

INSTITUTIONAL ECONOMICS

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

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June 2011

Week 8

New Institutional Economics I Property Rights (Transaction Costs) Economics. Law and Economics. New Political Economy. Governing the Commons. Mechanism Design

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Problem of choice

- New institutionalism in economics: rapid proliferation at the end of the last century; multitude of cross effects; is there a family tree?
- For instance, how can one separate the economics of property rights and transaction costs from the new theory of the firm, contract theory, industrial organization or law and economics, in particular, when they appear in historical/comparative research programs?
- Starting with the Coase–Williamson line: do they lend more than they borrow? Consensus about their primacy; the same applies to the importance of New Economic History; finally, evolutionary economics is chosen in this presentation because of its exciting development in our days.

Property rights, transaction costs

- Originally called Property Rights School (or Theory of Organization): Coase, Alchian, Demsetz
- With Williamson: TCE (Transaction Cost Economics), although he got the Nobel Prize under the heading of “governance”
- Coase’s papers (*The Nature of the Firm*, 1937; *The Problem of Social Cost*, 1960) are the original source
- Transaction costs: the term coined by Marschak, 1950 (search, information, measurement, bargaining, decision-making, control, insurance, legal procedures, etc)
- Original idea: Commons
- The Coase–Williamson line: key concepts
 - Firm (hierarchy, vertical integration) is in the center of analysis: why do firms emerge at all?

- Main choice: firms versus markets instead of firms versus the state; the school deals with hierarchies rather than markets, and with institutional arrangements rather than institutional environments
- No new theory is needed for understanding the institutions: the neoclassical paradigm, if extended, is sufficient; property rights and transaction costs are to be included.
- Buchanan: economics moves from the science of choice to the science of contracts.
- Transactions differ: by “asset specificity“, uncertainty and frequency
- Sorts of transactions: market, managerial, political
- Exchange of commodities or property rights?
- Property rights (bundle: use, income generation, transfer) and their distribution
- Coase theorem(s): if the property rights are well-defined, and there are no transaction costs, externalities will cease to exist (what if they are not well-defined? what if there are transaction costs?, etc)
- Firms: internalization of externalities
- Choice between governance structures (markets, hierarchies, mixed forms): relational contracts, asset specificity, reducing transaction costs
- Class interests, technological change, monopoly power, etc are excluded from the set of variables
- Bounded rationality and opportunism (shirking, subgoal pursuit, etc)
- Assumption: the transaction cost is not zero; if it were zero, there would not be any firm; the entrepreneur excludes the market from the firm; thereby creating agency problems
- Coase (modestly): *“I have made no innovations in high theory.”*
- Against “blackboard economics“ : looking into the firm
- Facing the large enterprise (“small planned economy“) during his visit in the US (1932)
- The name “Coase theorem“ is given by Stigler
- Coase: postulating positive transaction costs and checking if state intervention

(Pigou) is better/worse than private agreement

- Entering the world of contracts: origins of law and economics
- Williamson is right, admits Coase, I did not specify how choices between hierarchies and markets are made
- Need for empirical research: case studies first, mathematical synthesis later
- Williamson leaves the property rights issues behind: organizations and transactions interest him more than ownership rights.
- Stressing the links with neoclassical theory: situating his research in the middle; widening the mainstream rather than eliminating it.
- Levels of institutional analysis (see presentation No 2): TCE close to the neoclassical paradigm
- Williamson: the suggestion "*get the prices right*" is as misleading as the "*get the property rights straight*" maxim.
- The property rights theory will be developed further by Cheung, Alchian and Demsetz, and applied by North and his followers in history-writing.
- Williamson's optimistic prognosis on TCE (1990): "*The main axis will be economics and organization theory, where the former provides an economizing orientation and the latter supplies added behavioral and organizational content, to which the law (especially contract and property law) provides added support.*"
- He expects to see a combination of four NIE subdisciplines: public choice, property rights theory, theory of agency and transaction cost economics.
- Healthy relativism? Both hierarchies and markets have advantages and disadvantages.
- Williamson's prediction had come true before he formulated it: public choice had been prospering for three decades, and law and economics had already everything except for its own name.
- These NIE subdisciplines will be discussed rather shortly; focusing on their place in history of economic ideas; anyway, they are subjects of separate Eltecon courses.
- Instead, we will present two other branches of the Coase–Williamson school: "governing the commons" and mechanism design

- They were already there when NIE was born, though their Nobel Prizes are only some years old.

New Political Economy

- Thus far, we have talked about *public choice*; rival designation: *constitutional economics*;
- *New political economy* (rarely, *political economics*) is rooted in public choice, and relies on 19th century political economy as well
- Among the “famous”, Krugman, Stiglitz, Rodrik, etc represent the school (macroeconomics and international economics as incentives for joining)
- Public choice: neoclassical tools in political science; self-interested, utility-maximizing bureaucrats, pressure groups and voters; the state as a business enterprise (rent seeking, agency problems, etc); political markets and transactions; market versus government failure
- Buchanan and Tullock (*Calculus of Consent*): New Economic History takes the same road; North, Weingast, Greif, etc (see the next presentation)
- As compared to this (“Virginian” and “Chicago”) discourse, New Political Economy moderates the neoclassical mood, insists on empirical testing and launches comparative institutional projects (Acemoglu, Besley, Persson, Tabellini, Roemer, etc)
- Besley: “*New Political Economy is not about economic imperialism, but about bringing new insights into important policy issues in situations where economists have a comparative advantage*”.

Law and Economics (cont.)

- *Law and economics*: legal theory returns to economics; since the time of the classical economists, it was just a few "old" institutionalists who cherished legal thought in economics; Alchian, Demsetz, Coase and Buchanan pave the way for a new breakthrough; Becker's contribution (economics of crime).
- Law is ready to join forces: contract theory; accepting a few neoclassical postulates; legal rules as economic institutions (rules of the game); informal rules: are they part of legal analysis?
- Reducing transaction costs and distributing property rights more efficiently by legal instruments
- Sanctions as prices; contractual systems as governance structures; rational choice of legal institutions; legal rules and economic behavior
- Law and economics: troubled relationship in the beginning; Posner's quarrel with Coase and Williamson (1993); accusation: rhetorical innovation but insistence on conventional postulates of the mainstream
- Calabresi, Posner, Cooter, Ulen, Hart, Shavell, Kaplow, Landes, D. Friedman, Miceli
- Main research themes: property rights and incentives, credible commitment, incomplete contracts, implicit contracts, self-enforcing agreements, relational contracts, bargaining theory

"Governing the commons"

- Common/communal/public ownership as the underlying problem of the theory of communism
- The issue of *governing the commons* was preceded by setting up a neoclassical model of workers self-management (see presentations No 11, 12); novelty:

interpreting communal property as a form of governance

- Local, community-based ownership (village community as an old pattern); “The Tragedy of the Commons” (Hardin)
- Elinor Ostrom: *common-pool resources*, game-theoretical approach, normative thrust
- Self-governing communities, created from below, connecting freely; reciprocity; neither private nor public ownership; growing networks (internet, ecology); collective (instead of public) choice; between the market and the state
- Property rights propositions: clear boundaries, exact rules, self-control, clear sanctions

Mechanism design

- Part of the third wave of the socialist calculation debate; Hurwicz: unfortunately, there was more talk about ownership than (de)centralization.
- Close links to the Coase–Williamson line; enhanced mathematics; lack of property rights arguments; impartial/technical approach to the “state versus markets” choice
- Hurwicz (“*Optimality and informational efficiency in resource allocation processes*”, 1960) is the pioneer; Nobel Prize: together with Maskin and Myerson
- Key concepts: allocation mechanisms, mechanism as a communication system, incentive compatibility, revelation principle, implementation theory
- Message: there is always an optimal mechanism of resource allocation; the real mechanisms have to be compared to that.
- Game theory: institutions as non-cooperative games; auction control;
- Back from NIE to neoclassical theory?

Readings

Mandatory

Coase: The Problem of Social Cost, 1960

Williamson: Markets and Hierarchies, 1975 (chapters)

Hurwicz: The Design of Mechanisms for Resource Allocation, 1973

Buchanan: Constitutional Economics, 1987

Ostrom: Governing the Commons, 1990 (chapters)

Additional

Becker: Crime and Punishment: An Economic Approach , 1968

Posner: The New Institutional Economics Meets Law and Economics, 1993

Coase: Coase on Posner on Coase, 1993

Williamson: Transaction Cost Economics Meets Posnerian Law and Economics, 1993

Mueller: Public Choice III, 2003 (chapters)

Annex

Biographical sketches

- Coase
- Williamson
- Buchanan
- Ostrom

Final questions

- Predecessors/successors of the school
- Friends and foes
- Discoveries
- Changes in the research program