact of slave trade on social capital in Africa. Closer to home, post-communist transition to market economies is shown to diminish the social capital stocks in Central and Eastern Europe and the former Soviet Union (Aghion et al. 2010). Other studies focus on cross-regional comparisons of areas which were affected by civil wars. Conversely, historical experience of self-governance can lead to accumulation of trust. Putnam (1993) and Guiso et al. (2008) explained differences in civic values and activism across regions of Italy with the historical experience of democracy and self-rule in the Italian city-states.

Measuring informal institutions

To measure social capital one can look both at 'inputs', which are common values, beliefs or dense social networks, and 'outputs' which are participation in associations and widespread civic norms (Guiso et al., 2010). Associations and group memberships and civic behavior are classical measures of social development employed by civil society scholars from de Tocqueville to Putnam. Participating in non-profit organizations, clubs and other associations, people reveal their ability to act collectively for achieving common goals, and therefore group membership statistics could be a good proxy for social capital. Unfortunately, it is very difficult to separate '*Putnam groups*' that advance broad societal interests from '*Olson groups*' which pursue narrow interests by means of rent-seeking.

Another and perhaps more reliable source are various sociological surveys that measure values, attitudes, and behavioral patterns. The best known of those are the periodic World Values Survey and similar data collection programs in the US, Europe and elsewhere in the world. Trust is the most popular and most studied measure of beliefs and culture used in economic literature. The trust scores across countries correlate with other related indicators. Importantly, trust levels seem to be very persistent – their changes since the first wave of the World Values Survey in 1981 were minor in relation to other economic and institutional indicators.

Social capital and norms could also be gauged by voting and referenda participation, philanthropy, blood donation, newspaper readership (indicators of citizens' interest in local problems), compliance with laws and regulations, and other similar measures. Finally, and increasingly popular

source of data are laboratory experiments, such as various trust and public goods-like games. However economists treat such measures with some caution, as they can be influenced by other situational and environmental factors such as legal enforcement, supporting government programs, economic payoffs, etc.

Norms, trust and development

Attempts to explain the difference in economic development across the globe and history reveal a 'missing link' that is being filled by informal institutions. The increasing number of empirical confirmations of the relevance of informal institutions is consistent with their role as substitutes and complements of formal institutions, as argued earlier in this survey. Keefer and Knack (1997) were the first to show that trust level in a country is an important determinant of its GDP per capita and investments in the national economy. A large literature that followed (reviewed in Bjornskov, 2009 and Halpern, 2005) confirms the importance of social capital-like factors for economic growth, government efficiency, institutional performance, quality of life and life satisfaction, etc.

Thus, Tabellini (2010) demonstrates the influence of culture on the development of European regions. Self-expression values form (constitute) another important group. Gorodnichenko and Roland (2010) argue that the individualism-collectivism dimension of culture (Hofstede, 2001) is the most robust cultural determinant of growth and innovations, while other values seem to be less important. Individualist culture is conducive for innovation and growth, whereas the collectivist one facilitates consensus and collective action. These two traits support resp. dynamic and static efficiency, and their interlay and relative merits and demerits require further research.

Another widely accepted, but still not properly researched, fact, is the importance of social networks for development. Networks nurture trust, used to disseminate vital labor market information and make individual reputation publicly known (Coleman, 1988), thus strengthening incentives for collaboration even in one-shot prisoners' dilemma-like situations. Greif (1993) argues that social networks allowed Maghribi traders to conduct complex trade in Mediterranean in XIth century which otherwise would not be possible. Theories of network formation will help to incorporate sociological theories of strong and weak ties (together with in- and out- group trust, general and limited

morality) and estimate their impact on development. Greif and Tabellini (2010) attribute the difference in paths of institutional and societal development between Europe and China to their distinct social structures and cooperation mechanisms and patterns.

Network membership is also a basis for collective reputation that is shown to have a strong impact on economic behavior – positive collective reputation strengthens incentives for investments in human capital and behaving pro-socially, whereas a negative one has the opposite effect (Tirole, 1996). Such effects explain a number of real-life phenomena, including racial discrimination, deviant behavior, etc. (Akerlof, Kranton, 2000).

Recent advances in social networks economics build theories of network formation based on standard microeconomic concepts of utility maximization, incomplete information, and risk aversion (Kovarik and Leij, 2009). An important direction of such analysis is the spreading of social norms and behavioral patterns through networks, and (in)stability of such network-supported norms to local fluctuations, as observed in minority-influenced effects vastly exceeding their initial causes. Liu et al. (2011) investigate ‘driver nodes’ that could control the network’s entire dynamics. They show that sparse inhomogeneous networks are the most difficult to control, but that dense and homogeneous networks can be controlled and manipulated by using just a few driver nodes. Such analyses explain why norms could be stable in some societies and exhibit considerable instability in others.

Concluding remarks

In the light of recent advances in NIE, the main message of the discipline, i.e. that ‘institutions matter’, could be reformulated as ‘institutions *and* society matter’. The society affects the links between institutions and development in at least three important ways. First, it supplies informal institutions which comprise a vital part of modern institutional setups. Informal institutions, such as norms, trust, and networks, convey essential market information, reduce transaction costs and otherwise support investments and exchange. Second, the society at large and its different groups produce demand for formal institutions, and as such are pivotal for institutional change. Third, the *performance* of formal institutions depends on actions and attitudes of various social, economic, and political actors. For all of the above reasons, NIE is a natural field for inter-

disciplinary collaboration between economists and sociologists, as this brief survey hopefully demonstrates.

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