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New Institutional Economics

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Abstract

The new institutional economics (NIE) consists of a set of analytical tools or concepts from a variety of disciplines in the social sciences, business and law. The NIE addresses two overarching issues: what are the determinants of institutions – the formal and informal rules shaping social, economic and political behaviour? And what impact do institutions have on economic performance? It is the impact of institutions via property rights and transaction costs that ultimately affect the ability of individuals and societies (at a macro level) to extract the gains from trade which in turn can lead to enhanced economic well-being.

Keywords

agenda control; collective action; contract enforcement; corruption; creative destruction; credible commitment; firm, theory of the; free-rider problem; institutional path dependence; monitoring costs; New Deal; new institutional economics; political entrepreneurship; principal and agent; Prisoner's Dilemma; property rights; rational ignorance; rule of law; side payments; social capital; social norms; technology; transaction costs of exchange; transaction costs of production; transformation costs

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What is the new institutional economics (NIE)? The NIE adds to the neoclassical framework insights and concepts from a variety of social sciences as well as business organization, history and law. Unlike past interdisciplinary forays by economists into other disciplines, proponents of the NIE have been less imperialist and instead have been importers of various concepts. This does not mean that the NIE is internally inconsistent. Indeed, the NIE is a set of analytical spokes that when put together properly form a wheel of analysis capable of addressing a broad variety of issues. The NIE consists of analytical spokes from a variety of disciplines: anthropology, business organization, economics, history, law, political science, psychology, and sociology. My purpose in this article is to identify the spokes and try to form the wheel in order to give a better understanding of the NIE.

A framework for understanding the new institutional economics

The alpha and the omega of the NIE are institutions and economic performance (Alston and Ferrie, 1999; Eggertsson, 1996; North, 1990). Institutions determine economic performance and economic performance determines institutions. This is nothing new. What is new are the conceptual spokes such as transaction costs, property rights, credible commitment, and agenda control that determine the simultaneous causal links between institutions and economic performance. It is important to emphasize that the NIE does not abandon neoclassical theory. As Figure 1 illustrates, the conceptual arrows beginning with technology to transformation costs (production isoquants, along with relative prices) are still the backbone of the theory of the firm that determine the costs of production and in the neoclassical world led to discussions of how far inside and/or where on the production possibilities frontier a country would be. Because of the limited ability of this stark depiction of the theory of the firm to explain many of the ‘big’ questions facing economists – for example, the lack of convergence in standards of living across countries – many economists added various concepts. Let us begin with the role of institutions.

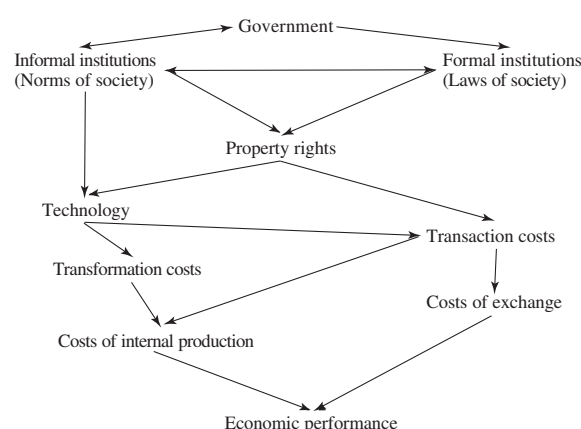


Figure 1 Institutions and economic performance

Institutions are the informal norms and formal laws of societies that constrain and shape decision-making or, as North (1990) defined them, ‘the rules of the game’. For a good treatment of the interaction of norms and laws see Greif (2006). For the importance of social capital or norms see Keefer and Knack (2005). Informal norms do not rely on the coercive power of the state for enforcement whereas formal laws do, in part. The enforcement of formal laws does not rely entirely on the coercive power of the state because some of their force is derived from the beliefs of its citizens. For example, if more people believe that littering is morally wrong, the costs that governments incur to police littering are lower. Similarly, if more people believe that recycling is morally right then they will incur their own costs to recycle even though to do so would not be in their self-interest strictly speaking. The existence of certain laws may simply be the codification of the norms of the majority. But, at times, and particularly during crises, some political leaders can influence the norms of citizens (Higgs, 1987). To the extent that political leaders can sway public opinion, the passage of laws may affect the beliefs of the constituents.

As Figure 1 shows, the norms and laws of society determine the property rights that individuals possess. Here I am concerned with rights that individuals have in

regard to goods and services: (1) the right to sell an asset; (2) the right to use and derive income from an asset; and (3) the right to bequeath an asset. Property rights are enforced in three ways. Individuals themselves enforce their assigned rights; for example, we put locks on our doors to protect our property. Societal sanctions such as ostracism can deter individuals from violating the assigned rights of others. And the coercive power of the state can be used to enforce property rights; for example, the police will evict trespassers.

Technology, which the standard neoclassical model took as exogenous, is shaped by the property rights, and the norms and endowments of citizens. Property rights along with technology determine the transaction costs and transformation costs associated with exchange and production. Robertson and Alston (1992) present a schematic framework for analysing the impact of technology on the transaction costs of production. Transformation costs are the physical costs (in an engineering sense but based also on relative prices) of combining inputs to produce output. The transformation costs of production depend on the technology in society. The transaction costs of production are the invisible costs of production and initially discussed by Coase (1937) in his seminal article for the NIE, 'The Nature of the Firm'. Transaction costs include: (1) search and negotiation costs; (2) monitoring labour effort; (3) coordinating the physical factors of production; (4) monitoring the use of the physical and financial capital employed in the production process; and (5) enforcing the terms of the contract. It is the transaction costs within a firm – along with transformation costs – relative to the transaction costs of using the market that Coase first identified as being decisive in determining the firm/market boundary. Others within the tradition of the NIE have extended this considerably, most notably Yoram Barzel (1989) and Oliver Williamson (1985). The extensions have provided answers to issues associated with long-term contracting, for example, Goldberg and Erickson (1987); Joskow (1985); hybrid contracts of various sorts (Menard, 2005) and various forms of business organization, for example, franchises (Lafontaine, 1992).

Both technology and property rights can affect the transaction costs of production in a variety of ways. Technology generally reduces both the direct costs of monitoring, through better surveillance, and reduces the need to monitor, that is, capital standardizes the marginal productivity of labour, holding constant monitoring. As an historical example, in agriculture, when workers cut down weeds by hand, monitoring costs were higher than when workers drove through the fields with a mechanical cultivator that cut down the weeds. Whether on the farm or in the factory, machines by their very nature reduce the discretion of labour. They standardize the production process and thereby reduce the variation in the marginal product of labour. In addition, technology influences the transaction costs of coordinating production; for example the computer is partially responsible for the observed increase in horizontal integration in commercial banking in the United States in the 1990s. The huge merger wave in the banking industry in the 1990s was partially the result of legal changes that in turn could have been prompted by the lobbying efforts from the financial industry in recognition of the cost savings associated with the advent of computer technology.

Norms and property rights can also affect the transaction costs of production. For example, if people believe in working hard in some cultures (perhaps because of past incentives), providing 'an honest day's work for an honest day's pay', then the monitoring costs borne by the residual claimant are lower. Similarly, if the property

rights in a society make it easy to dismiss workers for shirking, then monitoring costs would also decrease.

The transaction costs of exchange include the costs associated with negotiating and enforcing contracts. For some exchanges, the transaction costs of exchange are low because informal norms suffice to uphold bargains. Most local communities have well-established customs that limit opportunistic behaviour. Similarly, repeat transactions often give a sufficient incentive to deal fairly. Though local or repeat exchanges may have low transaction costs, the gains from such trade are limited because the extent of the market limits the number of individuals with whom one can deal locally or repeatedly. Formal institutions are necessary if the full gains from specialization in an extended market are to be captured. I use the term ‘full gains’ because some trade can be accomplished through self-generated reputation and the prospect of repeat business without relying on outside formal government institutions (Telser, 1981). This is particularly evident in the case of international transactions where the participants do not share a common body of law. For example, the extension of the market may require that more trades occur among anonymous parties or that more trades occur where payment and delivery are not simultaneous. Institutions can reduce the potential for unscrupulous behaviour inherent in such arrangements.

The presence of ‘honest’ courts and a body of law that upholds contracts and safeguards exchanges is a formal institution that determines the property rights of individuals which in turn affect the transaction costs of exchange. The shorthand concept used to describe this system is ‘the rule of law’ (Arrunada and Adonova, 2005; Beck and Levine, 2005; Hadfield, 2005). This does not imply that the courts are used frequently, only that they form a backdrop for exchange. The availability of recourse to law and the courts provides a safeguard for market participants engaged in anonymous or non-simultaneous exchanges. In the absence of honest courts, negotiation and enforcement costs will be higher. As a consequence, contracts will be written in ways that will safeguard the exchange should one party desire to act opportunistically. Williamson (1985) describes how contractors shield themselves from the potential opportunistic behaviour of others. Levy and Spiller (1994) illustrate the role of institutions in providing commitment in the context of safeguarding investments in the regulation of telecommunications. Firms (and legislative and executive bodies) also use the courts strategically but here I treat firms as responding exogenously to their expectation of decisions by courts.

At times there may be insufficient safeguards so that the result is not an exchange. For example, large investments are generally required to reap economies of scale. A part of that investment may not be readily transferable to other uses (that is the investments are asset specific – see Williamson, 1985, for an expansive treatment of specific assets). Before the investment is made, if there is a fear that some of the value of the investment will be expropriated, either through nationalization, taxes, regulations, or opportunistic behaviour by one of the contractors, firms will not invest as much as they would in the absence of such fears (Spiller and Tommasi, 2005). Expropriation could occur either through actions taken by the state (such as regulation or nationalization) or through actions taken by one of the parties (such as refusing to execute the exchange without a renegotiation of terms).

Given the set of institutions in a society, residual claimants will construct contracts with the suppliers of inputs to minimize the sum of transformation and transaction costs within a firm, and between firms and firms and consumers. The

results are a variety of contracts with differing transaction cost and production cost components, and different total costs of production. The varying contracts in turn influence economic performance. As an example there is a voluminous literature associated with principal agent problems ranging from tenancy in agriculture (Alston, 2003) to corporate governance (Fama, 1980).

The conceptual framework presented in Figure 1 and discussed thus far is basically static; it illustrates the ultimate importance of institutions for economic performance but it does not address the determinants of institutions and institutional change (Alston, 1996; North, 2005). To understand the process of institutional change, it is useful to think about economic performance or economic growth as a process of creative destruction (Schumpeter, 1942). Creative destruction means that there are winners and losers associated with economic performance (see Figure 2). The losers have an incentive to lobby government for institutional change to protect them from the ravages of the market, while the winners have an incentive to lobby for the status quo or an even better outcome. Consumers have an interest in the outcome, but given the existence of rational ignorance and free-rider problems consumers tend not to be as effective as special interests in the political marketplace. By rational ignorance, we mean that it does not pay the consumer to be as informed about legislation as special interest groups (Olson, 1965; Buchanan and Tullock, 1962). The free-rider problem arises because of the large numbers of consumers have difficulties in organizing collectively to prevent policy changes. Political entrepreneurs may attenuate both these problems because the interests of consumers are represented somewhat through competition amongst politicians who bring issues to the attention of consumers, and thus limit the power of special interests (Denzau and Munger, 1986).

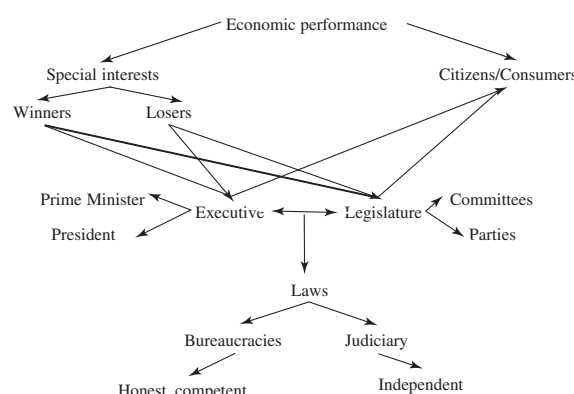


Figure 2 The determinants of formal institutions

We can think of those who lobby for changes in institutions or for the status quo as the demand side of legislation. But special interest groups do not enact legislation. Their demands get filtered through a political process of government institutions – what I call the supply side of legislation. By using the terms ‘demand’ and ‘supply’ I do not mean that there is necessarily a unique outcome; the term ‘bargaining’ may be more appropriate. Curiously, until recently, economists have paid little attention to the supply side of government, leaving the modelling of the political process to political scientists; ‘curiously’ because the concepts of demand and supply are the two most important components of neoclassical economics. The supply of legislation can be initially decomposed into the executive, legislative and

judicial branches. In parliamentary systems, the executive, prime minister, and the legislature are more interconnected than in presidential systems, so that the same demands may end up with a different result depending on whether a country has a presidential or parliamentary system (Carey, 2005). Within legislatures there are a myriad of coordinating devices; historically, in the United States, political parties and the committee structure in legislatures have played major roles in shaping political outcomes (Cox and McCubbins, 1993; 2005; Shepsle, 1978; Shepsle and Weingast, 1984). Political parties and committees have a certain amount of agenda control. For example, the party leadership makes appointments to committees, and committees in turn have the power to veto bills simply by refusing to report the bill out of committee. In addition they can amend bills to better suit their preferences. In parliamentary systems, particularly two-party dominant parliamentary systems, the majority power has significant agenda control. In other countries, most notably those with strong executive powers, such as in Brazil or Chile, the demand for legislation is filtered through the preferences of the president who negotiates with members of Congress using his powers to sway votes (Alston and Mueller, 2006). Changes in either demand or supply side forces will result in institutional change. Legislation can be either specific or vague in content (Spiller, 1996). In either case the law is administered through bureaucracies, giving rise to another set of principal-agent problems between the legislature and the agency to which the law is delegated (Ferejohn and Shipan, 1990; Weingast and Moran, 1983; McCubbins, Noll and Weingast, 1987). In the United States, the Environmental Protection Agency (EPA) is frequently cited as an example of a bureaucracy with large discretion because of the vagueness of its mandate from Congress.

The outcomes of this demand and supply side bargaining are the formal laws and regulations of a society, subject to the explicit or implicit sanction of the courts. It matters a great deal whether the courts that interpret the constitutionality of legislation are independent of the executive and legislative branches. If the courts are truly independent the executive and legislative branches will enact legislation ‘in the shadow of the court’, knowing that the court could overturn legislation. The dismal political and economic history of Argentina since 1945 is a good example of the impact on economic performance from a Supreme Court that has not been independent (Alston and Gallo, 2007; Iaryczower, Spiller and Tommasi, 2002).

Where do we go from here?

Before discussing institutional lock-in, the topic to which I believe we should devote more of our intellectual resources, it is worth considering which parts of the framework of the new institutional economics we know best. The hands-down winner is the area of contracting. We have much empirical evidence on how contracts change in response to different transaction costs, which in turn result from the formal laws and informal norms in societies. We also know a good deal about why governments pass the laws and regulations that they do. Here there has been an outpouring by both economists and political scientists, with economists tending to specialize in demand-side explanations – for example, the role of special interests – and political scientists specializing in supply-side explanations – for example, the role of committees and the importance of agenda control. So if we know why we get the laws, and we know how laws affect contracting, what is missing? What is missing is a better understanding of the transaction costs associated with getting laws

and regulations that are more conducive to better economic performance, especially when it becomes obvious that the existing laws and regulations are not fostering economic growth (Shirley, 2005). In many scenarios special interests are in a position to either enact legislation or block legislation so that they reap the gains. Yet society is worse off by such activity. The question is: why cannot 'we', the citizens or consumers, buy out the special interests? For many societies, poor economic performance is explained by corrupt governments, who are more or less stealing from their own citizens. Here we focus on issues beyond corruption, though corruption is clearly in the domain of the NIE. There are several possible explanations for institutional lock-in:

1. Informational problems abound such that citizens are unaware of possible policy moves that would improve on the status quo (North, 2005 and citations therein).
2. Though citizens do not like the outcome, they approve of the process that produced the outcome.
3. Even when aware, there are serious collective action problems.
4. Insecurity in political property rights prevents transactions from occurring, that is, you cannot buy what someone else does not own.

Let us explore each of these in turn.

Given rational ignorance it may be that many citizens are simply unaware of property rights arrangements that would improve societal welfare. For example, under the Homestead Act in the United States settlers could acquire property rights to 160 acres of unoccupied federal land by residing and 'improving' the land. These homestead plots turned out to be economically too small and promoted externalities associated with wind erosion. Even after the great dust bowl of the 1930s, plots remained small because subsidies by the federal government enabled farmers to remain on the land. Why did the federal government not move to reallocate land or at least not interfere with consolidation through markets? It appears that the answer rests with the information available to citizens and their beliefs in the virtues of small landholdings. This is coupled with the efforts of local politicians to maintain a population base (Hansen and Libecap, 2004a; 2004b). Ironically, in the latter part of the 19th century Major John Wesley Powell recognized the potential problems of settlements in the arid or sub-humid regions of the country, but his reports to Congress were ignored in favour of boosterism (Stegner, 1954).

Another example concerns consumers who may simply be unaware of policy moves that would improve their welfare. For example, the United States and many other countries have allowed their ocean shippers to participate in cartels that set prices on ocean routes around the globe (Sicotte, 1997). When I mention this to scholars, most are unaware of this price fixing. What needs to be done is to determine how many redistributive programmes exist where a policy move would be wealth-enhancing yet does not occur either because of insufficient information or an inability of citizens to process the cause and effects of potential policy moves in the face of risk aversion, that is, we know the effect of the status and do not fully comprehend a counterfactual policy world. Many institutions are bundled in ways that makes decoupling difficult. It is partially a coordination problem and it is partially a case of risk aversion – once you open Pandora's Box you are uncertain as to the final outcome.

Another reason for institutional path dependence is circumstances where citizens have a deep belief in the process that produces laws and regulations even though they may disapprove of some legislative outcomes. The majority may opt to support the status quo legislation because changing the law would entail changing a higher order institution concerning overall institutional development. From US history an example of public disapproval of changing the system of checks and balances was the attempt by President Roosevelt to add Justices to the Supreme Court. Roosevelt wanted to stack the Court because the Court was ruling that some major legislative acts were unconstitutional, for example, the Agricultural Adjustment Act and the National Industrial Recovery Act. By adding Justices, Roosevelt believed that his New Deal legislation would pass the constitutional test. Even though most people supported the New Deal legislation, there was a public outcry against Roosevelt's attempt to change the rules affecting checks and balances so as to achieve his legislative goals.

Alternatively, people may be aware of the dissipation associated with the status quo arrangement of property rights, but it is in no one's self-interest to mount an organizational campaign to change the existing regulations. This is the classic collective action problem developed independently but almost simultaneously by Buchanan and Tullock (1962) and Olson (1965) – one could also model this as a multi-player Prisoner's Dilemma game. The collective action problems are particularly acute in situations entailing multiple governments across international boundaries, for example, overfishing in international waters or global warming. The difficulties for international property rights are twofold: specification and enforcement. Specification is difficult because of knowledge or beliefs about the state of the world differ (for example, global warming) but even if beliefs are the same, preferences can vary across countries because of incomes (for example, the United States versus Mexico) or simply preferences (for example, the United States versus Germany on green issues). Collective action problems occur in representative democracies as well as dictatorial regimes. We have instances of both types of regimes not specifying and enforcing property rights at what would appear to be optimal times. For example, the United States squandered considerable oil reserves in the early 20th century and Indonesia mowed through a large stock of their tropical hardwoods in the latter part of the 20th century.

A fourth possibility for the lack of policy reform is insecure political property rights. It may be that individuals are aware and willing to organize but there is no 'market' for the emergence of property rights. Suppose that the winners from a status quo policy have the political power to veto or allow policy changes. Given their power, they would be foolish to acquiesce to policy moves that made them worse off, even if they were wealth enhancing. But, they would allow such a policy move if they were compensated. The actions of the landless peasants' movement (MST) in Brazil are consistent with this argument. The MST is very effective at swaying public opinion and thereby prompting politicians to expropriate land and transfer it to peasants; but they do not support deeding the land to peasants. The MST prefers to keep the peasants dependent on the MST as a collective because it is easier for them to extract payments from the group than individual farmers (Alston, Libecap and Mueller, 2005).

Why is it that we generally do not allow such side payments? One answer is that transparent side payments would undermine the legitimacy of the organization, whether the organization is the MST, a union or a government. If the current property rights arrangement is viewed as inferior to an alternative, people 'believe'

that they should not pay to move to a better property rights arrangement. The result is institutional lock-in. Yet there have been examples of improving the status quo for all parties involved. A case involving the sale of water in the 1990s illustrates the difficulties in changing the status quo. The Imperial Valley Irrigation District, a governmental unit that has jurisdiction over water, entered into a contract to sell some of its water to the city of San Diego. The Imperial Valley Water District has property rights to water that are subsidized by US taxpayers. As such it can sell water at prices higher than it pays. Interestingly, members of the Imperial Water District decided that they would only sell water that they have conserved through better irrigation technologies. The interesting question is: why didn't they fallow all their land and sell their entire water allocation? I speculate that they were concerned about the political fallout that could have resulted in the district losing its current subsidy. In short, it appears as if they have secure property rights to the rental stream of water but not the clear 'political' property right to the stock. The establishment of 'water banks' throughout the West – whereby farmers could sell their flow of water to urban users or resort users – have failed primarily because farmers are afraid of losing their property right when it becomes transparent that farming is not the highest-valued use of water in the West.

Another factor promoting the insecurity of political property rights falls under the rubric of credible commitment (North and Weingast, 1989). In representative democracies politicians face the demands of constituents who may be harmed or obtain benefits from a rearrangement of property rights. The demands of the majority of voters may not coincide with the optimal arrangements of property rights, and politicians cannot commit to making side payments over time to compensate the losers. Authoritarian regimes are subject to similar problems associated with catering to populist demands. A good example of this was the infringement in property rights by Peron in Argentina in the late 1940s. Peron imposed rent and price controls in the Pampas, the most fertile and productive agricultural producing area in Argentina. The punitive arrangement in property rights lead to a decline in investment which, along with political instability, affected growth in the long run (Alston and Gallo, 2007; Spiller and Tommasi, 2003; 2007).

A more cynical view of political behaviour suggests that we do not want to encourage paying for changes in property rights because to do so would promote the creation and maintenance of non-optimal property rights in order to be paid to move to a more optimal situation. Campaign finance and corruption around the globe may be testimony to special interests trying to 'bribe' politicians to maintain or change property rights. In some instances politicians may use part of the contributions to make side payments (Norlin, 2003).

Explaining institutional rigidities in the face of poor economic performance is a difficult research agenda. To understand the lock-in requires insights from the disciplines that comprise the NIE – anthropology, business organization, economics, history, law, political science, psychology and sociology. Yet the potential reward from an understanding of the forces that account for poor economic performance is huge. The research agenda includes both international cross-sectional studies and case studies of successful and unsuccessful institutional change. The international cross-sections allow us to quickly determine the correlates of successful economic performance, for example secure property rights, while the case studies allow us to stack the building blocks that will ultimately allow us to produce a more general framework for the determinants of institutional change (Alston, 2007).

See Also

- firm, theory of the
- growth and institutions
- ‘political economy’
- political institutions, economic approaches to
- property rights
- transaction costs, history of

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