



An Economic Analysis of the New Institutional Economics

by

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The market for academics determines the evolving university institutions. This in turn shapes the incentives and the behavior of academics with regard to the New Institutional Economics. The highly competitive market for academics prevalent in North America and in future Europe induces abstract research with little concern for specific institutions, while interdisciplinarity is neglected.

Restricted, less competitive markets existing at the borders of economics and partly in law and other social sciences enable and induce academics to study concrete institutions and to engage in advising and in a political career, transferring insights from New Institutional Economics into practical policy.
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1. Is the New Institutional Economics Recognized in Economics?

Economists regularly attending international conferences experience that the dominant approach in economics consists in maximizing a social welfare function subject to the resource constraints. This is well exemplified by the neoclassical theory of public finance or public economics, where the socially optimal public prices or tax rates are derived by assuming that the government maximizes social welfare, or, equivalently, minimizes social dead weight costs subject to a financial constraint. In contrast, the New Institutional Economics offers a radically different perspective in which government is endogenous (the politicians pursue their own goals but certainly not principally the social good), and in which the workings of institutions are compared to each other (instead of taking an unreachable ideal, or "Nirvana," such as the Pareto-optimality, as a measuring rod). The fact that the social welfare maximizing approach disregarding all institutions is still dominant indicates that it is difficult or impossible to convince the majority of today's professional economists that the perspective of the New Institutional Economics represents a major step forward in social science research.

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Oliver WILLIAMSON [1993], and with him many other proponents of the New Institutional Economics, have a different perception of the extent to which our perspective is accepted in economic science. Williamson argues that a suitable indication of the importance of an approach is the number of emerging journals devoted to it. While he is able to name a considerable number, this indicator is questionable because there is a great number of new journals committed to other approaches, so that the relative position of the New Institutional Economics is uncertain.

A telling piece of evidence about the importance attached to the New Institutional Economics by economists at the present time is contained in the Centenary Issue of the *Economic Journal* [Vol. 101, January 1991, ed. by John Hey], where 22 leading economics scholars were invited to speculate about the future of their science. Only two of the authors even mentioned the New Institutional Economics (or equivalent names such as the Comparative Analysis of Institutions, Transaction Cost Economics, Property Rights or Principal Agents Theory). The space devoted to discussing the field is three quarters of one page, i.e. 99.5% of the space is allotted to other approaches and issues¹. Public Choice, or Modern Political Economy, does somewhat better. It is mentioned by 5 out of the 22 authors on four pages (2.5% of total pages). If the two fields are aggregated – which makes sense from many points of view – the total space devoted to the New Institutional Economics is thus raised to a total of 3%, which is rather small. It is, of course, not claimed that the New Institutional Economics has not made any inroads into standard economic theory. If one searches, aspects of this approach can be identified in many areas of economics (see e.g. RICHTER [1992]), but the same could be said of a great many other approaches, e.g. game theory or social welfare maximization.

It follows that there is still much to be done to make the message of the New Institutional Economics generally known and accepted among orthodox economists. The findings also underline that a relentless effort is needed to inform scholars as well as the public about the great advances made and major insights gained. The annual conference on the New Institutional Economics conceived and organized by Professors Rudolf Richter and Eirik Furubotn is as necessary and topical today as much as ever. The same holds for the professional publications such as the *Journal of Institutional and Theoretical Economics*.

This contribution attempts to apply the New Institutional Economics to New Institutional Economics in order to evaluate to what extent, and in what variants, the field is likely to progress in the future. What I claim is (1) that the

¹ A count arranged by Richter reveals that the share of pages in the four most often quoted journals (see GARFIELD [1989]) devoted to the New Institutional Economics is somewhat larger; it is 4% in the *Review of Economic Studies*, 6% in the *American Economic Review*, 12% in *Econometrica* and 13% in the *Journal of Political Economy*. Such a classification is, of course, to a considerable extent a matter of judgement.

New Institutional Economics is at present of quite restricted importance in economics as understood by leading scholars and published in the top journals of our profession (for an identification see e.g. POMMEREHNE [1986]); and (2) that a specific, abstract version only is likely to gain general acceptance in the international market for economics. Due to space limitation, the use of economic analysis for studying this academic field is necessarily sketchy².

2. *Academic Markets, Institutions, Incentives and Behavior*

Our analysis proceeds in the following steps: the characteristics of the market for academics (in particular economists) determines the nature of the university institutions as they exist and evolve. These institutions shape the constraints under which academics are acting and hence their incentives to conduct research in a particular form and direction. The behavior of academics thereby induced illuminates the New Institutional Economics as it exists today and is likely to be in the future³. Two types of markets for academics are distinguished: a competitive C-market and a restricted R-market.

2.1 *The C-Market*

There exists a large, open market for economists in which information is readily available and there is little government intervention. This highly competitive C-market for academics favors corresponding university institutions which have to survive in this market. Universities are induced to attract productive scholars by paying them according to performance. In such a market, an academic's quality can reliably be evaluated by his or her publication and citation record. Accordingly, the scholars have a high incentive to conduct research which is publishable in the recognized organs of the field, in particular in the professional journals.

² The presentation of this paper at the conference on "New Institutional Economics: Recent Progress; Expanding Frontiers" was considered very controversial, partly due to misunderstanding as to the goal of this paper.

My objective is to present a *positive* analysis of the New Institutional Economics. I want to *explain* as objectively as possible the actual state and the future prospects of this approach. On the other hand, I refrain from normative evaluations.

I do not need to emphasize that personally I am an enthusiastic supporter of the New Institutional Economics; I am convinced that it is a most useful approach to the analysis of economic and social problems. However, the paper is not an exercise in wishful thinking, but seeks to be a sober study. This strict separation between positive and normative analysis is one of the distinguishing characteristics of the New Institutional Economics to which I wish to adhere.

³ The analysis is based on a more general theory of the interaction of academics' markets, institutions and behavior. It has been developed jointly with Reiner Eichenberger. See FREY and EICHENBERGER [1992 a], [1992 b].

The C-market for academics (economists) is characterized by three features:

(1) The research undertaken tends to be abstract and formal⁴, must bear fruit (publications) within a short period, and must deal with clearly defined issues (often minor variations on a previous piece of research). This kind of academic production can be easily evaluated because it allows the contributions of the various scholars to be compared in a (relatively) objective and time-saving way, namely by its rigor and formal quality.

(2) What is considered "good" or "bad" research is, in the C-market, to a large extent self-defined and is little or not at all related to real-world problems. The internal dynamics of this disconnected research tends to produce academic bubbles and fads.

(3) Academics have high opportunity costs for non-academic activities such as advising or a political career, because their income and prestige is determined mainly by their publishing performance.

2.2 *The R-Market*

The restricted market for academics is characterized by high entry barriers and is strongly regulated by the state. The academics have little mobility. The corresponding university institutions are run by the government and are often a part of public administration. Due to the thinness of the R-market, the participant's activity cannot be, and is not, evaluated by publication activities and citations. Rather, professors are appointed for life, and their promotion and pay is governed by bureaucratic principles, in particular age and number of people ranking below them, and is essentially unrelated to academic performance.

The research carried out in the R-market is governed by intrinsic motivation. On the one hand, rather unclearly defined major real-world problems and, on the other hand, issues of local relevance are studied, often in a rather eccentric way; researchers are ready to take up ideas from other sciences and have little or no concern for quick publication or purely formal rigor. The academics have an incentive to enhance their reputation by engaging in advising the government and major social groups (e.g. the trade unions), or by embarking on a political career of their own.

⁴ There exists a valid type of theorizing not based on formalism, as e.g. practiced by Coase. Coase normally refrains from stating a general "theorem" underlying his examples. He chooses to present the profession with a "Coase insight" and leaves formal details to be worked out by others. As BERGSTROM [1989, 1158] puts it: "Each theorem is at least as useful as a heuristic generator of insight as it is as a formal proposition. Anyone who only reads about the Coase theorem without reading Coase's insightful discussion of examples has missed the best of the story."

3. *The Role of Institutional Analysis*

The distinction between a C-market and a R-market for academics allows us to derive empirically testable propositions about the present state and the likely future development of the New Institutional Economics.

The highly competitive *C-market* presently includes the internationally known part of the North American market for economists. As a consequence of European integration, in the future it will cover increasing parts of European economics as well.

For the New Institutional Economics, three major propositions follow.

Proposition 1. The study of institutions in the C-market is abstract and formal and on a high scholarly level. There is little or no research devoted to specific local institutions or to the particular social problems connected with them. Case studies are therefore rare.

This type of research orientation, for which Holmstrom or Tirole are examples⁵, is not only represented in America, but is already clearly visible in the doctoral programmes gradually emerging in Europe, which care for the international C-market and where national or local institutions are therefore of little interest (see e.g. SCHWEIZER [1993]).

In contrast to the view of WILLIAMSON [1993] or COASE in his Nobel prize lecture [1991, 12], no "natural progression" of the New Institutional Economics is postulated. Rather, the movement towards increasing formalism and abstractness induced by the scholarly incentives evolving in a C-market are identified as an inevitable consequence of the size of the market for research in institutional economics.

Proposition 2. In the Americo-European C-market, interdisciplinary aspects tend to be driven out because their value is much more difficult to evaluate than formal rigor, and because the self-defined boundaries of economics are transgressed, which is inimical to an academic career still geared to the traditional disciplines. Inputs from law, sociology, psychology or from the cognitive sciences tend to be disregarded or even trivialized by subjecting them to the orthodox economic approach.

One example supporting this proposition is provided by the empirically well-founded results on human decision-making, showing that individuals systematically violate the von Neumann/Morgenstern axioms underlying the standard economic model under uncertainty, i.e. expected utility maximization. These findings have, in the C-market, either been pushed aside or purely formally integrated into the individuals' utility function. Thus, the expected utility function has been generalized (e.g. MACHINA [1987]), so that its maxi-

⁵ Or the (already considerable) share of papers devoted to Institutional Economics in *Econometrica*; see footnote 1.

mization yields the behavior observed. While "anomalies" have been turned into "normalities", it is doubtful whether many insights have thereby been gained. As long as the preferences postulated cannot be observed independently of behavior, it is certainly a sounder methodological procedure not to explain (changes in) behavior by unobservable (changes in) preferences (see explicitly STIGLER and BECKER [1977]). Another piece of evidence supporting this proposition is the treatment of bounded rationality, which has been trivialized by reducing it to utility maximization subject to an informational constraint. In both cases, no serious effort has been made by academics who are subject to the incentives of the C-market to recognize that cognitive aspects of human thinking are involved, to which justice cannot be done by only formally dealing with them and overlooking their substantive content (see FREY [1992]).

The incentive system induced by the C-market entails that ideas and concepts which do not readily fit "normal science" are excluded, not necessarily because they are considered unimportant, but because their value and relevance cannot readily be evaluated by other scholars. Such concepts are, among others, ideology and the power of ideas (NORTH [1993]), customs, norms and rights (COLEMAN [1993], SCHLICHT [1993], OPP [1979]), solidarity groups (LINDENBERG [1983]) or beliefs, attitudes and political culture (WEINGAST [1993]).

Proposition 3. The evaluation of an Americo-European C-market will drastically change the interaction between the economists involved. At present, the relationship is rather one-sided; the Americans have no incentive to cite European authors, and they consequently abstain from it, while Europeans tend to cite all the American work they know of. A future integrated market will be characterized by cross quotations not only by Europeans, but also by Americans from European sources.

The restricted *R-market* mainly exists in economics faculties in closed national markets in Europe. Even if European integration is fully successful, there is a strong tendency towards regionalization, which hampers competition among academics (in particular because of language regulations⁶). The *R-market* also exists in some parts of America, mainly in universities of only local importance and with professors not publishing internationally. A third area in which it exists at least up to a certain measure is in other social sciences, in particular sociology and political science.

Two additional propositions may be derived.

Proposition 4. In *R-markets*, scholars conduct research on institutional aspects of economics, but they tend to be only loosely or not at all connected to mainstream research in the area, and they may not even be aware that they are

⁶ In the European Community, everyone is free to compete for a professorship in, say, Barcelona – but he or she may be expected to speak and write Catalan; and in Santiago de Compostela or in La Coruña, he or she may be expected to master Gallego, etc.

part of New Institutional Economics. Due to the fact that there is limited interaction with other academics working in the field, the quality of research exhibits a large variance. Part of it is of little importance, while part of it is highly original, but risks being overlooked by the literature.

COASE [1993, 361] relates that after he received the Nobel prize for his work in New Institutional Economics (Transaction Cost Analysis), many people wrote to him making him only then aware that there are many scholars in the field working in a more or less isolated setting.

Proposition 5. Academics in the R-market have higher benefits and lower opportunity costs from engaging themselves in advising and in political careers. Through that avenue, insights from the New Institutional Economics are transferred by academics to the political realm and to public decision-making.

There is a long list of European professors of economics working in R-markets, who have achieved the rank of president, minister, or head of central banks (see FREY and EICHENBERGER [1992 b]). In December 1991, for example, no less than three full professors of economics were cabinet members in the Netherlands and in Spain, respectively.

It may well be that the influence on practical politics via professors of economics is stronger than the influence via academic publication (but it is, of course, not mutually exclusive). While POSNER [1993] perhaps overestimates Milton Friedman's impact on politics in the United States⁷, the transfer of knowledge by politically active economics professors in Europe should not be slighted. This may help to explain why the practical political actions in Europe are quite often superior from the economic point of view (e.g. the liberalization of drugs or transport policy) despite the fact that the corresponding academic fields (health economics, urban and transport economics) are largely dominated by Americans.

Proposition 6. The R-market and therewith the interest in studying specific institutions in real-world problems is more prevalent in law schools and in the other social sciences than in economics departments.

It is no accident that the founders and major contributors to the American New Institutional Economics are (almost) all not based in traditional American departments of economics. Among the scholars organizing this conference or presenting papers, the evidence is clear: Coase, Posner and Scott are at a Law

⁷ There may also be a reverse causation: because the type of conservative policies advocated by Friedman became more popular in the U.S. in the 80s, he became more prominent. Similarly, the type of social democratic (liberal) policies advocated by Galbraith made him prominent in the 60s and 70s, while he is much less known today. This interpretation is consistent with the observation that Friedman's longstanding and intensive campaign for liberalizing drugs has had no effect in the United States; official policy consists solely in deterrence or "drug war."

School, Coleman and Lindenberg are in sociology, North is in economic history, Weingast is in political science and Williamson and Furubotn are in schools of business administration. Coase also experienced a very long time period between publishing an article and being recognized for it, and he favors case studies (see also SCHANZE [1993]).

4. Conclusions

The economic analysis of the New Institutional Economics allows various conclusions to be drawn about the likely future development of this field:

- (1) A highly competitive market for academic economists comprising America and Europe is emerging. In this market, institutions are studied under a unified approach, characterized by abstract theorizing.
- (2) Concrete institutional research driven by practical problems of the real world and interested in interdisciplinary aspects is carried out rather on the edges of economics and in the neighboring social sciences than in departments of economics.
- (3) Important and practically applicable ideas are introduced into the political realm by academics working in restricted markets, who have a strong incentive to engage in advising and to embark on a political career.

Zusammenfassung

Der Markt für Wissenschaftler bestimmt die Ausgestaltung der Universitätsinstitutionen. Diese wiederum formen die Anreize, die das Forschungsverhalten innerhalb der Neuen Institutionenökonomik prägen. Der in Nordamerika dominierende und im zukünftigen Europa zu erwartende Wettbewerbsmarkt für Wissenschaftler veranlasst diese, formal-abstrakte Forschung ohne Beachtung spezifischer Institutionen zu betreiben. Interdisziplinarität wird vernachlässigt.

Auf Wissenschaftlermärkten mit weniger Konkurrenz, wie sie an den Rändern der Ökonomik und teilweise in der Rechtswissenschaft und anderen Sozialwissenschaften bestehen, werden die Analyse konkreter Institutionen sowie beratende und politische Tätigkeiten begünstigt. Dadurch werden Erkenntnisse der Neuen Institutionenökonomik in die praktische Wirtschaftspolitik eingeführt.

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Concluding Comment

by

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I have been asked to give some reflections on the interesting, and even lively, discussions which we have had at this conference on the New Institutional Economics. There has been much said here which we will do well to ponder when we return home as well as some no doubt that it is better to forget.

It is the belief of most participants at this conference, and it is certainly my belief, that there is a need to incorporate institutions such as the market and the firm, into modern economic theory. This does not imply a rejection of economic theory, whose analytical tools will continue to be used although in my view the inclusion of these institutions will bring about a change in the structure of the theory. We will not think about exchange without specifying the institutional arrangements within which the exchange takes place. We will not ignore the fact that transacting is costly and that methods of coordination other than through market transactions such as happen within organizations may therefore be more efficient. And we will not ignore that the process is extremely complex. It is not possible to have markets, other than the most primitive, without firms and you cannot have firms, other than the most rudimentary, without markets. What the optimal arrangements are is the result of an extremely complicated process which we have yet to understand.

Recent events in Eastern Europe have made crystal-clear that an economic theory which does not incorporate institutions is for many purposes largely useless. The people in Eastern Europe are told to allow market forces to operate. But without the appropriate institutions, no markets, other than the most primitive, are possible and one shudders to think what society the forces of freedom will produce unless these institutions can be established. Institutions matter.

It is one of the disadvantages of the neglect of the role of institutions that we are able to give so little useful advice about the transition from communism to a market economy at the present time. We are still engaged in the process of shooting off arrows to find out where the targets are. Much work needs to be done. But at any rate we can be encouraged by our discussions here and will return home to undertake our research activities with renewed energy. As you know, it is impossible to undertake good empirical work without a theory and difficult to formulate theories without good empirical work. Empirical work

and the improvement of our theories have to go on simultaneously. But sometimes the need is greater for more theoretical work and sometimes for more empirical. It is my view that at the present time we are so ignorant that it is difficult to formulate theories to explain the working of the economic system, at any rate in that part of our subject termed industrial organization but no doubt elsewhere. The need at the present time, in my view, is for more empirical work. However, those wishing to undertake such work in the United States are handicapped by a lack of data. It is to remove this impediment to empirical work on the institutional structure of production that I, together with Oliver Williamson and Victor Goldberg and other scholars, are collaborating in setting up The Center for Research on Contracts and the Structure of Enterprise at the University of Pittsburgh. The aim is to establish a Center which will co-operate with, and make available data to scholars in all academic institutions in all countries. I hope that some of you will be able to take advantage of its facilities once it is established and running.

Richard Posner says of the views of Oliver Williamson and myself that it is a school with a small faculty and few students. He exaggerates. There is no school, no faculty and no students. What we have are fellow workers, some of whom are to be found at this conference but most of whom are situated in countries all over the world and are mainly unknown to us. What we have going for us is that powerful spontaneous activity of which Hayek has told us. One of the advantages of having received the Nobel Memorial Prize is that I now know of some of this work, for example, in China, of which I was previously unaware. I leave this conference encouraged and confident.

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