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NEW INSTITUTIONALISM, ECONOMIC AND SOCIOLOGICAL

Victor Nee

The focus on institutions as a foundation concept in the social sciences has given rise to a variety of new institutionalist approaches. Not since the behavioral revolution of the 1950s has there been so much interest in a cross-disciplinary concept; one that offers a common theme for exchange and debate. The writings of Ronald Coase, Douglass North, and Oliver Williamson on the endogenous emergence and evolution of economic institutions have inspired a broadly based movement in economics. In sociology, neoinstitutionalists—principally John Meyer, Richard Scott, Paul DiMaggio and Walter Powell—have redirected the study of organizations by analyzing how institutional environment and cultural beliefs shape their behavior. In a parallel shift of analytic attention, economic sociologists—Neil Fligstein, Richard Swedberg and I—argue for a new focus to explain how institutions interact with social networks and norms to shape and direct economic action. The common starting point of these approaches is the claim that institutions matter and that understanding institutions and institutional change is a core agenda for the social sciences.

This essay does not seek comprehensiveness in its coverage of the new institutionalisms in the social sciences.¹ Instead I focus selectively on the new institutionalisms in economics and sociology as a means to lay out core features of a New Institutional Economic Sociology, which brings back into the research agenda a crucial

¹ There are recent reviews that provide overviews of the new institutionalisms in economics (Eggertsson 1990; Williamson 1994; Furubotn and Richter 1998), in organizational analysis (DiMaggio and Powell 1991; Ingram and Clay 2000), in rational choice political science (Ordeshook 1990; Weingast 2003), and in historical institutionalism (Thelen and Steinmo 1992; Hall and Taylor 1996; Pierson and Skocpol 2003). Scott (2001) offers a useful conceptual inventory of advances in organizational new institutionalism.

focus on explaining the workings of shared beliefs, norms and institutions in economic life. My aim is to integrate a focus on social relations *and* institutions into a modern sociological approach to the study of economic behavior by highlighting the mechanisms that regulate the manner in which formal elements of institutional structures in combination with informal social organization of networks and norms facilitate, motivate and govern economic action.² Thus both distal and proximate causal mechanisms are addressed and incorporated into a comparative institutional analysis of economic life. This entails revisiting Weber's (1904-05; [1922] 1968) view that rationality is motivated and guided by systems of shared beliefs (religious and cultural), norms and institutions. A conceptual framework underscoring such context-bound rationality serves as the foundation for examining the emergence, persistence and transformation of institutional structures.

New Institutional Economics

In the view of new economic institutionalists, the old institutionalism offered penetrating and insightful descriptions of economic institutions (Veblen [1899] 1934, 1909; Mitchell 1937; Commons 1934, 1957), but ultimately failed in the bid to shape the direction of modern economics. Instead, it remained a dissident movement within economics, which, Coase (1984: 230) quipped, produced a “mass of descriptive material waiting for a theory, or a fire.” With the limitations of the old economic institutionalism in mind, he noted that “what distinguishes the modern institutional economists is not that they speak about institutions...but that they use standard economic theory to analyze the working of these institutions and to discover the part they play in the operations of the

² See Granovetter (1992) for an application of a social constructionist approach to the study of economic institutions. This offers an interpretive account of institutions

economy.” Kenneth Arrow (1987: 734) offers a similar assessment in his answer to his rhetorical question, “Why did the older institutionalist school fail so miserably, though it contained such able analysts as Thorstein Veblen, J.R. Commons, and W. C. Mitchell?” The new institutional economics has been influential, he thinks, not because it offers “new answers to the traditional questions of economics—resource allocation and the degree of utilization,” but because it uses economic theory to answer “new questions, why economic institutions emerged the way they did and not otherwise.”

Without question new economic institutionalists have sought to differentiate themselves from the old institutional economics by adapting, rather than rejecting, as did the earlier institutionalists, neoclassical economic theory. First, Coase’s theory of transaction cost corrected an important omission in neoclassical economics, and shows that Pigou was wrong in arguing that taxation and regulation are the only effective way to deal with negative externalities.³ His use of transaction cost reasoning is not essentially different from Stigler’s adding information costs to correct neoclassical theory. Second, the idea that human agency is “intendedly rational, but limitedly so” (Simons, 1957: xxiv) can be incorporated into a “thick” view of rational choice as context-bound; as Posner (1993: 80) points out, “rationality is not omniscience.”⁴ Third, through concepts like “asset specificity” and “opportunism,” Williamson extended microeconomic reasoning to understudied topics in economics such as vertical integration, corporate governance and long-term contracts to show that transaction cost economizing can generate predictions about the organizational boundaries and governance structures of firms competing for survival and profit in a competitive environment. Fourth, North’s

amenable to historical studies of institutions and institutional change.

³ Coase believes nonetheless that state intervention can be effective, but not always or automatically.

account of institutional change views organizations as rational actors in pursuing marginal gains stemming from changes in relative prices.

The differences between the old and new institutionalisms may have been overstated, however (Rutherford 1994).⁵ The old economic institutionalists were not as lacking in theory as Coase's quip suggests. Veblen's concept of cumulative causation is consistent with modern ideas about explanation and path dependence. Mitchell (1927), who founded the National Bureau of Economic Research (NBER), was not a dust-bowl empiricist, but espoused the idea of research driven by middle-range theory. Both old and new economic institutionalisms argue that the mathematical formalism of neoclassical economics has contributed little to understanding real-world economic behavior. Both espouse a realist orientation, which, as Coase writes, seeks to study economic behavior "within the constraints imposed by real institutions."⁶

⁴ Furubotn and Richter (1998) show, however, that bounded rationality cannot be incorporated into neoclassical economics as such.

⁵ A thoughtful review of the old economic institutionalism by Hodgson (1998) argues that habitual behavior was the starting point of its institutional analysis. The old institutional economist examined patterns and regularities of human behavior—habits—as the basis for the approach to macroeconomic systems. It was not that the old institutionalists failed to generate important findings, but they were displaced by the rise of mathematical economics. See also Yonay (1998) for an examination of the conflict between the old institutionalists and neoclassical economists.

⁶ Stinchcombe (1997) in fact views Coase's "The Nature of the Firm" (1937) as an important contribution to the old economic institutionalism's core research agenda, identifying the institutional elements making possible the competitive structure of capitalism. According to him, Coase's analysis of the nature of firm boundaries complements Commons's work on the noncontractual basis of the contracts that constitute the firm. Williamson (1981:549-550) explicitly acknowledges his own intellectual debt to Commons (1934), who "recognized that there were a variety of governance structures with which to mediate the exchange of goods or services between technologically separable entities. Assessing the capacities of different structures to harmonize relations between parties and recognizing that new structures arose in the service of these harmonizing purposes were central to the study of institutional economics as he conceived it."

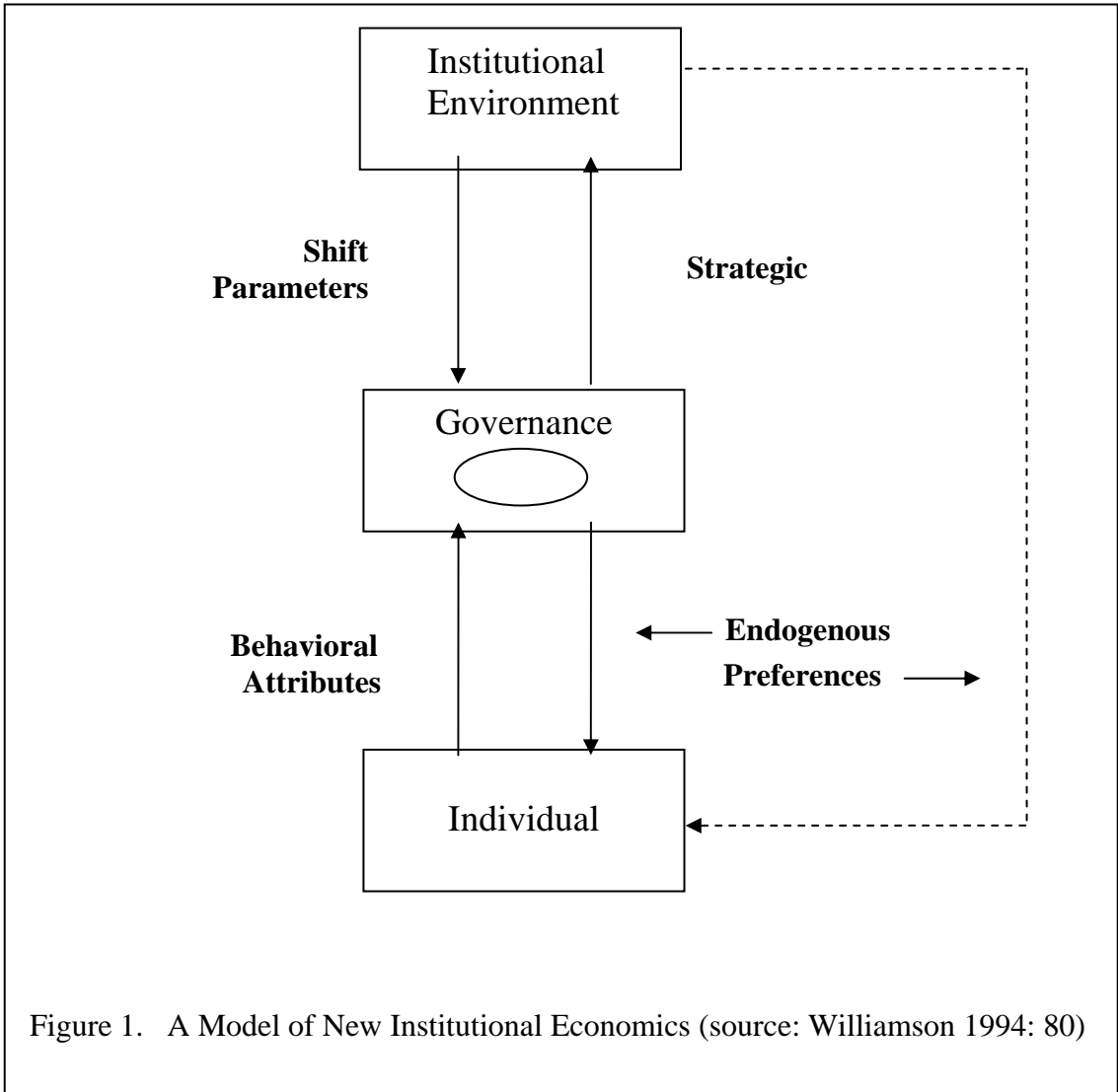


Figure 1. A Model of New Institutional Economics (source: Williamson 1994: 80)

Figure 1 provides a schematic view of the causal model posited by the New Institutional Economics, as adapted by Williamson (1994: 80) from Richard Scott. In this model, the institutional environment is shaped by the rules of the game (see North 1981). The downward arrow indicates that if shifts in the broad parameters of the institutional environment—property rights, legal change, and norms—result in altering the relative prices for firms, this induces changes in governance structures or efforts by the firm to lobby government. The model includes a purposive actor whose behavioral attributes—“self-interest seeking with guile”—lie behind many of the transaction costs governance structures are designed to address.

The place of transaction cost reasoning

The core concept of the New Institutional Economics is transaction cost—the cost of negotiating, securing and completing transactions in a market economy. In Coase’s (1988: 15) view, neoclassical economics “is incapable of handling many of the problems to which it purports to give answers” because it assumes a world of zero transaction cost in which institutions are superfluous to economic analysis:

In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost (Coase 1960: 15). Hence in contrast to the world of zero-transaction costs assumed in neoclassical economics, transaction cost reasoning provides a method enabling economists to “study the world that exists.”

In “The Nature of the Firm” (1937) Coase applied transaction cost reasoning to explain the endogenous existence of the firm in a competitive market economy. If market transactions were costless, Coase argued, there would not be sufficient motivation for entrepreneurs to operate firms. But, in fact all solutions to the problem of measuring the performance of agents and enforcing contracts are costly. Information asymmetry and uncertainty are found in all institutional environments; hence the same agency problems found in markets also apply to the firm. The distinguishing characteristic of the firm is the suspension of the price mechanism. The entrepreneur has the power and authority within the limits set by the employment contract to direct workers from one part of the

firm to another. Thus “firms will emerge to organize what would otherwise be market transactions whenever their costs are less than the costs of carrying out the transactions through the market” ([1937] 1988: 7). In other words, the reason for the firm’s existence is that the “operation of a market costs something” and the firm saves on this cost.

The New Institutional Economics includes a diverse group of economists with important differences and ongoing debates.⁷ I focus here on three distinctive approaches—pioneered by Williamson, North and Greif—that are of interest to a new institutional economic sociology. The unifying theme of all three is the proposition that social institutions matter to economic actors because they shape the structure of incentives.

Williamson builds on Coase’s insight that information asymmetry and uncertainty make credible commitment to agreements difficult to secure, integrating this insight with other literatures.⁸ His synthesis emphasizes that corporate governance is principally concerned with addressing the problem of opportunism and reducing the risk of malfeasance in agents’ performance.⁹ By examining the comparative costs of planning, adapting, and monitoring agents’ performance, Williamson derives testable predictions

⁷ Significant early writings of the new institutional economists influenced by Coase’s classic essays include Alchian (1950), Alchian and Demsetz (1972, 1973), Cheung (1970, 1974), Davis and North (1971), Demsetz (1967, 1968, 1983), North and Thomas (1973), Barzel (1982, 1989), Williamson (1975, 1985), and Ostrom (1990). In a recent review, Williamson (2000) includes six Nobel Laureates among key figures in the new institutional economics: Kenneth Arrow, Friedrich Hayek, Gunnar Myrdal, Herbert Simon, Ronald Coase, and Douglass North. The founding of the International Society for New Institutional Economics by Coase, North and Williamson in 1996 has provided an annual forum for new work, much of it empirical, and has greatly expanded the scope of research addressed by new institutional economists.

⁸ Specifically, the contract law literature and the organization literatures of Barnard (1938) and especially the Carnegie school (Simon 1957; March and Simon 1958, Cyert and March 1963).

⁹ “Problems of contracting are greatly complicated by economic agents who make ‘false or empty, that is, self-disbelieved threats or promises’ (Goffman 1959, p. 105), cut

about alternative governance structures. His prediction turns on three types of asset specificity—site, physical, and human—that firms encounter. Because firms compete in Darwinian-like selection in markets to survive and remain profitable (Hayek 1945), they are under continuous pressure to adapt by economizing on transaction costs. Hence, where asset specificity is greater, principals and agents “will make special efforts to design” a governance structure with “good continuity properties” to reinforce incentives for credible commitments to agreements. By contrast, if “assets are nonspecific, markets enjoy advantages in both production cost and governance cost respects: static scale economies can be more fully exhausted by buying instead of making; markets can also aggregate uncorrelated demands, thereby realizing risk-pooling benefits; and external procurement avoids many of the hazards to which internal procurement is subject” (1981: 558).¹⁰ Williamson’s contribution has been to build a theory-driven research program in which core hypotheses derived from Coase have been empirically verified.

A second research program stimulated by Coase’s seminal essays emphasizes the importance of property rights in shaping the incentive structure (Cheung 1970, 1974; North and Thomas 1973; Alchian and Demsetz 1973; North 1981). Cheung showed that in a neoclassical world of zero-transaction costs, private property rights can be dropped without negating the Coase Theorem, an insight that North extended to develop a new institutionalist property rights approach to explain economic performance. Because transaction costs make up a significant part of the cost of production and exchange, North reasoned that alternative institutional arrangements can make the difference between

corners for undisclosed personal advantage, cover up tracks, and the like” (Williamson 1981:554).

¹⁰ Transaction cost economics concurs with population ecology’s core assumption that competition in a market economy is the driving mechanism of adaptive fitness of organizational forms (Hannan and Freeman 1989) and offers a firm-level answer to their

economic growth, stagnation, or decline. The first of the new institutionalists to explicitly disavow the efficiency assumption of the functionalist theory of institutions (Schotter 1981), North asserts that because incentives are structured in institutional arrangements, perverse incentives abound and give rise to property rights that discourage innovation and private entrepreneurship. It is frequently profitable and more rewarding for political actors to devise institutions that redistribute wealth, which can dampen incentives for innovation and private enterprise.

North's approach is state-centered in that it focuses analytic attention on the role of the state in devising the underlying structure of property rights in society.¹¹ In his view, the central task in explaining economic growth is to specify the events and conditions that provide incentives for political actors to establish formal institutional arrangements supporting efficient property rights.¹² In the rise of the West, this entailed the dilution of state control over resources and the emergence of some form of political pluralism.¹³

question "Why are there so many kinds of organizations?" Its predictions have been confirmed in empirical tests (Joskow 1988; Shelanski 1991; Masten 1993).

¹¹ Because the essence of property rights is the right to exclude, North (1981) reasoned that the state, which has a comparative advantage in violence, plays a key role in specifying and enforcing property rights. North's theory of the state is neoclassical insofar as it assumes that rulers seek to maximize revenue through an exchange of protection and justice for revenue from constituents. Although the ruler has an interest in devising property rights to maximize state revenues, the existence of rivals capable of providing the same services constrains the state. Because the free rider problem limits the ability of constituents to carry out society-wide institutional change, the state, which as a monopolist does not face a free-rider problem, is the source of institutional innovations.

¹² Campbell and Lindberg (1990) analyze how a weak state structure like the U.S. derives enormous power through its control of formal rules governing property rights.

¹³ North and Weingast (1989) argue that in the English case, the key events and conditions stemmed from the eruption of the tension between ruler and constituent that gave rise to institutions limiting the capacity of the state to expropriate resources from producers, and hence the needed incentives to fuel economic growth through innovation and private enterprise.

