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ECONOMIC BEHAVIOR AND INSTITUTIONS

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Economic behavior and institutions

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For Anne Cotterill

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Part III. Explaining economic organization

Part IV. Explaining property rights

PREFACE

This book grew out of my interest in organizational forms and institutional arrangements and their impact on economic outcomes. Price theory or microeconomics, in its conventional form, treats organizations and institutions the same way as it treats the law of gravity: These factors are implicitly assumed to exist but appear neither as independent nor as dependent variables in the models. Such economy in model making can be eminently reasonable. It enables us to isolate critical relationships and simplifies the use of mathematical tools in the analysis. However, unlike the law of gravity, organizations and institutions are not invariant; they vary with time and location, with political arrangements and structures of property rights, with technologies employed, and with physical qualities of resources, commodities, and services that are exchanged. In fact, production involves not only the physical transformation of inputs into outputs but also the transfer of property rights between the owners of resources, commodities, and labor services. In the transfer of rights, whether within firms or across markets, agents maximize their objective functions subject to the constraints of organizations and institutions.

Once our research questions involve variable organizations and institutions, either as exogenous or endogenous variables, conventional microeconomic analysis becomes a rather blunt instrument. Our traditional tools are not well suited for examining the nature of the firm, the variation in industrial organization, institutional change in economic history, the organization of exchange in formal markets and nonmarket settings, or comparative economic systems. It was a logical development, which we have observed in recent years, that economics departments at various major universities gradually would give relatively low priority to fields of study that deal with organizations and institutions – fields such as economic history, comparative economic studies, the economics of growth and development, and various economic policy areas. This trend in priorities was also reflected in leading journals of economics. One could say that the structure of the economic system itself and of its parts was no longer a central focus of inquiry.

In 1984, I set out to investigate whether my demand for institutional analysis had created its own supply, whether the thesis of institution-free economics had created its antithesis. My working rule was to limit the study to contributions that did not alter the core of the economic approach, particularly the rational-choice model, and to seek a new synthesis of neoclassical and institutional economics. Neoinstitutional Economics is the term I use.

The renewal of a scientific discipline usually does not originate at the center, and I found what I was looking for in various outlying branches of economics. Tremendously interesting ideas were being developed and discussed in subfields within economic history, the theory of the firm, and industrial organization; in the new field of law and economics; and by political scientists who employed the rational-choice model. These contributions had in common the introduction of transaction costs to the analysis. The modern use of the concept of transaction costs originates in two articles by Ronald H. Coase, "The Nature of the Firm" (1937) and "The Problem of Social Cost" (1960).[1] In looking back on these classic articles, Coase (1988) has summarized his contribution in these words:

1. Coase, Ronald H. (1937). "The Nature of the Firm." *Economica*, New Series *16* (No. 4): 386–405; idem (1960). "The Problem of Social Cost." *Journal of Law and Economics 3* (No. 1, October): 1–44.

> Transaction costs were used in the one case to show that if they are not included in the analysis, the firm has no purpose, while in the other I showed, as I thought, that if transaction costs were not introduced into the analysis, for the range of problems considered, the law had no purpose.[2]

The economic approach suggests that, in the absence of transaction costs, their self-interest would always guide the members of society to contract for the establishment of political structures and systems of property rights that maximize the national wealth. In this instance, the study of political processes is of little interest for the student of economic systems. However, this generalization is not valid if we introduce transaction costs into the analysis of political exchange. The rational-choice model is now consistent with structures of property rights that fail to maximize the national wealth and may even bring economic decline, which we can interpret as organizational failures due to transaction costs.

As I see it, there are several levels of analysis in Neoinstitutional Economics, depending on which variables are treated as endogenous. At the first level, the structure of property rights and forms of organization are explicitly modeled but are treated as exogenous, and the emphasis is on their impact on economic outcomes. At the second level, the organization of exchange is endogenized, but the fundamental structure of property rights remains exogenous. Exchange within firms, across formal markets, and in nonmarket situations is organized by means of contracts that constrain economic agents. For instance, the firm is defined as a network of contracts. At the third level, attempts are made to endogenize both social and political rules and the structure of political institutions by introducing the concept of transaction costs.

My book is organized on the basis of these three levels of analysis. Its intended contribution is to bring together heterogeneous work by scholars in various fields in order to suggest a new research

2. P. 34 in Coase, Ronald H. (1988). "The Nature of the Firm: Influence." *Journal of Law, Economics, and Organization 4* (No. 1, Spring): 33–47.

program, a new approach to the study of economics systems, which at the same time is essentially a generalization or extension of microeconomics. Most of the work I discuss is new; Neoinstitutional Economics as a unified research program took shape in the 1980s. I hope the book will convey a sense of the tremendous potential I see in the new approach that I predict will one day be referred to as economics.

The main contributors to neoinstitutional analysis usually operate at only one of the three levels of analysis that I have described, except for Douglass North. North's vision that the economic approach, augmented by transaction costs and property rights, is a general tool for the study of society at all levels has inspired this book. In fact, the turning point in my thinking was the chance discovery of one of his articles. He responded swiftly and generously to a letter from me and invited me to join his political economy group at Washington University in St. Louis for one semester. The one visit became three, lasting four semesters, and North's continuing support literally made it possible for me to write this book. My debt to Washington University is great. I have been a visiting professor in the Economics Department, a visiting fellow of the Center in Political Economy, and a research associate of the Center for the Study of American Business. Of numerous friends at Washington University I would especially like to thank Wilhelm Neuefeind, Murray Weidenbaum, and my friends and benefactors Lee and Alexandra Benham, who followed my work closely with sound advice, critique, and encouragement and helped me establish important contacts with leading contributors to Neoinstitutional Economics, which included a memorable evening with Ronald Coase in Chicago.

Many of the scholars cited in this book have provided me with unpublished papers and manuscripts and read chapters relating to their work. I would especially like to mention Armen A. Alchian, Yoram Barzel, Robert Bates, Louis De Alessi, Arthur Denzau, Stefano Fenoaltea, Barry C. Field, Eirik Furubotn, and Jack Hirshleifer in the United States; Anthony Scott in Canada; and Bruno

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