

INSTITUTIONAL ECONOMICS

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Week 2

Institutionalism: "old" and "new"

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NIE and OIE

- The main accusation against NIE is not that it accepts Becker's concept of rationality but that it embodies the imperialism of neoclassical economics.
- An opposite view: imperial overstretch? Implosion?
- So far so good: NIE has been a success story, a progressive research program in Lakatosian terms (Williamson (2000): vitality of NIE – "its best days lie ahead"); proliferation of subdisciplines.
- Inflow of institutional knowledge in the mainstream; methodological reconciliation; meanwhile, neoclassical economics retains important components of institutional thought in the applied disciplines (labor economics, finance, etc).

- Organizing new institutionalism: international/European association; *Journal of Law and Economics*, *Journal of Institutional and Theoretical Economics*, *Journal of Economic Issues*, *Journal of Economic Perspectives*; university centers (Virginia, Indiana, Berkeley, St. Louis), Coase Institute, etc
- Who is the first NIE scholar?
 - Coase, 1937, *The Nature of the Firm*, dormant discovery (Nobel Prize, 1991)
 - Williamson joins in: 1975, *Markets and Hierarchies*, 1985, *Economic Institutions of Capitalism*
 - In between: "Californian Chicago"(Armen Alchian, Harold Demsetz); the other NIE theories unfold simultaneously.
- A few words about OIE:
 - Designation: Institutional Economics (Hamilton), NIE (Williamson)
 - A whole series of schools: we will go beyond listing them to discuss their main theses in detail (Marxism, German Historical School, Austrian School, Ordo-Liberalism, American institutionalism(s), Comparative Economic Systems.
 - OIE was not killed by NIE but outcompeted by neoclassical theory: American "Methodenstreit" in the 1940s.
 - Coase (1984) about OIE: a "mass of descriptive material waiting for a theory, or a fire".
 - It collected country- and case-specific information that was difficult to generalize.
 - A low-key survival (Galbraith, Comparative Economic Systems, etc).
 - OIE features (a more nuanced analysis will come soon): culture, history, evolution, comparative/interdisciplinary research, critique of rationalism, lack of formalization, empiricism, induction, etc.

NIE: a short summary

- NIE: there is no consensual definition; with time, the number of subdisciplines grow
- The theoretical strands that most historians of economic thought put under the heading of NIE:
 - Property Rights (Transaction Cost) Economics
 - Law and Economics
 - New Political Economy
 - New Economic History
- We will discuss other subdisciplines as well (e.g., evolutionary economics, new comparative economics, etc), and mention others (e.g., behavioral economics, experimental economics) only *en passant*.
- The latter may challenge the mainstream by criticizing its alleged hyperrationalism rather than its alleged institutional myopia.
- NIE's main features:
 - Behavior: bounded rationality
 - Actors: individuals and institutions (methodological individualism)
 - Utility maximization (in broad sense)
 - Institutions are human constructs (planning, choice)
 - Transaction costs
 - Measurement: game theory and econometrics
 - Firm: no production function but a structure of governance
 - Incomplete contracts, opportunism
 - Trust, commitment, social capital
 - Cautious relativism (markets and hierarchies as well as private and collective ownership are possible; choice on the basis of efficiency)
 - Coase: reservations concerning the use of mathematics in economics

- Williamson – institutional analysis on four levels: 1. embeddedness (social and cultural foundations), 2. basic institutional environment (rules of the game), 3. governance (the play of the game, contracts, transaction costs), 4. allocation of resources (neoclassical economics).
- James Duesenberry: economics is all about how people make choices; sociology is all about why they don't have any choices to make.
- Williamson goes beyond this bon mot: on level 2–4, sociology and institutional economics overlap.
- A few definitions:
- Coase (1984): "What distinguishes the modern institutional economists is not that they speak about institutions, ... Nor that they have introduced a new economic theory, although they may have modified the existing theory in various ways, but that they use standard economic theory to analyze the working of these institutions and to discover the part they play in the operation of the economy."
- Arrow (1987): The new institutional economics has been influential not because it offers "new answers to the traditional questions of economics— resource allocation and the degree of utilization –," but because it uses economic theory to answer "new questions, why economic institutions emerged the way they did and not otherwise."
- Furubotn/Richter (2003): "...positive transaction costs, methodological individualism and (bounded or perfect) rational choice are assumed. ... In its narrower sense, NIE deals with institutional arrangements. In its wider sense it deals with institutional environments."
- How to position NIE?
 - Relations with the mainstream: in Lakatosian terms, NIE inserts auxiliary hypotheses in the protective belt of the neoclassical research program.
 - But the core of the program does not change.
 - Does NIE save the mainstream or dig its grave?

- They may part eventually.
- The Big Historical Question: to what extent is NIE to be explained by internal (theoretical) reasons and external (sociological) ones ranging from the "fatigue" of neoclassicism, through the success of interdisciplinary research, and the emergence of new mathematical procedures, all the way down to globalization and the collapse of communism? (Danger of reductionism)
- Three (wrong) Big Theoretical Questions: 1. Is NIE better than OIE? 2. Does NIE develop? 3. Will NIE be able to produce a consistent theory (once OIE proved unable to do so)?

On the concept of institution

- How do new institutionalists define institutions?
 - Canonical definition (Furubotn and Richter, 2003): "... A set of formal, or informal, rules, including their enforcement arrangements. These constraints are, in effect, the rules of the game whose purpose is to steer individual behavior in some particular direction."
 - The majority seems unwilling to give a proper definition; they cite North instead (rules of the game): rules and sanctions, durability as criterion, formal and informal institutions, spontaneous and planned institutions.
- Institutions versus organizations: according to NIE, institutions are not lifeless organizational shells; (Schmoller: organization is the personal side of institution); not every institution is an organization.
- Organizations define their boundaries, separating insiders and outsiders, establish decision/responsibility structures
- According to North, organizations are groups of people who coordinate their actions and profit from the institutions.
- Were there institutions prior to the favorite institutions of the economists (property, market, money, state, etc);

- Are cultures (habits, norms, conventions, routines, etc) institutions, or rather fillings of organizations?

What does an institution do?

- (in OIE parlance): it steers interactions , controls collective action, sets common routines, justifies itself, etc
- (in NIE parlance, in addition to the former): it reduces transaction costs, establishes governance structures, controls free riding, rents, guarantees commitment, generates trust, expectations, etc.
- Important research areas:
 - Institutions and rationality
 - Endogeneity of institutions
 - Institutional compatibility
 - Path dependence
 - Formal and informal institutions
 - Why do institutions exist, how do they emerge, and why are they so different?
 - How do they become stable?

Readings

Mandatory

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

Joskow: Introduction to New Institutional Economics, 2008

Coase: The New Institutional Economics, 1998

North: Institutions, 1991

Coase: The Nature of the Firm, 1937

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)