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Quick guide to New Institutional Economics

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ABSTRACT

Eggertsson, Thráinn—Quick guide to New Institutional Economics

The old field of Comparative Economic Systems lacked a theoretical framework, which New Institutional Economics now provides. The paper is a brief guide to NIE: its strength, weaknesses, policy implications, and future tasks. The intellectual interest in the NIE approach is directly related to the gap between prevailing economic property rights (institution) and best practice (most productive) arrangements. A large productivity gap on a national scale is mainly found in two circumstances: in low income countries that fail to import and adapt existing technologies, and in high income countries failing to cope with new technologies, such as digitization. *Journal of Comparative Economics* **41** (1) (2013) 1–5. Institute of Economic Studies, University of Iceland, 107 Reykjavik, Iceland; Hertie School of Governance, 10117 Berlin, Germany.

1. The brand name

The name *New Institutional Economics* (NIE) may confuse the reader.[1] In the NIE context, the word "institution" does not refer to organizations (government agencies, industrial associations, corporations, hospitals), and, as Ronald Coase has emphasized, NIE is not a modern version of the old *Institutional Economics*.[2] Following North (1990, 3), most NIE authors define institutions as the effective rules of a social game in which individuals and their organizations are the players. The rules of the game (laws, regulations, norms) and their enforcement mechanisms create constraints and incentives that shape the behavior of decision makers. In the long-run, organizations often invest in changing the rules of the game but fundamental changes are usually stepwise and cumulative. Basic institutions, in particular social norms, are slow moving.

Economics has lacked a theoretical framework for studying comparative economic systems. NIE provides such a framework and in retrospect the name Comparative Economics, rather than New Institutional Economics, would be a more suitable or transparent name for the field. Alas, brand names are path dependent (we now have three international societies identified with NIE), and it is probably too late to rename the field.[3]

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[1] The name New Institutional Economics is due to Williamson (1975). In Economic Behavior and Institutions (1990) I use, ill-advisedly, the term Neo-Institutional Economics, which did not catch on.

[2] Coase (1984, 230), referring to the old Institutional Economics, states: "Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire."

[3] International Society for New Institutional Economics (www.ISNIE.org), founded in 1997, the European School of New Institutional Economics, founded in 2002 (www.ESNIE.org), and the Ronald Coase Institute, founded in 2000 (www.Coase.org).

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2. The most useful concept

The most useful theoretical contribution of NIE is the idea that transactions are costly. In our world of incomplete information, measurement and enforcement in voluntary and involuntary transactions is costly; we have unavoidable transaction costs.[4] Transaction costs and property rights are two sides of the same coin: the act of acquiring, protecting and transferring property rights creates transaction costs. Beware that the concept "property rights" in NIE has a more general definition than the legal term. In NIE property rights refer to the actual degree of control that someone has over specific dimensions of an asset, whereas in law property rights constitute a more narrow category of *formal* ownership rights and duties. In NIE, the broad concept of (economic) property rights includes illegal and immoral rights (control) that are neither supported by law nor common moral theory. Theft, for instance, when successfully carried through, involves transaction costs and establishes economic property rights (but usually not moral or legal rights). The focus on actual control teaches NIE scholars to avoid statements such as "the country's ocean fishing grounds are property of the nation". They focus instead on the effective rules of the game and the structure of incentives, asking: Who really has the power to use, receive income from, allocate, transform, and sell the relevant assets, and how are these decision makers going to use their rights?

The concept of transaction costs is essential for understanding the logic of all types of social systems, otherwise the organization of firms, markets, parliaments, churches, armies and the mafia has no sensible or productive explanation. For instance, in his general equilibrium analysis Walras randomly selects one of the commodities traded as a common denominator and unit of measurement but measurement is costless in his model and the commodity has no specific productive function.[5] In NIE the structure of social systems reflects attempts to lower the cost of transacting.[6]

Very high transaction costs (and corresponding weak economic property rights) interfere with specialization and trade and undermine effective public administration.[7] The economic history of China since the 1970s, however, illustrates that there are other ways to establish economic property rights than the traditional Western legal approach, at least when a country is well inside the technical production possibilities frontier and imports its technology (Qian 2003).

Finally, the transaction-cost approach helps us understand how technological change shapes the structure of social organization by providing new technologies of measurement on which the choice of ownership and governance arrangements depends. A modern high tech society has an enormously wider choice of property rights arrangements and forms of organization than a stone-age society. Future advances in measurement technologies may possibly transform common pool regimes into private property regimes, if we so desire, for instance when new measurement technologies make possible the monitoring of individual fishes or schools of fish in the oceans.

3. The weakest link

NIE studies not only rules (institutions) that formal organizations (parliaments, courts, business and professional associations, golf clubs) create and enforce but also *informal institutions*. Informal institutions correspond approximately to self-enforced social norms. Self enforcement is spontaneous and decentralized, involving alternatively self control, second party enforcement, or third party enforcement. Third party enforcement occurs when someone who is not directly involved punishes norm violators for their illegitimate behavior (littering, ignoring a red traffic light, shoplifting), and thereby supplies a public good (sanctions) and solves the so-called second-order social dilemma. Social norms are important because the enforcement of new formal rules depends usually on their compatibility with the community's prevailing social norms. When organized political opposition to institutional policy is insignificant, NIE usually blames policy failures (for instance failures of transitions to markets or attempts to create rule of law) on prevailing informal institutions. Incompatible social norms, which are out of reach for policy makers, are said to have undermined the reforms. Recent studies that employ data that span centuries and use advanced statistical methods have found that informal institutions are path dependent.[8] These studies find that prevailing community norms of non-cooperation and distrust originated centuries ago in specific social circumstances. Dominant norms often differ between regions with unlike historical origins even when in our times the regions are part of the same nation state.[9]

NIE, while recognizing the importance of informal institutions, has not developed a powerful theory for explaining the life cycle of social norms, in part because economists have a history of not attempting to analyze the formation of tastes and preferences in psychological terms. Forewarned by Stigler and Becker (1977) that *de gustibus non est disputandum,*

[4] The idea of transaction costs (but not the name) goes back to Coase's (1937) analysis of the firm. Many NIE studies differ from standard microeconomics only in that they recognize transaction costs, and now, when microeconomics has partly embraced transaction costs, NIE may face an existential threat or perhaps neoclassical economics faces an existential threat! The emphasis on transaction costs makes NIE differ from standard neoclassical economics by making zero-transaction-cost equilibria an irrelevant benchmark for welfare economics; we cannot simply ignore a critical and unavoidable cost category. Comparative institutional analysis studies the choice between social arrangements that are all failures or sub-optimal by pure neoclassical standards.

[5] In Iceland, the country's complex system of fisheries regulations uses 'cod equivalence' as a unit of measurement, which reminds one perhaps of Walras.

[6] When the rules are chosen by some authority, they obviously reflect the interests and goals of those in power with lower transaction costs as a secondary target.

[7] Barzel (1989) provides a classic introduction to the economics of property rights and transaction costs.

[8] For a recent survey see Nun (2009), *The Importance of History for Economic Development*.

[9] See, for instance, Grosjean (2011), *The Weight of History on European Cultural Integration. A Gravity Approach*, and Guiso et al. (2011), *Civic Capital as the Missing Link*.