THE NEW INSTITUTIONAL ECONOMICS WITHIN THE PRESENT ECONOMIC PARADIGM: A BRIEF REVIEW

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Abstract

The present-day world is not the one it used to be. An attempt to explore a new reality emerging under complex conditions poses a challenge to social researchers. However, the current social and economic paradigm appears inadequate in apprehending, let alone predicting, such phenomena as globalization, hypercompetition, acceleration of R&D, increasing disarray of the world financial system, and crises. The role of resources, capital, labour, technologies and other inputs and the efficiency of collaboration among firms should be revised within global markets. The past few decades have made it evident that the neo-classical concept based on perfect competition, complete rationality and price mechanism is losing its relevance. It requires that we search for an alternative theory able to manage the shortcomings of the neo-classical approach. The present paper attempts to show the new institutional economics to be an appropriate tool for the analysis of the present trends in the world economy.

Key words: the new institutional economics, transactions, transaction costs, the neoclassical theory.

JEL Code: JEL B15, JEL B25, JEL E02

Introduction

The present-day world is not the one it used to be. An attempt to explore a new reality emerging under complex conditions poses a challenge to social researchers. However the current social and economic paradigm appears inadequate in apprehending, let alone predicting such phenomena as globalization, hypercompetition, acceleration of R&D, increasing disarray of world financial system and crises. The past few decades have made it evident that neo-classical concept based on the perfect competition, complete rationality and mechanism of prices is losing its relevance. It requires that we search for an alternative theory which might be able to manage the shortcomings of the neo-classical approach.

The present paper attempts to show the new institutional economics to be an appropriate tool for the analysis of the present trends in a world economy.

New institutional economics is known to rest on two arguments: «institutions matter[1] and are susceptible to analysis»[2]. It is reasonable to wonder, what institutions are. According to Douglass North`s definition, «institutions are the rule of the game in a society[3]», more precisely, they are the humanly determined limits that frame human interactions. Ultimately they structure political, social or economic incentives in exchange. In other words, rules form the core of institutions. Many researchers consider rules to be the key characteristics of institutions. For instance, Scharpf [4] describes institutions as « a system of rules that structure the course of actions that a set of actors may choose». Klijn and Koppenjan identify institutions as a «set of rules, which influence, guide and limit the behavior of actors[5]». For the purpose of present paper it is reasonable to realise, why institutions, in particular rules, are so crucial nowadays.

It is commonly agreed that the neo-classical theory is based on «three pillars»: the completeness of information, the perfect competition and «economic man». For the sake of further analysis it seems necessary to detail these key issues.

Completeness of information. Economic agents should seek to possess the whole information on the products and exchange conditions, with the information ideally to be presented in prices. It was Leon Walras who attempted to simulate an artificial market process that would bring the system to equilibrium, a process called "tâtonnement" (French for "groping"). The tâtonnement was a trial-and-error process in which a price was called out and people in the market would declare how much they were ready to demand or supply at that price. If there was a surplus of supply over demand, then the price would be decreased so that less would be supplied and more would be demanded[6]. The exchange is regulated by "commisaire-preseur" (French for "auctioneer"), who is responsible for bidding between the seller and the buyer. As this "commisaire-preseur"may be the invisible hand of market.

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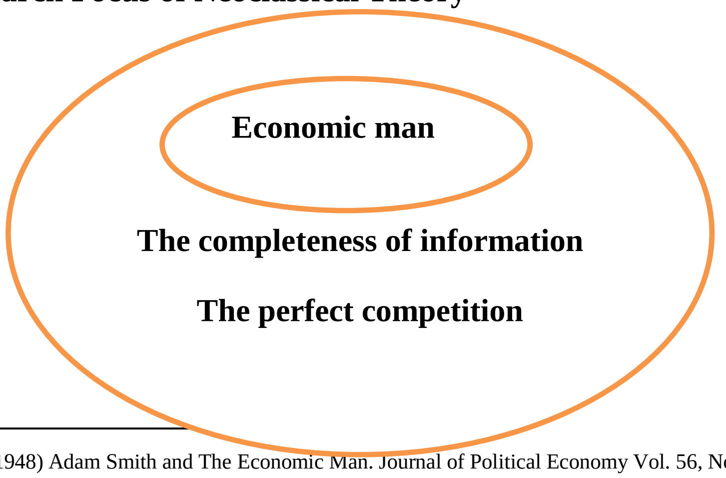
[1] Williamson, O. E. (1996). The mechanisms of governance. New York: Oxford University Press, p.3
[2] Matthews, R. C. O. (1986). The economics of institutions and the sources of economic growth. Economic Journal, 96.p.903
[3] North D.(1992) Transaction Costs, Institutions, and Economic Performance. Cambridge: Cambridge University Press. p.3
[4] Scharpf, F.W. (1997) Games Real Actors Play: Actor-Centered Institutionalism in Policy Research , Boulder. CO: Westview Press.
[5] Klijn, E.H. (2006) Institutional Design. Changing institutional features of networks .Public Management Review. Vol.8, №1., 143
[6] Milton Friedman. (1995).Leon Walras and his Economic System. American Economic Review. p.900

Perfect competition. The second requirement of the neoclassical theory is minimal interdependency of economic agents, saying with other words, the decision –making by one agent does not depend on decision-making by another one. The minimal interdependency can be reached only in the framework of a completely competitive market. Under perfect competition all firms are small scale, products in each industry are homogeneous, consumers are perfectly informed about what is sold, and all sellers are what economists call price takers (i.e., they have to “take” the market price and cannot charge a higher one for their goods). Moreover, property rights are fully defined and reliably protected, all resources allocated are unspecific, i.e. are quickly and easily replaceable with the result of their using being the same.
«Economic man». The final attribute of neoclassical paradigm is a model describing the social behavior is known to be most preferable in terms of exchanging in the market place. William Grammp identified him as “alarmingly rational creature who invariably seeks his own interest, who reacts with lightning speeds to actual and anticipated changes in his real income and wealth, turning with ease here and there upon the slightest fluctuation in relative prices.<…> He is unencumbered by any personal relations which might interfere with his relentless maximizing, being a disembodied creature without a soul and devoid of human compassion.”[7] . Thus, it is a purposeful, narrowly self-interested egoistic man, being stable in his preferences and aiming at maximizing his utility as a consumer and his economic profit as a producer, who is the cornerstone for the neoclassical theory.

These three neoclassical assumptions mentioned above can be visually embodied into two structural elements: hard core (a number of substantial unchangeable assumptions) and a protective belt (less meaningful convictions exposed to adjustments). The Figure 1 displays schematically the research focus of neoclassical theory.

Fig. 1. Research Focus of Neoclassical Theory



[7] Grampp W.D. (1948) Adam Smith and The Economic Man. Journal of Political Economy Vol. 56, No. 4

Source: by author

Thus the fundamental assumptions resulting from these two levels are as follows:

1) People do have rational preferences among outcomes;

2) People act independently on the basis of full and relevant information;

3) Individuals maximize utility and firms maximize profits.

The paradox is that all these basic assumptions developed for the market structure can be realized either for a local market such as a medieval trade fair, where the stable and limited number of traders provided the whole information about economic agents and dealings ex ante and the reputation of the traders was the best safeguard against opportunistic behavior, or for centralized pricing with a planning agency being a “commisaire-preseur”. It follows that this neoclassical model does not correspond to a nowadays trends in the world economy, where the global entering the markets makes impossible the functioning of perfect competition and being completeness of information. This observation is however the one aspect of the problem.

Another issue results from the global entering the markets caused by international division of market and doctrine of free trading developed by Adam Smith and updated by David Ricardo. While both classical scholars could only propose a possibility of market saturation in the long-term, further generations faced this phenomenon in reality. The market saturation induced by a global competition with no trade barriers resulted in confrontation of firms on a large scale. To survive within such high competitive environment, firms are forced to struggle for the resources and spheres of influence. It is of high importance to highlight this thought because such a situation is unprecedented and has no comparison throughout history. The economy has never been subject to such tensity provoked by intention of firms to save their leadership on the market.

This confrontation needs mechanisms providing acquiring, alienating, transferring and controlling the property. These mechanisms are transactions. This term deserves greater attention and therefore it makes sense to apply to the well-known definition of transaction proposed by J.Commons. He determined transaction as the means, under operation of law and custom, of acquiring and alienating legal control of commodities, or legal control of the labor and management that will produce and deliver or exchange the commodities and services, forward to the ultimate consumers[8]. As far we are able to realize, in terms of J.Commons, transaction is – within the framework of micro-analytical approach – a core unit of an economic activity. Whereas the economic activity is constituted by economic agents, it is reasonable to postulate that transaction means an interaction between economic agents by acquiring, alienating, transferring and controlling of property for the aim of extracting benefits.

Another issue is the cost of transacting. Douglass North highlights that «many – indeed most – participants in an economy don not produce anything that individuals consume. So it is not surprising that transaction sector (those transaction costs that go through the market and therefore can be measured in gross national product) of the American economy in 1970 was 45 percent of GNP.[9]» However there is only one aspect to be considered, whereas transaction costs is more than costs of the labor force engaged in facilitating and maintaining the economic system. It is also the force, noted by North, «that drives individuals to structure the economy to favor themselves at the expenses of others[10]».This idea is expressed more precisely by Thrainn Eggertsson who holds that «in general terms transaction cost are the costs that arise when individuals exchange ownership rights to economic assets and enforce their exclusive rights.[11]». In other words and referring the definition of transactions given above, transaction costs are the costs arising in interacting between economic agents via acquiring, alienating, transferring and controlling of property for the aim of extracting benefits.

Nowadays, in complex societies and economies, when crises occur unpredictably and market fails to overcome economic imbalances, transaction costs are high as they have never been since firms are forced to struggle for their leadership on the market. When transaction costs are significant, both formal and informal rules having been intended to keep the economic system stable play the determinant part in functioning of the latter. In other words, «when transaction costs are significant, institutions matter[12]».

[8] Commons J. (1934) Institutional Economics The American Economic Review., 648-657
[9] North D.(1992) Transaction Costs, Institutions, and Economic Performance.An International Center for Economic Growth,.6
[10] North D.(1992) Transaction Costs, Institutions, and Economic Performance.An International Center for Economic Growth,.7
[11] Eggertsson.T (1990) Economic Behavior and Institutions. Cambridge University Press, 14
[12]. North D.(1992) Transaction Costs, Institutions, and Economic Performance.An International Center for Economic Growth,.6

Taking the above-mentioned into account the «three pillars» of neoclassical theory – economic man, perfect competition and completeness of information –. lose their validity and are replaced with the another three. These are following:

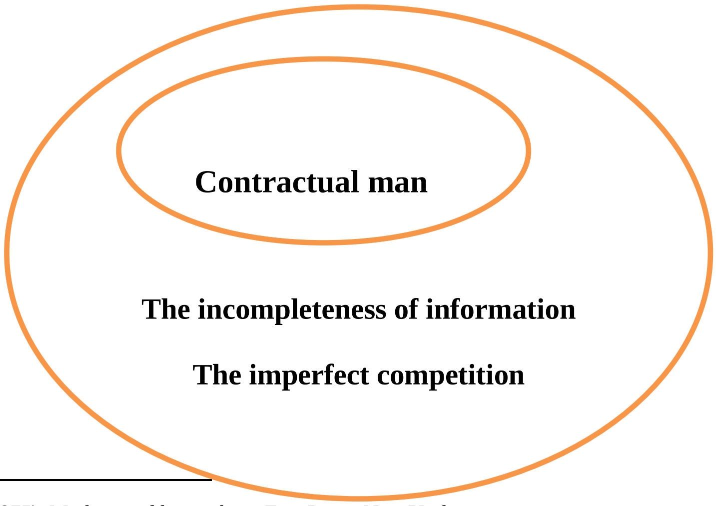
Incompleteness of information. Information is one of the sources that is costly and asymmetrically distributed. Receiving additional information about goods, competitors or market environment and, furthermore, verifying the received information are closely connected with high transaction costs.

Imperfect competition. Under imperfect competition consumers are not well informed or even absolutely misinformed about goods and services to be sold. Goods are heterogeneous, i.e. prices are not determined by choice, the decision to buy or not is influenced by the quality of goods and services. The property rights are incompletely defined which results in acquiring, alienating, transferring and controlling the property. There are monopolistic or oligopolistic firms determining supply and demand on the global market.

Contractual man. This term was introduced by Oliver Williamson to describe the model of a human who corresponds to the reality in a more precise way than an economic man[13]. Typical of the contractual man are limited ability to get, process and serve the information, referred to as bounded rationality and a disposition to act with guile imposed by own interests, referred to as opportunism.[14]

These three guidelines form the research focus of new institutional economics. Figure 2 shows it schematically.

Fig.2-Research focus of the new institutional economics



[13] Williamson O. (1975), Markets and hierarchies .Free Press, New York.

[14] Williamson O. (1987) Transaction Cost Economics. The Comparative Contracting Perspective. Journal of Economic Behavior and Organisation 8, p.618

Source: by author

Conclusion

To conclude the advantage of the new institutional economics is that it takes into consideration the imperfect human nature «as we know it[15]» and attempts to generate the comprehensive paradigm of economic system without simplifying. This paradigm should allow for uncertainty around, which acts destroying our intentions to revive the modern economic system being crushed down by crises and hypercompetition, by currency wars and financial bubbles. Only tough rules and enforcement to fulfil them could structure the economic system and reduce costs preventing the further economic development. These rules are institutions and their role should be estimated properly within a new institutional economics.

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