What are institutions?

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NDSU NEW INSTITUTIONAL SOCIAL SCIENCE

Outline

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'Old' institutionalists

- Three leading figures: Thorstein Veblen, Wesley Mitchell, John Commons
- Mitchell concentrated on cyclical fluctuations and aggregate disequilibrium; and on quantification and measurement as the main methodological aim or criterion
- Commons focused mainly on the legal framework of economic activity, or transaction costs, and in particular, on tendencies to collectivism and collective action.
- Veblen emphasized on the social embeddedness of economics. He is known for his criticism of traditional static economic theory and of capitalism.

  > Veblen was as much a sociologist as he was an economist, who rejected the notion that economy is an autonomous, stable, and static entity.

'Old' institutionalists

- 'An institution is of the nature of a usage which has become axiomatic and indispensable by habituation and general acceptance" - Thorstein Veblen
- Commons saw institutions as "shaping each individual."

  For Commons, an institution was "collective action in control of individual action."
- Institutions are the "habits of thoughts which prevail in a given period" - Wesley Mitchell, 1949

'Old' institutionalists

Social concepts are the core of social institutions. The latter are but prevalent habits of thoughts which have gained general acceptance as norms for guiding conduct. In this form the *social concepts attain a certain prescriptive authority over the individual.* The daily use by all members of a social group unremittingly *molds those individuals into common patterns without their knowledge* and interposes definite obstacles in the path of men who wish to act in original ways. -Mitchell, 1910.

Outline

'Old' and 'New'

- Important theoretical and philosophical differences *between* each camps, but also *within* each camp.
  - But the two schools are *not* readily distinguishable in terms of ideology.
- Both start from a criticism of orthodox economic theory for its "too high a level of abstraction."
- That the individual is not given, but can be reconstituted by institutions, pervades the institutionalist tradition. (Hodgson, 2005)

> The wants and desires, the end and the aim, the ways and the means, the amplitude and drift of the individual's conduct are functions of an institutional variable that is of a highly complex and wholly unstable character.
> \- Veblen

'Old' and 'New'

- A *radical criticism* of orthodox (mainstream) theorizing and of its fundamental assumption about rationality and knowledge.
- The task of an economist is viewed as one of studying **customs, usages, and habits of thoughts (i.e. institutions)** and their evolution in order to explain how economic decisions and actions are undertaken in different times and places, rather than to assume a particular, highly simplified pattern as universal. (Hutchinson, 1984)

> 'Wants' are not primary. They are not inborn physical mechanisms and they are certainly not spiritual attributes. They are social habits. For every individual their point of origin is in the mores of his community; and even these traditions have a natural history and are subject to modification in the general process of social change. -Clarence Ayres, 1944.

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'Old' and 'New'

- More generally, institutionalists recognize the potential influence of many institutions on individual habits, conceptions, and preferences.
- Galbraith (1969) argued that individual wants can be synthesized by advertising, catalysed by salesmanship, and shaped by the discreet manipulations of the persuaders.

Outline

'Old' versus 'New'

- The 'old' institutionalism is distinguished from both mainstream economics and the 'new' institutional economics precisely for the reason that it *does not assume a given individual*, with given purposes or preference functions.
  -Hodgson, 2005
- The 'old' institutionalism holds to the idea of *interactive and partially malleable agents,* mutually entwined in a web of partially durable and self-enforcing institution.

'Old' versus 'New'

- Criticized for its overemphasis on structural or cultural determinism and underemphasis on the role of individual sovereignty and influence.
- Individual as 'a puppet of social and cultural circumstances.' -Hodgson, 2005
- Neglect of individual autonomy and agency.

  'There is no such thing as an individual.' - Ayres, 1961.
- The danger is to see social order as *exclusively* a 'top-down' process in which individuals are formed and cajoled by institutions.
- Criticized for 'not being economics enough' (with focus on power structures and social determinism)

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'Old' versus 'New'

Even bigger ciriticism was its lack of a coherent theory.

> The American institutionalists were not theoretical but anti-theoretical, particularly where classical economic theory was concerned. Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire. So if the modern institutional economists have antecedents, it is not what went immediately before.
>
> -Ronald Coase, 1984.

Outline

The New Instititional Economics

Mainstream economics, as one sees it in the journals and the textbooks and in the courses taught in economics departments has become more and more abstract over time, and although it purports otherwise, it is in fact little concerned with what happens in the real world.

- Ronald Coase, 1991 Nobel laureate in economics

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Lost in formalization

- Economists since Adam Smith have devoted themselves to formalizing his doctrine of the invisible hand, the coordination of the economic system by the pricing system.
- Economics is [should be] ‘an analysis of a system of *extreme decentralization.*’ -Harold Demsetz
- Increased focus on abstraction (optimization, utility, mathematical modeling); less on exchanges. -James Buchanan (*What should economists do?*)
- Forgot that transactions *aren’t* costless.

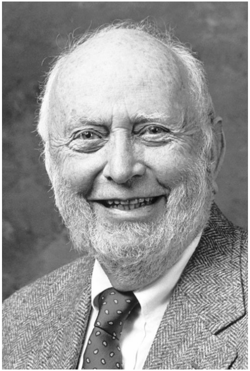
The New Instititional Economics

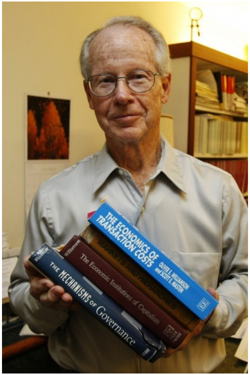
Key point:
The costs of exchange depend on the institutions of a country: its legal system, its political system, its social system, its educational system, its culture, and so on (Coase, 1998).

- Cost of exchange is either ignored, downplayed, or worse, simply assumed.
- Markets don't happen in vacuum. If it did, there would be markets in all corners of the world. That there are hungry people willing to exchange their labor and skills for food is incompatible with the assumption that markets just happen or that costs of exchange is zero.

Three Key Figures

North, Ostrom, and Williamson





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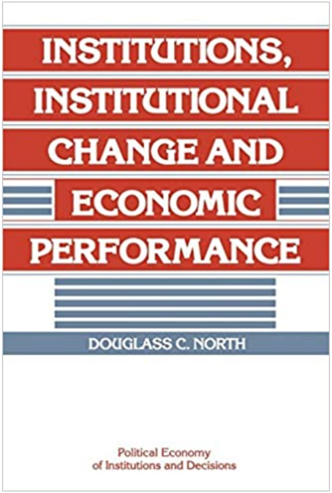

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Institutions

Douglass C. North

Institutions are the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange. Together with the standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity. They evolve incrementally, connecting the past with the present and the future; history in consequence is largely a story of institutional evolution in which the historical performance of economies can only be understood as a part of a sequential story. Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline. In this essay I intend to elaborate on the role of institutions in the performance of economies and illustrate my analysis from economic history.

Douglas North, 1993 Nobel laureate in economics

What are institutions

- Institutions are *humanly devised constraints* that structure political, economic, and social interaction.
- Informal constraints: sanctions, taboos, customs, traditions, and codes of conduct
- Formal constraints: constitutions, laws, property rights
- **Purpose:** humans devise institutions *to create order and reduce uncertainty in exchange*.
- Together with standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity.

Institutional Evolution

- They evolve incrementally, connecting the past with the present and the future.
- History is largely a story of institutional evolution => performance of economies can only be understood as a part of a sequential story.
- Institutions provide the incentive structure of an economy. This structure shapes the direction of economies towards:
  a) growth,
  b) stagnation, or
  c)decline.

The central issue of economic history and of economic development is to account for the evolution of **political and economic institutions that create an economic environment that induces increasing productivity.**

=> ... Institutions to capture the gains from trade

- The earliest economies are thought of as local exchange within a village.
- Gradually, trade expands beyond the village: region (bazaar-like economy) => long distances (through caravan or shipping routes) => the world.
- Question he sought to answer:
  How does this evolution (from local autarky to specialization and division of labor at a global scale) happen?

Village trade

- Small-scale village trade exists within a ‘dense’ social network of informal constraints that facilitates local exchange.
- High-levels of trust => transaction costs are low.
- People have an intimate understanding of each other, and the threat of violence (typically from outsiders) is a continuous force for preserving order.
- Very few products, so trade is simple.

Beyond village

- More products can be exchanged, but transactions get more difficult.
- Possibilities for conflicts over exchange grow.
- Low levels of trust => transaction costs increase sharply as ‘dense’ social networks are replaced.
- Old institution becomes insufficient.
- Occasionally, religious precepts imposed standards on conduct.
- Absence of state to enforce contracts.
- Frequent breach of trust => incentives towards autarky.

Development of long-distance trade

- Caravans and lengthy ship voyages
- Significant changes in the incentives (Benefits/Costs) occur => requires a sharp break in the characteristics of an economic structure.
- Specialization occurs:
  1. Specialization in exchange by individuals whose livelihood is confined to trading and the development of trading centers
  2. Geographic specialization based on comparative advantage
  3. Occupational specialization follows
- Transaction cost problems associated with long distance trade.

Two distinct transaction costs problems with long distance trade

1. Problem of agency:
    - Historically resolved (very imperfectly) with the use of kin in long-distance trade.
    - As trade volume grew, kin solution became problematic.
2. Problem of contract negotiation and enforcement
    - Enforcement: armed forces protecting the ship or caravan or by the payment of tolls or protection money to local coercive groups.
    - Negotiation (and enforcement) entailed: development of standardized weights and measures, units of accounts, a medium of exchange, notaries, consuls, merchant law courts, and enclaves of foreign merchants protected by foreign princes in return for revenue.

Two distinct transaction costs problems with long distance trade

- By **lowering information costs and providing incentives for contract fulfillment**, this complex of institutions, organizations, and instruments made possible transacting and engaging in long-distance trade.
- A mixture of voluntary and semi-coercive bodies enabled long-distance trade to occur.
- Of course, these institutions evolved differently in different societies.

Expansion of markets

- Long-distance trade paved way for the expansion of markets
  $=>$ More opportunities to generate wealth/ More transaction costs problems
  $=>$ More institutions devised to solve them, and so on.
- More goods and services to produce and consume
- Economies of scale $=>$ hierarchical producing organizations full-time workers (either in a central place or in a sequential production process)
- Emergence of towns and small cities
- Occupational distribution: manufacturing exists alongside agriculture.
- Significant shift towards urbanization

Early Market society

Such societies need **effective, impersonal contract enforcement**, because personal ties, voluntaristic constaints, and ostracism are no longer effective as more complex and impersonal forms of exchange emerge.

- Personal and social alternatives are still important, but insufficient.
- In the absence of effective impersonal contracting, the gains from "defection" are great enough to forestall the development of complex exchange.
- More institutions devised to check "defection."

Further Market Expansion

- Capital markets (investment) entail security of property rights over time; It will simply not evolve where political rulers can arbitrarily seize assets or radically alter their value.
- Establishing a credible commitment to secure property rights over time requires:
  - a ruler who exercises forbearance and restraint in using coercive force, or
  - 'shackling of the ruler's power to prevent arbitrary seizure of assets.'
- Factor and product markets: also undergirding such markets are secure property rights

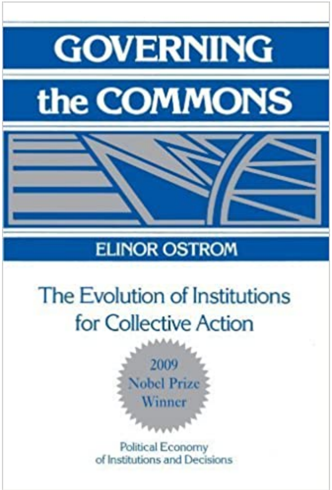
  => This entails a) political-judicial system for low cost contracting, b) flexible laws permitting a wide latitude of organizational structures, and c) complex governance structures to limit the problems of agency in hierarchical organizations
- Some societies have been unable to achieve this.

The Last Stage: Modern Western Societies

- Agriculture requires a small percentage of the labor force
- Markets become nationwide and worldwide
- Specialization increases
  - => requires increasing percentages of the resources of the society to be engaged in transacting, so that the transaction sector rises to be a large percentage of gross national product.
  - => Trade, finance, banking, insurance, & the coordination of economic activity involves an increasing proportion of the labor force.
  - => Highly specialized transaction organizations emerge.
- International specialization and division of labor requires property rights preserving institutions across international boundaries so that capital markets can take place with credible commitment.

- When do institutions not evolve?
- Tribal society, a regional economy with bazaar trading, the long-distance caravan trade are unable to develop from within.
- E.g. Suq bazaar in North Africa and Middle East:
  - Widespread and relatively impersonal exchange and relatively high costs of transacting exist.
  - Missing are 1) effective legal structure and court system to enforce contracts <= political institutions to create such a framework.

There are no institutions devoted to assembling and distributing market information; that is, no price quotations, production reports, employment agencies, consumer guides, and so on. Systems of weights and measures are intricate and incompletely standardized. Exchange skills are very elaborately developed, and are the primary determinant of who prospers in the bazaar and who does not. Haggling over terms with respect to any aspect or condition of exchange is pervasive, strenuous, and unremitting. Buying and selling are virtually undifferentiated, essentially a single activity; trading involves a continual search for specific partners, not the mere offers of goods to the general public. Regulation of disputes involves testimony by reliable witnesses to factual matters, not the weighting of competing, juridical principles. Governmental controls over marketplace activity are marginal, decentralized, and mostly rhetorical.



Public Choice 48: 3-25 (1986).

An agenda for the study of institutions*

ELINOR OSTROM
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1. The multiple meanings of institutions

Recently, public choice theorists have evidenced considerable interest in the study of institutions. William Riker (1982: 20) recently observed, for example, that 'we cannot study simply tastes and values, but must study institutions as well.' Little agreement exists, however, on what the term 'institution' means, whether the study of institutions is an appropriate endeavor, and how to undertake a cumulative study of institutions.

Riker defines institutions as 'rules about behavior, especially about making decisions' (1982: 4). Charles Plott also defines institutions to mean 'the rules for individual expression, information transmittal, and social choice . . .' (1979: 156). Plott uses the term 'institutions' in his effort to state the fundamental equation of public choice theory. Using $\oplus$ as an unspecified abstract operator, Plott's fundamental equation is:

$$\text{preferences} \oplus \text{institutions} \oplus \text{physical possibilities} = \text{outcomes} \qquad (1)$$

Plott himself points out, however, that the term institution refers to different concepts. He ponders:

Elinor Ostrom, 2009 Nobel laureate in economics

Begins with Charles Plott's fundamental equation:

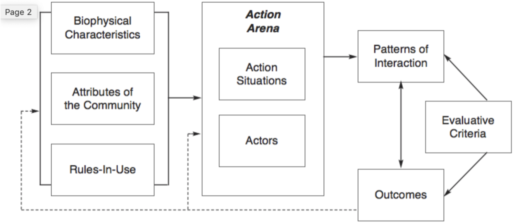
$$\boxed{\text{preferences} \bigoplus \text{institutions} \bigoplus \text{physical possibilities} = \text{outcomes}}$$

$\bigoplus$ is an unspecified abstract operator (i.e. unspecified relationship)

- One concept of institution - that of rules - is used as a referent for the term 'institution.'

Institutions as rules

- Instead of viewing rules as directly affecting behavior, Ostrom views rules as directly affected the structure of a situation in which actions are selected.
- Rules are different from physical or behavioral laws.
- Rules are means by which we intervene to change the structure of incentives in situations.



Ostrom's Institutional Analysis Development Framework (Ostrom et al. 2014: 271)

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Institutions as rules

- Rules $\neq$ Formal Laws.

  For formal law to become a rule, participants understand it, at least tacitly, and are held accountable for breaking it.

- Seven broad categories of rules:

1. Position Rules: specify a set of positions and how many participants hold each position
2. Boundary Rules: specify how many participants are chosen to hold these positions and how many participants leave these positions
3. Scope Rules: specify the set of outcomes that may be affected and the external inducements and/or costs assigned to each of these outcomes
4. Authority Rules: specify the set of actions assigned to a position at a particular node
5. Aggregation Rules: specify the decision function to be used at a particular node to map actions into intermediate and final outcomes
6. Information Rules: authorize channels of communications among participants in positions and specify the language and form in which communication will take place
7. Payoff Rules: prescribe how benefits and costs are to be distributed to participants in positions

Institutions as rules

Two methodological issues:

- Configurational character of rules
- Multiple levels of analysis

However, if the way one rule operates is affected by other rules, then we cannot continue to study each rule in isolation from others. A simple, scientific program is more difficult to envision once the configurational nature of rules is accepted. A configurational approach affects the way we do comparative statics. Instead of studying the effect of change of one rule on outcomes, regardless of the other rules in effect, we need to carefully state which other rules are in effect which condition the relationships produced by a change in any particular rule. We cannot just assume that other variables are controlled and unchanging. We need to know the value of the other variables affecting the relationship examined in a comparative statics framework.

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Multiple levels of analysis

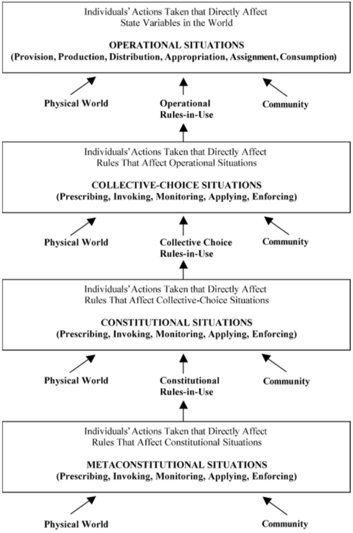
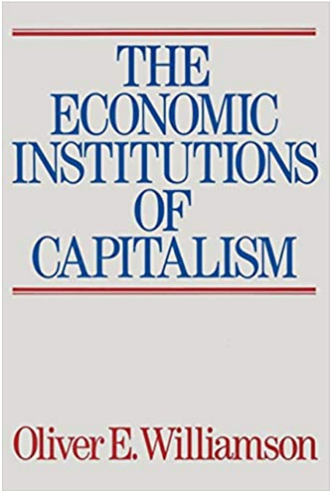


Figure 3. Levels of analysis and outcomes.



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The New Institutional Economics: Taking Stock, Looking Ahead

OLIVER E. WILLIAMSON[1]

1. *Introduction*

I OPEN MY DISCUSSION of the new institutional economics with a confession, an assertion, and a recommendation. The confession is that we are still very ignorant about institutions. The assertion is that the past quarter century has witnessed enormous progress in the study of institutions. The recommendation is that, awaiting a unified theory, we should be accepting of pluralism.

Chief among the causes of ignorance is that institutions are very complex. That neoclassical economics was dismissive of institutions and that much of organization theory lacked scientific ambitions have also been contributing factors. As to progress, that is what most of this paper is about. There being many instructive lenses for studying complex institutions, pluralism is what holds promise for overcoming our ignorance.

Speaking for myself, I subscribe to Jon Elster's view that we work predominantly on partial mechanisms rather than general theories at this stage of development (1994, p. 75). In consideration, however, of the "splendid plausibility of error" to which Lord Acton refers,[2] we need to sort the sheep from the goats. That is accomplished by asking each would-be theory to advance refutable implications to which the data are applied.

R. C. O. Matthews, in his presidential address to the Royal Economic Society in 1986, pronounced that "the economics of institutions has become one of the liveliest areas in our discipline" (Matthews 1986, p. 903). Such a pronouncement was a surprise to most of the profession. Hadn't institutional economics long since been relegated to the history of economic thought? Whence the vitality to which Matthews made reference?

Matthews' response was that the new institutional economics (NIE) turned on two propositions. First, "institutions do matter"; and second, "the determinants of institutions are susceptible to analysis by the tools of economic theory" (Matthews 1986, p. 903). The second of these is what distinguishes the NIE, it being the case that institutional economists of all kinds—old and new—are unanimous in the view that institutions matter.

Indeed, although both the older and newer styles of institutional economics

[1] University of California, Berkeley. owilliam@haas.berkeley.edu. This paper was first presented at the third annual meeting of the International Society for New Institutional Economics in Washington, DC in September 1999 in my capacity as president-elect. Helpful comments received there and from Bengt Holmstrom and John McMillan are gratefully acknowledged.

[2] As quoted in Daniel Boorstin (1998, p. 281).

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Oliver Williamson, 2009 Nobel laureate in economics

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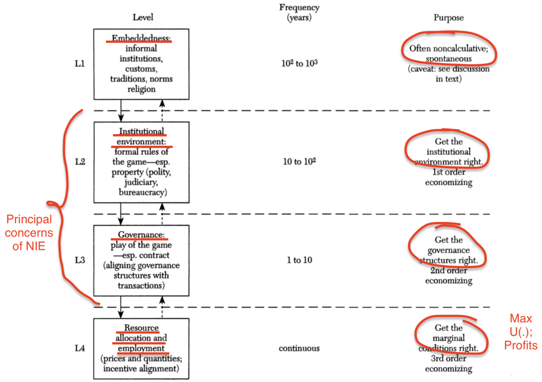
Two Basic Propositions of NIE

1. Institutions do matter.
2. The determinants of institutions are susceptible to analysis by the tools of economic theory.

(Matthews, 1986)

- Williamson's view is that NIE has progressed *not by advancing an overarching theory but by uncovering and explicating the microanalytical features*... by piling block upon block until the cumulative value added cannot be denied.
- Very much a core part of microeconomic theory.

Four levels of social analysis



L1: social theory
L2: economics of property rights/positive political theory
L3: transaction cost economics
L4: neoclassical economics/agency theory

Figure 1. Economics of Institutions

Level 1: Social embeddedness level

- Informal institutions with spontaneous origins
- Evolutionary origins => they are "adopted" and thereafter display *a great deal of inertia*
- Pervasively linked to complementary institutions (formal and informal)
- Have a lasting grip on the way a society conducts itself.
- Frequency: 100 to 1000 years

Level 2: Institutional Environment (Rules of the game)

- Structure is partly evolutionary (connected to level 1), partly by design
- "Formal rules" (constitutions, laws, property rights) are introduced
- First-order economizing: get the formal rules of the game right

=> esp. property rights (aspects: polity, judiciary, bureaucracy)

- Tools: executive, legislative, judicial, bureaucratic functions of govt & distribution of powers across levels of govt
- Although important, cumulative change is very difficult to orchestrate.
- 'Defining moments'
- Frequency: 10 to 100 years

Level 3: Governance (Play of the game)

- Governance of contractual relations
- Second-order economizing: get the governance structures right
- Periodical reorganizations of transactions among governance structures (e.g. through elections, legislations)
- Frequency: 1 to 10 years

Level 4: Resource Allocation and Employment

- The world of neoclassical economics (Econ202; Econ341)
- Third-order economizing: get the marginal conditions rights (e.g. $MaxU(.), \pi(.)$ s. t. constraints)
- Focus is on: Production/Utility
- Tools: Prices and quantities; incentive alignment
- Frequency: continuous

- The idea is that neoclassical economics (which assumes perfect property rights/benevolent government, no transaction costs) can be greatly enhanced by accounting for higher order economizing.

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Takeaway

As an institutionalist studying empirical phenomena, I presume that individuals try to solve problems as effectively as they can. That assumption imposes a discipline on me. Instead of presuming that some individuals are incompetent, evil, or irrational, and others are omniscient, I presume that individuals have very similar limited capabilities to reason and figure out the structure of complex environments. It is my responsibility as a scientist to ascertain what problems individuals are trying to solve and what factors help or hinder them in these efforts. When the problems that I observe involve lack of predictability, information, and trust, as well as high levels of complexity and transactional difficulties, then my efforts to explain must take these problems overtly into account rather than assuming them away. In developing an explanation for observed behavior, I draw on a rich literature written by other scholars interested in institutions and their effects on individual incentives and behaviors in field settings.

- Elinor Ostrom, 2009 Nobel laureate in economics

Takeaway

referred earlier—is centrally implicated.

Feasibility. Students of the NIE eschew hypothetical ideals—which work off of omniscience, benevolence, zero transaction costs, full credibility, and the like—and deal instead with feasible organizational alternatives, all of which are flawed. Coase (1964) and Demsetz (1969) were among the first to take exception with the asymmetric standards that were once used in the "market failure" literature—according to which markets are beset with failures whereas "omniscient, omnipotent, benevolent" governments (Avinash Dixit 1996, p. 8) would reliably administer efficacious remedies. As we all should have recognized (but needed to be told), all feasible forms of organization—government included—are flawed.[4]

- Oliver Williamson, 2009 Nobel laureate in economics

Takeaway

The change will not come about, in my view, as a result of a frontal assault on mainstream economics. It will come as a result of economists in branches or subsections of economics adopting a different approach, as indeed is already happening. When the majority of economists have changed, mainstream economists will acknowledge the importance of examining the economic system in this way and will claim that they knew it all along.

- Ronald Coase, 1991 Nobel laureate in economics

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