Original Institutional Economics and New Institutional Economics: Revisiting the Bridges (Or the Divide)

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Introduction

Institutional economics remains today an influential field in economics, despite the prevalence of orthodox neoclassical economics in most economics departments and policy-making institutions. The interest in this field has increased in the last fifteen years, and a section on "institutions" is common in international meetings in our discipline. There is a consensus that "institutions do matter" and that "determinants of institutions are susceptible to analysis by the tools of economic theory" [Matthews 1986, 103; Williamson 2000, 595].

It is also well known that mainstream Neoclassical economics has recently incorporated the study of institutions based on the assumptions of this paradigm, modifying its former habit of ignoring institutions, or by taking them as given. Indeed, today, attempts to explain institutions on the basis of rational choice models combined with game theory approaches are common. However, two basic strands of economic thought regarding institutions maintain an important presence in our field today: 1) the Original Institutional Economics (OIE[1]) based on the tradition of Veblen, Ayres, Commons, and Mitchell; and 2) the New Institutional Economics (NIE) based on Ronald Coase's theory of transaction costs. NIE is known as the North-Williamson school, and it has extended its theoretical developments to different areas such as property rights economics (Demsetz, and Alchian), Public Choice (Olson, and Mueller), and the theory of the firm (Schotter, and Shubik). [2]

The purpose of this paper is to present the main differences between NIE and OIE. In doing so, I challenge some of different proposals among OIE economists that call for building bridges between the two approaches. My perspective does not preclude the possibilities of a dialogue. I admit that when I began this research, I was optimistic about the possibilities of building bridges between the OIE and the NIE. However, a theoretical examination of the works of the main NIE's economists led me towards the idea that the divide between these two approaches to Institutional economics is outstanding. Indeed, both approaches have different ontologies and epistemologies and this result cannot be ignored for the sake of eclecticism.

In NIE, one can find statements that OIE has no theory, or that OIE consists of data collection without theory – despite Williamson's recognition of Commons' work. Yet, in the OIE field one easily encounters voices of dialogue and reconciliation with NIE. However, NIE's economists do not pay much attention to OIE's messages.

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Stanfield, a recognized OIE scholar, has optimistically proposed that "OIE and NIE will choose to develop the institutionalized transactions that can serve their particular niche of the human division of labor" [Stanfield 1995, 465]. In the same mood, Rutheford suggests that "the reconciliation of the rational and the rule-guided aspects of human behavior and to the development of a theory of ideology and ideological change" [Rutheford 1995, 450]. Later on, writing about the increasing popularity of North and NIE, Stanfield asserts that "those who do OIE should undertake the development of a more systematic and unified analytical framework. This effort may well lead toward an integration with NIE" [Stanfield 1999, 247-248].

Without ignoring some important theoretical developments in North's work, I contend that NIE is a school that operates on the periphery of the Neoclassical paradigm and that the bases of OIE are more closely linked to an evolutionary (Darwinian) economics.[3] OIE is therefore quite distinct from the Neoclassical paradigm. As far I am concerned, despite the temptation of following the road of eclecticism, the task of integrating the OIE and NIE suggested by Stanfield seems impossible.

My conclusions are derived from an analysis of the main issues regarding research programs (including methodology), the concept of institutions, the transaction costs approach, the firm, and the state. In addition, I underline the differences and similarities between the OIE and NIE with respect to the Neoclassical paradigm. Finally, I lay out some of the tasks that OIE's scientists need to undertake in order to face the challenge that NIE actually represents to OIE's survival.

Methodology

In this section, drawing on some of Rutherford's (1994) arguments, I discuss the methodological differences between NIE and OIE regarding the following topics: a) formalism vs. anti-formalism, b) individualism vs. holism, and c) induction vs. deduction.

a) If we define <u>formalism</u> as "the use of an abstract language such as mathematics or symbolic logic in place of natural linguistic or literary methods of presentation" [Rutheford 1994, 7]. Neoclassical economics represents the highest degree of formalism. Its well-developed mathematical models in micro and macroeconomics, combined with game theory models and stochastic approaches, have made graduate economics programs more attractive to math and engineering students than to students interested in economics with its political, social and cultural implications. Building 'models', represented by a set of assumptions, equations, calibration of parameters, simulation models, and econometric testing, have become the usual tools in our profession, but not among the majority of OIE economists.

This trend gives the false impression that OIE has no theory, despite the efforts made by OIE economists during the last century. This is not the place to debate the issue whether Mathematics is simply a valuable tool in our field and does not guarantee that our theories are better or worse. It is a challenging endeavor for Institutional economics to incorporate its theoretical framework in a set of equations due to the complexity of the issues, as some game theorists have discovered lately. Here, however, one must recognize that OIE's style of presenting theories has been very informal and rhetorical, even though some have made serious attempts to formalize ideas in models.[4]

NIE economists have not been unified on the formalization issue. One can find mathematical models in game theorists such as Shubik and Schotter, but curiously the theory of transaction costs which is the core of NIE was never formalized by Coase himself, who was able to present the theory with simple arithmetic examples accompanied by a nicely written prose. At the same time, Williamson uses some mathematical models in his theory of the firm but without getting much into mathematical intricacies. North uses some basically cliometric techniques but his analysis hinges upon an historical approach.

Hence, we can conclude that NIE is less formal than neoclassical economics but somewhat more formal than OIE. It could also be the case that Rutheford is correct in asserting that more formalist and non-formalist methods are needed for the advancement of both OIE and NIE [Rutheford 1994, 50].

b) With respect to <u>individualism or holism</u>, this is a methodological issue that strongly divides OIE and NIE. Even though one can find some sort of middle ground between holism and individualism in Commons,[5] it is very clear that OIE's analysis is based more on the role of society in defining values, mores and formal institutions, without denying of course the interaction and feedback processes between the individual and society.[6]

In the case of NIE, its approach is basically individualistic; its point of departure is the individual itself. In NIE's analysis, institutions are derived from individual behavior, through interaction among individuals. Here, NIE remains faithful to Neoclassical economics. As Hodgson has pointed out, "the individual, along with his or her assumed behavioral characteristics, is taken as the elemental building block in the theory of the social or economic system… it is thus possible to distinguish the New institutionalism from the 'old' by means of this criterion. The distinction holds despite important theoretical and policy differences within the new institutionalist camp" [Hodgson 1993, 6]. Hence, Rutheford's call for developing some sort of 'institutional individualism' as a middle point between OIE and NIE remains eclectic. In this matter, Rutheford departs from OIE's main methodological and epistemological characteristics [Rutheford 1994, 50].

Another important matter between OIE and NIE is the role of rationality in rules followed by society. This is too complex a theme to develop here, but one can also distinguish important differences. OIE always underlines the role that habits, norms, and institutions play in directing human behavior, without discarding some rationality in individual behavior but constrained by the social and economic environment. OIE has always questioned the utility maximizer individual since Veblen's famous description of her (him) as a 'lightning calculator'.

However, if one carefully reviews Eggertsson's (1990) and North's work (1981 and 1990), the basic neoclassical assumption about human individual behavior still remains (despite some improvements in North's later works) giving stronger role to informal institutions in shaping human behavior. Williamson (1985) introduces an individual that is not a utility-maximizer but is still subjected to bounded rationality. Some behavioral assumptions are crucial in Williamson's analysis. First, Williamson borrows from H. A. Simon the notion of *bounded rationality* in contrast to the neoclassical rational assumption of profit maximization. For Simon, actors are "intendedly rational, but only limitedly so" [Simon 1961, xxiv]. The idea stems from Simon's vision of the modern firm as composed of a set of cooperative decision makers who need to make decisions via their limited capacities, constrained by limited information, and tied to a social group. Individual firms

strive not to maximize profits but to find solutions to the problems they face. In sum, "people don't know everything and so they make mistakes; moreover each person may know different things" [Alchian and Woodwards 1988, 65-78].

The second assumption upon which Williamson bases his theoretical work is that economic agents are affected by opportunism, which he characterizes as "self-interest seeking with guile" [Williamson 1985, 47]. Opportunism causes appropriate safeguards to be devised *ex-ante* in the face of contracts between parties. Moreover, this individual follows an opportunistic behavior with guile [Williamson 1985, 388-389]. This aprioristic assumption about human behavior still remains within the individualistic ontology of neoclassical economics.

One cannot deny that these important assumptions in Williamson's theory modify somewhat the traditional underpinnings of neoclassical economics. Notwithstanding these advances, Hodgson is right when he claims that "Williamson's break from neoclassical theory is partial and incomplete, and much of the core neoclassical apparatus is retained. In fact, Williamson's claimed departure from orthodoxy sits uneasily alongside his repeated invocation that agents are marked by 'opportunism' […]. Despite much discussion on 'altruism' by neoclassical economists, self-interest remains a typical assumption of the mainstream of economic theory" [Hodgson 1993, 11].

c) Last but not least, there is a divide between OIE and NIE regarding the method to be used. OIE has always been linked with the inductive method,[7] following John Dewey's pragmatic or instrumentalist philosophy. As Stanfield asserted, OIE relies more, although not exclusively, on the comparative method, which uses case studies to create an ethnographic record from which generalizations are derived [Stanfield 1999, 236]. On the other hand, if one carefully reviews Eggertsson's, North's, and Williamson's methodology, one finds that NIE has basically a deductive method as in neoclassical economics. Their point of departure is always an individualistic one with some behavioral assumptions from which they have built concepts on institutions, governance, state, and so on. It is true that North is basically an economic historian, but he approaches history from a framework built rather closely on neoclassical assumptions.

However, regarding the issue of the predominance of the inductive method among OIE scholars, it is important to recognize that there has been a confusion that many OIE economists have themselves contribute to disseminating. Indeed, if one reviews carefully the epistemology involved in what Dewey called 'inquiry', the basic concept is far from the idea of the inductive method. As Sturgeon pointed out, "the cumulative and dynamic character of the continuum of inquiry, and the continuum of value, arise out of and are based upon instrumental valuing and knowing, not ceremonial valuing and knowing, which are discontinuous in character" [Sturgeon 1984, 605-606]. Therefore, it is incorrect to characterize pragmatist Methodology as inductivist.

In sum, despite some similarities that could be suggested between OIE and NIE, from a methodological standpoint the divide is stronger than the chances of a possible unification. This fact, of course, does not rule out a constructive dialogue between the two approaches. OIE is based more on a realist Dewey-based pragmatic ontology and epistemology where as NIE remains faithful to the positivist ontology.

Institutions

Both schools of thought recognize the role of institutions and agree that institutions do matter. Yet, it is necessary to take a closer look at the concept of institutions they use and the idea of their evolution and design. OIE's concept of institutions rests on the Veblenian idea that institutions are prevalent habits of thought with respect to particular relations and functions of the individual and society [Veblen 1899, 132]. Based on the Veblenian dichotomy,[8] changes in institutions occur through an evolutionary process. Ayres underlines the role of culture in shaping institutions while Commons proposes his famous definition of institutions as collective action in control, liberation, and expansion of individual action [Commons 1990 (1934), 69]. From this, one can see that institutions in OIE are viewed from a holistic and historic standpoint, though not wholly culture-based, without neglecting the role of individual action, as Commons underlined, but through collective processes.[9] Also, the evolution of institutions in OIE is based more on an evolutionary approach suggested by Veblen's view of the Darwinian analogy. Here, habits play a crucial role, based on history and culture but stemming also from the biological nature of man as a 'social animal'. Institutions are not simply built on some economizing device such as the reducing transaction costs rationale.

NIE's perspective on institutions (such as firms, markets, and property rights) has been developed on the basis of transaction costs theory. There is always some 'efficiency' rationale behind the evolutionary process of institutions aimed at the reduction of these transaction costs. Iniatilly North defines institutions as "a set of rules, compliance procedures, and moral and ethical behavioral norms, designated to constraint the behavior of individuals in the interests of maximizing the wealth or utility of principals" [North 1981, 202]. This definition underlines the contractual (written or unwritten) relationships or 'terms of exchange' between principals and agents.

This definition incorporates the traditional assumptions of neoclassical analysis of individuals maximizing utility, but they are subject to constraints that make possible human organization, thus limiting certain types of behavior. Otherwise, as North points out, "in the absence of constraints we exist in a Hobbesian jungle and civilization is impossible" [North 1981, 203].

The dynamics of the theory comes from the continuous tensions between the gains from specialization in economic activities and the increasing costs that arise from the same process of specialization. These increasing transaction costs include information costs, agency costs, costs of shirking and opportunism, costs arising from uncertainty, costs of measuring quality of the goods and quality of the output, costs of enforcement of property rights, costs of compliance and costs of detecting violations. All these costs are going to constantly redefine the rules of the game, which will generate changes of the structure through the political process. For this reason, North asserts that "economic history conceived as a theory of the evolution of constraints should not only explain past economic performance but also provide the modern social scientist with the evolving contextual framework within which to explain the current performance of the political-economic system" [North 1981, 209].

In a later work, North defines institutions as "rules of the game in a society" or "human devised constraints that shape human interaction" [North 1990, 3]. Institutions have to be integrated into economics and economic history in order to show how they

shape the evolution of societies through time. The set of choices of an individual are defined and limited by these institutions. Therefore, institutions play the essential role of reducing uncertainty for individuals and society as well [North 1990, 4].

North distinguishes organizations from institutions, or equivalently, it becomes necessary to differentiate the rules from the players. Organizations are “groups of individuals bound by some common purpose to achieve objectives” [North 1981, 5] (i.e., political, social, economic, educational…). Institutions determine organizations, but at the same time, these organizations affect the evolution of institutions.

The inclusion of organizations in the analysis is an innovation in North’s work, compared with his former writings, and enriches his analysis on change and economic performance. However, North remains faithful to neoclassical analysis and methodological individualism when he asserts that his theory on institutions must “begin with the individual” as long as institutions are the creation of human beings. Hence, his unit of analysis is the individual except that in his theoretical framework, institutions impose pervasive restrictions on the choice set that individuals face. This methodological position, according to North, will be the unifying thread in his social science research.

In earlier works, North had embraced the neoclassical idea that competitive pressures would lead to the elimination of inefficient institutions. In his later writings, he contends that organizations, through their interaction with institutions, are going to tailor the process of institutional change. This feedback process is the explanation of why inefficient institutions – from an economic growth perspective – are able to remain through centuries. Hence, the reason for this problem is going to be found in the incentive structure generated by the institutions regarding the organizations and the feedback process that this implies for the changing opportunity set for individuals [North 1981, 7].

Looking at institutions as ‘rules of the game’, or ‘human devised constraints’, is simply a redefinition of the choice set of individuals under neoclassical utility maximization framework based on the rational choice vision. Whereas, the Veblenian idea of institutions is basically an evolutionary and social one, underlying habits of thought of individuals regarding their interaction within the community.

Moreover, Ayres also reveals a ‘social’ vision of institutions when he examines the relationships between technology and ‘ceremonial’ institutions. With respect to Commons, institutions are defined as collective action in control, liberation and expansion of individual action. For that reason, the ‘institutional’ individual in OIE and its unit of analysis (‘transactions’ in Commons’ view) is quite different from North’s, although they could arrive at similar conclusions. Also, as some authors have pointed out, institutions are not only constraints but also instruments of social change. [10]

North builds on Coase’s transaction costs when he criticizes the neoclassical analysis of human cooperation based on perfectly defined property rights and a costless process of acquiring information. Based on a game theory approach with no-repeated games, if information is incomplete, following North’s analysis, it is necessary to look for a different theoretical explanation regarding the successful history of Western economies, where political and economic exchange has been so extended. In order to solve the free-rider problem posited by Olson (1965), North is forced to accept some additional behavioral assumptions that are going to improve the limitations of rational choice models: 1) institutions modify the price individuals pay for having ideas, ideologies, and dogmas; thus, ideology plays a crucial role in the decision-making process of individuals; and 2)

individuals process information from an environment through subjective perceptions of reality that affect their choices. For these reasons, institutions help reduce uncertainty for individuals; however, this does not necessarily mean that these institutions have to be efficient.

North develops his theory of institutions from the neoclassical theory of human behavior, but he also adds Coase's theory of transaction costs. He claims that, in the real world, it is costly to transact because of the costliness of measurement (the value of an exchange to the partner with all the problems of moral hazard and adverse selection it could imply) and the fact that enforcement of contracts and property rights is also costly. North states that neoclassical theory takes enforcement for granted but, in reality, it can come from internal codes of conduct, from the social environment, or from the state itself [North 1990, 33].

According to North, important elements in transaction costs arise from informal and formal constraints, as well as the cost of enforcement. Here, North is going to pay more attention to the set of values he calls 'informal constraints'. These constraints are determined by culture, and, in the Veblen-Ayres tradition, play an important role in determining human behavior and economic activity. North recognizes that "informal constraints are pervasive features of modern economies as well" [North 1990, 39], solving coordination problems and enforcing codes of conduct. Later on, North will emphasize how important they are in the evolution of institutions and path dependence.

With regard to the 'formal constraints', referring to political and judicial rules, economic rules, and contracts, North underlines their function in facilitating exchange and reducing transaction costs. On this topic, one could think of Commons' approach when he proposed his categories of bargaining, managerial, and rationing transactions in order to analyze the 'working rules' of economic activity. In fact, some authors think that, in this area, there is common ground between North and earlier Institutionalists.[11]

Despite these points of contact, one has to recognize that the vision that OIE has of institutions is quite different from NIE's. As Hodgson states, "once institutions have emerged on the basis of individual behaviors, they are seen simply as providing external constraints, conventions or openings to individuals who are taken as given. It is assumed that individuals' actions lead to the formation of institutions, but institutions do not change individuals, other than supplying information or constraints. The possibility that individuals themselves may be shaped in some fundamental manner by social institutions is not considered" [Hodgson 1993, 8].

In sum, neoclassical economics tends to ignore institutions in its theoretical framework, although in the last decade it has tried to incorporate them from a game theoretical perspective. NIE, being located on the periphery of Neoclassical economics, has developed an important amount of work on institutions, but its vision on them remains different from OIE's. To OIE, institutions are an historical and evolutionary outcome where rational man is a simplistic and misleading picture of human behavior and where markets are not an eternal feature of human society.

Transaction Costs

This theoretical tool is crucial to the NIE theory. For that reason, it is necessary to analyze it more deeply in this paper. Let's start by establishing that neoclassical economics

had ignored this concept for a long time until Ronald Coase won the Nobel Prize. However, despite this fact, the only thing that mainstream economics recognizes from it as important is the "Coase Theorem", and it is common knowledge that many graduate economics departments ignore the theory altogether in their courses.[12] Transaction costs have become a key theoretical category in Coasean economics, because, without them, many aspects of the functioning of the economic system remain unexplained, including the emergence of the firm itself.

Transaction costs are the costs of using the price mechanism – that is to say, the cost of discovering trading partners, negotiating contracts, and monitoring performance.[13] Dahlman (1979) suggests that transaction costs include search and information costs, bargaining and decision costs, and policing and enforcement costs. Usually, these costs will be registered, in a macro account framework as the income of police, security personnel, lawyers, brokers, clerks, managers, and entrepreneurs.[14] Transaction costs stem from the fact, according to Coase's insight, that the use of the price mechanisms is not costless [Medema 1994, 17]. Following Medema's (1994) view, one can see that transactions and their costs play an important role in Coase's economics, even though Commons was more explicit in taking the transaction as the basic unit of economic analysis through the concepts of *bargaining, managerial and rationing transactions.* Here, we can find a theoretical link between Commons' institutional economics and Coasean economics.

From this point of departure, when one accepts the role of transaction costs in an economy, one begins to explain, according to Coase, the existence of certain economic institutions, as long as they have been created as mechanisms to reduce transaction costs in a society [Medema 1995, 165]. In the real world, it is not easy to measure transaction costs because they are embedded in the accounting process of any economic activity. However, Douglass North attempted to measure the "transaction sector" for the U.S. economy in order to explain the important role of these costs in a developed economy. The results were striking: the transaction sector of the US economy was approximately 46% of the GNP in 1970.[15]

From a microeconomic perspective, Williamson builds on Coase's definition of transaction costs (i.e., "the costs of running the economic system") as being equivalent to 'friction' in physical terms. However, Williamson distinguishes between *ex-ante* transaction costs (e.g., drafting a document or contract, negotiating and safeguarding an agreement) and *ex-post* transaction costs (e.g., maladaptation costs, misalignments) [Williamson 1985, 21]. This idea of combining *ex-ante* and *ex-post* transaction costs reveals important differences between the traditional neoclassical industrial organization approach and the NIE view.

NIE's approach leads us to place institutions at the center of the analysis, where the law and the economic role of government are going to be a decisive matter of analysis and inquiry somewhat far away from the neoclassical world of zero transaction costs. These issues are going to be points of divergence between Coasean analysis and mainstream economics. Also, the introduction of the transaction costs analysis is going to be a crucial contribution for understanding the economic, political, and social institutions in a modern society, strongly upgrading Common's analysis of transactions even though, from a paradigmatic view, his analysis is closer to mainstream economics.

OIE does not ignore transaction costs in its analysis as different authors have underlined quoting Veblen's famous work on *The Theory of Business Enterprise* [Knoedler 1995, 385]. However, the logic in using this tool has been different from that of NIE. In NIE, the rationale that guides the usage of the transaction costs approach has been the economizing principle.[16] In OIE, the logic of reducing transaction costs among firms is based on pecuniary strategies more linked to the control of markets and enhancing the economic power of corporations [Knoedler 1995, 393].

North himself saw the necessity of going beyond the economizing principle in order to explain institutional change [North 1990, 86]. North clearly evolves beyond his initial works where he accepted the efficient neoclassical theory of institutions. Moreover, he proposes a bargaining approach to explain stability in a society, moving away from the mainstream thesis on the evolution of institutions. To a certain extent, North is now closer to Commons' ideas on economic power based on the "limits of coercion" that define the set of possible outcomes between the parties involved in transacting.

Informal constraints are recognized by North also as an important source of institutional stability despite discontinuous changes caused by revolutions and radical changes in the formal rules, as social scientists have discovered in Eastern European economies after the withering of socialism. He recognizes, as the "old" Institutionalists did before, that "informal constraints […] have great survival tenacity because they still resolve basic exchange problems among the participants, be the social, political or economic" [North 1990, 91].

As a consequence, what determines, according to North, the path of institutional change? Basically, two forces: 1) increasing returns, where organizations acquire feedback about the continuous changes between them and institutions, learn by doing, and increase the profitability of their businesses; and 2) imperfect markets characterized by incomplete information, where transaction costs are important and the behavior of agents is affected by *ideology* and limited information. These two forces are going to determine what North calls 'path dependence' in order to define the limitations of the choice set that agents face through a process of link-decisions through time. As North points out, "path dependence means that history matters" [North 1990, 100].

The notion of "path dependence" has been carefully defined by Paul David as "a quite precise set of connotations [… that] refers to a property of contingent, non-reversible dynamic processes, including a wide array of processes that can be properly be described as 'evolutionary'" [David 2001, 15]. However, OIE's idea of path dependence is developed from a Darwininian vision of the economy where the 'path' in which societies are 'locked-in' is not compared with an ideal one followed by Anglo-Saxon societies. To OIE economists, each path becomes a specific one. In that sense, from a policy-making perspective, the 'solutions' cannot be always to approximate these institutions toward some 'ideal' set. According to OIE, these policies should be developed from a perspective more inspired in a pragmatic (Dewey) theory of value.[17]

To sum up, despite North's attempts to break up with the economizing principle in transaction costs, it is clear that OIE approximates transaction costs from a different perspective, based more on the notion of economic power in the case of the firm. The core of NIE economists, except North, remain faithful to the rationale of the economizing principle in dealing with the transaction costs theory and applying it to different scenarios such as the firm, organizations, markets, and the law.

The Firm

The firm has been considered by NIE economists as one of the most important institutions of the modern world and they have devoted a lot of efforts to analyze it, to examine its evolution, and to theorize the governance structure within the firm itself. There are significant differences between neoclassical economics, OIE and NIE regarding this important theoretical element in economics. Neoclassical economics defines the firm on the basis of the production function, which at the same time is just a technology. Given input prices, the production function defines a cost function. Hence, technology is the main factor determining the size of the firm. Neoclassical economics ignores the governance structure within the firm as long as it considers that it could be explained through a replication of the market system.

NIE starts with a different approach. Coase underlines that economic theory has been characterized as an analysis of choice, but in this sense, "economics has no subject matter" [Coase 1988, 3]. The problem with this view, according to Coase, is that the entities, on which economic analysis is based, are empty, without substance. The consumer is reduced to a set of preferences, and the firm is just a production function with a technology behind it. Therefore, According to Coase, "we have consumers without humanity, firms without organization and even exchange without markets" [Coase 1988, 3]. Coase claims that economic theory needs to take a more realistic approach in which the firm, the market, and the law play a crucial role in the functioning of the economic system. For him, economic policy implies a choice among different social institutions that are created by the law or are supported by it [Coase 1988, 28].

In "The Nature of the Firm", Coase points out that the economic system is coordinated by the price mechanism, but this does not mean that there is no planning by individuals within the firm. External to the firm, everything is coordinated through the price mechanisms but, within the firm, the market transactions are eliminated and substituted by the entrepreneur – coordinator. For Coase, "the distinguishing mark of the firm is the suppression of the price mechanism" [Coase 1988, 36]. For Coase, using the price mechanism is costly, and this fact is the basis for the creation of firms. By forming an organization under the command of some authority, some marketing costs[18] are saved and a firm can be established.

Following Coase's analysis, it is not enough to have uncertainty in the economic system to generate firms, as Knight asserted. Coase sees the firm as a system of relationships that become real when the command of the resources is under the direction of the entrepreneur. Thus, firms become larger as the entrepreneur organizes additional transactions. If the number of transactions organized becomes smaller, the firm will be smaller too [Coase 1988].

The size of the firm, according to Coase, is not just a problem related to the optimal output according to the cost curve. Coase recognizes that the entrepreneur function is subject to decreasing returns where the cost of organizing an extra transaction within the firm comes to a point where it is equal to the cost involved in performing the transactions in the open market or the costs of organizing such an extra transaction by another firm. But he also underlines the fact that as long as the organized transactions of the firm increase, the likelihood of the entrepreneur making wrong decisions increases as well.

Finally, the supply price of many factors of production could rise for a firm that becomes larger, thus loosing the advantage of being 'small'. According to this approach, the size of a firm is defined by the threshold consisting of the point where the costs of organizing certain transactions within the firm may be greater than the costs of carrying out the transactions in the market [Coase 1988, 43]. Coase considers incorrect the argument that the reason for the existence of firms is the division of labor because the price mechanism takes care of the problem of specialization.

Similarly, according to Eggerston (1990), the ownership structure of firms will depend on the structure of property rights, incentives, and technological characteristics of the production function. This production function can be defined as:

$$Q = F_R\ (L, K, M, C, T)$$

Where, Q = output	M = material inputs
L = labor	T = vector representing technology
K = capital	C= set of external rules of the game from which T is chosen

F_R is a production function (from a set F) that corresponds to a specific property rights structure. R is going to depend on legal restrictions, penalties for behavior, state enforcement, contract arrangements, and mores. The external rules of the game delimit C from which a defined technology T is chosen.

As one can see, the NIE's production function – following Eggertsson – is more complex because the traditional neoclassical ones are better suited to handle chemical and engineering processes as compared with those more based on human interaction with agency relationships. Eggertsson compares the case of open corporations with shareholders of a closed corporation, mutuals and nonprofit organizations. In the open one, the separation of shareholders from managers creates agency problems that are solved through capital market competition in the case of shareholders; and by the market for managers, where constraints are imposed on the opportunistic behavior of the managers; market competition allows the lowering of agency costs. In the case of a closed corporation, contradictions among shareholders are not easily solved with high transaction costs. Usually, its managers are personally connected with some of the shareholders, generating high transaction costs. Mutuals and non-profit organizations face agency problems and shirking between managers and owners. The case of 'political firms' (state-owned firms) is also analyzed where according to Eggertsson, evidence shows lower productivity compared with private ones, but where their existence is explained for political reasons such as a taste for these kinds of firms, information costs disadvantages not available to voters, or mechanisms for wealth distributions or guarantee of employment to some groups [Eggertsson 1990, 152].

Williamson (1985) has been elaborating, since the 1970s, a more developed NIE theoretical framework for the firm. Using Frank Knight's idea about 'diminishing returns to management' and quoting Coase's famous question, "Why is not all production carried on in one big firm?" [Coase 1988, 133], Williamson develops former ideas based on his previous works on *Markets and Hierarchies.* He shows that any sort of production requires a governance structure within the firm where contractual relations arise between the owners of the firm, labor, suppliers, and buyers of the final product. This governance

structure economizes transaction costs on the one hand but, on the other, it also generates some losses. The equilibrium between these two processes will determine the size of the firm. Then, Williamson defines two kinds of technologies in the production processes: general-purpose technology, and special-purpose technology. The later corresponds to those technologies that require greater investments in specific durable assets. The former refers to products less standardized than the second. Thus, in order for a firm to be able to adopt this sort of technology, it would require a more complex set of contracts with safeguards and credible commitments from both suppliers and buyers. This would be necessary in order to protect the investments that special purpose technology requires. Based on this, Williamson explores different sorts of governance structures characterized by private ordering of disputes, credible commitments, the hostage model of contracting, engaging of the supplier, franchising techniques and so on.

In the case of OIE, it is known that an adequate and developed theory of the firm based on the work of Veblen and Commons has not been built. However, these two authors left methodological and theoretical indications in order to build an evolutionary theory of the firm [Hodgson 1999, 219]. Starting with the early writings of Veblen in his *Theory of Business Enterprise*, Common's powerful analysis of transactions (managerial, rationing, and bargaining transactions), and based on the 'going concerns' as units of economic activity, OIE has initiated an analysis of the firm from a methodological point of view at odds with NIE's [Hodgson 1999, 218].

A posterior development in OIE came with the works of John R. Munkirs, an economist, in his own words, "rooted in America's institutionalism"[Munkirs 1985, ix]. Building on Adolph Berle's ideas about corporations as 'quasipolitical institutions', Munkirs updated Institutionalist views on American capitalism, seeing corporations as a structured totality of technology, mass production, distribution, and corporate concentration of power [Munkirs 1985, 42].

The notion of Centralized Private Sector Planning (CPSP) is crucial in Munkirs' analysis. He asserted that the CPSP "may be viewed as a process whereby the production and distribution activities of the economy's key corporations and industries are organized and coordinated so as to bind these corporations and industries together into a functionally integrated production and distribution system" [Munkirs 1985, 60]

Later, William Dugger (1980) studied in detail the dynamics within the corporate enterprise as an expression of corporate power. He starts paying attention to the study of corporate bureaucracy embedded in a pecuniary culture, despite its technocratic orientation [Dugger 1980]. The organizational evolution of the business enterprise has been characterized by shifts towards decentralization and diversification. However, Dugger claims that "US enterprises are becoming more top-heavy, even though some decentralization and de-diversification are taking place" [Dugger 1985b, 409]. The recent mergers and acquisitions during the 90s are just another sample of the same process.

From a leftwing radical perspective, Palermo (2000) states that Williamson's analysis cannot separate the issue of economic power from the efficiency principle. Even though Williamson recognizes that power matters when contracting conditions are problematic, Palermo claims that with Williamson's approach "it is not suitable to sustain either normative prescriptions or historical interpretations of the institutions of capitalism" [Palermo 2000, 585]. Palermo proposes a research program where economic power is a pervasive element within the firm and within the market, not being incompatible with the

theory of the firm and being harmonized with a class analysis. Original Institutionalists would agree with Palermo's insights on the limitations of Williamson's NIE, but they will be reluctant to give such weight to any class analysis. As Klein (1992) pointed out, "Institutionalists rarely focused explicitly on class in analyzing modern market-oriented economies" [Klein 1992, 543].

Williamson's approach represents a step forward in analyzing the organizational complexities within the firm and a good development in applying transaction costs theory. However, there is a risk in ignoring some Veblenian insights on the variety of pecuniary strategies of the firms throughout modern business history as Janet Knoedler (1995) pointed out. Last but not least, governance structures within the firm surely cannot be isolated from the realities of economic power. Hierarchies are not just a choice under bounded rationality and opportunism, they also stem from the social and political structure of a society that are translated into wealth and power inequalities.

The State

As Olson (1965) correctly pointed out a long time ago, neoclassical economics did not have a theory of the State. It reduces it to some aspect of fiscal policies and taxation, aiming basically to determine which public services should be managed by the State. Lately, state activities have been analyzed through the theory of Public Goods. As Olson posited, neoclassical economists "had a comprehensive theory which explained why most economic needs should be met by private enterprise; so it is natural to ask for a systematic explanation of the exceptional class of functions they thought should be fulfilled by the state […]. Even in this century, Pigou, in his classic treatise on public finance, gave collective goods for the most part only implicit treatment" [Olson 1965, 102]. Later on, rational choice theorists would supply Neoclassical economics with a theory of the State.

In NIE, it is well recognized that the absence of a theory of the State implies many flaws in its historical analysis of institutions. Eggerston considers a <u>positive</u> theory of the State to be crucial to NIE. In the end, enforcement of property rights depends on power, and the state is able to have economies of scale in the use of violence [Eggerston 1990, 61]. In this approach, rulers are trapped in an agency problem. Hence, there is no guarantee that the structure of property rights defined by the State is necessarily consistent with rapid economic growth. Political institutions are more stable than the rational-choice theorists assumed. Despite the results of Arrow's impossibility theorem, [19] in the real world, political institutional arrangements are more stable because they are based on economic power and are designed to foster cooperation among decision-makers. Ideology also plays an important role, and following North, Eggertsson accepts that the stock of social values is a form of capital. Without supporting ideology, the costs of enforcement of property rights and monitoring citizen's activities become extremely high. Eggertsson does not discard the rational choice approach but he seems to find it deficient in explaining the stability of political institutions.

Based on North's work, Eggertsson delineates some elements of a NIE Theory of the State. In a society, the stock of knowledge and the endowment of resources define the <u>technical upper limits for productivity and output</u>. Then, according to the community's political structure, a system of property rights is defined. This fact at the same time generates a feasible set of organizations. Those who minimize transaction costs and

maximize output determine the <u>structural production frontier.</u> Some political systems create incentives that bring the structural production frontier close to the technological frontier. Through a process of political change, it is possible to foster this process of approximation, and to undertake a cost-benefit evaluation of the reforms in which the costs of political change have to be included.

According to North, historical evidence seems to corroborate the proposition that states usually do not supply structures of property rights suitable to economic growth due to 'failures of organization'. Eggertsson claims that North's theory of the State is some sort of duality. On the one hand, the State is the classic Hobbesian predator but, and on the other, Eggertsson recognizes the productive and positive side of the government.

Eggertsson states that the joint effects of information asymmetries and the role of transaction costs, added to struggles over distribution of wealth, generate a propensity of states to create a structure of property rights that is inconsistent with economic prosperity. To illustrate this thesis, he analyzes the case of countries in tropical Africa and the agency problems in Soviet type economies. The case of public finance and property rights in early modern Europe is also presented. In sum, according to Eggerston, the stock of institutional changes in a society through obsolescence and new investments generates marginal changes. A credible commitment by the State to stable property rights helps in promoting investments and lowers the transaction costs. Eggertsson recognizes that NIE still needs to develop a theory of the State, even though he presents some important insights.

North (1981) recognizes the powerful analysis that neoclassical economics has built based on the work done by Baumol, Buchanan, Tullock and Downs, where a theory of choice has given an acceptable approach to the study of the State. North recalls that two general types of explanations for the State exist: 1) the contract approach (Rousseau); and 2) the predatory or exploitation theory (Hobbes, and Marx). However, these two strands are not able to explain why there has been a tendency for states to generate inefficient property rights on the one hand, while on the other, having some sort of instability that in the end leads to economic change and economic decline [North 1981, 23].

In order to solve this puzzle, North proposes the following model for the State:

1) There is a wealth or utility maximizer ruler by which the State trades services (protection and justice) for revenues (taxes). The State behaves as a discriminating monopoly, devising specific sets of property rights for each set of constituents in such a way that the State is able to maximize the ruler's revenue. There are opportunity costs for the members of this society that constrain the behavior of the State because of potential rivals to the ruler within the same society or external to it.
2) The State provides the rules of the game with the aim of specifying the rules of competition and cooperation while reducing the transaction costs in order to maximize output or wealth.
3) There are continuous tensions between the ownership structure that maximizes income for the ruler and 'efficient' property rights that reduce transaction costs and promote growth [North 1985, 25].

According to North, the ruler is not omnipotent. He/she has two basic constraints: first, he/she must avoid offending powerful constituents (competitive constraint); second, there is a transaction-costs constraint where by the collection of revenues is affected by the

structure of property rights. However, in order to explain the possibility of collective action North parts company with neoclassical analysis regarding the free-rider problem. For this reason, North recognizes the need of a theory of transaction costs and a theory of ideology. He borrows from Coase the theory of transaction costs. The necessity of a theory of ideology arises from the contradiction that the State faces. On the one hand, the State specifies rules that maximize the income of the ruler and his group. On the other, the State needs to devise rules that lower transaction costs to enhance growth. To achieve this, it is necessary to have a set of ideological convictions that constrain individual behavior. Otherwise, the transaction costs of compliance, monitoring and enforcement will be very high. Thus, ideology plays a central role, making the contractual relations between the ruler and the constituencies legitimate [North 1981, 44].

Throughout history, one can observe the actions of large groups that could not possibly have appeared under the logic of the free-rider approach. For that reason, North maintains that the neoclassical theory of the State neglects the important role of ideology. Ideology becomes an economizing device to simplify the decision-making process, being very linked to moral and ethical judgments. Ideology is modified when individuals find that their experiences do not match their ideology. The stronger the ideology in an economic system, the lower the costs of maintaining the present structure.

Based on this vision, North proposes that changes in economic history do not occur only because of changes in relative prices, as the neoclassical model assumed, but also because of changes of ideologies that drive individuals and groups to act against a given structure regarding their vision of the fairness of the situation they endure [North 1981, 58]. Throughout North's work, one can see a dual position. In some cases, the State is seen as the necessary third-party enforcer that lowers transaction costs and guarantees property rights. In others, the State is a source of insecurity and a factor in increasing transaction costs.

OIE finds this analysis of the State very weak, insofar as it does not deal with the concept of *economic power* as a result of a complex interrelationship between the polity and the economy. They claim that this interaction between the polity and the economy is also based on a social belief-system where the role of government in enhancing the life process is guided by the evolutionary process by which a society endeavors to build values internally. The State is not just a third-party enforcer among agents or in a principal-agent framework. This view of the State leads us to better understand the differences between OIE and NIE scholars. The latter have more favorable views of markets and a more negative view of the government [Rutheford 1994, 162]. However, this does not mean that OIE economists are more interventionists than NIE economists. OIE economists would claim that it is necessary to examine the role of the government in enhancing the life process, whereby the government would not only pay attention to the allocation of resources through market mechanisms but also to the deployment of resources to achieve those 'collective oughts' [Klein 1994b, 200].

Conclusions

I have reviewed the crucial discrepancies that show clearly that even though a dialogue between OIE and NIE can be fruitful, it must also be balanced, with both the similarities and contradictions between these two approaches spelled out. The fruits of this

dialogue are very beneficial to both schools of thought, but it is very unlikely to generate integration. The reasons are straightforward. OIE has been built from a heterodox paradigmatic view that is at variance with NIE. In my opinion, NIE remains today still on the periphery of the neoclassical paradigm.

I have attempted to show the significant differences, despite some complementarities, between OIE and NIE regarding methodology, conception of institutions, transaction costs, the firm and the theory of the State. In all of these, even though there are some complementarities with respect to the criticism of neoclassical economics, I am afraid that the divide is still greater than the possible bridges. Moreover, from a policy perspective, both strands of institutional economics end up with quite different sets of recommendations.

NIE economists do not look forward to a dialogue with OIE economists. Eggertsson stated that "[his] working rule was to limit the study to contributions that did not alter the core of economic approach, particularly the rational-choice model, and to seek a new synthesis of neoclassical and institutional economics […] Neoinstitutional Economics is the term [he uses]" [Eggertsson 1990, xii]. If we recall Coase's words regarding the change in economics that is necessary in order to incorporate the analysis of institutions, he asserts that "this change will not come about, in [his] view, as a result of a frontal assault on mainstream economics. It will come as a result of economists research on branches or subsections of economics adopting a different approach, as indeed is already happening" [Coase 1998, 73-74].

From a methodological standpoint, the only possibility that NIE could move to some positions closer to OIE would be based on a reassessment of NIE's ontology and epistemology. As Hutchison underlines, "if, therefore, in the new institutional economics, the high level of abstraction, which limits so much of modern microeconomics, is to be reduced, then the need for a considerable shift away from the primarily deductive method of much of classical and neoclassical theory, towards more empirical, historical and institutional methods, will have to be undertaken" [Hutchison 1984, 42].

For OIE, important tasks also need to be undertaken. OIE, based on Veblen's insights on evolutionary processes, should take a closer look at evolutionary theory, without discarding the usage of empirical and econometric techniques [Hodgson 1993, 22]. OIE must also develop a better theory of individual and collective agency, based on its Veblenian traditions but incorporating the state of the arts of current biology, physiology and Dewey's psychology.

Moreover, the relation between Nature and Nurture (biology and culture or society) regarding the conditioning of human behavior should be approached from a creative perspective without conflating agency with culture. This theoretical development would be necessary to allow OIE to part company with the hermeneutic or 'culturalist' tradition that is still predominant among its own rank and file members. Only in this way, could these two different approach on institutions from distinct paradigmatic views, produce and nurture new perspectives on what Institutional economics is all about.

Notes

1. I prefer using the term 'Original' instead of 'Old' in order to avoid prejudices about an 'out of fashion institutionalism' and a 'new' or 'modern' one.
2. Here, I am not going to include the Austrian thought represented by Hayek as belonging to NIE because doing so would expand the scope of the inquiry unnecessarily. Austrian

economics, in my opinion remains very close to mainstream economics despite its differences with neoclassical economics.

3. Evolutionary economics in the sense of a Darwinian perspective on economy and society as Veblen (1898) posited in “Why is economics not an evolutionary science?” This vision has nothing to do with Spencer’s idea of survival of the fittest.
4. See Klein (1994a), where he analyzes the demand theory and the impact of changing tastes. Also, Paul D. Bush (1989) tried to formalize models to represent mathematically the theory of instrumental value. Moreover, there seems to have been a change in the last issues of the *Journal of Economic Issues* where we can see more papers based on some econometric research. The problem regarding this matter, in my opinion, has been the predominant ‘culturalist’ or hermeneutic influence in OIE that implies a usage of research techniques more closely linked to this social science paradigm. But it is fair to recognize that this is not the case of all OIE economists who have been incorporating other methods. See, for example, Williams, W. et al (2002).
5. I recall here Commons’ notion of institutions that involve specific relations or ‘transactions’ among individuals or groups of individuals embedded in a specific hierarchy. Commons was also very well aware of the importance of Dewey’s Social Psychology in attempting to grasp a theory of agency [Commons 1990 (1934)].
6. One must recognize, however, that a complete theory of agency and structures must be rebuilt within OIE in order to part company with the hermeneutic paradigm. This theoretical development should be based more on the Darwinian tradition that Veblen supported and it should take into account all the modern developments in biology, physiology, and psychology regarding individual and social human behavior.
7. It must be clarified of course that pragmatist Methodology has nothing to do with logical empiricism or logical positivism.
8. This dichotomy is explained by C.E. Ayres who states that “what happens to any society is determined jointly by the forward urging of its technology and the backward pressure of the ceremonial system” [Ayres 1962 (1944), ix].
9. This is a very simplistic version of the idea. Very complex matters remains to be developed within OIE such as the role of technology in institutional change in order to avoid technological determinism, and a more developed theory of individual agency based on the Darwinian Veblenian tradition regarding the role of instincts, habits, and behaviors.
10. See Groenewegen, Kerstholt and Nagelkerke (1995).
11. See Cheng-Pin (1999), and Vanderberg (2000).
12. A review of the well-known and widely used textbooks of Varian (who ignores transaction costs all together) and Mass-Collel, Winston and Green (just one page) reveals this problem.
13. See Medema (1995).
14. See Dahlman (1979).
15. See Wallis and North (1995).
16. This can be seen in Williamson’s work about the theory of the firm and also in Eggerston’s views when he analyses the evolution of property rights as well as in earlier works of North.
17. A good example of these policies were the contributions of many Institutional economists to the creation of successful social policies after the Great Depression and World War Two regarding social security programs, unemployment compensations and others.
18. In Coase’s language, these ‘marketing’ costs are basically the costs of using the price mechanism. The concept has nothing to do with the usual marketing cost of a product.
19. This theorem stated that under certain assumptions about people's preferences between options, it is always impossible to find a voting rule under which one option emerges as the most preferred.

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