ЕКОНОМИКА ƏE Vol. 60, october-december 2014, № 4
ISSN 0350-137X, EISSN 2334-9190, UDK 338 (497,1) Стр. 69-76

Zoran Stefanović, PhD[1]
Branislav Mitrović, PhD[2]
University of Niš, Faculty of Economics

ORIGINAL SCIENTIFIC ARTICLE
Received: November 15, 2014
Accepted: December 02, 2014

REVISITING NEW INSTITUTIONAL ECONOMICS: BASIC CONCEPTS AND RESEARCH DIRECTIONS[3]

Abstract

In the last four decades there is a renewed interest within the economic theory for the institutional structures. Numerous, multiple and often unpredictable effects of institutions on economic process are differently reflected among the leading schools of economic analysis. Certainly, in this sense, the greatest attention should be given to the stream of economic thought known as institutional economics. This heterogeneous research orientation today is already clearly differentiated on Veblenian and the new institutional economics. The paper will make, in the light of its recorded achievements and the subjects of interest of its main protagonists, a general insight into the new institutional economics.

Keywords: *neoclassical economics, institutions, new institutional economics, property rights, transaction costs,*

JEL Classification: B31, B41, B52, D21, D86, E02, N01.

РЕКОНСИДЕРАЦИЈА НОВОГ ИНСТИТУЦИОНАЛИЗМА: ОСНОВНЕ КОНЦЕПЦИЈЕ И ПРАВЦИ ИСТРАЖИВАЊА

Апстракт

У последње четири деценије обнавља се интересовање економске теорије за институционалне структуре. Бројна, вишеструка и неретко тешко предвидива дејства институција на економски процес промишљају се на различите начине међу водећим економским правцима економске анализе. Свакако да у том смислу највећу пажњу заслужује ток економске мисли познат као институционалистичка економија. Ова хетерогена истраживачка оријентација данас је већ јасно диференцирана на вебленовску и нову институционалну економију. У раду ће бити, у светлу њених досадашњих достигнућа и предмета интересевања главних протагониста, учињен генерални приказ нове институционалне економије.

Кључне речи: *неокласична економија, институције, нова институционална економија, својинска права, трансакциони трошкови.*

[1] zoran.stefanovic@eknfak.ni.ac.rs

[2] branislav.mitrovic@eknfak.ni.ac.rs

[3] This paper is part of the project "Improving the Competitiveness of the Public and Private Sector by Networking Competences in the Process of European Integration of Serbia", which is, under number 179066, funded by the Ministry of Education, Science and Technological Development of Republic of Serbia.

Introduction

For a long time the economic theory tries to decipher the nature and channels of influence of those structures that cannot be grasped within the conventional, equilibristic thinking about economic processes. It may be no exaggeration to state that the history of economic thought records permanent warnings of the dangers of ignoring the subtle, cultural, historical and socio-psychological processes that pervade economic activity. Some of the great thinkers of the economic science, such as Smith, Mill, List, Marx, Hayek, and others, have dealt with, in their systems of economic thought, among other things, their detection and explanation. Some of the modern schools of economic thought ascribe special importance to the non-economic components of the processes in the contemporary economy. This applies particularly to the economic doctrines of heterodox orientation - the Austrian school, radical, gender, behavioural, institutional economics and others. The above-mentioned theoretical streams and schools of thought strive to sensitize the economic orthodoxy on institutional structures or find an epistemological alternative. Undoubtedly a significant step forward in the above sense is made within institutional school of economic thought, which considers institutional arrangements of society and their economic implications as its central point of occupation. This economic doctrine is composed of two, it could be concluded without a lot of reserves, partially conflicting theoretical currents: the old and the new institutionalism. The paper will outline relevant concepts of the new institutionalism. For these purposes will serve the insight into the main lines of research within the new institutionalism: the economic theory of property rights, institutional economic history and theory of the firm based on transaction costs.

1. New Institutionalism - A General Overview

The new institutionalism represents a school of economic thought with growing influence, as evidenced by the awarding the Nobel Prize in Economics, to the three of its leaders - Ronald Coase (1910-2013), Douglas North (b. 1920) and Oliver Williamson (b. 1932). Armen Alchian (1914-2013), Harold Demsetz (b. 1930), Steve Pejovich can also be counted among the major representatives of this doctrine.

The protagonists of the new institutional economics seek to extend conventional economic theory, by introducing the concept of institution into its analytical apparatus. It should firstly be explained, what is meant by the expression "conventional economic theory" or "economic orthodoxy".

Economic orthodoxy is the common name for the widely accepted theoretical framework, known also as neoclassical, developed within marginalism, starting with the parallel contributions of Alfred Marshall (1842-1924) and Léon Walras (1834-1910). It is based on well-known model of economic reproduction, understood as a generalized market exchange between households and firms, which is managed through the variations in market prices and application of the marginal principle in shaping the supplied and demanded quantities of goods and resources. It should be noted here that this model is articulated differently by the aforementioned founders of the economic mainstream. Valrases theory of general equilibrium, in principle, rests on the same mechanisms as Marshal's, with some differences related to the issues of the role of the time factor, nature of non-equilibrium states, generality of equilibrium and others. (De Vroey, 2004, p. 64-65)

The starting point of neoclassical economics are "agents " (individuals, households or firms), whose desires and needs are unlimited. On the other hand are the restrictions embodied in scarcity of resources to address these needs. The tension between the needs and constraints is solved by the market, where the pulsating of prices leads to responding to the needs of agents (Weintraub, 2002). Theoretical architecture of neoclassical economics relies on the specific assumptions that can no be put to the question, that have naturalistic, universal validity (Weintraub, 2002):

1. agents have rational and stable preferences of the outcomes;
2. agents behave as maximizing subjects - individuals maximize their utility, companies maximize profits;
3. agents act independently and have complete information about their environment.

All the above mentioned assumptions can be summarized in one - agents are rational. Since they have a perfect knowledge of the environment, they always make optimal decisions, thus maximizing their target functions. The rational behaviour of agents leads to equilibrium, at which any further reallocation of assets and resources is sub-optimal, because it would not have been achievable without deterioration of one’s relative position (Pareto optimality).

Neoclassical understanding of the economy owes its current influence to the fact that it represents a logical approach, extremely suitable for the mathematical interpretation and further theoretical upgrading. Most of currently dominant economic doctrines, with certain adjustments, accept neoclassical microeconomic model as a framework for their research and creation of new economic concepts.

New institutionalists observed deficiencies in the neoclassical reflection of the economy. Developing on neoclassical grounds, they try to modify and redesign this epistemological structure in order to increase its level of realism.

In this sense, the new institutionalism accepts the neo-classical propositions of scarcity, competition, economics as a science of choice under certain restrictions, and the role of relative prices in the allocation of resources. The proposition that the new institutional economics modify is rationality. Furthermore, the concept of institution is considered as an essential element of economic analysis (North, 1994).

Institutions are defined as the humanly devised constrains, that structure political, economic and social relations between individuals (North, 1991, p. 97). Institutions are the “rules of the game” in a society, which fundamentally influence the behaviour of agents (North, 1990, p. 3). Preferences of agents, their incentives for economic activity, as well as their degree of rationality are largely the result of influence of social institutions under which they live.

The entire institutional economics is concentrated around institutions as the central concept. The essential features of institutions may be indicated as follows:

1. Institutions are the rules (patterns) behaviour.
2. They consist of unwritten rules and legal norms.
3. Institutions exercise long-lasting impact on the behaviour of individuals (more on that in Stefanović, 2009, p. 16). In other words, institutions represent long-term, trans-generational phenomenon.

Given that they exert significant influence on the behaviour of agents, institutions must be incorporated in the economic analysis. New institutional economics is focused on explaining the origins, mechanisms of change of institutions as well as their effects on the economic process. Within the new institutionalism, special attention is devoted to the analysis of social institutions governing property relations between agents. Also, a stream of new institutional economics deals with the explanation of the companies, as a kind of institutional alternative to market mechanism.

2. Ownership Institutions and Economic Efficiency

The essential inspiration for new institutional economics was provided the Coase's research on industrial organization (Coase, 1937). One of the major problems within the neoclassical analysis is explanation of the existence of the companies. Neoclassical economics implies that the allocation of resources operates at the market, which performs this function efficiently. The question is, however, why then there are alternative allocative structures - firms. In addition, the structure of the firms is quite the opposite to that of the market - they are centralized, command and hierarchical structures (Coase, 1937, cited in: Jovanović, 2004).

Coase explains the existence of firms by the cost of using the market mechanism, related to the discovering of relevant prices, negotiating and concluding contracts. If these costs are too high, the market is being replaced by the firm as allocation mechanism (Jovanović 2004).

The economic process is understood here as a set of transactions between agents. The subjects of the transactions are not only goods and services but also property rights over them. Market exchange is therefore the exchange of property rights. Costs that are generated during this exchange are called transaction costs.

Coase established the relationship between property rights, transaction costs and resource allocation, which became known as the Coase theorem (Coase, 1960). The initial schedule of property rights over resources has no impact on the efficiency of resource allocation, if property rights are clearly defined and transferable, or if transaction costs are zero (Jovanović, 2004, p. 236). In other words, if property rights can be exchanged at no cost (transaction costs are zero), then they will be, regardless of its initial configuration, always ultimately arranged in a way that ensures optimal allocation of resources.

Message of the Coase theorem is unambiguous - the existence of transaction costs during the exchange of property rights may disturb the efficient allocation of resources. Neoclassical economics has ignored transaction costs, and according to its logic resources are always allocated in an optimal way. However, the fact is that, in the real economy, there are transaction costs, which has implications for the efficiency of resource allocation (Coase, 1988, p. 175). If there are transaction costs, then the ways in which property rights are regulated become important.

The function of regulation of property rights in the society is performed by property institutions. The relationship between property institutions, transaction costs and economic efficiency is the central preoccupation of the branch of institutional economics led by Alchian, Demsetz and Pejovich. This stream of institutional thinking studies alternative systems of property rights (different forms of ownership) and their impact on economic efficiency (Alchian, Demsetz, 1973).

Only stable, credible and fully protected property rights enable the efficient allocation of resources (Pejovich, 2001, p. 4). In the regime of fully protected property rights, individuals have clear authority over their resources. If property rights of all agents are well protected, then they can enter into transactions without fear that their access to their own resources will in some illegal way be affected. Safety in exchange for its part affects the reduction of transaction costs, and contributes to the optimal allocation of resources.

The optimal structure of property rights, which would allow the minimization of transaction costs, is identified as fully protected private property. The institutional structure of the society that would allow such ownership regime is based on the rule of law. This sort of socio-economic regime protects individuals from attacks on their property rights by ruling groups, the state, the predatory-minded agents and others.

Institutions should, therefore, be changed in the direction of this type of social structure (Pejovich, 2001).

3. Institutional Evolution and Economic History

In an effort to empirical verification of the influence of property rights institutions on economic efficiency of the society, North has conducted research in economic history of some Western countries (North, Thomas, 1973). This scientific enterprise was based on an assertion that economic development is a result of traditional developmental factors (technology, demographic potential), but is also essentially dependent on the subtle influence of the institutions of society, especially those that define property rights. The evolution of institutions shapes the ability of the society for the long-term growth. North comes to the conclusion that there was the asymmetric development of property institutions in different countries of the West. In the UK and the Netherlands systems of stable and well-protected private property rights were established, while in other countries inefficient forms of ownership dominated throughout economic history.

In order to explain such a trajectory of institutional evolution of western countries North introduces a distinction between formal and informal institutions (North, 1990, p. 3). Formal institutions are embodied in the legal system (constitution, laws), while informal institutions are of unwritten character (culture, tradition, customs and beliefs).

Informal institutions exert strong and firmly rooted influence on the behaviour of agents. Their impact on the agents is reflected in the existence of the so-called "mental models", or their beliefs about how the environment is structured and what are acceptable and desirable modes of behaviour in society. Individuals, who live in a society, are exposed to the same cultural and historical influences. Therefore they will form the same mental models, which will strongly affect their behavior (Denzau, North, 1994). The problem is that in some societies, historical circumstances and cultural background generated informal institutions and modes of socio-economic thinking and cooperation that are not compatible with private property and a market economy.

If informal institutions, expressed through the prevailing mental models of individuals in a society, are hostile toward private ownership and similar arrangements, then latter institutions will not efficiently operate in such an environment. Even when private property and market norms are imposed by formal rules (constitutions, laws), informal institutions will for a long time impede the process of creating a capitalist ownership structure. The problem is further complicated by the fact that the state, as the entity responsible for the enforcement of property rights, is largely inert and ineffective in the process.

Resistance of informal institutions can explain the delay of certain western countries (France, Spain, for example.) in the historical process of development of capitalist property institutions. This model can also explain the current slow transition to a market economy of countries of Latin America and certain post-socialist economies (North, 1994).

4. The Theory of the Firm based on Transaction Costs

Another stream of new institutionalism is focused on the issues of the firms as non-market institutions. The leader of this research orientation, Williamson, explains the existence of firms through the concept of transaction costs. Similar to frictions in physical systems, transaction costs hinder market mechanism. Transaction costs arising from disputes and conflicts between participants in the exchange, lead to delays, interruptions, etc. (Williamson, 1985, p. 1-2).

Transaction costs are divided into two groups. Ex ante transaction costs related to the activities of entering into contracts between agents. They include the costs of negotiating and concluding contracts. Ex post transaction costs are generated during the contract execution. Since it is almost impossible to to cover all possible situations within the propositions of the contract, contracts are “incomplete”. If, during the execution of the contract, contingencies occur, agents bear certain costs related to interruptions, eliminating disputes, securing guarantees that parties will comply with contractual obligations etc. (Williamson, 1985, p. 21).

The level of transaction costs is determined by the characteristics of the transaction (Williamson, 1981, p. 1547-1551):

1. the specificity - one or both parties invest specific resources in order to perform the transaction;
2. frequency - doing business with the same supplier often reduces transaction costs, such as those pertaining to quality control;
3. uncertainty - with greater uncertainty in the exchange, contracts will have to be more detailed, which increases the relevant transaction costs.

The uncertainty in the exchange is the main source of transaction costs. It is generated by bounded rationality and opportunistic behaviour of agents. Agents strive for rationality, but they are only limitedly successful therein, because they cannot have all the relevant information. Thus, the rationality of agents is bounded. Bounded rationality opens space for opportunistic behaviour. In this context, opportunism is an attempt to realize one’s own interests with the help of guile, through incomplete and distorted presentation of relevant information (Williamson, 1985, p. 47).

Limited rationality and opportunism increase the level of uncertainty in the exchange. Uncertainty makes transactions more “expensive” and discourages agents to participate in market exchange. The society still finds alternative, non-market institutions, to carry out the exchange, which, according to Williamson, represent so called “governance structures”. Governance structures reflect the efforts of the society to economize on transaction costs. The organizational forms of these institutions are firms. Due to their organizational structures, firms can successfully control the transaction costs. Specifically, within companies, the exploitation of knowledge is more economical, the opportunistic behaviour of agents is more efficiently controlled, information asymmetry is reduced, hence the uncertainty is lesser (Williamson, 1975, p. 40).

Williamson concludes that, in line with the economic circumstances, governance structures evolved, from the former unitary corporations toward contemporary decentralized multidivisional organization. Its modern offshoots are conglomerates and multinational companies.

It should be noted that within the new institutional economics, there are different explanations of the company as a non-market institution. Alchian and Demsetz explained the emergence of firms as the result of inability of the market to organize “team production” (Alchian, Demsets, 1972, cited in: Screpanti, Zamagni, 1995). In such a mode of production, markets do not provide enough information for measuring the contribution of individual factors of production on the basis of their marginal product. This motivates employees to behave opportunistically, through not investing enough efforts in production, thus reducing the efficiency of production. It is necessary, therefore, to introduce someone to oversee and control team members. However, a mechanism must be found to prevent the supervisors from “tolerating” team members. The solution is to ascribe to the supervisor all the residual income, rest upon the remuneration of all factors of production. Since the opportunistic behaviour of team members reduces his income, the supervisor is strongly motivated to suppress it. The conclusion of this theory is that the most effective supervisor in fact is the owner of the company (Alchian, Demsetz, 1972).

Conclusion

The methodological framework of the mainstream economics is based on well-known and in academic circles widely accepted principles describing the economy as a closed system, with rational economic actors as the backbone of the theoretical architecture. Their decisions, guided by pulsating market prices, by definition, are optimal and lead to balancing the forces of supply and demand, which, in essence, define any economic situation. Such epistemological matrix, “liberated” from the contents not directly involved in the immediate process of market equilibration, has considerable analytical value, since it provides exemplary clarity, firmness of logical relations and undeniable suggestiveness in the consideration of economic phenomena. However, there is an increasing amount of accumulated evidence which testifies to the fact that this model of understanding the economy has reached its limits. There is increasingly less justification for an economic analysis that ignores the numerous and heterogeneous non-economic structures operating at all levels of the economic space. The limits of orthodox epistemological framework are comprehended in numerous research fields, including the problems of economic growth, technological development, innovation, financial systems and others. There is, therefore, in economic theory, a growing awareness of the importance of the institutional dimension of the economic mechanism. Perhaps the most significant reflection of the aforementioned trend in economic thought is the emergence of new institutional economics. This theoretical current of institutionalism seeks to bridge the shortcomings of neoclassical analytical framework, i.e. its insensitivity to the institutional structure. In this sense, while maintaining a general analytical orientation of neoclassical framework (equilibrium mechanism, scarcity of resources), this line of thinking modifies the principle of rational actors, and associates market coordination process with the exchange of property rights and transaction costs. Suboptimal definitions of property institutions generate transaction costs that impede and deform the optimal allocation of resources. Quality of specification of property rights depends on the way of articulating the rationality of actors in the economy, through the existing cultural-historical framework and socio-psychological context, embodied in informal societal institutions. Economic reality in every society, in accordance with the above-mentioned framework, can be regarded as an effort, joint or individual, spontaneous or organized, to find arrangements for economizing on transaction costs. New institutional economics showed significantly higher level of responsiveness to some important determinants of economic currents, which are not compatible with the widespread reasoning of the equilibrium type. This may have an impact on increasing the realism and usefulness of the prevailing model of study of economic reality.

References

Alchian, A., Demsets, H. (1972) Production, Information Costs and Economic Organization. *American Economic Review*, 62(5), 777-795.

Alchian, A., Demsets, H. (1973) The Property Rights Paradigm. *Journal of Economic History*, 33(1), 16-27.

Coase, R. (1937) The Nature of the Firm. *Economica*, 4(16), 386-405.

Coase, R. (1960) The Problem of Social Cost. *Journal of Law and Economics*, 3, 1-44.

Coase, R.(1988) Notes on the Problem of Social Cost, in: Coase, R. (ed.) *The Firm, the Market and the Law*. Chicago University Press. Chicago.

De Vroey, M. (2004) The History of Macroeconomics Viewed against the Background of the Marshal-Walras Divide. *History of Political Economy*, 36(5), 57-91.

Denzau, A., North, D. (1994) Shared Mental Models: Ideologies and Institutions. *Kyklos*, 47(1), 3-31.

Jovanović, A. (2004) Ronald Coase. *Ekonomski anali,* 161, 233-242.

North, D., Thomas, R. (1973) *The Rise of the Western World: a New Economic History*. Cambridge University Press. New York.

North, D. (1990) *Institutions, Institutional Change and Economic Performance*. Cambridge University Press. Cambridge.

North, D. (1991) Institutions. *Journal of Economic Perspectives*, 5(1), 97-112.

North, D. (1994) Economic Performance through Time. *American Economic Review*, 84(3), 359-368.

Pejovich, S. (2001) *The Economics of Property Rights Vol I*. Edward Elgar. Cheltenheim UK, Northampton, USA.

Screpanti, E., Zamagni, S. (1995) *An Outline of the History of Economic Thought. Cambridge University Press. Cambridge.*

Stefanović, Z. (2009) *Institucionalistički pravac ekonomske misli*. Zadužbina Andrejević. Beograd.

Weintraub, R. (2002) Neoclassical Economics, in: Henderson, M. (ed.) *The Concise Encyclopedia of Economics.* Liberty Fund Inc.

Williamson, O. (1975) *Markets and Hierarchies*. Free Press. New York.

Williamson, O. (1981) The Modern Corporation: Origins, Evolution, Attributes. *Journal of Economic Literature,* 19(4), 1537-1568.

Williamson, O. (1985) *Economic Institutions of Capitalism*. Collier Macmillan Publishers. New York.