

Institutions, Markets, and Firm Strategy

- What are institutions?
- Institutional change
- Key market institutions
- Firm strategy when key institutions are missing

Institutions, Markets, and Firm Strategy

- What are institutions?
 - Institutions defined
 - Formal vs. informal institutions
 - Key properties of institutions

Institutions Defined

- General definition

A set of humanly devised behavioral rules that govern and shape the interactions of human beings

- Or more simply

The “rules of the game” in a society

Formal vs. Informal Institutions

Formal

- Laws
- Constitutions
- Written contracts
- Rules of exchange
- Organizational bylaws

Informal

- Shared values
- Norms
- Customs
- Ethics
- Ideology

- Institutions involve rules that constrain behavior and give rise to behavioral regularities

Property of Institutions #1: Substitutability

- Different institutions may perform the same function

<u>Information</u>	<u>Firm Disputes</u>	<u>Decision Rights</u>
• Market prices vs. govt statistics	• Trust vs. contracts	• Majority vs. minority shareholder
• Credit bureaus vs. country clubs	• Lawsuit vs. intimidation	• Courts vs. police
• Monster.com vs. family network		• Legislature vs. autocrat

Property of Institutions #2: Quality

- Some institutions are better at promoting certain objectives than others

“Good” institutions align individual actions/incentives with what is good for society

- The economic role of institutions

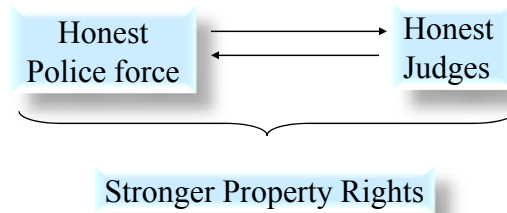
Institutions help define individuals' objectives

Institutions constrain the actions individuals choose

- Examples
 - Communism vs. Capitalism
 - Monterrey vs. Gomez grupos

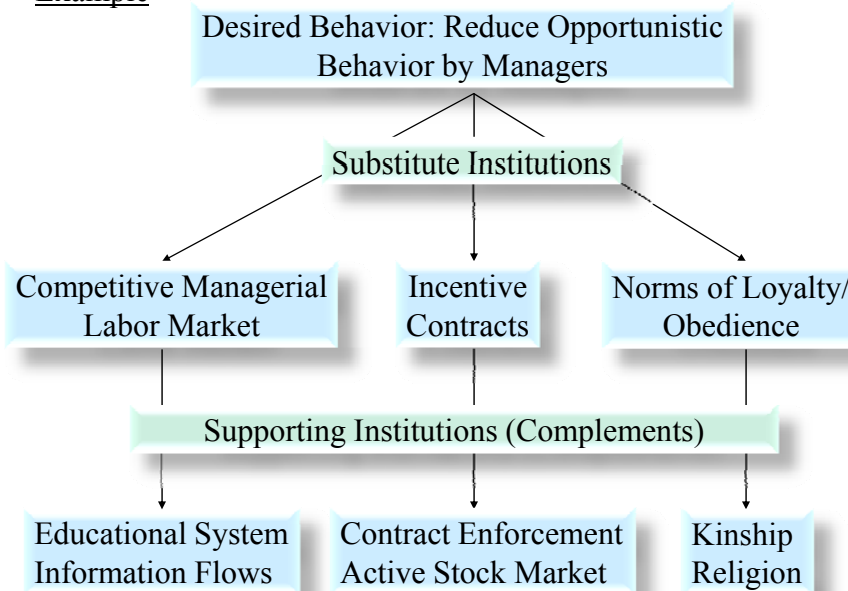
Property of Institutions #3: Complementarity

- The effectiveness of one institution will often depend on the nature of other institutions



- Need to consider overall institutional context

Example



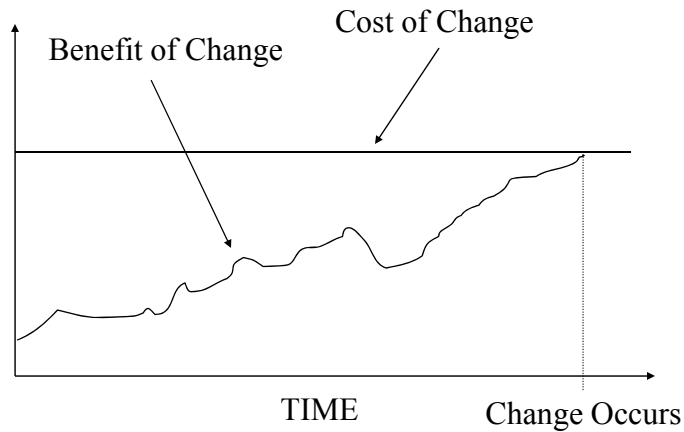
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Institutional Change and Development

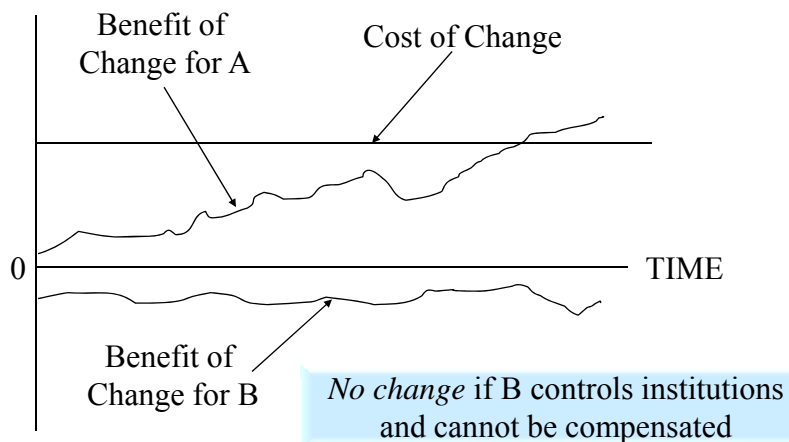
	<u>Stage of Development</u>	<u>Foundation of Dominant Institutions</u>
Development Process ↓	Subsistence	Kinship
	Emerging Market	Relationship-based Governance
	Developed Economy	Rule-based Governance

Punctuated Equilibrium



- “Punctuated Equilibrium”
 - Institutions (a) stable and (b) optimal, due to cost of switch
 - Change is sudden and discrete
- Examples: Corporate merger, divorce; Fall of USSR, grupos (?)

Vested Interests: Obstacles to Change



- Vested interests
 - Institutions (a) stable but (b) sub-optimal
 - May explain long-run stickiness of institutions (Session #2)
- Examples: “Bad” dictators, corruption, grupos (?)

Institutions: A Summary

- **Definition:** “The rules of the game” in a society

Properties of Institutions

- **Substitutability:** Different institutions may serve same function
- **Quality:** Some institutions are better than others for achieving certain social objectives
- **Complementarity:** The effectiveness of institutions is interrelated

Institutional Change (or lack thereof)

- **Punctuated Equilibrium:** Changing institutions is expensive; change may be rare, sudden, and large
- **Vested Interests:** Socially optimal changes may be thwarted by vested interests over very long periods

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Key Market Institutions

- What institutions support the efficient operation of markets?
 - Information provision
 - Contract enforcement
 - Property rights
 - Protections against corruption
- “Good” institutions for economic development create incentives for the efficient allocation of resources
 - Direct capital to best use
 - Direct labor to best use

Weak Institutions in Emerging Markets

- “Market Failures” (Anand, Khanna, and Rivkin)
 - If market institutions are weak, market transactions become risky for private enterprise
 - Weak institutions prevalent in emerging markets
- Weak legal system
 - Contracts cannot be enforced
 - Property rights may not be protected
 - Corruption hard to combat
- Poor public information provision
 - Raises search costs
 - Allows opportunism in relationships
 - Market collapse and the lemons problem

Focus: Institutions that Impact the Reliable Flow of Information

- Third party providers
 - Business press
 - Consumer information organizations
 - Organizations that certify workers' skills
- Information regulation & enforcement
 - Transparent accounting rules
 - Restrictions against insider trading
 - Government auditing agencies

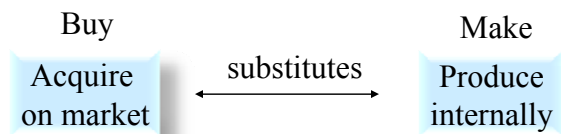
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Institutions, Markets, and Firm Strategy

- Firm strategy when key institutions are missing
 - Make or Buy
 - Market entry

Markets vs. Firms



Market Costs

- Cost of product
- Information costs
- Contractual costs

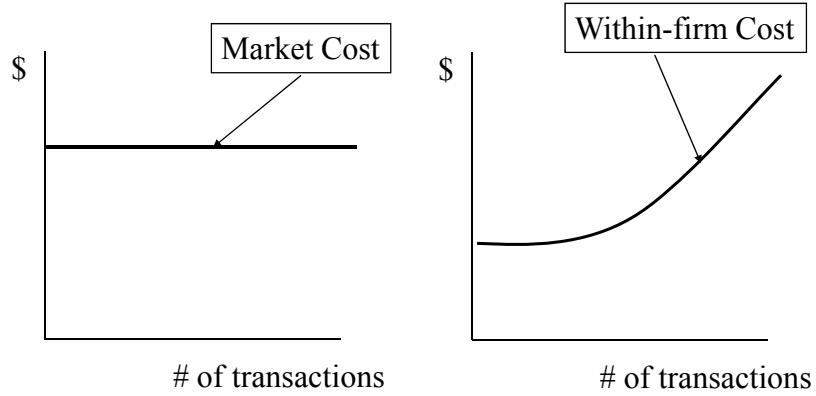
vs.

Firm Costs

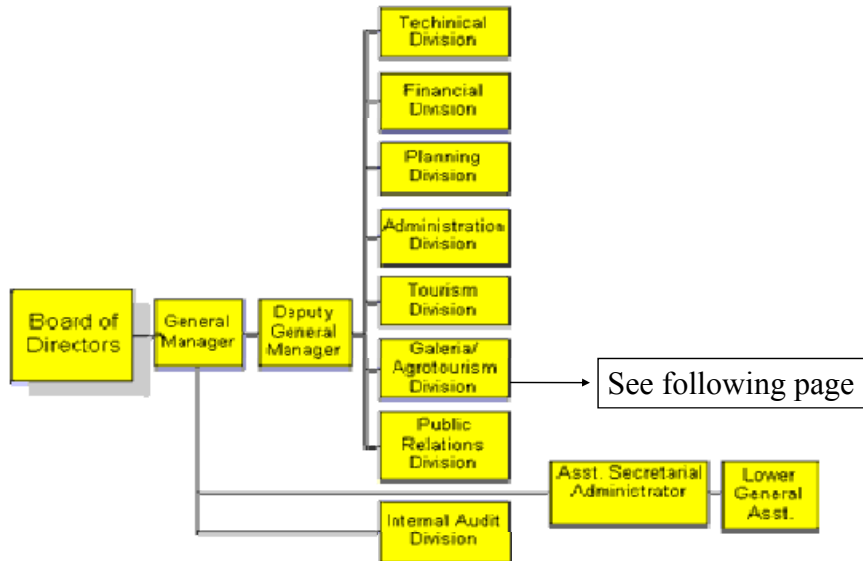
- Cost of inputs
- Coordination /
Bureaucracy costs

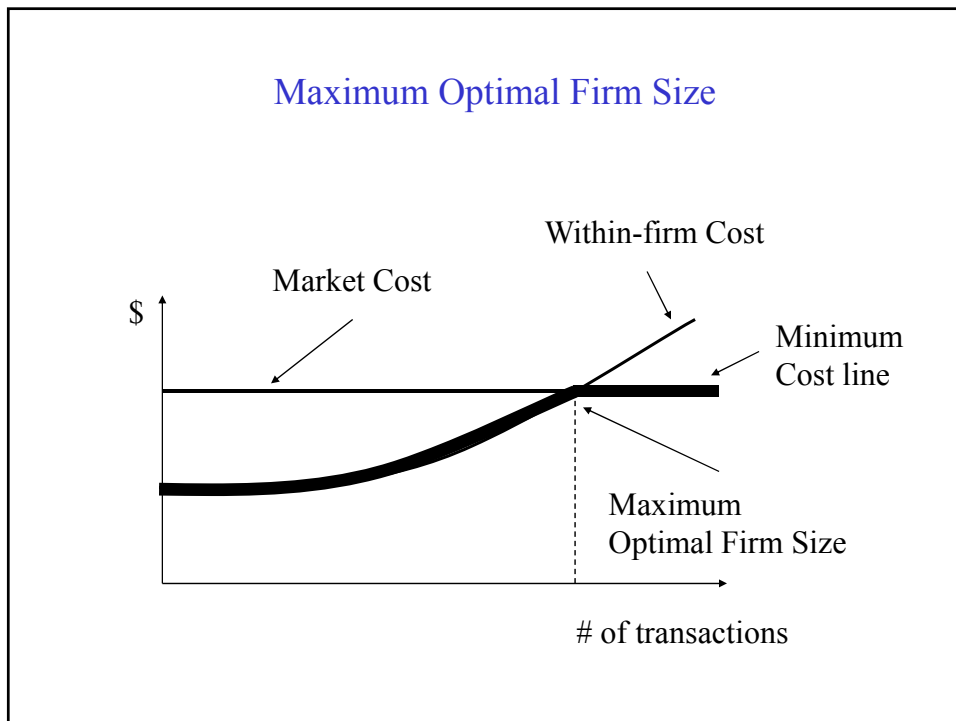
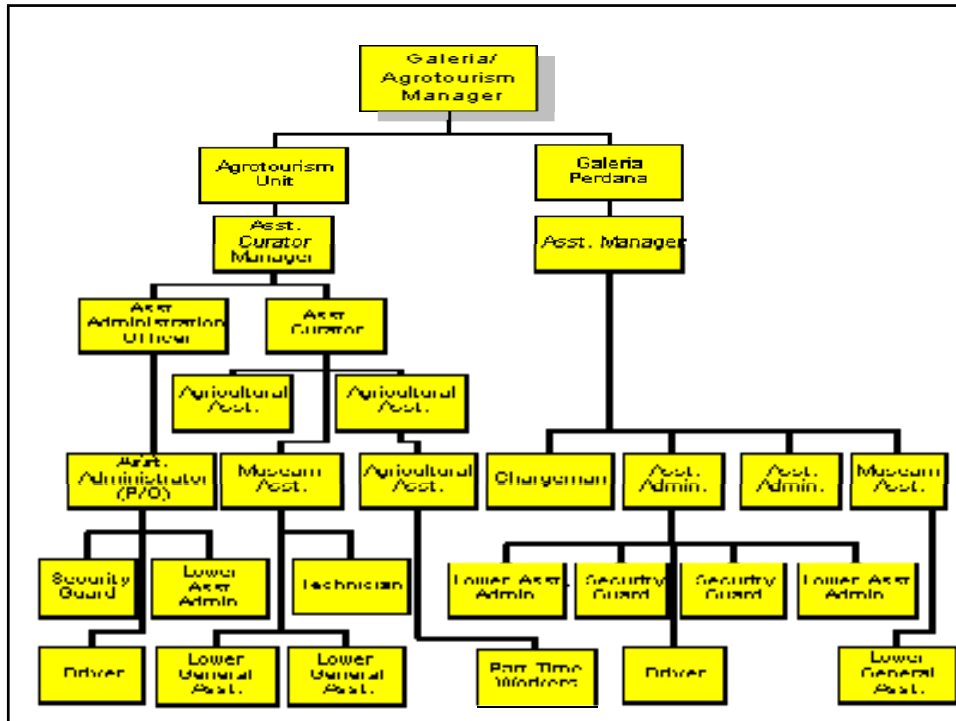
- This is the *Transaction Cost* approach to understanding firm size, originally associated with Coase (1937)

Coase's Claim/Insight

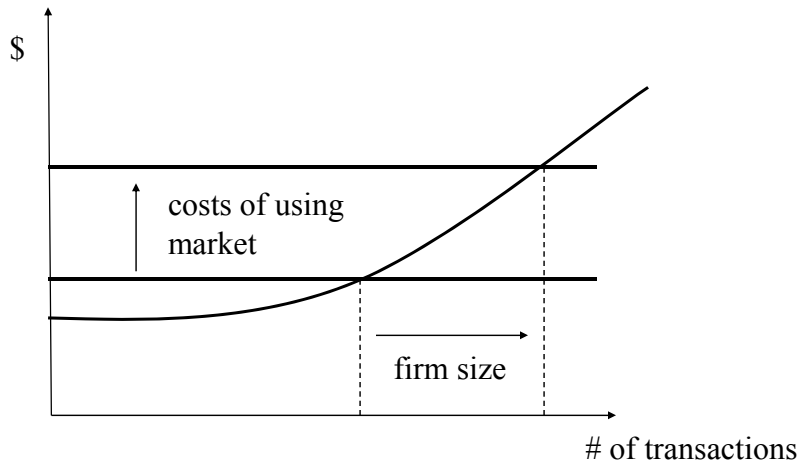


Example: The Organization Chart of LADA



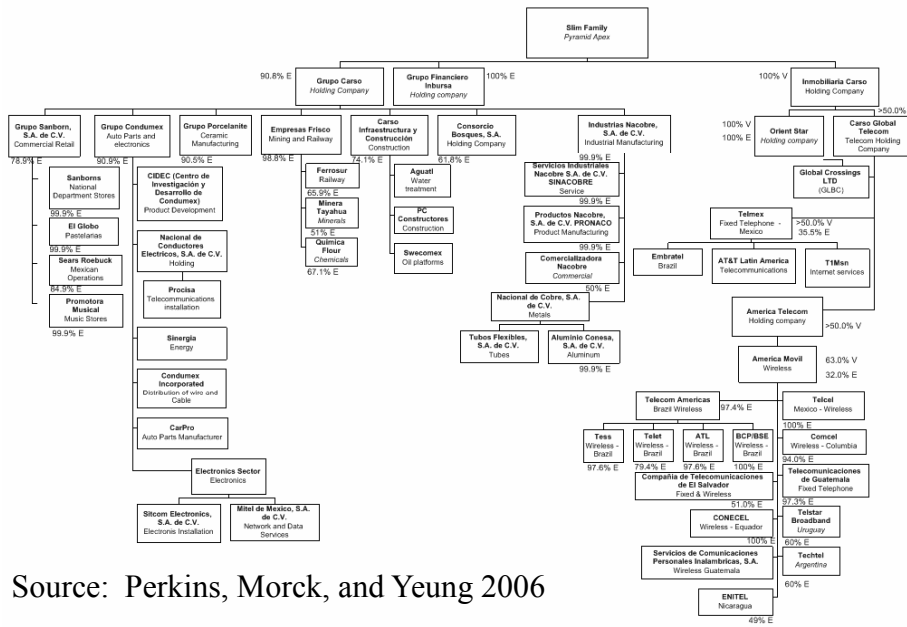


Firm Size and Quality of Market Institutions



- Prediction: Firms will be larger when market institutions are weak or missing

Example: The Slim Helu Group



Source: Perkins, Morck, and Yeung 2006

Evidence on Firm Size

- Extremely large, diversified companies common in emerging markets
 - *chaebols* (S. Korea)
 - *grupos* (Latin America)
 - *houses* (India)
- Solve market failures “in house”
 - Internalize capital markets
 - Internalize labor markets
 - Avoid contracts
 - Share brand
 - etc.

Other Evidence

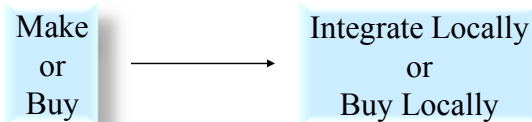
- Vertical integration
 - Acemoglu, Johnson, and Mitton (2005)
 - Examine 750,000 firms from 93 countries
 - Vertical integration is greater in poorer countries
 - Associated with weaker contract enforcement, weaker financial market development, and greater regulatory barriers to entry
- Firm size
 - Kumar, Rajan, and Zingales (2003)
 - Countries with worse judicial systems have (1) ↑ *range* of firm size but (2) smaller firms on average (!)
 - Interpretation: (1) Large firms by local standards, but (2) less growth opportunity with weak market institutions

Summary: Markets vs. Firms

- Trade-off between market and hierarchical costs determines optimal firm size
- Anand, Khanna, & Rivkin
 - Institutional weaknesses raise market costs more than they raise hierarchical costs
 - *Corporate strategy should favor internal production in emerging market settings*
- Caveats
 - Coordination still difficult
 - May need strong internal auditing system
 - Increasing opacity to outside investors

Market Failures and Market Entry

- Joint Ventures (JV's) are a common arrangement when foreign firms enter emerging markets
- Standard motives
 - Limit risk by limiting equity
 - Local laws demand partnerships
 - Local knowledge needed
- “Market failure” arguments that favor internal production may also apply to integration with a local partner



Market Failures and Market Entry

- Information problems
 - ⇒ Integrate with local partner(s)
 - Avoid search costs
 - Avoid buyer/seller opportunism
- Weak legal systems
 - ⇒ Integrate with local partner(s)
 - Avoid contracting problems
 - Gain local political power
- Are there risks from JV's that "market failures" also bring?
 - Will local partner take advantage of you?
 - What does the local partner want?

Part I (Session 3 – 9)

