

# INSTITUTIONAL ECONOMICS

Sponsored by a Grant TÁMOP-4.1.2-08/2/A/KMR-2009-0041

Course Material Developed by Department of Economics,  
Faculty of Social Sciences, Eötvös Loránd University Budapest (ELTE)

Department of Economics, Eötvös Loránd University Budapest

Institute of Economics, Hungarian Academy of Sciences

Balassi Kiadó, Budapest



Author: János Mátyás Kovács  
Supervised by János Mátyás Kovács

June 2011

## Week 1

# On institutional thought in economics

## Contents

- History of ideas or economics?
- Misleading dichotomies
- The trouble with classification
- Becker and the NIE

## History of ideas or economics?

- Presenting the overall history of the discipline instead of interpreting its subdisciplines
- Precise title: Chapters in History of Institutional Economics
- No history of heterodoxy but of certain formerly heterodox schools (e.g. behavioral economics and experimental economics are not primary subjects of the course)
- Main focus on "institutional turn" but the "old" institutional schools will also be discussed in more detail than usual

- Where did the history of institutional thought in economics begin?
- Xenophon? Ibn Khaldun? Scottish Enlightenment? There was hardly any economic idea without institutional components.
- Nevertheless, the first "old" institutionalists in the 19th century defined their own theories in contrast to the classical economists.
- In this course, institutional thought will be examined from the second half of the 19th century on when its great rival, neoclassical economics emerged.
- The story became really exciting once New Institutional Economics entered the scene in the last third of the 20th century.
- Methodological challenge: Why do institutional concepts and interdisciplinary research programs appear in economics from time to time? (theoretical and sociological considerations)
- Business as unusual: Marxian institutionalism, Eastern European history of economic thought and the interrelations with other social sciences will also be discussed at length
- Course content: a long conceptual introduction followed by an analysis of "old" institutionalism; then new institutional schools will come under scrutiny; finally the troubled history of the reception of institutionalist thought in Eastern Europe will be presented

## Misleading dichotomies

- As a rule, the family of institutional schools are compared to that of the neoclassical ones.
- Conventional dichotomies:
  - History versus theory
  - Ideal versus real
  - Empirical versus abstract research
  - Induction versus deduction

- Description versus analysis
  - Qualitative versus quantitative study
  - "Soft" versus "hard" science
  - Dynamic versus static view
  - Change versus equilibrium
  - Process versus end-state
  - Emergent versus planned/crafted institutions
  - Verbal versus formal analysis
  - Endogenous versus exogenous institutions
  - Economic sociology, law, history, politics, psychology versus economics
  - Institutions versus individuals
  - Methodological collectivism versus individualism
  - Bounded versus perfect rationality
  - Changing versus stable preferences
  - Friction versus frictionless procedures
  - Critique of capitalism versus its apology
  - Reformism versus evolutionism
- An example of similarity: ideological flexibility (social/neoliberalism, socialism, conservatism, reformism, nationalism (fascism), environmentalism, etc)

## The trouble with classification

- The "institutions matter" truism has many meanings: a) institutions affect the behavior and performance of economic actors, b) they can be objects of economic analysis (choice of efficient institutions), c) are institutional environments or arrangements that matter?, d) not only economic institutions but also political, social and cultural ones are studied.
- Defining institutional economics: the enumeration of many dozen subdisciplines does not substitute for a historical typology.

- Instead, let's start off from another truism: a school without a Nobel Prize does not exist
- Thus, new institutional economics (NIE) does extremely well:
- NIE Nobel laureates (broad picture)
  - 2009: Elinor Ostrom, Oliver Williamson, 2007: Leonid Hurwicz, Eric Maskin, Roger Myerson, 2002: Daniel Kahneman, Vernon Smith, 2001: George Akerlof, Michael Spence, Joseph Stiglitz, 1998: Amartya Sen, 1993: Robert Fogel, Douglass North, 1992: Gary Becker, 1991: Ronald Coase, 1986: James Buchanan, 1982: George Stigler, 1978: Herbert Simon, 1974: Gunnar Myrdal, Friedrich Hayek, 1972: Kenneth Arrow
- Even a broad interpretation is not too biased – a few examples:
  - Hayek (market institutions, law, knowledge, order, evolution)
  - Simon (bounded rationality in organizations)
  - Stigler (government regulation, information costs)
  - Becker (family as economic institution)
  - Sen (social choice, distribution of rights)
  - Akerlof (information distortion in institutions, incentives)

The "Nobel record" of NIE remains fantastic even if we choose a narrower interpretation: Buchanan, Coase, Fogel, North, Hurwicz, Ostrom, Williamson

- These seven scholars represent subdisciplines with attributes distancing their school from both old institutional economics (OIE) and neoclassical economics the most.
- Difference:
  - analytical rigor (as compared to OIE): use of standard neoclassical methods,
  - realism/relevance (as compared to the mainstream): bringing life back in economics by accepting the critique of neoclassical theory by old institutionalism concerning methodological individualism, rationalism, formalization, deduction, etc.
- Creating two enemies with one blow
- NIE: providing shelter for those who do not master mathematical methods (OIE experts) and/or cherish anticapitalist views and/or lack legitimacy (ex-Marxists in

Eastern Europe).

- Is it possible to borrow only the good features (realism and accuracy) from the two worlds of ideas?
- Challenging the mainstream concept of the individual by NIE: a) it is not the individual but the institution that acts; b) the individual acts in institutional (cultural, legal, political) contexts.

## Becker and the NIE

- A "forgotten" institutionalist: how did he promote NIE?
- Becker both attracts and repels the new institutionalist thinkers.
- Attraction: measurement and testing are part of the attempts at realism; the same applies to including research into the family and the household, i.e., an important institution in economics, and to thinking in contractual terms (contracts between generations).
- Resistance: toward the extensive concept of rationality (transcending utility maximization in pecuniary terms: "*individuals maximize welfare as they conceive it*")
- Strong assumptions: forward-looking behavior, consistent comparison of costs and benefits, stable set of preferences, ignoring irrationality, etc
- Bounded rationality (cf. *satisficing*) is assumed away; no other methodological framework than perfect rationality would work better in logical terms.
- However, a majority of new institutionalists insist on the thesis of changing preferences (rejecting the *de gustibus non est disputandum* principle); the actors are myopic, inclined to wishful thinking, the choices are incommensurable, etc.
- The concept of instrumental (parametric) rationality can be criticized from the perspective of situational, procedural, strategic, and interactive rationality as well.
- Game theory is ready to help, and OIE has been waiting for decades to join the mainstream again.

- The old institutionalists ought to accept some of the neoclassical assumptions (is that possible at all?) and/or those in the mainstream who got disillusioned with the alleged sterility of neoclassical thought ought to open up to "reality" (e.g., North), or discover those who already did so (Coase).
- One may go ahead not only by extending the territory of traditional economic research (family, law, etc) but also by deepening the study of conventional themes (theory of the firm, government regulation, industrial organization, etc).
- What is called market failure literature today (principal/agent, moral hazard, adverse selection, etc), or, in general, theories of information, agency and the like, have made resolute moves toward institutionalism.
- Example: *X-inefficiency*, Leibenstein, 1966

## Readings

### **Mandatory**

Becker: Irrational Behavior and Economic Theory, 1962

Hutchison: Institutionalism Old and New, 1984

Furubotn and Richter: Institutions and Economic Theory. The Contribution of New Institutional Economics, 2000 (chapters)

Nee: The New Institutionalism in Economics and Sociology, 2005

Williamson: The New Institutional Economics. Taking Stock , Looking Ahead, 2000

Rutherford: Institutions in Economics. The Old and the New Institutionalism, 1994 (chapters)

Coase: The New Institutional Economics, 1998

### **Additional**

Furubotn and Richter (eds): The New Institutional Economics, 1991 (chapters)

Aoki: Toward a Comparative Institutional Analysis, 2001 (chapters)

Langlois: Economics as a Process, 1986 (chapters)

Hodgson: The Evolution of Institutional Economics, 2004 (chapters)

Chavance, Institutional Economics, 2008 (chapters)