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The Economic Approach to Institutions

INSTITUTIONS MATTER

The Comparative Analysis of Institutions

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It may often be observed that when demand falls, prices rise. An important example is agriculture. This does *not* mean that economics is wrong but that the relationships are shaped by an institutional setting outside the price system. In this instance there are obviously political and administrative interactions which produce a perverse relationship between demand and price. Such interdependencies are very common in the world we live in, and it is therefore necessary to explicitly consider institutions beyond the price system in economic analysis.

In order to highlight the relationships between economics and institutions, five propositions will be advanced and discussed.

Proposition 1. Economics has had superb success dealing with one institution – the price system – but as a consequence many other institutions crucial for society have been neglected.

While economics leaves much to be desired, and many problems remain unresolved, if considered in absolute terms, it has great achievements compared to the other social sciences. Economics is characterized by a precise and coherent analysis applied to all areas of the economy, and relies less on ideology and rhetoric than on clearly stated assumptions and testable hypotheses. The close link between theory and empirical research (econometrics) is unique.

A second major success of economics is its widely and internationally accepted core [see, empirically, Frey, Pommerchne, Schneider and Gilbert (1984)] which makes neoclassics a point of reference even for dissenters. In both respects, economics is in marked contrast to sociology or political

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science which have many diverse approaches, or psychology which consists of widely separated factions (ranging e.g. from experimental models to psychoanalysis), and where even the various effects identified stand disconnected.

In view of these achievements, economics is sometimes, and not undeservedly, considered to be the 'Queen of the Social Sciences'. Economics has reached this enviable position by concentrating on only one institution of decision making, the price system or market. It has resolved the crucial aspect of the relationship between individuals and society, an aspect which tends to be disregarded by the other social sciences: either they look at individuals only, or they resort to an organic conception of society (a view prevalent in parts of sociology and law). In economics, the aggregation problem is successfully solved by taking the market price as given to suppliers and demanders. As soon as prices are not given to individual actors and firms, and there is a *direct* interaction between the actors, major problems arise [see Coleman (1984)]. Economists have reacted by focusing even more strictly on the price system, which enables them to minimize even more the assumptions necessary to reach definite results. Instead they should have added *more* structure, in particular, institutions [as postulated e.g. by Sen (1982) or Hirschman (1984)].

Institutions are arrangements which structure repeated human interactions. There are two major types.

(1) *Rules* constitute the *basic environment* in which a game between actors takes place. This aspect has been studied by Constitutional Economics [see Buchanan (1987)]. Essential elements are the veil of ignorance and unanimity without which no rules can be found. The need for a consensus is best visible in the international setting where no rule-setting supra-national government exists [International Political Economics, Frey (1984)].

The most important constitutional rules determine the decision making mechanisms to be applied. Its properties have been extensively analyzed by Public Choice [Mueller (1989)]. The often used distinction between market and plan is too narrow for most purposes; to distinguish between market, bargaining, administration and democracy [Dahl and Lindblom (1953)] makes it clear that each decision process involves quite different types of behaviour, and produces different outcomes.

Rules may also develop in the *current politico-economic process* in the form of conventions, social norms, private contracts and government laws [for the relevance of norms for explaining unemployment see e.g. Akerlof (1980)].

(2) A second type of institution consists of *organizations* such as firms, interest groups, bureaucracies, parties, governments, nations and supra-national bodies. These institutions are analyzed by two closely related approaches [Eggertsson (1990)]. The incentive structures resulting from the particular assignment of property rights (e.g. private or public) are systemati-

cally related to different amounts of monitoring and shirking. The reaction may consist in more current control, or the development of other institutions of property when the gains from internalization exceed the cost of internalization [property rights theory, De Alessi (1990)].

. Transaction cost analysis [Williamson (1990)] focuses on the differential cost of contracting. It sees the firm not as an input-output relationship or production function but as a governance structure. The analysis of the firms' internal structure, incentives and controls open novel perspectives compared to conventional price theory.

The approaches mentioned focus on different aspects of institutions but employ the same mode of analysis: people are taken to respond in a systematic and hence predictable way to changes in relative prices (costs). Preferences are assumed stable; they are not subject to unexplicable shifts (which would render the analysis empirically untestable) but they are (in the extreme) taken to be immutable and identical for all individuals [Stigler and Becker (1977)].

The Comparative Analysis of Institutions consists of a set of approaches applied to different aspects of institutions [see, recently, e.g. Matthews (1986) or Arrow (1987)]. The points of reference are alternative institutions as they exist in reality, and not unreachable ideals. Hence, both the concept of 'market failure' and of 'government failure' are rejected as they correspond to a 'Nirwana' view. There exists in general no ideal market and no ideal government which could remedy the shortcomings of the other decision making mechanisms in a perfect way.

Proposition 2. Institutions mutually interact with individuals; they affect individuals and emerge from, or are created by, human action. Institutions have important discrete aspects.

When studying economic processes, institutions may rarely be taken as given; often they are influenced by the outcomes produced. When farmers suffer from falling prices and incomes in the market, for instance, the price system is put out of force and political and administrative institutions are chosen to counteract this development. This choice takes place between discrete structural alternatives [Simon (1978)] which means that one has to go beyond purely marginal analysis.

An adequate general analysis considers the impact of institutions on individuals (through its effects on the opportunity set, or relative prices, costs and income), as well as the influence of individuals on the emergence and conscious design of institutions [in game theoretic terms e.g. Schotter (1989)]. In both cases an important public good aspect is involved. An analysis of the interactions between individuals and institutions allows to work out dynamic aspects. This may be undertaken either in an evolutionary

[e.g. Witt (1986)] or historical [see the New Economic History, North (1986)] perspective.

Proposition 3. The Comparative Analysis of Institutions is able to solve long-standing theoretical problems which so far have not been treated in a satisfactory way.

To substantiate this claim for the case of the Comparative Analysis of Institutions, two concrete examples are provided.

(a) Following economic theory, in the presence of a (pure) public good there is an incentive to free ride. Both in unique and repeated games nobody is predicted to contribute to its provision. In contrast, empirical evidence [Dawes and Thaler (1988)] shows that individuals are prepared to contribute substantially (often 40–60% of the total cost).

Attempts to theoretically explain the empirical observation have mainly relied on introducing additional factors into the individuals' preference functions, such as altruism and reputation. Quite another approach is to consider the reactions of the individuals: People know that they are prone to free riding (under anonymous conditions) and therefore set the institutional conditions so that the outcome becomes more favourable. There exist many historical and actual cases in which this was successfully achieved [Ostrom (1989)].

(b) Experimental and real life evidence has convincingly shown that the rationality assumptions as formulated in the von Neumann–Morgenstern axioms are systematically violated by individuals. Behaviour under uncertainty cannot be adequately analyzed by maximizing subjected expected utility [Schoemaker (1982)]. Theorists have responded by developing a generalized SEU-model in which some of the axioms are dropped or reformulated, so that it is possible to integrate (some of) the anomalies [e.g. prospect theory, Kahneman and Tversky (1979) or Machina (1987)]. Empirical evidence suggests, however, that another approach is needed: The extent to which anomalies arise depends crucially on the institutional conditions obtaining. The more competitive a market is, for instance, the more 'irrational' actors are eliminated and the less anomalies are observed [e.g. Coursey, Hovis and Schulze (1987)]. When, on the other hand, the aggregation process is dominated by democratic and/or administrative institutions, the anomalies appearing at the social level may even be larger. When, for instance, the government burdens profitable firms run by rational managers by taxing them, and supports firms making losses run by irrational managers by subsidizing them, this intervention leads to magnified anomalies at the aggregate level. Individuals are often aware that they are prone to paradoxical behaviour and create institutions serving to reduce the cost, and occurrence of anomalies [Frey and Eichenberger (1989a, b)].

Proposition 4. Institutional Economics is interdisciplinary without giving up strict economic reasoning. It may become the general social science paradigm.

Institutions determine the constraints defining the individuals' opportunity set. In addition to the conventional monetary and time constraints (leading to the full income constraint) there are constraints imposed by psychological limits of cognition, by tradition and thus by history, by norms (studied in sociology), by government regulations (analyzed by administrative and political science), and by laws. While part of the economic model, the nature of these restrictions must (at least partly) be explained by the various sciences just mentioned. Interdisciplinarity refers to content; the theoretical approach remains unified.

The general social science paradigm which may emerge is based on the notion that individuals react systematically to (generalized) relative cost which may consist of many different aspects, and is conveyed by many different institutions and respective social sciences. Not surprisingly, there is much scepticism towards this 'imperialist' [Stigler (1984)] claim, but it has been accepted by many serious scholars in political science and in 'rational choice' sociology [Coleman (1986)], law ['Law and Economics' movement, Posner (1987)] and even 'economic psychology' [Van Raaij, van Velthoven and Wärneryd (1988)].

Proposition 5. European economists have a comparative advantage in the Comparative Analysis of Institutions – but so far have not adequately used it.

There are three aspects in which Europeans may deploy a comparative advantage compared to American economists.

(1) They live in countries between which, and partly within which, there are *wide institutional differences*. Economic, social security and monetary systems vary widely, administrative and political decisions range from strongly centralized to strongly decentralized, political participation (also) in economic decision making extends from purely representative to direct democracy, and there are many different languages within, and between, countries [see Pommerehne (1990)].

(2) Due to a different educational system, European economists probably have, on average, a superior knowledge of history [Kolm (1988)]. Therefore, they may have a better notion of *institutional variations over time*.

(3) The third source of European economists' comparative advantage lies in a better knowledge of the *history of doctrines* from which modern institutional analysis can benefit. 'Old' Institutionalists tend to be restricted to American economists like Veblen (1899) or Commons (1934) who have the major shortcoming that they lack analysis, or are not based on methodological individualism. Europeans could profit from more theoretically

inclined European scholars like Böhm-Bawerk (1881) or Menger (1871) who all have made interesting, but neglected, contributions to understanding institutions.

So far, European economists have not exploited the comparative advantage they may have in the Comparative Analysis of Institutions. The reason is an institutional one (the lack of incentives in most European universities) and may be overcome by creating institutions designed to find ways of dealing with this shortcoming. The European Economic Association is one of these efforts.

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